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By Richard Cluver February 2019

If you are, dear reader, as perplexed and mournful about the state of the South African economy as most I have spoken with this past week and, judging by their conversations, now seeing our situation as insoluble, then know that you are probably in a majority who are arguing once again that the time has come to leave the country.

So let me start by noting that as someone who has spent a lifetime of global travel asking myself if "I could live in this country or that" and always ending the question with the view that nowhere offered me a better way of life than South Africa, I might justifiably be labeled as the eternal optimist.

However, I have to offer what life has also taught me, that only with hard work and diligence has there always been a rainbow at the end of the journey. Practically everyone I know who today enjoys a comfortable lifestyle, got there by hard work, a sense of conscience about our community which required that one put back something of what life had offered us, and a degree of frugality. Most who entered the race with the proverbial silver spoon in their mouths and little self-discipline have, on the contrary, ended in some penury.

If this seems like a homily for a younger generation that has been used to having it all without much effort on their behalf, then forgive this as an argument from someone of an earlier generation which cut its teeth among parents of the Great Depression who perpetually offered the argument that one should take care of the pennies and the pounds would take care of themselves.

All I can offer to the gainsayers of that argument is that they have not lived long enough to have learned the real truths of life.

But how does this apply to the current crisis when we seem to be sinking into a morass created by the Guptas, Watsons, Zumas and a whole legion of thieves who, rather than apply the above lessons of life, have bled this country dry and as a result of whom, we face an imminent downgrading by the global ratings agencies and a deepening morass of hardship?

Let me start by noting with some relief the passing of the annual Budget speech, with the observation that it could have been far worse for that fast-dwindling minority of "wealthy" South Africans who might again have been targeted. The annual nail-biting afternoon has come and gone and, by now I am sure you are nearly as bored by the subject as I am…and relieved that by and large investors have been left alone.

The fact is that the country is in deep stuck and the Minister of Finance did not have many options when called upon to balance the nation's books. Who can forget, for instance, then Finance Minister Pravin Gordhan raising the dividend tax from ten to fifteen and subsequently to 20 percent which probably on its own did more to accelerate the flight of capital from this country than any other single act!

Hopefully the penny has dropped and it is safe to assume that the current minister Tito Mboweni is well aware of the recent comments from Acting SARS commissioner, Mark Kingon who, speaking at an audit conference in August, noted that overburdened taxpayers were evading the payment of revenue due to government's own irregular expenditure and tariff circumvention.

He advised that Value Added Tax evasion had resulted in at least R1.5 billion still being owed to the national fiscus by roughly 35 000 vendors who have not submitted their VAT (value added tax) returns. Many small businesses, because under the direction of Tom Moyane VAT refunds were being held back, simply could not afford to pay further VAT bills. They would have been bankrupted had they done so.

Kingon added; *"This year, Sars has one of the most crucial risks, with low levels of public trust and credibility which impact on the fiscus. Public trust and behaviour of taxpayers in doing what is right is of a serious concern to us as the revenue service – and specifically regarding people who are simply choosing to not pay their taxes."*

The real consequence is that just 270 000 people out of a population of 65-million will pay 40 percent of all our taxes. While just 6 982 943 will together foot 84.5 percent of the bill. The reality is that investors are taking their money and leaving the country at an unprecedented rate.

Table 4.6 Estimates of individual taxpayers and taxable income, 2018/19

Taxable bracket	Registered individuals		Taxable income		Income tax payable before relief		Income tax relief		Income tax from medical tax credits		Income tax payable after proposals	
R thousand	Number	%	R billion	%	R billion	%	R billion	%	R billion	%	R billion	%
R0 - R70[1]	6 557 245	–	170.2	–	–	–	–	–	–	–	–	–
R70 - R150	2 502 678	33.4	262.0	10.8	11.1	2.2	-0.9	12.5	0.04	5.0	10.2	2.0
R150 - R250	1 790 280	23.9	351.8	14.5	34.3	6.7	-1.3	17.3	0.16	23.1	33.2	6.6
R250 - R350	1 178 901	15.7	349.8	14.4	51.6	10.1	-1.3	18.4	0.15	22.1	50.5	10.0
R350 - R500	934 615	12.5	386.8	15.9	74.2	14.5	-1.6	21.5	0.15	21.9	72.7	14.4
R500 - R750	576 469	7.7	348.4	14.3	85.6	16.7	-1.2	16.1	0.10	14.3	84.5	16.7
R750 - R1 000	233 652	3.1	200.7	8.3	58.4	11.4	-0.5	6.5	0.04	6.1	58.0	11.5
R1 000 - R1 500	161 014	2.2	192.3	7.9	62.4	12.2	-0.3	4.5	0.03	4.4	62.1	12.3
R1 500 +	109 783	1.5	339.4	14.0	134.8	26.3	-0.2	3.1	0.02	3.2	134.6	26.6
Total	**7 487 392**	**100.0**	**2 431**	**100.0**	**512.5**	**100.0**	**-7.3**	**100.0**	**0.70**	**100.0**	**505.8**	**100.0**
Grand total	**14 044 637**		**2 601**		**512.5**		**-7.3**		**0.70**		**505.8**	

1. Registered individuals with taxable income below the income-tax threshold
Source: National Treasury

The elephant in the room, of course, has all along been Eskom, looted to within an inch of South Africa's economic life while nine "No Confidence" attempts to dislodge former president Zuma were hailed by ANC members of Parliament as political triumphs and innumerable successive Eskom turnaround strategies proved each in turn to be abject failures; inevitably because the principal objective was successive bailouts that fed the looting.

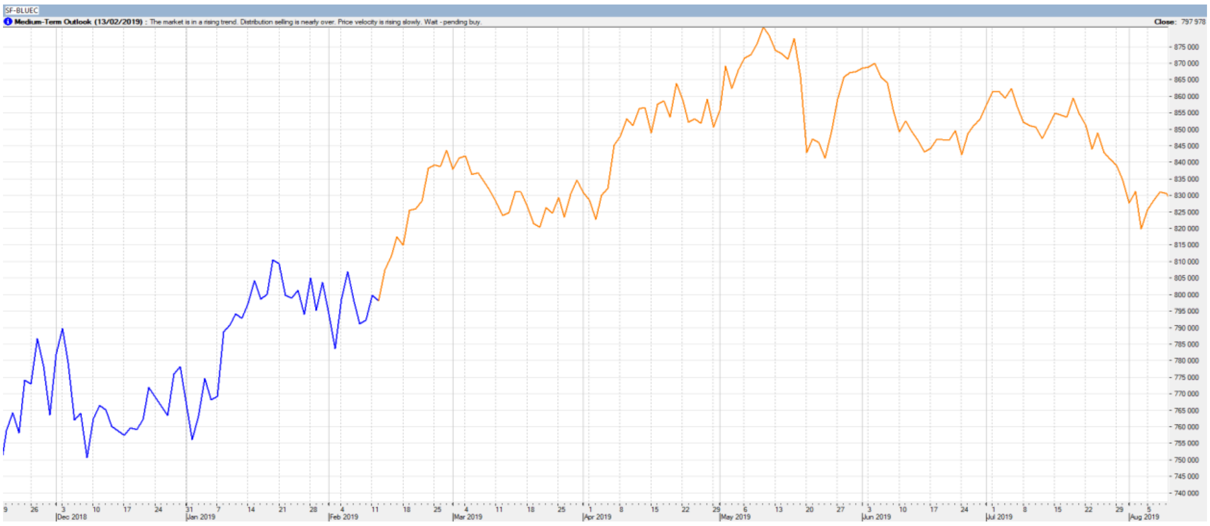
And despite Mboweni's claim that ""The national government is not taking on Eskom's debt," the fact is that he actually committed to continue doing so at R23-billion a year which the National Treasury has subsequently confirmed could amortise to R230-billion over the next decade.

