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In our 29th year of service to the South African Investing Public!

Why not make SA an investment friendly country?

by Richard Cluver

A model citizen, so they say, works hard, pays his taxes and saves sufficient during his working life to ensure that he never becomes a financial burden upon his family or the state.

Sadly, South Africa has one of the world's worst savings rates. Reserve Bank figures show that the total of all forms of investment including pension fund contributions, insurances, retirement annuities, share and unit trust purchases etc total just 14.5 percent of GDP. As a result only 6 percent of retirees are financially independent at retirement. By comparison, the Chinese earn less than we do but manage to save 50 percent of their GDP, India manages 30 percent, Brazil 25 percent and Australia 22.5 percent.

To make matters worse, South Africans are now borrowing more money than they are saving. Household debt as a percentage of household income now stands at approximately 80% including loans, overdrafts, credit card debt, home loans and accounts.

It is thus understandable that the Government has introduced a tax-free savings scheme, but there is no evidence to show that it has significantly changed South Africa's savings culture. And without such a culture we will forever be dependant on foreign borrowing with all the hazards that implies including a volatile and unnecessarily weak Rand which in turn implies that we have to pay far more than we would otherwise need for imported goods. This latter fact means that we have to pay far more than other strong currency countries do when we build new power stations and other vital infrastructure items.

The knock-on effect means that local manufacturers find it extremely difficult to compete against their foreign counterparts because their electricity and transport costs are more expensive. Durban's commercial cost of electricity at 113 US cents

per kilowatt hour makes the city the eighth most expensive place on earth. Add in the highest rates in the country and one of the most expensive harbours in the world and it is clear that, even before we have to contend with a poorly-educated and internationally very expensive work force, we are being unnecessarily hobbled: locked into a downward spiral which in large measure explains why ours is one of the lowest economic growth rates in Africa which in turn explains why only 21 countries on this planet have a higher unemployment rate than ourselves.

It is a no-brainer that we need to make an all out effort to encourage saving if we are to end this cycle of human misery which has led to the rapidly growing popularity of political movements like the Economic Freedom Fighters who mistakenly believe that by re-distributing the wealth of the few in this country they will be able to solve the poverty problems of the masses. The Soviet Union, faced with similar wealth disparities in Russia, tried that a century ago and only managed to impoverish everyone.

Sadly, rather than educating our labour force to maximise its production capital, we have destroyed our education system and, rather than creating an investment friendly environment that would encourage long-term investment in this country, we have targeted investors with the consequence that South Africa leads the world as the nation with the highest levels of capital flight. Instead of treasuring our wealthy people whose invested assets represent this country's most valuable engines of growth, it is clear from regular politicians' comments on the subject that the wealthy are viewed as predators who have stolen the assets of the poor and as such should be marginalised and exploited by punitive taxation.

So it is very interesting to note Credit Suisse research which shows that South Africa's wealth distribution is almost identical with that of the US where the official policy of treasuring wealth has ensured that country remains the greatest industrial power on this planet enjoying one of the world's lowest unemployment rates: It found aggregate wealth in South Africa to be US $ 609 billion or $ 13 416 per capita, with 70% of it in financial assets. Noting that a decile represents 10% of the population, it estimated the distribution across deciles to be:

	South Africa	United States
Top decile (10th)	74.9%	75.4%
9th decile	11.4%	11.8%
8th decile	5.8%	6.1%
6th and 7th decile	5.5%	5.8%
Bottom half	2.4%	1.1%

Epitomising official attitudes to wealth in this country has been the Finance Ministry's targeting of trusts which, after all, are nothing more than instruments to protect wealth against being destroyed by taxation. And coupled with this are capital gains

taxes which make it all but impossible to efficiently manage wealth by locking investors into underperforming assets.

Investment, as opposed to speculative trading, is a globally-valued resource creating valuable reservoirs of capital which inevitably flow towards the best growth returns. It thus underpins infrastructure growth that enriches everybody, and is thus by its very nature long-term. Traditionally too, it stems from the savings of millions of ordinary folk who annually set aside a portion of income towards a fairly standard goal of a comfortable retirement. Very few of them are in fact multi-millionaires owning mansions and private jets. While it is true that South Africa remains the most unequal country in the world with the two richest South Africans (Johann Rupert and Nicky Oppenheimer, according to Forbes) having wealth equal to the poorest 50 percent (i.e. 26.5-million people) of the country. According to an Oxfam global inequality report, the bulk of South Africa's wealth is owned by millions of middle class citizens who have accumulated this asset by the simple process of setting aside a portion of income monthly throughout their lives.

And the greatest problem facing this reservoir of wealth and the people who own it, is the SA Revenue Service which is demonstrably intent upon destroying it. As proof, it is fair to assume that the country's most diligent savers back in the 1980s would have chosen the shares of Anglo American as a repository for some of their money, after all they were at that time regarded as the bluest of Blue Chips, rising in values as my graph indicates at a compound annual average rate of 19.8 percent a year for 22 years between 1986 and mid 2008 from an initial value of R11.50 a share on March 24 1986 to R553.00 on June 30 2008. Sadly, however, they began plunging downwards thereafter when it became plain to all that Gold's fortunes were virtually played out for South Africa. They then fell at a compound annual average rate of 26.6 percent until the beginning of this year when the shares touched R50.82.

Now let us take the case of a small South African investor who invested R10 000 in 1986 to buy a modest 870 Anglo shares. He would have seen this investment grow in value to R481 110 representing a gain of R471 110. Now technically had he seen the writing on the wall in June 2008 and sold his shares the sale would only have

attracted capital gains taxation for a portion of this increase, but the on-going reality for current investors is that that fraction will not apply in the future. Thus, were it to happen today to a pensioner with a modest monthly income of R20 000, the fiscus would collect R21 217 after allowing for an annual exclusion of R300 000. However, were our investor saving his money within a trust fund as he would have been prudently advised to have done by most financial experts back in the 1980s, he would forego the annual exclusion and be taxed at 32.8 percent in the current tax year. In this latter case the fiscus would deduct R154 248.

And of course the tax problems could have been far more severe. Anglo shares actually delivered a compound annual growth average of 14.3 percent over the 30 years to June 2016 but after taking Capital Gains Tax into account the effect would have been to drop that growth rate to just 12.8 percent which would have been only a little greater than the average inflation rate over the ensuing years.

Since the prudent investor would have sold the shares in anticipation of a market correction, he would to preserve his capital have re-invested the proceeds in another more suitable growth share and, some 12 to 18 months later when his income tax assessment fell due he would suddenly be looking for R154 248 which would in effect wipe out 65 percent of his annual income. And that is the best case scenario.

