MELLON ON THE MARKETS

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By Jim Mellon

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The dog days of the markets are apparently what we face for a while. There is no discernable trend in the equity markets of the West and even Japan seems to have stalled, hopefully temporarily. China is the only major market, (soundly recommended by Merryn Somerset Webb at the recent Master Investor conference), to be making headway. It's pretty speculative stuff though , with a couple of HK listed stocks engaged in solar power, in one case and – wait for it – fine wine and horses, in the other, losing over $50 billion worth of value in two trading days. That's the equivalent of one hefty British FTSE company going up in flames overnight!

But underneath the drifting flows of the markets, there has been a lot of paddling. At Master Investor 2015 (and if you weren't here you can see my speech here) I had a few conviction trades.

One was to short all low yield or negative yield bonds, and in particular the **10 year German bunds**. They were then yielding about 0.2%, and in the past ten days there has been a flash crash in prices taking yields back to over 0.7%. This yield still remains too low and I remain short 10 year bunds, but I would also look at shorting French or Italian bonds for the same reasons. Risk premia have been distorted by the ECB agreeing to buy vast quantities of sovereign and corporate bonds from Eurozone issuers, hoping to drive peripheral bond spreads down against Bunds and French Oats. This hasn't worked, so I suspect that the ECB will look to do its QE in a different way, buying more corporate bonds, or even bank bonds, to ensure a greater pick up in lending activity in the still depressed Mediterranean parts of the Eurozone.

It may at first seem counterintuitive in the context of QE that interest rates have gone UP, but it is in fact entirely logical. There is a lot of front running of central bank buying to begin with, but then the speculators lose hope, especially with a depreciating currency, and bale out. That is exactly what has happened in the case of the Bunds, and I feel that yields in 10 year German paper should easily exceed 1 per cent in the near future. After all, the asset bubbles caused by QE in property and stocks are potentially inflationary, as is the devaluation of the euro and the recent bounce in oil prices – so why wouldn't interest rates go UP? They are thus up and will continue to rise.

As far as stocks are concerned, we seem to have reached an impasse in the US. Clearly, earnings momentum is being lost, and the US corporate financing gap has now gone negative for the first time in a long while. This means that US companies are not generating enough cash flow to cover their commitments – including cap ex, interest, and most importantly the buyback of their own shares – a trend which has been a major helping hand to indices in recent years. This bodes badly for the markets, and while I am not signalling a major correction, we are now in pass-the-parcel mode.

We are seeing some evidence of this in more 'glamorous' stocks rapidly turning into fallen angels ; I advocated a short of**LinkedIn** at Master Investor , and it is now down by a quarter since the show. But LinkedIn is just one member of a cohort of stocks that could easily tumble if their earnings disappoint overheated expectations. I also suggested shorting **Just Eat** in the UK, and although this is down a bit, I would stay short.

Good quality stuff continues to do well; **Galapagos**, another conviction idea is now up 50% since the Show, and I would take half of the table, as the outcome of discussions with AbbVie for its lead drug will be binary.

I would stick with **Synergy Pharma**, listed in the US, which I think will be taken over. It is moving up, and I like the stock action.

In currencies, so far my **Swiss Franc** short is a little against, but it remains a conviction trade. I would hold on to it if you have the stomach for it. **Silver** conversely, is now in profit, and I would run with that. My target for that is at least $20 per ounce before year end, so with some leverage that could be a cracker.

The **Yen** is falling a little against the US dollar, and while it just might go to 125 against the greenback, I would not play it, and wouldn't hedge what should still be a long position in the **Nikkei**. Target there is 22,000.

Sunny Optical, another recommendation is up hugely since the show, benefiting from the HK/China speculative bubble that is going on at the moment. I would take profits there. Elsewhere, I would hold onto **Fanuc** and **Kuka** in robotics… they are destined to be long terms plays. I love robotics as a sector and I hope to have a couple more ideas for you in the next issue of Master Investor Magazine.

Since the Master Investor show, of course, the results of the British election have become known. A brief flurry on the FTSE and a bounce in the pound were all too fleeting and it's back to more drift. The scale of the problems that the UK faces, including the fiscal and trade deficits, mitigate against any huge uptick in either stocks or economic activity. Capital investment and savings rates remain woeful, and of course there is the upcoming referendum.

