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MELLON ON THE MARKETS

By Jim Mellon

The Signs of a Great Unravelling are Appearing

Another month of the phoney war in markets; range bound almost everywhere, except in Japan – which is performing well – and ahead of every other major market. (So it should: it's the cheapest and best bet!).

Don't think for one moment that this quiet period and low volatility will last – I've just been on a trip through the Somme and to the Normandy landing beaches; and our journey was a sobering reminder that phony wars have a habit of turning into something much worse.

There is something called the Dunning Kruger effect; incompetent people rarely realise that they are thus handicapped. And the best demonstration of this is the current crop of central bankers. Mostly incompetent to the core- and without realising it. While the likes of Kamikaze Kuroda and Mark Carnage are congratulating themselves on "saving the world", – Gordon Brown style – the signs of a *Great Unravelling* are appearing.

Bond yields are rising (and this could have been predicted by a monkey), the effects of negative interest rates are now generally believed to be pernicious by all except their perpetrators. And banks in many parts of the world are beginning to feel the strain – especially in Europe and in China. Corporate cannibalism, otherwise known as share buy backs, are having a progressively lessened effect on earnings, and indeed, on share prices. This is particularly so in the US, where despite US 175 bn of share buy backs a quarter, earnings are falling, and valuations remain especially stretched.

Oh, and the strength of the US dollar reveals an underlying cause; a shortage of dollars. US nominal GDP is slowing markedly, and world money supply growth, despite all of the QE experimentation going on, is hardly growing.

This shortage of US dollars is likely to cause problems in the future for highly indebted emerging markets as most of their debts are denominated in US dollars, and those debts have soared to record levels since 2008.

The most indebted of all emerging markets, however, is China, which is looking pretty perilous. Debt to GDP is now estimated at 300%, which makes Italy look parsimonious. Capital flight from China is proceeding at a rapid rate, depleting Forex reserves, despite strong trade surpluses. Property speculation has reached absurd levels, with second tier cities in China boasting property prices three times that of Manhattan, and setting up real estate exposed banks to a future crash.

Meantime, China's capital stock expansion, which has been in double digits for over 30 years, has left it with physical capital stock larger than that of the US. And that isn't a good thing, as China's stock of "soft" or brain powered capital is peanuts compared to that of the US. Instead, China has built too many factories, too much go–to-nowhere infrastructure, and too many inefficient energy plants. Some people have been forecasting disaster for China for what seems like forever, including Jim Chanos and Rob Citrone. They haven't been right yet, because China remains a command economy and the usual mechanisms of free markets to curb excesses don't apply to China – at least, not yet.

But, a crash is coming, and one has to believe that the best China short is the banking system, and of course the currency, which has fallen to a multiyear low against the dollar. So trade number one of this missive is to short YUAN against the US dollar.

Now, back to those crazy central bankers – Adair Turner, former head of the FSA, has said that we live in a world of **permanent monetisation**. By this he means that, although QE has supposedly come to an end in the US and in the UK, the chances of the bloated balance sheets of central banks being wound down, even if only by waiting for bonds to mature, are zero. Reducing the size of the balance sheet of central banks isn't on the cards anytime soon, as it would cause a deflationary bust. If it happened in the US, it would cause contagion in the rest of the world. Not going to happen.

So, what will central bankers do? I am guessing that there will be an American rate rise post the US election, but it will be small and won't be repeated more than twice in 2017. Mrs Yellen will be looking to send a signal of rate normalisation, and this is to be welcomed. Hopefully Mr Carnage won't do the opposite and cut rates further in the UK.

Mr Carnage is determined to prove that somehow he has stabilised the UK economy post Brexit – when the reality is that the recent strength of the economy has ABSOLUTELY NOTHING to do with him. He really is a **right Dunning Kroger**!

On the subject of Brexit, the legions of worthies, the sobbing artistes, self-styled economists and wise men and women who predicted disaster for the UK (yes, you did!) immediately post a vote to leave are now deferring their timetables. They remind me very much of the religious maniacs who from time trudge to the top of mountains to await the Second Coming, only to trudge down forlornly when it doesn't happen. They, of course, have the same resilient hope for disaster as the Remainers – that they just got their timing wrong, and redemption won't be long in coming. (In their deluded minds).

Well guess, what, four months on from D-Day (which they would describe as Disaster Day), the UK economy is likely to be the strongest in the G7 for yet another year, leaving the Eurozone trailing in its wake.

And I bet it doesn't do nearly as badly as the Deferred Disaster Mongers are making out, for 2017.

Sure, sterling is down , but it will recover, particularly against the doomed Euro, as our auto correct on the current account deficit is much faster than for other countries (because of the translation effect of the huge stock of foreign assets that the UK holds) .

The stock market has been booming, and possibly, too much so.There are opportunities in the UK, but generally I think stocks are pretty fully valued.

Especially as what's going to happen in Europe isn't going to be helpful to the UK, whether in or out of the EU.

Brexit should be regarded by serious investors as a side show to the much bigger play of the inevitable implosion of the common currency. Imagine it as a house, and you see fissures and cracks everywhere; the paint is peeling, the beams are exposed and overburdened, and one day – and that day isn't that far off – the ceiling caves in.

Italy and its referendum, Hungary and its pompous populist PM, elections in France and Germany, Portuguese stagnation, Spanish deficits, you name it, the cracks are evident. Oh, and the so called Target 2 balances , the massive overdraft of the feckless southerners at the Bundesbank's till , and mediated mediated by the ECB, just keep getting bigger.

So trade number 2 is short euro against the pound and the dollar. It’s going to blow!

Meantime, the usual stalwarts continue to be backed ; gold and silver, Gilead, Synergy Pharma, short all negative yielding bonds (there are less of them now!) , and short the yen and long Nikkei continue to apply. When the Euro blows up EVERY single European bank will be bust, so you might as well short them too!

Happy Hunting!!

Jim Mellon

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