30 April 2019

Building a retirement portfolio

By Richard Cluver

Ideally the creation of a retirement portfolio should begin on the first day you start work and, in many cases, even earlier based upon saved birthday gifts.

In the case of my own children, it began even earlier than that with pocket money every Saturday morning before they could even count. It was a small sum but they were encouraged to split it into three amounts: one for spending at once, two saved towards some desired object, and three always a ten percent long-term saving because I was intent upon creating an ingrained habit which, happily, has stuck….and the bonus was they started learning simple maths in a meaningful way long before school began.

Richard Cluver's latest book: An easy as A B C method of building and maintaining a market-beating investment portfolio that requires no more than ten minutes a day to stay ahead! Published as an E-Book for just $4.15, order on our website: www.sharefinderpro.com

The Ten Minute Millionaire

By Richard Cluver

But the big bonus, as I have repeatedly argued is that those who save one tenth of their income can afford to drop out of formal occupation within 12 to 14 years of starting work. Few actually do stop working at such an early stage but the important lesson everyone who buys into this concept soon comes to appreciate is that financial independence creates the freedom to choose whatever you want to do in life: to take on lesser-paid work that feeds the soul or to go travelling or whatever moves you!

Many, of course, simply enjoy the deep sense of security that a growing nest egg provides. In my own case I still recall the day when I realised that I had sufficient money to never need to work again and how it transformed my own attitude towards heading to the office each day knowing that it was my choice to go there.

It is difficult to convey, even now, the great pleasure I subsequently derived from my daily interaction with my work colleagues, for most of whom work was a necessity to put bread upon the table. Few grasped how lucky they were to be able to daily interact with the fine group of minds that made up the editorial team of the newspaper of which I was fortunate to be assistant editor. The need to earn their living simply crowded out all other observations.

When I was eventually forced to resign because of the increasing demands of the ShareFinder project that I had started a few years before, most colleagues thought I was so fortunate because I no longer needed my job. But I left with great sorrow because I knew how much I would miss the intellectual stimulation of those daily interactions…and still do quarter of a century later.

Sadly, for the majority of people, the great luxury of early retirement is impossible and retirement on an inadequate pension becomes an inevitable enforced period of deprivation. Accordingly, the most frequent cry for help that I receive is from someone needing to derive the maximum possible income from a relatively small sum of money.

This column is accordingly addressed to folk who, for whatever reason, have retired on inadequate means and who need to make whatever they have saved work overtime for them.

Ideally, if one were preparing an investment portfolio for someone who was retiring with savings adequate to provide for a comfortable old age, one would stick to the time-honoured prudential rules which argue that such a portfolio be based upon a significant holding of sovereign bonds such as the R186 government bond which, in recent years, has yielded interest that has fluctuated around an 8.8 percent yield. The graph below illustrates how the yield has fluctuated over the past eight years about a red mean line that has been rising at compound 1.3 percent.

The point to understand here is that if you bought the R186 or any other sovereign bond at, for example its peak yield of 9.9 percent at the time when then President Jacob Zuma fired his Finance Minister Pravin Gordhan. When foreign investors took fright, selling our bonds as fast as they could with the inevitable result of a historic peak yield of 9.9 percent, you would continue to receive 9.9 percent for so long as you cared to hold them.

The point to take to heart about sovereign bonds is the interest rate that you buy them at remains the rate they will you pay you forever-more…until the bond matures. Thus, had you bought them the Monday after Zuma fired Gordhan you could expect to receive 9.9 percent a year for so long as you held them even though the day to day value was constantly fluctuating.

Were you needing to sell them, your best timing would have been in March last year when, on a wave of Ramaphoria, the yield fell to 7.98 percent when you would have realized a 24 percent capital gain.

But for now let us stick with our well-provided-for retiree who has managed to provide for himself savings of R12-million which is currently around the perfect sum for South Africans to aim for. Were he to have invested the entire sum in such a bond he would have provided himself with an annual income of R1.188-million or R99 000 a month.

That seems to be a handsome monthly sum but, remember that inflation has been running at an average rate of five percent over the past quarter century which implies that the buying power of a fixed income will halve every 14.4 years. Thus, had our wealthy retiree given up work at 65 he would by age 80 have to live of the equivalent by then of R49 500 and if he lived on to 95, which is not particularly unusual any more, he would by then have to live on the buying power of just R24 750.

In order to protect his income, the prudent investor should accordingly have opted to put only half his retirement capital into a government bond and the balance into Blue Chip shares which would, at the cost of an initially lower aggregate income yield, assure him of a steadily-rising income that would negate the affects of inflation.

Were he, for example, able to place half his money into a share portfolio such as the ShareFinder portfolio which I have maintained for readers of my Prospects newsletter since January 2011, he would have enjoyed an annual capital growth rate of 20.9 percent while enjoying a commensurate dividend growth rate, and would thus, over the same 15 years see the R6-million equity portion of his investment grow to R103.4-million and his annual dividend from R150 000 a year to R2 585 150.

Of course, I have chosen ideal buying conditions and exceptionally high share growth rates, but hopefully you get the point.

Summarising those figures, the investor with R12-million at retirement who opted for a pure bond portfolio would see his income static over the entire period which, because of inflation, would over the next 15 years see its buying power reduced from R99 000 a month to R49 500.

The half bond half blue chip investor would see his bond income remain static over the next 15 years at R49 500 while his dividend income would grow from R12 500 a month to R215 429 taking his total income to R264 929 a month which by then would have a buying power of R132 464.50.

Now I am sure the numbers I have chosen will be a bit rich for most readers, but the point to take to heart is that while the traditionally safest investment is in bonds you should on average expect your buying power from such an investment to halve over the next 15 years. However, a half Blue Chip half sovereign bond portfolio might offer a lesser income to start off with but could be expected to grow more than four-fold over the next 15 years to achieve a buying power of more than twice that of the initial monthly income.

Sadly, however, most folk fail to understand the need for saving towards a retirement nest egg and accordingly end up with a significantly lower capital sum from which they hope to derive sufficient income to live on. In this light I was recently called upon to assist a retiree of advanced age who was deriving an income of 8.5 percent a year from his sovereign bond investment. That was providing him with a monthly income of R14 000 and he needed R20 000 to live on.

How I created a portfolio for him which provided R20 784 a month will be the subject of my next column. Furthermore, his portfolio should provide him with an inflation-

beating 8.5 percent a year growth based upon its average growth over the past decade

Is Ramaphosa really a reformer?

By Anthea Jeffery*

Some commentators are pushing for a strong vote for the ANC in the election so as to strengthen President Cyril Ramaphosa and his supposed reform agenda.

However, an ANC triumph at the polls will, of course, strengthen the ruling party and not Ramaphosa.

Even if the ANC wins 60% or more, Ramaphosa will still be subordinate to ANC secretary general Ace Magashule in the party hierarchy. He will still command only a bare majority on the ANC's powerful national executive committee (NEC).

After decades of mismanagement and corruption, a 60% ANC victory will also confirm that 'ANC' stands for 'Absolutely No Consequences', as Zwelinzima Vavi (then Cosatu general secretary) said some years ago. So long as it enjoys this impunity, why should the ANC even contemplate reform?

