The Investor

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Time to understand portfolio risk

By Richard Cluver

Recently I have been detailing issue-by-issue the case for choosing shares in "Investment Grade" companies as the optimum method of building an investment portfolio.

I define investment grade companies as those which year-by-year over a minimum period of five successive years have achieved steadily-increasing corporate earnings and, more importantly, have been loyal to their shareholders by providing them with steadily increasing dividend payouts over the years.

In recent issues of The Investor I have explained how such companies might be classified into six distinct categories ranging up in risk from the safest "Grand Old Favourites" which are ideally suited to the investment needs of pensioners, widows and orphans who require the safest possible investment. At the other end of the scale lie the Rising Stars and the Maverick Market Leaders; categories of companies which are usually vigorously-growing but are often young start-ups that lack the depth of management skills and capital resources of the big old blue chips. So, before you can start choosing shares for an investment portfolio, you need a clear understanding of your own investment needs.

A brief explanation is necessary here. Consider, on one hand the requirements of a young person who is just starting out in life and is seeking to achieve a capital sum with which to fund the eventual purchase of a home and, in the far distant future ensure a comfortable retirement. He can afford to take considerable risk in the search for high gains because a nest egg loss at this stage can relatively easily be replaced with patient saving. Contrast this with a relatively elderly person who is retired with an inadequate pension and a small lump sum from the sale of his home. His need is to grow his investment income as rapidly as possible but without taking any risks for it would be extremely difficult for

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him to rebuild his capital should he suffer a major loss. Clearly there is a vast chasm between these two individuals just as there is between the cash-strapped pensioner I have just mentioned and the wealthy retiree whose income is vastly greater than his physical need and who can accordingly afford to commit some of his capital to risk for the sheer fun of being involved. I dealt in some detail with these issues in pages 143 to 156 of my book The Philosophy of Wealth ISBN No 0 9583067 6 1 and do not intend to re-visit the issue so extensively here.

Clearly however, some categories of investors require high degrees of investment security in return for which they are prepared to accept lower than average market returns while, at the other end of the spectrum there are others whose overwhelming priority is to grow their wealth and who are both able and prepared to shoulder far greater degrees of risk in order to obtain this objective. Somewhere between these extremes lies every single investor and if you are intending to go it alone as an investor you need to make an accurate assessment of your position on this risk/reward scale. Furthermore you need to make regular annual assessments of this position as you progress through life lest you unthinkingly at age 60 take the same sorts of risks that you did at 20 and as a result find yourself suddenly staring bankruptcy in the face with little or no means of rebuilding your fortunes in the few active working years left to you. So it is important for us to now concentrate upon the issues of security versus capital growth versus income growth. To explain risk I need to digress a little at this point to take readers away from the share market and explain a little about the debt market.

Traditionally the safest investment of all is termed “Sovereign Debt,” borrowings by sovereign states with which to fund major infrastructure developments. Thus, for example, there can be no safer investment in South Africa than a debt guaranteed by the fiscus; in other words by all South African taxpayers. However, it is an issue that has recently come into sharp focus because of the deep indebtedness of many governments and the very real concerns of world-acclaimed economists that even some of the leading nations like Britain and America could be headed for a situation where the sum of all their tax revenue might be insufficient to meet the interest payments upon their debts. However inconceivable it might seem, many economists are in fact warning that Sovereign Debt might no longer be the safest investment or all and this has already proved to be the case in respect of debts raised by the Greek government.

But surely such concerns cannot be raised about the borrowings of the world’s great nations like the USA, Britain, France and Germany? Well let us consider the American example currently. The sovereign debt of the USA, that is the Federal debt expressed as a share of the nation's income, has varied down the years and with it the “risk premium” required by lenders. Historically, the US has run up deficits during wars and recessions, but the debt has subsequently declined. For example, in 1945 debt as a share of the economy peaked just after World War II at 112.7% of US gross domestic product. Subsequently it fell to a low of 30 percent in the late 1970s as the US Government gradually repaid its debts.

In recent years, however, sharp increases in deficits and the resulting increases in debt have led to heightened concern about the long-term sustainability of the federal government's fiscal policies. As of March 2012, debt held by the public was $10.85 trillion or approximately 70% of GDP, while the intragovernmental debt was $4.74 trillion or approximately 30% GDP. These two amounts comprise the national debt of $15.6 trillion, roughly 100% of GDP.

The public debt has increased by over $500 billion each year since fiscal year (FY) 2003, with increases of $1 trillion in FY2008, $1.9 trillion in FY2009, and $1.7 trillion in FY2010. As of February 2012, $5.1 trillion or

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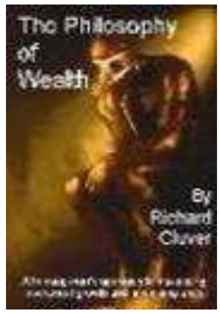

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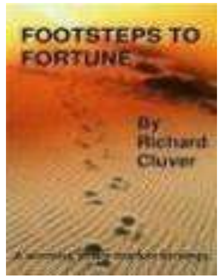

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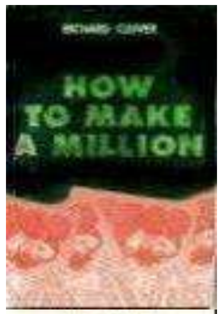

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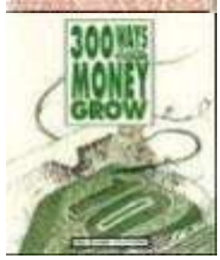

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approximately 50% of the debt held by the public was owned by foreign investors, the largest of which were China and Japan at just over $1 trillion each. Economists, moreover, argue that this figure is considerably undercounted because it ignores an actuarial measurement of the future cost of such items as the US national health service and state welfare costs which if correctly counted could take the ratio to nearly 200 percent.

Similar concerns have been raised about Britain and a number of other leading nations where weak governments have successively given in to the demands of their electorate for steadily increasing levels of welfare spending which have been funded by borrowing rather than from annual tax revenue. These concerns have led to the rise of the ratings agencies, organisations committed to the task of judging the ability of borrowers to meet their debt obligations. The big three agencies are Fitch, Moody's and Standard & Poors. What they do is assess how likely a borrower is to be able to repay its debts and help those trading debt contracts in the secondary market i.e. the ratings agencies offer a means for people who trade debt contracts such as Treasury Bonds to assess a fair price.

It is thus a supreme irony that by contrast with the US, South Africa’s total borrowings represent just 35.6 percent of our GDP, a level of indebtedness that we share with Australia. Ironically then the US ratings agency Moodys rates South African sovereign debt as A3, and the outlook as “Negative” while it rates the US as Aaa and outlook negative, the same as deeply troubled Italy. Against this, the US has just been downgraded by Moodys from AAA and outlook stable to Aaa and outlook negative.

But the crunch comes when you enter the marketplace to buy a long-dated US treasury bond. An investment in a US long-bond would at the time of writing yield you interest of just 1.86 percent while South Africa’s equivalent RSA 157 long bond would yield you a three and as half times greater 6.365 percent.
All other South African borrowing rates are a reflection of this difference. Thus in South Africa the Reserve Bank sets the scale of all interest charges by declaring a Repo Rate of 5.5 percent, the rate at which it lends money as a last resort to the commercial banks. The interest rate that commercial banks charge their most creditworthy customers is always considerably higher than the Repo rate and is currently 9 percent. In contrast the US prime lending rate is a third of our prime rate at just 3.25 percent and the implication of all of this is that, notwithstanding our very good indebtedness situation relative to that of the USA, foreign investors seemingly consider South Africa a far greater lending risk than the US.

How does one make sense of that? Well the core reason is South Africa’s relatively greater inflation rate and the impact of that upon the Rand/Dollar exchange rate. If you lend money to a country experiencing relatively high inflation rates whose currency is consequently weakening over time, you obviously need to recognise that you face the risk of being repaid a lesser amount than you originally loaned…unless of course the debt was raised in US Dollars or British Pounds as if often the case when South Africa seeks to borrow money overseas.

However, taking the example of a US investor who sends his money to this country to buy local bonds, we need to note that inflation in the US is currently running at 2.7 percent while the South African rate is 6 percent and the average for the past 20 years has been 10 percent. That is why the Rand has over the same period been losing value relative to the US Dollar at a compound annual average rate of 5.1 percent as depicted by the red line on my graph.

It is easy to understand then that a US investor buying a South African long bond would want to receive at least as much as he would from a US long bond, namely 1.86 percent plus the current inflation rate of 6 percent giving a required yield of 7.86 percent. Now compare that with the current actual yield of 6.365 and you will understand that the bond market has seemingly recognised the reality of the relatively lower risk of buying a South African bond…even if the ratings agencies have not.

