Our Monthly Free Newsletter
TheInvestor
In our 33rd year of service to the investing public of South Africa

By Richard Cluver April 2020

In the March issue I showed how young folk have on average made themselves slaves to the easy credit of our modern economic system. And I illustrated how a young couple who elected to delay marrying, buying a mortgaged home and shiny new cars soon after graduating from university could, within two years buy homes for cash and retire within nine years.

These sentiments are being made chillingly more relevant in these days of the Covid-19 lock-down in the day to day hardship so many people are feeling because they have no cash reserves to fall back on, because they failed to heed the lessons that their grandparents learned back in the 1930s when the Great Depression bit so hard.

The illustration I used of what was possible for folk who did without the tantalizing luxuries of shiny new cars on HP etc and invested wisely, was made possible by this graph which shows how Blue Chip shares have performed on the Johannesburg Stock Exchange over the past 35 years with a red trend line superimposed to show how these shares have risen steadily in value throughout at a compound annual average rate of 19.8 percent:

To illustrate what this growth rate means, let us assume that doting grandparents back in April 1986 decided to invest R100 a month in a cross section of such shares in the name of their new grandchild and kept on doing so until the child reached the age of 21.

In doing so and accordingly harnessing the incredible power of compound interest they would have created a remarkable R 374 628.00.

Such is the power of compound interest when allied to high compounding rates. So the obvious question is how do you identify such shares which can offer you such remarkable rates of growth?

Habitually in explaining investment techniques I have turned to the Johannesburg Stock Exchange to provide examples, but in recent years as the South African economy has succumbed to ANC misrule it has become both very possible for local investors to play the major global exchanges and to obtain higher returns and so it is worth noting that whereas the JSE offers only four companies that comply with my highest category of investment safety, the Grand Old Favourites, the New York Stock Exchange offers 52 whose average dividend growth rate over the past five years has been 42.74 percent. Bearing in mind that these are the safest shares you can invest in because their balance sheet statistics have passed through an extremely rigorous series of quality tests over extremely long periods, this is the category of shares most beloved of pension funds and the “Widows and orphans” trusts.

Now, arguably the greatest lesson you can take to heart about stock-exchange-listed companies is that the aristocracy among them fiercely guard their dividend growth rates because these underpin the value of their shares which in turn represent their most bankable and tradable assets. Should they, for example, decide to make a takeover offer for another company whose operations might profitably dovetail with their own, the “Imperial Purple of commerce” have traditionally had no need to use their own working capital and certainly have no need to approach banks for a loan. What they will normally do is make an offer of some of their own shares in exchange for those of the company which they wish to take over. Here though, I should qualify this statement by recognizing that within the new normal of negative interest rates, many listed companies have been using bank borrowings to buy back their own shares, but that era is likely to change soon.

The shares of these giants of the share market are so valued that they are better than gold because of the simple fact that every year for decades their dividends have increased by significant percentages. Furthermore, the parent companies of these colossuses can simply issue additional shares at will, effectively generating billions of dollars out of thin air while in extremely modest fashion diluting their issued share capital, at most, by just a few percentage points.

Smaller listed companies are unable to match this process because the effective dilution of their capital would be so great that shareholders would revolt. But bit by bit as one takeover follows another, they start to themselves become colossuses. That, for example, was the method employed by SA Breweries when it went on an overseas takeover campaign which ultimately led to it becoming the second largest global brewing giant before it was in turn swallowed by the biggest of them all.

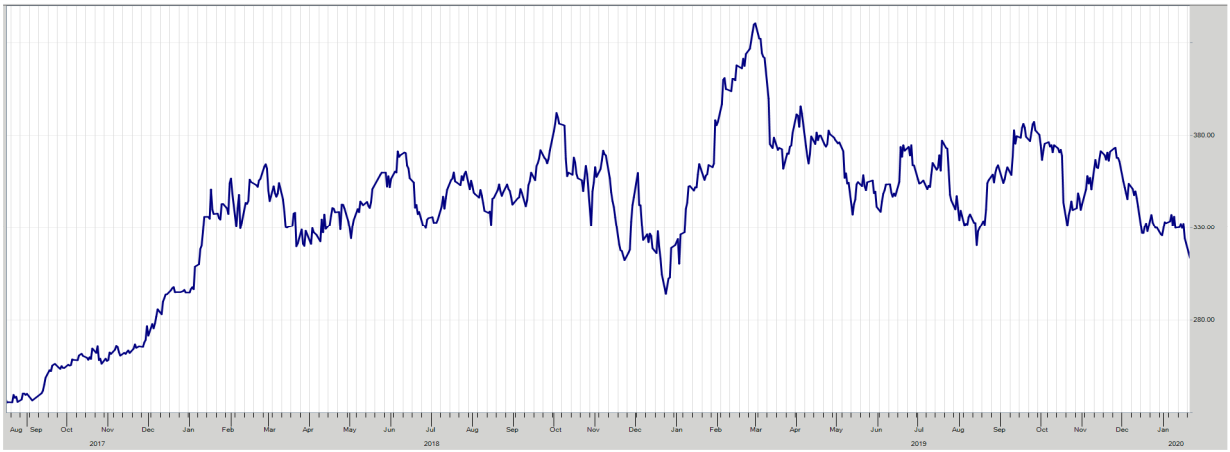
Now smart investors can piggy-back onto this process by the simple process of buying the shares of such top-quality companies. This is particularly the case where the average share price growth rate is lagging behind the dividend growth rate because you can be certain that over time the price will always catch up. So, consider the table below which I have extracted from the ShareFinder 6 Quality List of Wall Street-listed Grand Old Favourites.

Name	5YrDiv	5YrGro	Grade	Risk	F.Und/Ov	Price Rating
APOLLO GLOBAL MANAGEMENT, LLC	80.73	17.75	271...	67.41	-359.58	Cheap.
BANK OF AMERICA CORPORATION	77.23	19.77	370...	24.53	-82.94	Cheap.
ALASKA AIR GROUP, INC.	52.65	-2.42	114...	22.19	-15.30	Cheap.
MORGAN STANLEY	42.04	9.08	187...	27.12	-72.28	Cheap.
CELANESE CORPORATION	32.95	17.17	211...	9.53	-66.66	Cheap.
FEDEX CORPORATION	30.09	4.58	173...	24.18	-72.63	Cheap.
BOEING COMPANY (THE)	29.13	39.19	287...	22.29	-64.98	Cheap.
FIRST AMERICAN CORPORATION (THE)	29.03	12.66	150...	10.87	-50.26	Cheap.
BORGWARNER INC.	26.89	-4.20	54.00	41.93	-13.15	Cheap.
DELTA AIR LINES, INC.	25.65	6.00	161...	-5.44	-69.11	Cheap.

If you care to calculate it, the average five-year dividend growth rate of this top ten was 42.74 percent whereas the collective share price growth rate of all shares meeting the Grand Old Favourites criteria lagged behind with an average of 11.36 percent. You might thus conclude that over time this group of ten shares is likely to nearly quadruple in value.

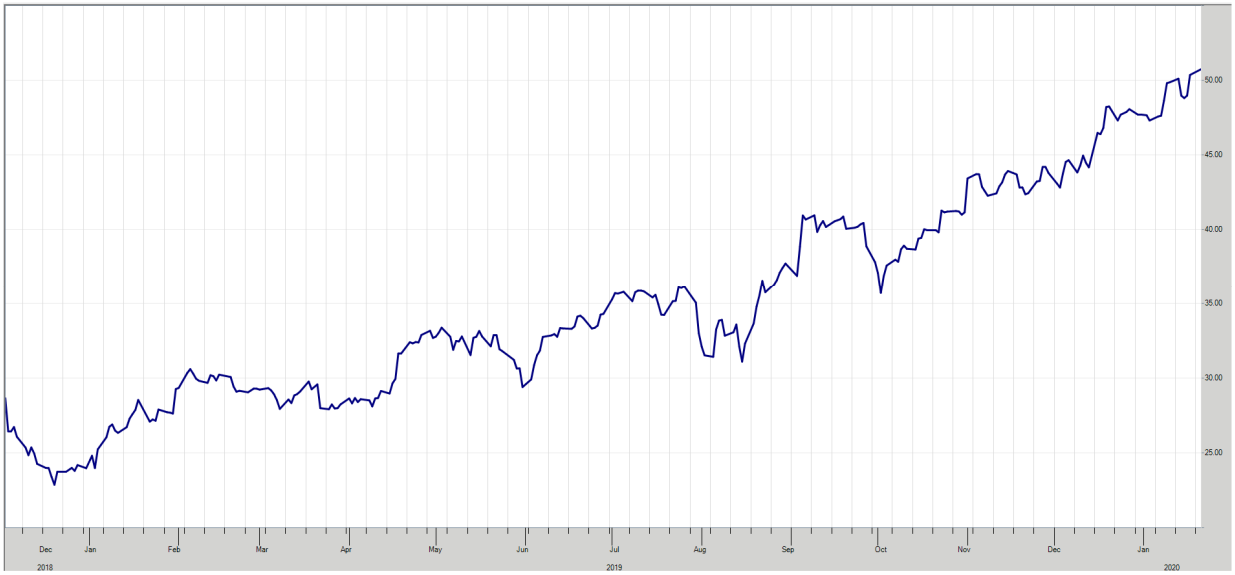
Obviously one should not simply buy blindly. Probably the most single important rule that every investor should take to heart is to be an avid reader of the Financial Press. I wrote a whole book about it entitled “The Ten-Minute Millionaire” which argued that you can make yourself a stock exchange fortune by choosing some 20 or 30 share market aristocrats and reading everything that is written about them **all the time**.

Thus, for example, it would only take a cursory reading to be aware that the Boeing Company is in trouble and the news is likely to get a lot worse before it starts to improve. As my graph below illustrates, the share price has so far fallen by 54 percent since its March 2018 peak value following two fatal crashes of its 737 Max aircraft that killed 346 people.



CEO Dave Calhoun recently advised shareholders that he did not expect the regulatory authorities to grant approval for the plane to fly until the middle of this year, and with airlines locked down for the foreseeable future, it is hard to expect any real improvement in the share price for some time.

However, it might already be too late to buy the shares of Apollo Global Management which have been rising rapidly since December 2018

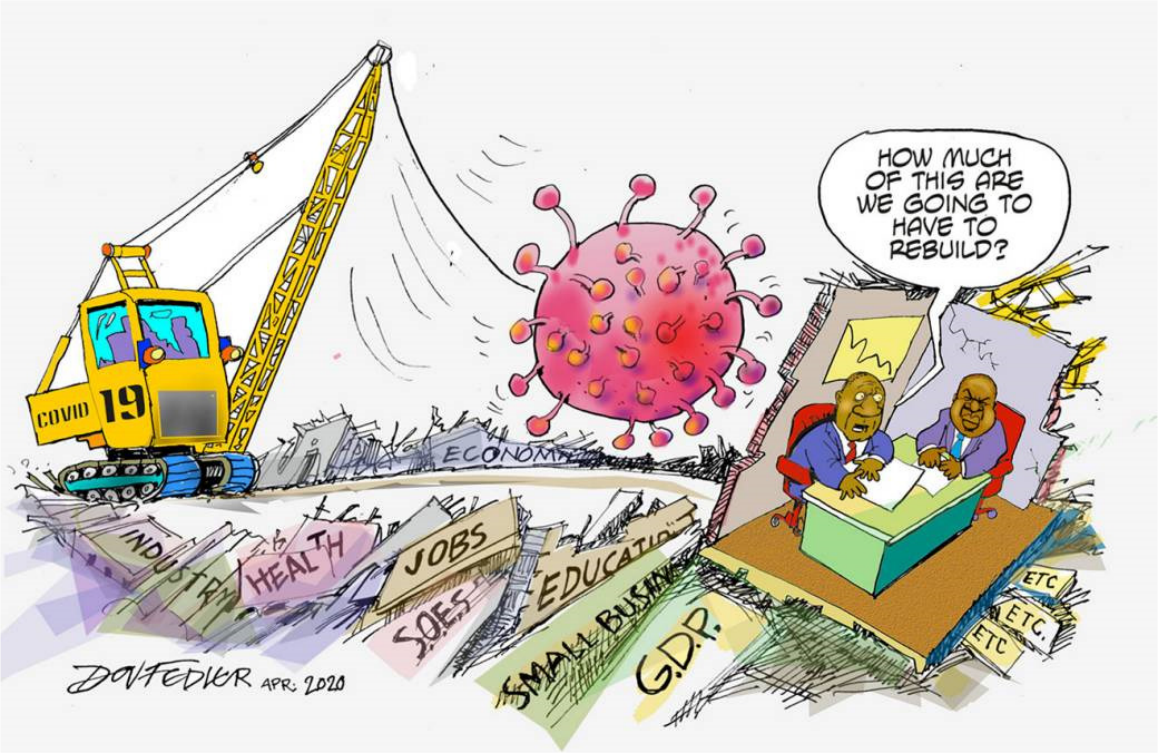


Next month I will discuss the fine art of timing share purchases.