Small wonder then that the ratings agencies were meeting with Treasury the following day to decide whether to plunge South Africa into “Junk” status which would result in catastrophic capital outflows and a massive destruction of local wealth.

Fatalistically, the average South African investor who with diligence and intelligence has spent a lifetime putting together a comfortable retirement nest egg will now be acknowledging that, short of taking a massive capital gains taxation hit upon his savings and emigrating to another less-politically destructive location, has little power over a future in which not a single “State Capture” thief has even been charged and nothing has been done about freezing stolen state assets.

In a democracy the numbers simply never stack up in favour of the investor class. Here, if every single tax-payer voted against the government in their next election, seventeen million dole recipients who daily thank the ANC for their monetary welfare would out-vote them three to one.

Which brings me to an interesting graph. ShareFinder’s projections of future Johannesburg Stock Exchange share prices have proved accurate 94 times out of a hundred over the past 16 years and for several months now that system has projected that on May 10, the day when the general election results will be known, the market will enter into a three-month bear phase. This is the graph with the future depicted in red:



While it is extremely unlikely that the ANC will fail to win the election, what post-election event could so unsettle the market? Given that the Ramaphosa administration is currently acknowledged as South Africa’s best hope, might it be that ShareFinder is telling us that he could be unseated by the Zuma faction….signaling the likely final and absolute looting of what remains of the economy?

ShareFinder has been wrong in the past in its bear market predictions and so I hope that on this occasion it is also wrong or that I am putting a wrong interpretation on the graph!

On a more practical level, however, there are some really good things to celebrate starting with the new sharp teeth given to our state prosecutors and the rising public demand that the crooks should be charged before we get to the elections. The Zondo Commission into State Capture now has that forensic evidence and the legal eagles tell us the prosecutors have a water tight case. Prompt action might thus be expected and if there is none then we will know the Ramaphosa administration is not sincere in its promises.

Most of us will remember that when Pravin Gordhan initially took over as Minister of Finance he very quickly turned around a then dysfunctional SARS by, on Friday nights, arresting some of the best-known tax offenders. After weekends in jail, most emerged with scary enough stories to guarantee that everyone else quickly fell into line.

That’s why the Eskom crooks need to go to jail quickly….to get the message to the rest who are still plundering State coffers. South Africa currently appears to be an over-borrowed nation but if we get rid of corruption it has been estimated that between 10 and 20 percent of tax revenue might be saved. That is between R140-billion and R280-billion currently being stolen each year.

If we can claw that money back we could clear our debts in just a few years and start to turn ourselves into a winning nation. There is lots more to do, but that would be a major start.

Budget in a nutshell

By Annabel Bishop, Investec chief economist

- The 2019 tabling of the Budget continues to show a tough fiscal environment. Revenue projections for 2018/19 and 2019/20 to 2021/22 are projected lower than in the 2018 MTBPS, and expenditure higher only in 2019/20.
- The fiscal deficit widens to 4.5% of GDP for 2019/20, from 4.2% of GDP previously.
- The projected fiscal deficit is seen to fall to 4.0% of GDP by 2021/22, coupled with gross debt projections stabilising at 60.2% of GDP and then falling to 59.3% by 2026/27.
- Eskom is to receive a R69bn allocation over three years. The additional monies allocated to Eskom will service Eskom’s debt, and allow it to meet redemption requirements, as well as funding urgent operational improvements.
- Moody’s said “(f)or the sovereign, financial support to Eskom accompanied by measures that durably stabilise its financial health would be credit neutral.”
- We highlight the risk of a downgrade this year to Moody’s outlook on SA’s dual long-term debt (local and foreign currency) credit rating from stable to negative but the Budget may do enough to avoid this.
- A negative outlook can indicate a rating downgrade within 18 months. South Africa’s debt servicing costs will rise as a consequence of the rise in debt projections, to R247bn by 2021/22 (4% GDP), the fastest growing item in the budget.
- The wage bill shows some containment as about half the reduction in projected expenditure is due to cuts in “compensation budgets, reflecting faster-than-expected declines in headcounts, as well as the anticipated effects of other interventions, including early retirement without penalties.”

- Direct taxes have not been increased (other than bracket creep which is expected to raise R12.8bn), vastly improved efficiency is planned at SARS in the face of falling levels of tax assessments.
- A broadening of the tax base is urgently needed, while policy uncertainty needs to be reduced, corruption and weak to failing governance eradicated and business confidence supported.
- Government reliance on private public partnership is set to increase, as has been announced by the President previously, while infrastructure investment in government and SOEs is likely to see tighter financial controls.

Nothing is being done to get back stolen billions

By Paul Hoffman SC

According to a press report, on 19 February 2019 President Cyril Ramaphosa again vowed his government would recover money stolen through State Capture and bring those involved to book when he addressed the National House of Traditional Leaders in Parliament.

He also touched on a need to strengthen Chapter 9 institutions and said this was necessary in the fight against corruption and to ensure checks and balances in a democracy. While both of these statements are welcome, they both require interrogation.
Many experts in the field of debt recovery are by now cynical about the prospects of recovering the loot stolen through State Capture. Too much time has elapsed since the misappropriations took place, too little energy is being devoted to civil debt recovery proceedings both in and outside the country, too few freezing orders have been sought and obtained and no loot has yet been declared forfeit to the state.

Some of the looters have already fled the country, probably tipped off by corrupt elements in the criminal justice administration, and others are proving hard to find, whether inside the country or elsewhere.

No attention is given to the civil remedies available worldwide to facilitate recovery of the loot. Instead, the Hawks, who only investigate priority crimes, and the SIU, severely capacity constrained, have been tasked with recovering the loot. No civil proceedings are pending, no attempts have yet been made to civilly freeze assets squirrelled away by the looters, no following the money with the help of international agencies specialising in the field has taken place and no political will at the coal face is in evidence yet.

