MELLON ON THE MARKETS

January 2015

By Jim Mellon

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The pandemonium in the foreign exchange markets has been something to behold; when the Swiss National Bank unpegged the franc from the euro rate it had established as a floor last week, the **Swissie** soared at one point by 39 per cent. This is absolutely the biggest one day move in a major currency in living memory, and has had the effect of wiping out a number of forex brokers, putting some others under the spotlight, and busting at least one major fund, **Everest**. Many people thought they were being smart by continuously selling Swiss Francs to the central bank, only to be bitten in the proverbial when the Bank did exactly the opposite of what was expected . **Saxo Bank** had to reset its customer's trades to avoid what are posited as losses for itself, and the whole industry of leveraged foreign exchange trading must now be under a cloud, especially as margin percentages will rise sharply.

The real lesson of all of this mess is never to trust a Central Bank and the so called wisdom of the crowds. One day before they acted, the Swiss were verbally defending their peg with solid words, the next day, causing mayhem by reversing position.

Whether or not this was a good policy move is yet to be determined; a million trees have been felled so far in analysing the consequences of this dramatic action .But what it is, is symptomatic of the peripheral, and soon to be mainstream, effects of central bank interventions on such a massive scale on hitherto free markets.

The move to zero or ultra-low rates in almost every sort-of solvent government bond market is an artificial construct of monumental bond buying by central banks. This has been the policy response of every major bank, soon to be amplified by the expected moves by the European Central Bank on the 22nd January. These policy moves have utterly changed the dynamic of markets, and while in some ways it makes them more predictable in the short to medium term (i.e. go with the tide of central bank moves), it will, as with the Swiss situation, lead to catastrophic and systemic losses when the policy is abruptly reversed, as in many cases it will undoubtedly be.

In the last letter, I talked about sifting for probable outcomes among lesser uncertainties, an unscientific art if there ever was one. I spoke of my absolute conviction that the euro was headed down (now at 1.15 – but beware, I think it may be due a short term bounce), and that the yen had been oversold, with every analyst then calling for it to be weaker. And so it has proved. The Swiss situation, on the other hand, was a probable train wreck waiting to happen and those who were short Swiss francs (or borrowed them to fund investments) were playing a game of chicken which would end with their heads lopped off.

So let us look for the other mugs who are "playing a Swissie" in markets elsewhere. I think it is fair to say that the absolute consensus is the ECB will unveil a monster QE package, and bond yields in the Eurozone are forecasting this- and negative inflation to boot. What happens if the package disappoints? Probably bond yields in France and Germany will rise – and so I am short the **Bund market**. At the same time, the euro will rise – short term. I see a technical bounce in the Euro to possibly 1.20 against the dollar. And this is the first time in two years I have removed my euro shorts!!

US interest rates continue to fall, despite robust growth in the domestic economy; I feel that this is based on expectations of ultra-low inflation and of small, if any, interest rate rises for the foreseeable future. What if this didn't happen? Actually, I think that there may be a negative surprise in this respect, as wage inflation begins to seep into a nearly fully employed economy, and that yields could rise sharply in the US later this year. So short – but cautiously - the US bond market at the long end.

Meantime, the Japanese bond market, now way overbought by a sole buyer, the **Bank of Japan**, represents perhaps the greatest toxic threat to world markets that there is. Interest rates at the long end measured in small shoe sizes might just be one of the greatest shorting opportunities of the next year. They yen, meantime, I am neutral on, but remain a huge buyer of the **Nikkei.** This is the only market as a whole that I am bullish on, and see 20,000 on the Nikkei as a target for this year.

What of other markets? The crack (not) forecasters who in mid-summer were calling for a rise in the oil price from US 110 per barrel got it totally wrong. Now there are trying to make up for past mistakes by forecasting oil down to US 20 or less a barrel. Let's get real - this isn't going to happen. No oil company would ever invest at that level, and while Saudi might be OK, the rest of the oil producers would be back to date cultivation in a heartbeat. Furthermore, while energy intensity is falling, overall demand for crude still rises, and oil just might be a great buy here now. Look at crude futures or **Ophir** as **buys.**

Likewise, **gold and silver** were in the doghouse it seems just yesterday, but have been ticking up since the volume of the naysayers reached maximum levels. I like them and would buy. JNUG is a good proxy.

So , my month's selection on a macro basis includes, BUY euro dollar on a short term basis, SHORT government bonds, BUY NIKKEI , trade S and P, half long DAX, and continue to short the AUD and go long gold and silver. And of course, buy CRUDE.

I have just been in **San Francisco** for two weeks at the **JP Morgan conference**, and saw nearly 80 companies overall. We are performing our usual triage on these, and are sifting them down some are private, some public, and in my next report, which I will do in the next couple of weeks, I will go over what I like and don't like in bio.

Biotech has been by far and away the best performing of all market sectors over the past couple of years. That won't last, but there is still opportunity, and I and the **Master Investor** team are determined to bring it to you.

Happy Hunting

Jim Mellon
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