Our Monthly Free Newsletter

TheInvestor©

In our 33rd year of service to the investing public of South Africa

By Richard Cluver **August 2019**

Stepping outside South Africa as I frequently do these days has helped me to shape a world view that is deeply distressing. No matter where one travels the current public attitude is one of steadily deepening contempt for political parties and leaders who are demonstrably failing to put their people first.

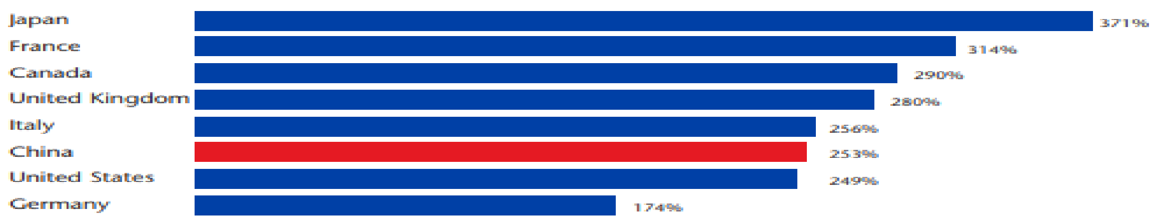
From America's Donald Trump to Britain's Boris Johnson and Europe's Jean-Claude Juncker, not to mention equally dangerous demagogues of the Third World such as North Korea's "Supreme Leader" Kim Jong-un, Venezuela's Nicolás Maduro and Turkey's Recep Tayyip Erdogan, the pattern of self-seeking power regardless of the best interests of the people is continuously evident.

It's hardly surprising that recent First World surveys have found that on average politicians command less public respect than used car salesmen. The latest in South Africa by Citizens Surveys put Cyril Ramaphosa's favourability rating at 62%, Ace Magashule at 11%, Pravin Gordhan at 26%, Deputy President David Mabuza's at 21% and Tito Mboweni at 29% while, outside the ANC, EFF leader Julius Malema's rating is now at 25%, a drop from 30% in the first quarter of 2019. DA leader Mmusi Maimane is at 28%. It's a telling testimony to the fact that ordinary folk long for change.

And while leaders posture, the world economy is like a runaway express train racing to disaster. Unable, or unwilling, to take the hard decisions of fiscal restraint now so compellingly necessary to end the global debt spiral, world leaders have turned to a new and clearly disastrous economic philosophy which argues that governments no longer need to exercise fiscal prudence since they also command the money supply.

The following graph, better explained in the following article by renowned US economist John Mauldin, succinctly sums up the problem:

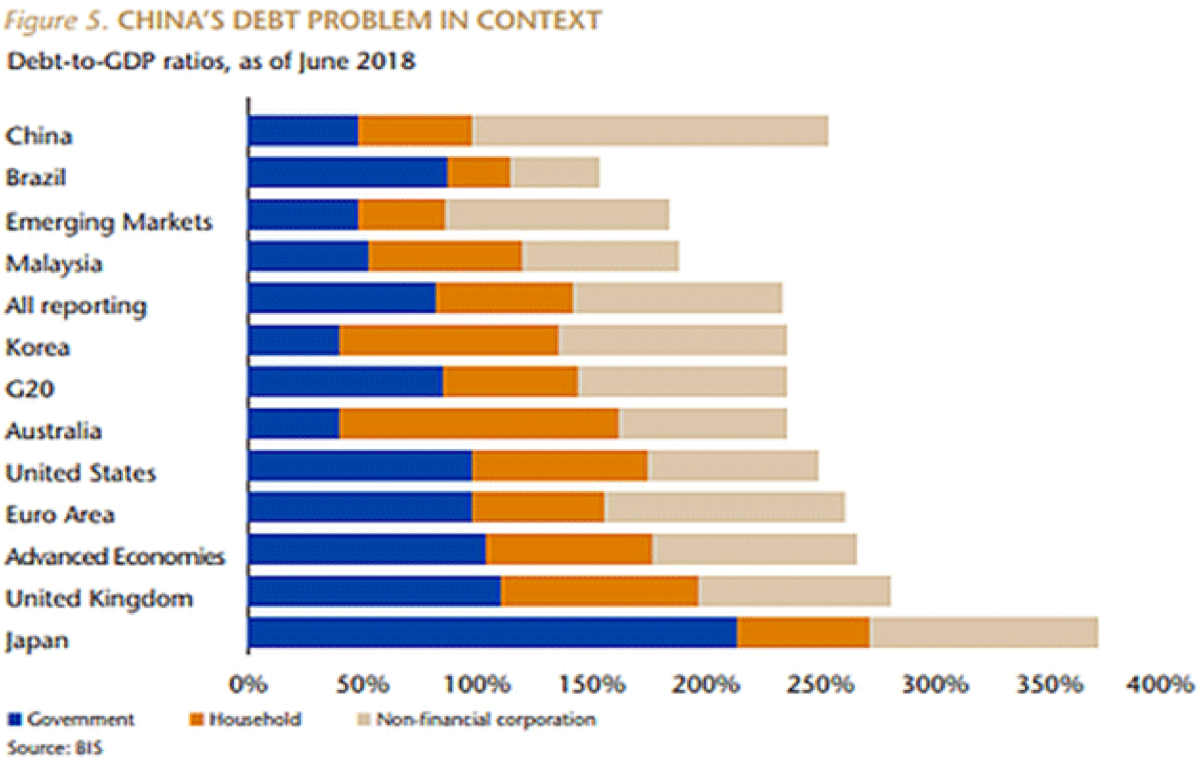
Figure 4. DEBT-TO-GDP RATIOS FOR G-7 AND CHINA, AS OF JUNE 30, 2018



Source: BIS

Now it is argued by China's economists that the most important difference between China's debt problem and past debt problems in Western countries is that in China there is little private-sector participation in debt creation. China's debt problem came in response to the Global Financial Crisis of 2008, when the state directed state-controlled banks to lend money to state-owned enterprises to carry out a public infrastructure stimulus program. There are no privately owned banks involved, so there is no mark-to-market pressure. As a result, and in contrast to the recent experience in the West, the Chinese government has the luxury of being able to control the timing of when bad loans are recognised and dealt with.

The following graph comparison illustrates how the composition of China's debt differs markedly from Japan's, for instance where more than 60 percent of the national debt is owed by the government and is largely internationally funded whereas only around 15 percent of China's debt in internationally funded.



All of this is, of course untested sophistry while the reality is that the world's debt rose by $3-trillion in the first quarter of 2019 following an almost unprecedented borrowing binge that brought total global debt to $246.5 trillion. That is why central banks have been forced to keep interest rates at unprecedented lows for over a decade at great cost to their retirees who currently struggle to obtain a fair return on their lifetime savings.

The big question then is what will happen when, notwithstanding interest rates which are often at negative levels once inflation is factored in, nevertheless exceed government tax revenue? What will happen when governments begin reneging on their sovereign bonds?

At the heart of the problem is the key issue of democracy which places governments in a social backstop position of having to provide housing, health care, financial assistance and a host of other services to an electorate which is increasingly dominated by economic “have-nots.”

Unable to raise sufficient income from taxes, governments have increasingly had to resort to borrowing to continue providing such services. Furthermore, taking into account evidence determined by organizations like Oxfam that all the financial engineering exercises of central banks since the economic crisis of 2008 have only served to increase the wealth of the top ten percent in society at the expense of the rest, politicians are now able to tap into a groundswell argument that the rich must be made to pay for the needs of the poor.

Easier said than done, however, since innumerable studies have shown that when any group believes it is being excessively taxed it ups stakes and moves away. When a nation loses its entrepreneurs it loses its ability to create jobs and so the ranks of the unemployed grow exponentially, a fact that neatly explains why South Africa’s unemployment rate has soared in recent years.

So where does that take South Africa as, increasingly our economists warn that the sheer inertia of our politicians in the face of an economic death spiral all but guarantees that we might soon have to prostrate ourselves before the International Monetary Fund for an economic bail-out?

Our own recent experience of politicians has arguably been worse than most other countries with every other day another corruption scandal leaving the public with the inescapable opinion that very few of our breed of politicians can be trusted to put the needs of the people ahead of personal greed and their own party political interests.

Which begs the question, do we really need them? According to the Independent Communications Authority of South Africa's smart phone penetration was 81.72% as at the end of September 2018. In other words, there are practically no South African households that do not have access to a smart phone and, furthermore, given the now widespread use of fingerprint and corneal recognition software in banking and other on-line transactions, it is now practical to conduct a referendum on every single issue of intended public policy.

In the “Good Old Days” when the public was truly represented by its politicians, one at least got to meet them in the weeks running up to a general election. They held “report back” meetings in their constituencies when they returned from Parliament and, furthermore, citizens with a problem or a gripe could visit them and at least get an explanation. Today in South Africa and pretty much everywhere else, the “Party” decides how its members shall vote and the Whips ensure the party line is followed.

