



In this issue:

- How I monitor for a recession
- The Santa Claus rally
- My divisive stock pick and why I believe it will soar

How to profit from the coming market “melt-up”

Eoin Treacy, Investment Director



*If you can keep your head when all about you
Are losing theirs and blaming it on you,*

*If you can trust yourself when all men doubt you,
But make allowance for their doubting too;*

Rudyard Kipling

I don't mind telling you I am writing this month's issue with a sense of trepidation. I am about to make a bold call that is far from consensus and could land me in hot water with you, my subscribers. However, my gut tells me I am doing the right

thing. In fact, the reason I am willing to make this call on the market is because it is not popular and because I feel like I am taking a risk.

Generally speaking the most successful trades in markets are made when you don't feel good about what you are doing because evidence to support your argument is thin on the ground.

If we remove emotion from the equation, which admittedly is not an easy thing to do, then we can accept that if we wait until everyone feels comfortable with an idea then lots of people have had the time to take advantage already. That means the price will be considerably above the low by

the time we enter and much of the potential upside will already have been captured by other investors.

It is times like these that we should really ruminate on the words of great people who came before us. Rudyard Kipling's words are particularly apt when emotions are running high in the market. So are those of Baron Rothschild:

“Buy when there is blood in the streets, even if the blood is your own”.

Most people have heard the first part of that quote but I would be willing to bet the majority of people are not familiar with the



rider on the end. It is never easy to buy in a time of perceived crisis.

Everyone else is panicking and projecting total disaster because they have taken personal losses and the last thing they want to see is the price rally back above where their sale price was. People tend to adopt a vengeful attitude in those circumstances and are much less likely to buy anything while the visceral memory of a pullback is still fresh and raw.

done in the first ten.

First off, major market declines, I mean those that we tend to remember for decades after they occur, generally coincide with a recession. However, there is no recession in sight right now.

Let's first review the indicators I monitor for a recession

First off, the yield curve spread has been contracting for three

Bull markets thrive on liquidity and they grow larger as long as the supply of new capital coming into the market continues to rise. When a major source of new capital is removed from the market, that creates a headwind for markets and they tend to peak anything from six to eighteen months after the inversion.

The yield curve spread is one of the most reliable lead indicators we have for future recessions and it is not currently signalling danger. Even if it was, markets tend to continue to rise for at least six months after the inversion occurs so the only conclusion is we still have plenty of time for the markets to rally before we see a meaningful top formation.

The yield curve spread is one of the most reliable lead indicators we have for future recessions and it is not currently signalling danger.

However, again, if we think about it logically, it is exactly when lots of people have had stops triggered and are nursing emotional and financial wounds that we can conclude everyone who wanted to sell has probably sold. That means all that are left are potential buyers.

Sir John Templeton was noted for saying to "buy at the point of maximum pessimism" so this month I am bringing you a bold claim that I think the market is about to melt up in a big way and the share I believe is poised to take full advantage of it.

However, I want to assure you I am not making this call just for the sake of it. If you are willing to bear with me, I'll explain why I believe the market is about to do a whole lot better in the last few months of the year than it has

years but more recently has been expanding, which is a good sign.

Let me explain how this indicator works...

It is the difference between the yield on shortish-term bonds (two-year) and longer-term bonds (ten-year). Banks make money by borrowing at the short end and lending long term. The margin between the two is where banks make their profits.

However, when central banks raise interest rates aggressively, the short end rises faster than the long end and the spread becomes inverted. That means banks stop making money from lending and therefore get a lot pickier about whom they lend money to. That action withdraws a major source of liquidity from the market.

That's not to say we are early in the cycle. Quite the opposite. There is growing evidence we are in the late stage of the credit cycle. That is why banking sectors, all over the world, are underperforming. These are interest rate-sensitive businesses and financial conditions have been tightening up. Globally, interest rates are still extraordinarily low with more than €7 trillion still on negative yields in the EU.