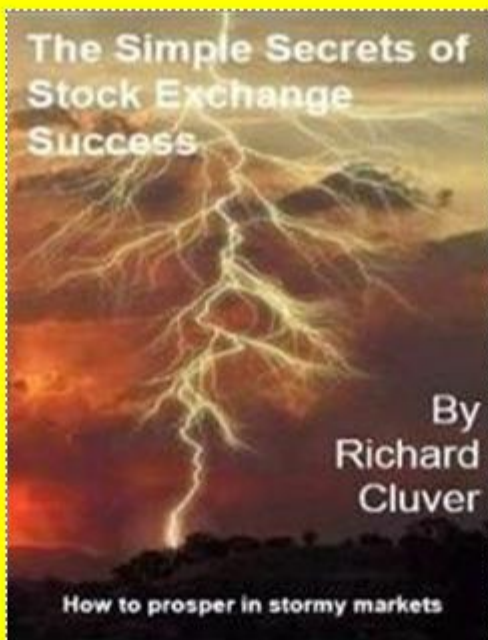
He might, in the circumstances, wish to wind up the family trust fund which was, after all, set up to ensure that death duties did not wipe out the bulk of his assets leaving his children with little to inherit. But dissolving the trust would attract similar Capital Gains Taxes on his entire portfolio which, to generate R240 000 a year from dividend income would suggest a lump sum of around R10 million and a possible Capital Gains tax of around R3.2-million leaving him with little to provide a retirement income.

So it should not surprise anyone if he instead opted to emigrate to a tax haven like Mauritius, taking his trust with him. In so doing he would be following in the footsteps of hundreds of other South Africans whose capital is flooding out of this country: reportedly the highest capital flight rate in the world.

How easy would it be to change all this? Well we could end capital flight and make South Africa an attractive investment destination with a few strokes of the administration pen. After all, it is not as if Capital Gains taxes bring in that much money to the fiscus.

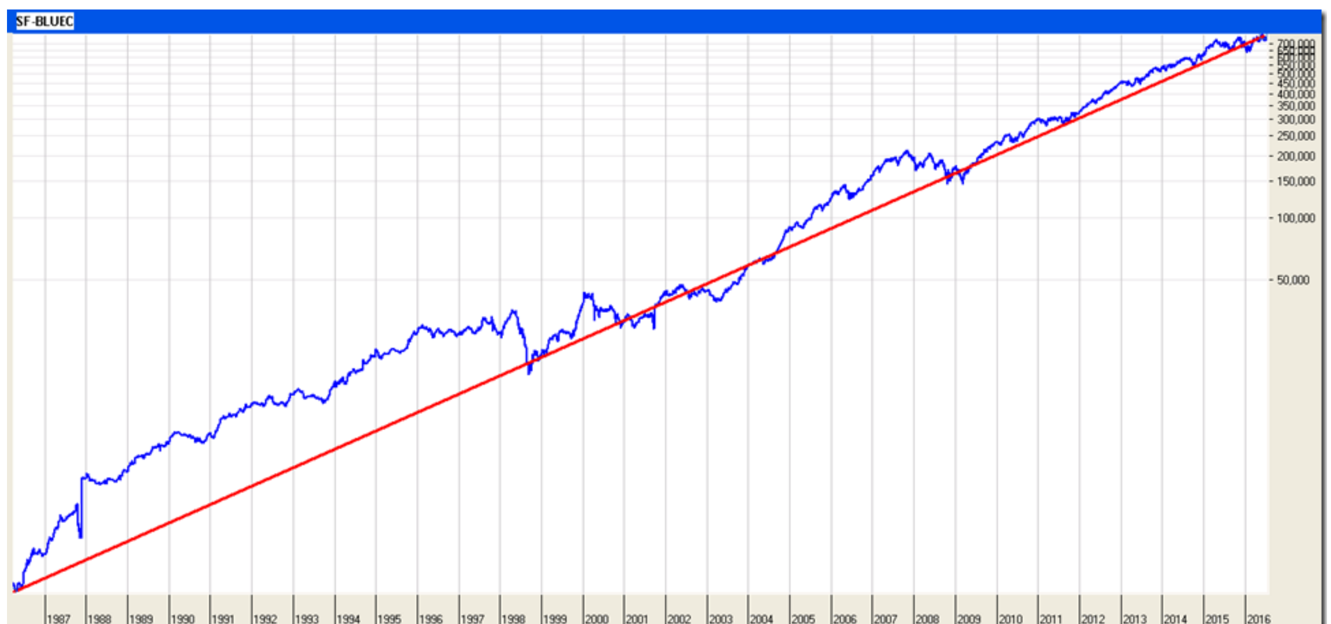
A new book by Richard Cluver

A new 225-page new Richard Cluver book entitled ***"The Simple Secrets of Stock Exchange Success"*** *has just been released. Detailing comparisons between the monetary events that sparked the Great Depression of 1929 to 1940 and the current global meltdown, Richard Cluver's latest work explains how to survive and grow rich in stormy markets. It is priced at R130 and can be ordered by E-Mailing* Support@rcis.co.za *with your credit card details or by phoning 031 9400 012*



And the other issue of solving the education crisis? Well again all we need is the will to stand up to the teachers union. How hard is that? Well they and the civil service are a vital voting block if the ANC hopes to hold onto power in this country. But then there seems a growing probability that the ANC might not be the government of the future and so the voting power of the unions might not be as important in the future!

There is, of course, a way to live with Capital Gains Taxes and that is not to hold individual shares for too long but rather to opt for a top ten Blue Chip share portfolio as selected by the ShareFinder programme which was in fact inaugurated back in 1987. There are always a number of blue Chips vying for top ten position within the ShareFinder selections and so, as individual shares completed their maximum growth cycles and fell back to more pedestrian growth rates, our investor would have been led by the programme to replace them with better performers. In that way the capital gains taxes that would have been attracted would have been in regular smaller amounts and the overall portfolio performance would been compound 22.9 percent – significantly better than the Anglo example - which would have taken his R10 000 to a current R3 953 708 as illustrated in my final graph below of the actual performance of the ShareFinder Blue Chips over the past 30 years.



Three SA props giving way?

by Cees Bruggemans

We have seen three SA props giving way serially these past six years, thereby fading GDP growth from a near "old normal" of just over 3% in 2010

to zero this year (rather than to a "new normal" National Development Plan aim of 5.5%).

And a critical question facing all of us: are all three props underlying our GDP demand still giving way, thus preparing the way for an even deeper

growth dive? Or are they stabilizing in preparation for a serial comeback, bringing growth back up with them? We are talking here commodity demand,

private fixed investment, and government-supported income boosts.

The answer seems to be that whereas one of the props seems to be stabilizing, the other two are suspect. Whereas one can tweak optimism, it is

similarly possible to tweak pessimism. So either growing signs of prop stabilisation overall, or on balance still fading. The GDP growth forecasts are

mostly heroic (1% and up after this year's final zero or even negative stumble) but we have been hearing that for five years now. And the SARB

leading indicator isn't looking up. It is still pointing down...

