Welcome to another WMW after an eventful week in the markets. This week we will take a look at why I am bearish on South Africa, an old newspaper inflation article featuring William McChesney Martin's fears in April of 1968, pine based rocket fuel, and much more.

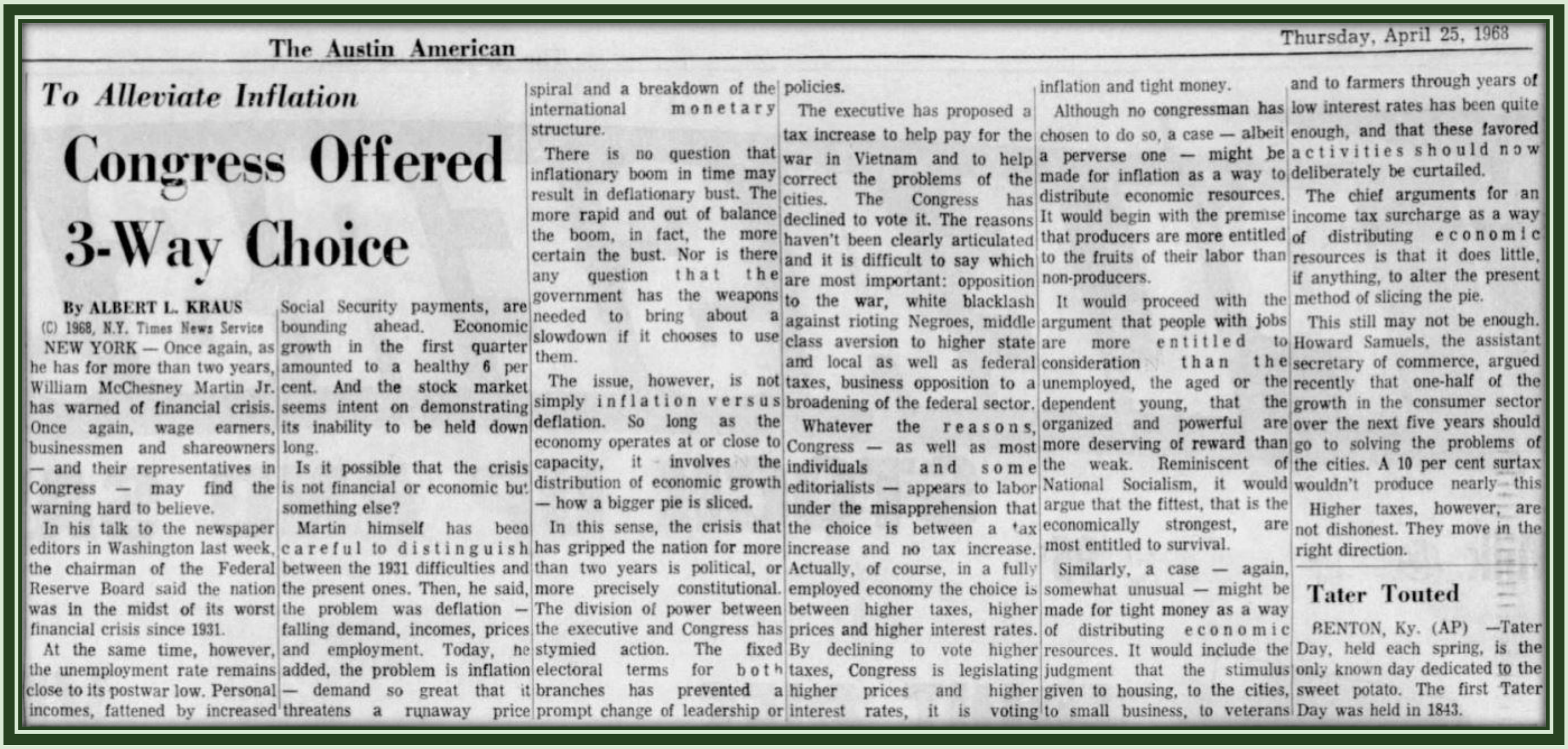
Pine Trees and Rocket Science

This week's education on the mighty pine outlines its use for rocket fuel – conifers know no bounds. Pinene based bio fuels used to power rockets are still developmental and not widely used, but the fact that a pine based compound can be turned into rocket fuel is pretty fascinating if you ask me. If you want to read an article about pine tree rocket fuel, check this out. This shows how something we all know well can be used in ways we would never expect. This led me to the question of what could be in our portfolios that can be used in a way we would never expect.

This brought to mind a presentation by Mark Spitznagel about safe havens and how tail risk hedging provides outperformance and risk mitigation – using something familiar in a way that provides surprising results. Adding a 3% allocation to a hedge that actually provides a 0% expected return, provides the same performance as a non-correlated asset that carries a 20% expected return. Math can be compelling and instructive in portfolio construction. A 3% allocation to a 0% expected return investment can give you a 50bps outperformance. Mitigating drawdowns can provide significant long run outperformance in a counter intuitive manner as the math shows us. Click the picture to listen to the talk.