However, the Federal Reserve has been raising rates in a slow but steady manner. The European Central Bank is at the end of its quantitative easing programme. The Bank of England has begun to raise rates, the Japanese are talking about tapering their accommodation and the Chinese have been trying to squeeze some leverage out of the system without causing a crash.



What this tells us is that we are coming to the end of super low interest rates but we are probably some way from conditions being too tight for comfort.

Here's the fun part. Strategists like me have been saying for years that central banks are serial bubble blowers. They keep interest rates too low for too long which over-juices markets and leads to overheating and eventually a crash. However, it is not every day that one of their own makes that claim.

Paul Volcker, one of the most storied chairmen of the Federal Reserve, did just that two weeks ago:

I have yet to hear, in the midst of a strong economy, that maybe the inflation target should be reduced!

The fact is, even if it would be desirable, the tools of monetary and fiscal policy simply don't permit that degree of precision. Yielding to the temptation to "test the waters" can only undercut the commitment to stability that sound monetary policy requires.

The old belief that a little inflation is a good thing for employment, preached long ago by some of my own Harvard professors, lingers on even though Nobel Prize-winning research and experience over decades suggests otherwise. In its new, more sophisticated form it seems to be fear of deflation that drives the argument.

By hewing to an inflation target of 2% and doing everything possible to achieve it, central banks all over the world are blowing a bubble of epic proportions.

My conclusion from everything I've seen so far is that **the most exaggerated advance in this bubble has yet to occur**. This is a very important time to be invested because the true acceleration is just about to unfold.

Let's get back to recession indicators before I go any further.

The next is unemployment. Right now, it's at a record low in the US and UK. It stands to reason that people need to start losing their jobs if we are going to have a recession, but there is no sign of that happening just yet.

Next up we have **high yield spreads**. Again, let me explain what this means. High yield is a polite term for junk bonds. These are the bonds of companies that a

strategy works well and demand for junk bonds drives down their yields which compresses the spread over government bonds.

It stands to reason that when liquidity conditions tighten, then companies that depend on access to credit to fund operations get pressured first and the spread of high yield bonds over governments should widen out again.

Right now, US high spreads are close to as tight as at any time in the last few years, which suggests companies still have no trouble sourcing credit. Again, that suggests we are still a fair distance from the next recession.

The last one is **oil prices**. When oil prices are surging higher, like they did in 2008, it puts extraordinary pressure on the economies of consuming nations, which can lead to recession. Right now, oil prices are contained.

In fact, they fell back rather

By hewing to an inflation target of 2% and doing everything possible to achieve it, central banks all over the world are blowing a bubble of epic proportions.

rational investor would consider risky.

When interest rates are low, investors get hungry for yield so they move further out on the risk curve and start buying the bonds of less creditworthy companies. When credit is abundant, that

aggressively over the last couple of weeks, not least because the US is now pumping more than 2 million barrels more than it was six months ago.

I look at all of these indicators and conclude that we are still some way from the top of this market.



If that is the case, then this is an attractive entry point.

Another indicator I take into account is **seasonality**.

It is simple fact that the market does best in the fourth and first quarters of the year. In other words, the “sell in May and go away” mantra really works if you only look at the market from a statistical perspective. Additionally, October is by far the most volatile of all months for stockmarkets and it has just ended with the second biggest decline for the month since the 1950s. That is setting up the market for a major rebound.

I was in Dubai and Singapore two weeks ago to talk with the strategists at a multibillion- dollar family office. They were saying the same thing as some broker friends I was chatting with at a Halloween party. “I’m really looking forward to this year’s Santa Claus rally because I really need it.”

Think about it this way. Put yourself in the shoes of someone managing money who is responsible both to their superiors and investors to produce a positive return. It’s the beginning of November and you’ve just been through a major setback which has erased your gain for the year. What do you do? After all, your job is quite literally on the line.

Well, you start buying in the hope that everyone else is in the same boat and doing the same thing and that it will all come good by 31 December. That’s how it almost

always works and a few libations at the many parties along the way, punctuated by Halloween, Thanksgiving, Hanukkah, Christmas and New Year help the market to get to a positive outcome for the year. It’s called the Santa Claus rally because it’s the gift the market gives to investors at the end of the year for all their hard work.

