Our Monthly Free Newsletter
TheInvestor
In our 34th year of service to the investing public of South Africa

ShareFinder's prediction for Wall Street for the next seven months:

5 Markets in your Pocket

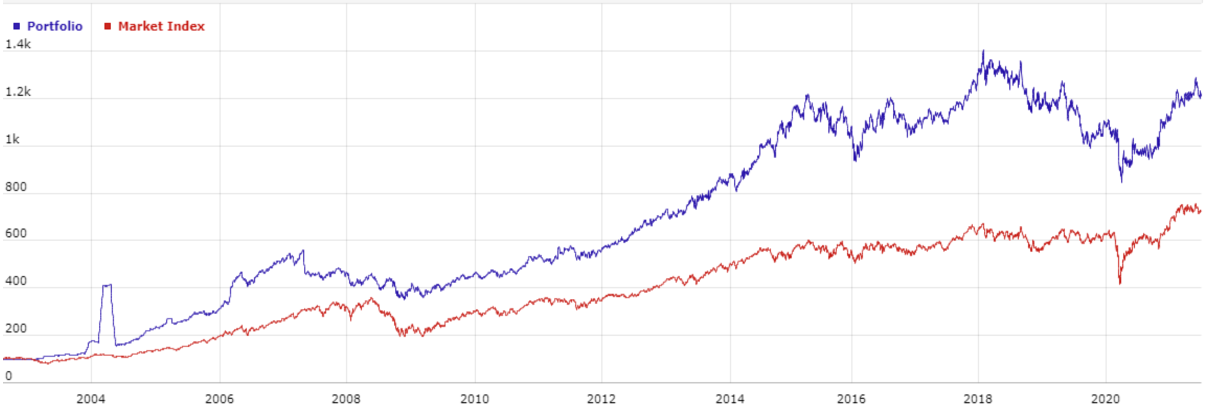
By Richard Cluver

Offering you instant analysis of your share market portfolios anywhere in the world at any time: that is what we strove to achieve with a mobile phone app which could offer investors the best features of the ShareFinder share market analysis software. And now it is done and available at the cheapest possible price.

Better still, for everyone who buys shares in ShareFinder International via the crypto currency linked initial public offering within the next few weeks, you can secure perpetual use of the SF6 Mobile at half the normal $10 monthly subscription rate…. More about that in the next article.

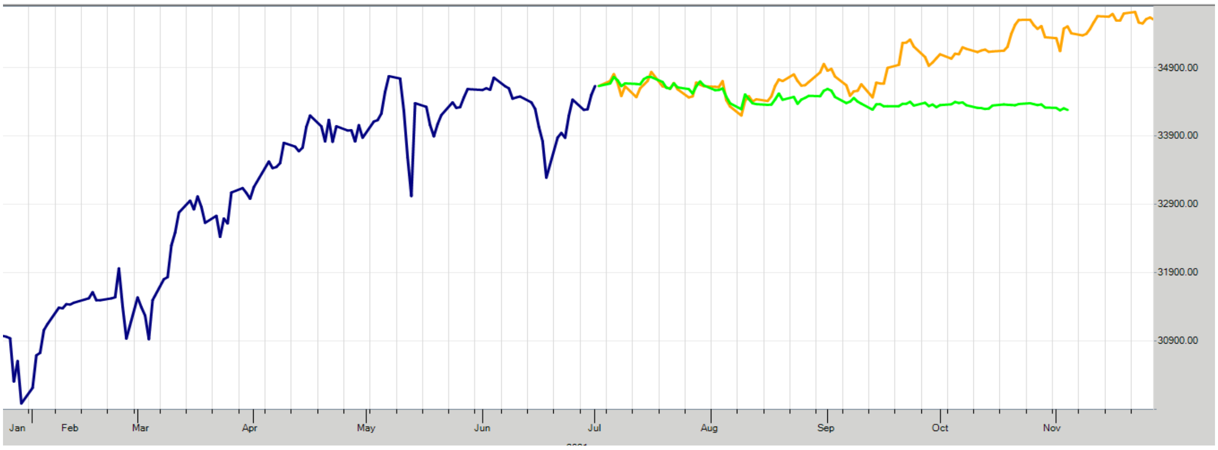
The lone limitation to the use of the Mobile anywhere in the world is the availability of an internet signal. Conceived to be used in conjunction with the ShareFinder desk-top module which will tailor-make portfolios tailored to individual users risk/reward preferences, the Mobile was developed as a means of providing investors with the peace of mind of being able to perform a quick portfolio health check whenever the opportunity presents itself; in an airport boarding lounge, on the bus or anywhere that you have a few free minutes to spare in your busy day.

It offers a snapshot of your portfolio performance relative to a market index; in the example below a South African portfolio relative to the JSE Overall Index…. but it will offer the same for portfolios based on two US markets, as well as in Britain or Australia….and ALL the worlds markets will soon be available to view on this amazing little phone app. And, of course, it will work even better on the larger desk-top and tablet screens.



Next it will tell you if any of those five markets is trending towards new price lows, as illustrated below, or new highs. And that graph is paired with the now famous ShareFinder artificial intelligence system's future projection of the Blue Chip Index.

It also provides future price projections for any security you are interested in. Below I have replicated what the Mobile expects New York's Dow Jones Industrial Index will do in future:



But the very heart of the Mobile system is its ability to identify any shares in your portfolio that might be underperforming the market average and offering you a selection of suggested replacements as illustrated in my next table:

Code	Full Name	Close	3 Month Price Grow...	5 Year Price Growth	Dividend Gro...	Grade	Risk	Total Return	Rating	Strategy
Based upon their five-year compound annual average returns the following shares in your portfolio are underperfoming the ShareFinder Blue Chip Index on price growth:										
MA	Mastercard Incorporated	18.29	-14.85	0.00	81.40	161.00	-32.50	3.52	Fair.	Wait - pending buy.
KFY	Korn/Ferry International	18.29	37.77	0.00	81.40	161.00	-32.50	3.52	Fair.	Wait - pending buy.
DOC	Physicians Realty Trust	18.29	9.11	-1.48	81.40	161.00	-32.50	3.52	Fair.	Wait - pending buy.
CXP	Columbia Property Trust, Inc.	17.44	-4.84	-9.30	53.33	61.00	3.32	-4.70	Cheap.	Wait - pending buy.
The Following shares, combine exceptional fundamental quality with high historic dividend growth rates :										
FSS	Federal Signal Corporation	39.94	8.21	24.15	40.10	207.00	11.93	24.95	Fair.	Wait - pending buy.
BRSS	Global Brass and Copper Holdi...	43.99	3.50	23.28	71.67	426.00	28.90	23.98	Fair.	Wait - pending buy.
APO	Apollo Global Management, LLC	64.23	138.55	22.62	80.73	282.00	39.04	25.62	Fair.	Wait - pending buy.
MS	Morgan Stanley	92.03	87.91	12.14	42.04	198.00	13.41	13.34	Fair.	Prepare to buy.
BAC	Bank of America Corporation	41.15	23.56	9.48	77.23	323.00	8.18	10.78	Fair.	Wait - pending buy.
BXS	BancorpSouth, Inc.	28.15	-26.74	-2.17	42.33	116.00	-17.71	0.03	Fair.	Wait - pending buy.
EVC	Entravision Communications Co...	6.76	959.50	-24.24	61.92	90.00	117.35	-21.24	Cheap.	Wait - pending buy.

And, finally, it offers you a news analysis so that you can keep up with the world:

Market News | This Week

Title	Description
Dow, S&P 500 edge back from records	Wall Street stocks were under pressure early Tuesday after last week's records as investors weighed the latest mixed trends on Covid-19 amid concerns about lofty equity valuations.
Oil price hits 2014 peak after OPEC+ talks fail	New York oil struck a 2014 pinnacle on Tuesday after OPEC+ crude producers failed to agree on lifting output despite demand soaring along with the global economic recovery.
Oil spikes above $77 amid rare public spate between Saudi Arabia, UAE	Saudi Arabia is engaged in a rare public spat with its Emirati allies over a critical oil output deal, escalating tensions ahead of another meeting of the OPEC+ alliance on Monday.
Gold regains shine after central bank buying drops to decade low	Central banks may be regaining their appetite for buying gold after staying on the sidelines for the past year.
European equities drop at open	European stock markets slid at the open on Monday, as dealers shrugged off earlier gains across most of Asia.

General News | This Week

Title	Description
Zim issues new largest-value bank note, featuring 19th century heroine	Zimbabwe will on Wednesday denomination banknote, whicl heroine who was hanged for le
Booze industry pleads for relief as possible sales ban extension looms	Sibani Mngadi, chairperson of Association, said the industry due to the current two-week s
Solar power is dirt cheap and about to get even more powerful	Boosting power generation pe amount of electricity from a sr
VW, Daimler, Volvo team up to build truck chargers	The truck manufacturing units Monday they will team up to b heavy-duty vehicles in Europe
Second coal train derails in recent weeks, Transnet to launch probe	Transnet said it had its second over the weekend.

You can order the Mobile today by going to the ShareFinder International web site or, if you can be patient enough to wait for the public offering of ShareFinder shares which are to be offered at $10 apiece, you will need to own only one share to be able to use the Mobile at $5 a month and just ten shares to be able to use the ShareFinder 6 for half price. Your invitation to subscribe will be e-mailed to you within the next few weeks!

How to buy cryptocurrencies

By Lloyd Lopes

Cryptocurrencies and blockchains have attracted a storm of interest in recent years. News articles abound about those getting rich, those losing their riches and those who are utilizing the blockchain for their projects. The tech geeks are using it for everything from loans to ownership in art.

I’ve spent the last month neck deep in the world of De-Fi and coming from a strict traditional blue-chip stock investment mind-set I’ve been excited and horrified by what I’ve seen.

This overview will give you some insight into how the new world of decentralized finance works, why it's important, and then a practical approach to actually using it for something useful. If you are familiar with traditional stock market investing and using a bank account, the similarities will be striking.

Breaking It Down

Let's say you've never heard of the blockchain before. As an icebreaker – it's a new way of digitally, and without a central authority, doing a lot of things we've been doing for a long time and that you're already familiar with. For example, you could run a currency (like the Rand) on a blockchain. You could keep a loan book on it. You could keep a record of ownership on it (like shares in a company, for example).

The units of record on blockchains are called **tokens or cryptocurrencies**. You might hold a token that represents $1 USD, in the case of USD-T – a popular stable coin. It might instead represent 1 share in a company. Or 1 unit in the case of a unit trust. Or 1 Satoshi in the case of BitCoin – a popular cryptocurrency.

A blockchain doesn't require that anyone co-ordinate it or control it. Checks and balances for keeping it secure and error-free are inbuilt. And it's proving reliable. The total volume on Uniswap – a popular exchange for tokens on the Ethereum blockchain hit $1.8bn USD as of yesterday, July 27th. Because of the growth involved in these types of areas, traditional investors are being forced to take note of them.

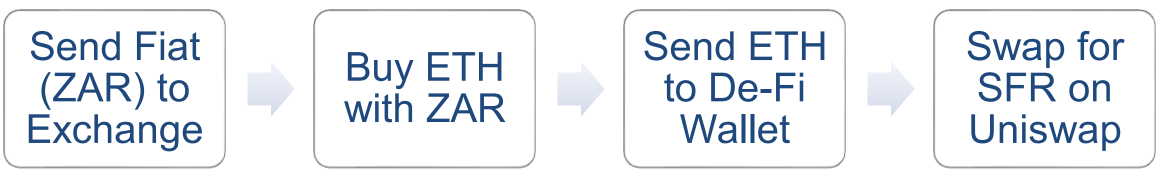
Just as in the normal world, scams are frequent in the Decentralized Finance world, and the old adage "If it's too good to be true" definitely still holds. Luckily, avoiding them doesn't require any additional knowledge if you already familiar with the basics of finance. If a 20 percent a month return sounds good to you, or if a token called "Punk-Zombie" sounds appealing, then you probably were not cut out for investing in the first place.

