MELLON ON THE MARKETS

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By Jim Mellon

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Every year, in this season of mellow fruitfulness, I come to the Viva Mayr Clinic by the beautiful Worthersee Lake in Austria. The clinic is a sort of detox retreat, and I have been put on Diet no. 1, which allows for Lilliputian morsels of food on two occasions a day. Diet no. 0, on the other hand, is liquids (and by that, they mean liquids with no calories), and apparently some are eager to sign up for that brutal regime.

Not so the world's central bankers; they are all apparently anxious to sign up to Diet Number Infinite, involving lashings and lashings of newly printed money. They are, however, while expanding their balance sheets with all this money creation, almost to a man (it's mostly men in central banking) trying to *shrink* the values of their national currencies.

Since my last missive, the Fed has balked at raising interest rates, despite a rate hike being necessary, in my view, if a normal economic backdrop is ever to be achieved. Mario Draghi in the benighted Eurozone, has indicated an expansion and most certainly extension of his own version of quantative easing, and China has cut reserve requirements and interest rates in an attempt to keep growing at the Politburo- endorsed 7 per cent real rate it demands.

Japan's central bank is said to be toying with more easing, and lots of smaller countries are doing their level best to play beggar thy neighbour policies by encouraging their domestic currencies down.

All this is having unintended effects. I have written and spoken before about the tremendous misallocation of capital that occurs when there is an actively pursued Zero Interest Rate Policy (ZIRP). Largely due to this, world productivity has flat-lined, and the IMF is issuing more world growth warnings than Volkswagen issues apologies. Now world GNP growth is forecast at sub 3% this year, the lowest in recorded memory.

At the same time, the asset bubbles that are the direct result of these ZIRP policies (and now even NIRP – negative interest rate policies) show ever increasing signs of being close to breaking point. Corporate debt spreads over US Treasuries and other (reasonably) certain governmental bonds are blowing out, and default rates (particularly in energy) are rising.

US profit growth, despite the huge amount of debt financed buy-backs I have spoken of before, has stalled and is now in reverse. And the US dollar's strength, the result of everyone else trying to export their deflation, is hurting. The US industrial sector is undoubtedly in recession, and while the overall economy is propped up by government expenditure, housing and consumption, it is now slowing markedly. Indeed, exports are now under severe pressure because of dollar strength and weakness in key markets such as China and Euroland.

And yet, the central bankers really don't know what to do; scared of jeopardising fragile recoveries by raising interest rates or adopting less expansionary policies, they are stuck in the Keynesian headlights which suck them ever closer to eventual disaster.

Everyone is trying to gain advantage by devaluation; at least three quarters of the world's central bankers are trying to talk their currencies down. But when everyone is at the same game, none can really succeed.

Taking the Eurozone as the pre-eminent example of trash talking its own currency, the consequences are even more nuanced. The Germans don't really (despite VW) need a devaluation; indeed their economy remains far too skewed to exports, partly the result of a way-too-low exchange rate. Their impoverished neighbours really, really need this weakening euro, however, and are damn pleased about it. It's not doing them a lot of good though, since France and Italy remain pretty desperately set. France in particular has made almost no progress on the reforms that it needs to get out of its quicksand. France and Italy (the FRITS**,** my very own acronym for this pair of economic millstones) are caught in debt traps. No matter how hard they try, their nominal GDPs cannot grow fast enough to overcome the corrosive effects of rising debts, even at low interest rates.

And woe betide them when interest rates rise, perhaps on the back of a recognition that even Super Mario can't hold the tides of market reason back for ever. Sooner or later, this pocket Canute will be overwhelmed by the rolling waves coming right at him.

If there were no referendum in the UK, I reckon the implosion of France (probably the least anticipated thing in economics at the moment) as well as the refugee crisis would do the job of taking Britain out of the European Union by themselves. And that would be because there would be NO EU to leave!

It is inconceivable that Germany would allow the monetisation of all French and Italian debt (which would be the only solution to a full blown crisis in Euroland). Nein, danke, as it would represent a massive transfer of wealth from Germany to the others. More likely is a breakup of the Eurozone into hard and soft zones – something that should have been done in the first place.

