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MELLON ON THE MARKETS

By Jim Mellon

It's a Glittering 2017 for Commodities.

My family has gathered on the Isle of Man for the holiday period, and a jolly time we have had. The one unpredictable and notorious feature of this beautiful island is the "four seasons in one day" phenomenon, which means we go from lashing rain to bright clear skies in literally a matter of minutes.

And isn't that the story of the markets in 2016? Convulsive gyrations, mostly downwards when reality of the outcome ran against the conventional wisdom (Brexit, Trump, Italian referendum); then recovery – and a resumption of the developed world bull markets that have become very long in the tooth, particularly in the United States.

So, we end up 2016 with a positive overall performance by most major indices, but with huge internal rotation on the way. The US dollar has been on a real tear in the post Trumpian world, especially as the Federal Reserve has signalled a resumption of interest rate rises for 2017.

Post Brexit, most commentators had a negative view of (the) markets. There was a strong belief that the apocalyptic pronouncements of the (now derided) cohort of experts, drawn from an army of economists, politicians as well as such luminaries as David Beckham, would be proved right.

Well, surprise, surprise! How wrong they have been proved to be. And Niall Ferguson, one of the original hand wringers, has had the decency to admit just that!

Although most of these self-described experts now have the default view of "just you wait and see", they have missed out on a truly huge move upwards in almost all large cap UK stocks, one which carried over to the markets of other major developed nations. Sure, some of that move was due to the positive exchange effect of a falling Sterling (well overdue, Brexit or no Brexit); but much of the move has been due to a realisation that the UK might do quite well out of this after all. Threatening noises from some outright prats in Euroland (M. Barnier comes to mind, along with Herr Martin Schulz and the Prime Minister of Malta (who he, Ed?), have had little effect on sentiment.

The fact is that the UK economy continues to bowl along quite well; I would wager that 2017 will see another year of circa 2 per cent real growth, outpacing all the major European economies for the umpteenth year in a row. I would also forecast that our current account deficit will shrink dramatically, and that inflation will not be anywhere near what doomsayers were projecting – maybe 2 per cent. I also project a slight strengthening of Sterling, as the dollar weakens somewhat, and the Euro against the pound also falls. I think the British market is valued, and that investors won't be able to ride a surge as in 2016 – they will have to look carefully for bargains.

The same game was played out post The Donald's election; dire predictions followed by a resumption of bull markets. In each case the paroxysm of anxiety in markets, induced by the collective horror of the liberal elites, was quickly replaced by the reality of President-elect Trump's overall purpose. This is to simplify the ridiculously complex US tax system, to encourage repatriation of offshore cash held by US companies, and to ease the regulatory burden on enterprise. I am sure that the protectionist guff will be toned down, and indeed that new trade treaties will be negotiated, at least in part. I am sure the UK will get a treaty with the US in the immediate period post a Brexit. Within 3-4 years. Considering that the EU didn't manage to negotiate one with the US in the last 50 years, that will be a considerable achievement!

But the good news is now well baked into US prices, which depending on the methodology show the markets to be somewhere between either ridiculously overvalued or somewhat overvalued. This is especially the case now that the US dollar has risen to 14-year highs against a basket of currencies. This is not a warranted valuation, and while weakness in the yen and in the yuan, as well as in the Euro and Sterling, might be cheering to their respective central bank chiefs, it isn't justified at these levels.

US earnings are about 50 per cent driven by foreign derived income and these will be highly affected by the greenback's strength – at a time when earnings were rolling over in any case, partly due to wage pressure.

I have been a big proponent of shorting the yen, but when Evil and I met before Christmas at his local for a small dose of cheer – principally to discuss our shared race horses – we both agreed that the yen's fall was overdone. Sure, the Bank of Japan has been acting like a confetti factory on overtime, but the US isn't Switzerland, and there is a price for everything. The bottom price for the yen has been reached, and I think the US dollar could fall back to 114-115 fairly smartish, which for nimble traders is a good opportunity.

Similarly, I am bullish on the Euro at this level. The Eurozone's problem hasn't been one of exports; it has a big current account surplus with the rest of the world, and that will only grow with the multi-year weakness of the Euro against the US dollar. The problem for the Eurozone is and has been domestic demand, which remains woeful, particularly in the periphery. There is no end in sight for that, nor is there an easy fix for the Eurozone's banking problems. The Euro as a currency will be toast in the relatively near future, and its shape cannot be determined post split-up. But that is at least a year away, and in the meantime, I see a quick bounce in the Euro against the dollar to 1.08 from 1.04, and that to traders such as us, is a BIG move.

My friend Steen Jakobsen has highlighted the stresses beginning to show in China, with short-term offshore yuan financing costs spiking, as traders anticipate a devaluation of the Chinese currency. This downturn is exacerbated by very large amounts of capital flight – and this is strongly evidenced by the massive fall in forex reserves at the central bank. One way people get money out of China is via yuan Bitcoin, and that is spiking, too. Tin hats on for this one, as China's problems, while probably containable for the short term, are big. The bad debt situation is dire, and the quantity of debt is almost beyond comprehension.

There are two very big fault lines in the world economy for 2017; the perennial one is of course my bete noir, Europe, and the second is China. Both demand that we as investors remain heavily exposed to gold. Don't worry if it falls a little from here; it's just another opportunity to buy more. I really would be big in gold and silver for 2017; I would remain short bonds, particularly Italian and Japanese bonds, and I would be out of the US market and cautious on markets elsewhere, except for Japan, which has really developed a taste for share buybacks and is still cheap.

Top stocks for now are Sony, any Nikkei ETF, any gold ETF, Billing Services Group in the UK, and Synergy Pharma in the US. Top shorts are almost every bond out there, Amazon, Facebook and Plus 500 in the UK.

People are signing up to the Master Investor Show at a rate of 300-500 a DAY now, so please get your ticket as quickly as possible as it's going to be massive, constructive, educational and fun. It's on 25 March 2017 at the Islington Design Centre in London. I hope to see you there.

Happy hunting!

Jim Mellon

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