Why Decentralized Finance Matters

We see a world in which a significant amount of value is posted on the blockchain. Gains will be associated with some of the assets which keep their records on a blockchain. Much like the stock market – if you don't know how to use it you will miss out on these potential returns.

A Practical Example

Let's buy a ShareFinder Equity Token (SFR) (running on the Ethereum network), step by step, from the beginning. This represents one share of ShareFinder International, our holding company. An overview of what we're going to do looks like this:



There are multiple pieces to this puzzle, but thankfully they are pretty straightforward. Before you begin, have a look at the useful screenshots section below this article to help you envision what the end result will look like.

In this example we'll use:

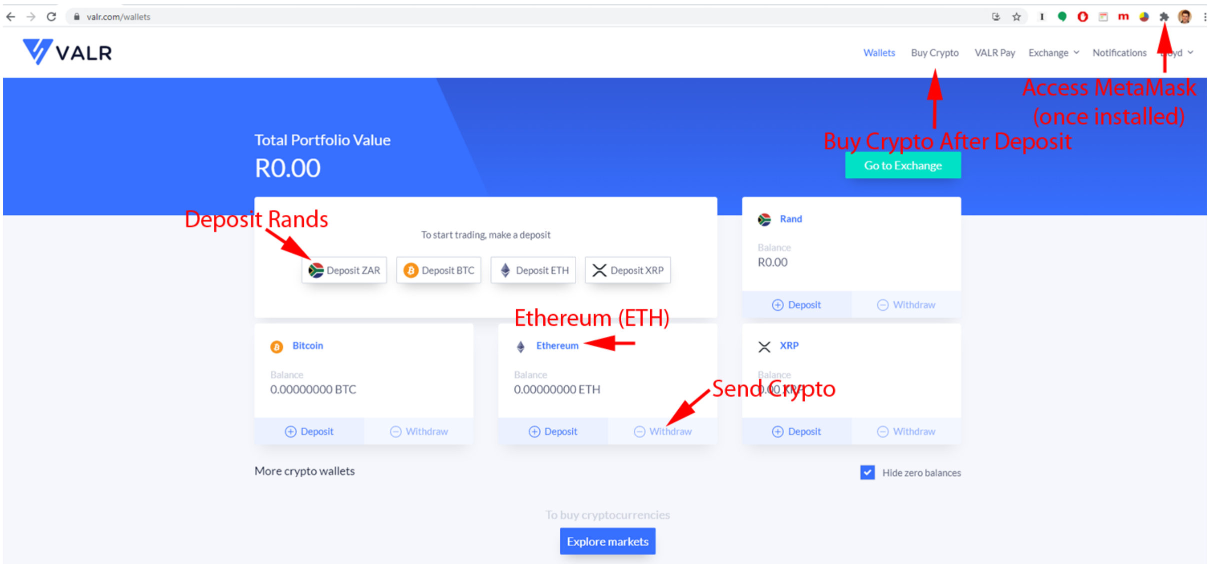
- [VALR] as our crypto exchange. You can, however, use any other exchange of your choice.
- MetaMask as our De-Fi wallet
- Ether (ETH) as our base token
- Uniswap for exchanging our base token for the SFR token
- Authy for two factor authentication. Install via the Play Store or App Store on your phone.

An amount of **R500-R1000** would be useful for this example to play with the system.

This process can be done either on a smart phone or desktop computer. Some steps are well documented by the different providers and so links will be provided rather than detailed instructions.

1. To begin, open a VALR account. This will allow you to send an EFT in Rands to the VALR exchange so that you can buy a cryptocurrency in order to exchange for an SFR token. You'll need to verify your account by providing an ID document or passport and your address. At the time of writing proof of address was not needed. An in-depth account of signing up can be found at this link. If you want to enable two factor authentication, download Authy onto your phone and use this link for the step-by-step process on VALR.

2. During the day it takes approximately 30 minutes for your account to be verified with VALR.



3. I like to use a MetaMask wallet, and this is an add-on to the chrome browser. Open on  **Google Chrome** and navigate to https://metamask.io/download.html

   Click the "Install MetaMask for Chrome" button and follow the prompts.

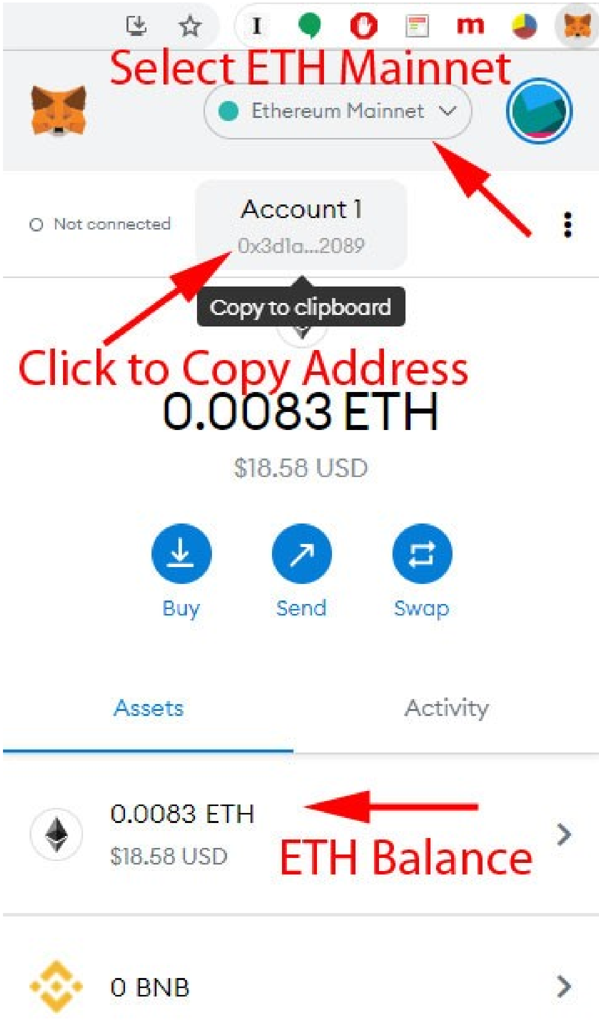
4. Here are instructions on how to deposit Rands into your newly created VALR account. Make sure you are careful to use the deposit reference labeled **"reference number"** and nothing else to make sure your deposit clears without delay.

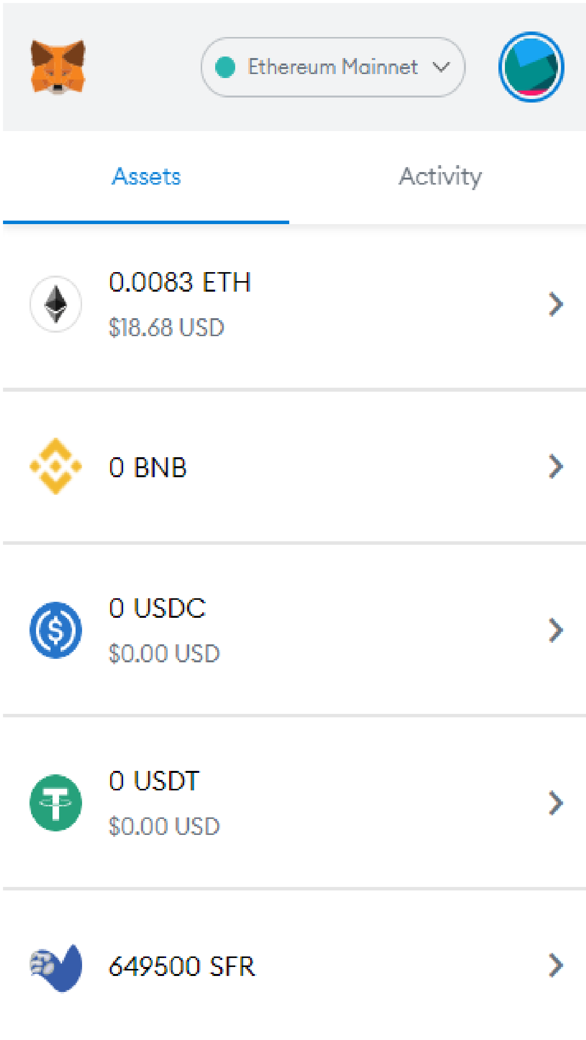
5. Once cleared, follow these instructions and buy Ether (ETH) on VALR.

6. My ETH wallet on MetaMask has an address of *0x3d1a41959FbFAF2413F8c2930d62b3a051102089.* Find yours in MetaMask using this link as a guide. The address will look similar to mine.

7. Send the ETH you just purchased to your MetaMask wallet. This is often called “send” or “withdraw” and in VALR is called “withdrawing” crypto. See instructions here

MetaMask





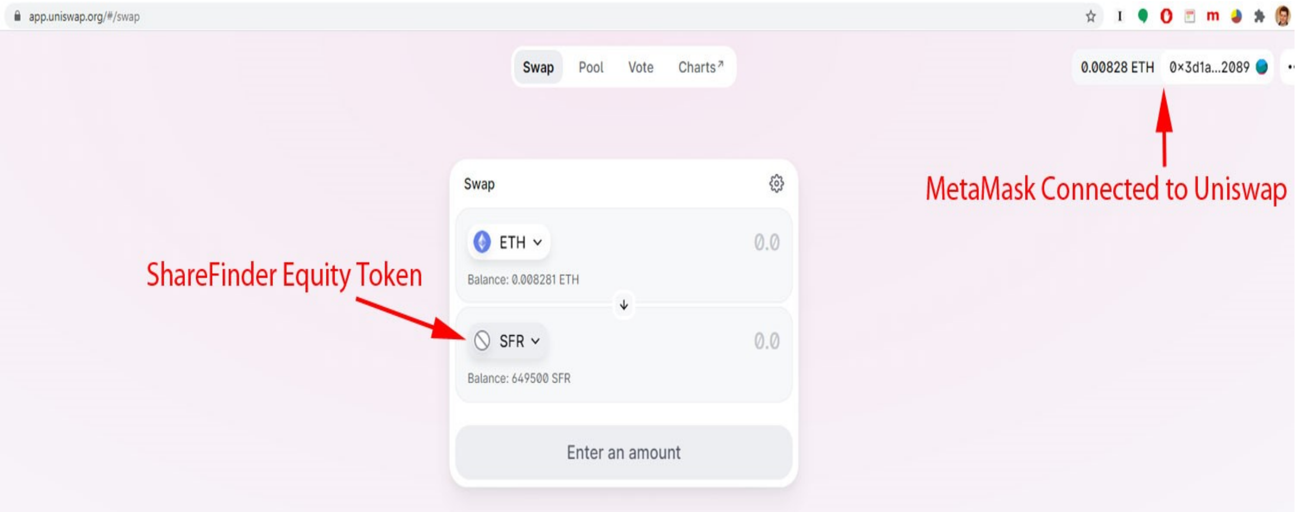
8. Connect Uniswap to your MetaMask wallet. Instructions on how to do this are here

9. Add the SFR token to Metamask. There’s an easy to use button at https://rcis.co.za/sharefinder-token/ - click on “Add SFR (ERC-20) to metamask”, or use our contract address: **0x93b816e32d3920a295438a81a325a27571a25728** and follow these instructions here