Warren Buffett, the world’s most successful investor and CEO of Berkshire Hathaway, took the decision following the announcement of third quarter results to buy back shares.

Buffett does not believe in paying dividends because he thinks he can invest profits from the company’s diverse operations

If the world’s most famous value investor is buying back his own shares then that is about as clear a signal as we might wish for that we have just seen an important low in the market.

It’s not all about desperation for a positive annual return. The sell-off in October has really created value in the stockmarket. Valuations on Wall Street are back at where they were before the presidential election in 2016. What that means is that the so-called “Trump bump” has been completely priced out of the market.

There is widespread belief that the Democratic Party will retake the House of Representatives in today’s midterm elections and will do everything in their power to stop the Trump administration from passing any additional laws for the next two years.

That means he no longer expects new support from government, but that conclusion ignores the fact that the tax cuts are still in effect and benefiting both companies and consumers.

As if to ram that point down the throats of investors,

better than anyone so there would be no point. He has also expressed the opinion in many of his annual letters that share buybacks are only justifiable for when the price comes back below what he describes as intrinsic value.

If the world’s most famous value investor is buying back his own shares then that is about as clear a signal as we might wish for that we have just seen an important low in the market.

So, what is the thing that everyone has been worried about that caused such volatility in October? The two big issues are the trade war with China and the ruckus Italy is causing in Europe. Logically we need to see some resolution to these problems if investors are going to concentrate once more on the promise and potential of the technology sector.

Let’s set aside for the moment the



quantity of debt the US is accruing to pay for its fiscal stimulus, which is undoubtedly going to cause a problem in future, and concentrate on the results. The lowest unemployment in decades, rising productivity and the fastest wage growth we've seen for years. That's exactly what restive populations all over the world are agitating for.

Therefore, the answer for Europe is not to sanction Italy but to join it in a fiscal stimulus which could finally break the region's economy out of its funk. I am not saying that is going to happen tomorrow, but it is the clear answer to the rise of the populism that threatens to wash away the centrist parties which have presided over the EU since its founding. If the EU is going to survive, it needs to abandon the fiscal strait jacket that has contributed to lower standards of living for hundreds of millions of people.

China is also starting to get a

economy and that means a fiscal stimulus.

Bull markets thrive on liquidity and we have seen extraordinary monetary policy feed this bull market for almost a decade. We are now at a point where the tide of monetary largesse is turning and there is a real possibility it will be replaced by an incoming tide of extraordinary fiscal spending on a grand global scale.

We already see that is having an effect on bond portfolios. The supply of bonds is increasing because governments are borrowing so much, which means their prices fall and yields rise.

If you talk to any IFA they will tell you that their model portfolios have anything from 40% to 60% invested in bonds. They are supposed to be the stabilising factor and they have been because yields have been falling for decades. However, that is now changing and there is a lot

into stocks. The bond market represents a major source of capital to fuel the rest of this bull market in stocks.

Even with all of these arguments there is no doubting we are late in the cycle because the market has already been rising for almost a decade so let's think about how major bull markets fueled by abundant liquidity generally end.

I can say it in one word...

Acceleration

AKA: a melt-up.

The technology, media and telecoms bubble was ticking along nicely between 1990 and 1998 and then it went truly haywire and almost doubled in about 11 months.

The Japanese bubble was the climax of a 20-year bull market but the market just about doubled from the low immediately following the 1987 crash and the peak in the last week of 1989.

The Roaring Twenties climaxed in 1929 and in the 13 months ahead of the crash the market rose almost 100%.

Just a little more than a year before gold's decade-long bull market climaxed in 2011 the price just about doubled.

Central banks raise interest rates because they are confident of economic environment and a little worried about the rise of inflation. It's also generally a time when companies are doing well and profits are rising.