Moreover, when a 60% vote for the ANC is combined with a likely increased showing for the EFF, the two-thirds majority needed to amend the property clause and other core constitutional provisions will have been secured. This will give the ANC yet more reason to press ahead with damaging radical shifts, rather than abandon them.

There is also little reason to believe that Ramaphosa is really a champion of reform. Since actions speak louder than 'new dawn' words, the most telling factor is how policy is changing under Ramaphosa's watch. As yet no significant policy reforms are under way or have even been proposed.

Instead, the Expropriation Bill and Constitution are to be changed to allow expropriation without compensation; the supposedly immutable 26% BEE ownership target in mining has been raised to 30% for new mining rights; the labour minister is being empowered to set damaging employment equity targets for businesses in different sectors; companies which are deemed (on unconvincing grounds) to be too dominant are to be forcibly 'divested' of some of their assets; private medical schemes are to be economically crippled and pushed out of

operation in preparation for the NHI; the South African Reserve Bank is to be nationalised, increasing the risk of disastrous changes to macroeconomic policy; and prescribed assets for pension and other investment funds are being probed.

All these policy shifts are integral to the national democratic revolution (NDR) the ANC has been implementing since 1994 and is now intent on speeding up. Ramaphosa has never tried to stop the NDR. If anything, he has confirmed his own commitment to it at various times.

In addition, if the 'actions over words' test is applied to the pre-1994 period, this shows that Ramaphosa's commitment to the ANC's incremental revolution has been in place for 30 years or more.

In 1987, as general secretary of the National Union of Mineworkers, Ramaphosa led a three-week mining strike which was ruthlessly enforced against those unwilling to put jobs and pay at risk. Two non-strikers were necklaced on the first day, while several others were hacked to death, strangled, shot or poisoned with insecticide. At least 18 people were killed, while over 500 mineworkers were injured. No wage gains were secured and striking workers lost R115m in wages and bonuses. But the ANC's revolutionary cause was advanced, albeit at great cost.

In May 1992, as secretary general of the ANC, Ramaphosa played a crucial part in the ANC's demolition of the multi-party negotiating process, the Convention for a Democratic South Africa (Codesa).

When Codesa first met in December 1991, it endorsed the ANC's proposals, thereby earning the organisation's supposedly fervent support. But in May 1992 Codesa voted against what the ANC wanted on the crucial issue of federalism, over how much power should be devolved to provinces. It also rejected the ANC's sudden demand that the constituent assembly responsible for drawing up the final constitution should effectively be able to decide its provisions by a 51% majority after six months.

When these issues were put to the vote among the 19 parties represented at Codesa 2, the ANC lost by 11 votes to 8. However, the ANC refused to accept its defeat. Instead, it orchestrated an upsurge in violence around 16th June 1992, in which some 40 people were killed and three deemed IFP supporters were necklaced in Boipatong.

On 17th June 1992 hundreds of IFP members living in the disused KwaMadala hostel – all of whom were refugees from earlier ANC attacks – launched a massive revenge raid on Boipatong in which 45 people were killed. The ANC immediately claimed that the police had helped to carry out the attack. This was a blatant lie ('fake news', in today's parlance), as was later confirmed by both the trial court that convicted 17 KwaMadala residents of murder and the amnesty committee of the Truth and Reconciliation Commission.

Despite the falseness of the accusation, Ramaphosa blamed state president FW de Klerk 'in person' for the killings. He also claimed that the police role in the Boipatong massacre had put the whole Codesa process in jeopardy. Soon Ramaphosa and

other ANC/SACP leaders terminated the ANC's participation in Codesa, plunging the constitutional negotiations into a crisis.

The supposed police role in the Boipatong killings was not the real reason for the ANC's demolition of Codesa. This lay rather in the fact that the ANC had suffered a humiliating defeat at Codesa 2 and could no longer control the convention's decisions.

In the climate of outrage orchestrated by the ANC, political violence surged further, with 120 people (many of them IFP supporters) killed within four days of the massacre. In September 1992 came the Bisho killings, in which 29 people – having arguably been led to their deaths by the ANC 'like lambs to the slaughter' – were shot dead by the Ciskei army.

Recognising the ANC's apparent willingness to wade through rivers of blood to gain untrammelled power, De Klerk capitulated. Effectively, he now agreed to what the ANC had demanded at Codesa 2, but had lacked the support to secure. He also agreed to a new multiparty negotiating process which did little but rubber stamp the bilateral agreements the ANC could now force the NP to endorse.

From then on, Ramaphosa's role in the negotiating process was outwardly increasingly benign. He had nevertheless played a key part in torpedoing Codesa, sparking a further upsurge in killings, and delaying the transition process by at least a year.

Behind Ramaphosa's smiling visage lay the ANC's ruthless determination to destroy its key black rival (the IFP), reject the majority decisions reached at Codesa 2, prevent a free and fair election in 1994 – and so secure the 'prime prize' of 'state power' it would need to advance the NDR in the post-apartheid period.

It is easy to understand the widespread hope for a better future that underpins Ramaphosa's current electoral appeal. But Ramaphosa has been integral to the ANC's revolution for more than 30 years. There is nothing in his actions to identify him as a closet reformer who will start rolling back the NDR once the ANC has used him to secure state power for a crucial further five years.

- **Dr Anthea Jeffery is Head of Policy Research, IRR. Jeffery is also the author of People's War: New Light on the Struggle for South Africa, soon to be available in all good bookstores in abridged and updated form.** ***This article is republished from the*** *Daily Friend.*

Keeping Up With a Multibillion-Dollar Empire

It's probable that readers of The Investor are unlikely to be followers of the television series *Keeping Up With the Kardashians* which has just entered its

16th season in the USA, but you might be very interested to know that the series has spawned a relentless business empire.

- Kim Kardashian's KKW Beauty line sold about $14.4 million in product during the first five minutes it went live in 2017.
- Kendall Kardashian, who recently became the world's highest-paid model, pocketed $26.5 million in just 53 paid Instagram posts last year.
- And Kylie Kardashian is (however hotly debated) Forbes's youngest self-made billionaire thanks to her 100% ownership stake in her Kylie Cosmetics brand. And don't forget about the time she toppled $1.3 billion off Snap's value after tweeting, "Sooo does anyone else not open Snapchat anymore? Or is it just me … ugh this is so sad."

We think the New York Times put it best: "The sisters are a media company if it swallowed a makeup conglomerate, mated with a fashion line and birthed athleisure babies." Will they get alliterative names, too?

The land issue puzzler

By Felicity Duncan of BizNews

The ruling party's land reform programme has attracted a lot of attention. Much ink has been spilt decrying it as socialist nonsense/utopianism. Others have risen to its defence, arguing – not without reason – that a land grab is SA's original sin and restitution must be made.

But, for me, the real puzzler is not whether the policy is good or bad. Rather, why is the ANC pursuing it at all? South Africa is an urban country. Its biggest economic sectors are 'finance, real estate, and business services' and 'trade, catering, and

accommodation'. Agriculture is less than 3% of GDP. People have been flocking to the cities in record numbers ever since they were permitted to do so by the end of apartheid. There can't possibly be a huge constituency of people who desperately want to take up subsistence farming. Mostly, I would imagine, people want good jobs and reliable electricity.