As long ago as 12 October 2018, *Accountability Now* wrote to the Minister of Finance, Tito Mboweni, in the following terms:

"*One of the aspects of State Capture which needs urgent prioritisation by your ministry is the recovery of public funds and assets misappropriated and taken off-shore by the perpetrators of State Capture. There appears to have been a lack of political will, or perhaps the necessary expertise, to effect recovery of public wealth squirrelled away by miscreants. If necessary, engage outside expertise, readily available in SA, to follow the money and recover it wherever it may be found. Huge recoveries can and should be affected to swell general revenue. The SWIFT banking system and the Reserve Bank's IT make it possible to track funds if the political will to do so can be mustered. The longer this task is left unattended, the harder it will be to track down and recover funds."*

Not only has the letter gone unanswered, nothing has been done to take the simple steps suggested. Efforts to interest the SIU in civil debt recovery processes have been made, all to no avail.

It is possible that a lack of the specialised skills required in officialdom is to blame for this serious omission. There is no good reason for not seeking outside help, which is readily available. It is the bread and butter business of the US Homeland Security agency and the Serious Frauds Office at Scotland Yard to deal with recovery of proceeds of crimes like State Capture. They stand ready to help, in accordance with the interventions by the US, UK, German, French and Swiss ambassadors to SA.

It is possible that the lack of political will to take the civil action needed to freeze funds is based on fear of reprisals from the looters, many of whom still haunt the corridors of power. Then there is the issue of treating the R40 million donated to the ANC by Bosasa as an illegal transaction, reversible at the instance of the liquidators of Bosasa in the interests of its creditors, who are mainly the long-suffering taxpayers of SA. At present the ANC is unable to pay to keep its website going, its ability to repay the sum of R40 million in an election year is therefore also questionable.

The Minister of Public Enterprises, when approached in relation to recovering the loot stolen from Eskom, Transnet and other SOEs demurred with a "we have processes we must first follow" type of dilatory response.

If the processes involve tenders from debt collectors, call for them; if they involve commissions of inquiry, don't wait for their reports; if they involve the ability to *vasbyt*, then *nyamezela*! Without the necessary political will and leadership required, nothing will be done to recover the loot. The suspicion that the ANC has become a criminal enterprise will be reinforced and its ability to govern will be completely undermined.

The words of the President will be revealed as more ‘smoke and mirrors’ talk with no concomitant action, an action which is already overdue and is certainly required now. There is no rocket science involved in recovering the loot: let the international debt collectors loose and take advantage of the lower standard of proof required in civil proceedings for debt recovery. Freeze accounts wherever they are found and do so swiftly, secretly and ruthlessly without fear or favour.

The presidentially proposed strengthening of Chapter 9 Institutions, in order to secure checks and balances on the exercise of political power, is most welcome. These institutions are all constitutionally required to act without fear, favour or prejudice. With their independence secured in this and other ways, they could become a source of reinforcement of the integrity needed to govern in the manner contemplated by the Constitution: openly, accountable and responsively.

There is more than a need for the proper resourcing of the Chapter 9 Institutions. Their independence needs to be audited. Patronage appointees, deployed cadres of the National Democratic Revolution and slackers should be ruthlessly eliminated from all these institutions. Loyalty to the revolution conflicts with the constitutional independence required.
A new Chapter 9 Institution, the Integrity Commission, tasked with the prevention, combating, investigation and prosecution of grand corruption, State Capture and kleptocracy, is the first and best way to strengthen the hand of Chapter 9 Institutions and to bring the looters to book in our criminal courts. There is already in existence draft legislation that can be processed for the purpose of creating an anti-corruption body of this kind. This will ensure proper compliance with the rulings of the courts in litigation aimed at securing effective and efficient anti-corruption machinery of state that is adequately independent. The president, and anyone else interested in beefing up Chapter 9 Institutions may visit the Glenister case page on www.accountabilitynow.org.za for more information and the draft legislation on the topic.

The report prepared by the late Professor Kader Asmal, with the assistance of Professor Pierre de Vos, should be dusted down and reconsidered in order to rationalise the various Chapter 9 Institutions. Better use of scarce public resources is appropriate in these times of fiscal belt-tightening.

The most heartening aspect of what fell from the lips of the President in Parliament is his acknowledgement of the need for checks and balances on the exercise of political power. This puts him firmly in the constitutionalist camp in the ANC and sets him against those who still misguidedly seek “hegemonic control of all the levers of power in society” in accordance with the revolutionary tenets that really have no place in a constitutional democracy under the rule of law, one in which the separation of powers holds pride of place. A free media, an impartial judiciary and the full enjoyment of the rights and freedoms guaranteed to all in the Bill of Rights are also hallmarks of the intended new order in SA. It is an order in which there is no room for revolutionary claptrap of the “hegemonic” kind that does not countenance checks and balances on the exercise of political power.

The first test of the presidential resolve to strengthen Chapter 9 Institutions will arise in the Justice Portfolio Committee of the National Assembly later this month. The committee has the fitness for office and competence of the Public Protector coming up for debate. If the ANC continues its long filibuster on this issue, know well that the president was not being sincere; if the merits of the matter are tackled, take heart – the Constitution will be upheld in a manner consistent with the oath of office of those in the debate and those who lead them politically.

Quite apart from her competence, which is under attack by the Democratic Alliance, the committee has before it a complaint about the lack of integrity of the Public Protector, whose *prima facie* mendacity remains unexplained by her and unaccounted for by the committee which received the complaint more than two years ago and has yet to respond to it. The complaint is accessible online here.
The first test of the credibility of the professed presidential resolve to strengthen Chapter 9 Institutions will come rather sooner than he may have anticipated. Here's hoping he passes it will flying colours.
Paul Hoffman SC is a director of Accountability Now.

Is our case terminal?

By Magnus Heystek*

At least the citizens of ancient Rome only had to endure listening to emperor Nero's fiddle for about 7 days while their city was burning. South Africans on the other hand have had to endure the sacking of a country, economically speaking, for almost ten years while former president Jacob Zuma graced our political stage, not playing a delicate instrument, but prancing around calling for someone to bring his machine gun.

And after all the destruction, the carnage and pillaging he has the audacity to be quoted on Timeslive as follows:

"I remain proud of much of what we and the country achieved over the past decade. Could we have done more? Yes. Could it have been better? Yes. Was it a wasted decade? No."

Against almost ALL financial metrics the country under Zuma's ANC experienced a dramatic decline. The damage, in some instances, is irreversible. In most others, it will take a stupendous effort by government and private sector to reverse the damage to the vital organs of SA Inc.

As long-standing ***Sunday Times*** columnist and former colleague Barney Mthombothi wrote recently: "He wreaked so much havoc during his nine-year reign it doesn't bear thinking about".

Were that so easy, and while certain formal sector economist employed by the large banks and asset management companies have done their level best to avoid thinking and speaking out about this, is an objective contemplation necessary to truly comprehend the extent of the damage done by Hurricane Jacob, the one-man wrecking ball.

Take your pick of vital signs: economic growth, foreign investment, unemployment, the currency, property values, government debt, budget deficit, performance of the JSE, retirement fund returns – they all show symptoms of a slow-moving financial tsunami gathering speed and spreading to all corners of our beautiful country.
Over the course of the past four years or so I have often dared to venture outside of the warm-fuzzy circle of sunshine financial journalism. You know the kind – the ***alles sal regkom*** – school.

