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MELLON ON THE MARKETS

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My birthday lunch in Brussels last month was a jolly affair, with 21 people attending, including the editor of Master Investor. After the lunch, and after its effects had worn off, I turned to contemplation. No, I haven't suddenly gone all "mindful", but February 17th has always seemed a good day for internal reflection. And some of that reflection of course has to be about the past year's mistakes, some personal and some investment related.

My main error in the past year, from an investment point of view, has been to underestimate the general stupidity of governments and their central banks. Today, one third of the world's developed economies have negative interest rates on their government bonds. Japan, Sweden, Switzerland, Germany and others all get paid by investors (possibly not the right word for this pack of morons) to hold their bonds.

The idiots who buy such bonds are playing a greater fool theory, which ALWAYS ends in tears. No doubt, the governments that issue these types of negative yielding bonds think they are being clever; after all, what is not to like about receiving interest rather than paying it?

What is not to like about the idea that by forcing investors and banks to acquire riskier assets, they are somehow or other kick-starting their faltering economies into life? In addition, these negative interest rates have the general effect of making the currency of the underlying issuer less attractive, with capital flight to higher yielding bonds elsewhere, and a welcome fillip to the export sector of the issuing nation.

The idea runs further. With negative interest rates, and a declining currency, incipient or actual deflation in the issuing country gets exported elsewhere, and the (vain) hope is that inflation begins to pick up domestically. Fat chance.

What these fools don't realise (and Janet Yellen does, albeit belatedly) is that by engineering a "false" rate of interest, either very low, or below zero, three things happen.

One is that the domestic savings industry gets destroyed. How can pension funds, insurance companies and wealth managers generate any sort of return when they are crowded into trades where a negative return is GUARANTEED? In countries such as Germany or Switzerland, this destruction is becoming evident, and the consequences are dire. If people prefer to hold cash, or not to go into savings plans, the flow of capital required to build factories, replace machinery and undertake research and development dries up.

That is why the capital stock of countries such as Germany and Japan is ageing at the same rate as the population – i.e. fast. That means that productivity growth – which is almost zero – will continue to decline, and the consequences are horrible.

In addition, the assault on savers means that pensions provision (and can any of us live on state pensions?), at a time of demographic urgency in most developed nations, will become less and less adequate. Make no mistake, the United Kingdom is in no better position than Germany and Japan, despite the fact that we still have marginally positive interest rates. Our less-than-Iron Chancellor is attacking pension savings with gusto, beggaring the future for short-term political gain. He won't be around (hopefully) to see the effects of his "raids" on pensions, but all of us will suffer as a result. He is an arch tinkerer without a clear vision for long-term growth, and I hate to say it, certainly not a "conservative" chancellor.

Of course, some will argue that negative interest rates are having some effect on spurring alternative investments, which might spur economic growth. My analysis of this is the opposite: rather, it seems to be encouraging speculation in gold (the cost of holding gold is less than the cost of holding cash in many cases), and in financial engineering by companies (e.g. share buybacks), as well as in unproductive property.

Knut Wicksell, of whom I will be speaking at the Master Investor Show in April, suggested that a "normal" interest rate should be one at slightly below the return on new capital investments by corporations, encouraging companies to borrow at an appropriate rate to fund productive investments.

A negative interest rate suggests a dysfunctional economy, one in which large corporations reap a windfall from the lower cost of debt, but smaller, entrepreneurial companies are frozen out of the market for debt. Zombie companies, which in a normal economy would be put out of business, are sustained by low debt servicing costs on their existing debts, leading to a tremendous and injurious misallocation of capital.

The second reason that negative interest rates are so bad for us is that banks – already hit by fines, the requirement for more capital, and challenges from a largely unregulated internet based fintech sector – can't make money. If they can't make money, they can't lend money, and that leads to further deterioration of the economic outlook.

And the third reason that negative interest rates are *so, so bad* is that savers, some dependent on income from interest, end up taking risks that they shouldn't, leading in some cases (many cases in future) to penury and dependence on the (impoverished) state.

All of this means that we are governed by idiots, that the funds that buy these negative interest bonds are managed by morons, and that most central bankers should be pilloried and removed from office.

Will this change? Well, if it doesn't, the long-term effect is likely to be economic catastrophe. This is why I feel that Mrs Yellen, who now "gets it", will continue to increase rates this year, albeit at a gentle rate, and that we can expect a rise in US rates before the end of the year.

As I have written before, this is likely to lead to a DECLINE in the US dollar, as normally (and perversely) happens when US rates rise. So I would generally be a BUYER of the Euro (despite its mounting problems), and possibly a buyer of the pound. I am neutral on the Japanese Yen and on commodity currencies.

As long as these beggar-thy-neighbour policies persist, however, and people talk about the abolition of cash, gold will benefit, and I suspect, as I wrote last time, that gold and silver remain great buys.

Stock markets remain range bound, with lots of day trading potential, but little longer term upside, except in the case of Japan, and now, just possibly, the beaten up emerging markets. I have been playing the in and out game, but I am able to do so because I monitor the markets closely, and have an able team helping me.

For those poor people dependent on pension fund managers who buy negative interest rate bonds, or insurers who are forced into sub-prime assets - God help them.

Happy Hunting!!

Jim Mellon

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