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MELLON ON THE MARKETS

By Jim Mellon

Finding value in the shadow of Brexit

Well, I'm on the road again. This time, I'm travelling around the US, in part researching for the new book, which I hope will be out in early May, but will definitely be featured in my talk at Master Investor 2017 on March 25th. The other part of the trip is to observe the US in all its glory – and also to understand its weaknesses.

I am writing this in Mama Mia's Trattoria in Portland, Oregon, after a long and rain lashed drive from San Francisco. Luckily, I am accompanied by my old mate and star stock picker Anthony Baillieu, he of Syrah and Aurora Labs. I will be going to Seattle, Jackson Hole, Boise, Boston, St Louis, Denver, Savannah, Memphis and Nashville, with lots of other stops. Then a grand finale back in Frisco.

In San Francisco, where I spend a bit of time and have an apartment, I met with some amazing so called key opinion leaders (KOLs) in the field of longevity and ageing. Everyone I have met in this field has been extraordinarily generous with their time and careful in their explanations to a neophyte. (Big call out for Aubrey de Grey, Laura Deming, Len Hayflick and Walter Borz.) On this trip, we have some exciting stuff lined up in Boston as well.

Similarly, in Oxford, the labs of Professor Alistair Buchan and Professor Matthew Freeman have proved enlightening. Without spoiling the story, which is still being written, I have seen in Oxford the actual atoms of a molecule displayed on a screen in 3D, which is something just a few years ago no one thought possible. Clearly, once the atomic structure of cells is revealed, so much more can be understood about their workings. And without a doubt, the keys to the story of ageing lie in the basic building blocks of our bodies – cells.

So I will speak of Al Chalabi's and my new book, *Juvenescence*, at MI, as well as giving my tuppence worth on markets and opportunities for investors. As attendees know, MI is a serious event, not given to pointless rants by those who couldn't spot a winner if it was presented to them on a plate. Collaborations with the likes of Fidelity International, Seven Investment Management, Syndicate Room, ISDX and Edison give me tremendous hope for the show. Our objective is simply this: to provide a collaborative platform for investors, companies, management firms and other practitioners of the art and science of making a return on assets. And in this, we succeed very well. I am excited about seeing everyone there. It is selling out fast so please do register. The ideas we presented last year have done particularly well in the past twelve months, and I will have a new crop to show this year. Ranters and attention seekers please stay away!

Moving on, I have a few observations from my trip in the US. Starting in San Francisco, home to the world's largest and most influential technology companies, any observer will see what is right and wrong with the US in a microcosm. Huge brand new tower blocks rise to accommodate the legions of tech workers who flood into the city pushing rents to the highest levels in the USA. Meantime, and everywhere, the poor and dispossessed, the crazy, the down-at-heelers and the addicted sleep on the streets and roam the town.

There are an estimated 40,000 homeless in San Francisco, about 5% of the population, and it is a shameful sight to see them, hopeless and unconnected to the gleaming world all around them. And yes, these dispossessed are everywhere else in the US, living cheek by jowl with abandoned cars, rusting trailer homes and quite stunning scenery. No doubt, this level of wretchedness will be evident on our whole drive through the US, excepting some manicured enclaves reserved for the rich and fortunate.

These scenes do not exist in Europe in my experience; sure, there are poor and homeless people, but not on the scale evident here. If you don't make it in the US, life is unkind, and once discarded by society, there is no easy way to climb back on the ladder.

Although California voted for Hillary, it's easy to see why Trump won. While levels of inequality in the UK have been falling, in the US they have been getting worse. It's hard to see what can be done; Trump's prescriptions of "America First" sound fine to the lower rungs of society, but informed readers appreciate that free trade is a great thing, and any barrier to it should be removed. Walls of physical or metaphorical types result in less prosperity, not more.

I can see Trump finding a way to tame the untrammelled transfer of wealth from the have-nots to the tech titans, most of whom he clearly has little time for. If you ask me, I think the days of Facebook (NASDAQ:FB) and Alphabet (NASDAQ:GOOGL) are ending, partly because they will become regulated utilities, and partly because hubris and size will inflict their own brand of Schumpeterian destruction on them.

I have mentioned this paradox of extreme wealth amongst the *sans-culottes* before, but it's getting worse. Probably the worst thing that could happen is that Trump can't deliver the hoped-for prosperity to the poor of America, and that amidst rising discontent he engages in that old trope of unpopular leaders, foreign adventure. I am hoping not, and it is weird that just months after having railed against the elites of Wall Street he is engaged with those very same elites to the point where they largely populate the top ranks of his administration. Interesting times, but so far, we all live on and the stock markets remain robust, particularly in the US.

I said in the last *Mellon on the Markets* that I thought the US was priced to perfection, and I stick with that. The quality of earnings in the US is deteriorating, buoyed by share buybacks and increased leverage, and the strong dollar will soon be a drag on reported earnings from overseas. A cut in corporate taxes is already priced in – and the cherry-picking of companies on a daily-shame list from the White House isn't conducive to getting the wheels of capitalism to run smoothly.

There are some US companies that look great, however, and I will mention them in Master Investor. The US remains the bustling centre of enterprise and research in the world and nothing will beat it for many years to come. It's just an expensive ticket to buy into it right now.

Meanwhile, my view that Brexit is a sideshow to much bigger problems in the EU appears to be coming true. A true cultural feast of terrible possibilities is displayed before us now. Where to start? The Dutch elections, the French or the German? Or the renewed travails of Greece? Portugal's effective bankruptcy? Or, more pressing, the certainty that Italy is in a debt trap?

All will be elaborated on at Master Investor 2017… But just consider this: although bond spreads between Bunds (German bonds) and those of the less prudent European nations have been widening, they are nowhere near wide enough to justify the risk of holding them. If you are foolish enough to buy Italian long bonds with a yield somewhere just over 2%, you deserve to lose your money, your house and spouse.

Given Italy's totally intractable position within the common currency, and its permanently rising debt, the better rate would be 10%, and even then, that might not compensate for the prospective devaluation of the new lira when (not if) Italy leaves the Euro.

Italy's debt to GDP ratio is now 132%, it has only run two years of primary budget surpluses since 1992, its nominal GDP has not and cannot outrun the increase in debt, and interest payments are just shy of 4% of GDP. In short, it's up one of those creeks, of which there are many in Oregon, without the proverbial paddle.

As they say on planes, "assume the brace position".

Happy hunting!
Jim Mellon
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