19 December 2013

The Investor

In our 26th year of free service to the South African investing public!

It is time to once again wish all of our readers a blessed Christmas and a happy New Year – time also to remind readers that the special rental price offer of R200 a month for the new ShareFinder 6 cloud programme ends of January 15. Just e-mail us or phone with your credit card details!

Our offices close for the festive season on December 23 and will re-open on January 2.

When R81 a month = R16.15-million

by Richard Cluver

The most often asked question by starting-out investors always goes something like this: "I would like to achieve financial freedom as early as possible. How must should I aim for?"

The answer, as I observed last month is "How long is a piece of string?" How much you need is entirely a question of what you materially need. So, for example, for the man whose need is just one loaf of bread, having enough money for two loaves makes him wealthy.

But since we are a completive breed, mankind is always peering over the back fence at his neighbour and wanting to be a bit better off. So let us start off with some averages, noting that the average South African has a total worth in US Dollars of 19 613 and so, if you have more than that, you are wealthy!

Looking a little further abroad, a report just completed by Credit Suisse suggests that the average adult on this planet is worth $51 600. That is R519 468 at the current exchange rate and, if you were to invest such a sum in a portfolio of investment grade shares on the Johannesburg Stock Exchange at their current average dividend yield of 3 percent you could expect an annual income of R15 584 or some R1300 a month which is clearly not sufficient for the average middle class South African to live on.

What about the average American or Englishman. Well Credit Suisse says the average US adult is worth $301 140 and the average Brit $243 570. Invested at 3 percent that would give the average US citizen $9 034 and the average Brit $7 307 or, respectively, R94 456 and R76 399 a year to live on: Still not enough for the average middle income South African to live on with any degree of comfort.

Clearly then, if you would like to live comfortably in middle class South African suburbia, you would need a lot more wealth than the average citizen of the world's wealthiest countries. Indeed, if my own calculations are correct you would need something between R25 000 and R30 000 a month to live comfortably in 2014 and, furthermore, to cope with an inflation rate averaging around 6 percent annually, you would need to achieve steady annual growth as well.

Compare that figure with the average South African employee who earns R27 797 a month and the median rate of pay which is R20 000. Median is the best rate to compare yourself with rather than the average rate. If you lined up, in order from highest to lowest all the salaries of people working in a particular occupation, the median salary is the one that falls at the midpoint of that range. The median salary is less likely than the average salary to be skewed by outliers, for example an extremely high salary or an extremely low salary that may be earned by only a few people.

Thus, if you set your investment target on the capital sum that in today's money (December 2013) will produce an investment income of R30 000 a month you will by definition be aiming to create for yourself 50 percent more than the median and, thus, will ensure for yourself a future in which you can always afford those few extra luxuries that allow for a sense of wellbeing.

Happily, noting the average investment grade share dividend yield at the time of writing is 3 percent then, unless you plan to continue working after your normal retirement age, you would need a capital sum of R12-million invested before you could think of retiring.

ANCHOR CAPITAL

RICHARD CLUVER INVESTMENT SERVICES

RICHARD CLUVER OFFSHORE MANAGED PORTFOLIO

The Parties

Richard Cluver is a legend of the SA private client investment world. Over many years his Sharefinder programme and regular publications have been guiding SA investors on the JSE and offshore markets. Richard is also the author of numerous investment books.

Saxobank is a Denmark-based bank, which focusses on providing trading platforms to investors all over the world. This portfolio is managed on the Saxobank platform and provides investors with 24-hour online access (PC, iPhone or iPad) to their segregated portfolios.

Anchor Capital is SA's fastest growing asset manager, and is the FSB-registered entity which will implement the Richard Cluver Offshore portfolio on the Saxobank platform. Anchor Capital has offices in Durban, Sandton, Irene and London.

The facts and figures

- Fund manager: Richard Cluver and Anchor Capital
- Asset class: Offshore developed market long-only portfolio of equities, initially limited to those listed on the London Stock Exchange
- Minimum investment: R500,000
- Nature of product: Segregated portfolio with shares owned in the investor's name. These are held on the Saxobank platform, with a London domicile.
- Default currency: Pounds
- Risk profile: Medium
- Management fee: 1% per annum
- Investment horizon: 3-5 years
- Liquidity: Investors can sell their portfolio at any time

Nature of the equity investment portfolio

This is an investment in offshore listed shares following a model portfolio compiled and regularly updated by Richard Cluver, in collaboration with Anchor Capital. The initial focus will be on London-listed equities.

The shares are purchased in an account in the investor's name on the Saxobank platform—in other words, the investor owns the shares directly. This is the ultimate protection in the volatile investment world, and there is complete transparency for the investor.

Richard's investment process has been developed and fine-tuned over decades. The approach is:

⇒ Firstly, to apply a number of **fundamental filters**, which identify shares of sufficiently high quality which are trading at attractive valuations.

⇒ Secondly, a **technical overlay** is applied which assists in timing the purchase of the shares and setting target prices for purchase.

⇒ A portfolio is the constructed taking the overall mix and exposure into account. Shares are **patiently accumulated**, with acquisition target prices in mind.

⇒ Shares will normally only be sold in the event of a deterioration in balance sheet fundamentals or unjustified valuations.

The objective of the portfolio is **capital growth over the long-term** and is appropriate for investors who wish to have a managed offshore equity component to their portfolio.

The risk profile is considered "**medium**", as equities are volatile by nature.

Contact: FJ Veldman (012-686 3481); Peter Armitage (011-783 4783); info@anchorcapital.co.za

Anchor Capital (Pty) Ltd, FSP number 39834. www.anchorcapital.co.za

To most folk that is, I know, a nearly impossible sum to even imagine; the sort of amount that can only find a place in dreams of winning the lottery or perhaps the “lucky” few fortunate enough to inherit such sums. Well let us quickly dispel such ideas. Of course someone has to win the lottery but the odds against you winning are so infinitesimally small that it is silly to base any dreams upon it. But let us put that one to rest by examining the probabilities:

In a simple 6-from-49 lotto like the South African version where a player chooses six numbers from 1 to 49 (no duplicates are allowed), if all six numbers on the player's ticket match those produced in the official draw (regardless of the order in which the numbers are drawn), then the player is a jackpot winner. For such a lottery, the chance of being a jackpot winner is 1 in 13,983,816.

In bonus ball lotteries where the bonus ball is compulsory, the odds are often even lower. In the Mega Millions multi-state lottery in the United States, 5 numbers are drawn from a group of 75 and 1 number is drawn from a group of 15, and a player must match all 6 balls to win the jackpot prize. The chance of winning the jackpot is 1 in 258,890,850.

The odds of winning can also be reduced by increasing the group from which numbers are drawn. In the Italian super lottery, players must match 6 numbers out of 90. The chance of winning the jackpot are 1 in 622,614,630.

More to the point, the probability of your holding onto your winnings after winning a lottery is less than 30%. The vast majority of lottery winners are broke within seven years and, furthermore, detailed studies into the success and happiness of lottery winners have made it abundantly clear that you are unlikely to find much joy out of life if you should win.

Interestingly, according to a 2006 study, the average SA Lotto player spends R81 a month on this gamble. So I wondered what the result would be if one invested that amount in a simple cross section of South African Blue Chip shares which have delivered an average growth rate of 25.75% annually over the past ten years and have delivered an average dividend over that period of 2.8% giving a “Total Return” of 28.55% if all dividends were re-invested.

