MELLON ON THE MARKETS

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By Jim Mellon

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As I write this, I am on a working Norwegian ferry, hugging the coast between Bergen half way up and Kirkenes in the far North of the country. Kirkenes was the second most densely bombed town (after Malta) in Europe in the Second World War, and is the nearest town in Norway to the Russian border and Murmansk. It is also farther East than St Petersburg and Istanbul.

It is also a point of entry for the wave of migration that is currently destabilising Europe. Readers may have seen video footage of asylum seekers crossing from Russia into Norway on children's bicycles; there is a rule that you can't walk across at this point, hence the bikes. About 5,000 people, mostly young men, have crossed in this way and now add to Kirkenes's small population.

Norway is keen that these people should settle in this Arctic region; it is underpopulated, and the 41 visits to small ports I have made on this trip so far reveal a plethora of hamlet-like towns with too few people to make them viable. As Norway's oil bonanza turns sour, indigenous young people are heading south, to the bright lights of Oslo, or even to those of London and Berlin.

At first, as applications for asylum are processed, the refugees will stay in the North; they have no choice. But as soon as they have papers, they will head south. People from Afghanistan, Syria, and Pakistan et al are unlikely to want to endure 20 hour days of darkness in winter, as well as freezing temperatures.

And they will, under the current rules in the Schengen area, which Norway is part of, be able to do just that – i.e. leave and travel freely, most likely to Germany and to Sweden.

Along with the millions arriving in Europe this year, and likely millions next year, the Kirkenes bicyclists represent the tip of a very large iceberg (pun intended).

These people are coming for a variety of reasons, but one that is not much talked about is the stalling of economic growth in the emerging markets, particularly those at relatively early stages of development. Emerging markets are growing at the lowest rate in recent recorded economic history; and in some areas, the decline in growth is downright worrying. In Africa, hailed recently as a miracle continent, overall growth in 2015 is only forecast at 3.5% in real terms, with countries such as South Africa and Nigeria suffering outright declines in GDP per capita.

The reality of the matter is that Africa's "miracle" was more likely due to a windfall from commodity price inflation in the recently broken super cycle for metals and minerals. It wasn't down to productivity growth; indeed, Africa's governance indices are lower than they were in 1999, a disastrous situation for a notoriously corrupt continent.

In Pakistan, Afghanistan, Morocco, Tunisia, Algeria and Albania, as in many other countries, the situation is the same: poor economic growth – or at least growth that doesn't produce enough jobs – and a surplus of manpower.

The rise of automation in the West and in Japan (and indeed in China) is depriving the poorest of developing countries of the lift they would hitherto have received just a few years back. This boost would have been from the movement off farms to the cities and to export manufacturing. This was the model for China, for the Philippines, for India (to an extent), and (earlier) for Singapore, Korea, Hong Kong and Taiwan.

And the model *did* work; compared to 1990, when 37% of the world's population lived in poverty (defined as less than $1.90 per day), today only 10% do so. Indeed, in Asia, thirty years ago, 60% of the population lived in poverty; now it's less than 4%.

Increasingly, manufacturing is being done at the point of consumption, using robots and other production techniques that are less labour intensive. This means that there is less work to go around for the people of the frontier developing countries, especially at a time when those beholden to commodity exports are having a tough time. The advantages conferred in the earlier era of developing markets don't seem to be the same for the latecomers. And hence the Great Migration.

This migration will certainly continue, with all the benefits (to Germany, for instance with its demographic issues) and disadvantages (some inevitable influx of radicals, poor integration and cost).

And this, along with the financial problems of the Euro Zone, as well as mounting terrorist outrages, could well mark the beginning of the end of the federalist European project. In fact, with or without a referendum in the UK, Brexit might happen simply because there is likely to be a fracturing of the current European Union set-up.

In particular, the debt trap that France and Italy find themselves in (I call them the **FRITS** – French and Italian Sinkholes) are ominously dangerous. France and Italy just can't grow their economies fast enough to avoid eventual default on their massive debts, which altogether are about 15x bigger than Greece's. Remember the ructions earlier this year about extending and pretending on the Greek debts, and imagine a comparable situation for France and Italy. We can't – because it is nightmarish to contemplate and nice Mr Draghi says he will do all that is necessary to avoid it. Well, he may not be able to hold these particular waves back.