Estimating the extent of the damage of Covid-19 to the economy

By Brian Kantor

Former Chief Investment Strategist of Investec Wealth & Investment SA.



How are governments and their central banks responding to the damage caused by the lockdowns forced upon their economies and their citizens? Are they doing all they can to minimise the damage to incomes sacrificed during the lock downs?

There is certainly no reluctance to spend. The issue is not about how much but rather how best to spend. Restraints on fiscal deficits and money creation have been abandoned – rightly so in the circumstances.

When so much central bank lending is to the government, even via the secondary market that replaces other lenders, the distinction between monetary and fiscal policy falls away. The UK government made this clear when it exercised its right to a large overdraft on the Bank of England. The Bank could not and would not say no to such a demand for funding, given the state of the economy. The US Fed has added over US$2 trillion of cash to the US banking system over the week to 10 April. It increased its balance sheet by 50% over a very busy week. The federal government has budgeted for trillions of dollars of extra spending, including spending to cover possible losses on the Fed's loan book.

Issuing money is usually the cheapest way for any government and its taxpayers to fund such emergency spending. When interest rates on long-term government debt are close to zero or even negative in parts of the developed world, issuing debt is almost as cheap as issuing money. Though the question should be asked: where would interest rates settle without the huge loans provided to governments and banks by their central banks?

This is not the case in SA and many other emerging economies. Issuing long-term debt at around 10% is an expensive exercise. Issuing three-month Treasury Bills at 5% is also expensive. For central banks to create money for their governments and taxpayers, would be a cheaper option. Is there not the same good reason for them to support government credit in the same exceptional circumstances as vigorously as is being done in the developed world to universal investor approval?

There is every reason for the SA government to rely heavily on its central bank at a time like this, with the same proviso as applies in the developed world. When the economy is again running at close to its potential, the stimulus should be withdrawn to avoid inflation. That test however will come later. There is an immediate challenge to be met now, and spending and lending without usual restraint is rising to the challenge.

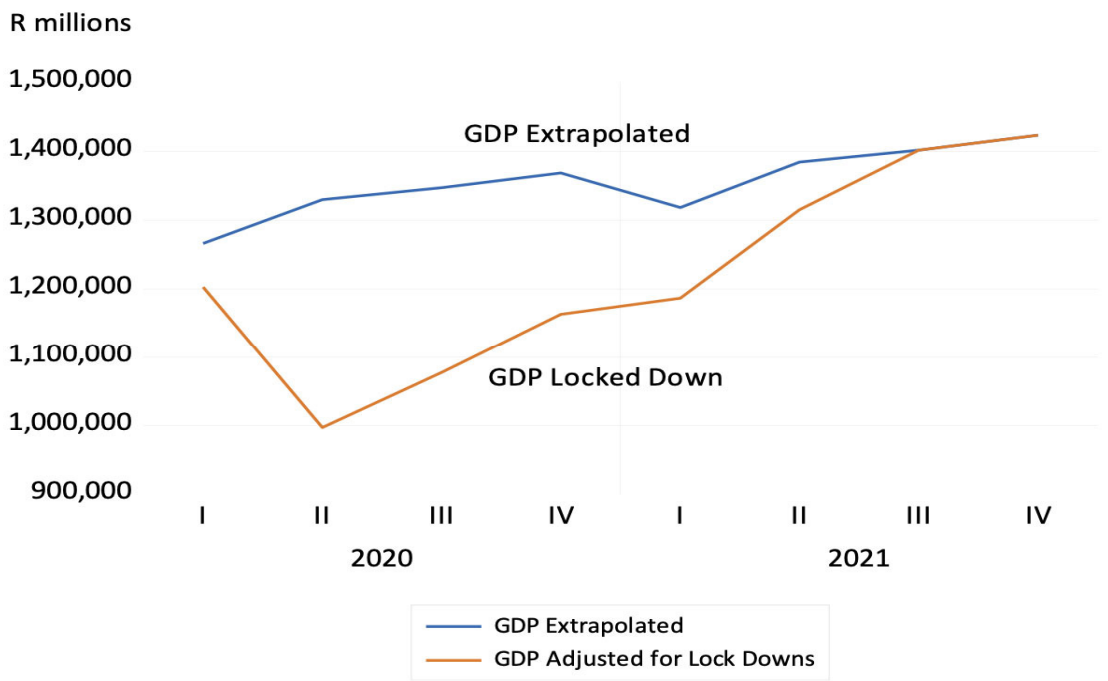
How much economic output and income will be sacrificed over the period of the lockdown and the gradual recovery after that? A broad-brush comparison between what might have been without the coronavirus and what may yet happen to the SA economy can be made. The loss in output as a result of the shutdowns – the difference in what might have been produced and earned had GDP performed as normal in 2020 and 2021, and what now is likely to be produced, can be estimated, as we do below.

We first estimate economic output and incomes (GDP at current prices measured quarterly), had the economy continued on its recent path, unaffected by the pandemic. To do this, we use the standard time series forecasting method. We extrapolate what might have transpired had GDP in money of the day continued to grow at its very pedestrian recent pace of about 4%-5% per annum.

GDP inflation in recent years has been of the order of 4% per annum, indicating very little real growth was being realised. We then make a judgment about how much of this potential output will be lost due to the shutdowns. We estimate a GDP loss ratio for the quarters between Q1 2020 and Q4 2021 to calculate this difference between pre and post pandemic GDP.

The cumulative difference – the lost output and incomes over the next two years – we estimate as R1,071-trillion of lost output that will be sacrificed to contain the spread of the virus. This is equivalent to approximately 24% of what might have been the GDP in 2020

GDP and GDP after Covid-19 (quarterly data using current prices)

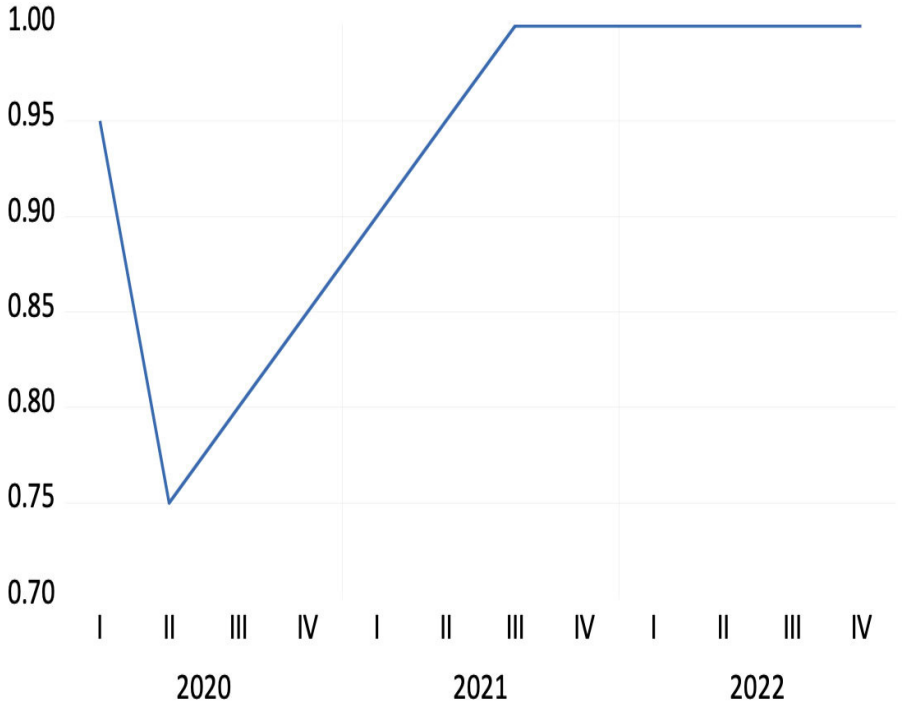


Source: SA Reserve Bank and Investec Wealth & Investment

The loss ratio – the percentage of the economy that remains after the shutdown – is the crucial judgment to be made. We have assumed that the economy operated at 95% of its pre-pandemic potential in Q1 2020. Then, as the impact of the lockdown intensifies through much of Q2, we estimate the economy will utilise only 75% of capacity in Q2. This, we assume, will be followed by somewhat less damage in Q3 when we assume the economy will operate at 80% of potential capacity as the lockdown is gradually relieved. We expect conditions to continue to improve by the equivalent of 5% each quarter, until the economy gets back to where it might have been without the lockdowns. We assume that to be in the second quarter of 2021.

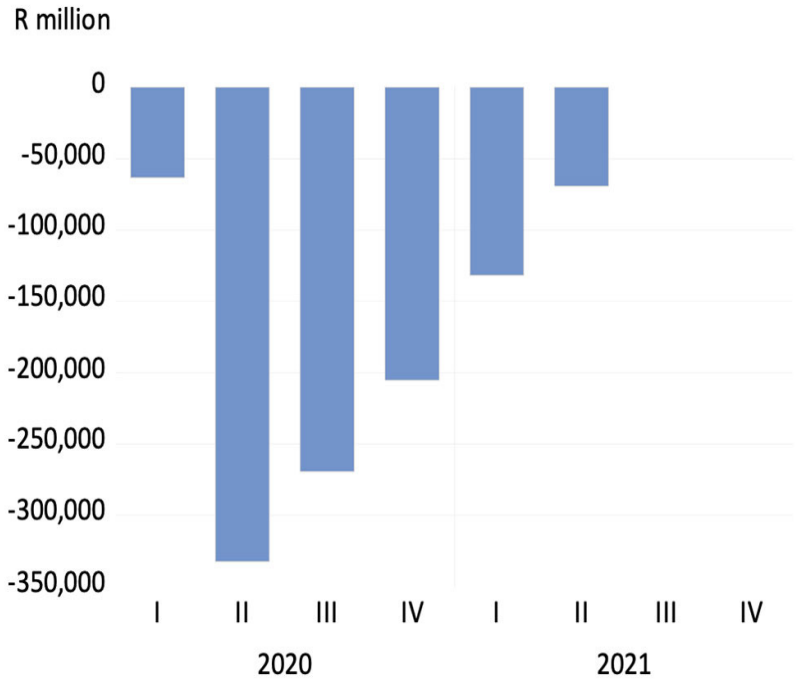
This almost V-shaped recovery might well be too optimistic an estimate. The losses in 2020 may well be greater and the recovery slower than estimated. But the output gap – the difference between what could have been produced and what will be produced – will be a large one.

Loss of output ratio – GDP-adjusted/GDP estimate (pre-Covid-19)



Source: SA Reserve Bank and Investec Wealth & Investment

Estimated loss in GDP per quarter in millions of Rands (sum of losses 2020-2021 = R1,071 trillion)



Source: SA Reserve Bank and Investec Wealth & Investment

Don’t hesitate to act boldly

The pace of recovery will depend in part on how much the government spends and how much the Reserve Bank supports the government and private sector with extra cash.

The more support provided to the economy by the government and the Reserve Bank, the more demand will be exercised and the smaller will be the eventual loss of output. Any reduction in economic damage of the likely large order estimated is a clear gain to the economy.

Any additional utilisation of what would otherwise be wasted capacity comes without real economic cost. That extra demand can bring forth extra supplies that would be a pure gain to the economy, especially if funded with central bank money.

The Reserve Bank has the opportunity to create more of its own money, without any cost, to help borrowers. This includes not only the banks and the government, but also private businesses directly through its lending. Any inflation that may come along later with a recovery in the economy, can be dealt with in its own good time.

Unlike its peers in the developed world, it also has scope to significantly lower short-term interest rates, all the way to close to zero if needs be. It has rightly taken a step on the way with its emergency meeting recently and the welcome decision to cut rates by a further one percentage point (100bps). We would hope further cuts are on the way. A mixture of aggressive QE and lower interest rates are the right stuff for the SA economy.