Well, if you did this every month for an average working life of 30 years you would achieve a capital sum of R 16 148 830.60: quite enough to retire on in considerable comfort in present day South Africa. And it would provide you with a monthly income of R37 681.

Furthermore, if you retired after 30 years and started spending ALL your dividends, the income growing at the same average rate would grow to R 118 485 a month in five years, R372 565 in ten years and R 1 171 500 in 15 years.

Contrast that with the average Lotto win of R3-million which would provide a monthly income of R7 000.

Now, 2006 research found that 82 percent of South Africans played the lottery once a week. Imagine if, instead they all bought Blue Chip shares! There would no longer be any need for a social pension or a national health scheme. The majority of us would be massively wealthy by world standards. Indeed, if 82% of our population had such incomes we would be the wealthiest nation on earth and the tax revenue potential for the Government at the current dividend tax rate of 15% would be quite stupendous.

Care to work it out; there are currently 51-million people living in South Africa and so the sum of the wealth of eight out of ten South Africans if they all invested R81 a month for 30 years would be an incredible R675 344 095 692 000 producing an annual aggregate dividend income of R18 909 634 679 376. At the current dividend tax rate of 15% that South Africans pay, the Government's share of that total dividend income would be R2 836 445 201 906.

Noting that the Minister of Finance's latest total revenue estimate for the current tax year is R1 006-billion, it is clear from my calculations that on the basis of the above the Government would be able to do away with ALL other taxes and still receive nearly three times what it currently receives in annual revenue. Such a situation would make us the envy of the world.

Just thought you might be interested!

Next Month: How to go about buying a Blue Chip portfolio

19 December 2013

The Ten Minute Millionaire

.

Technical Analysis; a simple overview

It is beyond the scope of this series to embark upon a detailed explanation of the very complex science of share market technical analysis and so I have here elected to confine my discussion to the principal technical tools that we employ in the ShareFinder fixed window analysis. Starting soon, however, I will begin a comprehensive re-examination of the subject last tackled in my book "How To Profit From Share Market Charting which was published 20 years ago.

Here it is important to stress that in selecting and developing the five analytical indicators for the ShareFinder fixed window analysis we examined scores of different technical analysis tools using computer optimisation in order to determine their accuracy. We then refined and developed the five best approaches in order to develop an analytical system in which buy and sell signals are only issued when all five differently-derived systems agree.

The fixed window appears whenever one left-clicks on the name of any share appearing in the ShareFinder Quality List which documents the balance sheet statistics of all "Investment Grade" shares selected by the processes I have already outlined within this series. So let us consider the graph composite below of Standard Bank as it appears in projection mode:

In the topmost graph of the composite we see the daily closing price of Standard Bank shares reflected on a day-to-day basis over the past six years. It is overlain with an orange "least squares fit" trend line dating back over the past five years of data and employs an algorithm which draws a straight line that passes through the greatest possible number of graph turning points in order to calculate the long-term price trend of each share. In the example, if one hovers one's cursor over the trend line, ShareFinder would supply the information that this line was rising at 4.8 percent compound which would have told the observer that this share was rising only sufficiently to keep abreast of the rate of inflation which, over the five years to late 2012, averaged 5 percent.

Also overlying this price graph is a curving green line which, because of its artificial intelligence, represents in our observation the most powerful long-term technical analysis tool available to share market investors today. When they are based upon price databases of 25 years extent and more, such as can be had with the ShareFinder Professional programme, these Fourier lines can be projected forward for years into the future without significant loss of accuracy.

The Fourier lines contain the facility to analyse the inherent sine waves within the data in descending order of magnitude and forward project them into the future. They are based on Fourier Transforms which owe their origins to the work of Baron Jean Baptiste Joseph Fourier (1768-1830).

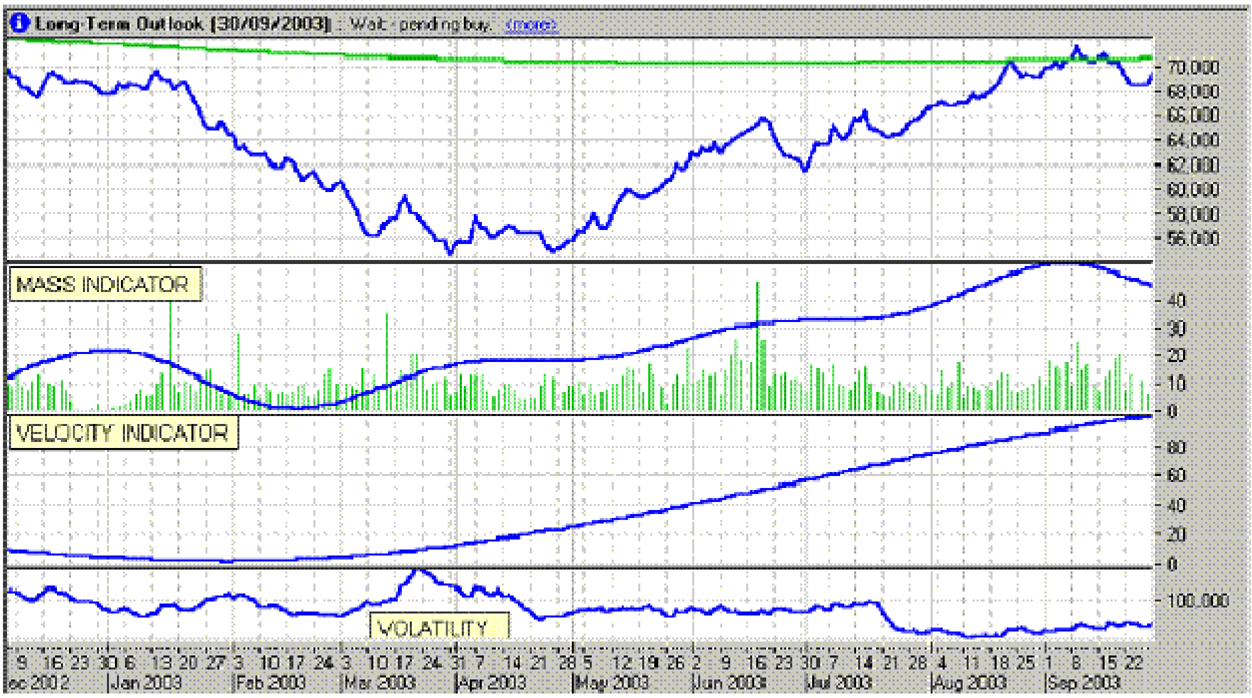
Fourier mathematics is quite complex, but what it seeks to do is relatively simple. It seeks the most dominant sine wave and then the second most dominant and so on until, in the example above, we are actually seeking the confluence of several thousand sine waves. The most dominant wave pattern sets the direction of the projection and all the others determine the extent that the projection oscillates around this dominant mean.

Within the ShareFinder display the long-term Fouriers are set to seek out and analyse only the dominant price cycles which, in the example, can be seen occurring every two years. These are customarily projected 30 months into the future with an observed average accuracy rate of 82 percent. The green long-term cycle line turns red when it is projected into the future.