For my sins I have been labelled as "negative", "cynical", ill-informed and the best of all a "financial pornographer" by a colleague in the investment world. My columns on other websites started to appear with a health warning: "The views in this article does not represent the views of XYZ…".

The small grouping of economists and financial commentators who have, from time to time, raised warnings about our economic decline, are either self-employed or working for small asset management companies who don't do much business with government. I would include Mike Schussler, Dawie Roodt, Russell Lamberti and agricultural economist Fanie Brink in this grouping.

You will not find any worthwhile commentary from the financial behemoths: the Old Mutuals, the Sanlams, the Allan Grays and more. Criticisms of the ruling party is considered off-limits, possibly career-ending.

The Futuregrowth-saga

We saw some years ago how potentially career-ending criticism of the ANC's economic policies could be when Andrew Canter from Futuregrowth, owned by Old Mutual, announced that he was no longer willing to invest in six state-owned enterprises, including Eskom as a result of concerns about governance.

I personally interviewed him on SAFM that evening and he was forthright, direct and very clear in his determination not to invest any more money into these SOE's. It's not our money, but that of our investors, he said very clearly. Good for him, I quietly thought to myself. Here at last we had someone from corporate SA standing his ground.

Well, that didn't last very long. Two days later he retracted his comments and apologised to all and sundry for his misguided comments. I heard him on another radio station and I could not believe I was listening to the same person: he was meek and apologetic and stuttered his way through that interview. I seem to recall some full-page ads placed by Futurgrowth grovelling before the government, begging its forgiveness.

This is how Business Tech reported on this dramatic reversal: "Futuregrowth Asset Management has conceded that its public announcement to halt funding of state owned companies in SA attracted unanticipated attention, and led to a range of unfortunate and possibly damaging misinterpretations.

South Africa's largest private fixed-income money manager announced at the end of last month that it had stopped lending money to six state companies because of governance and transparency concerns.

The company's decision was met with outcry from the state companies involved.

The funding suspension applies to Eskom, rail and ports operator Transnet, South African National Roads Agency, the Land Bank of South Africa, the Industrial Development Corporation of South Africa and the Development Bank of Southern Africa.

Futuregrowth CIO, Andrew Canter, said in a note that the firm came to an investment decision that, as fiduciaries for investors' savings, "we could not provide additional finance to some of the largest SOEs without having deeper sight of, and comfort around, their governance, decision-making and independence".

He said that Futuregrowth further decided, with internal unanimity and no external discussions, that it should make its views public.

"Notwithstanding a range of good reasons for a speedy dissemination of our view, in light of the fallout we must frankly concede that a more measured approach of direct consultation with each SOE, before contemplating public comment, would have been a fairer process."

"I would like to personally apologise to each of the SOEs concerned, and their respective government Ministers, for my failure to ensure a fair, one-on-one engagement," Canter said.

Let me remind you who is chairman of Old Mutual, parent company of Futuregrowth: none other than former ANC finance minister Trevor Manuel.

Since then the state of affairs at our SOE's, especially Eskom, has deteriorated significantly. I wonder how much of your and my money remains invested in Eskom via Futuregrowth, or any other fixed-income fund manager in SA? Need I remind you, dear reader, that Eskom currently has debts in excess of R400-bn.

Key variables

Let's have a look at some of the key economic variables over the period of time when Zuma's ANC was in power.

- SA's average growth rate since 2009 has barely exceeded 1.5% per annum to end 2017.
- The unemployment rate increased from 22.5% for 2008 to 27.5% for 2017.
- Total Public Debt as a percentage of nominal GDP ballooned from a low point of 26.5% in 2008 to exactly double that (53%) towards the end of 2017. SA's total debt is now close to R3trn, depending on the rand/dollar exchange rate. If the contingent liabilities of the State are included, the number rises to about 60%.
- Revenue collections are under considerable pressure. In December 2018 company income taxes were 6.6% lower than a year ago. Expect a grim 2019 Budget with an estimated budget deficit closer to 4.5% than 4%.
- Electricity prices ballooned 350% from 2008 to 2017.

- Per capita GDP declined from $8,066 per annum in 2011 to $6,268 per annum in 2017.
- Net SA FDI (Foreign Direct Investment) as percentage of GDP in 2010 = +22.7%. In 2017 it was a minus 29%.
- Government wages as % of GDP in 2007 = 10.5%. In 2018 it was 13.9%.
- Personal income taxes (as percentage of GDP): 2007 = 7.35%. In 2018 it was 9.81%.
- SA was the only OECD country in a recession during 2018.
- The SA economy is currently in its lowest growth trajectory since 1945.
- S&P Global Ratings and Fitch has reduced SA's credit rating to below investment grade. Junk status, in other words.
- Residential property market has been in a 10 year bear market. Prices have declined by 22% in real terms over this time. In the 3rd quarter of 2018 new mortgage applications dropped by 16%…and not a single word about this reported in our mainstream media.
- Average retirement funds have now not beaten inflation over 1, 3 and 5 years – soon 7 years.
- Annual average returns on the Johannesburg Stock Exchange have been last or second to last when compared to the S&P 500, MSCI World Index, MSCI Japan and MSCI Europe. Against is peer group – the MSCI Emerging Market – it has been lagging by almost 2% per annum since December 2015. Remember what happened in December 2015? The overnight sacking of Nhlanhla Nene as finance minister by Zuma. On cue capital starting flowing out of the local market.
- Since then more than R400bn has left our equity and bond markets.

So contemplate we must, because most South Africans have been engulfed by the financial tsunami unleashed by the Zuma years. Poverty is increasingly visible on every street-corner, in declining car and retail sales, in empty rugby and soccer stadiums, in dwindling golf and bowling memberships. The list is almost endless.

Magnus Heystek is a director of Brenthurst Wealth.

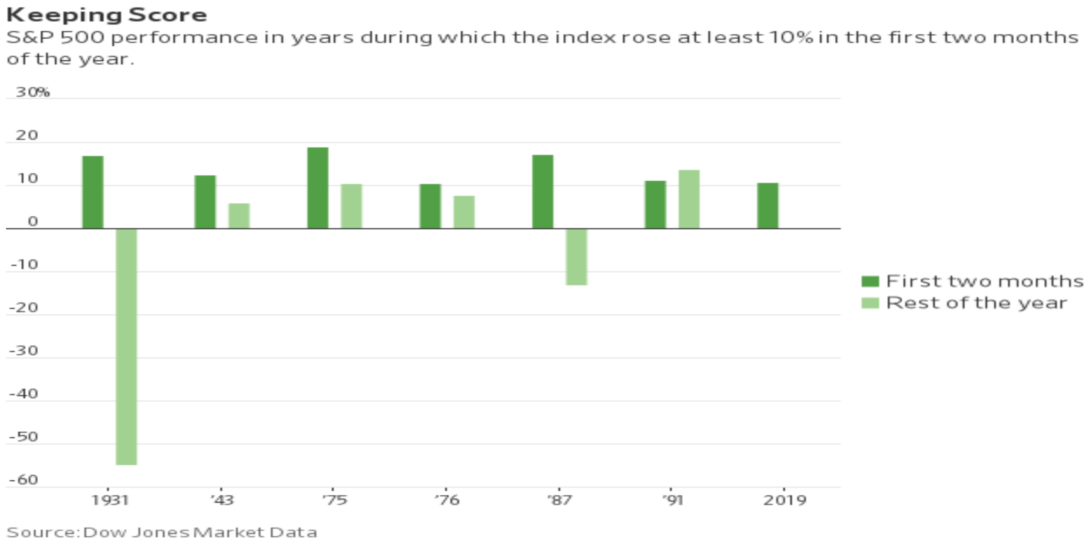
This Year's Stock Rally Has the Benefit of Breadth

By Jesica Menton of the Wall Street Journal

The S&P 500's industrial, energy and tech groups have led the way in 2019.