Postscript on growth rates: they will not mean what they usually do after the crisis

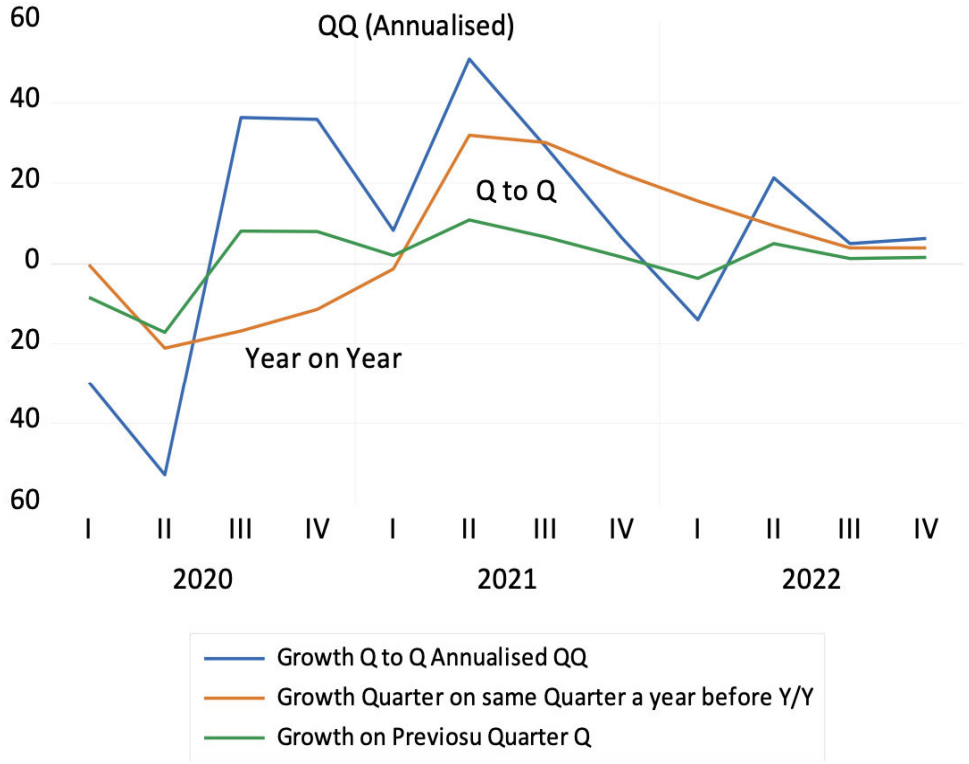
GDP growth rates are most often presented as the annual percentage growth from quarter to quarter, adjusted for seasonal influences and converted to an annual equivalent. This is the growth rate that attracts headlines. Two consecutive negative growth rates measured this way are regarded as indicating a 'technical recession'. The implication is that quarterly growth will continue at that pace for the next year. Under the lockdown scenario, growth measured this way is likely to become much more variable than it usually is.

This will be especially true in Q2 2020, when the impact of the lockdown will be at its most severe, maybe reducing growth to an annual equivalent negative rate of growth of 50% or so. Estimating growth on this quarter-to-quarter basis over the next few years will however be a poor guide to the underlying growth trends. It may show a very sharp contraction in Q2 2020, followed by positive growth of 40% in Q3 and Q4, 10% in Q4 and then as much as 50% again in Q2 2021. The recession will seemingly have been avoided and the economy will soon be recording boom time growth rates. A likely but highly misleading account of what will be going on with the economy, it must be said.

If GDP is compared to the same quarter a year before, we will get a much smoother series of growth rates. It is likely to show negative growth throughout 2020, (down by as much as -20% in Q2) with strong growth of 30% only resuming in Q2 2021, off a highly depressed base of Q2 2020 when the lockdown was at its most severe.

The better way to calculate the impact of the lockdown in terms of growth rates, would be to calculate the simple percentage change in GDP from quarter to quarter as the impact of the lockdown unfolds and gradually, we hope, dissipates. The worst quarters measured this way will be Q2 and Q3 2020, after which quarter-to-quarter growth in percentage terms will become positive.

Estimated quarterly growth rates between 2020 and 2022 under alternative conventions



Source: SA Reserve Bank and Investec Wealth & Investment

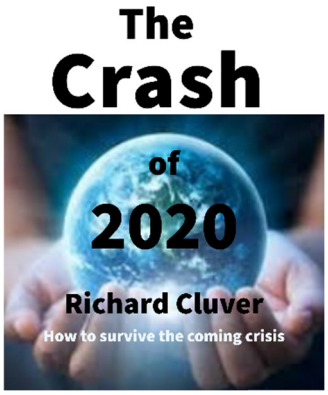
The upshot of this is that growth rates will not be able to tell us what has happened to an economy subject to a severe supply side shock that is temporary in nature. Measured in absolute terms, in money of the day GDP sacrificed each quarter, as we have attempted to do, will tell the full tale of economic destruction.

How to fix the system

If you have understood all my arguments to date you will recognise that the a systematically compromised global monetary system is buckling under massive consequent debt and is about to be overtaken by a tidal wave of change.

By the frank admission of no less a figure than Alan Greenspan, former governor of the US Federal Reserve, central banks have already lost control of the intermediation process whereby, through interest rate changes, they were able to regulate the boom and bust cycles of the economies they represented.

Excessive credit unleashed upon the world both by the mountains of debt racked up by governments unable to balance their budgets under the crippling weight of their social contracts - and by corporates capitalizing upon historically low interest rates which have been the direct result of the consequent explosion of the money supply – and also by the general public - has rendered central bank efforts effectively meaningless.



Continuing the serialization of Richard Cluver's latest book, you can order the full e-book version by right clicking on the following link http://www.rcis.co.za/the-crash-of-2020-order-form/

The world was in desperate need of a credit contraction and the situation was arguably too far advanced for a slow leaking puncture to reduce the pressure. Arguably, the only solution would before what has now happen: a global blow-out. So what investors need to understand, if they are to protect themselves from the frightening subsequent consequences of another Great Depression, is to understand how the blow-out happened.

Essentially, the world cannot go to war with itself and plunder its neighbours as nations once did in order to recycle their debts. Although growing debt and the consequent stagnation of more and more global economies is resulting in soaring unemployment across the world with political polarization between the "Haves" and "Have Nots," an inevitable consequence is the resurgence of inflation.

2008	0.1%	0%
2009	2.7%	0%
2010	1.5%	0%
2011	3.0%	0%
2012	1.7%	0%
2013	1.5%	0%
2014	0.8%	0%
2015	0.7%	0.25%
2016	2.1%	0.75%
2017	2.1%	1.5%
2018	1.9%	2.5%
2019	1.5%	2.25%

Official statistics suggest that along with historically low interest rates - which are the normal indication of low inflation rates – measurements of national inflation rates are equally low. However, many are beginning to question the manner in which inflation is measured. I refer you again to the table I printed in Chapter One which details, alongside the year, respectively the average US inflation rate and the average intermediation rate (read prime rate) of the US Federal Reserve between 2008 and 2018. If you care to do the calculation, the average US inflation rate based upon official figures was 1.63 percent throughout the past decade.

But now consider my graph below in which I have tracked the gold price in US Dollars:

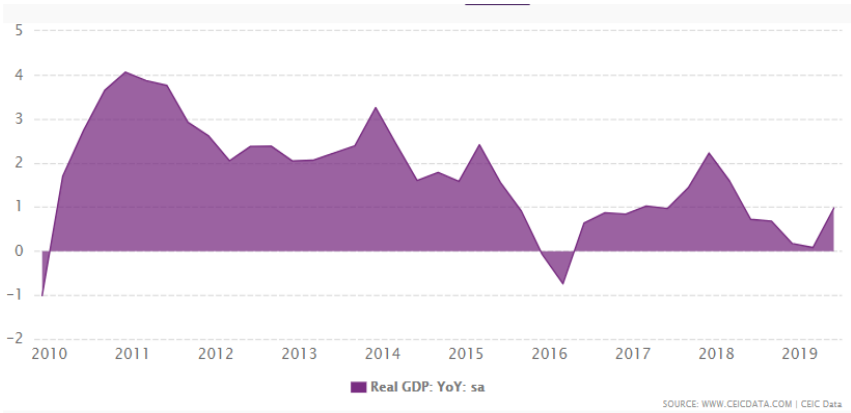
My red trend line shows that, although the global gold price fell between mid-2011 and 2015, overall, it rose by a compound average of 7.2 percent annually over the same period. Real GDP growth over the same period averaged 1.78 percent so, if you deduct that figure from the rise in the price of gold, you have to conclude that the actual inflation rate for the decade averaged 5.42 percent which is 3.3 times the official average of 1.63 percent. So, either the method of capturing the rising US cost of living is hopelessly inaccurate or someone is lying. After all gold bullion is the only commodity that is inflation proof.

Here in South Africa, the official inflation rate averaged 5.18 percent over the decade as you can deduce from the annual figures in the table on the right.

average inflation	inflation
CPI South Africa 2019	4.25 %
CPI South Africa 2018	4.50 %
CPI South Africa 2017	5.19 %
CPI South Africa 2016	6.59 %
CPI South Africa 2015	4.51 %
CPI South Africa 2014	6.14 %
CPI South Africa 2013	5.78 %
CPI South Africa 2012	5.73 %
CPI South Africa 2011	5.01 %
CPI South Africa 2010	4.08 %

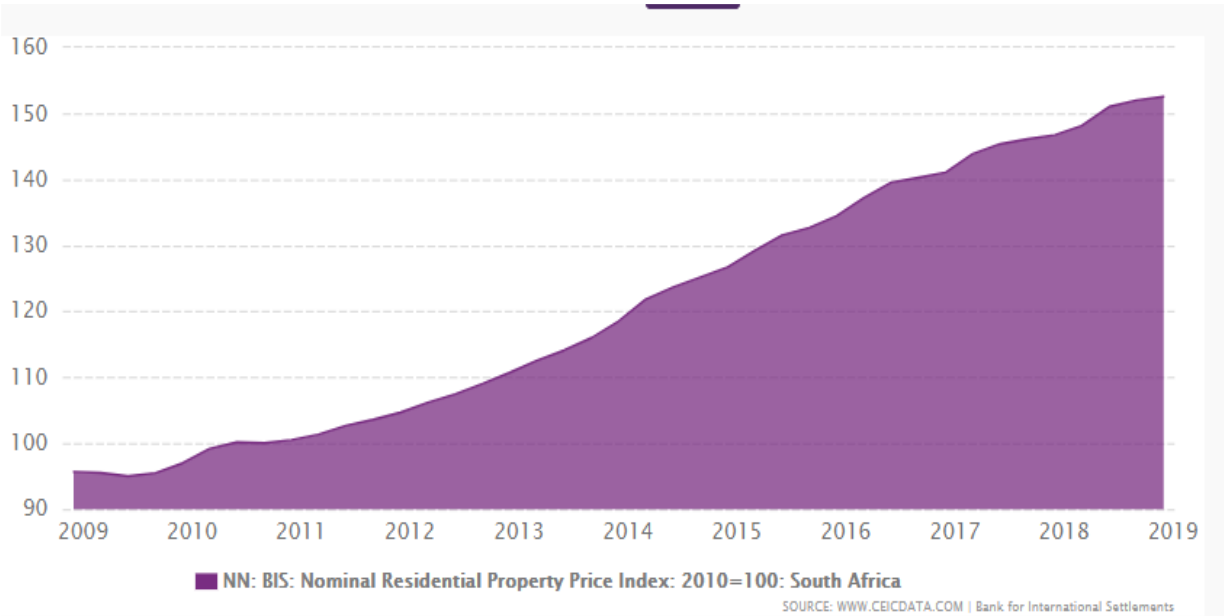
Now consider my graph below which illustrates that in Rand terms the gold price increased by an annual average of 12.4 percent a year which, if you deduct the official inflation figure, implies that the country enjoyed productivity gains averaging 7.22 percent a year.

However, my next graph illustrates that over the same period South African GDP growth never exceeded four percent with the average only a shade above one percent.



Again our method of measuring inflation is seriously flawed or someone is lying. Deduct 1.01 from 7.22 and you have to conclude that the REAL inflation rate in South Africa over the past decade has averaged 6.2 percent.

And consider South African house prices. Even in a depressed economy where practically no building was taking place and estate agents were reporting a stagnant market because young couples were emigrating in record numbers, nominal house prices rose at compound 5.5 percent.



All of this is happening in a world in which the monetary authorities are telling us that global inflation is as low as it has been in a century! If the ubiquitous US Dollar is losing value at 7.2 percent annually then dollar-denominated sovereign bonds are losing value at an alarming rate and along with that the interest that they pay is negative in real terms – and dramatically so in after-tax terms. Add to this the fact that, at this deduced inflation rate, the buying power of bond interest income will halve every ten years and you can obviously see that pensions that are determined in large measure upon incomes derived from bonds, are likely to be decimated.