The most hopeful is our terms-of-trade measure (export prices relative to import prices). After a horrendous commodity export price bust these past

five years, things seem to have bounced off early 2016 lows. Though commodity prices (iron ore especially) are volatile, and futures prices suggest

renewed weakness for some, the general outlook may be stabilizing, with gold and platinum prices also up. Imported oil prices, on the other hand, also

keep struggling south of $50.

Commodity export volumes are another matter, still drought and China ravaged. If drought is ending, we may hope to see better farming exports within a

year. On the other hand, China isn't finished shrinking its industrial overcapacity while the major global mining exporters are still boosting

production, taking market share (also at our expense?).

On balance, the Big Crunch of the past six years lies behind us. This prop is no longer undermining our national real income. It may even start to add

back in the coming year. Traditionally, the trade cycle turning up heralds GDP recovery for us, except that this prop merely stabilizing at low levels

won't be enough to pull the whole wagon out of the mud. And vigorous commodity export revival isn't on the cards anytime soon, it seems.

That gives the other two props undue influence over what lies ahead next year. Team SA under Gordhan tutelage is working hard on labour law, mining,

public sector governance and electricity good news stories to lift the general business boardroom gloom and get the private fixed investment flywheel

going again.

So far shrouded in (pre-election?) secrecy, but with tantalizing telltale nuggets dropped now and then, reminding of Kissinger Shuttle Diplomacy in

the 1970s, with similar aims (bringing implacable parties to a common view?), one is left asking at every turn “but will it be enough?”.

A labour breakthrough would be fascinating, a thorough spring cleaning of public sector governance would be even more impressive, and greater mining

certainty about ownership, too.

But about the only really believable bit is a growing electricity surplus as Eskom succeeds in doing more maintenance and reducing unplanned

shutdowns, to the point of generating an exportable electricity surplus. Instead of jumping with joy, along with the IMF and rating agencies (this

feat meaning the country can again produce more industrial output), we find Eskom prudently wanting to shut out more renewables, hardly a real vote of

confidence in rapidly recovering home electricity demand. Costs and base load availability are factors in this calculation, but presumably not the

only ones?

Any real, if limited, labour law, public sector governance and mining ownership breakthroughs would be hints of a reforming system, yet with a party

leadership and government generally hardly giving way on its transformative agendas particularly unfriendly to private interests, and as such keeping

any standoff alive, the business focus elsewhere, local demand poor, and this flywheel yet to sustainably reverse direction, keeping private job

growth negative.

Clearly a lot of hard work behind the scenes, with no doubt all to be revealed soon, but the crucial question being whether it will be for real, and

enough, or not sufficient? This before considering our next stage of instability, meaning ungovernable major cities as the ANC loses control in more of them, new political

coalitions taking over but any reform path hardly being smooth, yet more violent public protest intensifying business unease rather than smoothing the

way back to bigger investment quanta.

The global picture may also reinforce such defensiveness. Europe is hardly a stable proposition, the next American president could turn out to be a major discontinuity, Abe’s Japan may fail in breaking free from stagnation, China may prove unstable, and the big North Africa, Middle East and Near Asia footprints unruly (containing Syria, Iraq, Iran, Afghanistan, Saudi, Egypt, Turkey & the upper half of the African continent as potential disrupters).

To this intimidating geopolitical soup must be added macro-economic instability focused on top-tier central bank experimentation on live populations.

Global anxiety, reinforced by local concerns, may keep boardrooms conservative in their risk-taking, and keep the SARB leading indicator pointing down even if our commodity export profile were to stabilise at low levels.

It is at this crucial juncture that the third SA prop has been knocked out from underneath us. Government income redistribution policies have been a key prop in sustaining household income and spending momentum in the many difficult years behind us. But it may not continue in like fashion for a while.

By keeping budget deficits high near 4% of GDP, and allowing the national debt ratio to GDP to rise from below 40% to over 50% (that is two percentage points annually…), along with a seismic shift in the mix of government spending since 2010, away from capex towards wage bill support (and more than doubling social welfare recipients to 17m), government apparently effortlessly sustained consumer spending while deteriorating its finances.

This process became arrested from late last year under finance minister Nene, and intensified under Gordhan from this year, with the austerity intention going forward not insignificant. The budget deficit to shrink to 2.6%-2.8% of GDP by 2018 according to one rating agency, and the national debt arrested at 50% according to Treasury promises endlessly repeated by many third parties.

The social welfare recipient expansion is likely to be stunted (though not ended with 0.5% population growth, urban populations growing robustly at 2%-3% annually and extended unemployment still rising steadily).

More success may be had in freezing public sector job levels (though not when going by the track record since 2010 or the political leadership still in place). Least success may be obtained in restraining public wage and benefit growth to inflation, instead focusing on reducing wasteful public procurement, but this again dependent on political leadership cooperation as yet not a slam-dunk when considering who keeps running the show.

This is itself a major business uncertainty, the spectacle of a reforming Treasury confronting a transformative government for whom there apparently

exists no limits. One of these parties will have to lower its flag, yet with our politics entering ever deeper shifting sands.

For now, the public wage bill and social welfare juggernauts (between them over R600bn annually in largesse) are yet to be fully stopped, but momentum

loss is likely for real, and budget and debt objectives achievable by various means, including more taxes for all, thereby shaving down various income

props.

Overall by all means some hopeful signs, but also a realistic reminder that hardly every SA prop has turned up or will do so shortly. It keeps the SA

growth outlook iffy, and household prospects poor, even if petrol prices may fall next week by (over?) 100c/l on the back of a favourable Rand/oil

combo and food prices could fall into next year as (if?) farming stages a comeback, boosting real incomes.

This year is certainly the worst since 2009. As to next year, it remains to be seen how our various props perform.

A more stable SA prospect?

by Cees Bruggemans

Our SA prospect domestically is hardly stable, going by policy frames, business confidence and private investment trends. But globally? Traditionally,

we tend to be boosted along by global windfalls serendipitously coming our way, only for us to fall down once these disappear (at best) or reverse

direction (at worst).

And we have for some time now been having headwinds undermining performance, with fears of yet stronger headwinds to come.

But what if the current global transition were to become more benign for us, possibly in unexpected ways, but real nevertheless? Could we depend on

it? Would it make our external prospect more stable? Meaning sustained capital inflows, supporting our bond, equity and currency markets, tempering

our inflation and interest burdens (indeed shaving them down to unexpected low levels)? And this irrespective of our domestic shenanigans. Or do we

even here have some stability features so far unrated?

So what is the proposition? Domestically, the government has for years shown a great willingness to follow policies that undermine private confidence and growth. But when its

actions become risqué enough, to the point of market risk penalties being imposed (Nenegate), we hear that the government never wants to end up at

the IMF. If true (it is), that carries its own logic: do enough to keep the wolf from the door. Hardly an endearing strategy, but perhaps a survivalist one for many.