The answer for Europe is not to sanction Italy but to join it in a fiscal stimulus which could finally break the region's economy out of its funk.

taste for fiscal stimulus. It's been aggressively trying to squeeze leverage out of the system for the last few years and that has resulted in slower economic expansion than they were expecting. Now with the US imposing tariffs on an increasingly large swathe of goods, the Chinese administration has to act to support the domestic

of money in bonds that is going to need to find a new home.

The only market anywhere large enough to accommodate that cash and with the potential to deliver the returns necessary to meet pension obligations is the stockmarket. The longer bond yields trend higher, the greater the incentive to sell up and move



Right now, the perception among investors is that we have seen the peak in earnings but if history is any guide (it is) that is unlikely to be the case. In fact, the acceleration that can often mark the euphoric final stage of major bull markets could be just about to unfold so we need to be primed for that eventuality.

them. It rose 10.3% between the open on 1 October and the close on 31 October. The S&P 500 fell more than 7%.

Elon Musk is also one of the most divisive people on the planet but he has undeniably done what many people thought was impossible. He has disrupted the

production is dedicated to producing power pack for the Model 3.

Right now, Panasonic is running 11 production lines at the Gigafactory and is investing to bring two more online by the end of the year. Once that investment is done, it anticipates it will be running a profit on the production of all cells at the factory which will be churning out 35 gigawatt-hours a year.

The company's chief financial officer Hirokazu Umeda estimates profit from the factory will be kicking in as early as this quarter. Here is one of the most important things he had to say:

“We are finally at a place where we can move in lock-step with Tesla and make as many batteries as they make cars,” Tsuga said. “It’s a relief, because they went through hell this September. And so did we.”

Tesla’s share price tells us the same story: it has been rising and falling in an aggressive manner all year. It has been plagued by production delays, erratic tweets by Elon Musk and the threat that it would run out of money before it gets to production stability.

There is still the realistic possibility it will need to go to the market for additional capital because it has \$2.9 billion in cash and is expecting to make \$3 billion in capital expenditures alone in 2019. That’s why the prospect of profits from the Model 3 are so important.

Revenues are on a strong upward

It’s one of the most divisive shares in the world where opinions are the most polarised I have ever witnessed. It is the share that is most likely to accelerate higher and prompt euphoria as the bears eventually give up.

Technology has been the leading sector in this bull market so there is a real possibility that the wider market could just about double from current levels. My question therefore is whether there is a share that could do better than that.

Something that will epitomise the bull market and convince the naysayers that we really are dealing with the real thing.

I believe I have the answer. It’s one of the most divisive shares in the world where opinions are the most polarised I have ever witnessed. It is the share that is most likely to accelerate higher and prompt euphoria as the bears eventually give up.

I’m talking about Tesla Motors.

The case for Tesla soaring during the coming melt-up

There are a very small number of shares that finished October on a positive note. Tesla was one of

automotive sector. He has proved beyond doubt that it is possible to make electric cars sexy.

The big question now is whether he can get to profitability before he goes bust. I believe he can and let me tell you why now is the time to buy.

There is one company that knows better than anyone else how well Tesla is doing. It is the company that supplies Tesla with all of its batteries. That company is Panasonic. Tesla built the Gigafactory in Nevada but all the machines inside belong to Panasonic. Therefore, if we really want to get a perspective on how well Tesla is doing, then we need to keep an eye on what Panasonic is saying about battery demand.

Last week the CEO of Panasonic said profitability is in sight for the Gigafactory because Tesla is ramping up production of the Model 3. All the batteries for the Model S and X are produced in Japan but the Gigafactory’s



trajectory but profitability has been elusive because manufacturing cars is incredibly capital intensive. The only way to start a new car company, and a mass market car company at that, is to have a radically better offering than what is on the market right now.

Tesla has done that.

Tesla owners love their cars and the number of people I know who testify it is the best car they have ever owned is surprisingly large.

Even so, the challenges of getting to a position where mass market production is up and running would have been impossible in any other macro environment than what we have witnessed in the last decade.

Exceptionally low interest rates and abundant liquidity coupled with technological innovation are why Tesla is where it is today. If either of those conditions were missing, it could not have grown this large.