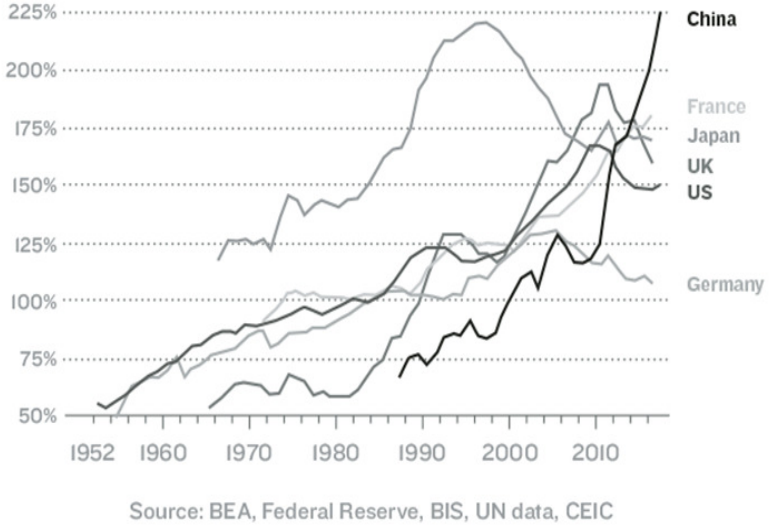
Furthermore, here in South Africa the Government is seriously talking about enacting law that will force pension funds to include prescribed levels of RSA Bonds in their asset mix. Pensioners who were civil servants under the National Party administration prior to 1994 can relate tales of the financial horror they had to live through in that period as their pension savings were similarly decimated by the high inflation rates of the time.

However, if you are a government deeply compromised by debt, allowing inflation to overcome your economy is a neat way of getting out from under your debt because it is relatively invisible to a financially illiterate electorate which might devastate you at the polling booth if you instead used direct taxation to achieve the same results. Inflation is an invisible tax on the savings of nations, one for which ruling political parties can duck responsibility!

From a global perspective, the debt problems of the South African Government are of course chicken feed. Since the 2008 global monetary crisis, when the world's growth rates tumbled, the International Monetary Fund has printed forecast after forecast predicting rebounding growth rates. But in reality, rates have fallen well short of these predictions and the mostly overlooked reason has been a massively increasing global burden of private debt; a combination of business and household debt which is considerably greater than the government debt which is continually being headlined.

In the United States, total private debt has reached $27-trillion while public debt is $22-trillion. More telling, since 1950, US private debt has almost tripled from 55 percent of GDP to 150 percent of GDP, and most other major economies have shown a similar trend.

Since GDP is largely the sum of all the spending of all households and businesses in an economy, this means that average businesses and households have three times more debt in relation to their income. Both private debt and government debt matter to the economy, but of the two, private debt has by far the greater and more direct impact on economic outcomes and so, addressing the issues associated with private debt is the more productive path to economic revival. The next chart relates the rise of private debt among the leading economies of the world. Note how dramatically Chinese debt has been rising recently for it might just lead to the next crisis tipping point:



Rising private debt brings many problems. Very rapid or "runaway" private debt growth often brings financial crises. It brought about the 2008 financial crisis in the United States, the 1991 crisis in Japan, and the 1997 crisis across Asia. Secondly, it becomes a drag on economic growth, chipping away at growth trends. When private debt is high, consumers and businesses have to divert an increased portion of their income to paying interest and principal on that debt and they spend and invest less as a result. That's a very real part of why the global economy is relatively stagnant currently since high private debt understandably suppresses demand.

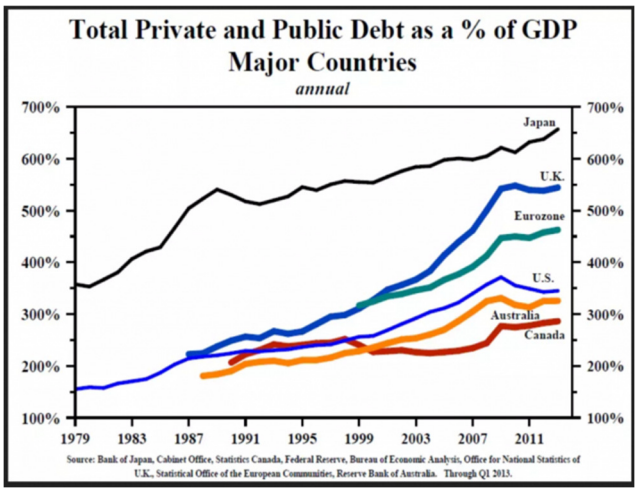
Most middle and lower-income households and businesses in the US (which is where the highest rate of debt growth has been) pay interest rates much higher than money market rates and the rates for these loans can be very high.

To state the obvious, in addition to interest, all these borrowers have to pay down the principal balance of the loan. High debt makes these borrowers more reluctant to spend or take on more debt.

Further, an estimated 6.4 million of the 56-million mortgages held in the United States are still severely underwater. And the world has just hit a new debt record of $250-trillion with China and the US accounting for more than 60 percent of it. Borrowing by governments, households and non-financial business now accounts for more than 240% of the world's gross domestic product, and it's growing faster than the global economy.

Meanwhile, the World Bank's Global Findex Database shows that South Africans are among the top borrowers in the world. An estimated two thirds of the population is being crushed under the weight of personal debt totaling nearly R1,7 trillion; nearly as much as the government's debt of more than R2 trillion. Consequently, at least a third of adults cannot afford to dedicate any money toward savings. CEO of Debt Rescue, Neil Roets, said they were seeing more and more people resorting to credit to feed their families.

The unprecedented amount of our global debt glut is underscored by the creeping presence of negative interest rates; a situation where the borrower, unbelievably enough, gets paid for borrowing. An estimated 15 percent of European corporate debt being issued now has a negative interest rate. If the massive $150-trillion glut of debt is the culprit that is curbing demand, then perhaps this European Central Bank experiment with negative rates is the inevitable response to this glut.



In the US, private debt growth has disproportionately affected the least well-off Americans. Since the debt level of the 20 percent of US households with the lowest net worth has grown two and a half times faster than all other households. Consumers are in fact carrying 13 percent more debt as a percent of GDP than they were in 2000, the moment before the ill-fated private debt boom that led to the 2008 crisis.

Since the US National Debt this year passed the $22-trillion mark and, based on the latest data, total private and public US debt has hit an astronomical record-high of $75.3-trillion, or a staggering 365 percent of GDP.

And a lot of other countries are in a far worse mess. As far back as 2012 Japan had passed 650 percent of GDP, Britain had passed 550 percent and the Eurozone 450 percent.

The imperative to ignite inflation is likely the most discussed subject whenever G7 Finance Ministers get together for a quiet after dinner coffee. Although a little old now, the graph above gives an indication of this quiet desperation.

Deleveraging all this debt even slowly through moderate increases in inflation would force significant, damaging downward pressure on GDP. The Great Depression saw such a deleveraging, and that's why those years were so tremendously painful. By contrast, in the years after 2008, the U.S. government and the Federal Reserve acted to prevent deleveraging. We were saved from another Great Depression, but we were left with a massive pile of debt.

To quote visionary US economist Richard Vague, "We are not at some ordinary moment in history. Instead, we are at an unprecedented, era-defining crossroads:

Debt to GDP is the highest it has ever been in history. Politicians are unlikely to address this since it has proven easy to sidestep and the associated issues are highly difficult, so we will almost certainly continue down this debt path, increasingly burdened by high levels of private and public debt, ignoring what is in front of us, and wondering why global growth remains so mixed.

"Part of our debt dilemma is that political leaders haven't even squarely acknowledged the issue, let alone addressed the problem. But the more vexing part of our dilemma is that deleveraging is a highly difficult proposition. It's hard to expect any major economy to deleverage with only the tools of painful inflation, growth in other debt, or unrealistic trade account surpluses."

In the absence of an event like the ancient option of Jubilee in terms of which all debts were cancelled from time to time, inflation is now the only way out. It could be managed by stealth which arguable, as I have demonstrated, might already be under way or by a controlled deliberate and coordinated central bank process. Left to its own devices, however, it could come with explosive force which could devastate nations and individuals, heightening social tensions to the point of catastrophic confrontation with uncontrollable knock-on consequences.

As with most impending crises which are not defused in time, the latter option of an explosive break-down of the global economy situation would probably result from a black swan event…..a curved ball coming from out field that catches everyone off their guard.

Of the "Big Four" nations which together constitute almost 65 percent of world GDP and have been the principal drivers of global growth in the post-World War II era, only China has shown rapid growth in recent years. And China's growth is now decelerating and will trend much lower in coming years. All four are now overleveraged and as a result will find it very hard to return to high growth.

At best we face a future of economic stagnation and steadily-rising inflation which will impoverish everyone. At worst a catastrophic economic crisis is inevitable, precipitated by a black swan event…something we can't anticipate but can at least prepare for.

Viral Thoughts

By John Mauldin

Today's letter will be another hop-around review of the crisis landscape. I'll touch on several topics instead of going deep into a single theme. So much is going on, it's really hard to know where to start. There will be something to annoy everybody. So, let's just dive in.

Actually, let's start with some good news. I talked with Dr. Joseph Kim of Inovio yesterday. They are beginning the initial safety/immune response phase human trials of a vaccine which should show data in June, and they should be in a larger phase 2/3 trial as early as July/August. Inovio plans (but isn't promising) to have a million vaccinations ready by year-end, and is looking for even higher capacity.

Many other vaccine trials are underway around the world, too. Dr. Kim named several he was familiar with, some of which are also beginning human trials. They use different mechanisms but with the same end goal. He is hopeful some will work, saying, "Look, think of it like 71

shots on goal. The more we try the more likely we are to score." Of those, probably 10 or so will look promising enough to draw funding.

Vaccine production capacity will be key. We will need millions per week and eventually billions per year. This is a global crisis and must be treated globally. Dr. Kim thinks people will likely need multiple vaccinations, probably every other year, but we just don't know yet.

The first vaccinations should go to healthcare workers, then those providing necessary services like food, power, and so forth. Then those who are most at risk, and finally everyone else.

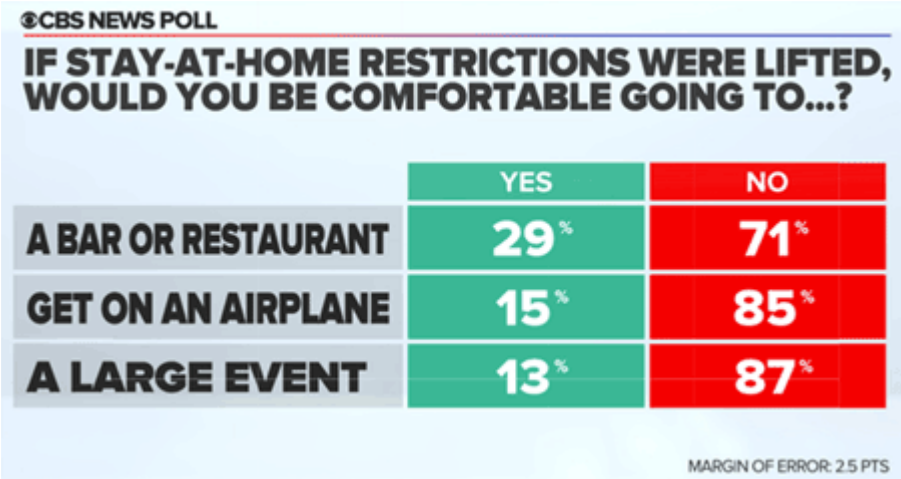
Future Trajectory

If you want to know the future, some say to look at China. The Corona virus originated there and China was the first to impose the kind of restrictions now common elsewhere. The virus had already spread rapidly through that highly dense urban population before lockdown measures.

What we see is that after 2–3 months of ruthlessly enforced lockdown, the virus receded enough to let people leave home and businesses begin reopening. The downtime created massive unemployment, disruption, and lost income that will take years to recover. Daily life is still heavily constrained, consumer spending is nowhere near what it was and will probably remain so until a vaccine is available. We don't yet see anything that looks like a V-shaped economic recovery in China.

Unfortunately, I think the US and Europe will follow a similar course. We will learn a lot in the next couple of weeks as some areas begin reopening. The key question: Can they do so without hospitalizations and deaths spiking higher? If so, maybe we can have a modified but somewhat normal summer. But there is a real risk of having to clamp down again if it doesn't work.

The economic trajectory is also uncertain but only in the sense that we don't know ***how*** bad it will be. I am sure you've seen poll data like this from CBS News.



Source: CBS News

There are other surveys with different timelines and activities but they all point in the same general direction. This is not going to be like turning on a light switch.

Absent miraculous breakthroughs, the economic pain is only just beginning. We are going to see entire industries either wiped out or hastily transformed. I was expecting some of this anyway, but over a much longer period of time which is why my forthcoming book is called the "Age of Transformation." Thanks to the pandemic, it is coming even faster than expected.

Juggling Act

Everybody wants to know when the economy can reopen. In one sense, that's the wrong question. The economy isn't "closed." Many essential businesses are still open. People still buy and sell things. Those sitting at home still engage in economic activity. But it is of a different nature, and the change creates costs.

So, what we're really asking is when the previously normal economy will be back. The answer is "never," I'm afraid. We will return to something quite different and as yet unknown.