Simultaneously, we are confronted with the weirdest of global playouts following the worst kind of crisis nearly a decade ago. And the question is:

can it yield us some temporary shelter (from raging storms)? Or is this shelter far more sturdy than it ever appeared to be, at least good for a

couple of years protection from raging global elements?

A big global crisis ending in recession is not good for us. Our exports fall off, and we also enter recession. Thereafter, in order to encourage

global revival, central banks tend to turn supportive and lower rates. SA rides the growth revival, while also benefiting from capital inflows seeking

our yield. So far, so attractive. Then, with the world sufficiently restored, the central banks start withdrawing their support, yield curves rise, drawing back capital flows from the

global periphery and risky SA is left high and dry, its asset markets unfavourably adjusting to such capital access reversal. So far, so traditional.

Except in this particular playout it only worked for a while (two years?) and thereafter went abruptly into decline, leaving us quite a different

playout.

So what happened? The Fed had been cruising in full support mode between September 2008 and May 2013, but then came the moment Fed chairman Bernanke

felt it was time to change direction.

Markets at the time, like central banks around the world, were still mostly in a traditional frame of mind, and took this signal as gospel (we will

taper bond purchases, then we will lift interest rates and thereafter we will normalise the Fed balance sheet). It will take a couple of years.

With US financial markets repositioning (bond yields starting to rise, within a year followed by the Dollar), risky global peripherals were actively

abandoned as their asset markets adjusted lower in response to changing capital flows.

But then in 2016 this process came to a grinding halt. Had something changed? The US recuperation, reason for Bernanke in 2013 to give the

starting signal for changing policy direction, has been real enough. But it has been very

slow, even if reabsorbing idled resources. More importantly, the world at large was lagging the US recuperation by a mile while episodically

detonating new crises.

Japan has been 25 years adrift, Europe entered into a series of intensifying existential crises of its own after 2009, while China by that date

concluded that its favourite development trajectory (investment and exporting) had reached non-sustainable limits. Most of the remaining emerging

markets had developed dependencies with one or all these leading economies, and had in turn found themselves cast adrift, their export engines

compromised (SA among them).

It was a greater world not succeeding in going back to normal quickly, thereby supporting the US revival. Instead, this global condition turned out to

be a drag, as much on growth as that their central banks stayed in supportive mode. And it was also good for episodic crises (Grexit, China's Yuan,

Brexit, Turkey) threatening the US revival story yet more while feeding safe haven flight.

Such global liquidity support ended up shaving down bond yields in all rich countries, including the US, while boosting the Dollar, sending warning

signals to the Fed that not all was well. Not so much with the US as the world at large, in an interconnected world thereby also threatening US

revival.

In 2016, these cross-currents came to a head. The Yellen Fed finally heard the message, and stood back, literally capitulating to market signals. In

the process, the globe in its totality reverted back to supportive mode, crisis conditions and central bank actions progressively favouring bond

values to the point of negative yields in places, and the risky global periphery (including SA) finding the search-for-yield turning back on with a

vengeance. This at a time that in rich countries political risk seems to have risen significantly, causing ours to fade into the background,

relatively speaking?

Instead of the Rand, which had reached 18:$ by early 2016, steaming on to 25-30:$, and our long bond yields, which had reached 10.4%, steaming on to

12-15%, it didn't play like that at all.

Instead, domestically, we reversed Nenegate, sang a good song, got the rating agencies to buy in, giving the impression of holding the dyke.

Meanwhile, global forces turned direction with a vengeance on Fed capitulation and the great fallback into monetary support, boosting bond prices and

eroding their yields, reactivated the global search-for-yield, boosting our SA asset markets, too.

But for how long? Only temporarily, as the US growth recuperation was no chimera, and would still eventually invite the Fed to resume policy normalisation? Also only

“temporary” if other parts of the world would succeed, like the Fed before them, to resurrect resource reabsorption, alternatively by doing more

fiscally (relaxing austerity)?

Or could this global support condition last an indefinite long time, because the US growth would remain too slow, while China, Europe and Japan would

remain in their respective transitions for much longer than thought, and the many risky peripheral dependencies as a consequence in dire straits for

longer?

The mental models of most public servants globally probably favour the temporary interpretation (indeed 2016 should by rights not have happened),

while many private market participants globally are inclined to the longer playout view, also because the growth dynamic seems to have shifted.

Loss of global nerve in the many crises and transitions underway, at a time that new technological advances have created a major shift away from the

traditional physical world in favour of services, requiring less investment quantum while giving greater scale advantages and cost reductions,

undermining traditional growth processes (innovate, invest capital, create income and spending flows, invest yet more).

So the “temporary” mindset keeps waiting for an early return to global policy tightening and reversing the search-for-yield (as happened in

2013-2015), placing risky global peripherals like SA under pressure.

The “long-view” mindsets see something quite different. A difficult global transition, inviting continuing central bank support and private flight

to safe havens, between them driving top-tier yield curves ever lower, in turn underwriting search-for-yield support bolstering risky global

peripherals.

How long is “temporary”? Short, months perhaps. How long is “long”? Possibly very long, many years even, given the resistance to shift to

fiscal support, and the inherent growth problem facing the world: loss of investment nerve even while steadily innovating, transforming economic

structures, and changing the growth dynamic in top-tier economies (and this not helping the peripheral caboose, including China steadily dialing

back).

If we are in “temporary” stop-the-clock mode, the world will again turn against us soon enough, and can we expect more of the same headwinds as

experienced in 2013-2015 (Rand under pressure to weaken, inflation to worsen, SARB to tighten short rates, and markets firming long rates, with

equities not happy).

In contrast, if this 1H2016 interruption towards “normality” lasts much longer, we may be so lucky as to be favoured by global search-for-yield

much longer, too, this being in the nature of an old-fashioned windfall, just coming via the capital account and not the trade account.

The very size and duration of this windfall could end up surprising many of us, shaving our interest rates way down (as has happened overseas) while

allowing the Rand to recover much more than expected (even reminding us of the Chinese commodity supercycle effects coinciding with Fed stimulus in

the mid-2000s decade).

Fanciful? I have for long dwelt in the “temporary” mindset, but have started to wonder where all these many global processes of this decade are

taking us.

Its election year in the US

by John Mauldin

It's election year in the US, so once again we see politicians promising the moon. That's what happens in a democracy. Regardless of party or office, all politicians make promises in order to get elected. This is their nature. Dogs bark, birds sing, politicians promise.

In the investment business, we're taught *not* to make promises because they create liability. Lawyers and compliance officers review documents for "promissory" language. Instead of "This fund will give you a profit," firms say things that generally sound like "This will give you *the opportunity* to profit," thereby avoiding lawsuits and regulatory action when profit proves elusive.