U.S. stocks are sitting pretty, if history is any guide.

The S&P 500, which has surged 11% to start 2019, is on pace for its biggest early-year advance in nearly three decades and is sitting 5.3% below September's all-time high. That potentially bodes well for the rest of the year: The index moves in the same direction in the first two months and the remainder of the year 64% of the time, according to Dow Jones Market Data.



A more flexible approach to monetary policy from the Federal Reserve, easing U.S.-China trade tensions and a better-than-feared corporate earnings season are among the factors driving this year's rally, following the fourth quarter's bruising selloff.

In 1991, the last time the S&P 500 climbed more than 10% in January and February, it rose an additional 14% over the following 10 months, according to DJMD. And in the other five years when the index added at least 10% to start the year, it rose at least 6% from March through December three times. The two cautionary tales: 1931, in the midst of the Great Depression, and 1987, best known for Black Monday. In both cases, the S&P 500 rallied sharply at the beginning of the year before suffering a major crash.

Among the risks that have given some investors pause this year are a projected slump in corporate earnings, slowing economic activity in China and Europe and the looming March 1 deadline for a trade agreement between Washington and Beijing.

Other investors, though, point to signs of breadth in the recent rally as an encouraging sign. The S&P 500's industrials sector has led the way in 2019 with a 17% gain, followed by the energy and technology groups, which have risen 14% and 12%, respectively.

Another bullish sign for stocks: the NYSE advance-decline line, a popular indicator of market breadth that tracks the number of stocks rising minus the number falling each day, has hit new highs. Meanwhile, 90% of S&P 500 stocks on Thursday were trading above their 50-day moving average.

The popular FAANG stocks—Facebook, Amazon.com, Apple, Netflix and Google parent Alphabet—are rising again after last year's tumble, but only two, Netflix and Facebook, are outperforming the S&P 500. That may not be a bad thing: Some analysts are encouraged to see broader participation in the market rebound across other sectors.

Modern Monetary Madness

By John Mauldin

Modern Monetary Theory espouses that the public through the government owns the process of money creation, and that in addition to borrowing and

taxing, should simply issue currency as payment for its obligations. This is not the sleight-of-hand that quantitative easing was. This is direct monetization in lieu of borrowing.

If that sounds like printing money, that's because it is. Upfront and in-your-face as a serious economic proposal. Most of the time when I am talking with my fellow writers and economists, when somebody mentions MMT, everybody smiles, maybe chuckles, and shakes their heads. The problem is, what seems like a joke is actually getting traction.

Let's get the official definition of MMT from Wikipedia. My comments inserted are in brackets.

In MMT, "vertical" money (money created by the government and spent in the private sector) enters circulation through government spending. Taxation and its legal tender enable power to discharge debt and establish the fiat money as currency, giving it value by creating demand for it in the form of a private tax obligation that must be met. [And thus higher taxes create more demand for the currency and help to maintain the value thereof.]

In addition, fines, fees and licenses create demand for the currency. An ongoing tax obligation, in concert with private confidence and acceptance of the currency, maintains its value. Because the government can issue its own currency at will, MMT maintains that the level of taxation relative to government spending (the government's deficit spending or budget surplus) is in reality a policy tool that regulates inflation and unemployment, and not a means of funding the government's activities by itself. [The more you want the government to spend, the higher the taxes have to be in order to keep from creating inflation, or so the theory goes.]

Proponents argue that unemployment is caused by lack of demand and lack of demand is caused by insufficient money entering the private sector, a problem the government can solve by creating money and spending it in the private sector. Voilà, demand is created and unemployment goes down. Inflation? That can be controlled by higher taxes. Hey, it's their theory. Don't ask me to explain it.

Economists advising major presidential and congressional candidates on the progressive and even "moderate" left are more and more openly talking about MMT and its practical applications.

Pet Economists

I have said before that economists are the modern-day equivalent of shamans and priests. Rather than looking at sheep entrails, economists look at "data" and tell the politician (king, emperor, or chief…) what they want to hear. I have been in more than one meeting where a politician is clearly shopping for a rationale for something that they would like to propose and do. Any serious politician is going to have more than a few economic advisors attached in one form or another to their campaign.

Let me quickly state that I am not disparaging the role of economists when they act as political advisors. I have done that myself. It is actually one of the rationales for the discipline. Indeed, it would be strange if that were ***not*** the case.

Can This Really Be a Thing?

90% of readers may wonder why we are even talking about this in a serious letter. The rest of you may tell me how I'm wrong and it really will work. Let me hasten to say that 10 years ago it was much less than 1%. And it is beginning to come from readers that I recognize to be fairly serious.

There are multiple and growing motivations and rationales for adopting MMT into your own philosophical base.

Why should this be on your radar? Let me give you just a few scenarios…

Politicians are increasingly talking about “free stuff.” Free college, guaranteed basic income, more total healthcare paid for by the public, basic housing, and more. It is almost like there will be an auction to see who can promise the most free benefits, paid for by taxes on the rich. They will cite economic advisors who say it is completely doable and even necessary for the general welfare.

“The richest country in the history of rich countries can easily afford to spend more on its citizens ensuring basic income and wealth equality.” More or less a direct quote from several interviews. Forget mere income taxes. The new political ante will be a wealth tax.

That means these ideas will be increasingly promoted in the public space. More politicians will argue for increased spending and/or at least different spending priorities. Guns and butter.

Over the next few years this will enter the national mindset. An increasingly large group of voters, especially younger voters, will feel a natural affinity with the idealism. Why shouldn’t a rich nation help those who are less advantaged?

Then somewhere, while we are having this conversation, there will be a recession. Unemployment will rise and deficits increase until we are on our way to a $30-trillion debt in just a few years. This will crowd out private investment, slowing whatever recovery there might be and making us vulnerable to a quick second recession, not unlike the recessions of 1980 and 1982.

But it will also produce the potential for a true “change” election. The frustration noted among Trump voters will still be there, but it will also be shared by many on the left who will see the promises as a way to change things. It is hard to argue in the middle of financial crisis and recession that we don’t need change.