According to Danielle Di Martino Booth's Quill Intelligence, less than 3% of US counties account for half of GDP and 61% of COVID-19 cases. Until these densely populated counties can reopen, economic activity will be lacklustre which drags on consumption. The urban areas will be the hardest to bring back online. But without them, we can't approach anything that looks like "normal."

As for when this can happen, we actually have a plan. On April 16, President Trump announced his guidelines for "Opening Up America Again." These are recommendation to governors, who may choose different paths, but the plan seems sensible. It envisions three phases, and each state would move through them based on 14-day periods of declining cases and adequate hospital capacity.

You may think Trump's plan is too relaxed or too strict, but it is at least relatively objective. It gives us targets to meet and recognizes local differences. Best of all, the phased approach should boost public confidence that the danger is easing—and that is ***critical*** to bringing the economy out of deep-freeze.

I get the resentment some feel toward being kept from work, but lockdown orders aren't the only barrier. Businesses won't reopen and put employees back on the payroll unless customers feel they can return safely, and the poll data shown above says they mostly don't.

All this will take time. There's no way around it. The measures we are presently taking have successfully "flattened the curve" nationally (local areas vary). We have to reopen without letting it shoot higher again. We also have to protect vulnerable people—the elderly and those with underlying health conditions. Doing all this at once will be a giant juggling act, but I believe we can do it. I think most of the US can be in phase 3 by the end of May ***if*** we do this right.

If we don't do it right? Good-bye, summer, and hello to a recession that lasts much longer than it otherwise would.

Testing Time

I am privileged to be in an email group (courtesy of Dr. Mike Roizen) that is helping provide counsel for state governments. The suggestions they make are somewhat similar to Trump's, but with a lot more detail. They break the population into five groups based on risk factors like age, and health condition.

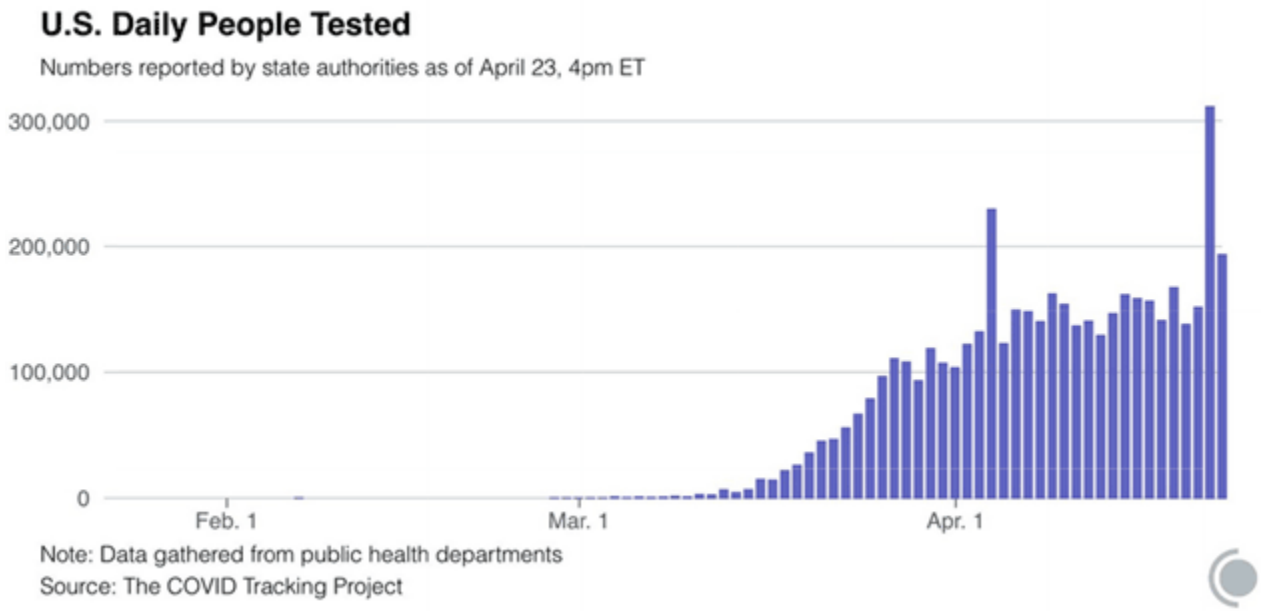
For instance, Group 1 is under age 50. Group 2 would be 50 – 65 without body mass indexes of greater than 39. Group 3 would be those with BMI over 39. (About 3% of Ohio, as an example.)

All those over age 80 and those age 65 to 80 with one or more serious co-morbidities (hypertension, obesity, type2 diabetes, chronic lung disease, immune dysfunction, kidney disease requiring dialysis, increased clotting disorders) are in Group 5 (about 3.5% of population and 55% of deaths).

The recommendation is to offer some type of financial inducement for higher-risk groups to stay home until there is adequate testing of the total community. If we do something like this, they estimate that 80% of the working population can be released initially, and another 10% in phase 2, and then everyone when adequate testing and a vaccine are available.

Testing is key to any reopening plan. Most of the experts think the US needs to be testing at least 500,000 people a day to truly get the pandemic under control. We are just starting to get into the neighborhood of 200,000 on average for the last few days. We need to at least triple that number. And then double it again. And then double that again.

And again. We know private labs have plenty of capacity. We trust them to test us for everything else. Get them working…



***Source:* [*COVID Tracking Project*]**

The tests and labs are not the only constraints here. Paraphrasing the old proverb, “For lack of a swab, the test wasn’t done.” Ditto for supplies like gloves and other protective equipment for health workers. We need to get every component, in adequate quantity, in the right places at the right times. Our initial inability to do that let the virus grow far faster in the US than it did in places with extensive testing, like South Korea and New Zealand.

I can’t stress enough how important this is. Widespread, reliable testing will help generate the confidence we need to get the economy moving again. Not enough testing will mean less confidence and slower recovery.

The Inflation/Deflation Debate

As I’ve been saying the last four weeks, without intervention we face the certainty of a massive deflationary depression. The Fed is leaning against this in unprecedented ways while the government tries to replace the lost income for businesses and individuals. This is not what we normally think of as “stimulus.” It is not intended to boost economic activity but simply replace a lost portion of it. The hope is to reopen the economy soon enough for recovery to take place on its own. I think this will take 2+ years, and we won’t see anything like a V-shaped recovery this year.

I sadly think that we will need even more rather large government spending. It will almost certainly be needed before the election, and quite likely before Congress breaks for the summer so that those checks and other help arrive in time for the elections. This is a bipartisan “need” for politicians.

Furthermore, although it offends every philosophical sense of right and wrong I hold dear, I understand why the Fed is intervening in the junk bond market to keep some zombie companies from going under. These companies represent jobs and the task right now, at least as the Fed sees it, is to prevent a major recession from becoming a depression.

Clearly that is going to help some companies but not all.

(Bloomberg)—More than 10% of US collateralized loan obligations are now at risk of cutting off cash payments to holders of their riskiest portions amid a surge in downgrades among leveraged loans backing the securities, according to analysts at Nomura Holdings, Inc. (H/T Mark Grant)

Essentially, many of the loans the Fed was trying to help are going to be downgraded anyway. The Fed’s action simply kept the price up, but did not increase the companies’ ability to actually service their debt. So many of the zombie companies will fail anyway.

But is all this Federal Reserve buying (NOT money printing) going to cause inflation down the road? Let’s turn to Dr. Lacy Hunt’s latest Hoisington Investment Management letter (emphasis mine):

Recent articles have suggested that the Federal Reserve and the Department of the Treasury are engaged in Modern Monetary Theory (MMT) or some form of "helicopter money," the famous Milton Friedman phrase also referred to by Ben Bernanke. The inference is that once the virus is contained, these new efforts will yield different and more powerful economic and inflation results than did the Quantitative Easing periods following the 2008–09 Global Financial Crisis (GFC).

Further, the suggestion is that the fiscal policy actions taken this year totalling $2.7 trillion will be far more effective than the $2 trillion stimulus package of 2009. Are these assertions that MMT is in place and monetary and fiscal actions will spur economic and inflation rates higher true? The short answer is no.

…For the Fed to engage in true MMT, a major regulatory change to the Federal Reserve Acts would be necessary: The Fed's liabilities would need to be made legal tender. Having the Treasury sell securities directly to the Fed could do this; the Treasury's deposits would be credited and then the Treasury would write checks against these deposits. In this case, the Fed would, in essence, write checks to pay the obligations of the Treasury.

If this change is enacted, rising inflation would ensue and the entire international monetary system would be severely destabilized and the US banking system would be irrelevant. Many cases of making a central bank's liabilities legal tender or its equivalent have occurred historically—China in the 1930s, Germany in the 1920s, Yugoslavia and Hungary immediately after WWII as well as multiple cases in Latin America. Inflation in these circumstances was so burdensome that economic conditions became horrific and serious political ruptures occurred. As these cases remind us, money printing would in the final analysis be an attempt to improve the economy by destroying its very basic foundations.

Note that Lacy is well aware that inflation and indeed hyper-inflation are possible under the right conditions. The Federal Reserve act would have to be changed.

Dr. Woody Brock in his latest writings pointed out that it was the rise of the service economy from 25% of the workforce in 1910 to 86% of the workforce today that produced the stability we have seen in the business cycle. (The instabilities were due to leverage, especially from low interest rates and the financialisation of the economy. These were an enormous monetary and regulatory policy mistake.)

The shock we are experiencing today is unlike anything we have seen in the past. We are simply seeing the service sector implode and we have no idea how long it will take to come back. As the quote at the beginning of the letter said, we are living in a world bounded only by our imaginations.

How High Will Unemployment Go?

Here are two predictions, the first from Danielle Di Martino Booth at Quill Intelligence and the second from Mike (Mish) Shedlock.

24 April 2020

Unemployment Rates by State				Unemployment Rates by State			
	Feb '20	Mar '20	Apr '20 est		Feb '20	Mar '20	Apr '20 est
Hawaii	2.7	2.6	25.7	Iowa	2.5	2.6	13.5
Kentucky	3.6	4.1	24.4	North Carolina	3.6	4.4	13.0
Michigan	3.4	4.6	24.0	Mississippi	3.5	3.4	13.0
Rhode Island	4.7	6.0	23.3	Wisconsin	2.7	2.6	12.6
Pennsylvania	3.6	6.3	22.8	North Dakota	3.5	4.5	12.6
Nevada	4.2	5.8	21.9	Kansas	2.2	2.2	12.6
Georgia	3.1	4.2	21.4	Missouri	3.1	3.1	12.5
Louisiana	3.8	5.1	20.5	Oklahoma	5.4	5.3	12.2
New Hampshire	5.2	6.9	18.8	Idaho	3.4	4.6	12.1
Washington	2.6	2.6	18.4	Connecticut	4.5	5.5	11.9
New Jersey	2.8	2.9	17.9	Arizona	3.2	3.1	11.8
Alaska	4.1	5.5	17.8	Illinois	3.5	4.8	11.7
Massachusetts	3.8	3.8	17.5	Arkansas	3.4	3.5	11.5
California	3.9	5.3	17.4	West Virginia	4.8	5.9	11.5
Ohio	5.8	5.6	16.8	Tennessee	2.6	3.3	11.4
Minnesota	3.1	3.1	16.4	Florida	3.3	3.3	11.2
U.S.	3.5	4.4	16.2	Virginia	3.3	3.3	11.2
Indiana	3.1	3.2	15.7	Oregon	2.9	4.2	10.9
Alabama	5.1	6.0	15.4	New Mexico	2.5	4.5	10.7
D.C.	3.5	3.5	15.3	Maryland	3.7	3.7	10.6
Montana	2.7	3.5	15.3	Colorado	3.5	4.7	9.6
Delaware	3.9	5.1	14.9	Texas	3.8	3.7	9.3
Vermont	2.4	3.2	14.9	Wyoming	2.5	3.6	8.7
New York	3.2	3.2	14.8	Nebraska	2.8	4.3	7.9
Maine	3.7	4.5	14.5	Utah	4.9	6.1	7.7
South Carolina	2.8	3.7	14.5	South Dakota	3.3	3.3	6.0

Source: BLS, U.S. Dept of Labor

Source: Quill Intelligence

Quoting Quill:

Extrapolating the data for the last five weeks indicates U3 unemployment rate for April payrolls should be around 16.2%; risk is to the upside surprise for the unemployment rate as some densely populated states' unemployment rates are lower than what would be expected

Mike Shedlock offered another analysis. You can see his math and methodology as to how he comes up with his numbers at the website.

Based on 26 Million Claims, What's the Unemployment Rate? My comfort range is 17–25% with an expectation of 20–24%. A U-6 rate well into the 30% range is likely in any case.

("U-6" is a broader unemployment rate that includes "involuntary part-time workers" who took those jobs but really want to work full-time.)