Name	Return	DY	5YrGro	5YrDiv	Grade
Averages:	16.53	3.4	13.14	32.85	763.2
Blue Chip Index Average:	17.16	3.0	14.13	20.35	570.6
Rising Star Index Average:	15.65	3.9	11.75	47.92	1 031.5
Grand Old Favourites					
Group Avg.	20.26	2.6	17.66	26.35	791.2
CAPITEC BANK HLDGS LTD	42.46	2.0	40.43	47.39	1 292.0
SHOPRITE HLDGS LTD ORD	35.99	1.6	34.34	31.23	786.6
CLICKS GROUP LIMITED	29.96	0.8	29.18	27.71	700.3
GROWTHPOINT PROP LTD	15.82	5.3	10.52	9.41	68.1
SABMILLER PLC	15.45	1.9	13.58	14.51	696.9
SASOL LTD	8.74	4.0	4.74	19.76	1 023.9
BHP BILLITON PLC	6.92	3.0	3.89	25.48	1 036.5
WILSON BAYLY HLM-OVC ORD	6.72	2.2	4.57	35.32	725.7

Sadly it is not that simple. Professional investors are always alert to the impact of inflation and so, when comparing the merits of one bond investment with another they always look at the "real" return. That is the current bond yield minus the inflation rate. Subtract South Africa's 6 percent inflation rate from the 6.365 percent yield on the R157 long bond and you get a real return of just 0.365. In contrast, subtract the US inflation rate of 2.7 percent from the 1.87 yield of a ten-year US treasury bond and you get a negative -0.83. So it appears that on a relative real yield basis, the investment markets, nomatter how unfairly, confirm the relative risk rating laid upon this country by the ratings agencies.

All of which brings me to the required yields on South African shares when viewed by international investors whose buying and selling actions largely determine what local share prices should be. Here we can ignore inflation because both bonds and shares are being bought in the same country and so each are equally exposed to inflation.

So, noting that the yield on a top quality South African long bond, one whose repayment is guaranteed by the South African taxpayer, is currently yielding interest at 6 percent, one would expect that an ultra blue chip share such as the category of shares I label the Grand Old Favourites should yield a very similar return. I have extracted the accompanying table from the ShareFinder programme Quality List from which you can deduce that the average dividend yield of the Grand Old Favourites was 2.6 percent at the time of writing and on average these shares were rising in price at a compound annual average rate of 17.66 percent. Add those two figures together and we get a "Total Return" of 20.26 compared with the total return of 6 percent offered by one of the safest of South Africa's long bonds.

The implication is that the marketplace currently would regard a portfolio consisting of equal value quantities of the seven safest of all Blue Chips as 3.37 times riskier that the safest long bond.

**** This column was written before the recent ratings agency downgrade of SA bonds***

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By Invitation

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It is a point that has been noted many times before. As Martin Jacques ("When China rules the world" Penguin Books 2012) puts it:

"The most striking difference between Europe and China is in the disparity between the sizes of their polities, which has persisted for two millennia and whose effects have been enormous. For roughly 2000 years, China has been united and Europe has been divided. This above all explains why Europe is such a poor template for understanding China". And perhaps he should have added, though it is perhaps irrelevant to his main thesis and focus, which after all concerns China exclusively, as to why China is such an excellent template for understanding modern Europe in its ongoing death struggle with monetary union.

Jacques once again:"After the collapse of the Roman Empire, Europe was never again to be ruled (notwithstanding ambitions by Napoleon and Hitler) by an imperial regime with the capacity to exercise centralized control over more or less the entire continent. Political authority instead was devolved to many small units. With the creation of the modern nation-state system, and the unification of Germany and Italy, Europe remained characterized by its division into a multi-state system."

This European reality was remarkable, given the contrast with China. For China retained the imperial state system that emerged after the intense interstate competition (the Warring States period) ending in the 3th century BC."China's equilibrium state has been that of a unified agrarian empire in contrast to Europe, which for two millennia has been an agglomeration of states."

According to Jacques, from this follows a fundamental difference in contemporary Chinese and European attitudes. While the Chinese attach greater importance to unity than literary anything else, the Europeans overwhelmingly believe in the nation-state rather than European-wide sovereignty. It is this that makes genuine European integration so extremely difficult to achieve at this belated hour.

While the rise of nationalism in Europe in the 19th century resulted in the break-up of old empires and the creation of many new states, this has never happened, and shows no sign of happening, in China. Europe's lack of attachment to unity exposed it to many intra-state wars that have scarred its history over many centuries. Also, for over a millennium various European states faced competition from rival elites seeking to limit the state's power. In Europe the elites remained relatively autonomous, except at extreme moments like war. The boundaries between the state and society in Europe were clearly delineated and constantly contested, as autonomous competing elites (nobles, clerics, burghers) fought to constrain the power of the state. In Europe this contest between state and elites was intimately bound up with both Church and class.

With a history like this, to decide today to voluntarily cooperate and integrate, in a matter of one or two generations, not merely economically by lifting boundaries and free markets, but to unify monetary, fiscal and banking systems and by implication standardize many economic and social rules, and ultimately integrate politically much more closely, is challenging in wanting to overcome millennia of separation and the many divergent cultures this nurtured.

China having been military unified at an early stage, as long ago as 3000 years, and staying more or less unified throughout, is a different proposition altogether from Europe which has always existed as separate entities and now suddenly again wants to overcome such many boundaries keeping all apart, this time not military but voluntary in a simple, quick, apparently effortless choice. It just isn't that easy, as we see playing daily in Europe today, even if the integration achieved since WW2 is on a millennium scale, and when contrasted to a long unified state like China, is truly nothing short of surprising and stupendous.

So it probably can be done, if on a very long time frame and with much intense effort (and accompanied with much more hardship) and resistance than seen so far? Yet the present European 'crisis' doesn't offer the luxury of having centuries, or even more generations, to spare to overcome deep resistance to full integration. If the Continent is to integrate fully, it should do so quickly or desist, otherwise running the risk of being torn apart in the attempt or putting together a flawed concept probably bound to fail eventually (as other attempts in its history have been before).

One is reminded of the way Bismarck unified modern Germany, which then took 75 years to show up inherent flaws allowing its demise. Also one is reminded of the post-WW2 Bretton Woods arrangement of fixed-rate currencies governing the global economy. This system fell apart because of its rigidity, from 1971 being replaced by a system of freely adjustable exchange rates, thus helping to insulate countries from policy mistakes and other shocks abroad.

It turned out that individual countries don't easily converge on each other, being unable internally to flexible adjust fast enough while keeping their exchange rates fixed. It was far more realistic to acknowledge deep differences between countries and rely on exchange rate adjustments as a relative painless adjustment mechanism maintaining trade competitiveness and attractiveness as investment destinations (within reasonable limits).

In contrast, the nature of the modern European integration challenge means convergence on the strongest country with the most throw-weight. And that is Germany. This leads to fundamental objections. Never mind the resistance of the weak to forced convergence with the strong. For the strong, too, profess many doubts as to whether they want to integrate more deeply with the weaker peripherals, fearing the implied burdens. Thus many are fighting the concept of taking European integration to its logical conclusion, preferring to remain uniquely alone in their own space, if freely trading with one and other and reaping the economic gains from common market areas. These arguments tend to lead to political compromise and huge implementation delay, keeps markets fretting, risk premiums high for peripherals and generally keeps the crisis atmosphere alive.

Instead of a clean decision not to proceed with integration (and undoing the monetary union) or overcome all resistance and rapidly complete full integration, enforcing convergence quickly, the third option is a flawed union, with as fourth option the very slow progress to full successful integration eventually. Even as more institutional safeguards are agreed every year, bolstering the monetary union, a flawed framework would eventually be tested to destruction, by markets as much as national electorates in the various countries, even if this were to take decades to come to the fore.

The impetus to monetary union was given in 1991 (Treaty of Maastricht) but its inherent flaws, although identified by some very early on, only came to the surface 18 years later following an Anglo-Saxon housing and banking crisis unhinging a large part of the global financial system and economy, causing fiscal disruptions also in Europe that finally exposed the deeper realities. Europe could be storing up many future problems if it doesn't execute a flawless integration attempt, with as alternative an early breakup and return to fragmentation.

Many of the local cultures preserved over millennia are unlikely to be overcome easily or quickly in the name of an ideal, with too much compromise inviting innate design flaws capable of wrecking future havoc. It is when we contrast with old China (or modern America) that the truth about full European integration can be seen starkly. Europe may not be able to go the whole hog, while a half-hearted attempt may end up being more costly than ever appreciated, if only eventually. But try telling this to political, commercial and financial elites less attached to ancient local lore and much more taken with futuristic global offerings.

Here we have a choice as to historic ruthlessness and futuristic ruthlessness to appreciate why these elites act the way they do. The post-WW2 generation contained large elements which wanted to end the potential for regional war, led by French hopes of finally tying Germany down, and a German willingness to play along if this offered the way to full revival. It was apparently understood by many, not only French and Dutch but most Europhiles, that political union was a prerequisite for the more technical monetary, fiscal and banking unions to work. Yet political union was way beyond the means of the Continent to achieve up front after millennia being apart. Instead, the Continent would have to grow together far more closely first to overcome such resistance. But not having centuries to spare to achieve such a goal, in a world evolving at a bewildering pace, with new and ever larger power blocs coming to the fore, the cynically inclined decided on a shortcut.

Stick with what is feasible, and it will unleash pressures that will make possible the rest, if in stages. Start with economic union (common market), progress to monetary union and let the (known) institutional flaws create crises that will force the breakthrough to “voluntary” political union. Did they ever really understand the nature of this choice? Whether they did or not, no longer matters. Europe (and the world) finds itself in the middle of the ultimate challenge to complete the full requirements of union or fail in the process of attempting it. And yet it was at the onset of this latest European crisis that something interesting happened. For whereas German agreement to monetary union had originally focused on gaining acceptance for German reunification (though with many warnings where this would lead technically), it was in 2006 that Germany apparently gained a new ideal.