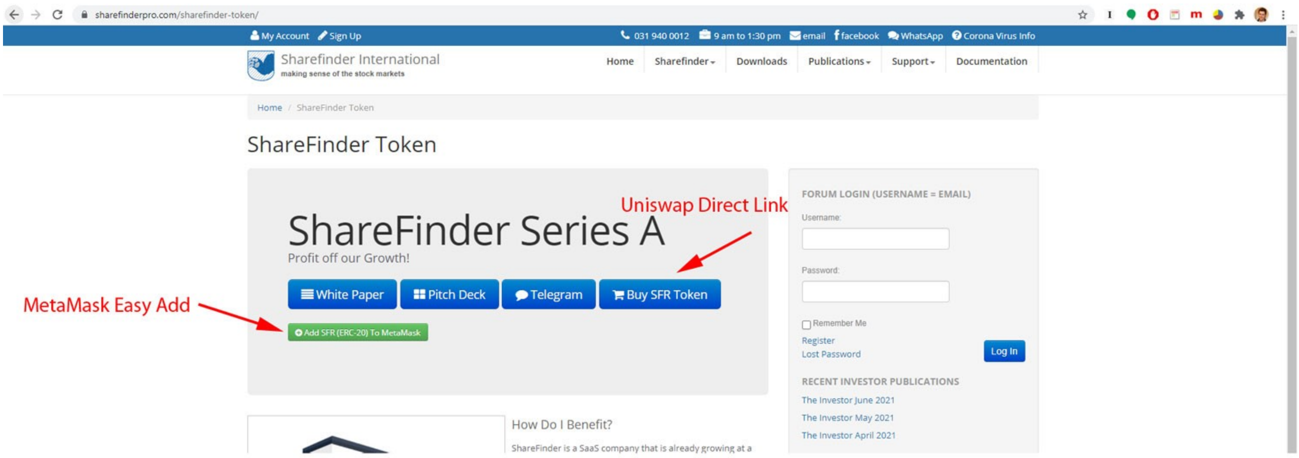
10. Swap your ETH for SFR on Uniswap. Direct link to that here. If you cannot find the token on Uniswap – use this contract address: 0x93b816e32d3920a295438a81a325a27571a25728

11. If you run into an error on UniSwap that says “not enough liquidity” – contact support on support@rcis.co.za

Uniswap



SF Site



Capitalism Under Attack

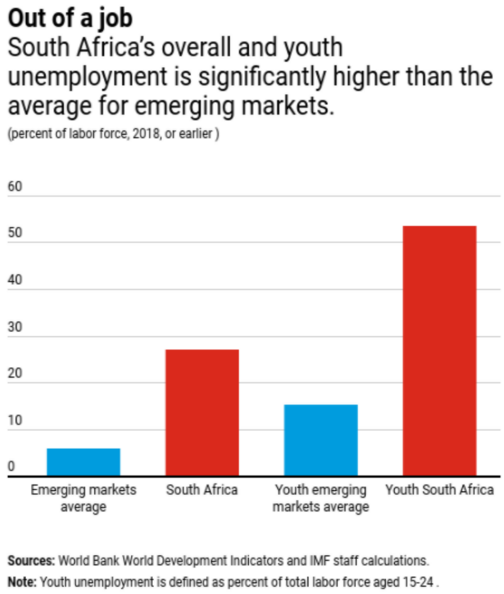
By Richard Cluver

Winston Churchill famously said, “*Many forms of Government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed it has been said that democracy is the worst form of Government except for all those other forms that have been tried from time to time.…*

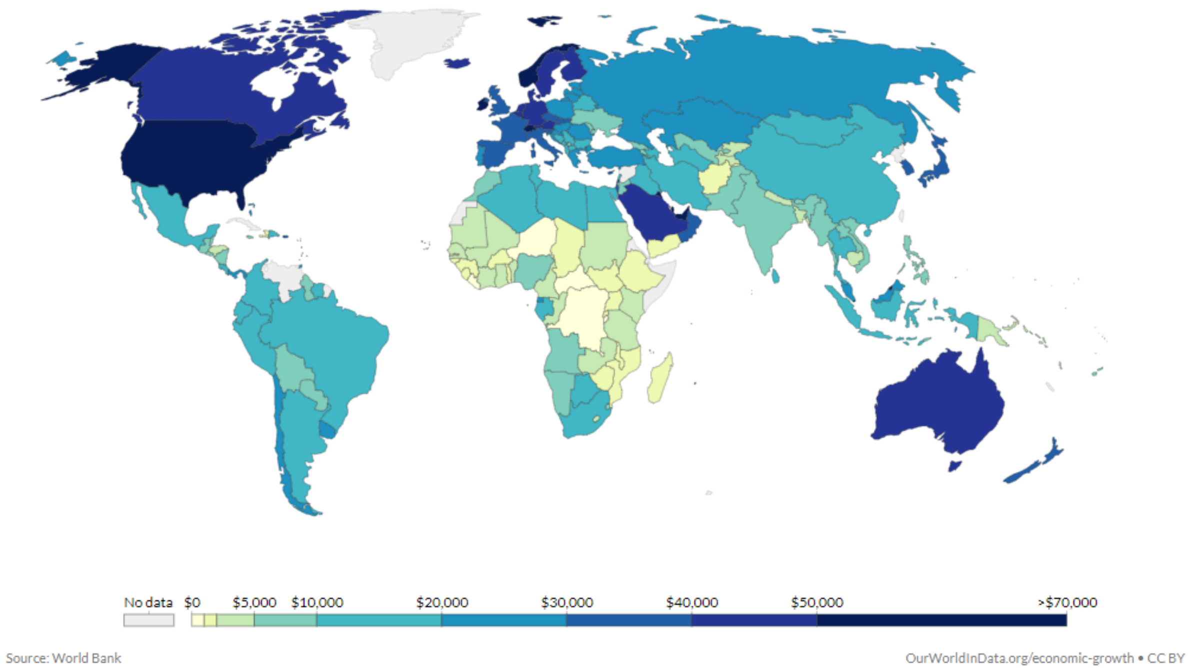
He might as well have said the same thing of Capitalism. Indeed, as a politician who spent part of his career on the Liberal Party benches of the British Parliament and was instrumental in bills which prohibited miners from working more than eight hours a day and piloted the Trades Boards Bill which introduced the minimum wage and the National Health scheme, one might have expected him to be a harsh critic of Capitalism. Instead, he offered the profound truth that "*The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries*."

The point has seldom been better illustrated than by South Africa's 27-year flirtation with socialism which has given us one of the world's highest youth unemployment rates and made us the world's most unequal society with a per-capita expenditure Gini coefficient of 0,63

For the few who are unfamiliar with the Gini Coefficient, it ranges from 0 (0%) to 1 (100%), with 0 representing perfect equality and 1 representing perfect inequality. And if you have any doubts about our levels of inequality, just note that according to the Inequality Trends in South Africa report released by Stats SA, the top 10 percent of the population spend 7.9 times more than the bottom 40 percent.



Don't, however, make the mistake of thus concluding that South Africans who are fortunate not to number among the bottom 40 percent are wealthy by world standards. By any test you care to name they are not. Their relative affluence when compared with the bottom 40 percent is simply a factor of how poor our poor have become in world terms. The chart below illustrates just how poor we have become under ANC rule:



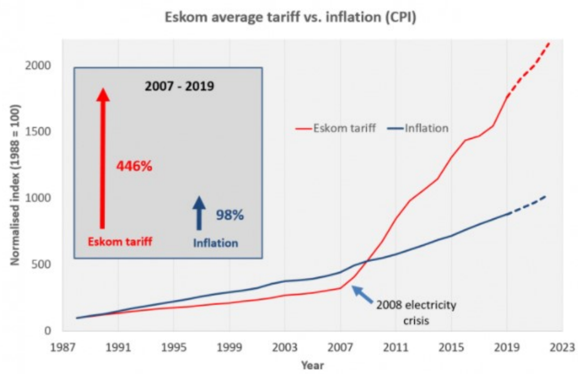
As a nation we sit at position 92 on a list of 194 world nations ranked from Luxenbourg which enjoys a per capita annual income of $118 002 to the poorest which is Burundi with $760. Our figure is $12 032. On this list the US sits at position 188 with $63 416 per capita, Australia at position 175 with $51 680 per capita, Britain at position 167 with $44 177, Portugal at position 153 with $ 34 043 and Brazil at 110 with $14 916.

As recently as May this year it led the chief executive officer of Business Leadership South Africa, Busi Mavuso, to proclaim that social inequality was "The biggest ticking time bomb we have in this country." And the rioting and looting this past month has made it clear how easy it is to light the fuse.

Now, it needs to be recognized that the World Bank, which is responsible for publishing the Gini coefficient ratings, only has data for 135 of the world's 195 countries and that South Africa's last data was submitted in 2015.
So the figures which give us our poor rating are not necessarily correct. Nevertheless, there is no escaping the bitter consequence of poverty and inequality which played out in the shopping malls, warehouses and factories of KZN and Gauteng this past month.

But by what stretch of the imagination can the blame for inequality be deflected from the ANC government to "White Monopoly Capital?" Setting aside for a moment both the fact that official JSE ownership statistics make it clear that more blacks than whites are in control of the economy – 23 percent of the JSE is in Black hands - and that South Africa's "Top Ten Percent" pay more taxes than those of practically every nation on earth, the burning question right now is would South Africa be better off if Capitalism were to somehow be outlawed.

Is it possible that if all property were to be nationalized, as Julius Malema's Economic Freedom Fighters would wish, that the scourge of unemployment could be eradicated? Well, ignoring for a moment the fact the even with never-ending subsidies and near monopolistic support from Government, South African Airways inevitably went into bankruptcy with Denel and hundreds of other State Owned Enterprises following in lockstep close behind, could the State deliver services more cheaply and efficiently than private enterprise?



Well we have a good example of how good the government is at running businesses in State-owned Eskom. Despite massive tariff increases which have made it increasingly difficult for private sector business to remain globally competitive, Eskom's debt is so severe that it threatens to push State debt over the proverbial fiscal cliff. From 2007 to 2019, electricity tariffs increased by 446%, whilst inflation over this period was 98%. Furthermore, based on the currently approved increases for 2020 and 2021, the total increase in electricity tariffs from 2007 to 2021 will be 520%. By then, electricity tariffs would have increased more than 5-fold in 14 years.

Now the very basis of capitalism is that it is based upon competition and thus its pricing is self-regulatory. Part of the striving of private enterprise to be the first to come to market with innovative new products is that, only in the beginning will that innovator have the market to himself and be able to, within reason, charge what he likes. Implicit in this is that the bigger the profit margin the quicker imitators will arise to compete such that in the end of the process only the most efficient producers will remain. The fact that Capitalism and Competition are inextricably linked is why the system remains an unbeatable philosophy.

The fundamental truth of this observation is being currently borne out by the fact that although Eskom is a statutory monopoly, one of its own greatest nightmares is that the public is flocking to substitute renewable energy sources for mains power and thus free itself from the tyranny of the monopoly. Consumers who have done their homework clearly understand that at current electricity costs, a solar installation will usually pay for itself in little more than three years. It thus represents an outstandingly attractive investment which is, of course, the heart and soul of Capitalism.

Now the reality of the South African situation is not that greedy capitalists have stolen from the poor, but rather that the State has failed to effectively use the excessive levels of taxation it levies upon its dwindling wealthy in order to uplift the poor. It needs to be recognised that the various constructs that make up the “Social Wage” – ranging for the dole to free education to a bloated public service – are simply temporary stop-gaps that do nothing to remedy entrenched poverty. The only way to uplift the poor is to educate them. But after 27 years of ANC socialism, the State schooling system is turning out fewer functionally literate workers than was the case under the apartheid state.

In today’s world a labourer is no longer someone inefficiently wielding a pick and shovel to dig up roads in an era when mechanical shovels do the work far more efficiently. Today he is likely to be a young graduate applying relatively low-level coding skills in a giant software factory. Young people who, in this new world, are functionally illiterate and innumerate are consequently doomed to the social scrap heap. They represent nothing more than wasted potential facing the daily temptation of crime as an outlet for their frustrations.