To the extreme right of the topmost graph, readers will also note that there are both an orange-coloured short-term Fourier projection and a medium-term projection coloured red in the topmost graph of the composite. While the short-term projection line is generated by analysing the past 90 days of data, the extended red line is based upon an analysis of ALL the data that exists in respect of the security that is being analysed and in respect of this data we search for ALL recurrent sine waves and sub-waves. In some instances this could represent well over 30 years of trading history for the more data that is available the greater is the accuracy probability of the forward projection.

In use, it is important to note that the accuracy of the projections is greatly enhanced when both the short-term and medium-term Fourier projections agree with regard to the direction they are moving in.

In order to understand how all five indicators in the fixed window work together to generate a series of trading strategy messages, I have reproduced a ShareFinder analysis which highlights the point when in April 2003 when the JSE Industrial Index turned upwards to signal the end of one of the longest bear markets of recent history.



Examining this display it can be clearly seen that the Velocity Indicator turned upwards on January 30 followed by the Mass Indicator which turned upwards on February 18 while the Volatility Indicator began rising sharply on March 3 to peak on March 21 all in anticipation of the JSE Index itself finally turning upwards on April 1.

Now it needs to be appreciated that in designing the fixed window we wanted to create a “Ready, Steady, Go” sequence of signals with each indicator drawing its conclusions from a quite different set of share market trading statistics. Thus, the proprietory RCIS Velocity Indicator derives its decisions from the Momentum or Rate of Change concept which sequentially compares the latest price of a security with that of a fixed number of days in the past. Under exhaustive testing the Velocity Indicator has shown itself to accurately foretell future price direction changes earlier than any other momentum-based indicator or indeed any of the conventionally-used indicators which can be found in this and in competing software. It can thus always be relied upon to provide a very early warning of impending price direction change.

Second in the sequence is the Mass Indicator which draws its decision making from the principle of volume accumulation\distribution that was first enunciated by New York analyst Mark Chaikin in his On Balance Volume indicator. Under computer optimisation testing, the proprietary RCIS Mass Indicator has proved itself consistently more reliable and earlier-signaling than the OBV Indicator. In this example the Mass Indicator signaled an upturn of the JSE Industrial Index 16 days later on April 25.

Then in final confirmation of the pending market direction change, the Volatility Indicator began surging upwards on March 3 indicating that the daily difference between the highest and lowest values of the JSE Industrial Index was rising steadily, highlighting the growing tug of war between the bulls and the bears as optimism gradually began to overcome pessimism.

These three indicators should ALWAYS be used in this sequence to foretell future market events. Except in the case of a very overheated bull market when security prices have risen far above their reasonable value, it is wisest to do nothing in cases where the three indicators disagree with one another.

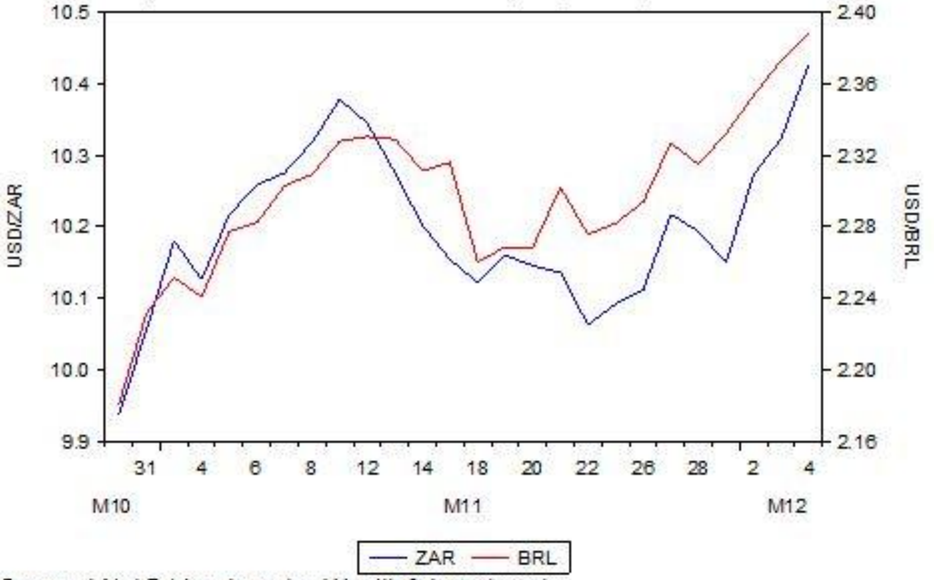
19 December 2013

The forces driving the rand and the Brazilian real are global, not domestic

By Brian Kantor

The recent weakness in the rand has once more much more to do with global forces than the disappointing news about the the current account of the balance of payments. The pressure on the rand has been matched by the pressure on the Brazilian real, making the rand cost of a holiday on Ipanema beach slightly cheaper than it was in late October.

The US dollar, the rand and the Brazilian real, daily data (November to December 2013)



Source: I-Net Bridge, Investec Wealth & Investment

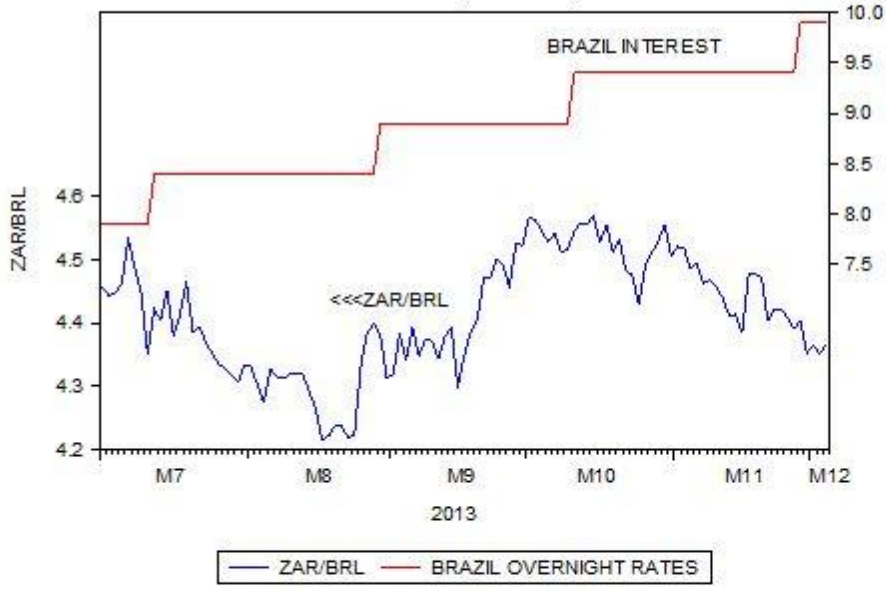
The rand cost of a Brazilian real, daily data (November to December 2013)

Source: I-Net Bridge, Investec Wealth & Investment

It is instructive to recognise that this weakness in the real and the relative stability in the rand/real exchange rate have come despite very aggressive increases in Brazilian interest rates, imposed in response to the weaker real.

These increases have not helped the real while they have probably weakened the growth outlook for the Brazilian economy. The SA Reserve Bank is hopefully taking note: higher interest rates do not necessarily protect the currency while they almost certainly restrain domestic spending. It is the growth outlook more than the short term interest carry that drives capital flows, which in turn support a currency and improve the inflation outlook. Sustain growth rates and the currency will be supported. Weaken growth rates and foreign investors are more likely to take their capital elsewhere – even back to the developed world.