To fully appreciate the significance of this, one must appreciate the down-to-earth attitude of most post-war German political leaders, who were mostly guided by practical realism rather than by flights of visionary fancy so beloved elsewhere on the continent. As Helmut Schmidt, German Chancellor in the 1970s, reportedly once put it: “People who have a vision should go see a doctor”. Chancellor Helmut Kohl didn’t so much have a vision of a future integrated Europe (though talking about it) as doggedly being determined to reunify Germany (and into the bargain see communism crumble). That didn’t take vision but focus and was delivered against many odds.

Apparently, German Chancellor Merkel today operates very much in this tradition as well. But if it isn’t vision, what is guiding her to be “the Accidental Architect of a New Europe” as Kaminski describes her? Apparently, it is again focus, the kind of focus that also guided the early post-war Chancellors in their dealings with their European neighbours. Specific later examples were Schmidt in his dealings with Valery d’Estaing in the 1970s, trying to make a beginning with recreating an island of internal European stability (the failed currency snake attempts) while having to deal with the wayward American behemoth. Similar was Kohl’s successful (if extremely costly) attempt to reunify (and neutralize communism). And again Kohl’s successor Schroder in focusing on getting German competitiveness restored through internal reforms (a process that he begun but left incomplete, and Merkel resumed but ultimately also has so far left incomplete, given the extent of domestic resistance).

When Greece’s debts exploded three years ago, Chancellor Merkel was thrust to the forefront only because Germany has Europe’s largest and healthiest economy. According to Kaminski, “with no firmly set policy ideas and little understanding of finance” (in other words, no vision), she picked up that baton. And a new focus, “with the hint of a broader vision”, started to come into view, if very gradually, and hardly always understood by the many demanding instant action of some kind.

Margaret Heckel, biographer of the German Chancellor, claims Merkel became “obsessed” with China after her first trip there, in 2006, which made her see that “Europe could survive in this new world only by being united”. Germany, too small to compete on its own with China and America, needs to be at the heart of a bloc that will revive the EU by enforcing the sort of economic discipline that Germany adopted a decade ago.

Letting little Greece go, or bigger Spain, or seeing Italy off, or going oneself off in a huff, or allowing Finland to do so? Those kinds of sentiments miss the bigger point entirely about the new German focus, or vague vision thing. Having lived in dread for decades and seen off Russia, and having been in the shadow of financially incorrigible America, while having to live with snapping and snarling Europeans at its heels every step of the way, and now facing serial Asian behemoths coming on stream, the new German focus is a rather straightforward one.

Get the rest of Europe into a reasonable shape, tie them in knots of disciplined monetary, fiscal and banking arrangements, get them all to focus on becoming structurally more efficient (and thus able to perform better and grow faster), and retain one's place at the global High Table where ageing fading erstwhile European Greats are rapidly losing their claims. Europe is engaged in a deep inner struggle with achieving this ideal and to do so voluntarily (as opposed to the forced handiworks imagined by a Napoleon or Hitler).

Yet many of its people, especially lower down the socio-economic scales, with most to lose from inevitable adjustment burdens and emotionally attached to the often quaint ways of their respective pasts, won't easily come along, as we see daily playing out in nearly every corner of the continent. It is the elitist focus/vision thing against the deep-willed resistance of many electorates which don't want to pay an inordinate price or carry inordinate burdens for something of which the advantages remain dimly hidden in the future and often poorly understood or simply denied.

The challenge is to define the mission right, not allow flaws to creep into the design and undermine the concept through future crises, and get electorates to accept in stages while keeping markets satisfied along the way.

It is ultimately a decision to commit to enormous adjustment burdens in democracies with low pain thresholds, giving up on easy adjustment mechanisms such as multiple exchange rates in favour of hard inner reform. This indeed takes years, all the while facing resistance from markets and electorates, having to pick one's pace and path gingerly.

Chancellor Merkel's existing (conservative) German coalition has allowed her to go only so far. With her personal popularity well established, and German politics shifting, next year's election on current trends will likely produce a CDU/SPD (right/left) coalition with Merkel at the helm (as currently the case in Holland). Such a grand coalition would ease the way for German constitutional amendments to gradually move ahead with an EU banking and fiscal union ("more Europe"), completing the technical foundations for a sounder monetary union, if still short of a closer political union that probably will evolve much more slowly.

Thus the Merkel challenge for Europe seems to be how to allow Europe to become institutionally more stable and economically more efficient while ever so slowly growing closer together without losing the plot.

These are not finites but relatives. A huge historic challenge, given the many millennia of fragmentation and conflict that lie behind us, and not least the often flawed partial attempts of the past 40 years at doing something 'collectively'. In contrast, China's Ideal and its challenges are quite different. It seems to involve how to remain one while gaining more efficiency.

We would all like something for nothing

Hands up those among you who could do with an extra increase in salary or wages? Make that 99.99% There is the odd person who really has enough AND knows it. But except for those most of us could dream up plenty of ways of using some more money.

So wanting it is not the economic problem of our time (though one day who knows). Getting it is the big thing. For most of us it is our scarcity value (of our talents, passion, energy, creativity, originality, dexterity, knowledge, negotiating ability, inventiveness, organizing ability, emotional intelligence or whatever) in an open market place that determines our income.

For those less skilled and therefore more mass-market dependent, less able to differentiate and capitalize on some specialized ability, collective bargaining with a union looking out for the common interest is an important defence when facing powerful employers. This way society acquires checks and balances among societal forces, not perfect but workable balances, with enough fairness, incentive and opportunity to make a difference to be attractive to the great multitude and these general rights then enshrined in law.

So that is our institutional frame. Though it has a lot in common with such frames prevailing elsewhere, it ultimately is pretty unique per country culture, each nation in turn over time having discovered (mostly the hard way through endlessly struggle) what works for it. In South Africa, as elsewhere, society isn't static but changing along with growing numbers, sophistication and wealth, flexibly (though hardly ever easily) adjusting its institutional rules of the game to suit the times.

This year has turned into a bit of a watershed in that department, with revolutionary change abruptly intruding. Everyone would like a bit more money if easily given, but few really want to go to war for it (potentially risking job and income). Although sweet reasonableness is different (especially when bonus pools need to be divided among the top performers or unions grow and lock horns with managements), most people accept the manner in which reward is established (or simply take their custom elsewhere if they can or want to do so).

It is really only exceptionally that whole work forces decide finally that neither employer, union, market place or the law has much to offer that comes close to what is needed, wanted or wished for. This usually only happens were despair runs high, where frustration has become unbearable with being unable to make ends meet, the gap between ends and means has become too big, perception has become grossly distorted as to what is achievable and realism has walked out the door.

It is then that the rules of the game can break down, where employer and union are no longer recognized as reasonable partners or representatives, where the market place doesn't offer a simple alternative, and where workers en masse take the law into their own hands. This is where unofficial, illegal wildcat strikes occur as workers attempt to rewrite the rule book entirely from their perspective.

We, our Band of Brothers, need more money and benefits and we need it now. The employer is rich. So, pay us more and we will work, but meanwhile nobody will work until our demands are met. Why did Willie rob banks? Because that's where the money is. Similarly, many seem to think South African mines are rich and profitable. So, there should be scope to give more to labour. To slightly adjust a famous car advert "We want it because we need it and you can afford it".

There is little evidence here of any insight in financial accounts, global developments or the true state of the company's health. Precious metal and base metal prices are high, management and union bosses are earning fancy salaries and perks, so mining companies must be rich, or so apparently the reasoning goes. In the absence of strong government leadership, both in setting a virtuous personal example and making the economy hum so that income grows faster than workers can dream up ideas to spend it (for long the challenge of the communist party in China, something they did successfully under Deng and his successors, especially when consumer choice remained curtailed), it is up to other social partners to restore order.

Police action may be needed to restore property rights. Mines and equipment do not belong to the workers. These assets cannot be used as a hostage and bargaining tool. Also, the law is very specific about violence. Thou shall not kill or otherwise poke your fingers in somebody else's eye, instead at all times staying within prior agreed boundaries of behaviour. If not, we would all end up very quickly in a chaotic jungle, where contracts wouldn't be enforceable and where economic agents spend so much time on their defences that there is really little time for anything else.

So despite 1% of the deployed work force thinking differently (at least during August-October), downing tools, preventing many from working, causing costly output losses, making ambitious demands, the rest of us basically got on with our lives, though many wondering how this would end.

The ending in the first instance is of course an old-fashioned one, where police restore public order and employers offer some sweeteners (some more generous than others), effectively meant to persuade workers that they have won a point, but that the business needs to survive, with costs covered and a return to shareholders for capital and effort at risk.

Some will be persuaded to step back onto the reservation so very recently vacated, ready to again work within the rules of the game, but these are changing as we speak, as law and labour practice get tweaked, for old unions have lost stature, new unions need to be accommodated, everyone seems to be thinking now is the time to pile on the pressure, with some employers ready to flexibly give an inch but otherwise slap everybody down. For the business needs to survive, not so?

As to those who don't want to see reason, don't want even to negotiate, bitterly hold out for the demand they have identified as temporarily satisfying their growing aspirations and expectations, there is ultimately resort to the law by employers and dismissal of those who can no longer operate within existing legal guidelines. With cost escalating, and labour that much more unpredictable, there is incentive to cut and trim, for the show needs to go on.