Furthermore, because increasing percentages of the budget are having to be diverted away from job-creating infrastructure spending towards the social wage in a nearly hopeless effort to placate the unemployed, South Africa’s ability to escape the poverty trap is steadily dwindling. On top of this, the billions of Rands that have been corruptly stolen from the fiscus at the instance of the ANC’s increasingly maligned Cadre deployment policy, have functionally removed most of our remaining capacity to re-invest in new and innovative productive capacity.

Meanwhile, because of our low skills base, we are completely unable to compete with Developed World industry. We are accordingly obliged to trade in competition with Developing World industries situated in countries which do not have minimum wage legislation. That is why most of our manufacturing capacity has collapsed in the past 27 years.

Now, following the willful destruction of so much of what remains of the country’s productive capacity in this month’s riots, many of our few-remaining entrepreneurs are openly admitting they are now re-thinking the wisdom of continuing the up-hill battle of trying to do business in a country administered by a government which has turned the words “White monopoly capital” into swear words and which frankly considers “employers” to be the enemy.

I could go on endlessly, but, in summary, if South Africa is to have any hope of escaping from its ever-deepening poverty trap and the social instability that results from it, then what we desperately need is MORE capitalism rather than slavishly trying to emulate precisely the policies which led ultimately to the total collapse of the old Soviet Union.

Instead of treating employers as adversaries, the ANC needs to recognize that the diminishing few still prepared to roll up their sleeves and put in the effort to re-build the economy are possibly their greatest single asset.

As a starting gesture, President Ramaphosa should ponder whether he is sending the right signals by retaining a Communist as his minister of Trade and Industry. Is Ebrahim Patel, whose contribution to the fight against Covid 19 was to tell shopkeepers what types clothing they could and could not sell, really the right person to inspire a new spirit of commercial renaissance?

The ‘real’ value of the rand – according to the Big Mac Index

Businesstech Staff Writer

The Economist has updated its Big Mac Index, showing how the rand continues to be one of the most undervalued currencies globally, relative to the US dollar.

The Big Mac Index is an initiative created by The Economist that aims to measure whether currencies are priced at their “correct” level.

It is based on the theory of purchasing-power-parity (PPP) – the notion that, in the long run, exchange rates should move towards the rate that would equalise the prices of an identical basket of goods and services (in this case, a Big Mac burger) in any two countries.

The Big Mac is selected for comparison as the popular fast-food meal is widely available, and remains fairly consistent in pricing; however, it is by no means an exact measure.

According to The Economist, ‘Burgernomics’ was never intended as a precise gauge of currency misalignment, but is merely a tool to make exchange-rate theory more digestible.

The index has, however, become a global standard, included in several economic textbooks, and is also the subject of at least 20 academic studies, the group noted.

The ‘real’ value of the rand in July 2021

The Big Mac Index measures the real value of currencies using two methods – a direct measure of PPP using raw prices, and an adjusted index that takes into account local GDP data.

Using the raw data, a Big Mac costs R33.50 in South Africa and $5.65 in the United States. The **implied exchange rate is R5.93 to the dollar**.

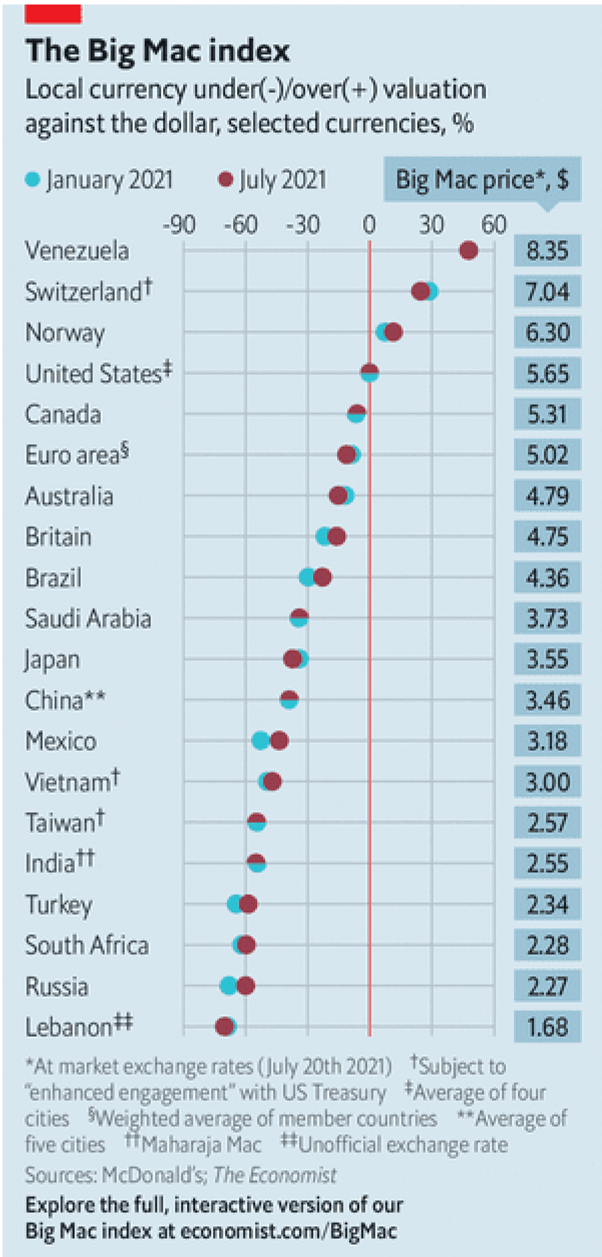
The difference between this and the actual exchange rate – R14.66 to the dollar at the time of the report – suggests that the rand is undervalued by 59.5%, which is the third most undervalued currency measured by the index in July.

The local unit ranks only above the Russian rubble and the Lebanese lira, which are undervalued by 59.9% and 70.2%, respectively – though The Economist noted that Lebanon doesn’t have a like-for-like Bic Mac to compare, using the Maharaja Mac instead.

GDP per capita

However, the raw index does not tell the full story of currency valuation.

Because many argue that, due to PPP, the cost to produce a Big Mac is cheaper in poorer countries, The Economist factors in another important indicator – GDP per capita – to draw a more accurate conclusion.



The Economist

"It is worth pointing out that it is common for poor countries to seem cheap relative to rich ones in any simple comparison of prices," The Economist said, noting that in most countries, "the price of a burger is about what you would expect given the country's GDP per person".

In the group's adjusted index, South Africa's currency still remains heavily undervalued (7th), but less so than when dealing with straight conversion data.

In PPP terms, a Big Mac costs 59.2% less in South Africa ($2.28) than in the United States ($5.65) at market exchange rates.

Based on differences in GDP per person, the index suggests the rand is 29.6% undervalued and **should be at around R10.32** to the dollar.

Using this measure, the Hong Kong dollar is the most undervalued currency relative to the US dollar, by as much as 45.7%. This is below the Taiwan dollar and Russian ruble, which are undervalued by 38.9% and 34.3%, respectively.

Adjusted for GDP per capita, Uruguay has the most overvalued currency at +38.7%.

Under-valued?

A currency is considered undervalued when its value in foreign exchange is less than it "should" be based on economic conditions.

However, currency value isn't determined objectively and may be undervalued due to a lack of demand, even if a country's economy is strong.

Other factors are also taken into account, including investors' appetite for risk, as well as a plethora of conditions, local and global, that play into the stability of a particular market.

In South Africa's case, the struggles in the local economy are well documented and have persisted for some time. This feeds into a wider and prolonged narrative of South Africa's economy being in decline, which feeds into investor sentiments.

Global markets have been marred by the ongoing Covid-19 pandemic, but in places like South Africa where vaccination strategies have faltered, and coffers have been looted, these global issues are exacerbated.

More recently, riots and violence in KwaZulu Natal and parts of Gauteng have contributed to this destructive narrative, with economists and the South African Reserve Bank warning that the effects of the unrest will be still felt in the economy for some time.

Xi's Big Mistake

By John Mauldin

I have mixed feelings about China. On the plus side, I think the country's massive economic transformation may be one of the most impressive events in human history. Bringing hundreds of millions from primitive rural lives into relatively prosperous cities within a few years was awe-inspiring. I greatly admire the millions of Chinese entrepreneurs worldwide who create jobs and technology. They've helped the entire world in countless ways.

And yet, I can't forget that China's leaders are devoted, ideologically centralist communists. Americans sometimes apply that term casually to our political opponents. Xi Jinping is an ***actual*** communist. His regime permits some limited market-like activity, but only to help achieve the government's goals, which remain communist.

When the West first began engaging with China in the 1980s and then allowed it into the World Trade Organization in 2001, many hoped exposure to our ways would tug China toward capitalism. It seemed to be happening for the first few decades, too. But the hope is fading.

In a 2015 letter (When China Stopped Acting Chinese), I said this:

> Beijing's stimulus efforts created the stock market bubble; now their unsuccessful efforts to keep it from bursting are shaking my confidence in their desire to allow market forces to play a greater role in the transition from a top-down society to a consumer-driven, bottom-up society.
>
> Still, I've learned not to underestimate the Chinese leadership. They make mistakes but usually recognize them and change course quickly. We'll see what they learn from their current misadventures in stimulus and their attempts at top-down control of an essentially uncontrollable market. If they don't learn the right lessons, China will face an even harder lesson in the future.

Six years later, it looks like Chinese leaders didn't learn the right lessons. Xi has been trying to balance economic freedom and authoritarian control and it's not working like it used to.

Today we'll review some recent events that illustrate where Xi went wrong. Then we'll think about whether the Xi government can change course, whether it wants to… and whether it will survive.

Selling the Rope

Chinese ride-hailing company Didi Chuxing had its US initial "public offering" (I'll explain those quote marks in a minute) last month, raising $4.4 billion. The shares plunged a few days later. Why? Widely called the "Uber of China," Didi seems to have good prospects. The problems came from outside.

For one, the Chinese government decided to investigate whether Didi presented a "cybersecurity threat." The company was ordered not to accept new users and its mobile apps were taken down from online app stores. But audits, or lack thereof, may be a bigger problem, and not just for Didi. My friend Mark Grant explains in one of his letters this week:

> The core of the issue is that the Chinese government will no longer give US market regulators, any of the regulating bodies, the power to inspect the audits of Chinese companies listed on US exchanges. There are at least 248 Chinese companies, listed on three major US exchanges, with a total market capitalization of $2.1 trillion, according to the US-China Economic and Security Review Commission.
>
> Earlier this year the Securities and Exchange Commission began rolling out rules threatening to delist foreign companies from American exchanges if they do not meet US auditing standards for three years. The Chinese response was that Chinese regulators will conduct the audit inspections and deliver their conclusions to the US Public Company Accounting Oversight Board. *This was soundly rejected, as it should have been, by the SEC.* (emphasis mine)
>
> In the press, recently, there has been all kinds of talk about the Didi IPO fiasco and the effect on Chinese tech companies and on new Chinese listings. This is all fine, but it does not go nearly far enough. The issues are much, much bigger.
>
> On the equity side, how can you invest in a Chinese company, any Chinese company, regardless of size, or theoretical revenues or profits, without audited financials? There will be no way to know if any of it is accurate and foreign assertions will have all of the reliability of a drop of water purportedly not dripping down the Great Wall, because of the Chinese sunlight. No one will have any reliable knowledge of what is actually going on. No one, in his right mind, would invest in any company, domiciled anywhere, on this basis.

Mark is right; investors shouldn't throw money at companies based on financial statements that don't have some kind of trusted third-party verification.

But there's a bigger problem here. The Didi IPO was not a normal IPO, at least as we think of them in the West. US investors who bought these "shares" don't actually own equity.

They own pieces of a Caymans "variable interest entity," (VIE) which has a contract with the parent company. This structure is necessary because under Chinese law foreigners can't own Chinese shares directly.

Didi duly warned investors in its US offering (see risk factors in their registration statement) that they had no shareholder rights and the Chinese government had final control. This isn't new. US-listed Chinese companies since at least Alibaba in 2014 have used the VIE structure. It's one of those things that works great until it doesn't.