William McChesney Martin on Inflation in '68

After last week's trip to the 90s I decided to head back to the late 60s for another inspection of the narrative around inflation as it was heating up before the famous 70s inflation. I do not have much commentary on this article but encourage you to read it. It is interesting to read about a **Fed chair warning of a financial crisis and inflation**. The article ran in The Austin American in April of 1968. I found the second half of the article interesting considering the current inequality debate.



The Austin American Thursday, April 25, 1968

To Alleviate Inflation

Congress Offered 3-Way Choice

By ALBERT L. KRAUS
(C) 1968, N.Y. Times News Service

NEW YORK — Once again, as he has for more than two years, William McChesney Martin Jr. has warned of financial crisis. Once again, wage earners, businessmen and shareowners — and their representatives in Congress — may find the warning hard to believe.

In his talk to the newspaper editors in Washington last week, the chairman of the Federal Reserve Board said the nation was in the midst of its worst financial crisis since 1931.

At the same time, however, the unemployment rate remains close to its postwar low. Personal incomes, fattened by increased Social Security payments, are bounding ahead. Economic growth in the first quarter amounted to a healthy 6 per cent. And the stock market seems intent on demonstrating its inability to be held down long.

Is it possible that the crisis is not financial or economic but something else?

Martin himself has been careful to distinguish between the 1931 difficulties and the present ones. Then, he said, the problem was deflation — falling demand, incomes, prices and employment. Today, he added, the problem is inflation — demand so great that it threatens a runaway price spiral and a breakdown of the international monetary structure.

There is no question that inflationary boom in time may result in deflationary bust. The more rapid and out of balance the boom, in fact, the more certain the bust. Nor is there any question that the government has the weapons needed to bring about a slowdown if it chooses to use them.

The issue, however, is not simply inflation versus deflation. So long as the economy operates at or close to capacity, it involves the distribution of economic growth — how a bigger pie is sliced.

In this sense, the crisis that has gripped the nation for more than two years is political, or more precisely constitutional. The division of power between the executive and Congress has stymied action. The fixed electoral terms for both branches has prevented a prompt change of leadership or policies.

The executive has proposed a tax increase to help pay for the war in Vietnam and to help correct the problems of the cities. The Congress has declined to vote it. The reasons haven't been clearly articulated and it is difficult to say which are most important: opposition to the war, white blacklash against rioting Negroes, middle class aversion to higher state and local as well as federal taxes, business opposition to a broadening of the federal sector.

Whatever the reasons, Congress — as well as most individuals and some editorialists — appears to labor under the misapprehension that the choice is between a tax increase and no tax increase. Actually, of course, in a fully employed economy the choice is between higher taxes, higher prices and higher interest rates. By declining to vote higher taxes, Congress is legislating higher prices and higher interest rates, it is voting inflation and tight money.

Although no congressman has chosen to do so, a case — albeit a perverse one — might be made for inflation as a way to distribute economic resources. It would begin with the premise that producers are more entitled to the fruits of their labor than non-producers.

It would proceed with the argument that people with jobs are more entitled to consideration than the unemployed, the aged or the dependent young, that the organized and powerful are more deserving of reward than the weak. Reminiscent of National Socialism, it would argue that the fittest, that is the economically strongest, are most entitled to survival.

Similarly, a case — again, somewhat unusual — might be made for tight money as a way of distributing economic resources. It would include the judgment that the stimulus given to housing, to the cities, to small business, to veterans and to farmers through years of low interest rates has been quite enough, and that these favored activities should now deliberately be curtailed.

The chief arguments for an income tax surcharge as a way of distributing economic resources is that it does little, if anything, to alter the present method of slicing the pie.

This still may not be enough. Howard Samuels, the assistant secretary of commerce, argued recently that one-half of the growth in the consumer sector over the next five years should go to solving the problems of the cities. A 10 per cent surtax wouldn't produce nearly this

Higher taxes, however, are not dishonest. They move in the right direction.

Tater Touted

BENTON, Ky. (AP) —Tater Day, held each spring, is the only known day dedicated to the sweet potato. The first Tater Day was held in 1843.

South Africa

I have been posting about South Africa (SA) on twitter for weeks. For me, this all started with the USDZAR chart – where I spotted a likely breakout and went long in early April. Fundamentally the reality vs. perception in SA were a clear opportunity to bet against the rand.

Ramaphosa was elected as the ANC leader which I saw as negative for SA assets but markets disagreed. Despite my bearish thinking, the rand rallied and so did stocks and bonds. The 10yr yield went down about 150 bps and the rand rallied 20%. Recently, more than half of that currency move has retraced (rand is down since Ramaphosa took office) and bond yields are about 50bps from new cycle highs.