Meanwhile, are we seeing the last convulsions of the recent labour unrest, or is a bigger counterpunch being prepared, as sympathy strikes get off the ground? Even more fundamentally, does the political game change, with different labour-friendly forces coming to the fore, ready to implement a Leftish revolution of some kind?

Such ideas and emotions flourish at times like these. But to the extent that politics can radicalize, it will probably radicalize as much on the Left as on the Right.

And so we await our collective fate, with police keeping the public order, employers compromising a little until finally left no choice but to dismiss labour.

Maybe so, but the last word may not yet have been spoken.

For we need to see how our labour dispensation is going to change as the rules of the game get tweaked quite a bit to take into account the deeper frustration and despair lingering out there, while also the bigger political dispensation gets shaken up, over time possibly fundamentally as new faces come to the fore.

But that is for the future. In the meantime, thousands are losing their jobs as the country licks its wounds, with output and income forgone, investing cut back and already much loss of reputation, stemming foreign investors cautious and putting rating agencies in a foul mood (for where could all this still lead eventually?).

In sum, all this constitutes progress, but of the most costly, painful kind. Yet is there really any other kind except when oozing sweet reasonableness, but when did you encounter this last (aside from Gauteng traffic)?

Stockbroker's views

by **Brian Kantor**
Investec Securities

Examining the relationship between the price of a bottle of wine and the score given at tastings by experts shows that the price may have more to do with intangibles like the perception of quality.

Michael Fridjhon is much perturbed about the state of the SA wine industry (see *WINE: The ailing South African wine industry,* Business Day, 31 August 2012). The problem for the industry, according to Fridjhon, is irrationally low wine prices – that is prices that do not reflect the underlying quality of the wines produced. This may be good for SA consumers, but very tough on the producers determined to compete on world markets, but unable to extract the prices that would make the effort profitable. SA wines, they argue, compete very well on score but badly on price.

To quote Fridjhon:*"The wine industry seems to lament the fact that our wine prices do not compare with the rest of the world….."*

He contends that:*"…. Wineries simply cannot charge as much as their products are actually worth. Supply so far exceeds demand in the world of Cape wine that even the very top end of the market cannot achieve the kind of price spread that reflects a healthy high-end consumer-goods environment."*

Economists, those specimens of inhumanity, of whom Oscar Wilde said, knew the price of everything and the value of nothing, would regard this statement as a *non sequitur*: what a product is worth to its producers is the price they are able to charge for them. Consumers who are free to choose may well regard this price as a (relative bargain) and worth paying. Wine however does offer another explicit measure of quality in addition to price that is not usually available to consumers of most goods and services: the scores received at organised wine tastings.

In these very public events, experienced wine connoisseurs taste and smell the wine "blind" and award scores based on the well recognised desirable characteristics of wine. The tasters are not informed about the origins of the wine or its grape, variety, vintage or (especially) its price. They are not literally blinded because the colour of the wine - white, pink or shades of red - is among the criteria evaluated.

According to the tasting methodology of the Wine Enthusiast magazine "The Classic wine - the pinnacle of quality" would score between 98 and 100. A superb wine would score between 94 and 97 and be regarded as "a superb achievement". "Excellent" wines score between 90 and 93 and come "highly recommended”. Wines that score between 92 and 90 are regarded as “very good and often offer good value, well recommended”. Good wines “suitable for everyday consumption” score between 83 and 86 and a score between 80 and 82 indicates an “acceptable wine suitable for casual, less critical circumstances”.

Fridjhon further elaborates on the problems faced by SA wine producers: *“For now, the US is the largest consumer of wine in the world. Great South African wines are starting to find their way on to shelves and menus here. Their value proposition is extraordinary value -- bottles of quality juice with real character selling for $8-$20 while tasting north of $20-$50”*

However the relationship between wine prices and their quality (as measured in organised wine tastings) is not nearly as consistent as Fridjohn might recognise. Years ago I examined the relationship between the prices of SA wine and their tasting scores as reported by the SA Wine Magazine. it to make its quality assessments.
To these may be added I found that the correlation between price and score was (fortunately for the reputations of the professional wine taster and the producer aiming at improved quality) a modestly positive one.
The higher the score, the higher the price – the relationship was and statistically significant, of the order of 0.67. But this statistical relationship is one that leaves much scope for other forces to influence price, other than “quality”, as measured by experienced wine tasters.

It therefore it occurred to me to test the Fridjohn hypothesis that the markets are in fact biased against SA wines; firstly by re-examining the strength and reliability of the relationship between tasting score and price; and secondly to test whether SA wines get a bad deal from the wine market compared to their rivals in the US. For this exercise, we compare SA wines with Australian wines. To this purpose I went to the recent on-line editions of the US wine magazine, The Wine Enthusiast. The Wine Enthusiast offers its readers a Buyers Guide that does for its readers exactly what Fridjhon would like it to do for the value conscious wine buyer in the US: it provides a comparison between the price of the wine in the US (as advised by the wine distributor and the scores realised in a tasting) – as well as providing a short description of the wine.

The magazine also regularly identifies bargain buys. In the recent editions I drew upon, SA wines are very well represented. The value news about SA wines is certainly out there. A few points about these scores and the quality they estimate need to be made. While price should not influence score (if the tastings are genuinely blind) scores achieved in public tastings will surely influence prices charged. Good scores will become widely known and lead the distributor to seek and realise higher prices.
Furthermore, while the scores range between a practical minimum of 80 and a maximum possible 100, there is no limit to the prices that may be charged from the $10 per bottle minimum that is barely enough to cover packaging and distribution costs. This improves the chances of significant outliers: wines that sell for much more than other wines with similar scores.
Information on 235 wines from recent editions of The Wine Enthusiast was loaded. This made a large enough and representative sample from which statistical inferences could be drawn with some confidence. Details about the wine, its price, score, variety and vintage were entered in the database: whites, reds and blends of them from either South Africa or Australia were selected roughly in order of their appearance in the Buyers Guide. They included all the major red and white varieties, Pinot Noir, Cabernet Sauvignon and Shiraz/Syrah (excluding Merlot for obvious reasons) and the red blends. The white wines included a number of very well regarded Chenin Blancs from South Africa (their scores ranged from 92 to 88) and Pinot Grigios from Australia, as well as a number of Chardonnays and Sauvignon Blancs. (Chenins from Beaumont, De Morgenzon, Jean Daniel and De Trafford all received 92 points).

The oldest wine surveyed was a 2004 vintage with most of the wines much younger than this. Wine producers in SA or Australia are apparently not laying their wines down for very long before release to the US market. Presumably this is because their wines are not made to benefit from the slow maturation of bitter, complex tannins in the bottle and to gain value as the best French wines do. However there is a tendency for wine prices in the sample to rise with the age of the wine (independently of the tasting score).

The average price asked for the wines in the sample of 235 was US$27.50 with an average score of 88.9. No wine included scored below 84. The highest price indicated for any wine in the sample was US$150 for a Penfold Syrah (2008) from Australia that scored 93. The highest tasting score realised in the sample was 94 for another Australian Syrah, a John Duval (2008) that sold for US$100. The most expensive SA wine in the sample was the Ernie Els Signature, a blended red (2007) that sold for US$95. This wine also achieved the highest score of all the SA wines, 93, though a number of the SA wines scored in the 90s. Another Ernie Els red blend, The Big Easy (2010) scored an average 88 points and sold for a below average US$20.(Just in case it is thought that the secret to success in wine is an association with a famous golfer, an Australian Greg Norman red blend, vintage 2008, that also scored 88 was selling for a mere US$15.

The South African wines included in the sample sold for an average price of US$24.15 and earned an average score of 88.6. The average Australian wine sold for a higher average of US$31.65 but realised a higher average score of 89.3. A higher price for a higher score does not indicate any obvious bias. Of the red wines, the average price for the 66 SA reds was US$27.31 for an average score of 88.7. The Australian reds, 90 of them, sold for a higher average of $34 but also with a higher average score of 89.6. However the observed relationship between price and score for the SA reds was a lot stronger than for the Australian collection. The correlation between the logarithm (log) of price and score for the SA reds was 0.69 and a much looser 0.49 correlation between price and score was recorded for the Australian reds. For the entire sample of 235 wines the correlation between the of price and score was a positive and statistically significant 0.65.

A regression equation to explain the price of an SA or Australian bottle of wine, using score and vintage as explanations of price, generated highly significant estimates for the influence of score and vintage on the price. The equation estimates that for every one per cent increase in tasting score, the price could be quite confidently estimated to increase by 1.18%. Laying the wine down for an extra year could almost as confidently be expected to add 0.53% to its price.

This equation realised an R square (or goodness of fit) of 49%. That is to say, the value equation explained only 50% of the observed price. This is a satisfactory result for the theory that tasting scores influence price, especially given the statistically significant influence of score and vintage on price. The equation proves that score and vintage matter (consistently and significantly) when it comes to the price charged. It does therefore indicate clearly that wine makers will be consistently rewarded for adding quality or age to their wines. Though the added value may not cover the extra costs incurred to achieve improved quality.

But it also proves that there is much more than quality and vintage at work on price. These regression results still leave 50% of the price of a representative bottle of SA or Australian wine sold in the US to be explained by other forces: it becomes very difficult to assert a bias in wine prices when more than 50% of the value of a bottle of wine cannot be attributed to its quality and/ or vintage.