And the truth is that the party line is decided by just six people; President Ramaphosa, his deputy David Mabuza, National Chair Gwede Mantashe, Secretary General Ace Magashule, deputy Jessie Duarte and Treasurer General Paul Mashatile. The 80 remaining members of the NEC in theory provide some guidance as do branches of the party but it is pretty much the case that the six top party members decide everything and all the rest do what they are told….and the ordinary citizen is virtually ignored within this design.

Since it is thus an open question whether politicians really represent the will of their constituents or serve any practical purpose at all, would it not be a great deal more representative to dispense with Parliament and hand the decision-making process directly to the public. The current process is, after all, a remarkably expensive one which South Africa can arguably ill afford. The lowest salary of an MP in the national assembly is R1,106,940 a year, or R92,245 a month.

Add to that all MPs qualify for:

- 88 single journeys a year (by air, train, bus or car)
- Daily commuting
- Travel to and from airports
- Parking at airports
- Relocation
- Travel for their dependants
- Tools of trade, including a cellphone, tablet and laptop
- Equipment and furniture for their offices
- Stationery
- Personal accident insurance
- Accommodation in parliamentary villages (three complexes in Cape Town that house MPs when parliament is in session)
- Transport from the villages to parliament

And of course a 100 percent pension for life after serving two terms of office!

Then, of course, in addition to the costs of individual parliamentarians there is the cost of Parliament itself; the price of maintaining buildings and paying the staff who run it all. According to the National Budget, R1.873-billion was set aside in the current financial year to pay for all of this.

Would we not be better served by a system within which public services like policing, public health, not to mention our State-owned enterprises whose Government guarantees alone stand somewhere north of R467-billion, are put out to public tender. Our medical aid funds might not be the best example to use, but given the current furore over the proposed National Health Bill, it is a reasonable probability that any one of the funds could do a far better job of running public health.

Similarly, given that Comair has turned respectable profits continuously for the past 72 years and last year made R325.6 million for its shareholders in sharp contrast to SAA which for this year alone is asking the State to bail it out to the tune of R21.4-billion, it is a no-brainer that private enterprise could do the job better.

Education is a costly disaster producing some of the worst outcomes in the world while private education companies like Curro are making massive profits for their shareholders simply because of public disenchantment with Government schooling. Last year Curro earned R248-million for its shareholders.

I could go on and on but I think the point is made. Private enterprise could do the job better at a far cheaper price and, since every contract could regularly come up for fresh tendering, a competitive bidding system backed by our respected judicial system would offer an effective barrier to the kinds of malfeasances that are commonplace within the present Parliamentary-controlled system.

Since the decision to move over to such a system would require our current political parties to effectively commit suicide and our Parliamentarians to vote themselves out of business, it would take a massive groundswell of public opinion to drive through such a change both in this country and overseas. Nevertheless it is clearly an option worth considering.

You Think the Fed Is One and Done?

By John Mauldin

I am sure Jay Powell and the rest of the US Federal Open Market Committee didn't expect recent bond market action. They cut rates hoping to mitigate or even remove the inverted yield curve, which is a pretty reliable recession precursor. The opposite happened.

Below is a yield curve snapshot from Bloomberg that Thursday after the markets closed. The 10-year bond yield dropped 14 basis points in just a few hours. It was a sporty 3.01% at this time in 2018. The three-month Treasury yield actually rose three basis points in the secondary market, making the yield curve even more steeply inverted than it already was.

Treasury Yields

NAME	COUPON	PRICE	YIELD
GB3:GOV **3 Month**	0.00	2.03	2.07%
GB6:GOV **6 Month**	0.00	1.99	2.03%
GB12:GOV **12 Month**	0.00	1.83	1.88%
GT2:GOV **2 Year**	1.75	100.02	1.74%
GT5:GOV **5 Year**	1.75	100.34	1.68%
GT10:GOV **10 Year**	2.38	104.36	1.88%
GT30:GOV **30 Year**	2.88	109.36	2.43%

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Source: Bloomberg News

President Trump didn't help matters by expanding tariffs on Chinese imports. Powell was quite clear that the Fed is paying close attention to trade data. The president gave them even more concerns for their next FOMC meeting in September.

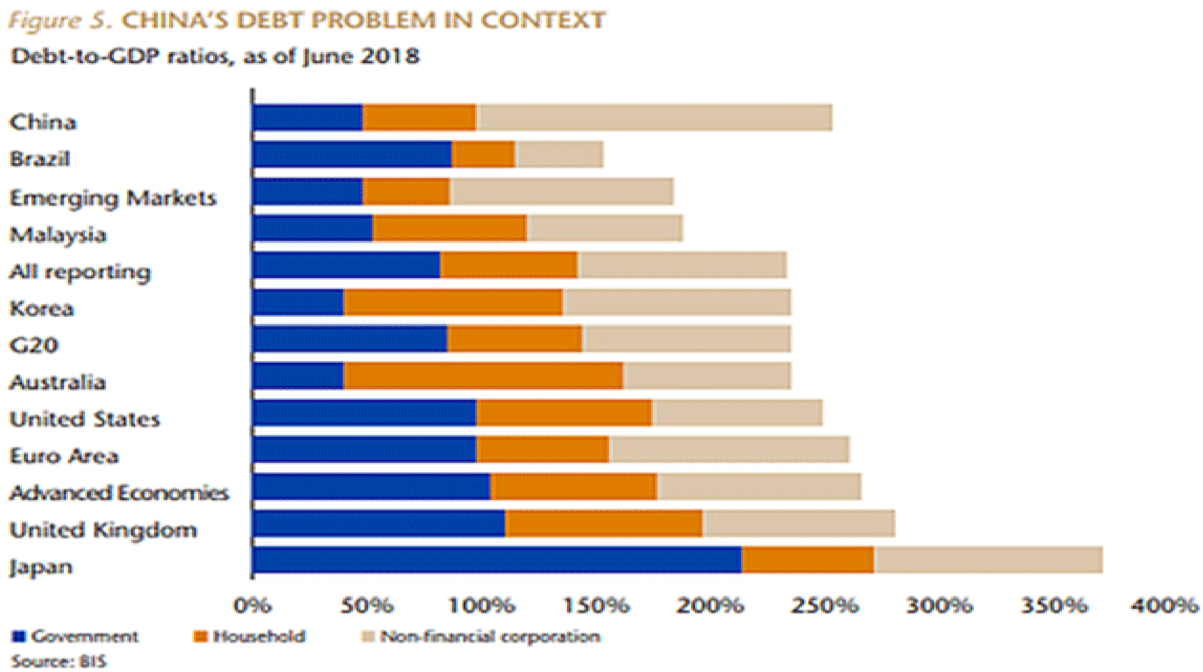
As I have written many times over the past 20 years, the longer an inverted yield curve persists and the deeper it gets, the higher the probability of recession within the next 9–15 months. Typically, the bear markets associated with recessions start even sooner.

That Thursday morning, the futures market saw 60% probability of another rate cut in September. By day's end, it was up to 90%.

Global PMI's are clearly showing a global growth slowdown, and we see distress signals in a number of US indicators. I don't think we're already in a recession but consumer spending is the only thing keeping GDP up right now. As long as that holds, GDP will remain positive. But when consumers get nervous (as a bear market could make them)? I think we'll see the GDP numbers roll over. I won't try to predict when, because betting against the US consumer is generally a bad idea, but it will happen.

And rate cuts hurt some 30 million US savers. We are once again on a destructive path of financial repression. This clearly hurts consumers, especially at the lower income levels.

As I keep saying, the world is awash in debt. Some of it is productive, but much is not. Here is a handy BIS chart (via my friends at Glidepath Wealth Management) combining government, household, and corporate debt relative to GDP.



Source: Glidepath Wealth Management

While some countries are more indebted than others, very few are in good shape. Direct your attention to the “All reporting” line. It shows the entire world is roughly 225% leveraged to its economic output. Emerging markets are a bit less and advanced economies a little more. But regardless, everyone’s “real” debt is likely much bigger, since the official totals miss a lot of unfunded liabilities and other obligations.