I know markets see him as a positive reformer, but I see him and his party at least holding the potential for significant economic destruction with land reform etc. The people in charge in SA are pretty hard core in beliefs I personally find to be unfriendly to growth. We are talking about an emerging economy that grows at a slower clip than most developed countries (1.5% is the best quarter for GDP growth in the last 12 quarters!). GDP growth is at 0.8%, unemployment sits at a staggering 26.7%. Inflation is running at 4.5% and picking up and the central bank has policy rates at 6.5%. Markets are currently pricing in 0.12% higher rates a year from now.

Now that the rand has fallen by nearly 15% in the past quarter while the policy rate was actually cut – pressure to raise rates should intensify soon. This is not an economy prepared to handle higher rates. Food and energy costs are moving up globally so it is difficult to imagine inflation not persisting in SA as we move forward, especially if the currency fall is not stopped at these levels. S&P and Fitch have SA's debt rated as junk, and for now Moody's is gifting the country with an investment grade rating because they are drinking the Ramaphosa Kool-Aid. The biggest debt problems in SA are the SOEs. There is genuine concern about the ability of SOEs to roll over debt. If they cannot, the government which has its own debt issues will be on the hook, which will not be super popular politically considering the looting done by SOEs over the years.

With the US sucking up liquidity and the dollar strengthening as SA grows at 0.8% - the chances of the rand continuing to fall (if the CB does not raise rates and murder the economy) is a very real threat.

We have seen Argentina, Turkey, and Brazil all feel pain as the world watches the US vacuum up capital as it raises rates. This has actually happened without US rates moving up at a steep clip or US financial conditions getting much tighter at all. If this changes, weaker EM countries with structural nightmares and big dollar debt will blow up. **I personally think SA will be at the epicenter of this dollar driven blowup.** In fact, I would rather have my money in Argentina or Brazil or Mexico than SA and it is not even close.

Investors seem to believe Ramaphosa will save the day, but the truth is the structural reforms needed would all cause significant and direct pain to his political supporters. He cannot create the reforms needed without blowing himself up politically, which I assume he will pass on. It is hard to serve your Marxist political allies while also serving global capital markets in a country with many competing pressure groups and ideologies willing to go to the streets.

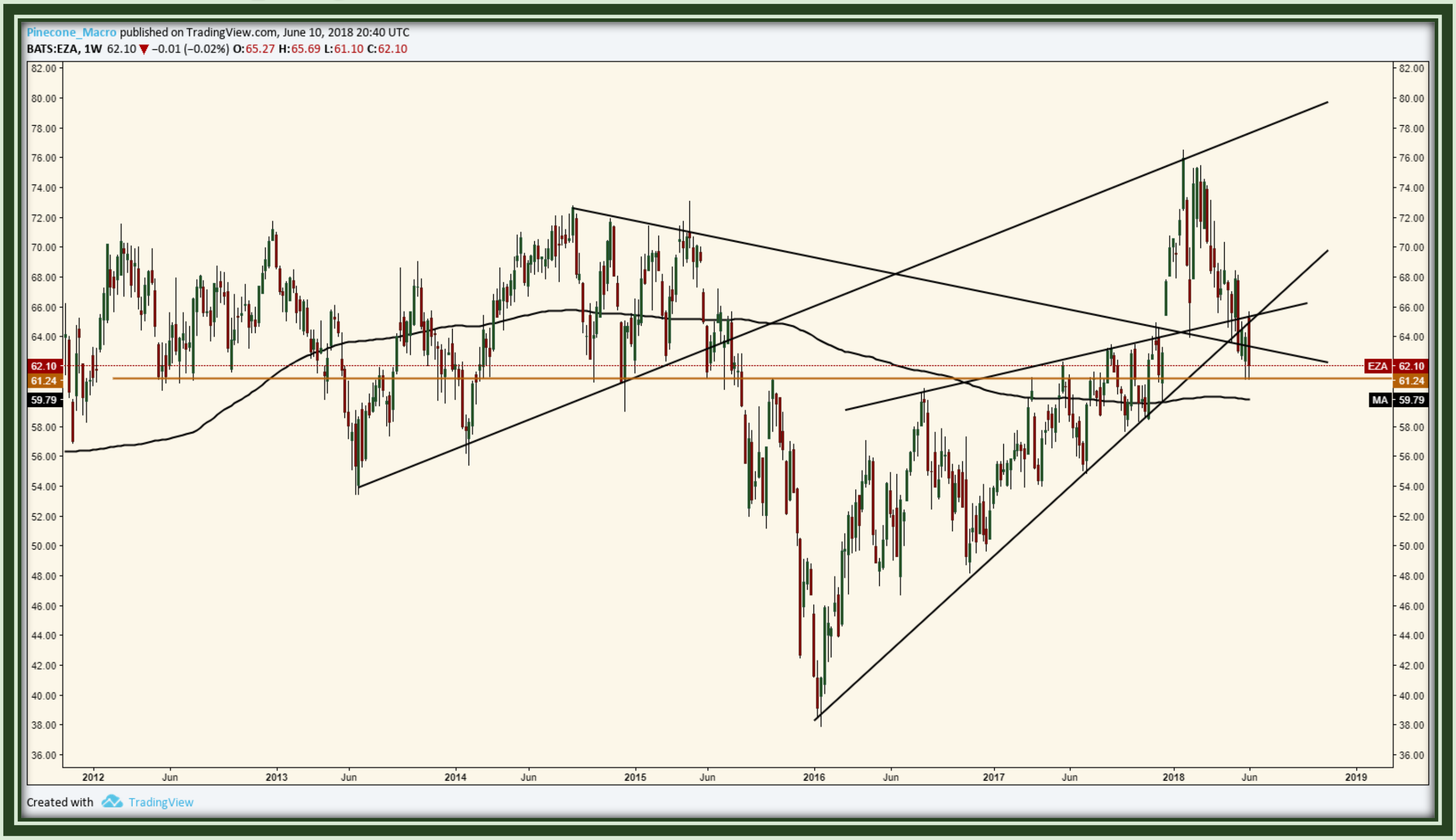
If Brent Johnson of Santiago Capital is even half right about his "dollar milkshake theory" - the funding issues in SA will be enough to break the SOEs, devalue the ZAR – which will necessitate a rate increase against a backdrop of 0% growth, 27% unemployment, and higher government debt to backstop busted SOEs. This would create political chaos and the questioning of not only Ramaphosa, but the ANC. This would lead to a Moody's downgrade and many indexes would drop SA assets. This is the kind of situation an EM country growing at 7% would struggle with, but one growing at 1% in a period of a global synchronized boom.... Perception vs. reality concerning SA investments shocks me. I am short the ZAR and short EZA. As long as the US is able to keep diverging and sucking in capital and causing painful funding issues in SA, and as long as there is no actual hope of sweeping structural reforms (and not the land stealing kind) - I will be short until the charts suggest otherwise. Speaking of, let's take a look at some SA charts.