The other 50% is to be explained by what might best be described as intangibles, the marketing magic or perceived values that consumers are willing to pay for and which we understand so little about. After all taste and preferences are registered in the brain rather than the mouth and our knowledge of how the brain works is very much a work in early progress. Consumers do not taste wine blindfolded – nor do they spit it out. They mostly do it in company and impressing the company with expensive wine selections on their behalf may be a price well worth paying especially if the buyer is on an expense account.

The regression equation can be used to estimate the “fair value” of a wine if the only price influences were the tangibles, tasting score and the vintage year. Wines that sold for more than this could be regarded by the value buyer as expensive and wines that sold for less than their predicted values as value buys. As may be seen, the overpriced wines, or rather what may be better described as the especially successful wines in the market place are rare and more conspicuous than the value buys (those that sell for less than their estimated value).

Some of the outstandingly overpriced wines in the sample are identified below. From the producers’ perspective they should be regarded as among the great success stories to be emulated by their competitors. However those who produce great value for money wines – from which consumers benefit so greatly – presumably know the science stuff pretty well too. It is the art of turning grapes into money, rather than into wine, that needs to be learned by the SA wine producers if they are to beat the market: they need to achieve prices that exceed the costs of producing the wine.

For SA value buyers, the evidence from the US market indicates that the Spice Route Chenin (2009) offers value. For its score and vintage it should command US$24 but is priced at US$15. The Thelema Chardonnay (2009), also at US$15, offers similar market beating value. For its 89 score it might have commanded a value of US$24. Among other bargain buys noticed in the list are Shiraz wines from Jardin, Kaapzicht and Robertson Wolfkloof, all 2007 vintages that achieved scores of 89 and sell for US$19, compared to fair value of US$29.32. Another bargain buy in the US, perhaps available also in SA is a Plaisir de Merle, Cabernet Sauvignon (2007) that sells for US$13 when its 88 tasting score might well have justified a price of over US$25.

There are bargains to be found in the Australian list. The Greg Norman blend that sells for US$15 has a predicted “fair value” of US$23. A Plantagenet Sauvignon Blanc (2010) scored 90 points and sells for a mere US$15, some US$8.5 less than its tasting score might suggest.

Stockbroker's views

Patrick Lawlor
Investec

Markets have now had time to digest the downgrading of SA's sovereign rating by Standard & Poor's and now the attention will switch to how markets go from now and what the policy response to the downgrade will be.

There has been a relatively muted response in the rand and bond markets to the news, with the rand already having weakened significantly since August, when the Marikana tragedy took place. Both the rand and the medium dated R157 bond have been steady since the S&P announcement. This suggests not that the issues highlighted by the rating agency are unimportant – but rather that markets had already discounted them (see chart).

Furthermore, there has been some cushioning effect thanks to inflows in the bond market due to the inclusion of SA government bonds in Citigroup's World Government Bond Index (WGBI). The ball is now firmly in the government's court to use the period of calm to reaffirm SA's credentials as an investment grade economy, and to prevent downgrades to the sovereign rating to below investment grade. Such downgrades – or rather, the strong expectation of imminent downgrades – would have a sharply negative impact on the currency and the bond markets.

The first chance for reaffirmation comes with next week's Medium Term Budget Policy Statement. In recent years the Statement has not been particularly newsworthy, thanks to the astute stewardship of National Treasury in managing the country's finances. However the challenges being faced by the mining industry and a disaffected mining labour force, have placed the spotlight back onto the fiscus.

Finance Minister Pravin Gordhan may well use the opportunity to reassert National Treasury's fiscally prudent reputation (a reputation forged over more than a decade) and to rein in spending of any departments that have stepped out of line recently. Against this, the pressures to increase social spending to alleviate poverty will certainly rise. However this implies a burden in the fiscus that National Treasury will surely want to resist – such fiscal strain is in any event exactly the sort of thing that will signal the rating agencies to downgrade SA further.

More broadly, the challenge is for the government to tackle the many structural issues that have been raised by the mining crisis. This is particularly important in an era of likely moderating commodity prices, which itself poses challenges for the mining industry. As Marius Kloppers, CEO of BHP Billiton pointed out today, the global iron ore market is likely to decline from the 800 million tonnes a year average over the last decade, to 650 million tonnes a year this decade, as China switches from investment and construction growth to consumption growth. Moreover, Europe's likely slow progress out of its current debt problems will also affect demand for commodities.

However the local political scene is likely to be marked by uncertainty as well. With an ANC leadership battle being fought in December, contenders for the position may be tempted to offer populist solutions for the unemployed and for a disgruntled labour force. The worry is that this may lead to further burdens on the mining industry and on business in general. Alternatively, should incumbent leader and President Jacob Zuma secure his position, he would also have the mandate to tackle the issues at hand, in a way that wins the approval of the investment community: he could quash talk of nationalisation and address the prickly problems of labour market inefficiencies.

The year end is almost upon us. But with key events lying ahead such as the ANC conference in December, we should have a better picture by year end of what the next change in SA's sovereign rating will be

USA Comment

By John Maldin

The Hoisington *Quarterly Review and Outlook* is one of the cornerstones of my reading on where the economy is headed. Van Hoisington and Lacy Hunt do a masterful job of turning data points into cogent, well-argued themes.

This month they waste no time in dissecting the Fed's recent move to QE3 and similar efforts in Europe, arriving at the conclusion that "While prices for risk assets have improved, governments have not been able to address underlying debt imbalances. Thus, nothing suggests that these latest actions do anything to change the extreme over-indebtedness of major global economies." Their expectation: global recession. The only issue left to sort out, they say, is How deep will the downturn be?

They make the interesting observation that with each injection of liquidity by the Fed, commodity prices have surged: "During QE1 & QE2 wholesale gasoline prices jumped 30% and 37%, respectively, and the Goldman Sachs Commodity Food Index (GSCI-Food) rose 7% and 22%, respectively. "From the time the press reported that the Fed was moving toward QE3, both gasoline and the GSCI Food index jumped by 19%, through the end of the 3rd quarter."

The QE picture gets even muddier. The unintended consequence of the Fed's actions, say Lacy and Van, has been to *actually slow economic activity:* "The CPI rose significantly in QE1 and QE2 (Chart 1). These price increases had a devastating effect on worker's incomes (Chart 2). Wages did not immediately respond to commodity price changes; therefore, there was an approximate 3% decline in real average hourly earnings in both instances. It is true that stock prices also rose along with commodity prices (S&P plus 36% and 24%, respectively, in QE1 and QE2). However, median households hold a small portion of equities, and thus received minimal wealth benefit."

Quantitative Easing: Critical Market Values
Positive Responders to Inflation/Risk

		QE1 Change	No QE	QE2 Change	No QE	W.S.J. QE3
		1.	2.	3.	4.	5.
1.	S&P 500	36.4%	-9.0%	24.1%	-5.6%	6.8%
2.	Gasoline	30.3%	-8.6%	36.8%	-5.5%	19.1%
3.	GSCI-Food	7.1%	19.1%	21.7%	-5.5%	18.7%

Source: Federal Reserve, Bloomberg, Haver Analytics, NYMEX, Standard and Poors.
(Column 5 is from June 20 through Sept. 30, 2012.)

Table 1

They proceed to tear apart the wealth effect that the Fed is banking on to restimulate the economy, drawing on several solid studies. They also make the key point that "When the Fed actions lead to higher food and fuel prices, the shock wave reverberates around the world, with many foreign economies being hit adversely. When prices of basic necessities rise, the greatest burden is on those with the lowest incomes since more of their budget is allocated to the basic necessities such as food and fuel."

The next few years are not going to be pretty. We're looking right into the teeth of a rolling global deleveraging recession—the End Game, I've called it. And the decisions we make in the next couple years about how to handle our debts and budget deficits—here in the U.S., in Europe, in China and Japan, and elsewhere—are going to be absolutely crucial.

Hoisington Investment Management Company (www.hoisingtonmgt.com) is a registered investment advisor specializing in fixed-income portfolios for large institutional clients. Located in Austin, Texas, the firm has over $4 billion under management, composed of corporate and public funds, foundations, endowments, Taft-Hartley funds, and insurance companies.

Growth Recession

Entering the final quarter of the year, domestic and global economic conditions are extremely fragile. Across the globe, countries are in outright recession, and in some instances where aggregate growth is holding above the zero line, manufacturing sectors are contracting. The only issue left to determine is the degree of the downturn underway. International trade is declining, so weaknesses in different parts of the world are reinforcing domestic deteriorations in economies continents away. With this global slump at hand, a highly relevant question is whether the U.S. can escape a severe recession in light of the following:

a) the U.S. manufacturing sector that paced domestic economic growth over the past three years has lapsed into recession;

b) real income and the personal saving rate have been slumping in the face of an interim upturn in inflation, and

c) aggregate over-indebtedness, which is the dominant negative force in the economy, has continued to move upward in concert with flagging economic activity.

New government initiatives have been announced, particularly by central banks, in an attempt to counteract deteriorating economic conditions. These latest programs in the U.S. and Europe are similar to previous efforts. While prices for risk assets have improved, governments have not been able to address underlying debt imbalances. Thus, nothing suggests that these latest actions do anything to change the extreme over-indebtedness of major global economies.

To avoid recession in the U.S., the Federal Reserve embarked on open-ended quantitative easing (QE3). Importantly, the enactment of QE3 is a tacit admission by the Fed that earlier efforts failed, but this action will also fail to bring about stronger economic growth.