This arrangement did have a key advantage, though, at least for the Chinese. It let Chinese enterprises rake in foreign capital while giving up no ownership and reserving the right to leave their own "investors" high and dry. This method may now be approaching its expiration date but it worked well for a long time.

That's how Xi and the Chinese Communist Party operate. They do things that ***look*** capitalist but really aren't, lacing them with unnoticed poison pills for later use. It's similar to their appropriation of US technology, trademarks, and other intellectual property. We are literally selling them the rope.

"Prepare for War"

We should distinguish between Chinese business leaders and the Chinese government. I think the former are mostly just trying to run their companies the right way. They are like entrepreneurs everywhere, trying to grow their businesses to the best of their ability. The latter group makes it difficult and sometimes impossible.

This can be hard to grasp. Xi and the other communists really believe they can have it both ways, conducting "business" while also maintaining iron-like control over everything. They may not exercise their control, but they want to have it.

Those VIE companies are a good example. Some experts say the whole structure is illegal under Chinese law, yet it is widely used. The government looks the other way. But by doing so, the authorities give themselves a giant weapon they can use any time. The business executives are aware of this and modify their behavior accordingly. (Note that verb "modify.")

In theory, this could still end well. Having successfully allowed people a taste of capitalism and its benefits, the government might think it can continue. Meanwhile those capitalist benefits might gradually usurp the Communist ideology.

Recent events say that's unlikely, though. Beijing appears to be concluding it has squeezed all the advantage it can from capitalism. Is Didi any more a technological risk than scores of other companies? Not really. Sometimes you have to create object lessons to keep everyone in line.

In hindsight, things seem to have gone wrong after the 2008 financial crisis. Facing potential social unrest, China responded with massive debt-financed investment in infrastructure, housing, and other projects. Some were needed, others were make-work distractions. But all the debt was real. And over time, it has become a heavier burden.

Xi Jinping inherited this situation when he took power in 2013. What is his plan? According to Cai Xia, a Chinese professor and high-level CCP member and now expatriate dissident living in the US, Chinese Communism hasn't changed. She wrote a lengthy paper under the auspices of the Hoover Institution. She maintains Xi is merely dropping the pretense.

Here’s Ambrose Evans-Prichard in a recent ***Telegraph*** column, writing a useful summary.

> Like many amateur observers of China, I had assumed that Xi Jinping’s iron-fist policies at home and abroad were a break with the more emollient approach from Deng to Hu Jintao (if you can call the Tiananmen Square massacre emollient), when China seemed to be softening from a totalitarian to an authoritarian regime. Cai Xia makes clear that the fundamental character of the CCP has been unchanging.
>
> The party has merely dropped the facade and dispensed with Deng Xiaoping’s tactical dictum: “bide your time, and hide your strength” (éŸ¬å…‰å…»æ™¦). It has also acquired the means of totalitarian control that Hitler and Stalin could only dream of, whether face recognition technology or digital tracking through the Social Credit System.
>
> The long list of Xi’s affronts, from the Nine Dash Line to the South China Sea, to the pitiless asphyxiation of Hong Kong, to the intimidation of Australia, to the Uighur camps, are by now well-known, culminating in wolf warrior diplomacy and state-sponsored disinformation on Covid-19.
>
> We are so inured to it that President Xi’s “wall of steel” speech at the 100th birthday party almost seems banal. We know what the party thinks. The Fifth Plenum text setting out China’s strategy until 2035 revives the term “prepare for war” (å¤‡æˆ˜), not used for over half a century.

“Prepare for War” is an exaggeration, at least I hope, but it is growing less unthinkable. When you have two great powers whose systems are irreconcilable, and neither is willing to change, the options list shrinks.

Sleepwalking to Confrontation

Not everyone thinks disengagement and confrontation is inevitable. Ian Bremmer outlined the issues in his last letter, reaching a different conclusion.

Ian pointed out that unlike the US-USSR Cold War, the US and China are highly interdependent. He broke it down into three components:

Hostility (where both countries want the other to fail): This includes mostly the national security issues like Taiwan and the South China Sea, plus issues both countries see as core principles, like China’s treatment of Hong Kong, the Uighurs, and Tibet.

Competition (each wants to outperform, but not destroy the other): These are the economic issues, like international trade and investment, technology, and domestic political stability. Both countries are the other’s supplier as well as customer. Each wants to win, but also needs the other.

Cooperation (both want to work together for mutual gain): This includes the global challenges like climate change, terrorism, etc. They agree on the goals but lack of trust makes cooperation difficult.

We naturally focus on the areas of conflict, but Ian thinks the full US-China relationship is actually working pretty well. It changes with time, of course. Ian rates the relationship as currently 20% hostility, 70% competition, and 10% cooperation. But he also says much of the competition is becoming hostility.

Ian takes as given that neither country will do anything that would be perceived as “weakness.” But if no one will blink, how do you avoid coming to blows? Ian thinks it is possible.

> More likely, a change in policy comes from internal failures of the present trajectory. How would that happen?
>
> In China: Xi leans into more state control of strategic sectors, high-performing talent starts to leave, productivity dives, and growth stalls and debt spirals… giving technocratic Chinese political leaders more space to nudge Beijing policymaking back towards more interdependence.
>
> In the United States: Domestic divisions make industrial policy half-hearted, the private sector retains capture of the regulatory environment, the post-Biden administration renders strategic reorientation of the US economy incoherent and affords allies more space to direct their own course.
>
> Historians tell us the dangers of sleepwalking into confrontation. But in the US-China relationship, domestic incoherence and lack of ability to effectively implement long-term strategy makes cold war less likely… precisely because it allows existing forces of interdependence to persist unmolested.

I hope Ian is right. From my perch, I'm not sure much of this is feasible. I think Xi has made a giant mistake with recent business crackdowns. He may have calculated he can do without Western companies. But without them, what will happen to the Chinese businesses that still turn to the US and Europe for capital, customers, expertise, and technology?

Moreover, can the Chinese miracle continue if millions of small entrepreneurs stop believing the government will let them succeed? I don't mean big companies. I'm talking about restaurant owners, drivers, shopkeepers—all those who keep the economy moving.

Cai Xia, who was in a position to know, has an even more chilling outlook.

> Cai Xia's contention is that the Communist regime is more brittle than it looks, like the Soviet regime before the end. "I recommend that the US be fully prepared for the possible sudden disintegration of the [Chinese Communist Party]," she said.

Imagining what such a "sudden disintegration" would look like, I suspect it wouldn't be pretty, even if good in the long run. Economically, it could make 2008 or even the COVID pandemic look mild.

China Problems and Big Brother

China is facing large problems, some obvious and others more subtle. But I think problem number one is Xi has made a giant mistake with recent business crackdowns.

China is the ultimate Orwellian Big Brother state. Especially within the cities, the government can literally watch everything you do and track everything you buy, from your noodles to your clothes, who you talk to, what websites you visit. All of the data Chinese corporations gather is available to the CCP, who use it to create China's "social credit system." If you Google that, the first thing that pops up says this:

> The **China social credit system** is a broad regulatory framework, intended to report on the "trustworthiness" of individuals, corporations, and governmental entities across China.

The consequences of a poor social credit score can be serious. **It affects travel prospects, employment, banking access, and ability to enter contracts**. On the other hand, a positive credit score can make a range of business transactions easier for both individuals and corporations.

Foreign businesses have to work with consultants to make sure they have good social credit scores, and the CCP dictates what that means. It is the ultimate top-down centralist panopticon.

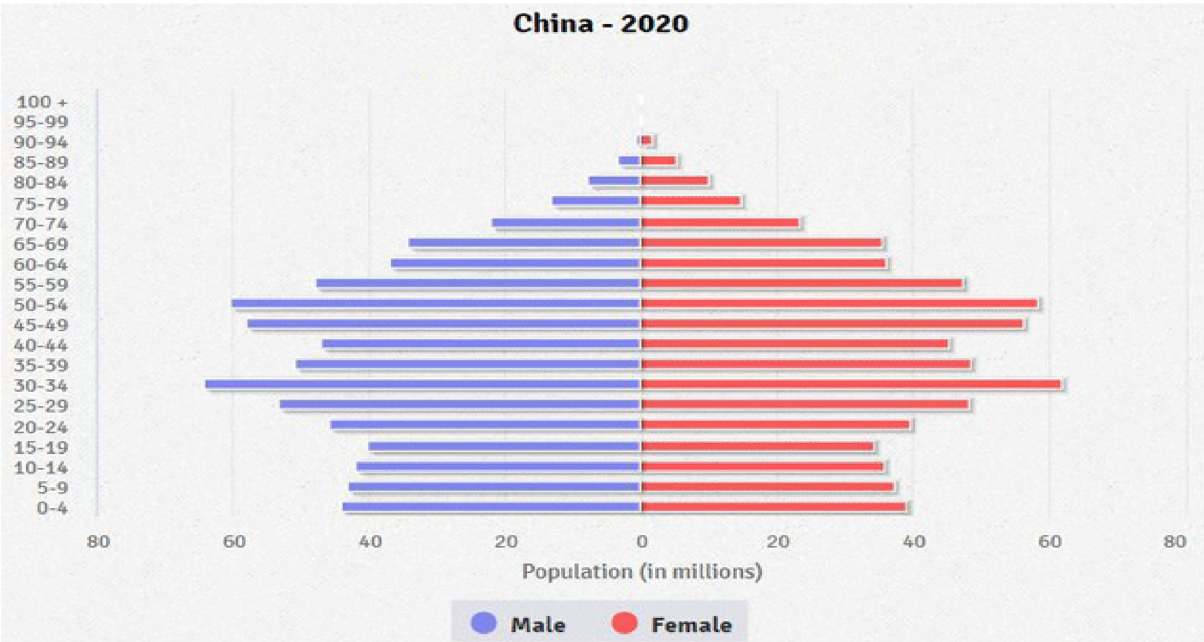
As mentioned at the beginning, many Chinese are quite entrepreneurial, given the opportunity. That being said, entrepreneurialism is not a racial characteristic. There is something in an entrepreneur that makes them want to start their own business or enterprise. A willingness to take risk is obviously part of that DNA. The United States is extraordinarily lucky in that we attracted people who were willing to take risks simply to come here.

I may not understand the Chinese mindset, but I think I have a pretty good grasp of the entrepreneurial mindset. Successful entrepreneurs don't fit into a mold. You can see why some entrepreneurs thrive and you have to scratch your head to figure out how others did it. Some work well within their system. Others simply create new territory and methods.

Xi is going to deprive China of that second set of entrepreneurs, those willing to create something entirely new that might not fit well within the current social credit system. I think the growing Big Brother state will stifle innovation. Who wants to risk their social credit score? It is one thing to risk your reputation and capital, and another to risk your ability to live and work.