Brazilian interest rates and the rand/real (ZAR/BRL)



Source: Bloomberg and Investec Wealth & Investment

The North American view

by John Mauldin

This week, Geert Wilders and his Party for Freedom in the Netherlands and Marine Le Pen of the Front National (FN) of France held a press conference in The Hague to announce that they will be cooperating in the elections for the European Parliament next spring and hope to form a new eurosceptic bloc. Their aim, as Mr. Wilders put it, is to "fight this monster called Europe," while Ms. Le Pen spoke of a system that "has enslaved our various peoples." They want to end the common currency, remove the authority of Brussels over national budgets, and undo the project of integration driven with so much idealism by two generations of European politicians. (My thought about Marine Le Pen after looking at her policies is that if Marine Le Pen is the answer for France, they are asking the wrong question.)

For now, Le Pen and Wilders are in a decided, if growing, minority (think Beppe Grillo, who got 25% in Italy in the last election). But as the graphic below suggests, the stitching that is holding the Frankenstein of Europe together seems to be getting a little frayed. And my new worry is that the real monster, one likely to pop many more of the tenuous stitches that hold things together, could be lurking in German banks. This week's letter explores a problem as "hidden" as subprime was back in 2006. Not as big, to be sure, but it might not need to be big to tug too hard the frayed threads that hold Europe together. (Note: this week's letter will print out longer than usual due to the large number of graphs and pictures.)

19 December 2013

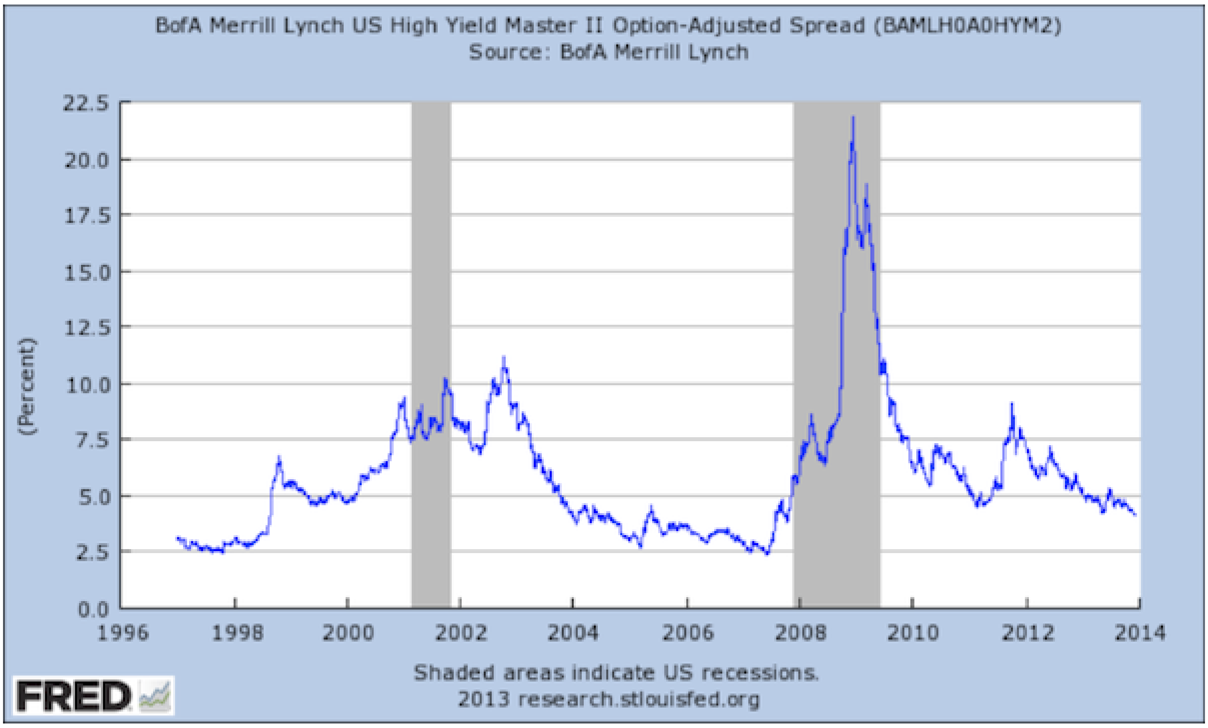
The Complacency of Consensus

"But where are you out of consensus?" came the question. I had just spent a few minutes outlining my view of the world to a group of serious money managers here in Geneva, highlighting some of the risks and opportunities I see. The gentleman's question made me realize that for the short-term, at least, I am all too sanguine for my personal taste. I have never thought of myself as one of those consensus guys. But when you consider that Japan is continuing down its path to starting a global currency war, with a currency that will drop at least in half from where it is now (plunging Japan into Abe-geddon); that China is launching its most serious economic overhaul in 20-30 years; that the US is still careening toward its day of reckoning with entitlement spending while dealing with the fall-out from taper tantrums in emerging markets; and that Europe is steering a course straight into deflation – the lot leaving us with Disaster A, Disaster B, or Disaster C as the consensus choice; then yes, I suppose I am a consensus guy, of sorts. But those are all worries that will come to a head later next year or the year after, not in the next few months or weeks, which is where most traders live. The trader who quizzed me wanted to know what was going to affect his book this week!

We seem to occupy a world where we are all somewhat uncomfortable. The problems are all so apparent; but somehow we are compelled to take risks anyway, hoping that the risks we take are properly managed or that we can exit at the propitious moment. The game seems to be moving along, absent another major shock to the system. It's not quite party like it's 2006, because the level of complacency is nowhere near the same; but we do seem headed down the same risk path, even though it scares us. Which means that it might take somewhat less than a subprime debacle and banking shock to trigger a crisis, since no one wants to be exposed when the next crisis happens. The majority of market players appear to believe that another crisis might materialize, but in the meantime you have to dance while the music is playing. Fifty Shades of Chuck Prince.

So, as investors and money managers, we must be on shock alert. Where will the next one come from? By definition, a shock is a surprise to the markets, something that few people recognize until it becomes too big to ignore. Ben Bernanke achieved a degree of infamy for saying that the subprime crisis would be contained, even as some of us were shouting that losses would be in the hundreds of billions (what optimists we were!). And then came the shock that created the biggest global economic crisis since the Great Depression.

But an almost desperate reach for yield and shouldering of risk are clearly in evidence. Junk bond issuance is over 2.5 times what it was in 2006 and twice as high as a percentage of total corporate bond issuance. Leveraged loans are back to all-time highs, even as credit spreads continue to fall (see graph).



Collateralized loan obligations (CLOs) are close to all-time highs after almost disappearing in 2009. And subprime auto-asset-backed paper is projected to set a new record in 2014. Party on, Garth!

But if you ask the participants in those very markets, and I do, if there is any sign that the reach for yield is easing, the answer is generally "Not yet." After 2008, everyone remains nervous; but when the analysis is done, enough buyers conclude that the future will be somewhat like the recent past. Although no one I talk to believes that in 2014 we will see another year in the stock market like the current one, still, the consensus outlook is rather sanguine. But I talk to more bulls than you might think. Last night in Geneva David Zervos was arguing (till rather late in the night, for me at least) his familiar spoos and blues with me (long S&P 500, long eurodollar). He is ready to double down on QE. Our hosts bought an excellent if outrageously expensive dinner (for the record, there is no other kind of meal in Geneva – can you believe $12 Diet Cokes?), and it was only polite to listen. And the trade has been right.

