MELLON ON THE MARKETS

April 2015

By Jim Mellon

Europe's Phoney Recovery

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Jim's top 3 thoughts of the month:
1 - QE will not successfully stimulate European economies.
2 - After making 130% on Apple, I would now go short.
3 - Synergy Pharma as trading buy.

I am writing this in my flat in Berlin, looking out over the Reichstag, scene of heavy fighting at the end of the last war. It's a beautiful morning and the building, topped by Norman Foster's remarkable cupola, is now the crucible of a verbal war raging around the extent of German subvention of the poorer members of the Eurozone, notably Greece.

This argument is not just academic, and **while the posturing of the ludicrously attired ersatz economist Greek finance minister has a comic element attached, the consequences of this spat are anything but funny.**

Literally, the whole of the world's currency dynamic, the future trends of global trade, and the allocation of portfolios worldwide are being shaped by this crucial debate. Germany has absolutely no need of a weaker euro, and indeed most of Europe doesn't need one either. But it has got it, and while in my last few articles I have emphasized the need to be short the euro against just about anything that moved, the extent of its fall – a direct result of the aforementioned debate – is now overdone.

When Mario Draghi announced his **QE programme** some months ago, in the teeth of German reluctance, if not downright resistance, he signalled a huge change in the character of the European currency union.

Now that the programme has started, the inevitable consequence of a collapsed euro has occurred. The euro has lost over a quarter of its value against the rampant dollar in the past year; it has also lost nearly 20% against the pound, and is now undervalued on nearly every indicator I look at.

Meanwhile, Eurozone interest rates, particularly at the core, are at record lows. The ECB has been buying German bonds, largely because there are more of them, with the intention of driving yields across the Eurozone down. The general hope is that this will force banks and others, unimpressed by the derisory (or even negative) yields on cash, to lend to productive causes.

The extent of QE as announced will be €1 trillion over eighteen months, and it's certainly a large figure. Stocks in Europe have soared, as investors believe that the declining euro will boost earnings, QE will revive growth, and dividends on stocks are much more attractive than bond coupons.

So far, so good. But there are tremendous problems with the ECB's approach. First, Europe, which overall runs a huge trade surplus (6% of GDP) with the rest of the world, doesn't have a balance of payments problem. Germany suffers from anaemic domestic demand, France and Italy have sclerotic economies, and the peripheral economies have already undergone massive internal devaluations characterised by high unemployment and collapsed domestic demand. **A weak euro will do little to encourage exports but might crimp imports, further adding to the inevitable savings glut that comes from huge trade surpluses.**

One of the consequences of QE, meanwhile, is to distort the allocation of capital, which is swirling around in government bond markets and not finding its way out of the still undercapitalised banking sector in Europe to the SME sector, which is where the money is needed. The big multinationals can meantime borrow at near government rates, but it's not them that need money – it's the small, job creating businesses which continue to be squeezed all across Europe.

That is why there is no productivity growth in Europe (or for that matter in the UK, the US or in China, all exponents of QE as well).

Capital is not being properly allocated, and while growth is ticking up slightly, to about 1% across the Eurozone, it is still at a derisory level which will not be significantly boosted either by the euro's weakness or by QE. In my opinion, what Europe needs is a concerted effort to boost growth by cutting taxes.

That's not going to happen – and that takes me back to my view of the Reichstag. The Germans are very reluctant participants in QE, and are not keen on the already evident consequence of a debased currency .The idea of a federalised European tax system is a leap too far for the populist press in Germany, already highly accomplished in railing against the feckless Southerners sucking German taxes down to their deckchairs and tavernas.

So what do we, eternally engaged in the hunt for investments that make a profit, do in these circumstances?

Firstly, although the **euro/dollar** rate will be very volatile, and indeed the **euro/sterling** rate as well, I think both are either at or close to the bottom.

So – and here comes a big step for me, so long a euro bear – I would close out euro short positions. I am not sure on **European stocks**, where foreign buying has been particularly evident. On the one hand, they aren't particularly cheap, and the Euro banks still need to raise more capital; on the other hand, there isn't much for, say, Germans to invest in when yields on bank deposits are so low. I am of the view that the European stock markets, now the market du jour, are probably best avoided until it becomes clear that QE doesn't really work in Europe, at which point there may be a correction.

There will be no great European renaissance as a result of these policies; sadly, I think Europe will limp along at best.

Meanwhile, the US economy seems to be stalling somewhat, China is definitively slowing down, and emerging markets, particularly the commodity dependent ones, are under severe pressure.

As I keep on saying, we only need one or two investments to go right per year to do well overall. My call this year was for the outperformance of the Japanese market and for the flat lining of the yen/dollar rate, and both of these things have happened. My target on the **Nikkei** was for 20,000, and we are within a whisker of that. I now raise that target to 22,000 and I would leave the currency unhedged.

The US market is overvalued and I am going to make a controversial call. Two years ago, at Master Investor, we called a rally in **Apple**, and boy has it rallied, way beyond our target. I now think Apple, the world's most successful company, is a SELL and indeed, even a short. I think we are on the verge of some disruption that I can't properly articulate, and in the same way that Apple crunched Nokia, it too could be crunched. I will reveal an idea at **Master Investor** on this theme.

In the meantime, a hunch and a look at trading patterns tell me to buy **Synergy Pharma** in the US. It has a drug for chronic constipation, and there's lots of that in the US. It's in late stage Phase 3 and I think it will end up being a blockbuster. The company will be at **Master Investor** show on 25th April at the **Business Design Centre in Islington. Evil Knievil, Merryn Somerset Webb, James Ferguson**, and I will be there along with many others and a lot of futuristic technology and entertainment. **Ticket sales are already twice what they were last year and it will be a heck of a day so please come along!**

Happy hunting!

Jim Mellon

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What Jim Read This Month

'10 enterprise technology startups you should keep an eye on'

From **Hot Topics**:

True to form, Jim keeps his finger on the pulse of technology investment as Hot Topics round up their top ten enterprise technology start-ups with some surprising contenders.

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'If an Algorithm Wrote This, How Would You Even Know?'

From **NYT Sunday Review**:

The New York Times' Shelley Podolny looks at the internet trend that went unnoticed: computer generated articles. Podolny looks at how advanced algorithms can fool anyone into thinking what they were reading was written by a human, when in fact it was formulated by a computer program, and that the practice is more common than one may think.

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'The truly personal computer'

From **The Economist**:

The Economist explores the era-defining technology that is the smartphone. With around a third of the world's population carrying one around, the article looks at how the smartphone is changing humanity. With a brain in our hands as well as our heads, will mankind forever be in two minds about our existence?

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'This Article Was Written With the Help of a 'Cyber' Machine'

From the **WSJ**:

WSJ's tech duo Danny Yadron and Jennifer Valentino-Devries offer a look at internet nomenclature, in particular the over-use of the word 'cyber', but opine that we have very few alternatives as even language struggles to keep up with the fast pace of modern technology.

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'Robots Rub Shoulders With Human Buddies'

From the **Financial Times**:

This article looks at co-bots or "collaborative" robots, a new generation of affordable robots set to revolutionise auto-mated manufacture and removing the need for a human overseer. Robots may well be taking our jobs after all…

Grab your copy of Jim's latest book, Fast Forward, for more on investment opportunities in the tech industry - Available on Amazon, Fruitful Publications £16.99.