Commodity Market Reactions

Commodity markets have risen in reaction to the Federal Reserve's liquidity injections into the banking sector (Table 1). From the time the press reported that the Fed was moving toward QE1 & QE2 commodity prices surged. During QE1 & QE2 wholesale gasoline prices jumped 30% and 37%, respectively, and the Goldman Sachs Commodity Food Index (GSCI-Food) rose 7% and 22%, respectively. From the time the press reported that the Fed was moving toward QE3, both gasoline and the GSCI Food index jumped by 19%, through the end of the 3rd quarter.

Two theoretical considerations account for the rise in commodity prices during QE3. The first is the expectations effect. When the Fed says they want higher inflation, the initial reaction of the markets is to "go with", rather than fight the Fed. The second linkage, which is the expanded availability of funds used for collateral (margin), was identified and subsequently confirmed by Newedge economist, Dr. Rod McKnew, who stated, "In a world of advanced derivatives, high cash balances are not required to take speculative positions. All that is required is that margin requirements be satisfied."

Thus, when the Fed massively expanded reserve balances in QE1 and QE2, margin risk was minimized for those market participants who wished to take positions consistent with the Fed's goal of higher inflation, and who had either direct or indirect access to the Fed's hugely inflated reserve balances. The April 22, 2011 issue of Grant's Interest Rate Observer documented support for McKnew's insight. They asked Darrell Duffie, the Dean Witter Distinguished Professor of Finance at the Graduate School of Business at Stanford University, whether excess reserves could serve as collateral for futures and derivatives transactions. Dr. Duffie's answer was "acceptable collateral is a matter of private contract, but reserve deposits are virtually always acceptable."

Devastation for Households

The unintended consequence of these Federal Reserve actions, however, is to actually slow economic activity. The CPI rose significantly in QE1 and QE2 (Chart 1). These price increases had a devastating effect on worker's incomes (Chart 2). Wages did not immediately respond to commodity price changes; therefore, there was an approximate 3% decline in real average hourly earnings in both instances. It is true that stock prices also rose along with commodity prices (S&P plus 36% and 24%, respectively, in QE1 and QE2). However, median households hold a small portion of equities, and thus received minimal wealth benefit.

Chart 1

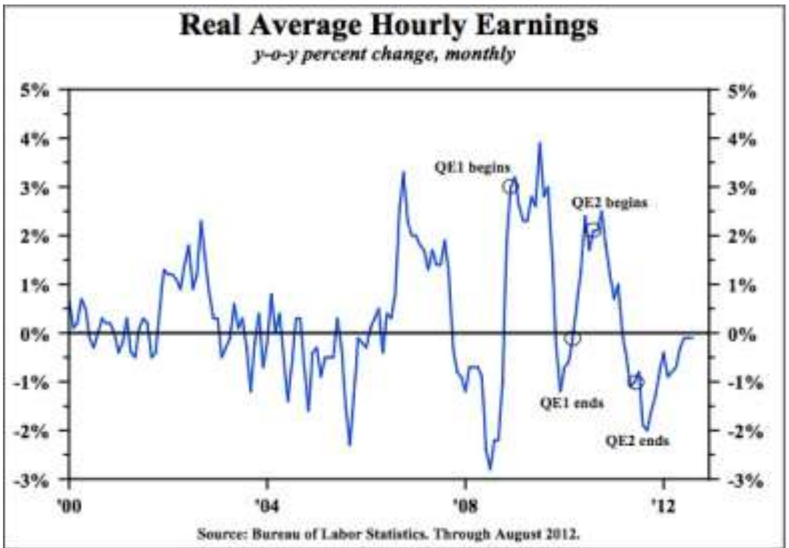

Chart 2

Despite the miserable economic results in QE1 and QE2, we now have QE3. Fed Chair Ben Bernanke and other Fed advocates believe the "wealth effect" of QE3 will bring life to the economy. The economics profession has explored this issue in detail. Sydney Ludvigson and Charles Steindel in *How Important is the Stock Market Effect on Consumption* in the FRBNY Economic Policy Review, July 1999 write: "We find, as expected, a positive connection between aggregate wealth changes and aggregate spending. Spending growth in recent years has surely been augmented by market gains, but the effect is found to be rather unstable and hard to pin down. The contemporaneous response of consumption growth to an unexpected change in wealth is uncertain, and the response appears very short-lived." More recently, David Backus, economic professor at New York University found that the wealth effect is not observable, at least for changes in home or equity wealth.

A 2011 study in Applied Economic Letters entitled, *Financial Wealth Effect: Evidence from Threshold Estimation* by Sherif Khalifa, Ousmane Seck and Elwin Tobing found "a threshold income level of almost $130,000, below which the financial wealth effect is insignificant, and above which the effect is 0.004." This means a $1 rise in wealth would, in time, boost consumption by less than one-half penny.

These three studies show that the impact of wealth on spending is miniscule—indeed, "nearly not observable." How the Fed expects the U.S. to gain any economic traction from higher stock prices when rising commodity prices are curtailing real income and spending is puzzling. This is particularly relevant when econometricians have estimated that for every dollar of gained real income, consumption will rise by about 70 cents. Conversely, the Fed actions are causing real incomes to decline, which has a 70-cent negative impact on spending for every dollar loss. Compare that with the 0.004 positive impact on spending for every one-dollar increase in wealth. Former Fed Chairman, Paul Volcker, summarized the new Fed initiative as sufficiently and succinctly as anyone when he stated that another round of QE3 "is understandable, but it will fail to fix the problem."

An International Corollary

The unintended consequences of QE3 could also serve to worsen and undermine global economic conditions already under considerable duress. When the Fed actions lead to higher food and fuel prices, the shock wave reverberates around the world, with many foreign economies being hit adversely. When prices of basic necessities rise, the greatest burden is on those with the lowest incomes since more of their budget is allocated to the basic necessities such as food and fuel. Thus, a jump in daily essentials has a more profound negative impact on living standards in economies with lower levels of real per capita income.

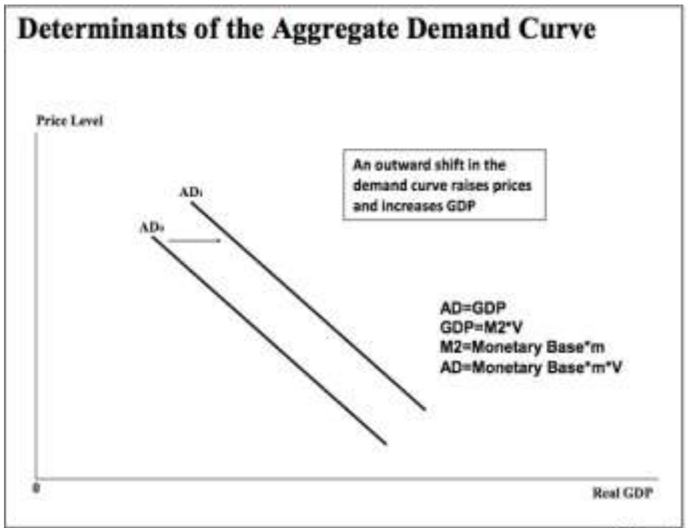

Chart 3

Can the Fed Create Demand?

Can all the trillions of dollars of reserves being added to the banking system move the economy forward enough to eventually create a higher level of aggregate spending? Our analysis of the aggregate demand curve and its determinants indicate they cannot. The question is whether monetary actions can shift this aggregate demand (AD) curve out to the right from AD0 to AD1 (Chart 3). If this were possible, then indeed the economy would shift to a higher level of prices and real GDP.

The AD curve is equal to planned expenditures for nominal GDP since every point on the curve is equal to the aggregate price level (measured on the vertical axis of the graph), multiplied by real GDP (measured on the horizontal axis of the graph). We know that GDP is equal to money times its turnover or velocity, which is called the equation of exchange as developed by Irving Fisher (Nominal GDP = M*V).

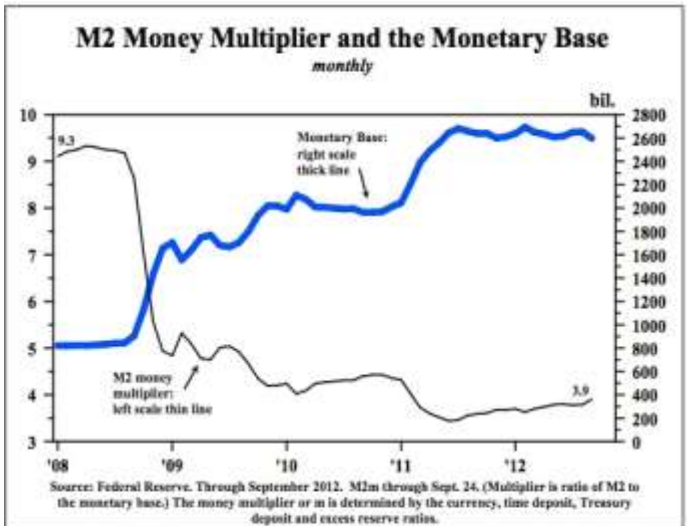

Chart 4

Deconstructing this formula, M (or M2) is comprised of the monetary base (currency plus reserves) times the money multiplier (m). The Federal Reserve has control over the monetary base since its balance sheet is the dominant component of the monetary base. However, the Fed does not directly control the money supply. The decisions of the depository institutions and the non-bank public determine the money multiplier (m). M2 thus equals the monetary base multiplied by the money multiplier. The monetary base, also referred to as high powered money, has exploded from $800 billion in 2008, to $2.6 trillion currently, but the money multiplier has collapsed from 9.3 to 3.9 (Chart 4). Therefore, the money supply has risen significantly less than the increase in the Fed's balance sheet, with the result that neither rapid gains in real GDP nor inflation were achieved. Indeed, with the exception of transitory episodes, inflation remains subdued and the gain in GDP in the three years of this expansion was the worst of any recovery period since World War II.