In a late-night conversation with Mish, we both agreed that the May number will be even higher, because unemployment will still be rising into their data collection, which is whatever day includes the 12th of the month. Depending on how fast the economy opens up, and how fast the large urban areas can begin to function, a 25% unemployment rate for a short period of time is quite possible. That is just ugly.

There is so much else I could talk about. Literally I could do another letter this size just from the data that is screaming to get on this page. But it is time to begin to close. But first, this quick notice.

I think this pandemic is accelerating the timeline for what I call The Great Reset, when we will have to rationalize global debt. My friends at CMG and I are redoing a paper on that along with some other COVID-19-related items. You can see these and more by visiting the CMG website. You can also learn how my team at CMG is helping clients navigate the current investing environment. I am proud of how our team has been working together to help clients just like you.

What the actions by government and the Reserve Bank tell us

Professor Brian Kantor
Investec Wealth & Investment

Government and the Reserve Bank have done the right things in response to the Covid-19 pandemic. However fiscal discipline will be required after the crisis to win the confidence of capital markets.

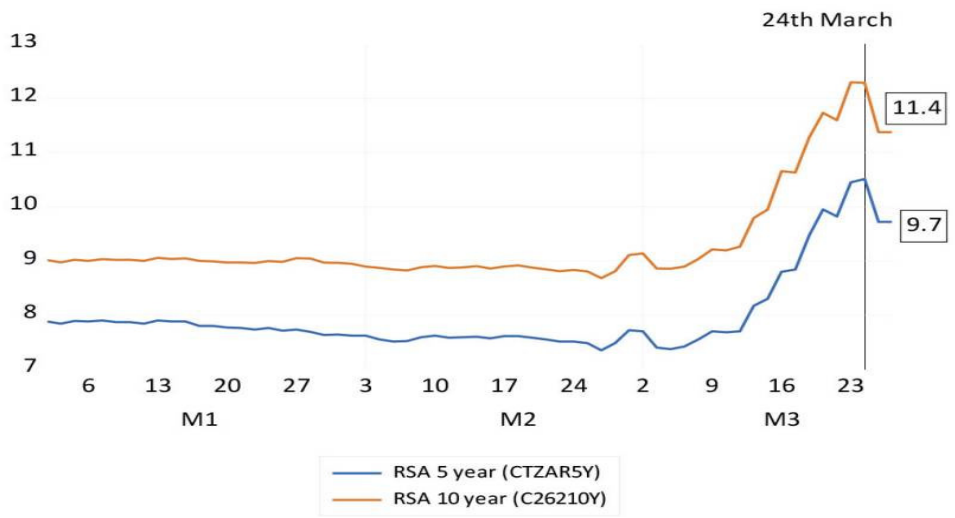
Last week we saw the government order and prepare for a shutdown of much economic activity, in order to deal with the health crisis. We also saw the SA Reserve Bank moved from conventional to unconventional monetary policy.

Everyone, including participants in capital markets, have tried to come to terms with the evolving realities at home and abroad.
The Bank, at its monetary policy proceedings the previous week, reported in an explicitly conventional way of tackling the issue. It cut its key repo rate by an unusually large 100bps (one percentage point) on an improved inflation outlook. By 25 March, it was practising quantitative easing (QE), by announcing that it would be buying government bonds in the market to reduce "excessive volatility in the prices of government bonds" and freely providing loans to the banks of up to 12 months.

The Bank is therefore creating money of its own volition. Cash reserves, that is deposits of the private banks with the Reserve Bank, are created automatically when the Reserve Bank buys government bonds and shorter-term instruments from the banks or its customers. These deposits with the Reserve Bank most definitely serve as money – and are created without any cost to the issuer (the central bank) acting as the agent of the government. They support the balance sheets of the banks and this should lead to extra lending by banks, as intended.

Had the Reserve Bank not done so, the bond market would surely have remained volatile. More importantly, it might not have been able to absorb a deluge of bonds and bills that the government would be issuing to fund its emergency spending.

This includes coping with a drawdown of R30bn of bonds sold by the Unemployment Insurance Fund to generate cash for the government to spend on income relief.



The yield on 10-year government bonds was about 9% in early March. By 24 March it was over 12%. It has receded slightly since in response to Reserve Bank action (see figure below). The derating of SA credit by Moody's had become inevitable in the circumstances and fully expected before the announcement on Friday evening.
Central banks all over the world are also doing money creation – in great quantities. Doing so is a predictable response to their own lockdowns, collapse of economic activity and threats to financial stability. But in the developed world bonds and other securities trade at much lower interest rates, though no doubt the scale of their bond and other asset buying programmes (QE) is part of the explanation for very low yields. Yet despite money creation on a vast scale, more inflation is not expected in the developed world.

Not so in SA and in many other emerging markets. Issuing longer-dated government bonds in their own currencies is a very expensive exercise for governments and their taxpayers and has become more expensive. Lenders to emerging market governments, in their own currencies, demand compensation for high rates of inflation expected, and receive compensation for the inflation risks they take in the form of high interest rates for long-term funding commitments. There is always the chance anywhere that the purchasing power of interest income contracted for, and the real value of the debt when repaid, will be eroded by inflation of the local currency.

The danger is that fiscally strained governments will one day yield to the temptation to inflate their way out of the constraints imposed by bond investors by turning to their central banks, rather than the bond market, to fund their spending. Issuing money to finance spending carries no interest cost. It can be highly inflationary, depending on how much money is created and for how long.

The growing risk that SA could get itself into a debt trap and create money to get out of it, has been the major force in recent years driving long-term yields higher. Bond yields have risen out of fear that SA would create money for the government to spend in response to ever growing budget deficits and a fast-growing interest bill. This is what the government is now doing, though in truly exceptional and justifiable circumstances.

Avoiding the debt trap, controlling budget deficits and convincing investors and credit rating agencies that the country can fund its spending over the long term without resorting to money creation, is the task of fiscal policy. In current circumstances, regaining such a reputation is more unlikely than it was when a promisingly realistic Budget was presented in February.

The Reserve Bank may hope to control domestic spending and inflation through its interest rate settings. It does not control inflation expectations though, nor the interest rates established in the bond market. The link between long and short rates is via expected inflation. Expected inflation over the long run is dependent on the expected fiscal trends, not necessarily on recent inflation. These fiscal trends have deteriorated almost everywhere, thanks to Covid-19.

How therefore should the government and the Reserve Bank react to the current circumstances when long-term yields are unlikely to recede significantly? Particularly when the yield curve is likely to get steeper, should the Reserve Bank reduce its repo rate further?

The government should and probably will fund as much as it can at the cheapest, very short end of the capital market. It could issue more short-dated Treasury Bills to fund spending and to replace long dated bonds as they mature with shorter term obligations. It will save much interest this way. The actions of the Reserve Bank adding liquidity (cash) to the money market through QE will have made it much easier to borrow short from banks and others.

And when the economic crisis is behind us it will remain essential to strictly control government spending to regain access to the bond market on more favourable terms. Only the consistent and expected practice of fiscal discipline will deserve and receive lower longer-term borrowing costs.

South Africa is bent on austerity: there's a strong case that it should change tack

By Dr Gilad Isaacs

Co-Director, Institute for Economic Justice, *University of the Witwatersrand*.

As government, economists, activists, business leaders and the public debate the size and scope of government support to the Covid-19 hit economy, it is worth asking a simple question: what is the impact of government spending?

This forms part of a wider debate over whether South Africa should continue on the path of austerity – cutting expenditure with the aim of reducing debt – or undertake a fiscal stimulus – spending with the aim of growing the economy.

Recent research by Professors Enno Schröder and Servaas Storm from Delft University of Technology throws useful light on this question. The research was prepared for the Institute for Economic Justice's on-going research into the viability, scope and nature of an appropriate fiscal stimulus for South Africa. The research was undertaken before Covid-19 hit. It is even more relevant now.

Read also: Here's the REAL price of the government gravy train – hefty taxes, vulnerable economy

The research shows that for every R1bn government spends, gross domestic product (GDP) increases by R1.68bn and 6,900 jobs are created. This means that spending 6% of GDP, R305.6bn, would increase GDP by R513.4bn and support the creation of 3,542,460 jobs.

Thus government spending is able to grow the economy, to the extent that it could lower the debt-to-GDP ratio. It also shows that additional government expenditure could sustain the economy through the current crisis period.

Does the economy have room for expansion?

An economy's ability to grow can be constrained by factors that limit its ability to produce goods and services – "supply-side" factors like poor infrastructure or a lack of education. It can also be constrained by a lack of funds to purchase the goods and services it does produce – "demand-side" factors.

The International Monetary Fund and South Africa's national treasury argue that the country's poor growth performance over the past decade is due to supply-side factors. These include infrastructural bottlenecks in electricity generation and supply, over-regulated (formal) labour markets, and increases in product market concentration (as seen in rising profit mark-ups).
The IMF and treasury therefore support budget cuts, labour market deregulation and tax cuts, all of which purportedly will promote private-sector led and inclusive growth.

Here the assumptions lead to the conclusions obtained. If the South African economy is assumed to be supply-constrained then naturally only supply-side interventions such as lowering labour costs will enhance growth. If this is the case, so the argument goes, then fiscal stimulus, which aims to raise demand in the economy, is a blunt tool, providing little opportunity for economic revival.

But this does not factor in the room for economic expansion that clearly exists.

According to the country's statistics agency, Stats SA, utilisation of production capacity – the capacity of the economy to produce goods and services, for example, through factory output – is on the decline. Between 2018 and 2019, production capacity declined by 2%, with eight out of ten manufacturing sectors showing a decrease.

At the same time, unemployment is unconscionably high, at 29.9% in the last quarter of 2019, and inflation is falling, now below the middle of the South African Reserve Bank's target range. It is true that infrastructural shortages such as expensive internet or inefficient rail transport can constrain economic performance. But targeted fiscal expansion – investment in free broadband or investment in rail freight services – can remove these bottlenecks and expand supply capacity, while also boosting demand.

South Africa's fiscal multipliers

The impact of fiscal expansion (and fiscal consolidation) is ultimately determined by the size of the fiscal multiplier. A fiscal multiplier measures the impact that each additional rand of government spending would have. Schröder and Storm estimate both the "income multiplier" – the impact of spending on GDP – and the "employment multiplier" – the impact of spending on employment growth.

In their first estimation, increasing demand in the economy (via government spending) will initiate additional production. That will require more labour input (a direct effect). The higher demand for labour services will increase labour income. This will cause higher consumption spending in a particular industry (an indirect effect) and in connected industries (an induced consumption effect).

The results of this first technique indicate that a fiscal stimulus of R1bn will raise South Africa's GDP by R1.5bn and create 6,100 jobs. This is in line with previous studies using this technique.

In their second estimation, they include an induced investment effect. This refers to a change in output, income and employment that would come from firms investing a fraction of the additional profits earned in supporting industries.

Read also: SA sees Moody's downgrade as opportunity to 'do the right thing' for the economy

For this technique, the estimated income multiplier shows that R1bn increases GDP by R1.87bn and generates 7,700 jobs.

The authors prefer an average of the two techniques, showing that a fiscal stimulus of R1bn will generate R1.68bn extra income and create 6,900 new jobs. This is because the first technique leaves out investment effects, but the second overestimates these because the data does not distinguish between private-sector and public investment.

These figures allow us to calculate the impact of different levels of additional government expenditure. Increasing spending by 3% of GDP, or just over R150bn, leads to an expansion of GDP of just over R250bn and almost 1.8m jobs. Spending of 6% of GDP (just over R300bn) leads to over R500bn in additional GDP and 3.5m jobs, and spending of 10% of GDP leads to an increase in growth of just over R850bn and also 6m new jobs.

Yet the path that the South African government has chosen is to reduce rather than increase government expenditure.

Fiscal consolidation and growth

South Africa's 2020 budget proposes, over the next three years, tax relief and rebate measures combined with reductions in public spending of approximately R48 billion (when taking account of both government cuts and increases, and comparing these to what an inflation-based increase would be). The argument goes that austerity will help revive the stagnating South African economy and kick-start economic growth by inspiring "confidence" in the business sector and global financial markets and contribute to the sustainability of public debt. This is the conventional wisdom.

Another view has it that austerity has in fact contributed to the slow growth of the South African economy and to the growing income inequality experienced in the 2010s. Schröder and Storm argue that continued fiscal tightening is counter-productive to the aim of raising the country's long-run growth performance.
In fact, the multipliers above suggest that the proposed cuts in public expenditure, of R48bn, will likely reduce South Africa's GDP by R81bn over the next three years 2020-2022. This amounts to a decline in GDP growth of around 0.5 percentage points, accompanied by the likely destruction of around 330,000 jobs.

The 2020 austerity budget is socially and economically destructive.