With the Republican convention just concluded and the Democratic convention just ahead, with the presidential candidates making promises by the dozens, let's imagine what a presidential promise would sound like if it had to comply with the same rules that investment advisors and brokers must adhere to. It would go something like this:

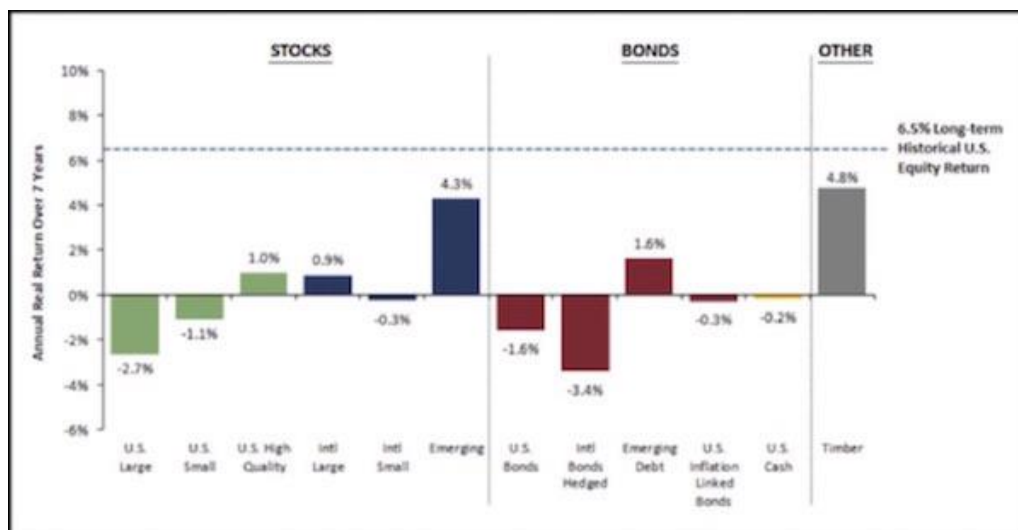
If you elect me as president, I will (insert promise), assuming of course that I can get both houses of Congress to agree, which means of course that I must persuade enough of the opposition Senators to bring my total up to 60 votes in the Senate, assuming that none of my own party votes against me. And that also assumes we can find the money to fulfil this promise, which is unlikely without some real (and unlikely) compromises.

Would-be elected officials face no such restraints, except from voters, who by the next election tend to forget what they were promised. There are exceptions, though. Some political promises don't fade away. They come back years later and demand fulfilment. Which brings us to the topic for today's letter: the promises made by politicians concerning public employee pensions.

Chicago residents are learning about this the hard way. They won't be the only ones. Voters all over the US will pay for the promises their elected officials made long ago – and broke.

Property Tax Blues

Previously we discussed the prospect of persistently low market returns in the coming years. Here is the GMO forecast again.



A portfolio balanced between major equity and fixed-income asset classes will be lucky to break even in the NIRP-heavy world I foresee. Poor returns will be an especially thorny problem for anyone who is contractually obligated to use portfolio returns to pay certain amounts on certain dates but hasn't set aside funds to do it.

Defined-benefit pension plans are the primary example. Today these exist mainly for public-sector employees. Private industry long ago shifted to 401(k) and other defined-contribution plans.

Public pension plans are rarely fully funded. They assume that future investment returns will make up the difference. What if they don't? Retirees go back to the taxpayers whose representatives made the promises and demand they pay up.

This is happening in Chicago right now. After years of fruitless argument and litigation, authorities raised property taxes to meet pension obligations. Cook County taxpayers recently received their bills and were not amused.

Outside the assessor's office, city homeowners told one property tax horror story after another.

"Our taxes increased fivefold," said William Phillips of Rogers Park. "I was expecting it to go up maybe twice as much but not four to five times as much."

"My tax bill increased almost $1,200 dollars," said Cornes King of Chatham.

"More than tripled. The city's piece more than tripled," said Logan Square resident Janelle Squire.

The bills that arrived over the weekend reflect rising Cook County real estate values and, in Chicago, the city's $588 million levy increase. Most of it is to restore police and firefighter pensions that Mayor Rahm Emanuel says his predecessors underfunded.

"A number of people across the spectrum politically, denied, deferred, and delayed the day of judgment," said Mayor Emanuel.

"I don't think that I'm getting the services what I'm paying for," said King.

Unfortunately for the taxpayers, that's not actually how the system works. Paying your taxes is not a commercial transaction. You don't give the government money in exchange for goods and services. You must pay taxes, but the government need not give you *anything* in return. They allow you to go on living somewhere besides a prison cell. That's all they have to do.

Of course, if we're unhappy with the way the city, county, or state is administering our taxes, we can vote for different politicians who will spend our money more in line with what the majority of us think. So, in general, we do get roads, police and fire departments, parks, and other services that are paid for by our taxes.

The problem is that, in all too many cases, politicians make promises to various government employees that include future retirement benefits, but they don't actually spend the money to fund those promises. And those unpaid balances keep adding up until the future becomes today, which is what is happening in Illinois and other states around the country.

When the current political powers that be in Illinois decided that they couldn't afford to pay for the promises made by past politicians, the unions and retirees (not unjustifiably) asked the courts to force the various government agencies involved to keep those promises.

And the courts determined that, under state law, retirement benefits cannot be reduced after the fact.

Thus Illinois courts have determined that retired public employees have more rights than taxpayers do. Retirees are entitled to what their elected officials promised them, no matter how impossible it may be to keep those promises. So elected officials are forced to either reduce current services such as police and fire and parks and roads, or raise taxes. Paying already contracted retirement benefits is at the top of the list of city expenditures.

Now, let's go back to that Cook County news story:

[T]he Chicago Public Schools Board is expected to approve a $250 million property tax hike to pay for teacher pensions. The new levy was enabled last week by the Illinois General Assembly and Governor Bruce Rauner. The additional charges, hundreds of dollars more for an average city house, will appear on tax bills a year from now.

"We might have to consider selling. I don't know if we'll be able to afford it," said Phillips of his Rogers Park home.

Mr. Phillips is free to sell his home, but to whom? And at what price? A home's market value is a function of supply and demand. Prospective buyers want to know more than the building and land costs before they buy – current and future tax liabilities are part of the equation, too. Mr. Phillips will have to set a selling price that reflects the known and unknown liabilities associated with his house.

In the US today, most people who are buying homes look not so much at the total mortgage but at whether they can afford the monthly payments. For instance, I have a mortgage on my apartment. But a prospective buyer of my home would be interested not only in how much my monthly mortgage costs but also in my tax and insurance bills as well as my homeowners association dues and payments for utilities and other services. It turns out that my HOA dues and taxes are significantly higher than my mortgage payments. The total of those costs affects the price I could get for my home if I wanted to sell.

So when Mr. Phillips says he may have to sell his home, those higher taxes are going to reduce its value. He's going to pay the higher taxes one way or another. He either stays where he is and pays them, or he sells the property at a lower price because of the taxes. Those are his choices.