No, I think that land reform isn't really about something people want in a material sense. Rather, it's about a persistent sense that the economic deck is unfairly stacked and a desire for a tangible victory on that front, even if it's a pyrrhic one. In that, it's a lot like the forces driving America's immigration backlash and Brexit. If land reform is an emotional issue, not a practical one, then it's no good trying to argue against it rationally. Rather, land reform opponents must find a way to create a compelling and inspiring vision for the future that will win more hearts and minds than land reform does. And proponents need to consider carefully whether emotions will sour when the reality of the land reform programme kicks in.

Towards income equality

Reproduced from The New Yorker March 2014

By John Cassidy

I've got a lengthy piece about "Capital in the Twenty-first Century," a new book about rising inequality by Thomas Piketty, a French economist, that is sparking a lot of comment and debate. (Brad DeLong has a useful summary of some early reviews.) I'll go further into that discussion in future posts, but first I thought it might be useful to portray the gist of Piketty's story in a series of charts.

Fifteen or twenty years ago, debates about inequality tended to be cast in terms of clever but complicated statistics, such as the Gini coefficient and the Theil entropy index, which attempted to reduce the entire income distribution to a single number.

One thing that Piketty and his colleagues Emmanuel Saez and Anthony Atkinson have done is to popularize the use of simple charts that are easier to understand. In particular, they present pictures showing the shares of over-all income and wealth taken by various groups over time, including the top decile of the income distribution and the top percentile (respectively, the top ten per cent and those we call "the one per cent").

The Piketty group didn't invent this way of looking at things. Other economists, such as Ed Wolff, of New York University, and Jared Bernstein and Larry Mishel, the creators of the invaluable State of Working America series, have long used similar charts and tables in their publications. But partly by using new sources of data, such as individual tax records, and partly by expanding the research to other countries, Piketty and his colleagues have deployed their charts to reshape the entire inequality debate.

For a long time, that debate was almost entirely focussed on what was happening to median incomes. That inevitably led to discussions of globalization, skill-biased technical change, and policies focussed on education and retraining. Now, thanks to

Piketty et al., the remarkable gains of those at the very top can't be avoided. And this means that the issues of politics and redistribution can't be avoided either.

The next chart is a simple one, and it concerns the United States alone. It tracks the share of over-all income taken by the top ten per cent of households from 1910 to 2010. Broadly speaking, it's cantered on a U shape. Inequality climbed steeply in the Roaring Twenties, and then fell sharply in the decade and a half following the Great Crash of October, 1929. From the mid-forties to the mid-seventies, it stayed pretty stable, and then it took off, eventually topping the 1928 level in 2007. (The chart shows the share of the top decile falling back a bit after the financial crisis of 2007 to 2008. New figures for 2012 from Saez, which came out too late to be included in Piketty's book, show the line hitting another new high, of more than fifty per cent.)

The second chart shows the share of income taken by the one per cent over the same period, and the teal line, which includes income of all kinds, has the same U shape. (Once again, the 2012 figures, which aren't included, show another step up.) The top percentile hasn't taken such a large share of over-all income since 1928. Interestingly, the recent rise in its share is a bit less dramatic when the analysis is confined to wage income. The difference between the bottom line (wage income) and the top line (total income) is accounted for by income from capital—dividends, interest payments, and capital gains. Because they own a lot of wealth, the one-per-centers receive a lot of their income in this form.

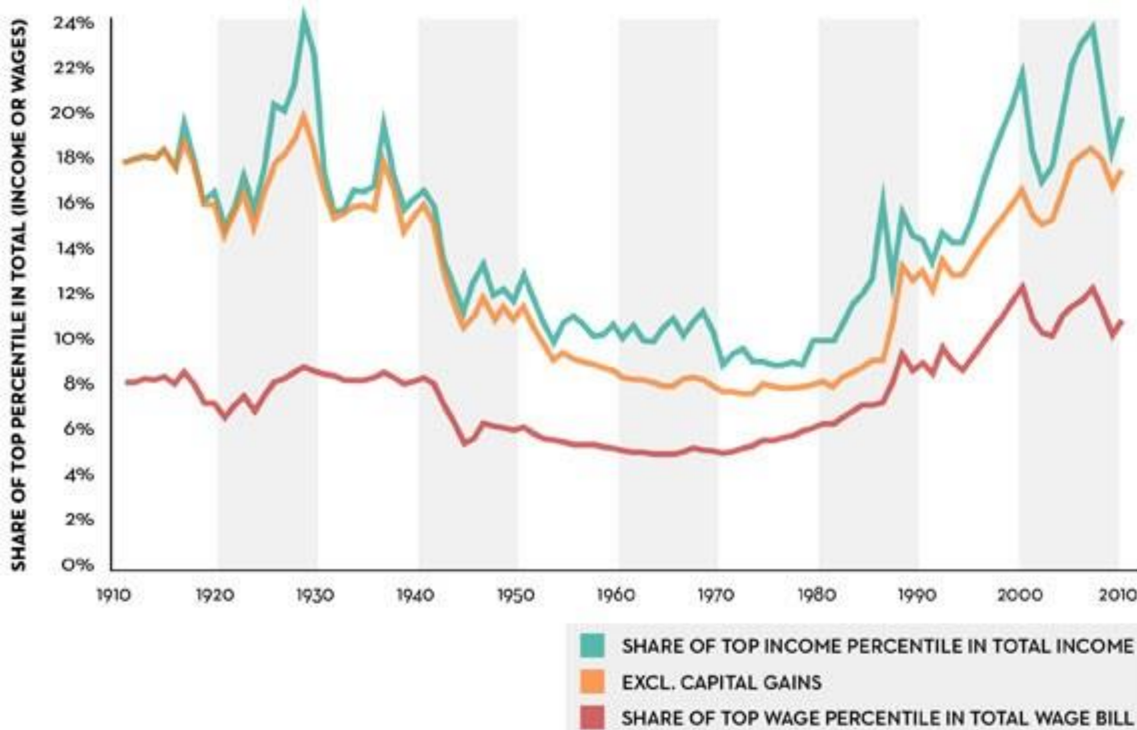


Chart Three expands the analysis to what Piketty calls other "Anglo-Saxon countries"— Australia, Canada, and the United Kingdom—and it confirms that rising inequality is a global phenomenon. Since 1980, the share of over-all income going to the one per cent has risen sharply in those three nations, too. However, the United States still comes out as the winner of the inequality race.

That's perhaps not too surprising: we tend to think of the United States as a very unequal country, but it's worth noting that this perception wasn't always accurate. The chart shows that, ninety years ago, the United States and Canada had roughly the same amount of inequality, according to this measure, while the United Kingdom was a markedly less equitable place.

Today, though, the U.S. has few challengers. Even in terms of income generated by work, Piketty notes, the level of inequality in the United States is "probably higher than in any other society at any time in the past, anywhere in the world."