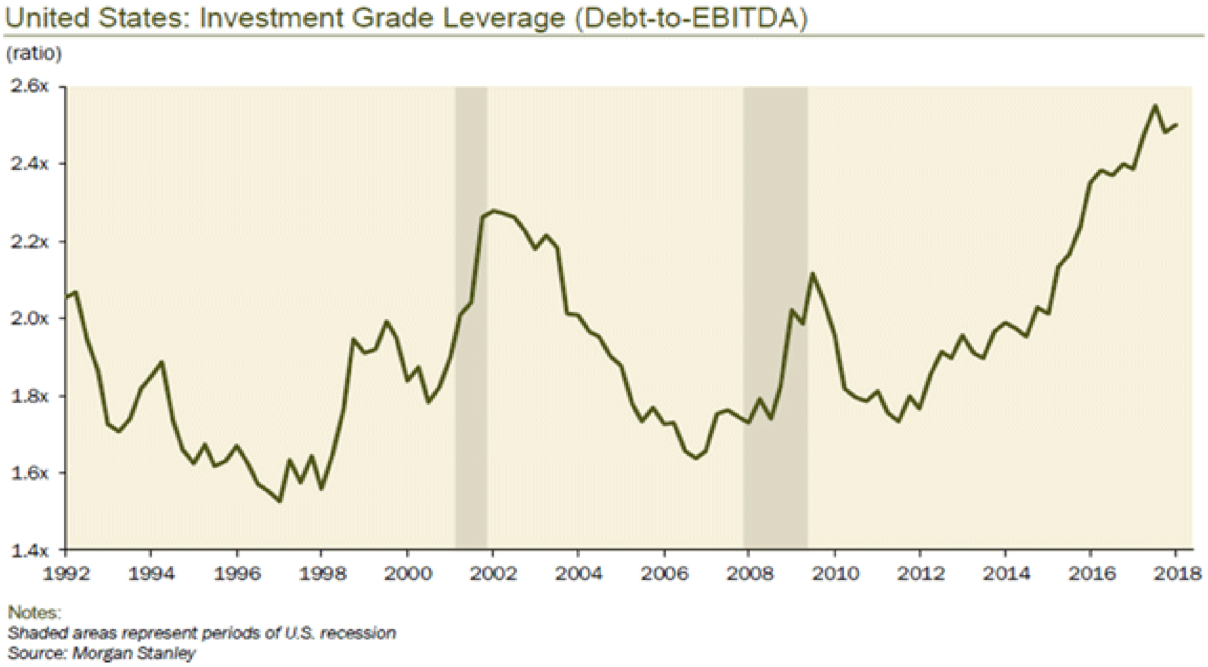
Debt is an asset owned by the lender. It has a price, which—like anything else—can go up or down. The main variable is the lender’s confidence of repayment, which is always uncertain. But there are degrees of uncertainty. That’s why (perceived) riskier debt has higher interest rates than (perceived) safer debt. The way to win is to have better insight into the borrowers’ ability to repay those loans.

In other words… if a lender owns debt in which his confidence is low, but you believe has value, you can probably buy it cheaply and, if you’re right, make a profit—possibly a big one. That is exactly what happens in a recession.

Investment Grade Zombies

While it’s easy to point fingers at profligate consumers, households largely spent the last decade de-leveraging. The bigger expansion has been in government and business. I’ve discussed government debt quite a bit lately, so let’s zoom in on corporate debt.

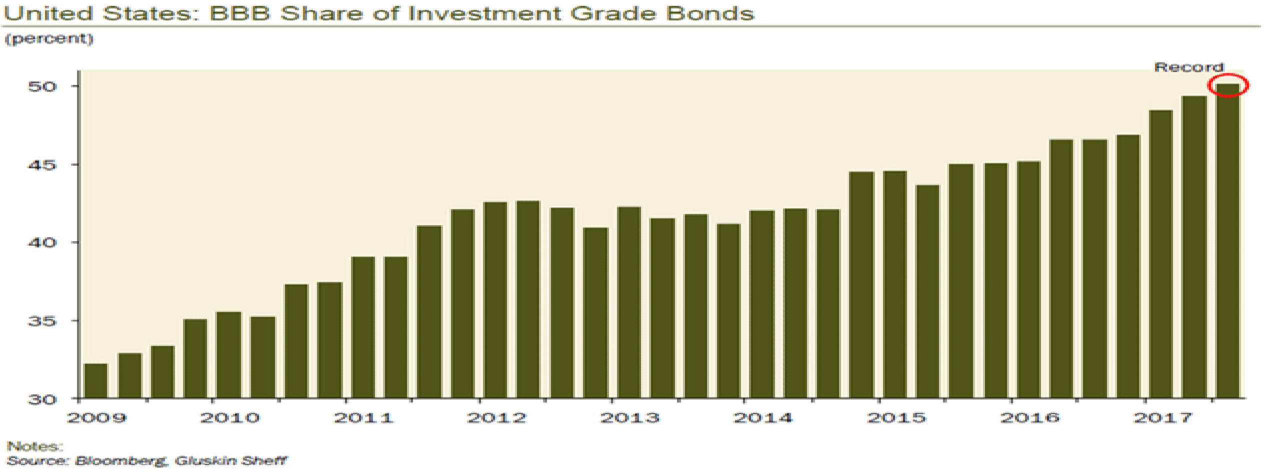
The US investment grade bond universe is considerably more leveraged than it was ahead of the last recession. Here’s a chart Dave Rosenberg shared at my Strategic Investment Conference.



Source: Gluskin Sheff

Compared to earnings, US bond issuers are about 50% more leveraged now than in 2007. In other words, they've grown debt faster than profits. Many borrowed cash not to grow the business, but to buy back shares. It's been, as Dave calls it, a giant debt-for-equity swap.

There's another factor, though. Today's "investment grade" universe contains *a higher proportion of riskier companies*. The lowest investment grade tier, BBB, now constitutes half of all issuers. All these are just one downgrade away from being high-yield "junk bonds." The best data I can find shows that there are roughly $3 trillion worth of BBB bonds and another roughly $1 trillion worth of lower-rated bonds that would still be called "high-yield."



Source: Gluskin Sheff

If it happens like last time, the ratings agencies will wait until their fate is already sealed before they cut ratings on these zombies. But that's only part of the problem.

Last year, I wrote extensively about a forthcoming High Yield Train Wreck. The Fed was still tightening rates at the time; their subsequent policy change has slowed down the process, but the train is still moving. I expect liquidity in these below-investment grade bonds to disappear quickly in the next financial crisis.

We got a small hint of how this will look in the December 2015 meltdown of Third Avenue Focused Credit Fund (TFCVX), which had to suspend redemptions and then spend two years liquidating its assets. As I said at the time, the fund managers made the right call to liquidate their holdings slowly, getting the best values they could. They ultimately recovered far more of the losses than they would have by selling under pressure. But that won't work if the entire fund industry is strained at the same time.

This is a structural problem with mutual funds and ETFs. They must redeem their shares on demand, usually in cash (though some reserve the right to do it in-kind). This can, if enough shareholders want out at the same time, force them to sell fund assets on short notice.

Average investors who don't trade large blocks often don't get how hard this is. Let's try a more familiar example.

Say you want to sell your house and move to a different state. Normally, you would set your price, take your time, and wait for a buyer who will pay it—or at least get close. You generally have the luxury of "price discovery" over time.

But imagine your mortgage lender says you must make a balloon payment three days from now or lose the house completely. You will then have to find a buyer fast or face a giant loss. In that scenario, you can't really afford to wait. You take the first minimally acceptable offer and run.

That's more or less what happens when a mutual fund gets mass redemptions, particularly in already-illiquid segments like junk bonds. Those who might buy its assets smell blood and make lowball offers. The fund manager must either take them, or do what Third Avenue did and shut down the entire fund permanently, slowly liquidating and paying investors over a much longer period. That is a career-ending, business-ending event for the managers, not to mention investors who can wait years to get back what's left of their money.

This is a horrible situation for both fund manager and investors. Even long-term investors get hurt. But we don't hear much about the other side: those who ***buy*** the distressed, must-sell-now assets at steep discounts to face value. Which would you rather be?

Falling Apart Quickly

When the recession hits, we will see junk bonds—and the riskier end of corporate debt generally—go into surplus. There will be more available for sale than investors want to buy. The solution will be prices dropping to a point that attracts buyers. I don't know where that point is, **but it's a lot lower than now.**

But there's a problem. We talked about that $3 trillion worth of BBB bonds. Any that are downgraded by merely one grade will no longer qualify as "investment grade." That means that many pension funds, insurance funds, and other regulated entities by law won't be able to hold them. They have a very short time to sell them back into the market.

Let's say company X issues $100 million of a bond rated BBB by Moody's or Standard & Poor's. There is a high likelihood that some will be in regulated pension or insurance funds, and there will be forced selling at lower prices. This will set a new price for that bond issue. Every mutual fund and ETF that holds those bonds will have to use the lower price when they mark-to-market at the end of the day.

This happens all the time, but in a recession, there is a great deal of forced selling. Investors in huge high yield and "investment grade" bond funds start to look for an exit as the price of their funds fall, which forces the funds to sell bonds "at the market price." Except in a high-yield bond bear market, the bids go much lower or simply disappear. The normal buyers of those funds are what you would typically characterize as "distressed debt" funds.

They will be looking to buy as cheaply as they can. At moments like that, distressed debt funds sit back and see how far down prices will go before competing distressed debt funds step in and start to buy—establishing a "floor," if you will.

I have seen this happen three times in my career. Yields go from fairly low to 20% or more at what seems like warp speed. If you are in one of those funds, you're going to see your value drop precipitously. Unless you are a professional and/or have some systematic trading signal that tells you when to trade, it's probably best to avoid anything that looks like a high-yield mutual fund or ETF.

More money is going to be lost by more people reaching for yield in this next high-yield debacle than all the theft and fraud combined in the last 50 years.

