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Challenging Conventional Wisdom

NEWSLETTER

Monthly Newsletter – March 2017

A Note from Theo and Warren

As we listened to the budget speech on 22 February, we were again reminded that we could have been listening to Des van Rooyen as Finance Minister if it weren't for decisive action in December 2015.

He would have had to deliver a budget within the framework of a nation whose debt was downgraded to junk status, with foreign investments drying up and no prospects of economic growth.

Pravin Gordhan had to deliver the budget in extreme political and economic conditions. The theme of radical economic and social transformation in President Jacob Zuma's State of the Nation Address is central to this year's government agenda. This, amid a struggling economy and rating agencies revisiting our debt rating by mid-year.

Transformation was mentioned several times, but we did not see any populist adjustments to expenses or projects. On the contrary, Gordhan repeatedly referred to the fact that successful economic transformation is dependent on a healthy economy experiencing strong growth.

On the revenue side, the minister will receive a large chunk of what he needs from the affluent part of the population. Basically, R20-billion will be received from income tax (R4-billion from the 103 000 taxpayers who fall in the top tax bracket who will now pay 45% on earnings above R1.5-million) and R6.8-billion from the increase in dividend tax to 20%. The remainder comes from other taxes and levies such as the fuel levy. Given the situation of the economy and the theme of radical social and economic transformation, it is logical that the more affluent part of the population would carry the burden.

Government will drive radical economic transformation in the following ways:

- Transformation requirements will become more stringent and more rigorously enforced if you want to do business with government in any way, whether by rendering goods or services, or if you need licences or approvals for any transactions.
- The Competition Commission and other regulators want to ensure that the market and its sectors are easier to enter for new competitors. Companies that comprise a large share of the market or a sector (i.e. the banks or any other 'monopolistic capital') will be under scrutiny this year, especially their contributions to redistribution of wealth.

The biggest negative of the budget is the growing government share in the economy. In 1994 the total tax revenue was 21.9% of our gross domestic product (GDP); now it is 29.8%.

Our growing debt burden is also of concern: in 2009 our debt was equal to 26% of our GDP, now it is more than 50%. This means that the interest on our national debt is now 10% of our expenses. This is more than we spend on healthcare or housing.

Your investments

So, how do the budget and the changes that come with it affect your investments?

The increase of tax on trusts to 45% and the new income tax bracket of 45% of income above R1.5-million together with dividend tax of 20%, leads to the effective tax rate of 42.4% on income received as dividends. This change complicates the decision of how your assets should be structured to ensure tax efficiency.

The proposed amendments to trusts imply additional tax for interest-free loans to trusts. The question was already raised in last year's budget as to whether a trust should still be used to house certain investments. Should companies or individuals not be considered instead?

The new effective maximum tax on capital gains is:

- Individuals: 18%
- Companies: 22.4%
- Trusts: 36%

Estate duty and donations tax were not adjusted in the budget, but adjustments are expected in future. The current estate duty levied on an individual's assets on his/her death is 20%, with the first R3.5-million per person being free of estate duty. Further deductions are also allowed for liabilities, bequests to spouses and certain non-profit organisations. Capital gains tax is also charged on a deceased estate. A trust on the other hand, does not pay estate duty and is only taxed on capital gains.

Endowment structures, where the tax is levied within the fund at lower rates, and investments in retirement annuities, are now becoming increasingly attractive for more affluent individuals.

- Theo and Warren

Will Trump be a Hero or Zero for your offshore investments?

Brash, rude, decidedly undiplomatic and definitely aggressive, Donald Trump is not your average common or garden US commander-in-chief. And he clearly intends wasting no time in getting off to a fast start. After initial bafflement, equity markets have responded with rapturous applause. Is the uncritical acclaim as irrational as the prior panic?

Presidents are often reflections (okay, poster boys) of their country folks' sentiment. Thus, we are seeing an America that is fed up with its role as a global leader. The US pays more than half of the UN budget, and contributions globally to other international aid are likely to be pulled back sharply. Bilateral relations are likely to be more "challenger" than "champion" (expect in Asia, for example, a closer relationship with India and Japan at the expense of China). Economic policy could also not only be disruptive, but inflationary.

There are two threads to this: tax and trade.

Tax policy

Trump has justifiably highlighted that the US tax code is a mess, a vast complicated patchwork quilt of assorted sneaky taxes and pork-barrel exemptions. He proposes a sweeping set of changes that will halve the number of returns submitted and substantially slash taxes for business, but also reduce the tax take overall.

Inevitably this needs to be squared away with the government budget, either by reducing benefits and/or increasing government efficiency and/or by government borrowing. He will start with easy wins by slashing extraneous global engagement costs, Obamacare, and corporatizing parts of government, but the rest must either come from trade duties and borrowing. So, tax policy appears inflationary.

Trade policy

His trade policy is clearly and unashamedly “America First”. His first shot is to offer US multinationals something of a Hobson’s choice: pay a reduced dividend tax rate and repatriate your overseas profits, or pay the tax anyway and leave them there.

The remaining issues on trade are what had markets worried about Trump in the first place. These have been put aside in favour of resolving the tax framework, but seem to have been swiftly forgotten. Trump wants to pull jobs back into America and also apply sales tax to import products, while exempting export products. While notionally fair, this approach may well be economically risky, since they may undermine the whole point of trade.

If country A makes product X best and country B makes product Y best, then by trading they swap their relative efficiencies. Interfering with that through border tax and/or higher tariffs could have inflationary consequences.

Thus, both tax and trade policy have a whiff of inflation about them. Since deflation has prevailed so long in the OECD, no one seems bothered about inflation, and most are pleased with the prospect of growth driven by higher inflation.

These policies have consequences that comprise a whole bunch of moving parts. The repatriation policies tend to strengthen the US dollar temporarily and possibly place pressure on emerging market borrowings. Accelerated growth in an economy that is fairly fully employed and driving government borrowings could see rate hikes and stimulate borrowing – possibly unpredictably.

Although the Fed has generated expanded money through Quantitative Easing, this hasn’t really pushed through to the economy as banks have been more cautious with their lending. An accelerating economy, however, would change that, leading to higher lending rates. This may well happen in an orderly fashion, but “money velocity” has a habit of sometimes suddenly popping.

So, what?

Trump is not only a businessman, but an aggressive one. Business economics are much more subtle than national economics. We don’t know what his final choice of trade policies will look like, so we don’t know whether to cheer or cringe.

Inflation, interest rates and equity markets are a relative game, so there's no point bothering with predictions there. US bond markets are definitely twitchy, and for good reason. Property markets are also mixed – and the picture is less clear. Property in the long-term loves inflation, but in the short term, higher interest rates can cause instability amongst geared players. An apparent winner would be precious metals.

A genuinely diversified global portfolio needs to look past the US dollar. The sheer size of US equity markets (60% of MSCI World index), makes them disproportionately large relative to US contribution to global GDP (24% in US$ and 16% by Purchasing Power Parity). Accordingly, clients of Galileo Asset Managers with direct offshore portfolios will tend to find their portfolios are relatively US-light (between say 30-45%) compared to global index benchmarks.

- Warwick Lucas, chief investment officer, Galileo Asset Managers