But for how long? Central banks are still going to be easy. But markets can be characterized as fully valued, at best, especially since there have been more earnings warnings this last quarter than at any time in the recent past. While the conditions are not quite the same as in 2006-07, we are getting a little frothy. So is it 2005, so that we can enjoy the ride into late 2006 and then look for an exit strategy? I would argue that the markets actually need a "shock" of some kind. And in addition to the "consensus-view" shocks mentioned above, I see one especially big, nasty lion lurking in the grass. In the form of German banks.

The Sick (German) Banks of Europe

Quick: I say "German banks," and what's the first thing that comes to your mind? The Bundesbank? Staid, no-nonsense central banking? The Bundesbank is all about maintaining the price of money – forget QE. Deutschebank? Big, German – must be stable and low-risk. The fact that southern Europeans are opening accounts left and right in DB must mean that DB is lower-risk than the local wild guys. Except that they have the largest derivatives portfolio, at $70 trillion (but don't worry because it all nets out, sort of, and of course there is no counter-party risk!), and they are the most highly leveraged bank in Europe (at 60:1 in the last tests – not a misprint), which might give you pause. Although their CEO argues that their leverage doesn't matter. And keeps a straight face. Just saying…

If something happens to DB, they are, in all likelihood, Too Big To Save, even for Germany. But Deutschebank is not my focus here today. It is their much smaller brethren, Too small to be called siblings, actually. More like first cousins twice removed. But there are a lot of them, and they all piled into some very interesting and, as it turns out, very questionable trades. And the story begins with the American consumer.

This Christmas, we will all engage, as will much of the world, in an orgy of gift giving. (I helpfully offer a few ideas of my own at the end of the letter.) The iPads and Xbox Ones and GI Joes with the Kung-Fu Grip (gratuitous esoteric movie reference) will be flying off the shelves. But the one thing that ties all those gifts together is The Box, the humble container unit, the TEU, which allows the world to transport all those items ever more cheaply. That story is resoundingly told in a book that Bill Gates featured in his Best Reads for 2013, simply entitled *The Box.*

It turns out that the shipping container was created in the '50s by a force-of-nature entrepreneur who fought governments and regulators (who typically tried to protect unions rather than help consumers) to bring the idea to market. It finally took off when the military decided it was the best way to ship material to the troops in Vietnam. It is one of those things that make sense and would have happened anyway, but as often happens, military spending drove the ramp-up.

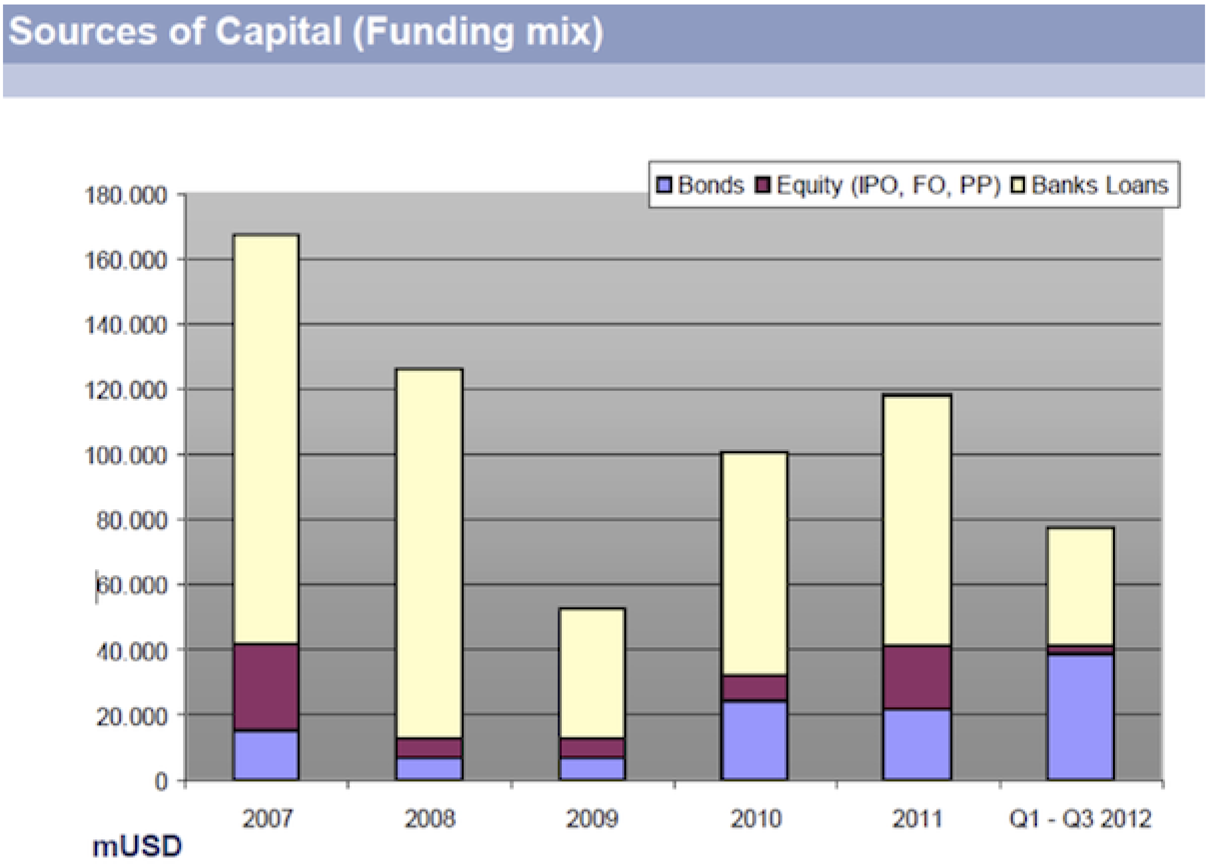
The container was not without controversy. Longshoreman unions fought it aggressively, as containers meant fewer high-paying jobs. But The Box also meant far cheaper transportation of goods, and so it helped boost international trade. Now it is hard to imagine a world without containers. And even though the container business started in the US, there is not one US firm in the top 18 container shipping companies. The business is dominated by European and Asian firms.

And container ships were profitable. Oh my, fortunes were built. And they were so successful that a few German bankers looked at the easy money made by US bankers securitizing and packaging mortgages and decided they could do the same with ship financing. I know it is hard to believe, but the German government decided to create pass-through tax vehicles that gave serious tax preference to high-tax-rate investors for all sorts of things, including movies (such cinematic monuments as *Terminator 3, I Robot,* and the forgettable Stallone flick *Get Carter* were financed with German "tax shelters"); but my research has so far unearthed nothing to equal the German passion for financing ships. Seriously, would any US government entity give tax breaks to a favoured industry? Would a Canadian or Australian or [insert your favourite country here] government? Such things are done by many governments, of course. Here we may apply Mauldin's Rule (stolen from someone else, I am sure): Any seriously out-of-whack financial transaction requires government involvement (generally in the form of some market-distorting law).