The present moment

The present context has made the picture more complicated, but this analysis even more essential. It has become clear that the economic fallout from the COVID-19 pandemic, and measures taken to stop its spread, will be massive. The economy could shrink by as much as 8.3%, some estimates show. This calls for bold interventions by government.
These interventions will not take the path of a traditional economic stimulus as the lockdown and associated measures purposefully attempt to slow the economy. Rather, the economy is being put on life support.

This life support must ensure that a viable economy still exists when the spread of Covid-19 is eventually contained. This will require an unprecedented increase in government spending. It's therefore essential to know how effective each rand of government spending will be in sustaining GDP.

Richard Cluver Predicts reprinted from last Friday:

Volume: 33

24 April 2020

Issue: 17

It feels like the Great Depression, the worst failure in the world's monetary history. However, while the people in charge back in 1929 might, perhaps, be excused for the catastrophic mistakes that they made out of a failure to understand how the economic system worked, they have no such excuse today!

So, while I must praise President Ramaphosa and his team for the steps they have taken so far, the acid test will be in the execution. Nobody can fault Team Ramaphosa for enacting the lock-down when he did for that action has undoubtedly saved countless lives. What I do fault, however, is their failure of detail. Which idiot in the team decided that tobacco and alcohol should be banned. I was once a smoker and I understand how desperation can drive decent ordinary folk to become criminals in search of their cigarettes.

But, as Prohibition in America taught the world, criminality flourishes when 'holier than thou' folk seek to restrict public access to their vices. So those who are desperate are still getting their fixes courtesy of a flourishing underground industry which, once established, is hard to stamp out. Meanwhile, the fiscus is being deprived of desperately-needed revenue.

The same goes for those who thought it smart to arrest people who, while keeping a suitable distance from one another, would like to take a little exercise by walking in our many open spaces. They bring the law into disrepute which is disastrous in the long term if we ever hope to return to being a normal law-abiding society.

I could go on and on! I guess Cyril has little option in his divided political party but to be obliged to incorporate a lunatic fringe. But, nevertheless, the Covid-19 crisis has allowed him to take command and stand up to the worst in his team, so perhaps he can be forgiven for allowing the idiots some concessions.

He has stood up to them where it really matters. For example, the bloated civil service wage bill did not take us further into the red last Wednesday by overpaid public servants being awarded further pay increases at precisely the time when all over the country private sector people are, at best, having their wages cut, and countless thousands of others can expect nothing at all.

Worse, nearly half of the country's small businesses are threatened with oblivion as a direct result of the lock-down. That is why the processes of "helicopter money" and "quantative easing" have been employed in the Developed World to ensure that those economies will keep on running after the immediate crisis is over.

As many readers of this column will by now have been made brutally aware, even Blue Chip companies have had to close ranks and many have deferred their dividends, guaranteeing hardship for millions of pensioners whose often quite meagre lifetime savings were invested in such Blue Chips in order to put a “few little luxuries” into the shopping baskets of the elderly when their inflation-eroded pensions no longer stretched that far.

That is why, before all the ink is dry on Cyril’s R500-billion rescue plan, I would like to add the suggestion of a quick and efficient means of saving hundreds of thousands of jobs and, in a win-win process, both serve to uplift South Africans collectively and polish the social image of the ANC. Furthermore, it could go a very long way towards ensuring the future prosperity and financial stability of the country, and guaranteeing team Ramaphosa and Mboweni a good place in history!

Furthermore, if Cyril can use his well-documented persuasive charm to prevail upon the Reserve Bank, this line of rescue need not either divert any money from the R500-billion rescue package, or need it add a cent to the Government’s already overstretched loan book.

The plan is simple. Extend an offer to South Africa’s property Reits to take up a minimum of five percent of their issued share capital which would give them vitally-needed working capital at this time when their tenants, the nation’s hard-pressed retailers, restaurateurs and thousands of ‘Momma and Poppa’ stores, are finding it nearly impossible to meet their rent bills as a consequence of the lock-down. The offer could be conditional upon the property-owners providing their tenants with something like a three-month rental holiday and, five percent would be enough to give the government a seat on the board. That way the benefit would trickle down to small businesses which, in return for the rent holiday, might in their turn be prevailed upon to maintain the wages of their employees.

If the landlords were required to issue convertible Preference shares in return for such loans, Government or, preferably the Reserve Bank, would be obtaining a real growth asset at a currently bargain price. Below I offer you graphs of what has happened to two of the property Reits that my ShareFinder system lists as topmost Blue Chips: Growthpoint and Hyprop. Hyprop was standing at R140 a share in mid-2016 when, as a consequence of State Capture, the South African share market turned bearish. Growthpoint lasted longer, peaking in early 2018 at R29. This week, Growthpoint could be bought for R13 and Hyprop for R18; bargain basement prices if ever they were!

In terms of the Reserve Bank Act, that institution is charged with issuing ‘promissory notes’ which we know as Rands. It does so in a strict ratio to the assets it holds; assets such as gold bullion, the International Monetary Fund’s Special Drawing Rights and the currencies of other nations. There is, however, nothing so far as I am aware to prevent it adding Blue Chip shares to that asset base. Alternatively, because the Reserve Bank accommodates the South African Government by buying its bonds, there is nothing to

prevent it from, within reason, buying “zero-interest” bonds that would allow the Government to buy such shares* Note the article at the end of this weekly column on this concept. Either way the shares would represent an asset in the hands of the people of South Africa.

The only limitation upon the asset backing of the Rand is the effect upon it in the marketplace and the authorities have obviously considered it an advantage to allow that relationship to decline over the years so that our exporters might remain competitive in global markets while, for example, mine wages have soared ahead of those of our mineral-exporting competitors. My graph on the right shows how the Rand has been allowed to decline in value from R3.14 to the US Dollar at the dawn of democracy to a current R18.99. The red trend line suggests that the decline has occurred at a mean compound annual average rate of 5.4 percent. Over the past two years, however, as our global debt rose to the extent that the ratings agencies have now all “Junked” our bonds, that rate has dramatically accelerated to 25 percent as denoted by the green line: a compelling reason why we must turn our economy round and restore it to job-creating growth rather than a centrally-commanded socialistic disaster.

In an aside, there have now been four times when the Rand has crashed in value. In 2001 it fell from R7.6 to the US$ to R13.13, again in 2008 it went from R6.54 to R10.64, the next one was more protracted during the Zuma years when the investment community world finally lost hope in the resurrection of our once healthy economy, rising from R6.69 in January 2011 to R16.57 in December 2015. And now, of course, we have had our ratings agency downgrade that was widely expected from December last year when the Rand stood at R14 to a current R19.12. That first spike prompted an inconclusive commission of enquiry which strongly fingered a cartel of foreign merchant banks in a concerted “shorting” attack upon our currency. But no official action is known to have been taken.

Nobody has since picked up the challenge as to why these spikes have occurred, but they should because opportunistic attacks upon the currencies of nations have had a massive cost effect upon their citizens; ask any South African who has children living abroad and, not unreasonably, would like to make periodic visits to them!

But, to return to my argument for the State buying direct stakes in Blue Chip local companies, the following graph of the ShareFinder Blue Chip index illustrates how a sovereign wealth fund created in such a manner would, by direct implication, benefit all South Africans and over time reduce Government’s reliance on tax revenue. The red line represents the mean value of such a portfolio as it has risen in value year by year at an annual compound average rate of 16.7 percent; that is better than three times the rate at which the Rand has lost value and grown their dividend distributions in the same manner.

What about the quality of these property Reits? That is determined by the quality of their underlying investments and in the case of the two examples I have offered, that is solid bricks and mortar which **in normal times** bring in enough revenue to GUARANTEE an income yield, in the case of Hyprop, calculated on the last financial year ended June 30 2019, of 10.2 percent.

Furthermore, until the market turned against this share simultaneously with the onset of the latest attack upon the Rand, it was offering compound annual price growth of 15 percent as illustrated by the red trend line in my graph on the right.

That represents a Total Return of 25.2 percent. Moreover, calculated upon the current price of R16.93 that represents a yield of 42.77 percent and a total return of almost 58 percent if things were to return to normal; possibly the greatest bargain I have seen in my lifetime as a financial commentator

As to the quality of the investment, Hyprop owns landmark retail malls: Canal Walk, CapeGate, Clearwater Mall, Rosebank Mall, Somerset Mall, The Glen, Woodlands Boulevard and Hyde Park Corner as well as significant holdings in Eastern Europe with, according to the last annual report, a very low vacancy rate of 0.8 percent.

Finally, as the extract on the right from the last annual report makes clear, against assets of R35.366-billion, the company has debts of just R8.75-billion. That is a gearing ratio of just 24.7 percent in an industry in which average gearing is 35.5 percent and it might be compared with an Investopedia analysis that claims the average debt ratio of US Standard & Poors 500 companies if 150 percent.

Consolidated statement of financial position

at 30 June

	Note	2018 R000	2017 R000
ASSETS			
Non-current assets		33 951 124	32 854 166
Investment property	2.1	30 141 027	29 128 477
South African portfolio		28 091 539	27 176 840
Ikeja City Mall (Lagos, Nigeria)		2 049 488	1 951 637
Straight-line rental income accrual	2.3	550 182	553 119
Building appurtenances and tenant installations	3	163 068	148 530
Investment in sub-Saharan Africa (excluding SA)		2 918 721	3 005 821
Loans receivable from joint ventures	10	2 918 721	2 995 718
Investment in joint ventures – sub-Saharan Africa	6.2		10 103
Financial asset	7.3	152 556	
Other investment	9	#	#
Loans receivable	10	18 723	17 434
Derivative instruments	18	6 846	785
Current assets		1 015 095	1 366 021
Loans receivable	10	40 716	
Trade and other receivables	11	258 071	230 741
Derivative instruments	18	815	9 530
Cash and cash equivalents	12	715 493	1 125 750
Non-current assets classified as held-for-sale	13	199 257	426 681
Total assets		35 165 476	34 646 868
EQUITY AND LIABILITIES			
Equity and reserves		26 395 237	24 882 553
Equity and reserves attributable to Hyprop shareholders		26 304 917	24 788 254
Stated capital	14	8 418 904	7 648 716
Non-distributable reserves	15.1	16 841 038	16 252 043
Share-based payment reserve	15.2	27 443	23 901
Retained income		1 004 408	861 877
Foreign currency translation reserve	16	13 124	2 217
Non-controlling interest	4.1	90 320	94 299
Liabilities			
Non-current liabilities		8 203 399	5 428 316
Borrowings	17	7 815 651	5 068 332
Financial guarantees	8.2	185 686	163 855
Derivative instruments	18	24 060	56 530
Deferred taxation	19	178 002	139 599
Current liabilities		558 683	4 322 925
Borrowings	17	69 343	3 832 306
Trade and other payables	20	486 090	489 681
Taxation		1 251	
Derivative instruments	18	1 999	938
Liabilities directly associated with non-current assets held-for-sale	13	8 157	13 074
Total liabilities		8 770 239	9 764 315
Total equity and liabilities		35 165 476	34 646 868

Value less than R1 000

Having lately been a buyer of significant quantities of Hyprop shares for my own portfolio, I have in the current idiom, demonstrably put my money where my mouth is. I trust Finance Minister Tito Mboweni who receives this column each week, similarly appreciates how ordinary South Africans could similarly benefit.

In closing, I note that the Stellenbosch Bureau for Economic Research (BER) is now projecting a budget shortfall of 11.1% of GDP, or R558bn, due mainly to lower tax revenue and higher debt service costs. Add to this, for example, a temporary R500 top-up to social grants for six months, and the deficit is closer to 12%. To fund the shortfall the government, which issues about R15bn of bonds every week, would need to increase issuance by another R5bn, says the BER.

In the weeks leading to the lockdown bond investors were already in full flight for the door, with bond yields close to 13% when the Reserve Bank entered the secondary market on a modest scale to itself buy government bonds. But the Bank stated that it would not target the price of borrowing and intended only to unfreeze the bond market.