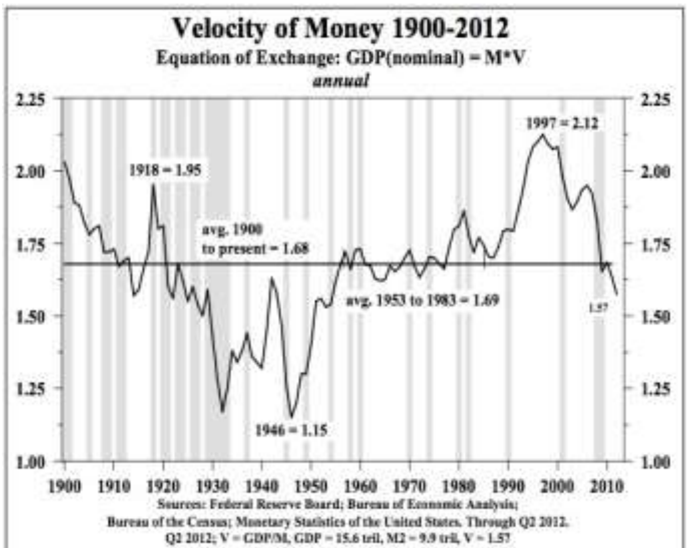

Chart 5

The other element that is required for the Fed to shift the aggregate demand curve outward is the velocity or turnover of money over which they also have no control. During all of the Fed actions since 2008 the velocity of money has plummeted and now stands at a five decade low (Chart 5).

The consequence of the Fed's lack of control over the money multiplier and velocity is apparent. The monetary base has surged 3.3 times in size since QE1. Nominal GDP, however, has grown only at an annual rate of 3%. This suggests they have not been able to shift the aggregate demand curve outward. Nor, with these constraints, will they be any more successful in shifting that curve under the present open-ended QE3. Increased aggregate demand and thus rising inflation is not on the horizon.

[For a more complete discussion of the complexities of the movement of the aggregate supply and aggregate demand curves please see the APPENDIX.]

Treasury Bonds

As commodity prices rose initially in all the QE programs, long-term Treasury bond yields also increased. However, those higher yields eventually reversed and generally continued to ratchet downward, reaching near record lows. The current Fed actions may be politically necessary due to numerous demands for them to act to improve the clearly depressed state of economic conditions. However, these policies will prove to be unproductive. Economic fundamentals will not improve until the extreme over-indebtedness of the U.S. economy is addressed, and this is in the realm of fiscal, not monetary policy. It would be more beneficial for the Fed to sit on the sidelines and try to put pressure on the fiscal authorities to take badly needed actions rather than do additional harm. Until the excessive debt issues are addressed, the multi-year trend in inflation, and thus the long Treasury bond yields will remain downward.

APPENDIX

One of the most important concepts in macroeconomics is aggregate demand (AD) and aggregate supply (AS) analysis – a highly attractive approach that is neither Keynesian, monetarist, Austrian, nor any other individual school, but can be used to illustrate all of their main propositions. However, before detailing the broader macroeconomics associated with the movement of the AD and AS curves, it is important to understand microeconomic supply and demand curves.

This can best be illustrated through the recent impact the Fed's decisions had on commodity prices. In the commodity market, like individual markets in general, the demand curve is downward sloping, the supply curve is upward sloping, and where they intersect determines the price of the commodity and the quantity supplied/ demanded. The micro-demand curve slopes downward because as the price of an item rises, the quantity demanded falls due to income and substitution effects (buyers can shift to a substitute product). The micro-supply curve slopes upward since producers will sell more at higher prices than lower ones.

Both supply and demand schedules are influenced by expectation, fundamental, and liquidity considerations. When the Fed says that they want faster inflation and that they are going to take steps to achieve this objective, both economic theory and historical experiences indicate that commodity prices will rise, at least transitorily (as seen with the surge in commodity prices after the announcement of QE1, QE2 and QE3). Information and liquidity available to the buyers is also available to the suppliers, so by saying faster inflation is ahead, suppliers are encouraged to reduce or withhold current production or inventories, moving the supply curve inward. Thus, in the commodity market, the Fed action spurs an outward shift in the micro-demand curve along with an inward shift of the micro-supply curve, producing higher prices and lower quantities. These microeconomic developments transmit to the broader economy, which we will now trace through A D and AS curves.

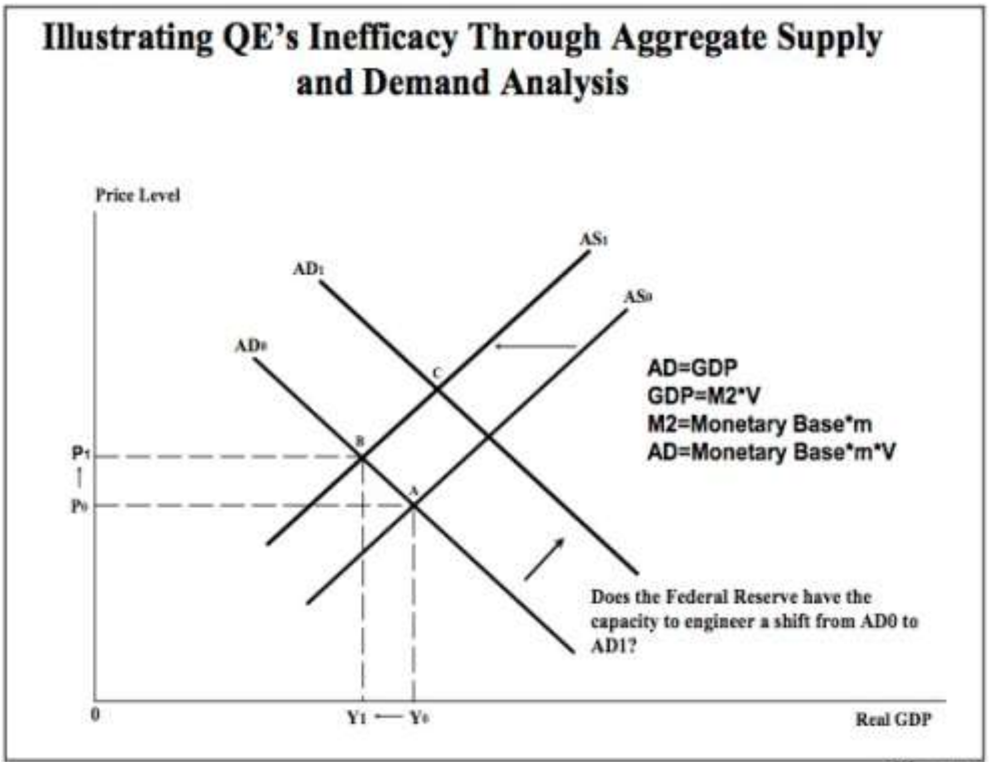

Chart 6

The AD curve slopes downward and indicates the amount of real GDP that would be purchased at each aggregate price level (Chart 6). Aggregate demand varies inversely with the price level, so if the price level moves upward from P0 to P1, real GDP declines from Y0 to Y1. When the price level rises, real wages, real money balances and net exports worsen, thereby reducing real GDP. The rationale for the downward sloping AD curve is thus quite different from the sloping of the micro-demand curve since substitution effects are not possible when dealing with aggregate prices. In order to improve real GDP with a rising price level, the AD curve would need to be shifted outward and to the right (from AD0 to AD1). And as detailed in the letter, the Fed is not capable of shifting the entire AD curve.

The AS curve slopes upward and indicates the quantity of GDP supplied at various price levels. The positive correlation between price and output in micro and macroeconomics is the same since the AS curve is the sum of all supply curves across all individual markets. When Fed policy announcements shock commodity markets, the AS curve shifts inward and to the left (from AS0 to AS1). This immediately causes a reduction in real GDP (the difference between Y0 and Y1) as the price increases by the difference between P0 and P1 (also Chart 6). Furthermore, as discussed in the letter, lower GDP as a result of higher prices reduces the demand for labor and widens the output gap, setting in motion a negative spiral.

For Fed policy to improve real GDP, actions must be taken that either (1) shift the entire demand curve outward (to the right), or (2) do not cause an inward shift of the AS curve that induces an adverse movement along the AD curve. Accordingly, the Fed is without options to improve the pace of economic activity.

Company reports

ANGLO 2012/10/18

JOHANNESBURG (Reuters) - Anglo American Platinum, the world's No 1 platinum producer, said on Thursday that it would delay the dismissal process at some of its South African operations. It said it is delaying dismissals at its Union and Amandelbult mines and while it will not reinstate the 12,000 dismissed at its Rustenburg mines, it remains open to discuss this with unions.

SABMILLER 2012/10/18

LONDON (Reuters) - SABMiller, the world's second-biggest brewer, posted an expected 4 percent rise in underlying first half beer volumes after growth across most other regions offset slowing demand in its key Latin American market. Beer volumes in Latin America, which represents around 32 percent of profit, grew by 4 percent, down from 8 percent in the same period a year ago with the firm reporting weaker consumer sentiment in recent months.