But there WILL be a referendum in the UK before that, and the result will be much closer than people, especially the bien pensants, who know little of forecasting economics and who were the biggest advocates of the UK's joining the Euro, think. So, onto money making opportunities. I have banged on about buying Japan since 8,000 on the Nikkei and it is still my favourite market. I wouldn't hedge the currency as Japan doesn't need further devaluation. It's now hovering around 19,000 and I think it could go to 25,000 before we turn elsewhere for gratification.

Elsewhere, I have sold Greece, which provided enough for a few ouzos, and I still remain long a little China on the bounce theory. The US treads water, and although from time to time it lurches violently down or upwards, it's hard to see huge traction when earnings are under pressure and value is hard to find.

In particular, the biotech sector has been hammered in the US, with the travails of Valiant, and the shining example of opportunistic overpricing provided by the little prick of a hedgie who triggered this sell off. But, in my view, investments in selected biotech stocks will provide the best returns over the next ten years, and we are buying selectively. I still like **Synergy Pharma** in the US and I like **Summit** in the UK – if its drug for Duchenne's muscular dystrophy works, then it will be huge. Binary, though.

I fancy **HSBC** for its dividend and for exposure to emerging markets, which are surely due a bounce, and I am tempted by **Rio Tinto,** yielding 6.2 per cent and with the financial capacity to destroy much of the competition.

In terms of FX, we are coming to a BIG opportunity, which is when to buy the Euro. I think now is still the time to short the Swiss Franc against the Euro (and that has already been a good trade – conviction idea at Master investor 2015) and be ready to buy Euros at about 1.09 against the dollar. This is not a forever trade, but it should yield a handsome return. Remember, get your FX right and you can make a lot more than by playing in equities!

Also, I am a buyer of Canadian dollars against the US dollar here. I look for 1.25 from current level of 1.31.

And I have a very positive feeling about gold and silver. I am loading up on those!

Happy Hunting!!

Jim Mellon

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What Jim Read This Month

Should a Self-Driving Car Kill its Passengers in a "Greater Good" Scenario?

http://www.iflscience.com/technology/should-self-driving-car-be-programmed-kill-its-passengers-greater-good-scenario

A car hurtles towards a crowd of people in the road, either it hits the crowd saving the driver within, or it turns to crash off the side of the road, likely injuring or killing the driver but saving the crowd. A research team from the Toulouse School of Economics are looking into the moral and ethical implications surrounding self-driving technology. They've not yet got to the scenario where one of the passengers grows up to be Hitler, but we await their findings.

Try my extrasensory jacket on for size

https://www.newscientist.com/article/mg22830420-500-my-smart-vest-will-offer-you-extra-senses/

"Our senses are just plug and play devices inherited through evolution". Neuroscientist David Eagleman has developed a wearable device which reacts to sounds and translates them as patterns of vibrations, essentially a vibrating jacket. The jacket is being used to open up the auditory world to the deaf by rewiring their brains.

Better data has the power to save more lives

http://www.wired.co.uk/magazine/archive/2015/11/features/wired-world-2016-melinda-gates?linkId=18331983

Data is being used in the smallest ways to improve our lives every day. It is used to determine which book we might like to buy next or what box-set we might want to binge-watch. But Melinda Gates wants us think bigger; she wants governments to use data to improve the lives of citizens in the nations that really need it. Not to recommend their next download, but to improve healthcare and education, making sure it gets to the right people in the most effective way possible.

Toyota's radical Kikai concept is the anti-connected car

http://www.theverge.com/2015/10/28/9625296/toyota-kikai-concept-tokyo-motor-show

It may look like a Chitty Chitty Bang Bang Decepticon, but Toyota's latest concept car aims to steer design away from the ultra-high tech trend of turning your car into an extension of your smart phone. Instead the Kikai returns focus to the automobile itself by displaying the raw mechanics on the outside, while placing the driver in the centre of the dashboard for fully immersive driving.

***Dictator*, Robert Harris**

http://www.amazon.co.uk/Dictator-Robert-Harris-ebook/dp/B00T19UNMQ/ref=tmm_kin_swatch_0?_encoding=UTF8&qid=1446124895&sr=1-1

Yes a book! Dictator is the final instalment in Robert Harris' trilogy, set in Rome in the first century BC and charting the rise and fall of the orator Cicero. Nearly a decade in the making, riveting and fast paced, bringing historical context to life with curiously familiar characters who wouldn't seem out of place in modern day Westminster.