With Model 3 production ramping up, the third quarter results were particularly impressive with the \$1.92 billion profit following four consecutive quarters of \$3.5+ billion losses. If Tesla can string together consecutive quarters of profits, it is likely to quickly morph from being pariah to a darling of investors.

There is no doubting that Tesla is also lucky because the diesel cheating scandal broke at just the right time for a company selling electric vehicles. Diesel cars are reliable, fuel efficient and last for

what seems like forever. There would have been no reason to migrate for most consumers if they were not also very polluting and a threat to public health.

Now, the established car companies are scrambling to ditch diesel cars because no one wants them and they have little chance of meeting tighter emissions standards. Daimler announced in September it is about to spend \$12 billion on battery plants for future electric vehicles, but its full range of vehicles will not be ready for sale until 2022.

LG Chem is South Korea's largest battery manufacturer and is the only battery producer that comes close to Tesla's production capacity. It is supplying batteries to Volkswagen, Volvo, Jaguar and General Motors to name a few.

in pole position to supply electric vehicles now and for the next few years. Today, 17.2% of revenue originates in China. That's the biggest car market in the world and the country with some of the worst air pollution so Musk is in talks to build another Gigafactory in China.

That means the company is not standing still but has ambitions to become the world's biggest car company by ensuring it is the primary suppliers of electric vehicles as the world transitions away from the internal combustion engine.

I said at the outset that Tesla tends to polarise opinion. For those who believe the story and love the cars, the company can do no wrong. For those who think Elon Musk is the equivalent of Lex Luther from the Superman

The situation right now is Tesla is in pole position to supply electric vehicles now and for the next few years.

To fulfill those orders, it is investing heavily in factories in China and Europe but each of those car companies is dependent on supplies being fulfilled from one company.

Chinese suppliers are primarily focused on CATL and BYD, which will primarily be supplying production for China's domestic market which is the largest in the world.

The situation right now is Tesla is

comics, the company is going to collapse imminently.

As a result, Tesla is one of the most shorted stocks in the market today. 26.48% of shares are lent out to people short the stock. That's a lot and tells us there are large numbers of people who are very heavily exposed if the stock does not in fact go down.

If you are short you are necessarily leveraged because you have to borrow stock in the hope



you can buy it back later at a lower price, so you can deliver it back to the people you borrowed it from in the first place. When the price moves higher, it puts these kinds of positions under pressure and the phone starts ringing because the people you borrowed money from want it back.

Against a macro background where there is real scope for a melt-up, Tesla is the share that has the greatest potential to rise because so many people have already bet it is going to fall that the short covering alone could send it higher in a very meaningful way. Think of it like a nitro-charge.

Add to that the fact that the wider automotive sector has to spend a pile of money to get out of diesel and into batteries and Tesla suddenly becomes the only one to own because it has already gone through the majority of its capital expenditure programme while the others are only starting.

I rate Tesla a buy up to \$400 and my target over the next 12 months if the market breaks out like I expect is \$1,000.

The risk is that class action law suits legal firms are lining up against Musk for his tweet

Action to take:	Buy Tesla
Ticker:	TSLA
Price as of 05/11/2018:	346.41
Buy up to:	\$400
52-week high/low:	\$387.46/\$244.59
Market cap:	\$58.630 billion

Figures accurate as of last market close 05/11/2018



relating to having funding secured to take the company private will hold back the share from its potential to breakout and contribute to continued volatile ranging. With shares with proven proclivity for extraordinary volatility, investors have to be prepared for potentially large swings both up and down so this is not a position for the faint-hearted.

As I said at the start, all the research, indicators and lessons I have learned to trust from the past tell me loud and clear: a melt-

up is coming. In my view, now is the time to be bold. Showing nerve today could pay off enormously as the final stages of this bull market really accelerate.

This may be the last great bull market of our times and I am not going to miss it.

It's time to capitalise.