I can understand the plight of retirees who are struggling to live on today's meagre yields. Those high-yield funds have been so good for so long, it's easy to forget how disastrous a bear market can be. But it gets worse.

Quick personal story, and I have to be vague about names here. Some bond issues have been bought in their entirety by a small handful of high-yield bond funds. The problem is that the company that issued these bonds has defaulted on them. Not just missed a payment or two, but full default. Their true value, if the funds tried to sell them, ***might*** be 25–30% of face if they actually traded, according to the people who told me this. But the funds still value them at the purchase price of $0.95 on the dollar.

How is it they're still valued much higher? Because the funds haven't tried to sell them. No transactions mean they can still be "priced" at the last trade, and since there have been no subsequent trades, there is no "mark-to-market" price.

If any of those few funds sold any of these bonds, it would set a "market price" and all would have to mark down the entire holding. So naturally, they aren't even trying. They would rather hold these bonds at what they know, realistically, is a huge loss, than take the hit to their NAV.

So here's my question: How many ***other*** junk bond issues are in similar positions? Note this isn't just high-yield funds. Lots more "conservative" bond funds try to juice their returns by holding a small slice in high-yield. Regulations let them do this, within limits, but these funds are so huge the assets add up.

If funds are carrying assets whose market value (if there were a market) is half or less of their currently booked value, that tells me this game could fall apart ***very*** quickly. Any event that triggers redemptions could set off an avalanche.

I don't know what that event would be, but I'm pretty sure one will happen. My own goal is to be a buyer, not a seller, whenever it occurs. For now, that means holding cash and exercising a lot of patience.

If I'm right, the payoff will be a once-in-a-generation chance to buy quality assets at pennies or dimes or quarters on the dollar. I think the next selloff in high-yield bonds is going to offer one of the great opportunities of my lifetime.

In a distressed debt market, when the tide is going out, everything goes down. Some very creditworthy bonds will sell at a fraction of the eventual return. This is what makes for such great opportunities. They only come a few times in your life.

There will be one in your near future.

Footnote: In the late 1980s it was possible to buy South African bonds at a yield in excess of 22 percent. As recently the then much-favoured Eskom 170 bond could be bought at a yield of 19.43 percent in August 1998 and that yield subsequently fell to 6.18 percent in May 2013 offering investors who bought at the peak an approximately 300 percent capital gain along with annual interest payments nearly seven times higher than prevailing blue chip shares dividend yield rates. Back then buying them was a no-brainer. Note my graph of the period:

Richard Cluver

The end of a postage era

By Ruan Jooste of **BUSINESS MAVERICK**

Drowning in paperwork, and with postage costs running into the millions with most envelopes returned to sender anyway — that's a casualty of past regulation for companies listed on the JSE. That is what was required to service the last of the countries about three million individual shareholders. But that paper trail is about to come to an end.

No shareholder shall be left behind. That was the intention of the various pieces of legislation that preceded the Financial Markets Act that came into play in 2014. The old laws said that for every circular released, interim report published and annual report made available, a listed entity shall send a copy to every individual shareholder by post, via the SA Post Office.

The regulators wanted to make sure everybody remained in the know. But this intention was never fully realised, despite the cost and effort involved for issuers.
Anglo American Platinum, for example, reports that it cost the company R690,000 in 2018 to send by registered post its printed annual report to each of its shareholders within this pool. Company secretary Elizna Viljoen says most of the copies weren't even collected from the Post Office.

But things are about to change. The law already has. The FMA allows for such correspondence to be distributed digitally, just as long as shareholders are informed of the fact. This can be done via cellphone messaging.

And so, the JSE division of issuer relationships and company services, headed by Ursula du Plooy, will launch a digital post box solution to be made available to each of these shareholders by the end of August 2019, and at no cost to them.

"It's a cloud-based letterbox accessible from anywhere, but centrally managed by the JSE, says Du Plooy. It has full audit trail functionality, so every deposit, extraction or other interaction will be logged and the involved party tagged, she says.

Apart from corporate communication, the JSE will distribute educational literature to shareholders on the intricacies surrounding their investment.

"You can also access your proxy form there, complete it and make it available to the JSE in a flash, which can then present it on your behalf at the annual general meetings at the required time," she says.

A linked electronic voting system will also be made available, she says, which will allow shareholders to execute their votes on their own terms.

The issuers will carry all the cost involved in providing such services to shareholders.
Viljoen says the time has come to think differently in how to communicate with shareholders.

"The Post Office is not effective and the costs involved are ludicrous", she says. "Now all communication will be available in one place, be easily accessible and we can track who has accessed the information and who has not. We are very excited about the benefits the solution will bring."

From late 2018, this department has offered the facilitation of AGMs from its premises in Sandton. Formerly, this was a function reserved for central-depository participants Computershare and Link Market Services, the only two other organisations in the country that look after this category of shareholders.

The JSE has turned up the heat since entering the fray and has facilitated more than 45 AGMs since 2018, including that of Standard Bank and the JSE itself.
With fewer IPOs coming to market and trading volumes down, the establishment of a central communication hub and related service offerings opens up a new revenue stream for the exchange.

JSE Equity Market revenue decreased by 26% to R206-million in the six months to June 2019, the company recently reported.

E-voting platforms have become quite the rage in SA and in other countries with the current proxy voting system for AGMs increasing in complexity. Bits and pieces have been added to the process through regulation, the growing influence of institutional investors has skewed the voting pool and the fact that companies are no longer restricted by the proximity of their owners has blurred the lines of communication.
For appointed proxy representatives, the waters get muddier by the minute when considering the time spent on figuring out who the shareholders are and confirming their voting preference.

The e-voting revolution will clean up a lot of that mess. In 2017 Strate, the authorised South African Central Securities Depository, announced that it would partner with Nasdaq to deliver a new blockchain solution that would bring electronic voting to local capital markets.

"By transforming both front and back offices, the Strate e-Voting Solution eliminates several inefficiencies in the market including proxy forms, voting reconciliation and letters of representation. Investors and custodians can vote prior to the meeting in person at the meeting or remotely," says Gregory Naicker, head of product development.

They have the flexibility to change their votes and appoint proxies at any time up until the resolutions close at the meeting, directly on the system. By using the e-voting system, voters will have control over the voting process and their voting will be transparent."

Naicker says Strate is in the "user acceptance testing phase" and will go live on 1 December 2019.

Computershare is not actively involved in the solution just yet. It has an international product being developed by Citi Bank called Proximity that will be a market-wide solution, the company says.

Keep SA Interest rates unchanged

By Brian Kantor

The wise thing for the SA Reserve Bank to do is to leave the exchange rate to find its own level, while basing its interest rates decisions on the outlook for the domestic economy.

The famous phrase by Yogi Berra, "It's déjà vu all over again," does not quite do justice to the recent turmoil in the SA currency and debt markets. The hope for a weaker dollar and stronger rand, as well as the lower interest rates, inflation, and faster growth that comes with a stronger rand, has once more been dashed.

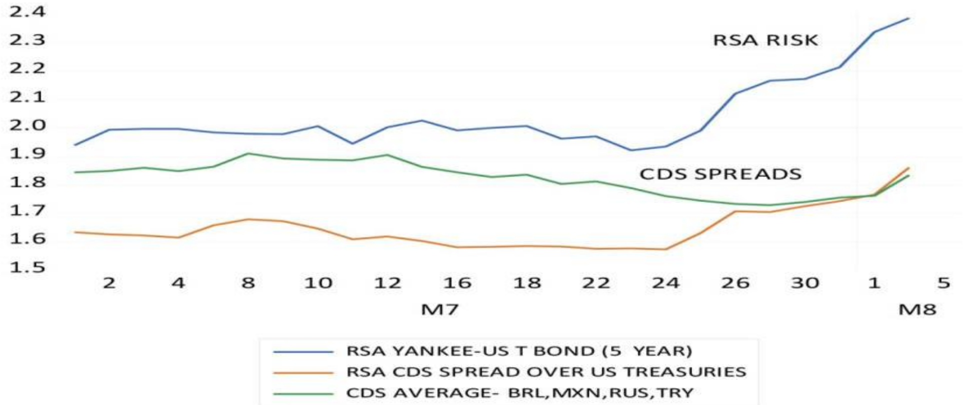
Trade wars and currency manipulation do less damage to the US economy than to others, simply because the US is less dependent on global trade and more dependent on the US consumer.

Hence in times of trouble, capital flows towards the US, raises the exchange value of the US dollar and depresses bond yields. Emerging market exchange rates weaken more than most and emerging market bond yields rise. The rand generally falls more than most other emerging market currencies.

Funding government debt has become more expensive, even as the volume of debt to fund extraordinary spending on Eskom increases at a very rapid rate. Long-dated SA government-issued (RSA) debt now offers an extra 8% over US Treasury bonds and almost as much extra when compared to other developed market issuers (many of whom now borrow at negative interest rates). SA is now paying 3% more than the average emerging market on its debt (in their domestic currencies).

