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MELLON ON THE MARKETS

By Jim Mellon

The BONDfire of the Vanities

Last week I was in New York, and by sheer chance I ended up right next to Trump's golden palace (and of course the many thousands of indignant demonstrators objecting to his position as President-elect). I'd come across on the mighty *Queen Mary II*, as I find it easier to research new books on the high seas, since phones and other shiny distractions don't work on board.

As everyone knows by now, some notable Brexiteers had a meeting with Trump, ahead of all the usual politicos, including the saintly Mrs May. The day after their meeting, my friends and I met up with the whole Brexit gang for a *long* lunch. I was presented with a copy of *Bad Boys of Brexit* by Arron Banks, which is a terrific read – get hold of a copy if you can!

And I gained some insights, most of which I can't disclose. I *can* say that, in my opinion, the new President will dial back the harsh rhetoric of the election campaign – in fact he is already beginning to do so – and many of his economic policies will be positive.

Already, it is clear that there will be an immediate and substantial cut in corporate taxes (probably to 12.5%) and an amnesty on the repatriation of what is believed to be $2 trillion of corporate cash held abroad. That will probably attract a one-off charge of 10%, which means $200 billion for US Treasury coffers. That's no chump change, and I expect almost all of the monies to be repatriated.

This repatriation will have a GDP benefit to the US, but will be negative for the tax havens where the monies are held. There will be, incidentally, very little FX effect, as most of the cash is already held in US Dollars. I would think that Singapore and Luxembourg based banks will be the biggest losers.

In addition to Trump's likely Reaganite moves, I believe he will also move to quickly cut income tax rates, particularly for the middle class, and will ride the so-called *Laffer Curve* in the hope that fiscal stimulus through tax cuts will increase economic growth – and thereby tax revenues. The economic virtuous circle. It doesn't make US stocks cheap, as dividends are declining, margins are under pressure, and the strong dollar has a negative effect on profits. In fact, apart from some pharma companies, I would say US stocks remain expensive.

In addition, just to blow the budget a bit more (and remember the Republicans now hold both parts of Congress), President Trump will start spending more on infrastructure, particularly on bridges and roads. Both of these, I can attest, are in terrible condition in the US, and add major drag forces to productivity.

All these factors are likely to lead to more inflation, and therefore Fed tightening. This is why the dollar is so strong (I do hope you followed us into Japanese yen shorts!). It is also why there has been a global bond rout in recent weeks.

As those who read this missive regularly will know, my main call this year has been for higher yields and lower bond prices, and Christmas has come all at once – at least in this respect.

In recent weeks, a group of certified morons (and the ECB of course) bought large issues of Italian 50-year bonds and Austrian 70-year bonds for derisory running returns. Well, if they didn't know before, they now know what *duration* risk is – and it's cruel! Believe it or not, the Italian bonds are down 20 per cent, and the Austrian bonds are down a whopping 30 per cent. That's showbiz!

This is a real BONDfire of the vanities (of central bankers and aforementioned morons!). And this particular fire has spread *everywhere*, with gilts, JGBs, Treasuries and of course BUNDfires all melting. This bond trade has further to run and I would now increase Eurozone bond shorts, and JGB shorts, and look to US 10-year bonds (rather than 30-year bonds).

This rout in bonds has coincided with a counterintuitive fall in gold and silver prices (though other commodity prices have been rising). This surprises me, because although gold and silver can be affected by higher interest rates, it is my experience that as prices in economies rise, such inflation *always* outpaces rises in interest rates. This persists until at least the end of the rates-up cycle. And higher inflation is *great* for precious metals.

Of course, Prime Minister Modi of India instituted a call-in of supposedly high value bank notes, with $80 billion worth of scrumpled 500 and 1,000 rupee notes being tendered for lower denominations. This has been causing havoc, and possibly some forced selling of gold. Indians are massive buyers of gold, and I expect that this note-swapping effect will be temporary as far as India's love affair with gold is concerned. Modi is trying to reduce black market and untaxed elements of the economy, and to clamp down on corruption. However, his currency move is likely to severely reduce growth as monetary velocity crashes, and this isn't great for India, at least in the short term.

So, given that gold and silver are probably down temporarily, I would now load up on the precious metals complex, through physical, futures, ETFs, or gold and silver miners. **Fresnillo (LON:FRES)** listed in London, is best for silver, and **Condor (LON:CNR)**, also London listed, is a good play for gold, in my opinion. (I am a shareholder and director of the latter.)

In addition, readers will have noticed that the pound has been rallying, particularly against the weak euro, in the past few weeks. This probably reflects the fact that the sky hasn't fallen in, despite the Bremoaners' dire warnings. But it also reflects something more important. This is the notion that the US bias under Obama towards Europe and away from the UK will be sharply reversed under Trump.

The Federalist Europeans are going to be out of favour with the new regime in Washington. Trump has already made it quite plain (and rightly so) that countries such as France and Germany need to up their defence spending and comply with NATO commitments. The Second World War ended a long time ago, and it is time to realise that the potential enemy isn't a resurgent Germany – and that, as a result, improved military capability in Europe isn't a bad thing.

On the subject of the euro (and I know I bang on about it), as the winter days draw in, the common currency is gasping and slowly sinking to multi-year lows against the dollar. It's going lower.

In fact, it's toast.

Italy, the Netherlands, Germany, Austria, and France all have elections coming up and any one of them could be the fuse that sets the death spiral into motion. I have said that I think the euro, as currently constituted, has between one and five years of life. It might be even shorter.

In particular I'd keep a very close eye on the Italian referendum on December 4th. It might make Brexit seem like a side show. If Italy leaves the Euro, events will overtake Brexit and almost every bank in continental Europe will be nationalised.

These are interesting times, and great for adaptable, curious and hardworking investors like us. "Make Investing Great Again" is the motto of Master Investor, and we are getting there! (Practising my sloganeering!)

Happy hunting!

Jim Mellon

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