INCOME INEQUALITY IN ANGLO-SAXON COUNTRIES, 1910-2010

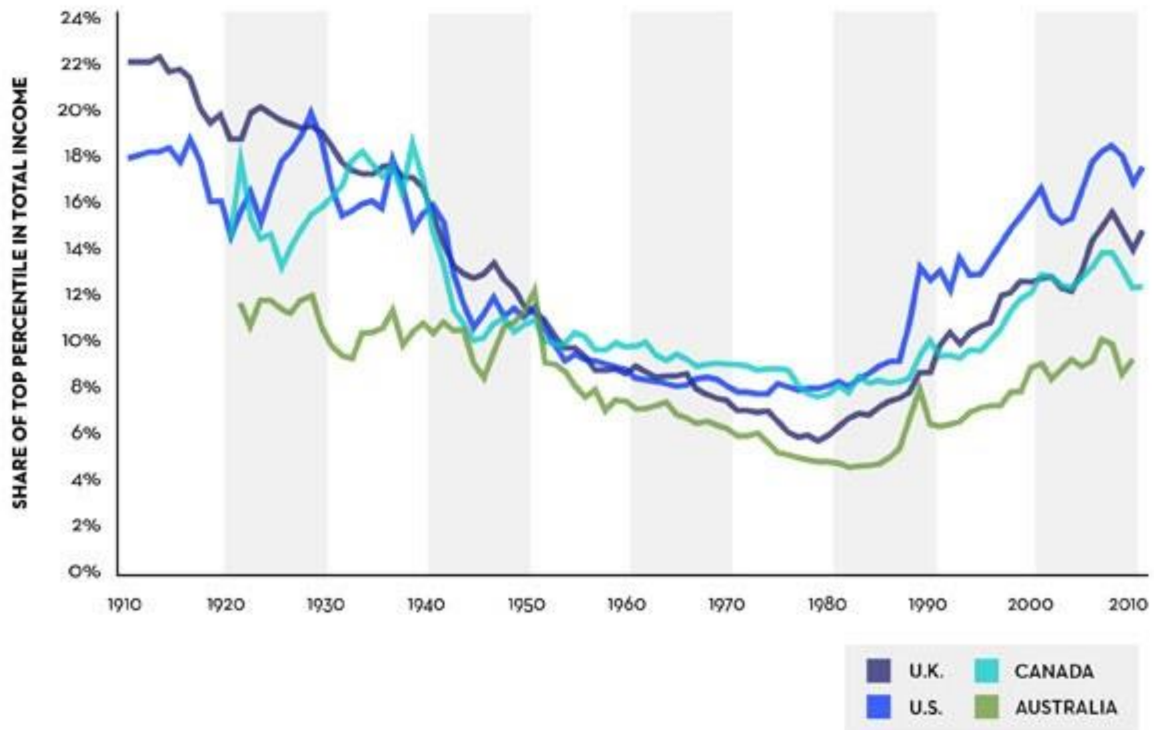


Chart Four shows what's been happening in six developing countries: Argentina, China, Colombia, India, Indonesia, and South Africa. Once again, we see the familiar U shape: during the past few decades, more and more income has been accumulating at the top. In most of these countries, however, the share taken by the one per cent is quite a bit lower than it is in the United States. The one exception is Colombia, where the figures are broadly comparable. (Compare Chart Four to Chart Two.) It barely needs noting that Argentina, Indonesia, and South Africa are highly stratified and grossly inequitable nations. But, according to this measure, anyway, they have less inequality than the United States does. Despite the recent growth of a big-spending nouveau-riche class, the same is true of China.

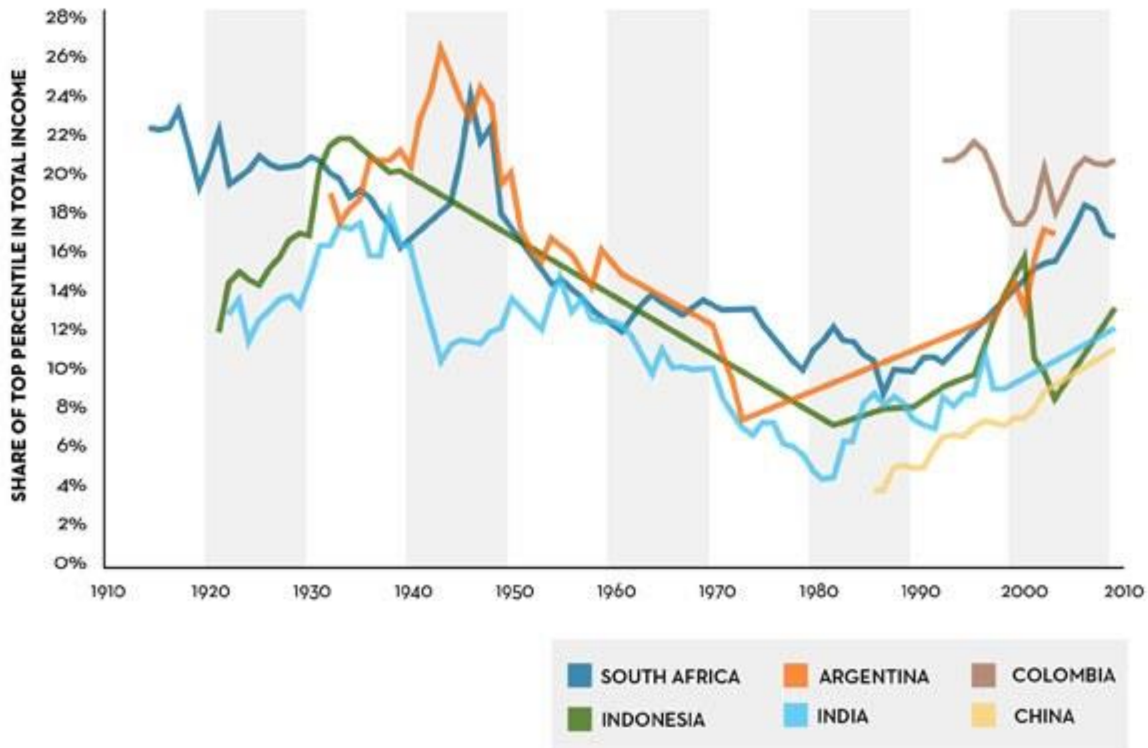
It only costs
R650 a year to

PROSPECTS
The Richard Cluver Investment Newsletter in continuous publication since 1987

subscribe to Richard Cluver's Prospects newsletter service...*The preferred e-mail share market information service*