For the government, raising US dollars has also become more expensive. Raising five-year dollar-denominated debt now requires an extra 0.4 percentage points (40 basis points) more than it did in early July 2019. The cost of insuring RSA foreign-currency debt against default has risen similarly and more than it has for other emerging market borrowers.

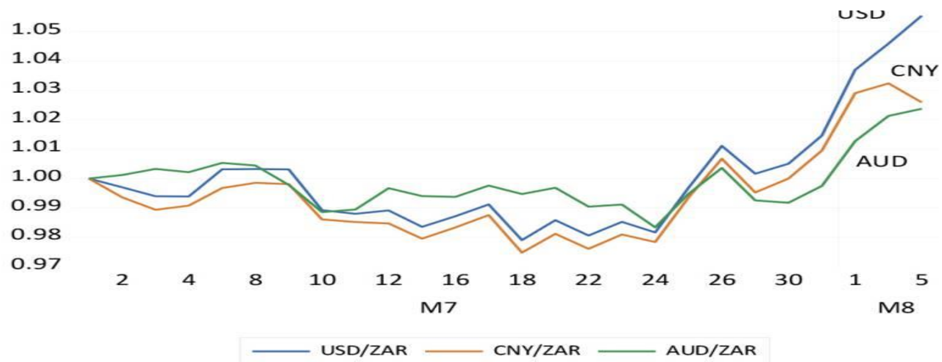
Sovereign risk spreads for RSA and other US dollar-denominated debt



Source: Bloomberg, Investec Wealth & Investment

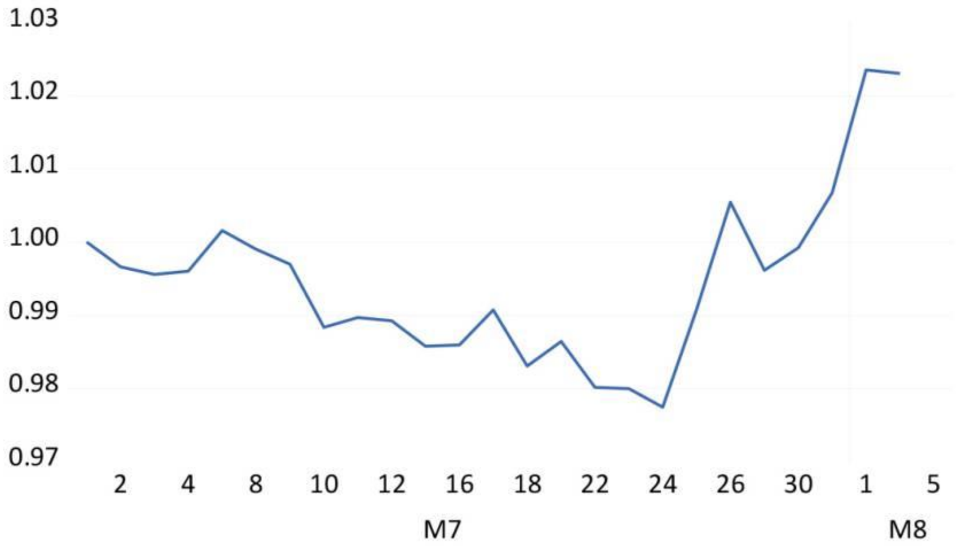
The rand moreover has performed particularly poorly when compared to other commodity and emerging market exchange rates. Since early July, the rand is about 6% down vs the US dollar, 3% down on the Chinese yuan and about 2% weaker vs the Aussie dollar and a basket of nine other emerging market currencies.

The USD/ZAR compared to the yuan and Aussie dollar (1 July = 1)



Source Bloomberg, Investec Wealth & Investment

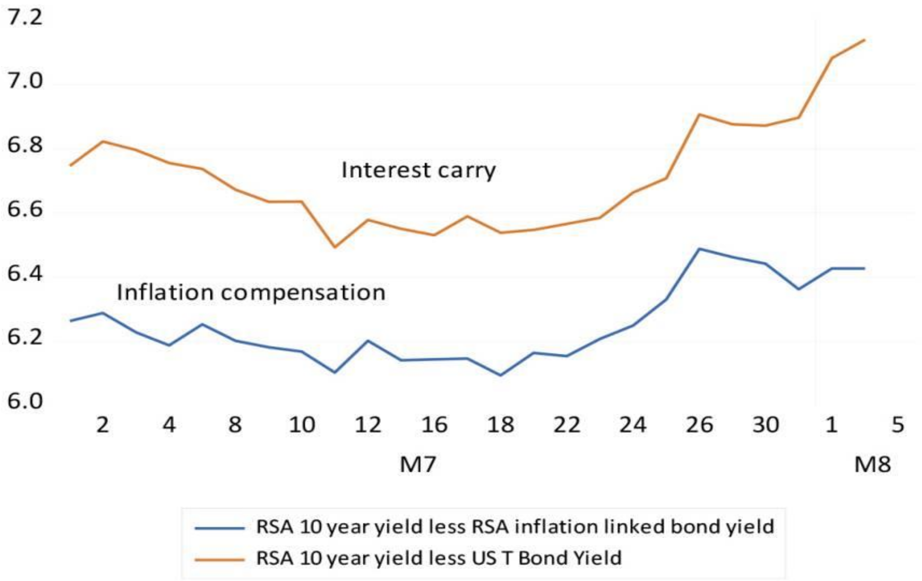
The USD/ZAR vs an equally weighted basket of nine emerging market exchange rates



Source Bloomberg, Investec Wealth & Investment

The cost of buying dollars for forward delivery has thus also widened, as has the compensation for bearing inflation risk in the RSA bond market. Both spreads are now over 6% for 10-year contracts. The attempts by the Reserve Bank to reduce inflation expected, by containing inflation itself (now about 4.5%, an outcome achieved by depressing domestic spending), have accordingly failed.

The RSA bond market interest rate carry and inflation compensation. July-August 2019 (10 year yields)



Source: Bloomberg, Investec Wealth & Investment

It should be recognised that the relative weakness in the rand and RSA bonds actually preceded the impact of the latest Trump tantrum. The Trump tariff threats came only at month-end. The earlier attacks of the Public Protector Mkhwebane on President Ramaphosa moved the market ahead of Trump.

What then can be done to mitigate this volatility and the damage it causes to the SA economy? The Reserve Bank cannot hope to anticipate exchange rate volatility with any degree of accuracy, or impose higher interest rates that offer no defence for the rand; they can only depress demand and growth further. The wise thing to do would be to leave the exchange rate to find its own level and accept higher inflation or the expectation of higher inflation that might follow (and which can easily reverse). The case for cutting or raising interest rates should be made only on the outlook for the domestic economy, which has not been improved by recent global events.

The Reserve Bank has called correctly for structural reform of the kind the President and his cabinet has responsibility for. It demands reforms so that SA can avoid the debt trap that Eskom has led us into. Any confident sense that SA can address its structural weaknesses will bring immediate reward, in the form of lower interest rates and lower expectations of inflation.

There is some consolation in recent events. The oil price in rands is no higher than it was. It would have been more comfortable had SA still been producing gold on something like the scale of previous years. A mining charter that revives the case for investing in SA mining, would be a confidence booster.

Brent oil rands per barrel

Source: SA Reserve Bank, Bloomberg, Investec Wealth & Investment

What I Learned at Camp Kotok

By John Mauldin

I am back from my 14th annual Maine fishing camp and the mood was decidedly different this year. The private event at Leen's Lodge is generally called Camp Kotok in honour of David Kotok of Cumberland Advisors who started these outings many years ago. CNBC and others began calling it the "Shadow Fed" but it is really just a meeting of wickedly smart people focused on economics and markets.

Throw in a little fishing, more fabulous food and wine than anyone should consume, formal debates and informal Q&A, and it really is one of the highlights of my year.

All this happens at a fishing lodge without many luxuries except for the food which is off the charts in the evenings.

For lunch, all the boats meet at one spot and the guides cook what we catch in a 2+ hour experience. (Only the hardcore go out fishing afterwards.) The lunch conversations are simply fascinating.

This year's conversations focused on three key long-term themes which were discussed one by one.

1. A future where global interest rates remain permanently near zero

2. Modern Monetary Theory (MMT) and US fiscal strategy

3. A fundamental change in the US/China relationship

Kotok offers a quick introduction:

> ***The 50-person gathering at Leen's Lodge encompassed diverse political views, financial and economic specialties, and asset classes focused from cannabis to currency trading, real estate to debt of all types, stock markets and ETFs, derivatives and futures, and more. Over $1 trillion in managed assets was represented as we gathered for each informal meal. No lectern, no PowerPoint. The China Panel and the MMT panel are public and in the social media domain and the press and public are free to use the video footage and quote the speakers. Other discussions were conducted under the Chatham House Rule.***

I was not around for the Thursday night survey, when 40 people were asked their opinion of Peter Navarro. One person supported him, three had no opinion, and 36 disapproved. It would have been 37 had I been there. I have said many times that Peter Navarro is the single most dangerous man in the Trump administration.

