MELLON ON THE MARKETS

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By Jim Mellon

GRADUATING FROM THE LOST DECADES

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The markets continue to grind higher, with Japan showing the biggest gains. I imagine Japan will continue through my target of 20,000 on the Nikkei, as it is the only major market to have classically aligned buy signals – rising operating margins, lack of alternatives to invest in, super low interest rates, a falling currency and a relatively low PE ratio.

You might well ask, what about **Europe**? Surely that benighted continent has at least some of the same characteristics? To a certain extent, yes, but the problem is that systemic shocks are still likely. The Greek situation has become one of extend and pretend, but waiting in the side-lines are the Spanish elections and the rise of Podemos, anti-Europe stirrings in other Eurozone economies, and of course the upcoming UK election. On top of this, domestic demand is still very anaemic in most Eurozone economies, albeit offset by an interesting but unlikely to succeed monetary policy emanating from the ECB.

While the scale of this much-heralded **ECB intervention** is impressive, what Europe really needs is a broad tax cut, underwritten by the ECB, which would stimulate demand, and thereby some inflation, much more effectively .The effects of the ECB intervention has already been to drive interest rates to zero or even negative levels, which in theory should force banks to offload bonds back to the ECB and to start lending elsewhere .The problem is that Eurozone banks are still not properly capitalised and have failed to properly account for their non-performing loans in an adequate way. This is going to hold back Europe for many years, and any idea that there will be a quick rebound is a fanciful one. Ultra-low interest rates are a sign of failure, not of success. **Japan is graduating from its lost decades, slowly emerging from the zero growth under which it has laboured for what seems like forever.** Europe is just going into its third or fourth year of elementary school.

It is notable that European productivity growth, economic growth and per capita income have fallen hugely behind those of the **US** in recent years. There is a sense that the US is set up for strong growth for some time to come, but actually there are worrying signs. Among them are a slowing housing recovery; weakening export growth in response to the strong dollar and to a slowdown in China; and renewed credit problems, principally in the energy sector.

Indeed, my friend Steen Jacobsen believes that US growth could grind to zero by the end of this year. He is famous for extreme forecasts, so I don't agree with him, but I take his general point. This means that US markets look set to become even more expensive. With US stocks already trading on an elevated CAPE ratio, the US is wildly overstretched, the quantity of new issues is becoming oppressive, and bullishness abounds.

Meanwhile, interest rates are slowly edging up, and corporate balance sheets are not as pristine as they were. Buybacks make a difference to EPS growth but can't go on forever.

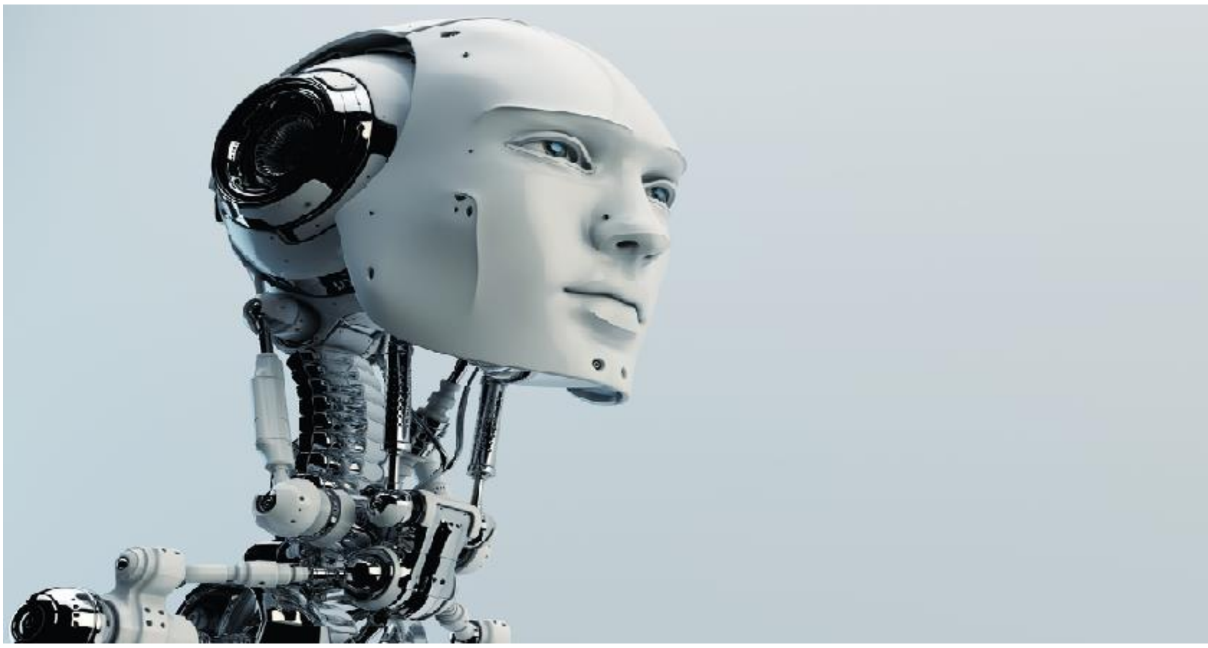
So, as for the last few missives, the picture is a mixed one. Japan remains my favourite market, and I don't think a yen hedge is needed here. Almost everything else appears to be range bound, with the only enlivening activity being takeovers in the biotech space and the shenanigans at almost every single big name bank.

That leads me to a short-term buy.

HSBC, which suffers from arrogance and a surfeit of self-satisfaction, has been beaten down recently. There has been a lot of noise from the analytical community about its cost of capital being roughly equal to its return on equity, which basically means it might as well be shut down. This isn't going to happen, and I imagine its cost base will be ruthlessly pruned, and some management heads will roll, though I really think the treatment of the CEO has been unfair.

In the meantime, HSBC trades on less than 10 times earnings, its dividend yield is 6%, its combined Tier 1 capital ratio is 13%, and it will one day return to growth. It is really a global business, and exposed to the Pacific Century in the best possible way. **Headlines sometimes make for good buying opportunities and this looks like one to snatch.** I see 20% upside.

In Japan, I would buy **Fanuc**, the world's leader in robotics - robots are going to be everywhere, and very soon. Fanuc has about a third of its market capitalisation in cash, and Daniel Loeb, an unpleasant but effective US raider, has taken a position with a view to getting them to pay some of it out. I think it's a very good long-term investment.



In a macro sense, I would really be looking at shorting the highly overvalued **German bunds**. When QE starts, I think interest rates in Europe will RISE, which is what happened in the US. The same could be said for **French OATS**, or indeed **Japanese bonds**, where yields have recently been rising – albeit from nothing to twice nothing.

We are still short the **Euro/Dollar,** and surely parity must be somewhere in sight. **Sterling** I am neutral on, and the same goes for the **yen**. The **Australian dollar** is a sell, and any short term rise above US 0.79 is a clear sell.

I would go short the S&P against the Nikkei.

In the meantime, I wish you all happy hunting, and don't forget to book your tickets for the Master Investor conference next month!!!

Jim Mellon