Richard Cluver **Predicts**
In our 32nd year of service to the investing public

that tells you what and when to buy and sell:
www.sharefinderpro.co.za

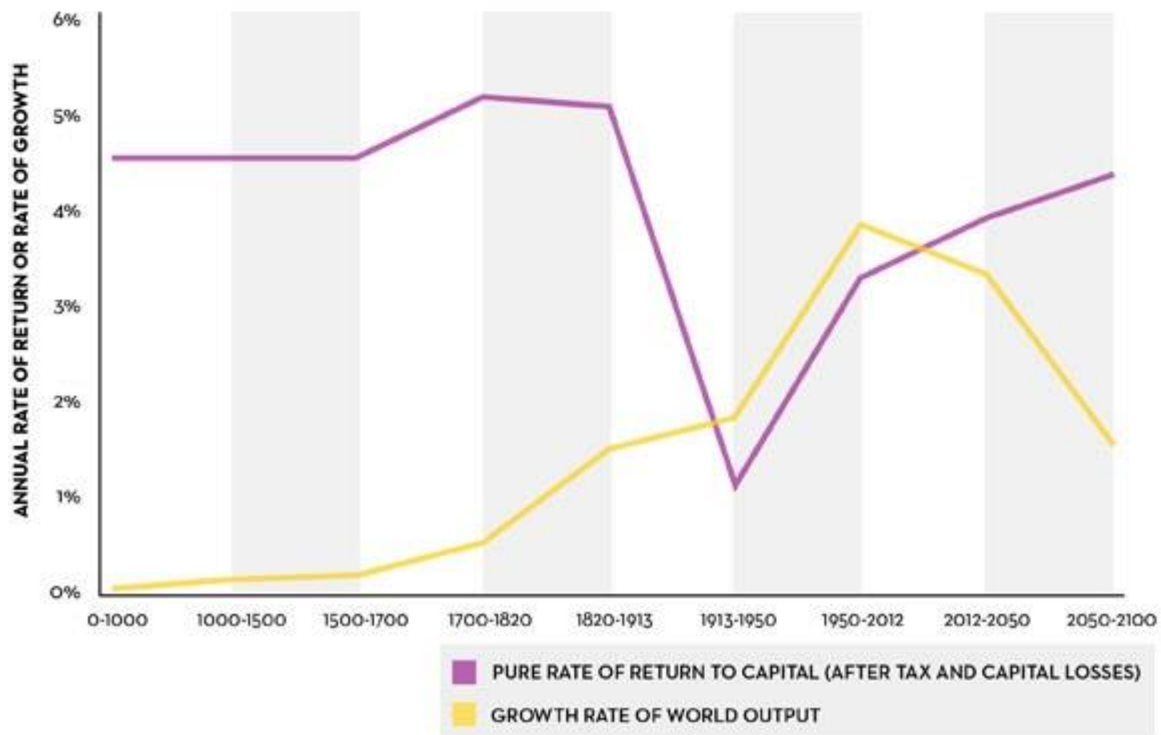


The fifth chart switches the attention from income to wealth, and it takes a long-term perspective. For much of the nineteenth and twentieth centuries, the class-bound societies of Western Europe were dominated by a landed and monied elite that owned much of the land and the wealth. The United States had rich and poor, too, but the wealth was still spread around a bit more widely. In 1910, for example, the one per cent in Europe owned about sixty-five per cent of all wealth; in the United States, the figure was forty-five per cent.

In recent decades, the roles have been reversed. The U.S. monied elite has outstripped its counterpart on the other side of the Atlantic, and wealth has become even more concentrated in the United States than it is in Europe. In 2010, the American one per cent owned about a third of all the wealth: the European one per cent owned about a quarter. Citing figures like these, Piketty warns that “the New World may be on the verge of becoming the Old Europe of the twenty-first century’s globalized economy.”

The last chart is a bit different. It concerns Piketty's theory that capitalism has a "central contradiction": when the rate of return on capital exceeds the rate of economic growth, inequality tends to rise. (That's because profits and other types of income from capital tend to grow faster than wage income, which is what most people rely on.) The purple line shows Piketty's estimate of the rate of return on capital at the world level going back to antiquity and forward to 2100. The yellow line shows his estimate of the global growth rate over the same period.

The important point to note is this: setting aside the period from the late nineteenth century to the early twenty-first century, which is roughly what we would call modernity, the growth rate has been below the rate of return, implying steadily rising inequality. The twentieth century, far from representing normality, was a historic exception that is unlikely to be repeated, Piketty argues. In the coming decades, he says, the growth rate will most likely fall back below the rate of return, and the "consequences for the long-term dynamics of the wealth distribution are potentially terrifying."



Piketty's projection is only guesswork, of course. (In my magazine piece, I suggest a couple of ways it could be turn out to be wrong.) But it's based on some serious arguments, and it's got a lot of people talking. Just like the rest of the book.

Charts adapted from the originals in Thomas Piketty's "Capital in the Twenty-first Century."

John Cassidy has been a staff writer at ***The New Yorker*** *since 1995.*

Ray Dalio Jose Sena Goulao/EPA, via Shutterstock

"It doesn't take a genius" to know capitalism needs fixing

From the New York Times

Capitalism helped Ray Dalio build his investment empire. But in a lengthy LinkedIn post, the Bridgewater Associates founder says that it isn't working anymore.

• Mr. Dalio writes that he has seen capitalism "evolve in a way that it is not working well for the majority of Americans because it's producing self-reinforcing spirals up for the haves and down for the have-nots."

• "Disparity in wealth, especially when accompanied by disparity in values, leads to increasing conflict and, in the government, that manifests itself in the form of populism of the left and populism of the right and often in revolutions of one sort or another."

• "The problem is that capitalists typically don't know how to divide the pie well and socialists typically don't know how to grow it well."

• “We are now seeing conflicts between populists of the left and populists of the right increasing around the world in much the same way as they did in the 1930s when the income and wealth gaps were comparably large.”

• “It doesn’t take a genius to know that when a system is producing outcomes that are so inconsistent with its goals, it needs to be reformed.”

The rules will change

By John Mauldin

“But the emperor has nothing at all on!” said a little child.

“Listen to the voice of innocence!” exclaimed his father; and what the child had said was whispered from one to another.

“But he has nothing at all on!” at last cried out all the people. The emperor was suddenly embarrassed, for he knew that the people were right; but he thought the procession must go on now! And the lords of the bedchamber took greater pains than ever, to appear holding up the robes although, in reality, there were no robes at all.

—“The Emperor’s New Clothes” by Hans Christian Andersen

When you write about controversial topics for hundreds of thousands of readers for 20 years, you develop a thick skin. Virtually anything I say will upset someone.

So, when people say something like, “John Mauldin wakes up sucking lemons and then moves onto something sour,” as happened after last week’s letter, it doesn’t bother me. (It actually made me smile.) I write what I believe is correct. Those opinions change over time as I get new information.

I’m not the only one who changes. Laws and policies that may seem etched in stone are often more flexible than generally thought. In last week’s Japanification letter, I described how no one anticipated the various extreme measures taken in the last crisis, from TARP to QE to NIRP. Yet once those ideas were in play, they happened quickly.

I think the next crisis will bring similarly radical, sudden changes. We will think the unthinkable because we will see no other choices. That means the range of possible scenarios may be wider than you think.

To think this may be so is not necessarily bearish.

Fiscal Insanity

As of now, my best guess is the US will enter recession sometime in 2020. I may be off (early) by a year or two, but it’s coming. We know two things will happen.

- Tax revenues will fall as people’s income drops.
- Federal spending will rise as safety-net entitlement claims go up.

The result will be higher deficits. Keynesian economics advocated running deficits during recessionary and economically difficult times and surpluses the rest of the time. That's not what we did.

Last year (fiscal 2018) the "official" budget deficit was $779 billion. The national debt went up $1.2 trillion. The "small" $421-billion difference was more than half the official budget deficit. That is the off-budget spending that Congress doesn't count. It includes the revenue and spending of certain federal entities that Congress wants to isolate from the normal budget process. Lately it has run in the multiple hundreds of billions of dollars, every year.

Below is a graph showing the projected budget deficits for 2019 and 2020 from a website called The Balance. You can find similar numbers all over the internet. I'm using the US but the situation is similar in most developed countries (though hopefully not yours).