There won’t be a President Warren Harding who essentially decided to do nothing in one of the deepest recessions/depressions in American history in the early 1920s. In that case, severe austerity allowed markets to clear but the recovery gave us the Roaring 1920s. Cause and effect? Numerous scholarly books have been written to suggest that.

But that will not be the case 100 years later as we face the 2020s. There will be an increasing drumbeat for “doing something.” Change will be the mantra.

It is not far-fetched to imagine a White House and Congress beginning to work around the principles of MMT, if not adopt it outright with sharply higher taxes and spending.

Now here's where it gets a little bit murkier. The Federal Reserve, even if a new president could pack the board with members philosophically attuned to a new president's desire to increase public spending through monetary creation, does not have the legal authority to directly create money. That is a right reserved strictly for the federal government and specifically the US Treasury. The Treasury can issue all the debt into the private sector it wants. The Federal Reserve can then go into the private market and buy all the debt it wants, adding that debt to its balance sheet. This is called quantitative easing. It is technically not the same thing.

Congress has tried to create agencies which would use the Federal Reserve to directly create money. These agencies and methods have all been ruled overwhelmingly unconstitutional by the Supreme Court. For the Federal Reserve to create money as MMT advocates want, you would have to amend the Federal Reserve Act. Certainly a possibility, but not easy.

Sound Bite Economics

Proponents of MMT point to how successful Japan has been in implementing what essentially looks to be the same policy. They have moved 140% of their GDP under the balance sheet of the Bank of Japan—essentially buying every bond available in the private markets. Their balance sheet is growing because they are buying stocks and carrying Japan's entire annual deficit, which is large.

Why can't we do the same? Japan and the US are both modern countries and economies. Europe, though not to the extent of Japan, also engaged in a large amount of quantitative easing. If it didn't cause problems the last time, why not try it again on a larger scale? Especially if there is a crisis?

The explanation for Japan not having inflation or hyperinflation doesn't fit into a sound bite and MMT proponents can answer it with dismissive sound bites that will be readily consumed and believed by a public wanting change, coupled with automation increasingly taking jobs and depressing wages. It will be a firestorm of political backlash and calls for change.

Do Deficits Matter?

The only way to really tackle the increasing deficits is to:

1. Reduce Medicare and Medicaid benefits, means-test Social Security and at the same time raise the age of eligibility. But few politicians will run on a platform of cutting Medicare and Social Security, because no matter how they propose it, that will be what it means.

2. Raise Medicare and Social Security taxes, or simply increase taxes on everyone or at least "the rich." A lot. The definition of "the rich" would have to be lower than you might think. Most of my readers will be seen as the rich. Whether you ***feel*** rich is beside the point. That will still not balance the budget but there's a high probability that it will send us into yet another recession, bringing calls for more direct spending and some form of money creation as the answer. That's what MMT says we should do.

Any politician who proposes to limit entitlement spending to balance the budget will be accused of forcing austerity on those least able to afford it. That is not a winning platform. There will be no Clinton/Gingrich compromise. Austerity has no fun and simple sound bites. It requires a certain amount of pain, which is generally not politically popular.

Oh, a segment of the population will embrace such, but we must remember that elections are won on the margin. President Trump won by razor-thin margins in a few Midwest states. A change election in the middle of a recession or its aftermath could not only see those margins evaporate, but bring a wave of progressive and socialist politicians to join AOC and her friends.

Think 1932. The country was in true turmoil and there was a huge shift to the left. FDR didn't get every policy he wanted, but he got a lot of them. It was truly transformational and has impacted the US for the last 100 years.

What would this look like? How do we get there? We are going to have several sessions at the Strategic Investment Conference to specifically address these issues. Is all this going to happen next year? No, but something along the above line is my base case for the 1920s. That means you need to begin structuring your life and your portfolios to avoid being in a tunnel with an oncoming train.

These are not simple changes, like simple buy and sell instructions, but will require much deeper structural change in not just your portfolios but perhaps your lives. It is something you want to think very seriously about while you have the luxury of time and not wait to the last minute. Waiting too long may mean you won't be as prepared as you will wish.

Think about how you would deal with taxes 20 or 30% higher (or more!) than today's, and potentially more. How would that change your lifestyle? What can you do today to deal with whatever may come? It may mean adjusting your lifestyle, saving more and getting out of debt, which takes time. For most families these are not quick decisions. But I think they will become necessary ones, especially if the first wave of a change election happens in 2020. Bluntly, Shane and I have already begun our own changes.

If somehow there is eventually a change back to austerity? Or a crisis forces it? That will mean even more change you need to be prepared for. And unfortunately, it's not clear what will happen. We will have to get much closer to the actual events and elections to get a feel for the way actual events may develop.

Dramatic Weakening

By John Mauldin

Recession antennae everywhere popped up on February 14 when the Commerce Department reported retail sales fell 1.2% in December. It was the worst month-over-month decline since 2009.

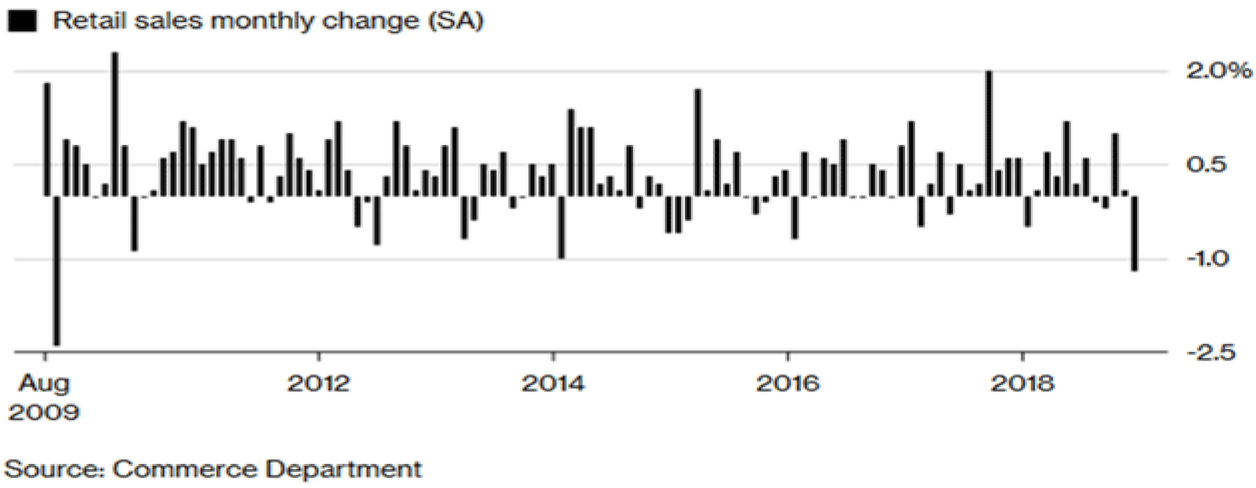
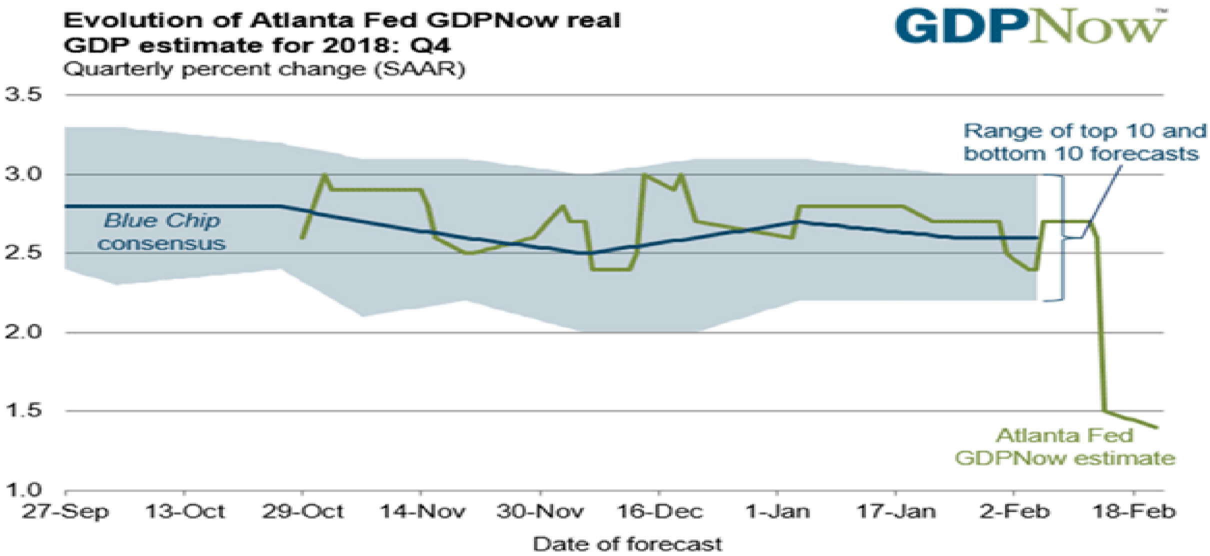