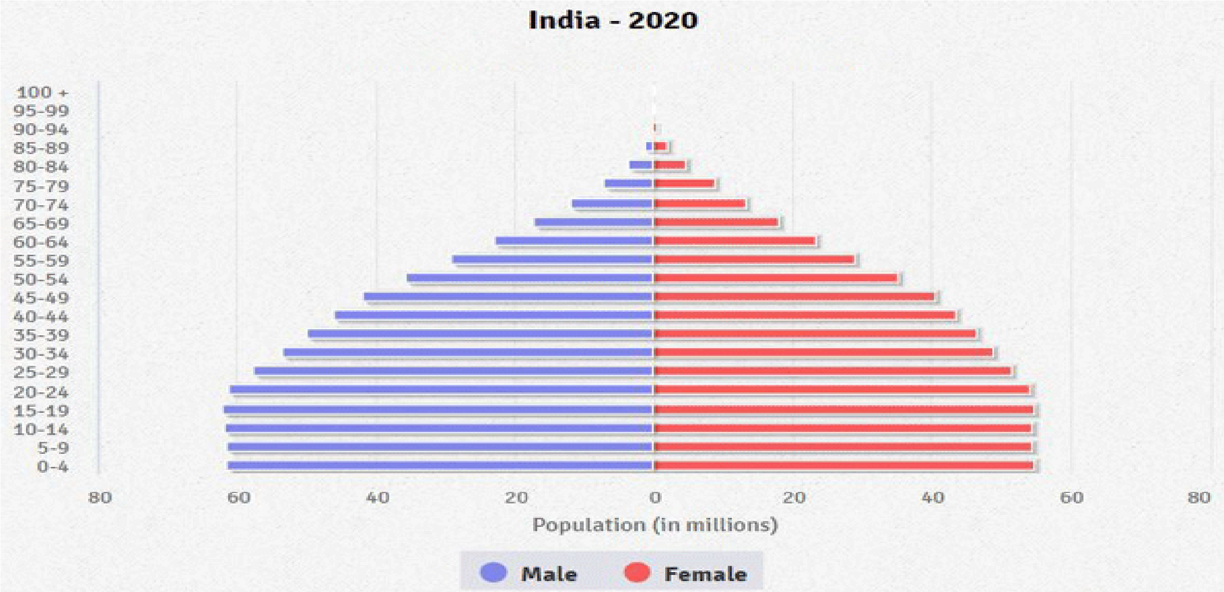
China's panopticon blocks that risk-taking impulse. The consequences will accumulate and reduce growth. And with over half the country still living in extreme poverty, that doesn't bode well for the future.

Further, China has a serious demographic problem. The one-child policy instituted in 1980 really kicked in around 1990, as you can see in the population pyramid below.



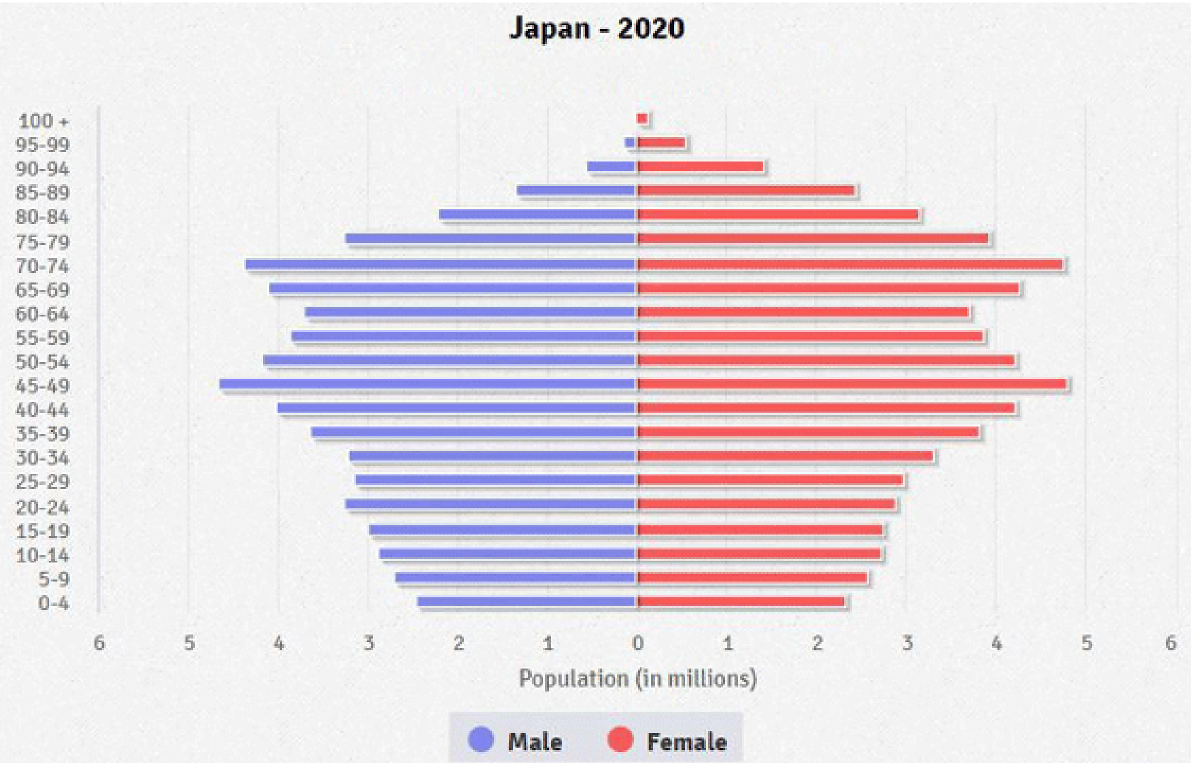
Source: Index Mundi

Normally, population pyramids are actual pyramids. Let's look at India as an example. ***This*** is a population pyramid.



Source: Index Mundi

While we are on this, let's look at Japan:



Source: Index Mundi

Japan has similar demographic characteristics to China, but with one huge difference. Japan grew rich while it grew older. China has grown older before growing rich.

All countries have problems, but even with all its impressive growth and infrastructure, China has more. Which to me makes it more dangerous.

The SEC is correctly insisting on audits for Chinese companies listed on US exchanges. I personally think we should ban new Chinese listings unless they agree to US audit standards. Kicking out currently-listed Chinese companies will be trickier, as US investors don't actually own the shares many think they do. We don't want to blow a $2 trillion hole into US investor assets.

US corporations need to rethink how they approach China. For some, there will be few issues. For others? Real problems.

This week the Biden administration warned US companies about doing business in Hong Kong. China has essentially removed the rule of law that enabled Hong Kong's financial activity. The US advisory reportedly cites the risks of electronic surveillance and having to surrender corporate and customer data to the government.

Xi apparently thinks that it is time to forgo access to the US markets. Maybe he thinks Chinese companies can list in Hong Kong and Westerners will still invest. Maybe. Then again, maybe not.

Rule of law should be critical to any right-thinking investor. When the CCP can nudge an auditor to give a thumbs-up or thumbs-down based on some concept of social credit, how can you trust their assurances? Will that happen often? We don't know. But we know it's possible.

I'm not saying avoid China entirely, as there are still opportunities. But you should have your eyes wide open and understand the risks. I would prefer China-exposed US or other Western companies that give you real audits and normal shareholder rights.

China is going to be a massive headache for the world over the next few decades.

Federal Reserve Folly

Great news: The US economy is officially out of recession. We know this because the National Bureau of Economic Research's official recession-calling committee said so this week. The economy has been in an expansion phase since last April, making this the shortest recession on record at only two months.

The NBER committee always makes these calls in hindsight—both the beginning and end of recessions. Literally everyone could see the economy coming to a halt in March and April. The signs weren't subtle. Yet it wasn't until June 8, 2020, that they said the economy had peaked in February, marking the recession's onset. I don't blame them for waiting to see the data, though. Caution is appropriate on these things.

But really, 15 months to affirm the economy has been expanding? Their statement was quite specific. They call April 2020 the bottom because that month showed clear troughs in unemployment, GDP, PCE, and personal income ex-transfers. All this was known long ago.

Unlike NBER, a private group with no formal power, the Federal Reserve can actually do something with this kind of information. Nor does the Federal Open Market Committee have to wait for confirmation. It can act whenever it sees a need, which it certainly did when the pandemic struck.

[Here's a handy timeline](#) summarizing the Fed's near-daily actions in March and April 2020. They did far more than just open the Quantitative Easing spigots ($120 billion a month and counting) and lower the Fed Funds rates to zero.

Announcement Date	*Operational Date or Proposed*	*Facility*	*Funded by CARES?*	*Acronym*
March 17	April 14	Commercial Paper Funding Facility	No	CPFF
	March 20	Primary Dealer Credit Facility	No	PDCF
March 18	March 23	Money Market Mutual Fun Liquidity Facility	No	MMLF
March 23	June 29	Primary Market Corporate Credit Facility	$50 Billion	PMCCF
	May 12	Secondary Market Corporate Credit Facility	$25 Billion	SMCCF
	June 17	Term Asset-Backed Securities Loan Facility	$10 Billion	TALF
April 9	April 16	Paycheck Protection Program Liquidity Facility	No	PPPLF
	June 15	Main Street Lending Program	$75 Billion	
	May 26	Municipal Liquidity Facility	$35 Billion	

As I said back then, the Fed's dramatic response (accompanied by the federal government's equally dramatic fiscal response) was appropriate given what was known at the time. It was an unprecedented situation, potentially threatening the economy and financial system's core stability. They had to act quickly and aggressively.

Where we can/should blame Fed leadership, though, is in the failure to recognize the time to slowly end the extraordinary measures, which are now having extraordinary and harmful side effects. Today I want to describe what is happening and tell you what I think the Fed ***should*** do. Though, to be frank, I have little hope they will.

Let me be very clear. I believe the Federal Reserve has already made a significant policy error that can lead directly to recession. An accompanying fiscal policy error by the US Congress could compound the Fed's error, although that remains to be seen, as it is not clear what will pass Congress.

Unneeded Fire Trucks

I greatly admire the skill and bravery of firefighters. I once had the personal benefit of their help (recounted [here](#)) and was glad they came.

In watching how firefighters work, I have noticed some patterns. When notified of an emergency like a high-rise fire, which could be either very serious or a mild annoyance, they ***assume the worst***. They arrive quickly and in force. Once on-scene, they decide exactly what is needed and the chief then either calls for reinforcements or releases the extra capacity to go elsewhere. But they initially bring it all "just in case." This is prudent when lives may be at stake.

What they ***don't*** do is stay on the scene in full force once the emergency is over. Of course, large fires can smolder for days. They might leave a small crew to extinguish any flare-ups but they won't tie up the entire department when it may be needed elsewhere.

Now imagine the Federal Reserve is our financial fire department. It got a 12-alarm call in March 2020 and rolled out every truck it had. That was the right response. But within a few months, or at most a few quarters later, it was clear the Fed's part of the emergency was over.

COVID-19 wasn't over, of course (and still isn't), nor was the economy in a great position. But the systemic meltdown risk had passed. The fire was still smoldering but at that point, it was mainly a fiscal fire. Fire Chief Jerome Powell himself said so, repeatedly begging Congress to deal with unemployment and business failures more effectively.

He admitted there was little else his fire trucks could do but ***he kept them there anyway*** in the form of massive quantitative easing and keeping rates at the zero bound. They are still on-scene now.

It is my opinion that this has the potential to go down as the greatest policy error in central bank history. I know that's saying a lot. Arthur Burns and G. William Miller letting inflation rise in the 1960s and 1970s ranks up there. Alan Greenspan kept rates too low for too long. Failing to better regulate the mortgage industry was a major problem. Powell's predecessors Ben Bernanke and Janet Yellen also kept fire trucks on scene even though the crisis was over. In fact, they even deployed ***additional*** trucks (QE2 etc.) long after the recession ended. But Powell is doing it on a vastly larger scale.

This might be tolerable if these financial fire trucks were just parked and waiting. That's not the case. They are blocking traffic, preventing deliveries, and slowing progress. Their revved-up engines are spewing fumes, choking innocent bystanders. And the highly-skilled firefighters are actually ***losing*** their skills as the needless deployment consumes their training time.

Leaving rates at the zero bound is financial repression. It harms savers and retirees. Buying $40 billion worth of mortgage bonds every month to hold down mortgage rates in the midst of an extraordinarily significant rise in housing costs seems counterproductive, especially for first-time buyers.

Even more egregious is the Fed seems to have assumed a third mandate: keeping the stock market rising. Not only does this exacerbate wealth disparity, it borders on malpractice because, at some point, the Fed will have to take its foot off the accelerator. When that happens the potential for another "taper tantrum" is significant. The Fed absolutely should not think the stock market is its responsibility. To do so (as I believe they are) sets up all of us for extreme future volatility.