He understands neither trade policy nor trade deficits and yet seems to have a Svengali relationship with the president. I missed that part of the discussion but Kotok summarized:

The damage incurred by Navarro's advice and Trump's policy was catalogued in detail, and it is ugly. It is spreading and appearing in more and more evidence and anecdotes.

Border and immigration policies were discussed in detail and with data. The group's outlook is bleak. Nearly all fault a dysfunctional Congress for its repeated failures. Here the group leaps over partisanship. Democrats and Republicans are guilty.

A big majority of a diverse group generally agreed the tariffs were having a global impact, slowing growth elsewhere in ways that will come back to haunt our own shores. Nearly everyone was glad Trump is pushing back on China, but most thought he should do it in another way. (As my friend Gary Halbert asks, why does China still have Most Favoured Nation status?) Tariffs hurt Americans. If you want to draw a line, get together with our allies and tell Beijing it needs to stop the intellectual property theft and allow competitors a level playing field or the rest of the world will move on without them. Now that's getting tough. Hardball? Yes, but I think we are all beginning to realize Chinese leaders are not our friends.

MMT or the Magic Money Tree

There was an open "debate" about MMT or Modern Monetary Theory. Brilliant young economist Sam Rines took the difficult position of being pro-MMT for the sake of debate. He thinks it would be a disaster but is truly afraid we will actually pursue such a policy. There was the usual pushback, which I've written about more than once, but I have to admit that I was struck by the private conversations after the debate. Many smart, well-informed thinkers were almost resigned to seeing MMT actually attempted in the next decade.

Mauldin take away: If we attempt MMT it will end the US dollar's reserve currency status, produce out-of-control inflation that will essentially destroy the Boomer generation's ability to retire with anything like most envision today. I can't say it any stronger. If I really see MMT coming I will reposition my portfolio to heavily weight gold, real estate, and a few biotech companies. I simply can't imagine a more dire economic scenario.

Honestly, though, I don't think we will go there. Are there politicians that would like to do it? Absolutely, and they have less economic understanding than God gave a goose. Even economists with whom I strongly disagree on many topics think MMT is not something to be trifled with.

Many participants had read my analysis of the potential for $45 trillion worth of US debt by the end of the 2020s. When I started talking about the potential for $20 trillion of additional quantitative easing, it was clear the question made some uncomfortable.

There was general agreement that neither political party can balance the budget. The latest "deal" between Trump and Congress raised spending $320 billion over the next two years. The previous "sequester" deal that at least tried to limit spending is out the window. With it will go any control on the spending process. Current deficit projections will seem mild compared to what we actually get.

Using CBO projections from earlier this year and assuming one recession, the national debt would rise to almost $45 trillion by the end of the 2020s. This new deal will add at least another $1.5 to $2 trillion to that amount. If there is a second recession, we would be looking at north of $50 trillion.

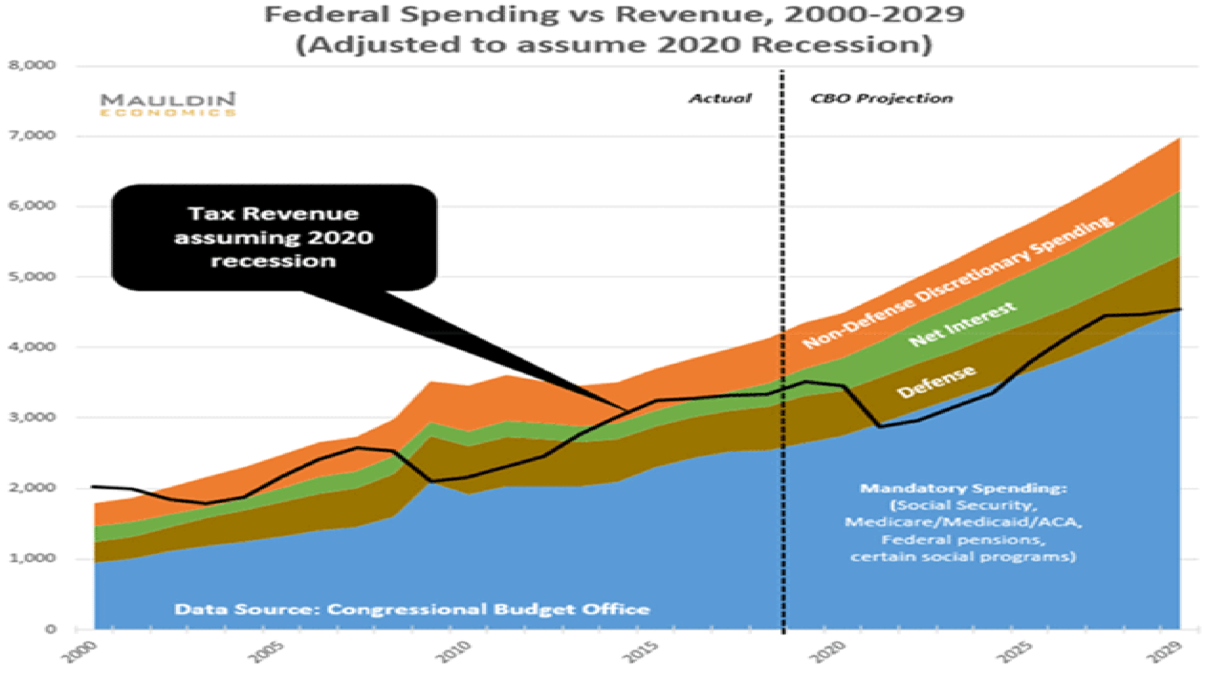
We don't have $40 trillion, let alone $50 trillion, to put into federal debt. It would crowd out all funding for productive private enterprises and sharply reduce GDP growth. Which is why I expect to see massive, currently inconceivable amounts of quantitative easing.

The 2020s will force us to continually think the unthinkable. No, that is probably too mild. We are going to find ourselves having to *continually DO the unthinkable.*

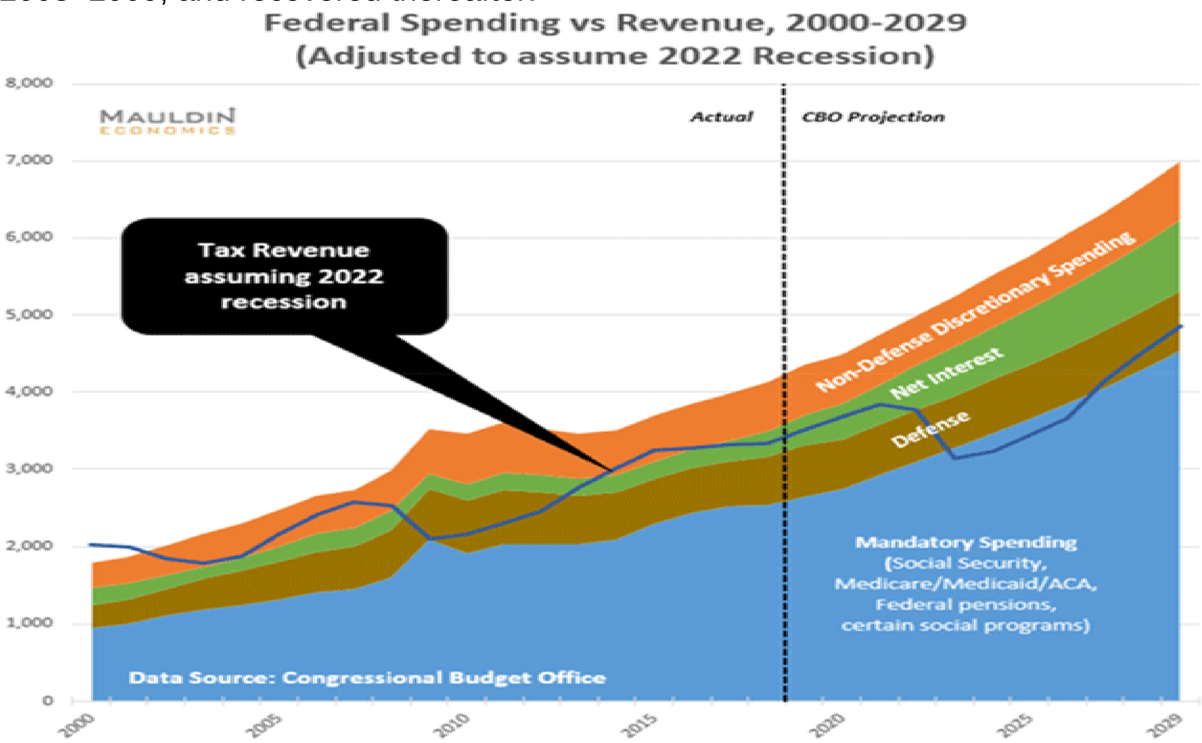
Doom and gloom? Not really. The math is from the Congressional Budget Office. It is politically impossible for them to project a recession, so they don't. I would also admit that it is also statistically impossible to predict a recession so they don't. I don't have such a restriction.