The Miller Lite, Grolsch and Peroni maker, which earns 70 percent of its profit from fast-growing emerging markets, also reported on Thursday an 8 percent rise in organic, constant currency group revenue in the six months to September. Including acquisitions and disposals, total volumes were up 9 percent.

The 4 percent underlying quarterly rise in beer volumes, after stripping out the effects of acquisitions, matched an analyst consensus forecast of 4 percent and follows a 5 percent volume rise in its first quarter. The brewer, which also makes Castle, Snow, Pilsner Urquell and Aguila beers, said that quarterly underlying volumes rose 6 percent in Africa, 5 percent in Asia-Pacific, and 1 percent in South Africa.

The United States, where it operates through its MillerCoors venture, remained weak, with sales to retailers falling 1.9 percent and sales to wholesalers down 1.2 percent. In Europe, lager volumes rose by 9 percent helped by selective price reductions, with the Euro 2012 soccer tournament boosting Polish beer sales, and demand for its Peroni brand pushing up domestic volumes by 5 percent in the UK.

The London-based brewer, which has expanded rapidly over the past two decades from its South African roots, added that its recently-acquired Foster's Australian business suffered a 13 percent dip in volume. The decline was partly because of the termination of some licensed brands after SABMiller's purchase of Foster's in December 2011. Soft drinks volumes were 6 percent higher year-on-year on an organic basis. Shares in the firm were down 1.15 percent in early trading.

ANGLO 2012/10/17

LONDON (Reuters) - AngloGold Ashanti, the world's No.3 bullion producer, could make a decision next week on whether to follow other miners and issue striking workers with an ultimatum to return to work or be sacked, its chief executive said on Wednesday.

South Africa has been swept by a wave of often violent industrial action in the last two months and some 35,000 employees, including contractors, at AngloGold's South African mines have been striking illegally since September.Other mining companies have responded to the wildcat action by issuing ultimatums to their employees, but AngloGold boss Mark Cutifani said the company had not yet decided whether to follow suite.

"We shall see how events unfold over the next few days. We'll make a judgement on that next week," he told Reuters in an interview on the sidelines of a conference in London.

ABSA 2012/10/10

JOHANNESBURG (Reuters) - South African black empowerment group Batho Bonke Capital plans to sell 24.7 million shares in Absa Group, a director for the consortium said on Wednesday."Batho Bonke is in the process of disposing its shares," Yolande Cuba, a director of Batho Bonke, told Reuters.

The sale would represent almost all of the group's stake in Absa, Cuba said adding that a "lock in" period on the shares had expired in March last year. The stake would be equivalent to roughly 3.4 percent of Absa's outstanding shares.

Absa is the South African bank majority owned by Barclays. Batho Bonke acquired a 10 percent stake in Absa in July 2004, according to the lender's website, in a deal to give black people formerly disadvantaged during South Africa's apartheid era greater ownership in the country's companies. Shares of Absa were down 2.6 percent at 134.85 rand.

MTN 2012/10/08

S.Africa's MTN hit by slide in Iran rial

JOHANNESBURG (Reuters) - The impact of Iran's currency slide has reached beyond its borders, hitting shares of MTN Group, the South African mobile operator that derives nearly a tenth of its revenue from the Middle Eastern country. MTN, which has been unable to repatriate profits from its Irancell unit because of Western sanctions on Iran, flagged in August that further rial weakness would deflate its second-half earnings. Its shares were down 3.7 percent at 152.06 rand in afternoon trade in Johannesburg, bringing its losses this month to nearly 5 percent. The rial has lost about a third of its value against the U.S. dollar in the last two weeks as U.S.-led sanctions cut the country's ability to earn hard currency from oil exports. MTN operates in 21 countries across Africa and the Middle East, including a 49 percent stake in Irancell.

"It's just that there will be foreign exchange losses that will be included in the earnings number for the year, that's the main concern," said one Johannesburg-based portfolio manager, who declined to be identified. The rial has collapsed two-thirds in little more than one year in the open market but the government's official rate has remained the same since January.

"The unofficial rate trades well below the official rate. The fear is always that if the official rate drops to the black market rate, then MTN will take a knock in their report," said one analyst, who also did not want to be named.

MTN said in August it was in talks with South African and U.S. officials about moving money out of the country. The company's chief executive said at the time it had been unable to take cash out of the business for at least six months.

MTN is being sued by rival Turkcell for $4.2 billion in a U.S. court, saying it used bribery and lobbied South Africa to support Tehran's military in return for a 2005 cellular licence in Iran that was originally awarded to the Turkish firm.

KUMBA 2012/10/04

JOHANNESBURG (Reuters) - Kumba Iron Ore suspended production at its Sishen mine in South Africa after employees who embarked on an illegal strike blocked access to the pit, the company said on Thursday. Kumba, a unit of Anglo American and one of the world's top 10 producers of iron ore, said it had sufficient stockpiles and output from other mines to supply customers for "some time".

COAL 2012/10/04

LONDON/JOHANNESBURG (Reuters) - Wildcat strikes by South Africa's platinum, gold, iron ore and diamond miners could spread to coal, potentially disrupting output from one of the world's biggest coal suppliers. As many as 75,000 miners, or 15 percent of the industry's workforce in South Africa, are on strike, undermining already shaky growth in Africa's biggest economy and threatening to spread to coal despite big differences between the sectors. Violent clashes during a six-week stoppage at platinum producer Lonmin resulted in the death of 46 people near the company's Marikana mine, close to the city of Rustenburg. Coal majors and smaller firms said they are watching developments closely. "There is potential for some noise (from the workforce), the situation should be manageable, but sometimes logic goes out of the window," said one executive at a mining major.

Some smaller miners said they could be more vulnerable.

"People at Rustenburg took matters into their own hands and got a good pay deal. So if others look at that and want the same, it could spread to other provinces or companies," an official at a small mining firm said, referring to Lonmin's pay rise.

"The truckers' strike has hit deliveries of diesel and explosives to the mines and massively hit the domestic coal market, supply to sugar and cement firms who run their own coal-fired boilers," industry sources said.

ERBACOM 2012/10/03

Revenue from continuing operations increased to R758.2 million (August 2011: R553.2 million). Operating profit from continuing operations was recorded at R15.1 million (August 2011: loss of R29.5 million). Loss attributable to ordinary shareholders was at R35.8 million (August 2011: loss of R83.7 million). In addition, headline loss per share from continuing operations was recorded at 17cps (August 2011: headline loss per share of 13cps).

Dividend

For the foreseeable future the board intends to allocate cash resources to the growth of the group, consequently no dividend has been declared for the interim period ended 31 August 2012.

Prospects

The imperative for the government to renew and deliver infrastructure should result in a further improvement of trading conditions. However, the board notes the short-term risks of work-stoppages and delayed contract awards resulting from widespread labour unrest affecting many of the group's clients. The secured order book of work still to be completed totals R1 300 million of which 40% is to be completed during the current financial year.

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PICKNPAY 2012/10/03

South Africa's Pick n Pay named the former head of Tesco's UK business as its new chief executive on Wednesday, as the country's No.2 grocer struggles to regain market share and fend off competition from U.S. giant Wal-Mart. Shares of Pick n Pay rallied nearly 7 percent after it said Richard Brasher, a Tesco veteran of 25 years, will take over in February, ending a roughly seven-month search for a new chief executive. Brasher will take charge of a retailer that has lost market share to domestic rivals and is now facing further pressure from Wal-Mart Stores Inc."It's major coup for Pick n Pay, particularly as the competitive environment heats up," said Natalie Berg, an analyst at London-based consultancy Planet Retail.

"It's clear that his expertise in going up against Wal-Mart in the UK, which is the most competitive market in the world, was the most obvious attraction to Pick n Pay."Brasher left Tesco in July this year after a shock profit warning prompted group CEO Philip Clarke to take a hands-on involvement in the UK business.

Wal-Mart, the world's biggest retailer, last year took a 51 percent stake South African discounter Massmart. It has since been on an aggressive push to increase its grocery business. Pick n Pay has focused on rolling out new distribution centres and a loyalty card programme in the hope of boosting profitability and sales. However, it has been squeezed as its rivals roll out more new stores.

LOWER PROFITS

It has trailed behind other South African retailers in terms of profitability. The company's return on equity over the last 12 months has been 33 percent, below the average of 41 percent for eight of its rivals, according to Thomson Reuters data. Its operating margin over the last five years has averaged just 3 percent, less than half of the average of its rivals over the same period.

As a result, its share price has missed out on the recent bull run by South African retailers, which have been lifted by expectations of strong growth across Africa. Shares of Pick n Pay have been the worst performer of nine major South African retailers over the last two years, gaining just 8 percent. By contrast, top performer Mr Price added 144 percent during the same period while Woolworths Holdings surged 139 percent.

The stock was booted from the Johannesburg Stock Exchange's blue-chip Top-40 index last year, while Mr Price and Woolworths have been since added.Pick n Pay's former head, Nick Badminton, stepped down in February while the company was still in the midst of a restructuring drive, leading to some speculation about tension among Badminton and the family of founder Raymond Ackerman, which still controls the business.

Shares of Pick n Pay were up 5.3 percent at 46.67 rand at 1231 GMT, after earlier rising nearly 7 percent. It was the top percentage gainer on the Johannesburg All-share index and on track for its biggest one-day gain since 2009.