I am targeting a new all-time low in the rand with a stop at 12 but trading around my small core position as the chart allows. I got long at 11.8.

USD/ZAR

The break of the 200d and the important horizontal line this past week was something to behold. I posted a chart on June 5th with a shaded area of resistance on twitter and warned people that if it gave way there would be a nasty move – there was (3% impulse move).

EZA – SA Equity ETF



We have a broken uptrend, a retest and failure of that uptrend, a failed bounce off of a previous downtrend and a new lower low in the move to end last week. EZA was stick saved by an important horizontal line that has acted as support or resistance at least 20 different days. Price has now tested that line (orange) twice in the move down. If this line gives way, I think a nasty move lower in EZA is likely. I have a stop at $67 and an initial target at $50. My position is small but I will add if we get a daily close under that orange line.

Next up is SA bonds…

SA 10yr Yield

Really quite a move in rates since a massive inverse H&S breakout in April/May. Rates hit a little congestion on an old down trendline and the 200d but then blasted off this week as the rand and SA stocks plummeted.

It has been an ugly month for SA, but the dollar has just started inflicting its pain on SA. With 4 hikes expected from the Fed this year and about $30 billion rolling off of the Fed's balance sheet at the end of the month (moving to $40 in July) where will the relief come from for a zero growth economy that could barely pay its bills before the dollar started its march higher?

Some of us have been watching how the US equity markets react on QT days, and I put that trade on last month and made some money…but I suggest keeping an eye on SA on QT days moving forward. No idea if QT will move EZA on those days but it did have a 1% down day at the end of May, so I will keep an eye on it at the end of this month and compare it to US equities.

That is all for this week, I hope you enjoyed my work. I feel so bearish about SA while so many have been so bullish that it feels as though I could be genuinely missing something. If you have a bullish case or a link to some good bullish research or something, by all means send it my way. Naturally, if the dollar rally is over as some believe, my bearish case loses a ton of steam.

"Floods will rob us of one thing, fire of another. These are conditions of our existence which we cannot change. What we can do is adopt a noble spirit, such a spirit as befits a good person, so that we may bear up bravely under all that fortune sends us and bring our wills into tune with nature's."

- Seneca, Letters from a Stoic

I also heard this said on a podcast this week and loved it – but cannot remember which guest or which podcast.

"Create what you are waiting on the world to give you."

Thank you so much for your readership and if you are enjoying the letter please send it to your friends.

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