These charts assume recession in either 2020 or 2022. You can see what happens to the deficits and revenues.

The first graph assumes a recession in 2020. Note that revenues fall below mandatory spending by the middle of the decade, then never get back above mandatory spending plus defence spending. Then by the end of the 2020s mandatory spending will again rise to consume all tax revenue. And again, these don't include significant off-budget spending.



This next graph assumes recession in 2022 instead of 2020. The pattern is basically the same, except that the $2-trillion deficits don't begin until 2023. Again, this uses actual CBO projections and adjusts revenues by the same percentage they fell in 2008–2009, and recovered thereafter.



I asked one person after another what they thought would happen. How can we avoid this? I got no good answers. Others were clearly just as frustrated as I am.

Let me tell you, I am way past frustration. I am seriously worried for the future of the Republic and our children and retirees.

I asked at least a dozen attendees (and maybe more) this question: ***If we introduce MMT and the result is what we all think it will be, I think there is a 50–50 chance some states will want to secede from the union. Do you agree or disagree?***

I got literally no pushback on that admittedly outrageous idea. When you undertake policies that will destroy the very fabric of society in the name of "justice and equality for all," those damaged in the process will push back.

The debate on MMT had some lighter moments. Everyone chuckled when one panellist called MMT the "Magic Money Tree." After someone said MMT could be used to fund universal health care and Space Force investments, Jim Bianco (channelling John F. Kennedy) said: "We choose to go to Mars, not because it's easy, but because it's free."

A Fundamental Change in the US/China Relationship

We talked quite a lot about China. Brent Donnelly said this in his Camp Kotok wrap-up:

It was interesting to hear how it now seems to be almost universally accepted that the United States is in a multi-year, multi-front (so far, non-military) war for global supremacy against China. No trade agreement is going to change that. The first challenge to US hegemony since the USSR. Attendees at Camp Kotok run the entire political spectrum but this issue seems almost totally non-partisan.

It was notable how even while many did not agree with the US escalation strategy against China, there was broad agreement that China should be challenged. The China/US long-term decoupling is an issue that will continue post 2020, whoever wins. A rare bipartisan issue.

A good part of the discussion centred around the book "China's Vision of Victory," written by Jonathan Ward, one of the attendees. Ward, a US citizen, told remarkable stories of boarding container ships, learning Cantonese and pidgin Indonesian, living in rural and urban China for several years and translating every document publicly released by the Chinese Communist Party to better understand China's motivations as it rebounds from the Century of Humiliation.

Dave Nadig wrote about his question-asking experience:

This year, my question was: "What's one thing—a risk, a concern, a data point, a situation—that's really important, that the rest of the econo-finance sphere isn't paying attention to?"

The answers here were dizzying. While there were a few somewhat predictable answers like, "We're in a corporate earnings recession and nobody's talking about it," there were also some big surprises for me, such as:

- *The entire global maritime fleet has to change fuel types in five months, <u>and it's going to cost a ton</u>.*

- *The New York PMI (producers manufacturing index) is flashing red lights about the service-based economy.*

- *Geopolitics is being swept under the rug, leaving us open to a "hot war" while we focus on all the economic wars.*

- *The risk from Chinese corporates like Huawei is enormous.*

- *The degradation of the National Weather Service is going to destroy US agriculture.*

The list of terrifying one-liners goes on and on.

Nadig and I, along with others, noticed the, for lack of a better term, political fatigue in the room. Normally there would be some passionate discussion, especially when under Chatham House Rules you can’t be quoted. Here’s Nadig again:

This year, the political discussions petered out quite quickly. It wasn’t disinterest that defused things, it was bone-penetrating exhaustion. Even folks I would’ve pegged as the most die-hard partisans seemed to have a hard time mounting a fervent defence of any politician or appointee. The opinions were still there, but the will seemed to have faded.

I feel the same way. Any thinking about policy for the last few years has been waylaid by a discussion of the people behind the policy.

Bone-Penetrating Exhaustion

That is as good a way as any to describe the mood in the room at the end of Saturday night. Bone-Penetrating Exhaustion. It is like we are staring into an abyss, it’s a long way down, and we simply don’t know what to do. Oh, there were ideas tossed around: infrastructure bonds to stimulate the economy funded by the Federal Reserve, different ways to fund the deficits that everybody can see coming. But we all agree that there is no political will to stop them.

I spent a long time talking with one of my favourite philosophical economists, Dr. Ben Hunt of Epsilon Theory fame. While we have some minor disagreements, we share the sheer frustration, the sheer worry about the policies our current government has been pursuing and what they will do to the retirement hopes of the Boomer generation, let alone the growth potential to fund the hopes and dreams of the Millennials.

We talked about how to help people get through what is going to be a very volatile and difficult time. I will share more on that in future letters.

I know this has been a little bit of a Debbie Downer letter. When the consensus is that we are going back to the zero bound on interest rates, we’re literally screwing an entire generation. People who have saved and worked and bled will be rewarded with zero interest rates and the need to take more risk in retirement, exactly the wrong time in their lives to be taking risk.

The Big Con: Reassessing the “Great” Recession

By Laurence Kotlikoff

Everyone knows what caused the Great Recession (GR). Bad banks issued bad mortgages. Bad bankers overleveraged. Bad shadow banks evaded regulators. Bad rating companies overrated securities. Bad regulators fell asleep at the wheel. Bad households drove up house prices. Bad derivatives expanded. Bad traders overtraded.

In sum, bad banks full of bad bankers did bad things.

Some degree of bad banking is a given. But this time was different. Virtually all outstanding mortgages were subprimes, and virtually all subprimes were no-doc, liar, NINJA, or other forms of fraudulent loans. Bank leverage reached record levels. Massively bribed rating companies gave triple-A ratings to securities that were triple-F. Regulators were totally outgunned, outnumbered, and out of touch. House prices soared forming an incredible bubble. Derivatives became “weapons of mass destruction.” Trading grew exponentially. And well-greased politicians looked the other way. The Financial Crisis Inquiry Commission (FCIC) summed it all up in two words: “pervasive permissiveness.”

There’s just one problem with this narrative. It doesn’t fit the facts. Worse, it diverts attention from the real problem. The real problem wasn’t bad actors misusing a good banking system. It was mostly good actors using a bad banking system—a banking system built to fail.

Structural failures have structural causes. The Hindenburg had a short circuit. The Challenger had faulty O-rings. The Titanic had unsealed bulkheads. The I-35W Mississippi River Bridge had inadequate gusset plates. Our banking system had and has leverage and opacity.

Thanks to these structural problems, the banking system failed colossally. Then it was bailed out and rebuilt to original spec. Consequently, it will collapse again.

Leverage and opacity are the O-rings of the banking system. They can cause it to collapse overnight. Recall ***It’s a Wonderful Life***—the Christmas movie featuring honest banker George Bailey. The movie starts with a run on George’s bank sparked by a rumour that there’s a run on George’s bank. Everyone runs because George’s bank is opaque and leveraged (in debt), meaning no one knows whether George’s bank has enough assets to cover what it owes.

Like all banks, George's bank has borrowed money, which it's promised to repay come hell or high water. If the bank misses repayment by even one dollar, it's game over and the bank fails. The bank's riskiest liabilities are demand deposits, which can be withdrawn ***on demand***. This is why checking accounts are called demand deposits.

But as George tells the panicked crowd assembled in his bank's lobby, he's lent out most of what he took in. If everyone is patient, they'll get their money back with interest in due course. But if they all want it back immediately, the bank will fail... and so will Bedford Falls, the town whose economy depends on George's bank.

Thus, the movie presents two equilibria (two places the economy can land). The first is everyone panics, the bank fails, and Bedford Falls' economy falls apart. The second is no one panics, the bank survives, and the local economy continues to thrive.

Fortunately, George, played by Jimmy Stewart, is a good talker. His plea to the crowd narrowly averts the bad equilibrium. This lets the movie continue for another hour until, yet again, George's bank confronts a financial panic but is again saved, this time thanks to a Christmas Eve miracle—a rich buddy of George's who wires him a large deposit just as the bank regulator is about to shutter the doors.

In the Great Depression, one third of US banks went under in precisely the manner depicted in the movie. They experienced runs by depositors for their money. But in 1933, President Roosevelt established FDIC insurance to convince depositors their money was insured by Uncle Sam. Had everyone called Roosevelt's bluff and continued to run anyway, Uncle Sam would have had to print tons of money to "insure" the deposits... leading to hyperinflation, leading to everyone running to retrieve and spend their money before prices went out the roof.

So, government deposit insurance also introduces multiple equilibria. Everyone believes that no one will run due to deposit insurance is one equilibrium. And everyone believes everyone will run despite deposit insurance is another—a very bad one. So far, in our country, the former equilibrium has held the day. In countries like Argentina, the second applies. No one there puts any trust whatsoever in government deposit insurance.

The Great Recession, which saw the collapse of 27 major financial companies worldwide, didn't feature people running on banks. (The fabricated promise of FDIC insurance, at least in terms of insuring the real value of one's deposits, worked its magic.) Instead, the Great Recession featured banks running on banks. The banks ran on the banks because of rumours—some true, some fabricated—that other banks were running on banks.