This isn't just a Chicago problem or an Illinois problem. A significant number of public-sector pensions everywhere are in the same fix, to varying degrees. They all assume their portfolios will deliver returns well above the 2% to 4% or so that they may actually be able to get in the next decade. They can try to extract more from taxpayers, but at some point the taxpayers will simply leave. That's what happened in Detroit.

Dubious Assumptions

Every state and local government has workers toiling away to provide public services, and their elected leaders have promised them certain retirement benefits. Some states and cities have been more generous than others. Some do a better job of managing their pension obligations. But nationally there is a big problem.

Estimates of the unfunded liabilities vary, not because of dishonesty but because the estimates necessarily involve many assumptions: life expectancies, healthcare costs, interest rates, stock market returns, tax rates, and more. Tweak any of those numbers just a little bit now, and the difference over 30–50 years or more can be dramatic.

An April 2016 Moody's analysis pegged the total 75-year unfunded liability for all state and local pension plans at $3.5 trillion. That's the amount not covered by current fund assets, future expected contributions, and investment returns at assumed rates ranging from 3.7% to 4.1%. Another calculation from the American Enterprise Institute comes up with $5.2 trillion, presuming that long-term bond yields average 2.6%.

Are any of those return assumptions reasonable? Over a really long period like the next 75 years, maybe so. I see almost zero chance of hitting them in the next 10 years. Failing to hit them will put many more plans on very thin ice. Baby Boomers will keep reaching retirement out until 2030 or so. If life expectancy keeps going up, people will survive to collect benefits longer. A big crunch is inevitable.

There is a fact about pensions that very few people actually understand. The largest part of the money that a pension manager assumes they will pay out in 20 years comes from the investment returns on current assets. Depending on the rate of return your pension plan assumes, as much as 70% (or possibly more) of your future payments depends on the returns your fund manager will make on investments. If you are a government employee who is 30 years old and expecting to get a pension in 35 years, the money you are putting into your pension fund will cover less than 20% of your expected future payout. Everything, *and I mean everything,* about your future pension payments depends on the rate of return your pension plan gets on its investments – and on the willingness and ability of future taxpayers to continue funding your underfunded pension plan.

My friend Rob Arnott, founder of Fundamental Research, is one of the most respected financial analysts in the country. He and his very talented staff spend a great deal of their time thinking about future returns for pension and retirement funds. We were together in Las Vegas last week, and one of the topics we discussed was the problem of underfunded pensions. The average retirement plan assumes it will get annual returns north of 7%, and many assume 7.5% or as much as 8%. Rob copied me on an email he sent this week to a high-ranking politician, asking about that very issue. Let me show you his calculations on potential future returns. Remember, he is talking about the long term here, not just the next 10 years. In our conversation in Vegas, we agreed that the next 10 years will be challenging in regards to investment returns. Quoting from his letter (in which he assumes the typical 60% equities/40% bonds ratio that most pension funds use), here's the math: 40% Bonds. Yield is 2% for the US aggregate bond market. 60% Stocks. Our base case is 5.4% for US stocks, but we think valuations are too high, so we trim this to 3.3% for the coming decade. Here's our logic:The yield is 2%.
Earnings growth over the past century has been 4.5%, of which 3.1% was inflation (real growth of 1.4% … far less than most people realize).
Inflation expectations are about 2%, so perhaps we should trim this forecast by 1.1%.
This gives us a base-case of 5.4%.

Valuation multiples are stretched, with the stock market priced at 25 times the 10-year average earnings, against a historical norm of 16.8x. If we're back to historical norms in 10 years, that costs us another 4.2%. Since valuation multiples could (a) return to historical norms, or (b) remain at today's lofty multiples, let's split the difference, and trim our return expectations another 2.1%.
This gives us a likely outcome of 3.3% from stocks.

If our logic is sound, we earn 0.8% from our bonds (40% allocation x 2% return) and 2% to 3.2% from our stocks (60% x 3.3%, or 60% x 5.4%). Add up the return from stocks and the return from bonds, and we get 2.8% to 4% from our balanced portfolio.

Bottom line … US public service pensions are toast. One of three constituencies gets nailed: the taxpayer (keeping in mind that the affluent are mobile!), the current and/or future pensioners (keep in mind that private-sector pensions are now far less generous than public pensions … there's an inequity here!), or the public services that are on offer to our citizenry, net of sunk costs from servicing past generations. Most likely, it'll be a blend of the three.

When Bankruptcy Is Not an Option

Our judicial system has a time-tested option for those who can't pay their debts: bankruptcy. Individuals and businesses use it all the time. The debtor submits itself to a court, which tries

to reach the fairest possible settlement with creditors. It's messy, but it usually works for the best.

Federal bankruptcy code permits cities, school districts, and other local governments to file bankruptcy. Some have done so, and I expect many others will in the coming years. Cities like Detroit and others in California have used bankruptcy to renegotiate their pension plans and other debts.

States are a different matter. Current law doesn't let them go bankrupt.

In theory, Congress could change the law and let states go bankrupt. For instance, there are those who agree with President Obama, as well as with Newt Gingrich and Jeb Bush, that Puerto Rico should be allowed to go bankrupt. If the law should change and a state actually tried to file for bankruptcy, creditors would immediately file constitutional objections under the contracts clause and the 10th Amendment. Some legal scholars think those barriers can be overcome, but at minimum the argument would go to the Supreme Court and probably take years to be resolved.

But getting Congress to pass such a controversial law could be quite difficult. There are good reasons to prevent state bankruptcies. The fact that they aren't eligible for bankruptcy allows states to borrow money at lower interest rates. Lenders assume states will always figure out some way to repay their debts. But will they? Recent history says yes. Go back some 80-odd years and the answer isn't so clear.

In 1933, debt-plagued Arkansas unilaterally restructured and extended maturities on a series of highway and other bonds. Nowadays we call that a default. Bondholders sued, of course. The next year the state and its creditors reached a compromise refunding. Creditors exchanged their old bonds for new ones funded by a 6.5 cent per gallon gasoline tax.

In today's dollars that would be about $1.16 per gallon, so this was a hefty tax on Arkansas drivers. I am sure they complained. That deal fell apart, and after many more twists and

turns, the federal Reconstruction Finance Corporation (predecessor to the FDIC) bought the new bonds.

Back to the present: the Moody's report cited above sees almost zero chance that the federal government will bail out an indebted state government. I agree; the other state delegations in Congress would quash any such idea. You can debate whether the Arkansas episode was a "bailout" or just a refinancing, but it is one of the few precedents we have for a state default.

That leaves us in a very murky situation with regard to state and local pensions. We know many will have a hard time meeting their obligations. Those at the state level can't go bankrupt, nor can they expect federal help. Something will have to give in those states. Whatever the outcome is, it won't be pretty.

And not every government below the state level can declare bankruptcy to discharge its pension obligations. Illinois and other states, including my own state of Texas, have passed laws that require cities to honor their commitments. They can change pension agreements going forward, but they are legally required to honor past agreements.