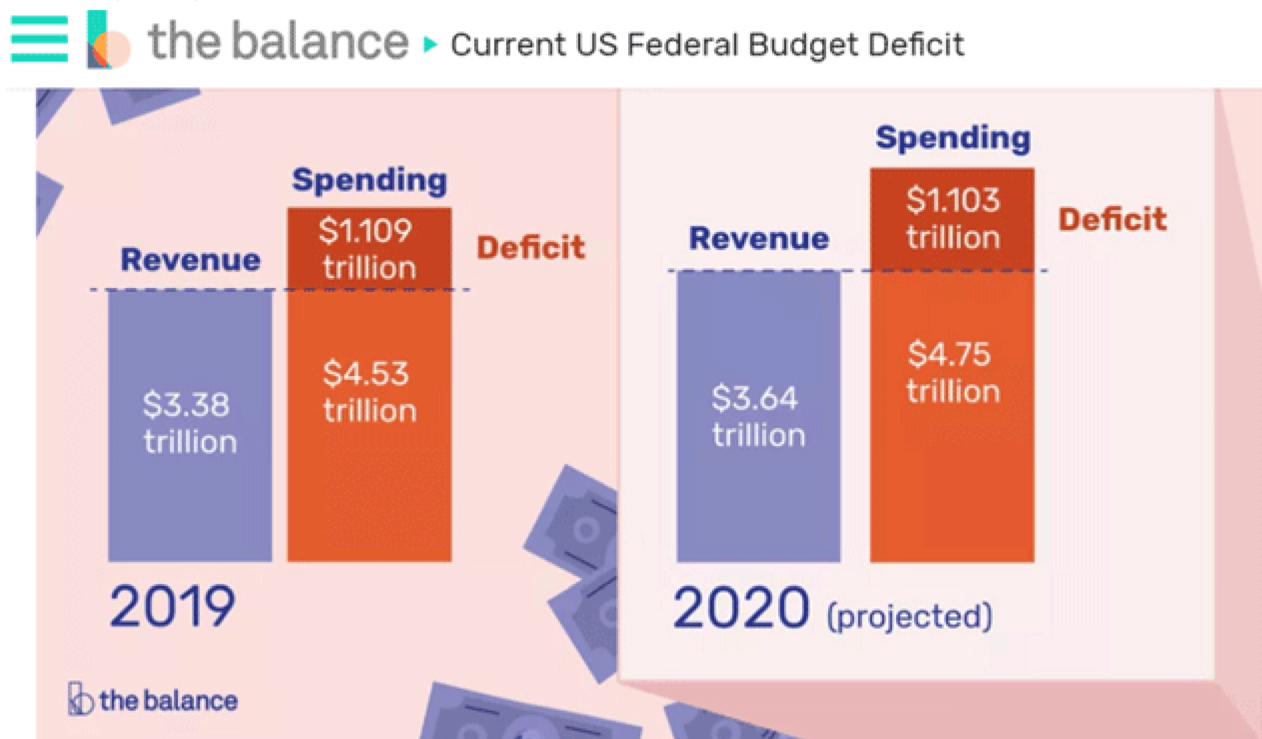


Image by Catherine Song. © The Balance 2019

Now, add another $400 million to each of those numbers. What is called the "unified budget" is now $1.5 trillion.

Next, let's go to a very handy website called The US Debt Clock. (Scrolling around you can find the debt for your own country and state and other useful data.) We see that halfway through fiscal year 2019, the debt is already well over $22 trillion. It will be $23 trillion before the end of this year. By the end of 2020, Trump's first term, it will be approaching $25 trillion. And that doesn't include state and local debt of $3 trillion plus their $6 trillion unfunded pension liabilities.

And as I pointed out before, all that is without a recession. The unified deficit will easily hit $2 trillion and approach $2.5 trillion in the next recession. Within 2 to 3 years later, the total US debt will be at least $30 trillion. Not including state and local debt or unfunded pension obligations (more on those later).

Recognizing that simple arithmetic is not being bearish. It's recognizing reality.

There are calls for a 70% tax rate on incomes over $10 million. Experts quoted in ***The Washington Post*** estimated it would produce about $72 billion a year. And you can guarantee that people will work their income statements to get below that. And in the face of a $2.5-trillion deficit? It doesn't do very much, let alone pay for any new programs.

The simple fact is that raising income taxes on whatever we think of as the wealthy doesn't get us close to a balanced budget. But what about actually doing a wealth tax? Like 1% of total net worth on the 1% wealthiest in America? Helpfully, ***The Washington Post*** article calculates that for us (my emphasis):

> ***Slemrod, of the University of Michigan, said in an email that the wealthiest 1 percent of Americans own roughly one-third of the $107 trillion in wealth in America. This group collectively holds about $20 trillion in wealth above $10 million per household.***
>
> ***From there the calculation of wealth tax is simple: a 1 percent wealth tax on the wealthiest 1 percent of households above $10 million could raise about $200 billion a year, or $2 trillion over 10 years. Tedeschi, the former Obama official, found a 0.5 percent wealth tax on the top 1 percent could raise at most $3 trillion over 10 years.***
>
> ***But this, too, would probably change Americans' behaviour and perhaps lead them to try shifting their wealth overseas, and the economists say the actual amount of revenue is likely lower than their estimates suggest. And this is assuming there are no exemptions to what is considered wealth, such as housing assets.***

Again, a few hundred billion a year is nothing to sneeze at, but at the rate we're going would make only a small dent in the deficit.

The real problem? Unfunded entitlement spending. The CBO is projecting literally trillion-dollar deficits in the latter part of this next decade simply because of unfunded entitlement spending. And then there's the pesky little fact that we spent $500+ billion last year on interest payments.

In a recession and bear market, the $6 trillion of unfunded pension liability on state and local balance sheets could easily rise to $9 trillion, a number most cannot meet. Either firefighters, police officers, teachers, former government workers, etc., would not get their agreed-upon pensions or state and local taxes would have to rise precipitously, or the federal government will have to step in.

All of this will happen in an environment in which the Federal Reserve will be fighting a recession and a slow-growth economy, trying to move those asset prices back up to help the pension funds. So for me to suggest that the balance sheet of the Federal Reserve could grow to $10 trillion by the middle of the next decade and $20 trillion by the end of the decade is not entirely outrageous. And we haven't really approached Japanese territory yet.

This analysis is not "bearish." It is simply looking at the numbers, doing the arithmetic, and observing that we'll have to borrow a great deal of money to meet our obligations.

I might be wrong if politicians from either party run and win with a platform of "I'm going to cut your Social Security and Medicare, slash the defence budget, and zero

out a lot of little other pesky expenditures that you probably like.” I feel sure that won’t happen.

Avoiding the Windshield

The Emperor isn’t wearing any clothes. Maybe I’m that naïve little boy who isn’t smart enough to see the beautiful cloth in which our national budgets are arrayed, and how easily we can raise more taxes from invisible sources.

And like the Emperor in the above story, we just keep walking and telling ourselves that nobody will notice.

The bulk of that debt will end up on the Federal Reserve’s balance sheet, just like the bulk of European debt will end up on the balance sheet of the European Central Bank, the Bank of England, and so on.