In 2008, financial panic here at home took down, in succession, Countrywide Financial, Bear Stearns, Fannie Mae, Freddie Mac, Merrill Lynch, Lehman Brothers, AIG, and Washington Mutual. The collapse of these massive and in many cases venerable financial companies (banks for short), whether via shotgun weddings, nationalizations, or bankruptcy, spelled economic disaster on Main Street along with financial disaster on Wall Street.

The reason is that Wall Street's bank runs triggered Main Street's firing runs.

Firing runs reference firing someone else's customers (i.e., your workers) for fear others are firing your customers (i.e., their workers). If you're an employer on September 15, 2008, the day Lehman died, and everyone is screaming "Great Depression," you don't wait months to see what's going on. You start to fire to reduce your biggest debt—your need to make payroll at the end of the month.

The firing runs expanded as one financial goliath after another crashed. They exacerbated the bank runs, which exacerbated the firing runs, which exacerbated the bank runs, all of which produced a vicious downward economic spiral that culminated in the swift loss of 9 million jobs.

The Usual Suspects

Given all we've been told about the causes of the Great Recession, the notion that pure financial panic, cultivated by opacity and leverage, tanked the economy is hard to swallow. So, let's round up the usual suspects and make sure we can rule them out.

Subprimes: Subprime mortgages are the bête noire of the Great Recession (GR). But their losses were far too small to produce a recession, let alone a great one. Indeed, during the GR, the subprime foreclosure rate peaked at 15%. Since at most 14% of outstanding mortgages during the GR were subprime, at most 2.1% (0.15 x 0.14) of all mortgages during the GR represented foreclosed subprimes. This is simply not big enough to matter to our massive economy.

The Housing Price Bubble: Between 2003 and 2007, real housing prices (home prices adjusted for inflation) rose at a 2 percentage-point faster annual clip than did real GDP. But this is hardly evidence of a bubble. One can construct economic models in which the stock of housing grows together with the economy and the real price of housing stays fixed. And one can construct models in which the stock of housing stays fixed and the real price of housing grows together with the economy. Given the increasing urbanization of our country, the fixed supply of central city land, and the remarkable foreign demand for US housing, an irrational bubble isn't needed to explain the pre-GR real housing price rise.

Ratings Shopping: The FCIC's report states that failures of the Big Three rating agencies were "key enablers of the financial meltdown." But economists have now studied tens of thousands of complex mortgage-backed securities and found that the number and values of the securities that may have been misrated could, at most, have impacted less than 1% of the US bond market. Again, this is trivially small.

Bank Leverage: A stable fable related to the run-up to the GR is that banks dramatically increased their leverage. Not so. Fed data show bank leverage falling from 1988 through 2008. Equity rose from 6% of bank assets in Q1 1988 to 10% in Q1 2008. Leverage was also not particularly high in either Bear Stearns or Lehman. Indeed, according to Christopher Cox, former chair of the Securities and Exchange Commission, Bear Stearns was well capitalized when it failed, with a capital ratio over 13% and a debt-equity ratio of just 6 to 1, not the 33-to-1 figure bandied about at the time.

As Chairman Cox stated,

> ***The fate of Bear Stearns was the result of a lack of confidence, not a lack of capital. ... [At] all times until its agreement to be acquired by JPMorgan Chase ... the firm had a capital cushion well above what is required to meet supervisory standards.***

In the event, Bear Stearns' actual capital ratio didn't matter. Multiple equilibria mattered. Creditors past and prospective came to believe, based on innocent and guilty rumours, that other creditors were pulling the plug. They did likewise.

Lehman was also well capitalized prior to its demise. Its capital (equity) was 11% of its assets when creditors pulled the plug. An 11% capital ratio is very close to the current banking system's figure, according to the Fed's recent stress tests.

Hence, today's banking system is no safer than was Lehman Brothers on the day it was driven out of business.

Mortgage Debt: Another "smoking gun" is the pre-GR run-up of mortgage debt, which roughly doubled between 2002 and 2007. But the increase in borrowing to purchase homes wasn't associated with a rise in household consumption relative to GDP. Instead, Americans borrowed to invest. And although the ratio of mortgage debt to household net wealth rose, the rise was minor. So, too, was the rise in debt payments relative to personal income.

Derivatives: The reigning narrative—that derivatives were overrated, complex securities sold to naïve investors—also doesn't jibe with the facts. Economists have studied thousands of residential mortgage-backed securities that were issued between 2007 and 2013 and rated AAA. Three-quarters of these securities experienced essentially zero losses through 2013. Most striking, AAA-rated residential mortgage-backed securities outperformed the universe of AAA-rated securities.

No Skin in the Game: Economists have also now examined the pre-GR executive compensation contracts of 95 banks. The stock and option compensation in these contracts exceeded wages by a factor of eight. The authors of one study write,

> ***Banks with higher option (and bonus) compensation ... for their CEOs did not perform worse during the crisis. Bank CEOs did not reduce their holdings of shares in anticipation of the crisis or during the crisis. Consequently, they suffered extremely large wealth losses in the wake of the crisis.***

Jimmy Cayne, Bear Stearns' CEO, is an example. He lost $1 billion. Dick Fuld, Lehman's CEO, lost some $80 million. In short, these and other big-bank bankers had plenty of skin in the game.

Regulatory Capture: The main job of bank regulators is overseeing bank leverage. Since bank leverage was not historically high and indeed fell in the run-up to the GR, regulators did their job. What they couldn't do is prevent our unstable economy from switching equilibria.

Democratization of Finance: Some claim that politicians forced Fanny Mae and Freddie Mac, the big government-sponsored mortgage entities, to permit too much risky lending to the poor. But for this to be a major cause of the GR, losses from subprime mortgage foreclosures would have had to be much larger.

Fed Interest Rate Policy: In the 1990s, the expected real 30-year mortgage rate averaged 7.91%. It averaged 6.27% between January 2000 and December 2007. This decline is too small to matter. Furthermore, the Fed doesn't directly control long-term nominal, let alone real mortgage rates. As for 5/1-year adjustable-rate mortgages, their real rate averaged 5–6% in the two years preceding the GR. Real rates of this magnitude are not low.

Unsafe at Any Speed

Bank runs, as indicated, are midwifed by opacity. Opacity permits misinformation to spread and be spread. Bear Stearns was among the first to be picked off by short sellers because it was viewed as particularly opaque.

According to business writer William Cohan, no one on the Street or inside the bank, knew what it actually owed or owned, let alone the true value of those liabilities and assets. The fact that Bear's stock was valued at $60 per share one week before it was sold for $2 per share says that its valuation was a matter of pure conjecture. Apparently, before it didn't, the market thought Bear's assets were worth something because everyone else thought its assets were worth something.

Such self-fulfilling prophecies are the stuff of multiple equilibria.

Lehman's CEO, Richard Fuld, certainly lays the blame for the GR on multiple equilibria. As he publicly stated, "what happened to Lehman Brothers could have happened to any financial institution."

The facts support his view. Bankers didn't destroy the banking system. The banking system destroyed the banking system. It operated in the dark, and it operated with leverage. That, plus rumours of rampant malfeasance, brought Wall Street's house of cards tumbling down.

The takeaway is that banking can't be fixed with cosmetic reforms, such as the US Dodd-Frank Act or the UK's Vickers Commission Report. What's needed is a system with zero leverage and full, government-supervised disclosure.

Why ***zero*** leverage and ***full*** disclosure? The answer is simple. You can't be a little bit pregnant. Any degree of leverage and opacity invites bank runs, which produces firing runs, which produces bank runs, which moves the economy from a good to a bad equilibrium.

Are we and our children stuck living with an economy that can instantly fall apart?

The answer, which I provided in my 2010 book, ***Jimmy Stewart Is Dead,*** is absolutely not.

The book lays out a very simple means, called Limited Purpose Banking (LPB), to fix banking for good. LPB would transform all financial corporations into 100% equity-financed mutual fund holding companies subject to full and real-time disclosure, done by private firms working exclusively for the government.

In considering LPB, it's important to note that not a single equity-financed mutual fund failed during the Great Recession. Yes, the Reserve Primary money market fund failed, but it and other money market funds were leveraged because they promised to back their deposits to the buck.

Limited Purpose Banking has been endorsed by a Who's Who of former top policymakers and economists. The list includes senior statesmen like George Shultz, Nobel laureates in economics, former chairs of the President's Council of Economic Advisers, and some of the top names in finance.

There is no reason to run our financial system and economy on a knife's edge. It's happening for one reason, and one reason only: It works for Wall Street, which pays our politicians to keep the current leveraged, opaque banking system in place.

Wall Street, as we saw in stark relief in 2008, takes the upside and forces taxpayers to bail it out when things go south. If and when this will change is anyone's guess. In the meantime, we each need to realize that the next collapse of our banking system, the stock market, and the economy can happen at any time.