Chart: [Bloomberg]()

Now, there are reasons to doubt this report's significance. It came out four weeks later than scheduled due to the government shutdown, and thus is more subject to revision than normal. It also conflicts with private-sector data like Redbook, which climbed sharply in December. And even if the data is right, this is only one month and one month doesn't make a trend.



Nevertheless, retails sales are an important input to recession models like the Atlanta Fed's GDPNow. That model's estimate for Q4 2018 instantly plunged from 2.7% just two weeks earlier to 1.5%. Ugh.

That will be a dramatic weakening if the final Q4 GDP report confirms it, but I doubt it will. I think this report is a glitch and will fade away as other data supersedes it. But even if it's right, 1.5% GDP growth isn't a recession. It would mean 2018 was an okay though not spectacular year, and a recession call by definition is at least six months away (since it takes two negative GDP quarters to mark one).

This illustrates an important point: The recession outlook is a moving target. It changes as we get new data. Forecasts should change with it, and I don't blame anyone who lets new information change their mind. It might make me trust them even more.

Missing Inversion

I trust Dave Rosenberg of Gluskin Sheff—enough to make him a perpetual SIC speaker and he has been my "leadoff hitter" on the first morning for at least 10 years—but at the moment we disagree.

Dave is screaming recession every chance he gets, which for him is every business day in his ***Breakfast with Dave*** letters. But he is not a perma-bear by any means. He's been bullish at the right times in the past, so I pay attention even if I'm not convinced. I should note he turned uber-bullish nine or 10 years ago, announcing his new forecast at my conference. It was way outside the consensus at the time, but Dave has never cared much about being part of the consensus.

Dave summarized his argument in a letter last month members can weeks before the retail sales report knocked the legs out of more bullish outlooks. If that data holds up, he's going to look more prescient than most.

His key points make a great launching pad for discussion about the probabilities of recession. This letter will be more like a back-and-forth between Rosie and I when we are together. I hope you enjoy our conversation. My comments are in brackets. His points are in italics.

His key points:

- ***We are now in month #115 of the current expansion, double the post-WW2 norm and five months from becoming the longest ever.***

[I guess I just shrug my shoulders and ask, "so what?" We have maybe a dozen data points of recoveries after recession. Maybe when we have 100 we can start talking about statistical probability. There is no statistical reason this recovery couldn't last a lot longer. Ask Australia. Maybe 10 cycles from now we'll have another lengthy recovery and start talking about this period as the longest recovery ever.]

- ***The yield curve doesn't have to completely invert for a recession call. It barely did so the last two times.***

[Agreed. This table from Michael Lebowitz at Real Investment Advice measures the ***size*** of the last five 2Y/10Y yield curve inversions. You see they've been getting progressively smaller. If that trend were to continue, we might not even need a yield curve inversion to signal recession.

Date	Yield Curve Max. Inversion
May-80	-2.14
August-81	-1.35
March-89	-0.32
April-00	-0.41
November-06	-0.11

Much of the curve is already inverted at the short end. Here are the rates from last Tuesday.

- 1-month: 2.41%
- 3-month: 2.45%
- 6-month: 2.51%
- 1-year: 2.54%
- 2-year: 2.50%
- 3-year: 2.47%
- 5-year: 2.47%
- 7-year: 2.55%
- 10-year: 2.65%

Notice the one-year to five-year is inverted by seven basis points. Likewise, the seven-year is only one basis point away from inverting against the one-year note. The short end of the curve is unusually flat and some points are inverted.

About five years ago, maybe more, I was at speaking at a conference where David Rosenberg and David Zervos were on a panel aggressively arguing that the yield curve would have to actually invert before another recession. Remember, this was when the Federal Reserve was holding rates at zero, seemingly forever. I aggressively questioned them later as to how the yield curve could invert? I maintained that we could have a recession without a full inversion. They both thought that eventually the Fed would raise rates, the yield curve would invert, and we would have a recession.

Times change and the facts change, too. But I think David is right now. We don't have to have a full 2Y/10Y inversion to signal a recession. It may happen, but then again that inversion is typically a year in advance.]

- ***Stocks appear to have peaked last fall. Average lead time from market peak to business cycle peak is seven months.***

[Maybe. Then again, a solution to the China trade war and a solution to Brexit coming at roughly the same time could cause a market melt-up and new highs. On the other hand, Doug Kass thinks the market is getting ready to roll over and is increasing his short exposure.]

- ***Fed policy changes are coming too late. It already over-tightened, as it did so often in the past. Rosenberg thinks "neutral" Fed Funds rate is no more than 1.75%, so the last two hikes were missteps.***

[Again, maybe. I agree the neutral rate is historically low but it may be somewhere close to where we are today. This is something we will only know for sure in hindsight. If 50 basis points is the difference between slow growth and recession, then this economy is extraordinarily weak and is likely to enter recession anyway.]