Cargo ships, especially container ships, were serious cash machines for long-term money. Buy the ship with some leverage, put it to work, and watch the cash roll in. The Greeks were especially good at this, but the Germans and Scandinavians caught on quick. The Germans went everyone one better and allowed small high-net-worth investors to put their money into funds that financed these ships. At one point, I am told, German banks might have been financing 50% of the world's cargo ships. (They control at least 40% of the world's container ship market today.) Anyone familiar with limited partnerships in the US in the late '70s and early '80s knows how this story ends for the investors.

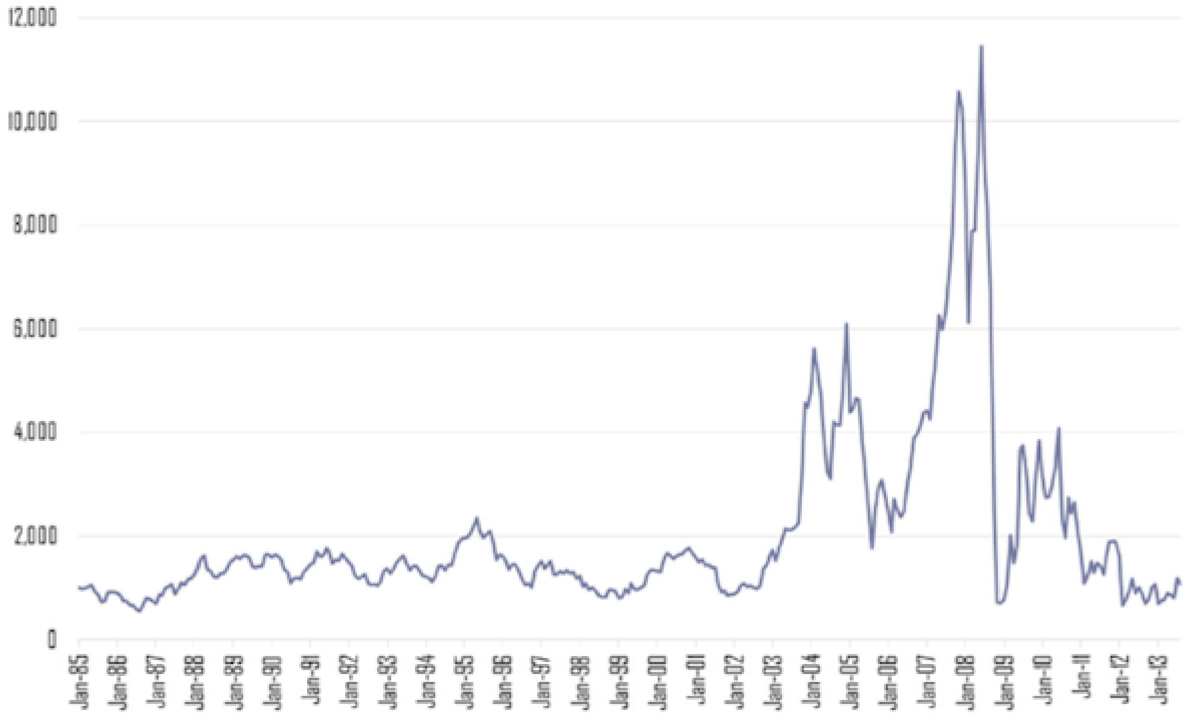
I came across this story from the inside, as a business partner of mine is in the shipping business; but he owns and operates a special type of ship: massive tugboats that move ocean drilling-rig platforms, and those are still in healthy demand. But his original financing many years ago was from Germany.

It turns out that if a little leverage makes a deal look good, then a lot makes it look even better. In 2007, ships were financed at 75% leverage (on average). It looks like 2008 vintages were financed in the 90% range! (Data is from a presentation I was sent, done by Dr. Klaus Stoltenberg of NordLB.)



And why not? Baltic Dry shipping rates were going sky-high! Shipping rates were up over five times from their lows only a few years earlier. Think of buying a commercial building, and suddenly the rents you're getting are five times higher. In the low-yield world of 2007, would you want some more of that?

Baltic Dry Index Shipping Rates Since 1985:



Then the bottom fell out in the credit crisis as international trade financial banking collapsed, shipping came almost to a standstill, and ships were barely able to cover their operating costs, there was so little cargo. Remember the pictures of hundreds if not thousands of ships moored in the South Pacific islands, unable to find cargo? Story here. I wrote a few paragraphs about them at the time.

New shipbuilding quickly fell as well, with stories in the press of no new ship orders in 2009. But governments wanted to make sure workers had jobs, so subsidies and new ship designs soon came into play. Making a long and fascinating dinner story short, it turns out that you can now buy a container ship that sold for $40 million in 2008 for $23 million today. That, of course, is a significant operating-cost advantage for new ships. But new designs also make new ships 25-30% more fuel-efficient! A ship is leased for a certain amount per day to cover operating expenses. Fuel costs are extra. Depending on the size of the ship, the savings can be up to $7,000 a day, money that goes directly to the shipper. A ship that is 60% of the price and costs significantly less to operate can make money at far lower shipping prices, and not surprisingly gets more of the shipping market share.

The result is that many container ships that were built pre-2009 are now simply uneconomical to operate. Depending on the ship, some cannot even generate enough income to cover their operating costs. (Please note that not all pre-2009 ships have issues; but a lot, if not most, of them do.) So those ships are clearly upside down on their loans. I was telling this story last week, and one trader said, "So the investors had to put in more money?" Good question.

As it turns out, the German banks, for the most part, actually make the capital guarantee part of their loan commitment. The investors lose 100% of their money but are able to walk away, kind of like defaulting US homeowners can in most states. The banks take the loss. Sure, they own the ships, but most are basically so much scrap metal, destined for dismantling in India, Pakistan, or Bangladesh.

(Sidebar: so many ships are being scrapped because they are uneconomical that the scrapping business has exploded. One source suggests there are less than three years worth of ships that are likely to be scrapped. But the number of new, larger ships being built is impressive, which suggests that the supply destined for scrapping will keep growing, at least for the time being.)

At the top of the market, Europe financed 75% of the ships being built, and German banks financed 75% of those, or maybe as much as 50% of the world's total. Moody's gave us an estimate this week that German banks will face credit losses of $22 billion in 2014. "Germany's eight major ship financiers have lent a total of 105 billion euros to the sector, a fifth of which are categorized as non-performing," Moody's said in the report. "We expect the extended downward shipping cycle to cause rising problem loans in the shipping sector during 2013-14, requiring German banks to increase their loan-loss provisions. This will challenge their earnings power."

Whether the losses can be "contained" (to borrow a word from Chairman Bernanke) depends on what new rules are implemented by the new European banking authority next year. Only 30% of the losses have been accounted for with loan-loss provisions. That is bad enough; but if what I am being told is true, the losses could soar much higher. German banks are still financing ships that are not making debt payments, rolling over principal and more in an effort to avoid having to write down losses. Further credit is being extended to shipping companies in the hope that they can work out the problems, as the banks do not want to go into the ship-operating business. Over 100 German ship funds have already shut down as the long-simmering crisis in global container shipping finally comes to a rolling boil. A further 800 funds are threatened with insolvency, according to consultants TPW in Hamburg.