Already, **Schengen i**s heading to the departure lounge; there are serious disputes in the Euro Zone about the extent, if any, of further monetary stimulus, and Germany's massive current account surpluses are showing up in vastly increased Target 2 balances at the ECB. In a nutshell, this means that Germany is keeping the Spanish and Italian banking systems afloat.

The tricks that Mr Draghi has used so far to keep the Euro project alive, notably QE and ultra-low interest rates, will have decreasing efficacy as the negative interest rates at the ECB reach the practical limits of the zero bound. He is limited in what bonds he can buy, as the supply of suitable ones is tight, and there are concentration limits. He might end up buying loans from banks directly. But this would be highly resisted by the Bundesbank.

The magician is digging deep into an increasingly empty box of tricks.

The Euro Zone remains the biggest single risk to the world economy; not China, which has problems, but is not a disaster, and not the US, which motors along, albeit at a reduced rate. The Emerging Markets are a mixed bag, and Japan is still fighting deflation, with modest success.

Coupled with the obvious problems from uncontrolled mass migration, Europe is the place to watch over the next year.

All negative yield bonds are a sell, and some are worth shorting. The Swiss Franc is a sell against everything, the pound is a sell against the dollar, the Canadian dollar a buy against the US dollar, and gold and silver are buys. I'd stay clear of overpriced US markets; the UK and European markets are for stock pickers, and there I like **Kuka and Siemens** in Germany, and **Shell** in the UK.

I like **Turkey** as a punt (Garanti Bank and Halk Bank), and I like **China** (large company ETFs), as well as Brazil (the cheapest market in the world (ETF again) – and I really like **Vietnam.** It's probably best to buy the listed closed end funds, which normally sell at a discount. **Vietnam** could just be the last developing country to escape the curse of automation and localisation. My company of the month is **Arrowhead Research**. I just met with them and I think they do have a cure for Hepatitis B!

Happy Hunting!!

Jim Mellon

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What Jim Read This Month

Skreemr, the Mach 10 supersonic aircraft

http://www.telegraph.co.uk/luxury/travel/90250/skreemr-the-mach-10-supersonic-aircraft.html?utm_campaign=Echobox&utm_medium=Social&utm_source=Facebook

Fans of the new Amazon web-series *Man in the High Castle* may have found themselves missing the 'good old days'… By that I mean super-fast air travel and not a global Nazi Empire, of course. But with plans to recommence Concorde flights by 2019, Canadian designers are looking to step it up a notch. They have designed the reassuringly name Skreemr, that would reach speeds of over Mach 10, around five times faster than Concorde.

Were the Luddites right about technology and jobs?

http://www.bbc.co.uk/news/business-34813903

At the recent Trade Union Congress, Bank of England's Chief Economist Andy Haldane warned that up to 15m jobs in the UK cold be replaced by robots. Of course this is nothing new, but the article looks to the ethos behind the Luddites (the real-life historical movement not the out-of-touch 40 year olds without Facebook who still use Nokia 3310s) and what this displacement of labour means for our society.

Robots take on more elaborate tasks amid worker shortage

http://www.wsj.com/articles/robots-take-on-more-elaborate-tasks-amid-worker-shortage-1448291203

On a related note, it seems the manual global workforce is actually facing a shortage, according to the Wall Street Journal. But the robot workers waiting in the side-lines aren't quite up to the job, say the experts. For now robots can only perform basic tasks, those requiring increased dexterity and complexity still require humans. But not for long, Stanford University's Vivek Wadha predicts that by 2050 robots will be capable of every task we are.

Silicon 2.0 promises super-powered chips and solar cells

https://www.newscientist.com/article/mg22830480-500-silicon-2-0-promises-superpowered-chips-and-solar-cells/

So apparently a whole sector, and indeed an entire valley, has been founded on a lie. Silicon, it seems, has been grossly over-estimated and is now 'holding back' advances in technology. A group of researchers are determined to find a suitable replacement. But to no doubt avoid the confusion of rebranding, they are looking to restructure silicon itself. Monocrystalline Semiconductor Valley doesn't quite have the same ring to it.

Technology: Banks seek the key to blockchain

http://www.ft.com/cms/s/2/eb1f8256-7b4b-11e5-a1fe-567b37f80b64.html#axzz3sKAKGvQR

"You should be taking this technology as seriously as you should have been taking the development of the Internet in the early 1990s. It's analogous to email for money." Declared Blythe Masters, head of Digital Asset Holdings, a block chain start-up set to revolutionise online money transfer. The latest advance in FinTech aims to drastically cut infrastructure costs for banks by harnessing the power of bitcoin.