Many thanks,

Eoin Treacy
Investment Director, *Frontier Tech Investor*

Medical



Company	Ticker	Rec Date	Price Then	Price Now	Gain/loss %
Autodesk	ADSK	19/07/17	\$108.83	\$133.50	22.67
Illumina	ILMN	05/09/17	\$207.22	\$324.14	56.42
PureTech Health	PRTC-L	09/01/18	155.75p	162.50p	4.33
Becton Dickinson and Co	BDX	03/05/18	\$221.35	\$237.32	7.89
Canopy Growth Corp	WEED:CN	21/03/18	C\$33.11	C\$52.53	58.65
Advanced Oncotherapy	AVO	03/07/18	48p	41.50p	-13.54
Boiquest	BOE:LN	07/08/18	440p	427.50p	-2.84
Aurora Cannabis	ACB-T	19/09/18	C\$12.35	C\$9.56	-22.59

Technology



Company	Ticker	Rec Date	Price Then	Price Now	Gain/loss %
SAIC	SAIC US	05/07/16	\$58.20	\$69.30	24.40
Garmin	GRMN US	02/08/16	\$55.75	\$64.85	24.63
Cisco Systems Inc.	CSCO:US	03/04/17	\$33.80	\$46.14	42.87
Microsoft	MSFT	31/07/17	\$73.04	\$107.51	50.03
Northrup Grumman	NOC US	07/11/17	\$301.66	\$279.44	-6.33
Intel Corp	INTC	06/06/18	\$57.03	\$47.67	-15.89
Activision Blizzard	ATVI:US	02/10/18	\$83.29	\$64.34	-22.75
Tesla	TSLA	05/11/18	\$346.41	\$346.41	-
Science Apps Int	SAIC	07/07/16	\$58.20	\$69.30	24.40

Energy



Company	Ticker	Rec Date	Price Then	Price Now	Gain/loss %
Ormat Technologies	ORA on NYSE	06/06/17	\$58.79	\$54.75	-5.87
Sherritt International Corp	S CN	06/02/18	C\$1.18	C\$0.62	-47.46

Moonshot



Company	Ticker	Rec Date	Price Then	Price Now	Gain/loss %
SolarWindow	WNDW	07/04/16	\$3.96	\$3.17	-20.03
Alkane Resources Ltd	ALK:AU	05/09/16	AU\$ 0.31	AU\$ 0.23	-26.23
Haydale Graphene Industries	HAYD	02/05/17	178.5p	25.50p	-85.71
Superconductor Tech Inc	SCON	03/04/18	\$9.60	\$1.93	-79.90

For the full portfolio including live prices, please visit the *Frontier Tech Investor* subscriber area. [You can view that by following this link.](#)

Risk warning

Your capital is at risk when you invest in shares – you can lose some or all of your money, so never risk more than you can afford to lose. Bid/offer spreads, commissions, fees and other charges can reduce returns from investments. The *Frontier Tech Investor* portfolio is not intended to represent the exact price at which you could buy or sell a share. Our reference price is the closing price the day before issue is published. Sometimes readers will achieve better entry/exit prices; sometimes worse. All gains are gross, and returns will be affected by dealing costs and taxes. Profits from share dealing are a form of capital gain and subject to taxation. Tax treatment depends on individual circumstances and may be subject to change in the future. The information and opinions expressed do not necessarily reflect the views of other editors/contributors of Southbank Investment Research Ltd. Small cap shares - Shares recommended may be small company shares. These can be relatively illiquid meaning they are hard to trade and can have a large bid/offer spread. If you need to sell soon after you bought, you might get back less than you paid. This makes them riskier than other investments. Small companies may not pay a dividend. Full details of our complaints procedure and terms & conditions can be found on our website southbankresearch.com Investment Director: Eoin Treacy. *Frontier Tech Investor* is issued by Southbank Investment Research Ltd. Registered in England and Wales No 9539630. VAT No GB629 7287 94. Registered Office: 2nd Floor, Crowne House, 56-58 Southwark Street, London, SE1 1UN. Southbank Investment Research Ltd is authorised and regulated by the Financial Conduct Authority. FCA No 706697. <https://register.fca.org.uk/>. ISSN 2398-2470. © 2017 Southbank Investment Research Ltd.