How bad is it? Banks are taking control of ships, marking them down to a fraction of their cost, and then financing 100% of the cost of selling them to Greek shipping companies. Can we say irony? Greek shipping families basically operate tax-free (a point I wrote about some four years ago) and take a very long-term and conservative view. They sold ships to the Germans at the top of the market for very nice premiums and are now buying them back at significant discounts.

The critical point is that a "European bank health check may trigger additional provisioning as loans benefiting from remediation measures – such as covenant waivers or an extension of repayment schedules – may be re-classified as problem loans under the new standard of the European Banking Authority...." (Reuters)

As Evans Ambrose-Pritchards wrote in *The Telegraph* last year:

"Most of the 20 top banks for the shipping industry have stopped all funding…. Shipping is the biggest casualty of the new regulations. All the banks are reducing their portfolios, using any breach of covenant to get out of contracts. The second-hand ship market has broken down," said Mr Smith…. Both bulk ships and tankers are trading at lower levels today than during the worst moments of the 2008-09 crisis. The odd twist is that Greek shippers are the ones quietly snapping up bargains from distressed German companies. "The Greeks are sitting on a pile of cash. They are in their own special cocoon completely removed from

Greece's political troubles," said Dimitris Morochartzis from Lloyd's List Intelligence.

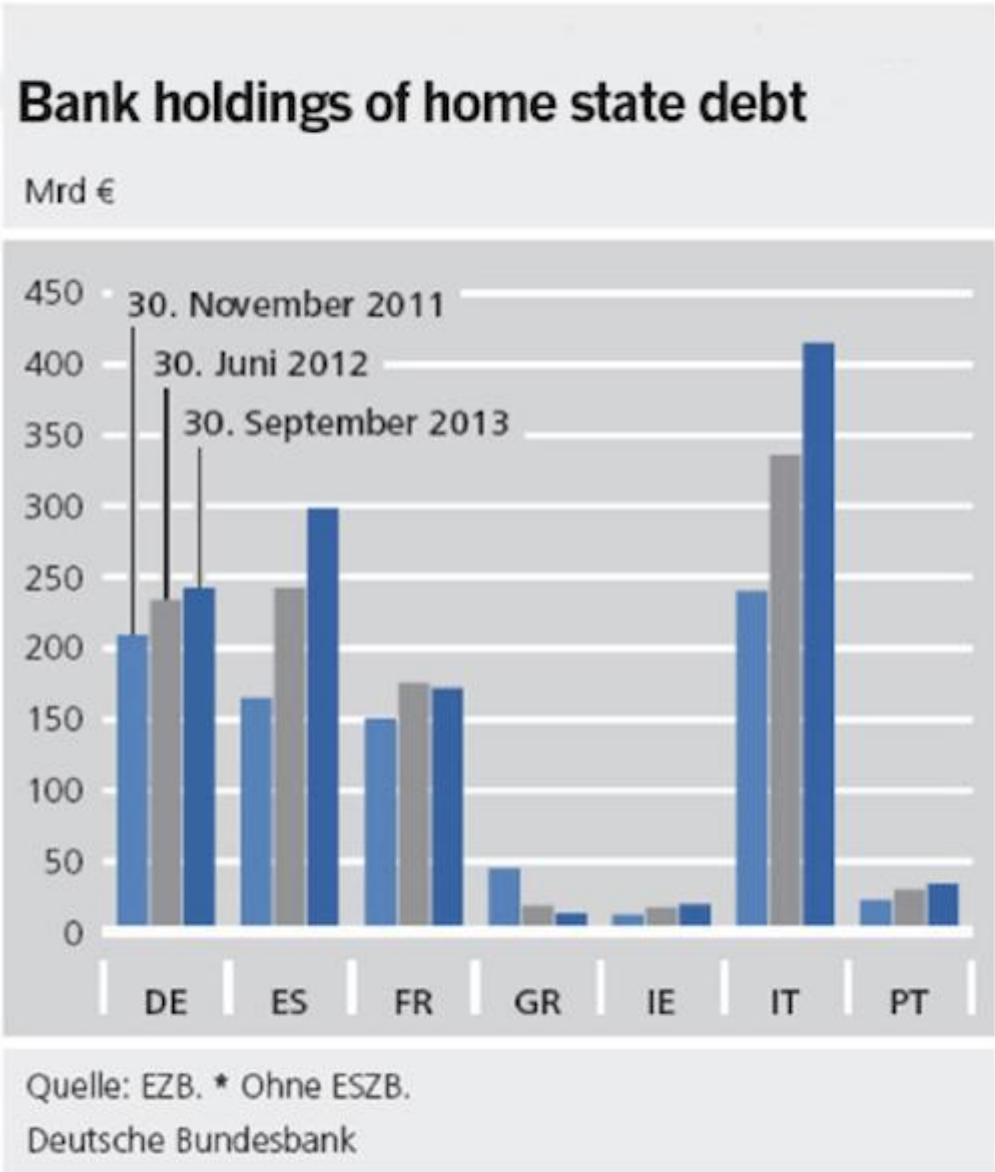
"They played their cards really well during the boom, selling ships for a profit at the top of cycle. They are now buying them back for a fraction of the price," he said.... Giorgos Xiradakis from consultants XRTC said Greek firms are teaming up with Chinese banks. Chinese premier Wen Jiabao pledged $5bn in loans to the Greek shipping industry two years ago, part of a twin-headed plan to gain a stronger foothold in the EU market and to provide vendor financing for the Yangtze shipbuilding industry – currently in dire straits…. German shipping experts say that two-thirds of the country's marine fleet is in financial distress. If the crisis drags on much longer, the Greeks may leapfrog ahead to become world leaders in container shipping. The irony of prudent Greeks cleaning up after a reckless debt spree by the Germans is lost on nobody.

Where There Is One Cockroach…

One of the rules of investing is that there is never just one cockroach. S&P noted this fall that Europe's banks still had a funding gap of €1.3 trillion at the end of 2012; and most of this has yet to be funded or loan-loss provisions made, so the financial system is not out of the woods by any means – no matter what the complacency of consensus indicates. Shipping is just one business segment of German banks, but given the present economics of shipping, losses are likely to be much higher than forecast. And if the banks have hidden the actual extent of their losses in those other segments, as they appear to have done in the shipping arena? Inquiring minds wonder about problems in the other business groups of these banks. The shortfalls could be much larger than we know. Bad debts in Spain keep hitting a fresh record each month, and I have written about the problems in French and Italian banks. There seems to be a Europe-wide problem with bank debt . That might explain the worry that Mario Draghi expressed last month, which we'll turn to in a bit.

The problem is not simply that European banks are inadequately capitalized. A committed ECB, given the freedom to act by Germany et al., could overcome that problem, though not without repercussions. The additional problem causing the current growth malaise and an unprecedented wave of high unemployment in the "developed" global economy is the rather perverse disincentives in effect for the banking industry in Europe. These disincentives have resulted in capital for businesses drying up.

The ECB has actually provided huge amounts of capital for banks in an effort to get them to lend to businesses. But faced with regulatory risks and the significant requirement for increased reserve capital imposed by Basel III, the banks have taken the cheap money and bought their national government bonds, because the spreads are so high and the reserve capital required for making a sovereign loan is still bupkis (a technical banking term pertaining to European sovereign loan-loss provisions to insolvent governments). Italy has now seen its debt-to-GDP ratio rise from 119% to 133% even as Italian banks buy huge amounts of debt, mainly from non-Italian banks. Ditto for Spain, Portugal et al. The chart below illustrates the issue.