Exactly the path the Bank of Japan has already gone.

Let’s examine how that worked for them. From one perspective, it has done quite well. From another, they have paid a cost. Is it worth it? I think many Japanese, likely a big majority, would say yes.

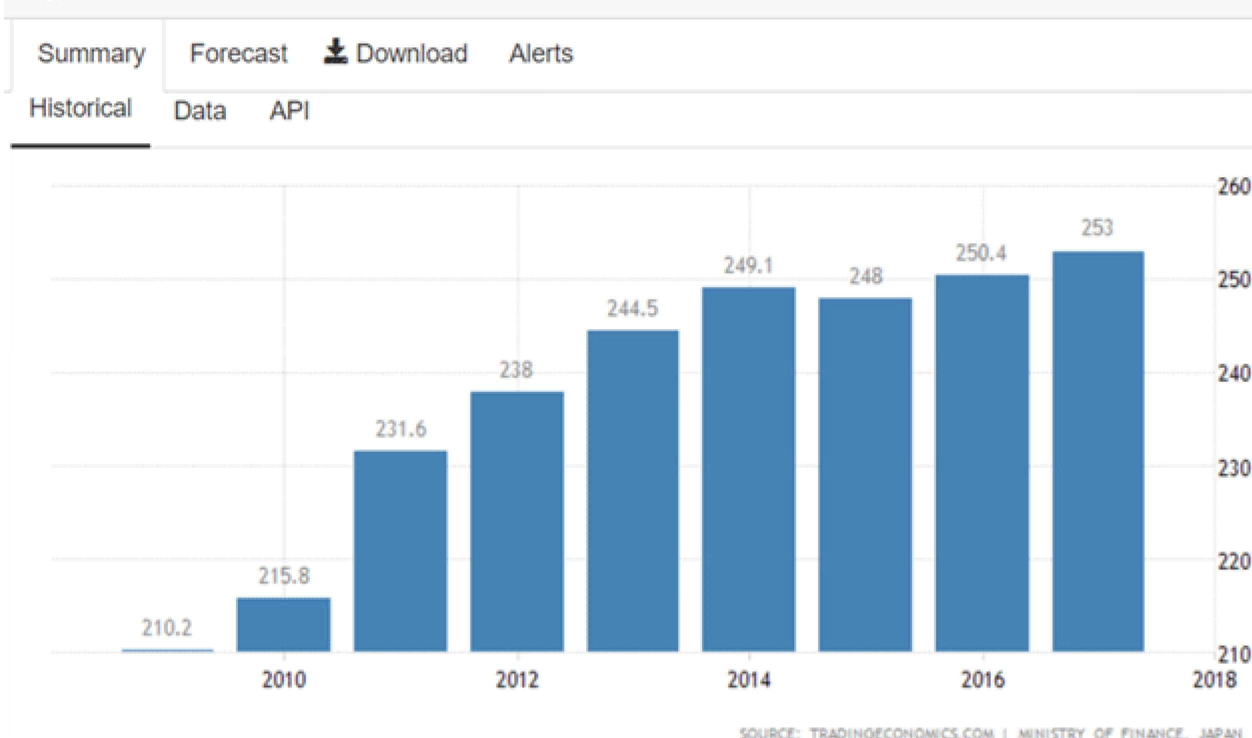
The Bank of Japan has more than 140% of Japanese GDP on its balance sheet. Its laws let it buy equities not just in Japan but all over the world and it has. Yet the currency is roughly the same value as it was when the Bank of Japan got busy with that project.

I am personally well aware of that because I was the one who called Japan “a bug in search of the windshield.” Just like I am predicting that much of the US deficit will end up on the balance sheet of the Federal Reserve, I said the same thing would happen to the Japanese. I also said it would devalue their currency. I actually put real personal money, not just token money, on the prediction. I bought a 10-year yen put option. That trade has not worked out so well. I don’t even want to open the envelopes from J.P. Morgan containing that information.

But I learned a lesson and I had a great deal of company. Many hedge fund managers and other investors made the same bet. In essence, we said that Japan is going to print money and the same thing will happen to it that happened to every other country in the same situation: The currency will lose value.

Instead, it brought one of the most surprising macroeconomic outcomes that I could imagine. Talk about thinking the unthinkable back in 2008. What happened is unthinkable to me, and to a lot of other people.

First, let’s realize that Japanese debt-to-GDP has risen to 253%. Notice in the graph below that the increases are much smaller each year. That is a (surprising!!!) point I’m going to make next.



For the last two decades, the Japanese have been promising they would balance their budget in 7 to 10 years—and they're actually beginning to make progress. Their fiscal deficit is in fact smaller every year in terms of GDP and actual numbers of dollars. Good for them.

Japan: Evolution of the deficit

Date	Deficit (M.$)	Deficit (%GDP)
2017	-154,022	-3.17%
2016	-182,017	-3.69%
2015	-167,104	-3.81%
2014	-273,287	-5.64%
2013	-407,827	-7.91%
2012	-533,972	-8.61%
2011	-581,597	-9.44%
2010	-542,983	-9.53%
2009	-533,973	-10.19%

Source: *Countryeconomy.com*

Books to guide your investment

The Philosophy of Wealth
How to identify the long-term share market winners.

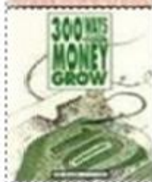
Physical: $8.99
E-Book: $4.15

Footsteps To Fortune
How to identify medium-term investment shares and effectively time the market
Physical: $8.99
E-Book: $4.15

Investment Without Tears
Richard Cluver's original best-seller: how to get started on the share market
Physical: $8.99
E-Book: $4.15

How To Make A Million
A step-by-step guide to the creation of investment wealth
Physical: $8.99
E-Book: $4.15

300 Ways To Make Your Money Grow
300 Investment growth solutions
Physical: $8.99
E-Book: $4.15



Making Money With the Mutuals
How to win as a unti trust investor
Physical: $8.99
E-Book: $4.15

The Simple Secrets of Stock Exchange Success
How to profit in stormy markets
Physical: $8.99
E-Book: $4.15

The Ten Minute Millionaire
Multi-millionaire status can be yours for just 10 minutes a day
E-Book: $4.15