Abandon State

This leaves an important question: which states and local governments will hit the wall first? Finding the answer is not as easy as you might think.

As noted above, evaluating a pension plan's future prospects requires all kinds of long-term assumptions. Near-term prospects are hard to judge for a different reason. States and localities all operate under different state constitutions, contract laws, labour laws, and other constraints. Two states might look the same, financially speaking, but have far different pension-system prospects for legal reasons.

Illinois, for instance, is in a jam because its state constitution doesn't permit it to reduce pension payments. Other states have more flexibility. States also give their pension managers different degrees of authority and liability. It's a mess. What states are most likely to raise taxes and/or cut government services?

I found one analysis that helps pinpoint the top risks, considering not just pension shortfalls but other financial obligations as well. The Governing Institute, a group for state and local leaders, reviewed three separate studies from J.P. Morgan, PricewaterhouseCoopers, and the Mercatus Center of George Mason University. JPM and PWC both point to the same four states: **Connecticut**, **Illinois**, **Kentucky,** and **New Jersey**. The Mercatus Center concurred on those four and added **Massachusetts** to the list.

This doesn't mean everyone else is safe. You might live in a very sick city in an otherwise healthy state. There are cities in Texas, arguably one of the healthiest states, with significantly underfunded pension plans. In our teacher retirement programs, many school districts are underfunded. You could also be in a sick city that is in a sick state, giving you double trouble if you own property there.

Oddly, you may be at risk if you stay, while your city and state are at risk if you leave. Property tax revenue depends on property values, and property values fall if too many people want to sell. If governments raise tax rates to compensate, then even more people will leave. At some point a death spiral sets in. Detroit went through this and is only now beginning to recover. People left the City of Detroit and moved to the suburbs.

I think we'll see many more Detroits. Make sure you don't live in one.

For instance, more and more affluent people are leaving California because of the taxes and other high costs. Dennis Gartman wrote this note:

According to the always interesting and strong proponent of free markets and small government, the Mercatus Center at the George Mason University, California now owes a stunning $118.2 billion. However, when we add to this sum the pension fund shortfalls and other major concerns, California actually owes $757 billion. On a population of 38.8 million, that's a stunning $19.5 thousand per citizen... Children included!

California's problem is that the state is adding nearly $15 billion annually to its deficits, and as those deficits rise the state’s ability to add to its roads, its universities, its hospitals, its bridges, its all-important water supplies et al are falling rapidly.

California, according to the *Investor's Business Daily,* is a “massive welfare state.” According to the IBD, one/third of all US welfare recipients live in California, which, with its generous welfare benefits, has become a magnet for impoverished immigrants from around the world. A quarter of the population lives near the poverty line.

And the news from California just gets worse. This from *Reason* magazine: Another year, another mess with California’s public employee pensions. The California Public Employees’ Retirement System (CalPERS) announced this week that the rate of return for its investments for the fiscal year ending on June 30 was less than one percent. It was .61 percent. As the *Los Angeles Times* notes, this is the worst returns it has logged since 2009, when the housing bubble burst and hit California particularly hard.

That’s a far cry from the 7½% CalPERS assumes it will get. And the newly passed $15 minimum wage in California will add almost $4 billion of annual cost for government employees as well as increase the state’s required pension payments.

Risk-Adjusted Retirement

I wrote about the retirement problem in depth a few months ago in “ZIRP & NIRP: Killing Retirement As We Know It.” I won’t repeat that analysis here, but I’ll say this: Whatever amount you are saving for retirement is probably not enough. The pension crisis is one element of a much bigger one.

If you’re a retired teacher, firefighter, etc., you naturally want what you were promised. You probably won’t get it. That’s just simple reality. The taxpayers don’t have the money. Now is an excellent time to accept that fact and make alternate plans.

In fact, that’s good advice for pretty much everyone. Your future plans, whatever they may be, probably won’t protect you from the storm I think is coming.

I may be wrong on this. I *hope* I’m wrong. There’s still a chance the central banks and politicians will get their acts together and change course. There are things they can do to restore *sustainable* economic growth and pull us out of the mud. We’ll be dirty but not drowned.

I’ve been having this conversation with my friend Ed Easterling. He pointed out that the crunch I am expecting could come in a very different way. Let me quote a paragraph from a recent email he sent me:

Lots of folks [he left the “like you” unstated] have been worrying about a looming financial catastrophe following

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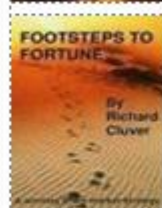

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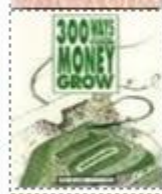

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policies that have included Fed QE, ZIRP, etc., and near-trillion-dollar stimulus programs. Maybe, just maybe, we'll look back in five or ten years, after no catastrophe, and applaud that such "good" actions saved the economy without negative consequences. When, in reality, the "catastrophe" will have been the loss of 20%, 30%, or more in our standards of living and wage growth. The anecdote of the Frog-In-Boiling-Water may again prove to be a truism of life….

For planning purposes, however, the prudent course is to assume the worst. How will you retire in a 0% world? In most cases, you won't. Kicking back at 65 or 70 won't be an option if your portfolio can't generate income sufficient to pay your bills.

If you intend to retire in the next few years, you need to do the math that so many pension sponsors avoid. You owe yourself an honest accounting. Will your savings be enough to cover your expenses in a zero-return world? Find a good financial planner to help you run the numbers in different scenarios. If he or she starts telling you that you'll get 9% long-term (or 7% real, inflation-adjusted) returns on your stock market portfolio, politely glance at your watch and remember an important meeting that you have to go to. Then find another financial planner.

I think it's important that everyone have a good financial plan and financial planner, someone who will give you a realistic estimate of your financial condition and what your retirement might look like.

If, as is likely, the numbers are discouraging, now is the time to adjust your expectations. If you're still working, you can try to increase your savings. The statistics say that's hard for most people. The better idea may be to follow the Mauldin Plan and don't retire.

I'm almost 67 and not ready to retire. I could probably retire if I downsized my home and lived a much simpler life. I don't want to do those things, so I'm still "working." I put *working* in quotes because if I retired I would want to be doing the same thing I am doing now. I have the advantage of enjoying my work and being in good health. Not everyone is so fortunate.

This brings us to an important point. Adjusting your portfolio is only one of the preparatory steps you should be taking. It's necessary but not sufficient. There's much more to do.

Your most important asset is **your own earning power**. By this I mean the mental and physical ability to generate income. If your portfolio returns drop to zero (or even if they go down), but you still have earning power, you have a chance to recover. So it makes sense to protect and expand your earning power.

Ideally, you want to be in an occupation that won't cut off your earning power at some arbitrary age. Better to have some kind of work you can do for as long as you wish. It should also be work you actually enjoy. No one wants to "retire" into slavery.

The other thing you should do is protect your health. Doing so gives you a double advantage. First, good health will enable you to work longer and more energetically. Second, people in good health have lower medical expenses.