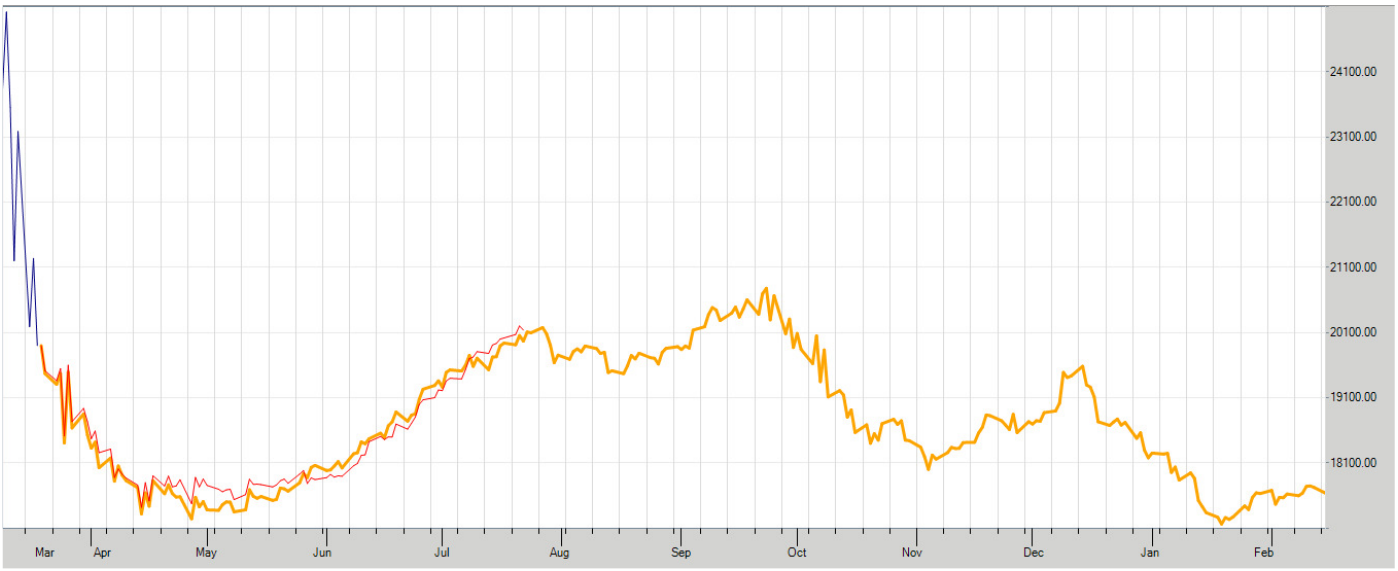
Now, with greater issuance and a credit ratings downgrade in the mix and yields still above 11%, the real prospect has emerged that the government could rapidly find itself in a position where it is unable to sustainably raise the money it needs. It could turn to short-term borrowing or use the cash reserves held at the SA Reserve Bank. It could also access concessional funding such as that offered by the New Development Bank, African Development Bank, World Bank and maybe even the IMF special Covid-19 facility.

It is doubtful, though, that any or all of these will be of the scale required to finance the government continuously for the next 12 months. The main source of funding is likely still to be weekly bond auctions. Unless confidence in this market is restored the government will have limited options, none of which is attractive.

Among them are: the route the apartheid government took of prescribed assets; bilateral loans from other countries; or a standby facility from the IMF.

The next move by the Reserve Bank will give us a sense of where we are heading. But clearly, we need to shore up our reputation as a reliable borrower with growth assets in our sovereign mix. That is another reason why I have touted the Property Reits investment idea. Of course, it need not be confined to the Reits once it is demonstrated to be a viable working concept.

Meanwhile, ShareFinder has turned increasingly pessimistic about Wall Street which went into reverse this week, possibly undoing the previous hope for a V-shaped recovery. The following graph shows our latest ShareFinder 6 projection for the Dow Jones Index, likely to be the most accurate forecast we have ever made given the increased forecast accuracy of our latest software:



The month ahead:

New York's SP500: I correctly predicted the recovery with this week's weakness likely to be over by the first week of May followed by gains until the end of September when the next sharp phase of weakness is likely.

London's Footsie: I correctly predicted the recovery which I still see lasting until the end of May, downhill from then until early July and then another recovery until early October ahead of the next big down-turn.

Hong Kong's Hangsen: I correctly predicted the start of a long recovery until January when the next down-turn is likely. In the short-term I see declines until mid-May.

Japan's Nikkei: I correctly predicted the short-lived recovery would be over by mid-month. Here the market has topped out and it is likely to be downhill until August before a recovery until late September.

Australia's All Ordinaries: I correctly predicted a worsening situation with the down-trend continuing until mid-August before it briefly recovers with further down-hill trending thereafter until year end.

JSE Industrial Index: I correctly predicted a modest recovery which I did not see lasting much longer. Now it is likely to be down-hill until the end of June followed by a brief July-long recovery and then a volatile decline thereafter.

Top 40 Index: I correctly predicted the start of a decline until late June and then a brief recovery which I still see lasting until late July followed by a weakening sideways trend until the next sharp decline, likely in December.

ShareFinder Blue Chip Index: I correctly predicted the beginning of a more modest phase of recovery which I now see lasting until late July though interim volatility must be expected. From July 23 it is likely to be downhill again.

Gold shares: I wrongly predicted further declines which I saw lasting well into 2021. But the current recovery is probably over now and I see declines from now well into 2021.

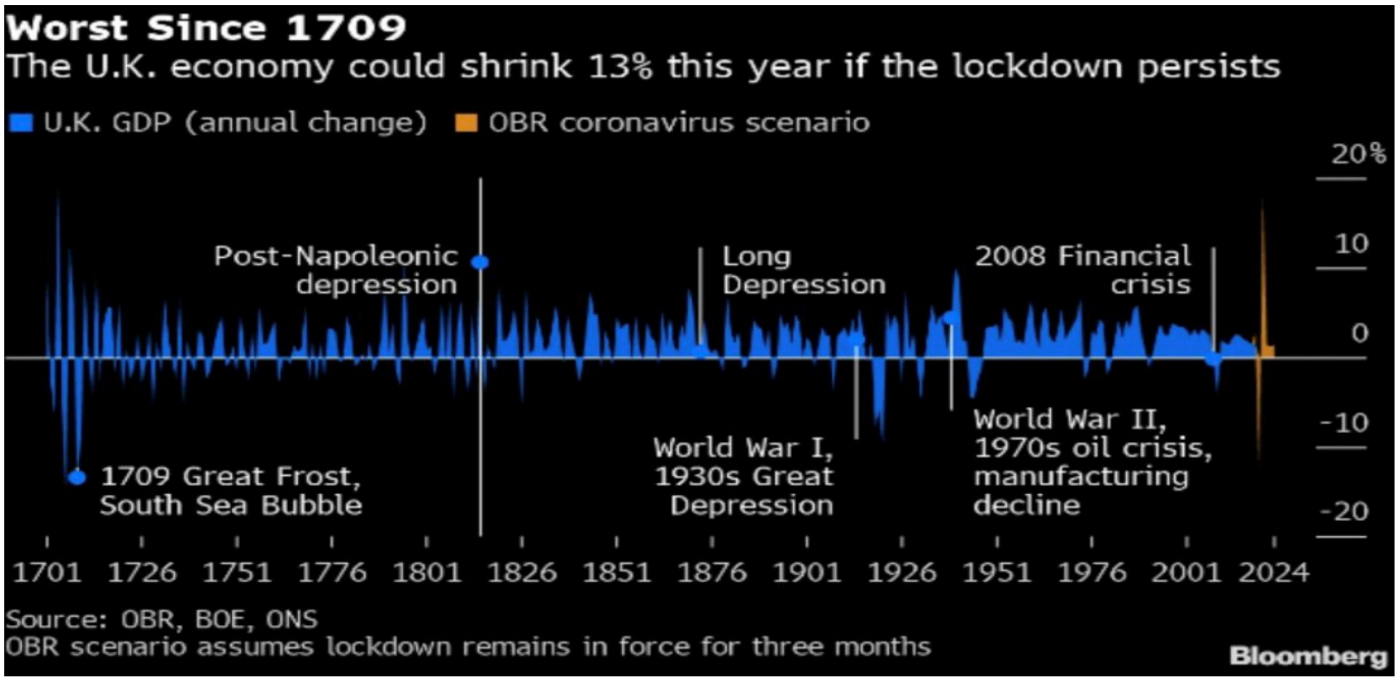
Gold Bullion: I correctly predicted a decline but missed the up-tick that followed. Now I see weakness lasting until mid-June before a long recovery begins and that is likely to continue well into 2021.

The Rand/US Dollar: I correctly predicted the establishment of a semi-permanent new level at around R18.60 to the dollar. Now I see modest gains until the third week of May.

The Rand/Euro: I correctly predicted a volatile recovery which I now see lasting until mid-June followed by weakness until mid-July followed by gains until late October.

The Predicts accuracy rate on a running average basis over the past 742 weeks has been 85.67%. For the past 12 months it has been 96.54%.

Richard Cluver



How other Governments are coping with the cost!

By Adair Turner, former chair of the UK Financial Services Authority

In response to the Covid-19 pandemic, the US Federal Reserve will buy unlimited quantities of Treasury bonds, the Bank of England will purchase £200bn ($250bn) of gilts, and the European Central Bank up to €750bn ($815bn) of eurozone bonds. Almost certainly, central banks will end up providing monetary finance to fund fiscal deficits. The only question is whether they should make that explicit.

Monetary policy, on its own, is clearly impotent in today's circumstances. Central banks have cut policy interest rates and bond purchases are depressing long-term yields. But nobody thinks that lower interest rates will unleash higher consumer expenditure or business investment.

Instead, depressed economic growth will be offset (as best possible) by increased government spending on healthcare, direct income support for laid-off workers, and a reduced tax take. This will inevitably result in unprecedented fiscal deficits.

In theory, funding those deficits by selling government bonds could raise bond yields, potentially offsetting the stimulative effect. But with central banks buying bonds and depressing yields, governments can borrow all they need at rock-bottom interest rates.

When the United States used that policy during World War II, the Fed's role in facilitating debt finance was explicit: from 1942 to 1951, it committed to buying Treasury bonds in whatever quantity needed to keep bond yields flat. This time round, such explicit commitments have been avoided, but the effect is the same: central banks are making it easy to fund yawning fiscal deficits.

Whether this amounts to permanent monetary finance depends on whether the bonds are ever sold back to the private sector, with central banks' balance sheets returning to "normal" levels. In the US after World War II, such a reversal never happened.

In their book, *A Monetary History of the United States*, Milton Friedman and Anna Schwartz later estimated that about 15% of the war effort was financed with central-bank money rather than by taxes or with debt which was never actually repaid. In Japan, where 25 years of large fiscal deficits have been matched by

equally large purchases of government bonds by the Bank of Japan, it is also obvious that the central bank's bond holdings will never be sold: permanent monetary finance has occurred.

So, monetary finance need not be explicit to be permanent. All asset purchases by central banks over the past decade — so-called quantitative easing (QE) — might in retrospect entail some monetary finance.

That possibility terrifies those who believe that monetary finance must eventually lead to hyperinflation. But such fears are absurd. Friedman famously said that in a deflationary depression, we should scatter dollar bills from a helicopter for people to pick up and spend. Suppose US President Donald Trump ordered just $10-million of such helicopter money: the impact on either real activity or inflation would be minuscule. But suppose he ordered $1,000-trillion: obviously, there would be hyperinflation. The impact of monetary finance depends on the scale.

Fears about the long-term impact on central-bank balance sheets and commercial-bank profitability are also misplaced. Central banks do not directly create the money held by individuals or companies in the real economy; what they create is the monetary base held as reserve assets by banks. As a result, central banks, which pay interest rates on reserves, will face an ongoing cost if they create more such money.

But central banks can create costless money by paying zero interest on some commercial-bank reserves, even while paying a positive policy rate at the margin. And while such zero-rate reserves might impose an effective tax on credit creation when economic activity revives, that could be desirable, because it would prevent the initial stimulus from being harmfully multiplied by commercial bank's future money creation.

So, on close inspection, all apparent technical objections to monetary finance dissolve. There is no doubt that monetary finance is technically feasible and that wise fiscal and monetary authorities could choose just the "right" amount.

The crucial issue is whether politicians can be trusted to be wise. Most central bankers are sceptical, and fear that monetary finance, once openly allowed, would become excessive. Indeed, for many, the knowledge that it is possible is a dangerous forbidden fruit which must remain taboo.

They may be right: the best policy may be to provide monetary finance while denying the fact. Governments can run large fiscal deficits. Central banks can make these fundable at close to zero rates. And these operations might be reversed if future rates of economic growth and inflation are higher than currently anticipated. If not, they will become permanent. But nobody needs to acknowledge that possibility in advance.

Paradoxically, the only danger with this approach is that central banks will be too credible. If individuals or companies believe policymakers' promise never to allow monetary finance and that all QE operations will definitely be reversed, they will expect that all the new public debt must be repaid out of future taxes. And anticipation of that burden could depress consumption and investment today.

The alternative approach is honesty — while offsetting the danger that honesty will lead to excess. Andrew Bailey, Governor of the Bank of England, argued on April 5 that explicit monetary finance is "incompatible with the pursuit of an inflation target by an independent central bank". But former Fed Chair Ben Bernanke has shown why that is not true, proposing instead that independent central banks should determine the amount of any monetary finance while governments decide how to spend the money.

Independent central banks could make explicit decisions about optimal quantities of permanent monetary finance. But whether or not they do, a significant proportion of today's QE operations will in retrospect have financed expanded fiscal deficits.

Note: Spain is currently considering the issuance of "Permanent Bonds" which might represent an alternative approach. RC