Supply chain problems are going to get fixed, albeit slower than we would like. Eventually, the fiscal stimulus will go away and everyone will have to adjust. Monetary policy isn't the solution for that particular problem.

This has to stop. The economy is growing now. Unemployment, while still elevated, is improving. Creditworthy borrowers can easily get financing. Even if another major COVID-19 wave strikes, we have thankfully progressed beyond the need for economy-stifling restrictions.

The emergency is over, at least from the perspective of the need for quantitative easing and low rates. The Fed should bring its fire trucks home.

Unfortunately, that's not happening… and it's having an effect.

Slamming the Brakes

Everyone agrees inflation would be a problem if we had enough of it for an extended period. Then the agreement breaks down. Are rising inflation benchmarks "transitory" or will they persist? If they do persist, do they even mean anything for most people?

We wrestled with these questions at the SIC in May (see Expecting Inflation and Deflation Talk). I've been more on the "transitory" side, but small differences matter. The Fed has a 2% inflation target. Sounds minor, but 2% annual inflation compounds to 22% higher prices over 10 years. Fed leaders think it's fine. It is not fine. Even "low" inflation harms savers and consumers.

Worse, the Consumer Price Index is a terrible proxy for consumer prices. It is massaged and adjusted, sometimes for good reasons, but the adjustments disguise inflation's impact on segments like housing. The "cost of living" grows faster than official inflation for many people, and in some cases ***far*** faster. The inflation we see today is especially pernicious for the lower 60% of the income and wealth brackets.

One argument, to which I am somewhat sympathetic, is that this doesn't matter because the Fed can't generate inflation even if it wants to. It's been trying and failing for over a decade. What we see now is less about Fed policy and more about pandemic-driven supply chain disruptions. As that passes, the Fed will be trapped again.

Moreover, some of this is outside the Fed's control. The rising prices that add up to inflation are the result of producer and consumer ***expectations*** for the future. It's a decentralized, complex process that can easily get out of hand—and force the Fed's hand.

In general, a loose monetary policy is by definition inflationary. And while Powell can make a real argument about inflation being "transitory," his monetary policy, coupled with an expansionary fiscal policy, is extending the period of time that we call transitory.

Businesses are raising prices. You can see businesses, small and large, specifically saying so in their quarterly calls, in the Beige Book, and other sources. You can also see it when you go to the store or shop online. Prices are rising. Clearly wages are rising. Those price increases and especially wage increases are going to be "sticky." Consumer inflation expectations are growing. Inflation fear embedding itself into the average economic mindset. That is dangerous. Those of us who lived through the 1970s know inflation expectations have a way of becoming ingrained.

The always-excellent Jesse Felder described it well in one of his letters last week (***Over My Shoulder*** members can read it here), A brief excerpt:

> … (T)he Fed might be able to afford to pursue the most aggressive monetary policy experiment in US history so long as inflation expectations remain in check. However, if inflation expectations take off then the jig is up.
>
> Because once inflation expectations become unanchored, consumer and business behavior shifts in a way to ensure that inflation is more than "transitory." People begin stockpiling things they fear they won't be able to get in the future due to rising prices or shortages. This pushes up prices further, exacerbating these very fears, inspiring even more stockpiling and so on.
>
> At this point, the Fed would be forced to break the inflationary psychology by rapidly reversing monetary policy to something far more hawkish than almost any market participant can imagine today. For some perspective, the last time core CPI hit 4.5%, as it did last month, the Fed Funds rate was over 5% versus 0% today.
>
> As Mohamed El-Erian put it, "**The facts on the ground call for the world's most powerful central bank to start easing its foot off the stimulus accelerator. By refusing to do so, the Fed runs a higher risk of having to slam the policy brakes down the road**." The longer the central bank waits to curb inflationary psychology, the harder they will have to hit the brakes when the time comes.

See, at some point inflation gets worse simply because enough people expect inflation to get worse. Then what?

In the 1970s, Burns and then Miller accommodated that inflation, not wanting to risk recession in order to control inflation. Then things got out of hand. Rather than small, controlled tightening efforts, we needed a massive shock to the system, producing the worst back-to-back recessions since World War II.

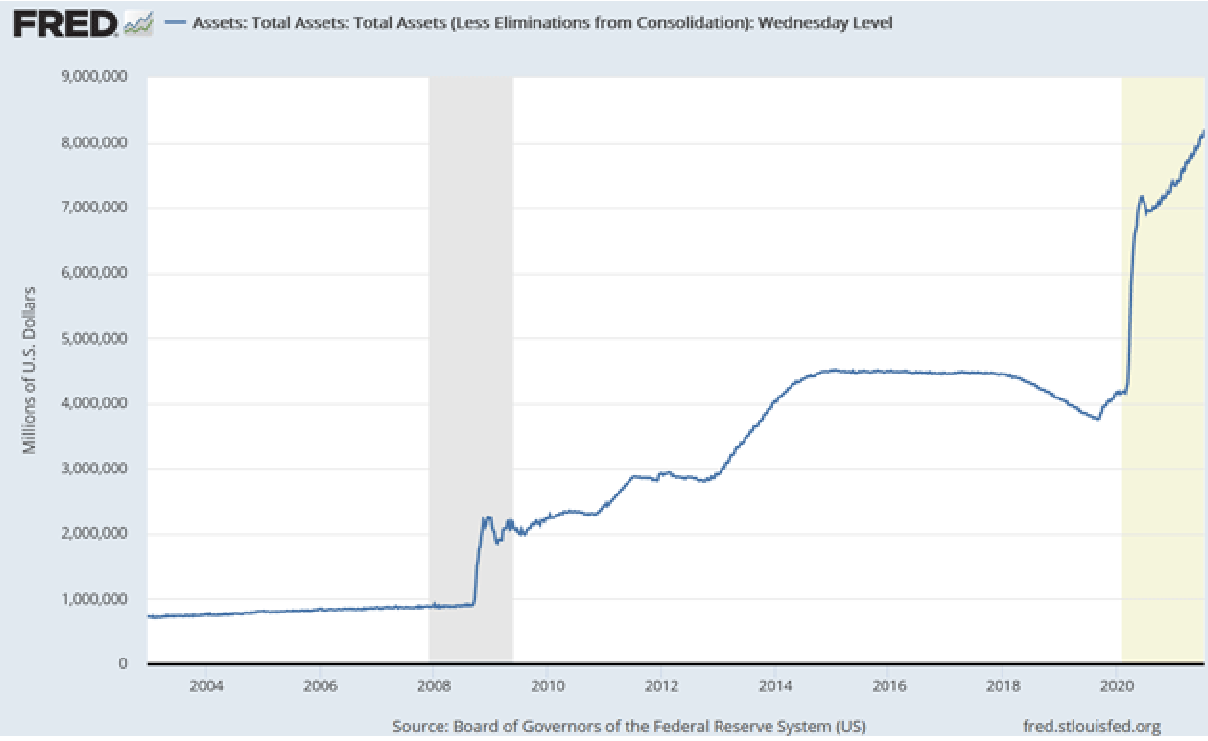
That's how we got Paul Volcker, incidentally. Jimmy Carter installed him in 1979 because inflation was so high. Volcker then did what should have been done earlier. Neither Powell nor any likely successors appear eager to normalize Federal Reserve policy. That creates severe economic danger, possibly forcing the Fed toward things it doesn't want to do.

Force-Feeding Liquidity

There's another way to look at the inflation question: Maybe we actually have major inflation already. Instead of CPI or PCE, it's showing up mostly in asset prices—mainly stocks and residential real estate. Both have risen significantly lately, arguably due to Fed policies and programs.

The connection is real. Stock prices and home prices both respond to liquidity, and the Fed is stuffing the economy with as much liquidity as it can. It injects another $120 billion into Treasury securities and mortgage-backed securities every month.

Recent activity far outstrips what they did in the Great Financial Crisis and following, which was itself unprecedented at the time.



Source: [FRED]

Look at the upper right of this chart. That sharp vertical line is the Fed responding aggressively and quickly to the unfolding crisis last year. They injected staggering amounts of liquidity which, at the time, made sense. Maybe they overdid it but, like those fire trucks I described above, they erred on the side of having too much help ready. Okay, fine.

But what happened after the initial alarm is less forgivable. Instead of pulling back, they brought in ***yet more*** horsepower, as shown in the jagged line. This is why stocks and home prices are rising. It's not so much the near-zero short-term interest rates, though that helps too. The Fed is simply force-feeding liquidity into the economy and it has to go somewhere. These assets are the path of least resistance.

Now, you might say Fed officials surely know this. Why are they still pumping? An excellent question. We may get an answer someday, years from now, when the people making those calls are able to talk more freely. For now we can only guess, and my best guess is that the Fed is effectively monetizing the giant and fast-growing government debt. They aren't ***technically*** monetizing because they don't have that authority, but it amounts to the same thing.

But why do that? Why encourage fiscal profligacy? Maybe because they think it will happen anyway, and they want to minimize the economic hit. The alternative is to let the Treasury issue trillions in new debt that would push interest rates far higher. That might end the inflation threat, but would have other serious consequences.

The Right Course

As I've said in the past, decades of policy errors leave the Fed with no good options. All the choices are bad and they can only choose the least bad. Not a good position to be in, but it's where they are. And the rest of us are with them, like it or not.

I was critical during the last period of tightening, with the Fed both raising rates and reducing their balance sheet at the same time. It was a risky two-variable experiment. Today is somewhat different. Here's what the Fed should do, in my opinion:

- Slowly begin reducing balance sheet growth, say by $10 or $20 billion a month, and sometime early next year begin slowly raising the Fed funds rate, meeting by meeting, Greenspan style.
- Stop being an arm of the US Treasury, which they certainly appear to be today, and let the government be responsible for its own mistakes.

The Fed's primary job is to control price inflation. I think its obsession with 2% inflation is a serious mistake. It's not "price stability" to reduce everyone's buying power by 22% in 10 years and 50% in 36 years.

It is certainly not beneficial to retirees who no longer have the ability to earn income and under the current financial repression can't even keep up with inflation. And while I know that Congress gave the Fed a mandate to maximize employment, nobody has been able to explain to me how monetary policy can do that. Yes, low rates make it easier for businesses to expand, but they also harm savers and retirees. Robbing Peter to pay Paul distorts markets.

I would like to go back to a time when we didn't wake up in the morning wondering what the Federal Reserve would do. Its actions have distorted the economy, repressed savers, and made the wealth and income divide far greater than it should be.

MONETARY POLICY

by Brian Kantor

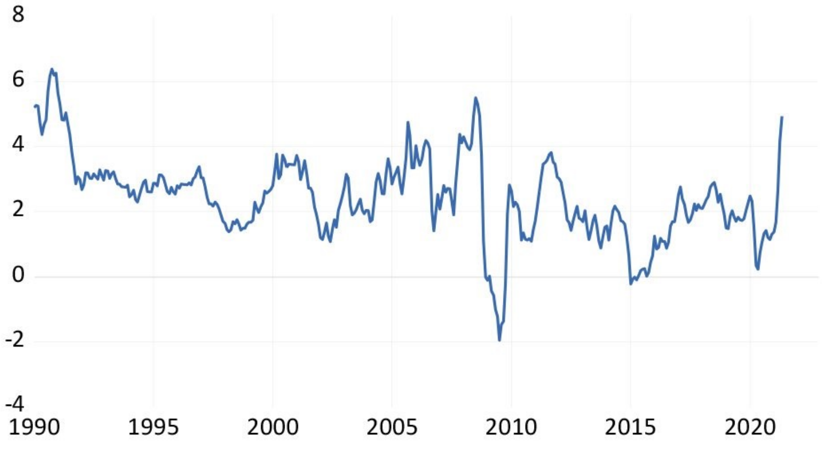
The steps taken in the US to counter the destruction of incomes and output caused by the lockdowns of economic activity can be regarded as a resounding success. Real US output is now ahead of pre-covid levels. By the end of 2021, GDP could well surpass the GDP that might have been expected absent the lock downs.