My friend Patrick Cox talks about "health span" instead of life span. The goal is not simply to live longer but to stay active and independent at an older age. That's what I hope to do. We are on the cusp of some major breakthroughs in life-extension technologies. I truly believe that 85 will be the new 65 long before I reach 85. Thus I may actually get to age backwards, at least for a few years. It's what I optimistically tell myself, anyway.

Even without new developments, you can do a lot to increase your health span. Get exercise, lose weight, stop smoking, watch your diet – you know the drill. The hard part is actually doing it. Most people don't, until it's too late.

In a low-return world, your health and your earning power may be the best option you have. Preserve them at all costs.

The Coup and Turkey as a Great Power

by George Friedman

In my book *The Next 100 Years*, I argued that Turkey is going to become a major regional power. Recent events would seem at odds with this prospect. But in fact, they confirm it. Emerging as a regional power puts great pressure on a nation. The shift in the external reality forces shifts internally as well. The result is what we have seen so far in Turkey: a clash between rival factions with diverse visions, a coup of some sort, and for now, a dictatorship.

Rising power in the world flows from greater domestic strength. But it feeds back into the internal system and creates strain on social and political fault lines. We can see examples of this throughout history.

How the US and Japan Emerged as Global Powers

The Mexican-American War turned the US into the leading regional power in North America. The war also spurred the early stages of industrialization. Railroads, the telegraph, and various forms of hydrocarbon-powered factories began to change the very nature of commerce.

So, one part of the US (the North) began quickly evolving its economic and social systems. The South wanted to retain its plantation-based economy and social system. The split led to the Civil War and the deaths of over half a million.

Some believed the Civil War would end the regional power status of the US and cripple its economy. It was a fair outlook, but it was wrong. From 1865 onward, the US grew its economic and global power.

Although tragic, the Civil War did not change the course of the US. Instead, it cleared the decks and created a new power structure to deal with the new realities of a mechanized society. The ascent of the US, to that of a regional power dominating a continent, ripped the social fabric and led to the war.

Also consider Japan's journey to become a major power as it industrialized in the late 19th century. After Japan defeated Russia, its economy evolved quickly while the social structure stayed fairly static. That led to severe tensions between the liberally minded business class and the socially conservative military.

Stepping into its new role as a regional and economic power created instability for Japan. This period was followed by military dictatorship.

There are also examples where emerging powers wracked by instability stagnate or falter.

It is not a hard and fast rule that instability is a natural product of a nation's growing power. However, there is no reason to assume that instability must undermine power.

Turkey's Path to Instability

Since the late 1990s, there have been three stress points that have borne down ever harder on Turkey.

First, it had a period of rapid economic growth. This caused tension between the existing elites and the new centres of economic power.

It also promoted political rivalry. On one side, a new economic order focused on exports and gaining access to the EU markets. On the other side, an older and less dynamic system tried to preserve itself.

Second, there was the festering question of Islam's role in politics. Turkey was founded by Mustafa Kemal Atatürk as a staunchly secular society.

However, in 2002, the dynamics of the region shifted, with religious Muslims gaining more power. The regional rise of Islam has affected Turkey as religious activists began asserting themselves.

President Tayyip Erdogan's party, the AKP, acted as an agent for the Muslim community. The army, which was constitutionally responsible for upholding secularism (Turkey is the only country I know of where this is the case), found itself confronting the AKP.

Third, its economic power and the complexity of the regional political climate were both growing. That meant that Turkey would inevitably get drawn into regional conflicts. In fact, the AKP tried to limit its involvement, but that created tensions with the US and other nations. It became entangled in events in Syria, Iraq, the Balkans, the Caucasus, and the Black Sea.

The Divide Between the AKP and the Military

The basic tension is between the AKP and the military. There was also friction between old and new money, and between secular Istanbul and the more religious and traditional Anatolia.

There was no way to continue militant secularism as the Muslim community grew more assertive. Yet, the military has always been part of Turkish politics and its officer corps is committed to secularism.

Turkey had to make room for religious Muslims as tension grew between the old Europhile elites and the Euroskeptic emerging powers.

Turkey also had to start managing its regional power. The first step would be to redefine its relationship with its old patron, the US. The military was pro-American, while ErdoÄŸan was not eager to engage in America's regional agendas.

These external pressures and internal social evolution created an unsustainable situation. Turkey was a volatile mix of political ingredients that was destined to explode. There was no civil war, at least not yet, and the military was unable to impose a dictatorship. But the new realities had to be dealt with.

Many observers have asked whether the coup attempt was real or staged by Tayyip Erdogan to justify a state of emergency. It's an interesting question. Whether the coup was genuine or not, the crucial fact is that a dictatorship has emerged and imposed a state of emergency.

Erdogan is conducting a massive purge of opponents, having arrested tens of thousands. The focus, though, has been on his natural enemy, the military. All parts of Turkish society are being transformed by culling those who Erdogan doesn't trust or who have strongly opposed him.

The state of emergency legally lasts for three months but can be extended. Or new laws can be passed to justify continuing the dictatorship.

By the time it is all done, if it is effective, dictatorship will not be needed as Erdogan will have broken his opposition. It is key not to personalize this. It is easy to think that this is about Erdogan. That would be a mistake.

What we are seeing is a convulsion in a system that has been under major pressure from the very things that have made it successful. Like the antebellum South in the US that could not accommodate the changes after the Mexican-American War, Turkey cannot cope with its stresses.

These stresses come from rapid economic growth, the tensions between secular and Muslim regions, and the beginning of Turkey as a great power.

Where Turkey Goes from Here

As the American Civil War and Japanese militarism showed, this is not a pretty thing to watch. It is a spasm that will have lasting effects.

It is also not a question of right or wrong.

The military has its constitutional function, and Erdogan was elected. In looking at the two, who is at fault? It is a futile question. Religious Muslims must pursue their interests as must secularists. The military is charged with protecting the state against the religious. New money always challenges old.

The state that Atatürk created can no longer exist. The pro-European secularism of the 1920s has largely weakened. The economic boom has introduced new players to what had been a closed circle of elites. The military can no longer function as overseer of Turkish politics. Those days are at an end, but they will not end quietly. Erdogan is now trying to bury the past.

But this should not be understood as the failure of Turkey as a society, nor as rendering Turkey incapable of being a regional power. These events actually strengthen the ability to act regionally and to act based on its own interests. In a way, they free Turkey from old assumptions at home and in its foreign policy.

I am not praising this process. It goes on regardless of my opinion, and that is the point. Nations that are succeeding are as open to disruption as nations that are failing.

Success in the US created the Civil War. To everyone’s surprise, the success continued long after the bloodbath.

History and geopolitics are unsentimental. They are indifferent to whether we approve or condemn the drama. The most we can do is try to understand it. And the key thing to understand is that the current chaos will likely strengthen Turkey, not weaken it.