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MELLON ON THE MARKETS

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The first month anniversary of Brexit was marked by an all-day debate in London hosted by the BBC and the admirable Intelligence Squared. I went along, partly out of curiosity, and partly to see my friend Dan Hannan, possibly the most articulate and passionate of the Brexiteers.

It being London, the audience was heavily stacked with disappointed Remainers, still sore and still hoping that it was all a bad dream. Get real guys and be democrats!

The Financial Times has been talking about economic collapse (and was doing so way before the referendum), but there is scant evidence of such Armageddon. That is despite the best effort of commentators, including the FT to create a “negative feedback loop”.

On every measure, the stock market in the UK has surpassed pre-Brexit levels, and it doesn’t seem that growth in the UK is much worse, or even imperilled by, the vote. Property prices had already been stalling before the plebiscite – and a good thing, too. They were too high, buoyed by easy money and a chronic shortage of supply. They will continue to drift gently, enabling many people who had been utterly priced out of the market to now get on the fabled ladder. At the moment, house prices are 9x average earnings in the capital, which is disastrous for anyone starting out.

Retail sales are mixed, with the internet continuing its relentless assault on conventional retailers, but little has changed in this regard either. The pound has fallen, but again, like real estate, it was too expensive in relation to Britain’s chronic trade deficit, and already, its fall is attracting bargain hunters. Most recently, Softbank’s bid for **ARM Holdings (LON:ARM)** for £24 billion illustrates the continuing attraction of the UK as a destination for inward investment.

Brexit, in whatever shape it eventually emerges, is a trivial sideshow compared to what is happening elsewhere, most notably in the Eurozone. This Eurozone problem is a theme that I hark back to because it is THE SINGLE MOST DANGEROUS THING IN WORLD MARKETS TODAY.

Before the referendum, at the Master Investor Show, I warned of the fragility of France and Italy. The Italian banks are really in a mess, and more evidence of this has been emerging in recent weeks. Make no mistake, there is no easy fix for these institutions, which, in every single case, are bust.

There isn't enough money, or indeed sufficient will, to rescue them. Italy, now 10 per cent smaller in real terms (economically) since the financial crisis started, will soon have no option but to leave the Euro. There is no way Draghi can pull a big enough rabbit out of his magical hat to avert this, and whereas I had been forecasting an Italian implosion 3-5 years out, I now think there is an even chance that this could happen in the next year.

France's problems are more nuanced, but recent events in Nice are likely to accelerate its demise alongside Italy. I forecast further ructions in that benighted country before year end also. The myth that businesses are going to move from London to Paris is just that; France has rigid labour laws, declining productivity, a budget deficit which is growing and a debt pile which is fast growing into an intractable problem.

Meantime, the original PIGS (excepting Ireland) are also in deep trouble. Spain's tax take is falling, at a time when its budget deficit has blown out to Brussels Rule busting levels. Without an effective government, it is hard to see how this particular hole can be plugged either.

I wrote in the last letter that I wasn't sure which way the Euro would go against the dollar; now, I think it carries considerable downside risks, particularly in the short to medium term. It is likely to trade at parity with the greenback, and we are going short euro dollar as quickly as we can.

The ECB has limited arrows left in its quiver to stem the death spiral of its love-child, the common currency, possibly the biggest economic mistake in modern history. Unlike QE and other measures undertaken in the UK, the US and Japan, where a single minded policy can be pursued, the ECB has to contend with Germany resisting many of its efforts to kick start the Southern part of its empire. Germany is not a fan of monetising the budget deficits of the feckless members of this ill-advised scheme, and nor is Germany taking the obvious fiscal measures to stimulate its own economy and to reduce its ridiculously high current account surplus.

While the economic forecasts for the UK have been reduced, they are not being reduced as fast as they are on the mainland of Europe. This is despite massive amounts of unconventional monetary measures being implemented, and certainly more to come.

Expect more bond buying (possibly in the form of more corporate bonds being added to the ECB's balance sheet) in a desperate attempt to revive flagging recoveries. This is a disastrous move, as buying corporate bonds interferes with normal market pricing for credit, allowing zombie companies to carry on misallocating capital. In turn, this contributes to further reductions in productivity and stifles smaller competitors which under normalised conditions could add to growth.

All of this adds up to more attempts to debauch the value of the Euro currency, and in this, I think the ECB will succeed. It is entirely the wrong policy, as Europe doesn't need a weaker currency (almost all countries have trade surpluses) – it needs stronger demand.

But with rapidly deteriorating budget deficits across Southern Europe, the idea of an integrated fiscal and monetary union is a pipe dream. That is why I believe that the continued debauching of the euro by the rapid expansion of the ECB balance sheet will indeed lead to the depreciation of the Euro against almost every currency in coming months, and investors should be so positioned.

Japan has been trying the same thing for years, admittedly, but it is a unified nation, not one riven by internal dissent; it has its own unique set of problems, some demographic, some resulting from previous policy failures. More monetary easing can be expected there, as indeed can further intervention in the stock market by the Bank of Japan. The BoJ is now a top ten shareholder in EVERY Japanese company of substance, and if any country is to be sufficiently crazy to implement helicopter money tactics (the creation of unsterilised money), it is surely Japan. Expect a potential melt up in Japanese shares, and a real fall in Japanese Government Bonds over the next year. JGB yields (along with plenty of other sovereign bonds elsewhere) are negative, and probably can't go much lower. This is because people will then hold cash as an alternative, and that is why shorting JGBs is a low risk trade with considerable upside.

I continue to like **Sony (TYO:6758)**, the world leader to be in VR, and it is performing well, especially as its movie studio is improving. If you have watched the performance of **Nintendo (TYO:7974)** shares since the release of Pokémon Go (up $20 billion in market capitalisation in a week!), you can see just how frantic the Japanese market can be when excited. The same could happen with Sony, in my opinion, when its VR headsets go on sale.

Gold and silver are in the temporary doldrums, awaiting events. Those events are coming, and will propel them higher...

Meantime, I'm off to catch a few Pokémons!

Happy Hunting!!

Jim Mellon

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