MELLON ON THE MARKETS

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It's summer's end, and I am ready to go off to Hong Kong, away from Ibiza's (for me) innocent charms. Believe it or not, I spend six hours a day here in a local café, where I have a kind of Stammtisch (Germanic for engraved, personal perch), reading and pondering.

These last two months have proved the worth of doing just that. Old certainties, such as the inexorable rise of the Yuan, and the infallibility of the Swiss franc, have been roundly trashed. In fact, as many a hedge fund has found out, there are NO certainties in investment.

Who, for instance would have thought that Volkswagen, the joint top dog in autos, would be exposed for dodgy emission controls in the US – a move which is going to result in BPesque fines and punishments? The VW saga is just starting, and I wouldn't be surprised if grasping governments everywhere try to extract their pound of flesh, severely weakening the company. This is potentially much worse than for BP, where it only lost out in the US. And who knows if other car manufacturers didn't do the same? I have been eyeing my Nissan Qashqai with a faint air of suspicion since the story broke.

Similarly, some idiot from Turing Pharmaceuticals has come out and added noughts and noughts to the price of an ancient drug; this has prompted a flagging Hillary Clinton to jump on the undoubted usury of the specialty US pharmaceutical sector, where drug prices seem to rise for whimsical reasons with no regard to patient costs, or cost of goods.

I have mentioned this as a key risk in biotech in the past, and now it comes to pass. That's why we like pharma/bio companies where there is little risk of pricing pressure in the world's biggest market, which remains the US. For instance, I would be very wary of owning **Alexion**, which stands atop a US 30 billion market capitalisation with one single drug, Soliris, which serves about 5,000 patients around the world with a $400,000 cost per patient per YEAR! Closer to home, **Shire** might well also come under some pressure for the cost of some of its orphan disease therapies.

So, the message is stick to companies where the drug cost is low, the effect is positive, and there are unlikely to be federal pressures to reduce margins. **Synergy**, recently recommended, is one such company in the US.

But back to the key point, flexibility is the watchword in successful investment, with some diversification, but most importantly, a careful understanding of risk and rewards. NOTHING is certain, and a long term investment is generally a short term investment gone wrong.

So where are we now? The Fed didn't bite the bullet and raise interest rates (which it should have done), but it will, and my guess is in December. It is true that inflation remains ultra-low in the US and in many other economies, but capacity constraints will soon show up in pricing pressures (particularly in wages) and the effect of low oil prices will gradually abate. In addition, the misallocation of capital caused by perpetual ZIRP is something that the Fed recognises – and will address. It is entirely possible that another QE programme could be implemented, this time focussed on buying assets other than government bonds, while at the same time the Fed raises shorter term rates.

For the moment, there is little need for such a move, as the US economy is relatively robust, despite the strength of the dollar and the consequent weak performance of exports. One thing to note, however, is that US corporate profits, rising as a percentage of GDP for decades, may now be going into reverse. This is partly because so much of large US corporations' earnings come from overseas, and these are now pressured by weak Asian markets and the dollar's strength. But it is also a function of the move to "living wages" across many developed countries, including the UK, which seeks to rebalance the share of economic spoils away from shareholders to employees.

This may not be a long lasting trend. Indeed, as wages rise, particularly for low paid workers, we may find that automation and robotics, already in the ascendant, get an additional spur. But for the moment, US corporate profits are under pressure. This makes the equity market even more vulnerable, and a gentle decline, with some violent episodes, is my forecast for the S&P. Bear in mind that the US has exceptionally high rates of corporate tax, and that balance sheets are being eroded by the continual practice of share buybacks, which has sustained earnings for some time.

As I have said before, China's fictional growth figures are now being exposed as tosh. China appears to be growing much more slowly than the commentariat thought, and no doubt this will hurt earnings, along with the need for the banks (a big chunk of the Chinese stock market) to get real on non-performing loans (NPLs).

But, as I wrote in the last letter, this might be a chance for us to establish positions – after all when all around are panicking, we followers of the **Master Investor** creed, with cool heads, are the ones buying!