I believe that the UK should leave the European Union, and thus be open to immigration from places which could yield us a healthier crop of talent than the largely unskilled migrants who come "a volonte" from the other 27 members of the EU.

The country has no future as a manufacturer of heavy goods, and we need, as examples, to develop in robotics engineering, in new material technology, in space technology, and of course in the internet of things. None of this will happen unless we have sufficient people of high calibre working in these fields. And we certainly don't have enough of them now.

At the moment people from China, India and the US, for instance, are being barred from entering our country to accommodate the tide (one a minute) of migrants from the EU.

If Cameron can't – and by the way he won't – negotiate a better deal, then of course we should leave. As the most important export market for many EU countries, we can negotiate a customs union, and avoid the inevitable decay that comes from being part of a bureaucratic, inefficient and rapacious Eurocracy.

Now if that happened, I really think the FTSE and broader market could take off, we would be exceptionally attractive to foreign investors and sterling would rise. Until it happens, however, there will be continuous uncertainty, and general stagnation in the domestic financial markets is to be expected. These types almost always get it wrong, and on this issue they will do so again. I think the result of a referendum will be close, as the EU and the UK government will spend taxpayers' money on a campaign of North Korean proportions to encourage the result that they want.

Until next time, when I will have some fresh recommendations…

Happy Hunting!!

Jim Mellon

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What Jim read this month

Cars of the Future, Today

From Mish's Global Economic Analysis- http://globaleconomicanalysis.blogspot.co.uk/2015/05/cars-of-future-today-flying-car-and.html

"The pace of technological advancement accelerates every year"- sound familiar? Mike "Mish" Shedlock takes a look at two prototype cars set to revolutionise the future of transportation: a flying car that wouldn't look out of place on the Jetsons and a two-wheeled self-balancing car that puts even the most pimped-out mobility scooter to shame. The prototypes have a little way to go before they are ready for the consumer market.

What Was the Worst Prediction of all Time?

From The Atlantic – http://www.theatlantic.com/magazine/archive/2015/05/the-big-question/389582/

The Atlantic compiles a name and shame list of the worst predictions made by so-called experts over the years, from David Pogue's statement in 2006 declaring Apple will "probably never" release a mobile phone, to the baseless "peak oil" hysteria. It makes for an entertaining, if a little embarrassing, read. Thankfully none of our own writers made the cut.

Moving to Mars: Preparing for the Longest, Loneliest Voyage Ever

From The New Yorker- http://www.newyorker.com/magazine/2015/04/20/moving-to-mars

The New Yorker's Tom Kizzia looks at the challenges astronauts will face on the impending (if we are to believe the excitable experts) voyage to Mars. Using the early polar expeditions as example, Kizzia looks at the extreme isolation and arduous journey ahead of any aspiring Martian explorer.

Uber Fund-Raising Points to $50 Billion Valuation

From The New York Times - http://www.nytimes.com/2015/05/09/technology/uber-fund-raising-points-to-50-billion-valuation.html?_r=0

That's right, Uber is fund-raising again. Everyone's favourite black cab bothering, billion dollar start-up is looking to fund strategic partnerships -not expansion- pointing to a $50 billion valuation. Only one other Silicon Valley start-up attained such a valuation as a private company: Facebook. Hail a cab no-more. All hail Uber.

Zuckerberg, Tech Investors Fund AltSchool Initiative

From USA Today - http://www.usatoday.com/story/tech/2015/05/04/altschool-scores-100-million-from-mark-zuckerberg-and-others/26740867/

Unfortunately, the irony that the man who brought us Facebook, heralding a new age of procrastination for the world's disenfranchised youth, has backed a reform of the American education system seems lost on the author… It is revealed a number of tech investors, Zuckerberg included, have pumped a $100 million dollar boost into AltSchool. AltSchool uses tailored software to personalise a student's educational needs and aims to allow teachers to "be their best selves" leveraging technology. With such high-profile backing, it looks to be a welcome solution to America's highly criticised educational system.