Thus there is a massive shortage of financing available for solid medium and small businesses. Further, regulators are now seriously thinking about not only applying additional controls on the capital that is loaned to banks, but also forcibly converting junior and senior loans to capital, aggressively hurting those who are lending to banks. So much so that ECB president Mario Draghi recently wrote a private letter (which of course did not remain private) to the various authorities imploring them to stop their efforts. The problem is, the authorities see the problems correctly and are trying to force recapitalizations at the expense of the private sector, which is the right thing to do. Taxpayer funding of private banks should not occur except under extreme circumstances and then only "with extreme prejudice," which means wiping out the private shareholders.

But if potential new investors think their ***loans*** are at risk for large haircuts, then the market for bank debt will dry up again. Didn't we watch that movie in 2008-09? The wording in Mario's letter asserts that punitive haircuts (the easy thing for a regulator to impose) and a full-blown assault on junior bank debt could lead to a "flight of investors out of the European banking market." There are no easy solutions for an overleveraged, out-of-control banking system. Except the one proposed by Irving Fisher late in his life, after he had witnessed the debacle of the Great Depression. His basic recommendation was to not allow the leveraging to begin with. It is too late to do anything after the fact except clean up the mess.

Draghi says the ECB's bank stress tests early next year will degenerate into a fiasco or worse unless EU leaders put in place "credible public backstops" to cover cases where there is not enough money from private investors to recapitalize the banks. The whole botched structure "may very well destroy the very confidence in euro area banks which we all intend to restore." *(The Telegraph)*

Draghi is clearly committed to providing as much central bank financing as he possibly can to keep the system liquid. (You do not write such an impassioned letter if you have no concerns.) As some have noted, the German Bundesbank has hinted that investors might see their capital impaired before the government has to admit to taxpayers the true cost of holding the eurozone together – no matter what the cost turns out to be to the system in general if investors take the hit. Then again, maybe the Bundesbank will feel that they can exert their will only in the midst of a crisis. If so, they may very well help precipitate one.

19 December 2013

I think a major risk to the current status quo is another European sovereign debt and banking crisis in a world where risky leverage is once again mounting in the quest for elusive yield. The uncertainty we face, no matter what the consensus view, is troubling to your humble analyst. How should we then invest?

The brilliant and always must-read Howard Marks of Oaktree summed the situation up nicely in his latest letter. (According to *Business Insider*, "[Howard's] letters read like Michael Lewis ghostwriting for Warren Buffett: insightful, direct, homespun, expert and sharply pointed. Their quality and insight have gained them a devoted readership among value investors.")

I quote a little liberally, because summing up his already succinct prose loses a lot in translation. (Note: emphasis in the original)

As I've said before, most people are aware of these uncertainties. Unlike the smugness, complacency and obliviousness of the pre-crisis years, today few people are as confident as they used to be about their ability to predict the future, or as certain that it will be rosy. **Nevertheless, many investors are accepting (or maybe pursuing) increased risk.**

The reason, of course, is that they feel they have to. The actions of the central banks to lower interest rates to stimulate economies have made this a low-return world. This has caused investors to move out on the risk curve in pursuit of the returns they want or need. Investors who used to get 6% from Treasuries have turned to high yield bonds for such a return, and so forth.

Movement up the risk curve brings cash inflows to riskier markets. Those cash inflows increase demand, cause prices to rise, enhance short-term returns, and contribute to the pro-risk behavior described above.

Through this process, the race to the bottom is renewed. <u>In short, it's my belief that when investors take on added risks – whether because of increased optimism or because they're coerced to do so (as now) – they often forget to apply the caution they should. That's bad for them. But if we're not cognizant of the implications, it can also be bad for the rest of us.</u>

Where does investment risk come from? Not, in my view, primarily from companies, securities – pieces of paper – or institutions such as exchanges. No, in my view the greatest risk comes from prices that are too high relative to fundamentals. And how do prices get too high?

Mainly because the actions of market participants take them there. Among the many pendulums that swing in the investments world – such as between fear and greed, and between depression and euphoria – one of the most important is the swing between risk aversion and risk tolerance.

Risk aversion is the essential element in sane markets. People are supposed to prefer safety over uncertainty, all other things being equal. When investors are sufficiently risk averse, they'll (a) approach risky investments with caution and scepticism, (b) perform thorough due diligence, incorporating conservative assumptions, and (c) demand healthy incremental return as compensation for accepting incremental risk. This sort of behaviour makes the market a relatively safe place.

But when investors drop their risk aversion and become risk-tolerant instead, they turn bold and trusting, fail to do as much due diligence, base their analysis on aggressive assumptions, and forget to demand adequate risk premiums as a reward for bearing increased risk. **The result is a more dangerous world where asset prices are higher, prospective returns are lower, risk is elevated, the quality and safety of new issues deteriorates, and the premium for bearing risk is insufficient.**

It's one of my first principles that we never know where we're going – given the unreliability of macro forecasting – but we ought to know where we are. "Where we are" means what the temperature of the market is: Are investors risk-averse or risk-tolerant? Are they behaving cautiously or aggressively? And thus is the market a safe place or a risky one?

Certainly risk tolerance has been increasing of late; high returns on risky assets have encouraged more of the same; and the markets are becoming more heated. The bottom line varies from sector to sector, but I have no doubt that markets are riskier than at any other time since the depths of the crisis in late 2008 (for credit) or early 2009 (for equities), and they are becoming more so.

As I close on a beautiful Sunday afternoon, the following darkish note hit my inbox, and I think it's the perfect thing to wrap up with. It seems the world's largest investor, BlackRock (at $4.1 trillion), suggests in their yearend letter that investors should be prepared to pull out of global markets at signs of serious trouble, but should try to squeeze out more returns in the process. Their advice should make you think about your own investment decision process. "Beware of traffic jams: easy to get into, hard to get out of," they write. They highlight the risks that are posed by central banks (shades of Code Red!):

"The banking system in the eurozone periphery is under water, with a non-performing loan pile of €1.5 trillion to €2 trillion. Germany and other core countries are unlikely to pick up the tab. Eastern Europe could become the epicentre of funding risk in 2014 due to big refinancings," it said. BlackRock said the eurozone is "stuck in a monetary corset", failing to generate the nominal GDP growth of 3pc to 5pc needed for economies to outgrow their debt burdens.

The European Central Bank has allowed passive tightening to occur as banks repay funds under the ECB's long-term lending operations. The group says the ECB may have to start printing money, but the politics are toxic. "German opposition is a roadblock, unless the risk of deflation expands beyond Europe's southern tier," it said. The risk in the US is that Fed tapering could cause the housing recovery to stall. The Fed has purchased three times all net issuance of US mortgages so far in 2013. *(The Telegraph)*

It's Quiet Out There. Maybe Too Quiet…

My porous old memory can't quiet place the source, but I think it might have been an old John Wayne movie, where the sergeant says, "It's quiet out there," and Wayne answers, "Maybe it's too quiet" – just before all the Indians in the world swoop onto the camp out of the darkness.

The consensus seems to be saying it is quiet out there. And I can't hear anything, either. And that makes me even more nervous. Be careful out there.