And we have done just that, focussing on China large company ETFs, although I admit I was a little early on the call.

Similarly with Greece, we bought when the streets were rife with riot and disorder and Merkel was the greatest villain since, well, you know who!

And that has worked out nicely. The stock market is up a lot and remains cheap, and even the economy appears to be stabilising. I have no doubt that Greece will have to leave the euro at some point, but it's some way off and for the moment I would hold **Hellenic Telecomm** and the **National Bank of Greece**. It seems that NPLS may not be as bad in Greek banks as first thought.

A good proxy for China and emerging markets in general is **HSBC**. Its dividend yield of 7.2% (yes, amazing!) is well covered, it has strong capital, and is well diversified. It is run by banking veterans and is surely a good buy. In fact, as I write this, I am going to buy more! As long as a VW/BP type situation doesn't befall it, I think we should be OK with this one. This will be the second time in (and hopefully!) out this year.

In a world of uncertainties, a reasonably certain outcome is a lower **Swiss franc** as a banker (pun intended) and I remain short CHF against the USD and Euro. I remain convinced that, despite the fact that the Fed didn't raise interest rates, crazy low bond yields – and in some cases, negative ones, as in the case of the CHF government bonds – are good sells. What sort of idiot lends money to the Swiss government to receive a negative interest rate of nearly 1 per cent?

Well, there are clearly plenty of them around and I would love to meet some of these gullible lemmings to sell them some of the "long term investments" in my own portfolio.

And on that subject, remember that many of the unicorns (tech titans) of today will be the dogs of tomorrow!

Stay diversified, agile and wary.

Happy Hunting!!

Jim Mellon

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What Jim Read This Month

Restaurant of the Future? Service with an Impersonal Touch

http://www.nytimes.com/2015/09/09/upshot/restaurant-of-the-future-service-with-an-impersonal-touch.html?em_pos=small&emc=edit_up_20150908&nl=upshot&nlid=65452075&ref=headline

Usually when an article begins "There's a new quinoa restaurant…" my interest dissipates faster than the next fad-diet, but Claire Cain Miller takes a look at the robotic restaurants taking San Francisco by storm. Here you can order your food and get served without ever having to interact with another human being, presumably also without having to leave a tip. Paradise for misanthropes like us.

Scientists discover 'flu severity' gene

http://www.ft.com/cms/s/0/5ae8e68e-555b-11e5-97e9-7f0bf5e7177b.html#axzz3mTvXcXar

No, it's not simply a Y chromosome… Scientists at the Wellcome Trust Sanger Institute near Cambridge have discovered a link between the severity of patient symptoms infected with the flu virus and the IFITM3 gene. The gene is thought to strengthen cell walls in certain individuals, protecting against the virus. The discovery could lead to a 'tailored' approach to the winter flu vaccine.

Uber Would Like to Buy Your Robotics Department

http://www.nytimes.com/2015/09/13/magazine/uber-would-like-to-buy-your-robotics-department.html

Everyone's favourite Taxi-Taunters are back and this time they've got their eye on the academics, in fact whole departments of them. In what's been called the 'Silicon Valley Talent Binge', Uber has lured away 40 senior employees from the Carnegie Mellon University robotics department to work on their own project at their newly opened Advanced Technologies Center in Pittsburgh.

The Sardex factor

http://www.ft.com/cms/s/2/cf875d9a-5be6-11e5-a28b-50226830d644.html

What do you do when you graduate with a Humanities degree and try to get employment on a Mediterranean island ravaged by the financial crisis? You make your own currency of course. And that's exactly what a group of childhood friends did, creating Sardinia's first local currency, trading €31.3m in Sardex this year alone.

A bridge to the future

http://www.economist.com/news/technology-quarterly/21662647-civil-engineering-3d-printing-technologies-are-being-adapted-use

We all know that robots will eventually steal our jobs, but construction workers may have a new threat – 3D printers. New 3D printing technology is being developed that means the objects being printed are no longer restricted by the size of the machine. This innovation could pave the way for entire structures to be built autonomously.