- ***Recessions historically begin when the unemployment rate climbs 0.4 percentage points above its cycle low, which this time seems to have been 3.7%. So 4.1% unemployment, when it happens, should ring an alarm bell.***

[Completely agree. I've actually used charts in the past connecting small increases in unemployment with the onset of recessions.]

- ***The recession will probably be mild but there is no correlation between a recession's severity and how far equity markets decline.*** [Agreed.]

- ***This time, the bubble is on corporate balance sheets as firms borrowed money at historically low rates. Instead of productive use, much of the borrowing went to share buybacks. This did nothing to cover future debt-servicing costs.***

[This is something I've been writing about at length. I think corporate and high-yield debt and leveraged loans will end up being the next recession's subprime mortgage loans, triggering a liquidity crisis which could be quite severe.]

- ***While many focus on high yield, the leveraged loan market is in a bubble of its own. A key risk for this year is a debt refinancing "tsunami" as trillions in debt has to be rolled over at higher rates.***

[No argument here. That "tsunami" could actually cause a recession.]

- ***Share buybacks and capital spending will be curtailed as cash flow falls while wages and debt servicing costs rise.***
- ***A 35% decline in stocks would be typical for this kind of recession, though Rosenberg thinks some non-cyclical and defensive names could outperform.***

To zero in further, I think the main question is whether the Fed stayed hawkish too long, as Dave thinks, or is loosening up in time to keep the economy growing. We don't know yet. For that matter, we don't ***know*** if they are turning dovish. We only know they're talking about ending the rate hikes and/or ending the balance sheet reductions. The FOMC meets again March 19–20 so whatever they do then should tell us more. And if the economy perks up? The Fed can talk about more tightening later in the year.

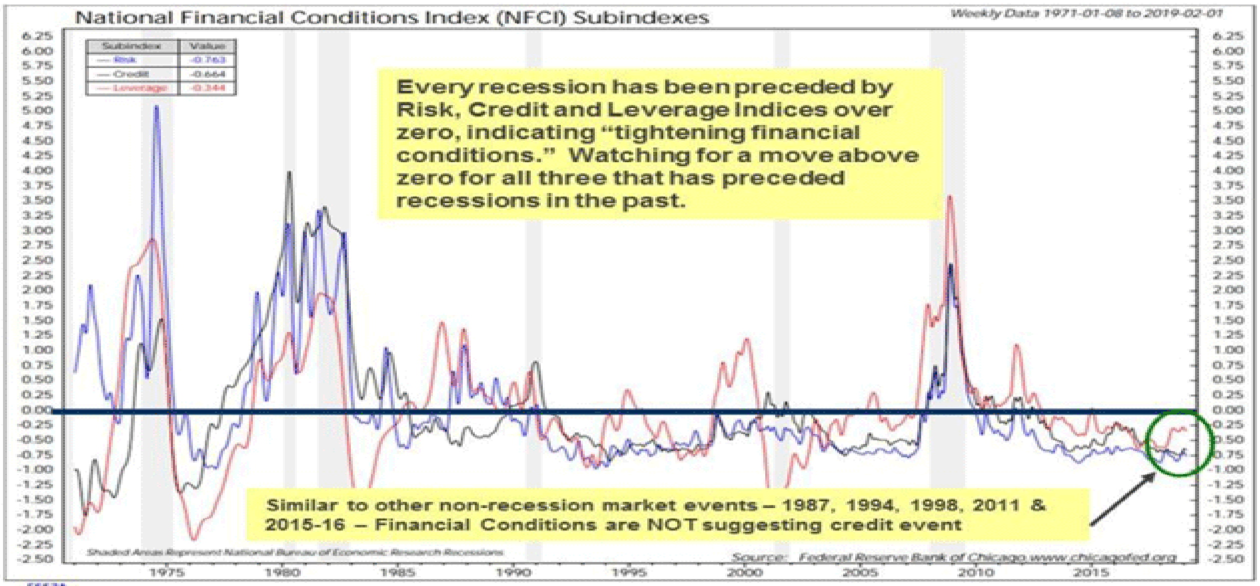
No Credit Stress

Canaccord Genuity analysts Tony Dwyer and Michael Welch differ from Rosenberg, and outlined their own case in a February 13 Macro strategy note titled "Still no recession in sight."

Dwyer and Welch concede all the big question marks: slowing growth, Brexit, trade war, and so on. Their conclusion is these will make the Fed even more dovish than it would otherwise have been. They think the Fed can do this because four factors will forestall recession. Quoting from their note:

- NFIB Small Biz Optimism Index cycle peaks offer long runway. Clearly, survey-based indicators have seen sharp declines from their respective August 2018 peak, which makes sense given the Q4/18 market crash and early-year US government shutdown. The good news is the cycle peak in the NFIB Small Business Optimism Indices historically leads recession by a median 41 months. It is even longer if you use the last three credit-driven cycles.

- Credit Stress Indicators never even budged as market swooned. It is hard to have a credit crisis when there aren't any signs of credit stress. Again, we turn to the Chicago Fed's National Financial Conditions Subindices that measure 105 indicators of credit stress in banking, shadow banking, and the financial markets. These subindices barely moved, suggesting a fear-based market event rather than a sign of a coming credit crisis-driven recession (Figure 3). ***Source: Canaccord Genuity***



Source: www.ndr.com / Canaccord Genuity

If Rosie is right and the Fed has already tightened too much, we should see it in credit conditions. We don't, at least not yet. Credit is still available to businesses that need it, although at higher rates in some cases. That's not all bad; it might mean fewer "zombie" companies haunting the economy. The question is whether their demise will cause other damage. We shall see.

Not Going Global

So far we've talked about the US economy, but no country is an island anymore. All are exposed, more or less, to the greater world economy. So let's look overseas.

In Italy the recession argument is over because they are officially in one. That got lost in other news but it really is happening. The Italian economy shrank 0.2% in the fourth quarter, following -0.1% growth in Q3. That is about as mild as a recession can be, but it counts. Germany may not be far behind. Europe's largest economy contracted -0.2% in last year's third quarter. Reports suggest the fourth quarter was no better and possibly worse.

Meanwhile in Asia, China is not in recession and nowhere near one, if we believe government data. Much depends on how (or if) the country resolves trade disputes with the US. As of now, a comprehensive agreement still looks elusive but Trump appears willing to extend the March 1 deadline for another tariff hike. The uncertainty isn't good, but it's better than a major trade war.

Looking internally at China, we all want to know how long Beijing can sustain such amazing growth rates. Gavekal's Chen Long wrote in a report this week that China's credit cycle appears to be turning back up after a few rough months. He sees solid bank lending and a recovery in the "shadow" banking sector contributing to overall credit growth. This typically leads economic growth by 6–9 months, suggesting the Chinese economy could be back on firmer ground by this fall.

Again, all this is subject to macro risks. All bets are off if China weakens too much or the UK makes a hard Brexit. As of now, however, nothing is exploding in a way that would set off a worldwide recession. That suggests 2019 may not be a great year in the markets, but it won't be a terrible year, either. Things could certainly be worse.