It took a great deal of income relief in the form of cheques in the post from Uncle Sam, supplemented by generous unemployment benefits and relief for businesses. The extra income means an increase in deposits, in other words money placed with the US banks, to be spent later or exchanged for other financial assets.

Deposits held by banks with the Federal Reserve System have increased by 85%, and deposits at the commercial banks have grown by 26% since March 2020. The source of the extra cash, the deposits at the commercial banks and the Fed, has been additional purchases of government bonds and mortgage-backed securities in the debt markets from the banks and their clients, which are being maintained at the rate of US$120bn a month.

The assets and the liabilities of the Fed have increased by 36% over that period. This is money creation on an awe-inspiring scale and it has worked, as intended, to promote demand for goods and services. Providers of goods and services are struggling to keep up with demand, while also struggling to add to payrolls, leading to upward pressure on prices. The US CPI was up by 5% in May – a rate of inflation not seen since 2008 and before then only in the 1990s.

Inflation in the US – annual percentage changes in CPI



Source: Federal Reserve Bank of St Louis and Investec Wealth & Investment, 15/06/2021

However, the outlook for inflation in the US is less obvious than usual. The Fed has been surprised by the pick-up in the inflation rate, as was indicated by the Federal Open Market Committee and Fed chief Jerome Powell's press conference on 16 June. Powell remains confident that the increase in inflation is transitory and the Fed does not intend raising interest rates any time soon, at least not until the economy has returned to full employment, which is judged to be some way off.

(It should be noted that full employment may mean a lower number than previously estimated, given that two million potential workers have withdrawn from the labour market since the lockdowns. They may however wish to return to employment should the opportunities to do so present themselves; this is one of the uncertainties the Fed is trying to deal with as it looks to understand the post-Covid world.)

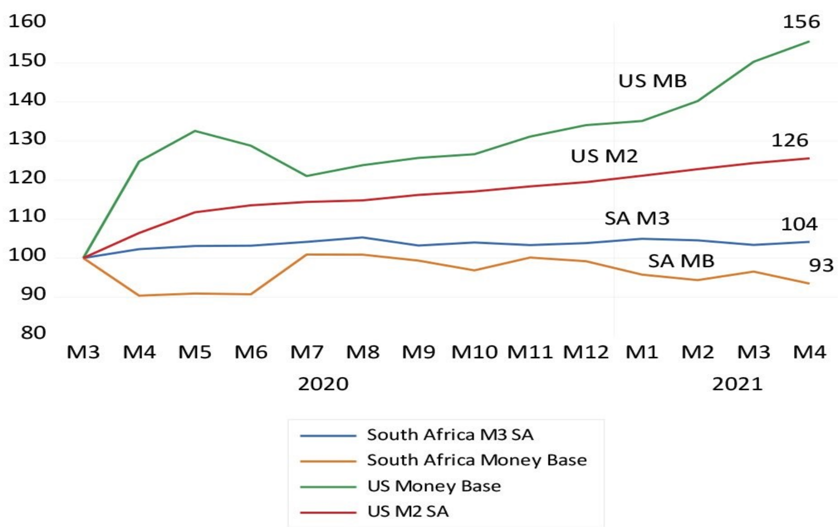
A number of Fed officials however have brought forward the time when they think the Fed will first raise its key interest rates, to the first quarter of 2023, a revision that surprised the market and moved long-term interest rates higher. The bond market nonetheless remains of the view that inflation in the US over the next 10 years will remain no higher than the 2% average rate targeted by the Fed. The Fed will be alert to the prospect that more inflation than this will arise.

A tale of two central banks

The contrast of the actions of the Fed with those of the South African Reserve Bank (SARB) is striking. The SARB balance sheet contracted by R115bn, 10.8%, between March 2020 and May 2021. Since January 2020, the sum of notes issued plus deposits of the banks with the SARB (the money base) has declined by 6%, the supply of bank deposits (M3) has grown by a paltry 4% and bank credit by 2%. These are shocking figures for an economy struggling to escape a deep recession.

The SARB may be of the view that money and credit are less important for the economy, and that changes in interest rates are the only instrument they have to influence the economy.

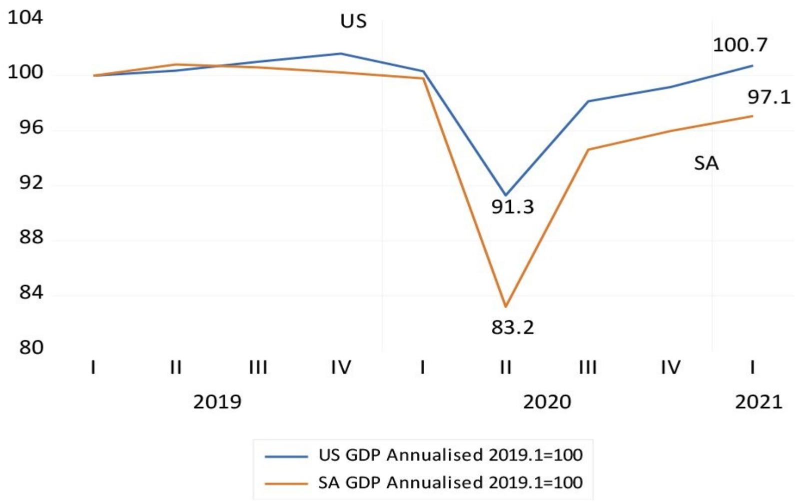
Monetary comparisons between SA and the US (March 2020 = 100)



Source: SA Reserve Bank, Federal Reserve Bank of St Louis and Investec Wealth & Investment, 15/06/2021

The SARB seems to believe their lower interest rate settings have been accommodative and helpful to the economy. Higher interest rates would, of course, have been unhelpful and lower rates were certainly called for. However, the money and credit numbers indicate deeply depressing influences on the economy, influences that the SARB could and should have done much more to relieve, following the US example. There is more to monetary policy and its influence on the economy than movements in interest rates.

GDP in the US and SA (March 2000 = 100)



Source: SA Reserve Bank, Federal Reserve Bank of St Louis and Investec Wealth & Investment, 15/06/2021

It would be easy to despair of the prospects for the SA economy given the current, discouraging trends in the supply of money and credit. However, we can draw hope from the possibility that the US cavalry (with some Chinese assistance) will rescue us, in the form of rising prices for metals and minerals that are very much part of the inflation process currently under way in the US.

Metal prices have always led the SA business cycle, in both directions. They may well lead us out of the current morass, after which the supply of money and credit will then pick up momentum to reinforce the recovery, as they have always done in a pro-cyclical way. The responses to the lockdowns have made it clear how our monetary policy reacts to the real economy. A favourable wind from offshore may lift the money supply and bank credit, without which faster growth is not possible.

US seeks crypto regulation

By Kendall Little of Next Advisor

Federal Reserve Chairman Jerome Powell said on Wednesday, July 14, that the U.S. lacks a regulatory framework for cryptocurrency — something he deemed necessary if certain types of cryptocurrencies continue to become more mainstream.

The U.S. government this week laid more groundwork for potential future cryptocurrency regulation.

Federal Reserve Chairman Jerome Powell spoke Wednesday, July 14 about the Fed's interest in regulating stablecoins and the potential for a central bank digital currency (CBDC), while testifying before the U.S. House Committee on Financial Services.

Stablecoins (Tether and USD Coin, for example) are a category of cryptocurrencies that peg their value to an existing fiat currency, like the U.S. dollar. That helps stabilize their value, so they're better suited for digital payments — unlike more volatile digital assets like Bitcoin. Ideally, these coins are underwritten by a reserve of the currency they're tied to, but today there's little official regulation enforcing that.

Powell compared them to money market funds or bank deposits, which have a strong regulatory framework in the United States. “That doesn’t exist for stablecoins,” he said. “And if they’re going to be a significant part of the payments universe — which we don’t think crypto assets will be, but stablecoins might be — then we need an appropriate regulatory framework, which frankly we don’t have.”

What Does This Mean for Crypto Investors?

Experts we’ve spoken to largely agree that long-term crypto investors should stick with well-known cryptocurrencies like Bitcoin and Ethereum. Unless you’re doing more active trading — and are comfortable with the risks of buying lesser-known coins — the two most popular currencies are the best options for most people.

Regulation like what Powell is talking about is more likely to impact stablecoins and other smaller altcoins, experts say. “They have different use cases,” says Mike Uehlein, founder and financial planner at WealthU Advisors, referring to Bitcoin versus stablecoins.

If Bitcoin is “digital gold,” stablecoins are more comparable to the current money system, he says, having an infinite supply and centralization. Bitcoin is a store of potential value, while stablecoins are better suited for digital transactions and converting digital assets to and from “real” money.

“Investors buying Bitcoin as a store of value and buying stablecoins for a store of value are two different things,” says Tyrone Ross, a financial advisor and CEO of Onramp Invest, a cryptocurrency platform for other financial advisors. A central bank-backed digital currency would be a market competitor for stablecoins, but not Bitcoin, Ross says.

Still, any new regulation has potential to affect your portfolio.

While stablecoin regulation or a CBDC may not have a direct effect on Bitcoin — which is decentralized and operated by users across the globe — it is likely regulation could bring more volatility to the crypto market. Already, we’ve seen crackdowns on cryptocurrency regulation from China play a role in Bitcoin’s recent $30,000 price drop. We’ve also seen how the price of coins often follow each other — when Bitcoin’s price takes a hit, altcoins often follow. Regulation could eliminate many cryptocurrencies available today, Uehlein says.

Still, the regulations Powell mentioned would likely have a much bigger impact on the value of stablecoins or smaller altcoins, rather than Bitcoin. “DeFi, stablecoins, and other things are ripe for regulatory scrutiny,” Ross says. “Don’t make large bets in the space now, and stay educated on recent developments and news.”

Why Regulate Stablecoins?

Because crypto trading and prices move very quickly, stablecoins can help traders move their funds within an exchange faster than if they were depositing cash from a bank account. Trading coins for actual dollars in and out of your bank account could take several days (and charge higher fees) than exchanging a coin for a stablecoin.

But without regulation, even these coins are risky.

“Stablecoins are currently used as a replacement for the U.S. dollar, pegged 1:1 with the dollar,” Uehlein says. “Verifying this peg has been in question for many investors and regulators. Many investors would feel better knowing the dollars are backed by the U.S. treasury.” And that’s where a potential U.S. government-issued digital currency comes in — since it would have that backing.

What's the Purpose of a Central Bank Digital Currency?

Powell's testimony also reiterated the Fed's interest in a central bank digital currency for the United States. A CBDC would make it easier to make transactions digitally. Because it would (hypothetically) work on a blockchain network, those transactions would also be secure and much faster than money transfers are today.

While it's generally unwise to use crypto to make a purchase, that's exactly the purpose a potential central bank digital currency could serve. "A fed-backed CBDC could replace stablecoins such as Tether or USDC," Uehlein says.

As far as any real implementation of a CBDC, both Fed officials and the experts we spoke to believe there's a long way to go before we reach that point, at least in the United States. While he says he's very interested in seeing how CBDCs in countries across the world continue to evolve, Uehlein says "it is too soon to tell how serious the U.S. is about a CBDC."

What's Next In Crypto Regulation?

Now, all eyes are on a coming report from the Federal Reserve, which Powell expects to publish around early September.

"We're going to address digital payments broadly," he told the committee. "So that means stablecoins, it means crypto assets, it means CBDC. That whole group of issues and payment mechanisms, which we think we're really at a critical point in terms of the appropriate regulation."

In addition, the Fed plans to ask the public about the risks and benefits of cryptocurrency and a potential CBDC, alongside consultation with national groups, including Congress. The purpose of the report, Powell said, is "to lay out the possible potential benefits and also the potential risks" of a central bank digital currency, and how regulators might weigh those costs and benefits.