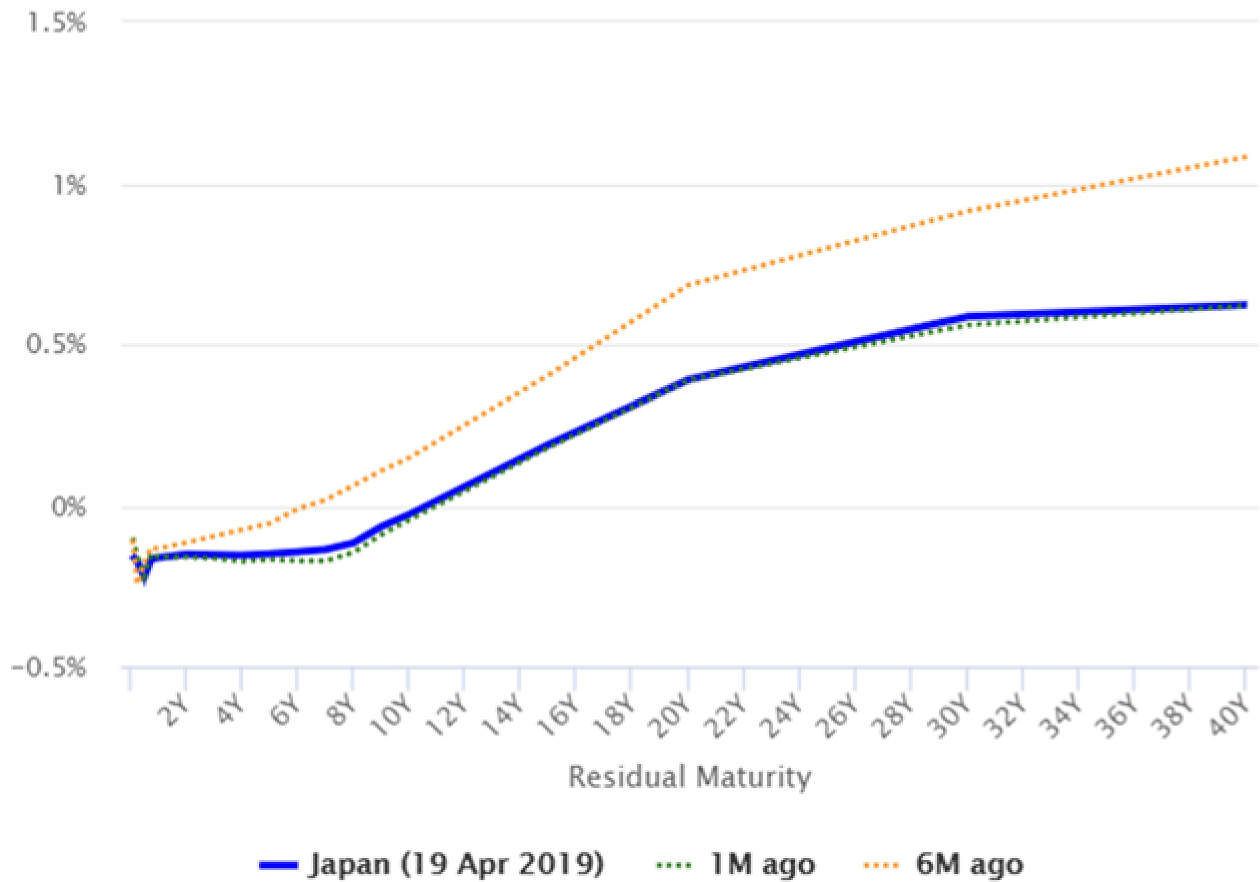
The deficit should fall even further as they have a small sales tax increase kicking in the fall of this year. It is, of course, controversial whether they will actually implement the tax, but I expect them to eventually do so. And sometime in the next decade, it is entirely possible that Japan will actually have a balanced budget, and then a surplus that lets the government begin paying down that debt.

Of course, they have to navigate global recessions, and all the ***sturm und drang*** and vicissitudes of life, but they are clearly trying to move in the correct direction. Kudos to Abe and Kuroda-san.

The Cost of High Debt

All this has not been without cost. It brought severe financial repression on savers. If you could somehow buy a new Japanese government bond, which is almost impossible because the BOJ buys everything that isn't nailed down, you would get negative yield. That's one reason Japanese savers are not selling their bonds. Even 1–2% on bonds bought "back in the day" is a lot more than they can get now.

The Japanese government bond market was once one of the world's most liquid. Now it trades by appointment. Here is the JGB yield curve right now. Notice it is negative out to 10 years. So if somehow you had bought a 20-year bond 10 years ago, which makes your Japanese bond now a 10-year bond (effectively), you would have a nice capital gain. But then where would you put the proceeds if you sold? That's why there are very few actual sales in the Japanese bond market.



As Lacy Hunt will demonstrate to us at the SIC, massively increasing debt actually reduces interest rates, productivity, and GDP growth, exactly as we see in Japan. They ran massive government debt, bringing future consumption into the then-present, and now must live in a world where that future consumption doesn't happen, GDP growth is negligible if not negative, and investors have to live by new rules.

To some degree, we already see the first evidence of that in the US. My good friend Ben Hunt notes that the S&P 500 companies have the highest earnings relative to sales in history.

Source: Ben Hunt

Quoting Ben:

> ***This is a 30-year chart of total S&P 500 earnings divided by total S&P 500 sales. It's how many pennies of earnings S&P 500 companies get from a dollar of sales… earnings margin, essentially, at a high level of aggregation. So at the lows of 1991, $1 in sales generated a bit more than $0.03 in earnings for the S&P 500. Today in 2019, we are at an all-time high of a bit more than $0.11 in earnings from $1 in sales.***
>
> ***It's a marvellously steady progression up and to the right, temporarily marred by a recession here and there, but really quite awe-inspiring in its consistency. Yay, capitalism!***

Ben goes on to say many people think that is because of technology. He argues it is the financialization of our economy and the Fed's loose policies. I agree 100%. If you think they haven't changed the rules since the 1980s and 1990s, you aren't paying attention, boys and girls!

It goes without saying that those profits are not going to labour, and the same monetary policies that were supposed to enhance the economy have contributed mightily to wealth and income disparity. When you muck around with the markets, don't be surprised if you get unintended consequences. We have them in spades, and everybody wants to blame "the rich" rather than the incentives the government and Federal Reserve created.

New Rules, or Moving the Goalpost

I don't think it is bearish to notice the political and arithmetic implications of our budget process. I want to help my readers understand that the rules are going to change. That is not necessarily a bad thing. It is just what it is.

The massive increase in debt, huge quantitative easing programs, and increased financialization of the investment process are going to change the rules of investing we have lived under for the last 50 years.

It is going to be difficult, more difficult than now, to get a positive return on your bonds without taking significant risk. And your returns are going to be lower. Think Japan. Think Europe. For that matter, think the US.

If somehow the gods of American football changed the rules so you needed 12 yards for a first down, the field was now 120 yards long, and gave a few advantages to receivers, the nature of the game would change. It would still be recognizable as football but it wouldn't be the game we know.

That's not unprecedented. Football in my father's day was significantly different from now. I'm sure there are people nostalgic for the way it was. I just want to watch the game as it is today. And when it comes to investing, if I have to change my style and look for different opportunities, it is just acknowledging a rule change.

I am not being bearish when I say there is the potential for future rule changes. I am simply pointing out what I see.

I think I am truly the most optimistic man in the room. Everywhere I turn I see opportunities. But then, I'm looking beyond my Bloomberg or business TV.

The world is changing around us and we have to adapt. Many won't notice the changes and end up like the dinosaurs. That is very sad. What will happen to people who are counting on pension funds is also going to be very sad. Or we taxpayers are going to have to step in and bail them out. As a taxpayer, that is also sad.

Is there a way out of all of this? Absolutely. We can overhaul the tax system like I wrote two years ago, actually balance the budget, fund all the entitlement spending, and watch GDP growth once again become part of our national conversation.

But it will take a crisis before we consider that. In the meantime, let's pay attention to how the rules are changing and adapt.

Now, how is that bearish?

The rules really are changing and past performance is not, and will not be, indicative of future results.