



## **CUP & HANDLE MACRO**

Greetings,

It looks like hedge funds will underperform the S&P 500 [for the sixth consecutive year](#) in 2014. In my opinion, these managers continue to struggle for two reasons. First, artificially low interest rates and non-existent volatility make alpha-generation nearly impossible for such large funds. And secondly, impatient investors who expect positive returns week-in and week-out make it impossible to hold positions for any extended period of time. As a result, HF managers pile into the same non-controversial trades and dial up the leverage to meet their benchmarks. It works great when those positions rise, but [can get ugly when everyone rushes towards the exit](#).

Non-professionals need to take advantage of the fact that they don't have a benchmark. Why leverage up when there's no need? I've kept at least 40% of my portfolio in cash since launching in August, and have still managed to return 18%. Over that period, the S&P 500 is up only 6%, while the HFRX Global Hedge Fund Index is down 3%. I sleep well at night knowing that cash gives me flexibility to limit downside risks and take advantage of new opportunities when they arise.



Unfortunately for hedge fund managers, it doesn't look like volatility will spike anytime soon. Last Friday, ECB President Mario Draghi gave an extremely dovish speech that opened the door for sovereign debt purchases in the future. Draghi continues to make it perfectly clear that he wants the Euro to decline in order to keep deflation at bay. So far he's getting his wish. The Euro is trading at a two-year low against the US dollar, and has declined 5% this year on a trade-weighted basis.

As we approach Thanksgiving here in the US, I'd like to give thanks to central bankers around the world for continuing to up the stimulus ante. Asset prices are soaring everywhere. The S&P 500 is back at all-time highs. Christie's [held the biggest art auction in history this month](#), selling \$853 million worth of contemporary and post-war art. These policies are unsustainable. Even if central bankers are successful in growing the economy, there will be major dislocations (i.e. money-making opportunities) in the process.

The stock market rallied just over 1% last week, but I actually made more money on the short-side. My [Marketfy portfolio](#) finished the week 4% higher, and I may start putting some cash to work soon. My investment pick for November was sent out to Newsletter subscribers yesterday. I've had a position in this name for a few weeks, and it's already up 7%, but this is just the beginning. If you'd like to start receiving these picks, a subscription is \$8/month. That's so cheap that if you invested \$1,000 in my portfolio from August, the profits alone would pay for 20 months' worth of subscriptions. I'm excited to boost these returns once the market starts to whipsaw. I hope you'll join me. [Click here to subscribe.](#)

Today's letter will cover several topics, including:

- China Powers Down
- Gold on the move
- Monetary Matters
- Chart of the Week

As always, if you have any questions or comments or just want to vent, please send me an email at [mike@cup-handle.com](mailto:mike@cup-handle.com).

Until next time, tread lightly out there,

**Michael Lingenheld**

*Managing Editor – Cup & Handle Macro*

## China Powers Down

I don't want to spend too time on this subject, [because so much was written about it over the weekend](#), but China's central bank cut interest rates on Friday for the first time since July 2012. The one year deposit rate was lowered by 25 bps to 2.75%, while the one year lending rate was lowered by 40bps to 5.6%. It's widely understood that Chinese GDP figures are artificial, making it difficult to anticipate rate cuts. However, there are other metrics that give a better indication of what's really happening in Mainland China.



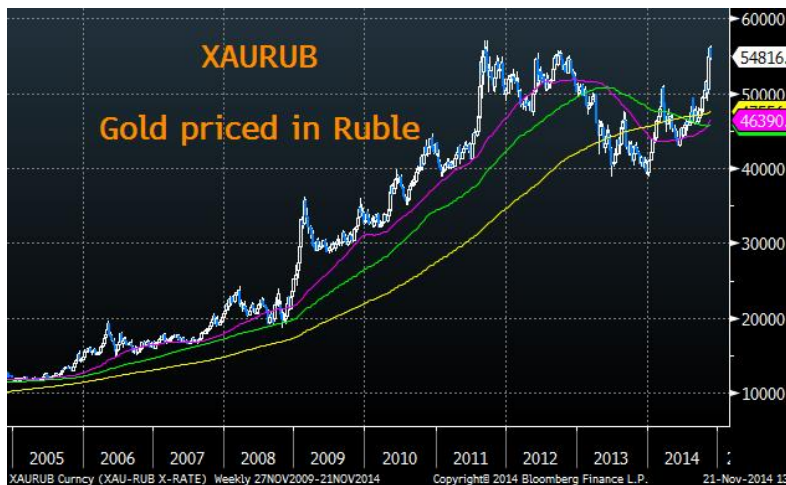
For example, total energy consumption is much harder to manipulate than GDP. The chart seems to confirm that Chinese growth has not been as strong as the government would have you believe. Lower interest rates should encourage lending and hopefully stimulate business activity, but China first needs to figure out how to compete with Japan's freefalling Yen.

## In Russia, Gold Buys You!

Last week, in a surprise announcement, Russia's central bank Governor Elvira Nabiullina told the lower house of parliament that the bank has purchased 150 tons of gold (\$5.8 billion worth) this year. Nearly half of those purchases have come since August. The statement was likely coordinated with Putin and the Kremlin to signal how Russia views their gold reserves as a potential geopolitical weapon.

However, if Putin thinks he can win a currency war with gold, he'll be badly outgunned against the West. Even though [Russia ran down its FX reserves](#) in order to defend the Ruble, gold holdings are still only 10% of total reserves. Although, it has been a great investment for Putin. Gold priced in Rubles is up 40% YTD.

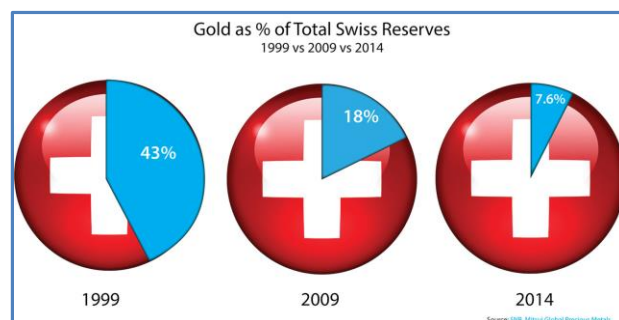
	<u>Gold as % of Total Reserves</u>
Portugal	83.2%
United States	71.9%
Venezuela	71.1%
Greece	69.1%
Germany	68.4%
Italy	67.0%
France	65.1%
Cyprus	63.5%
Slovakia	58.3%
Netherlands	54.3%
Russia	9.7%



While we're on the subject of gold, I want to touch on an [under the radar story](#) from Friday. The Dutch central bank, which holds more than 50% of its reserves in gold, is repatriating bullion from the US to address public concerns on the matter. The goal is to keep 31% of its gold at the central bank's vault in Amsterdam, up from 11% previously. Germany famously bowed to public pressure

in 2013 by repatriating some reserves from the US and France.

Switzerland, meanwhile is bracing for a referendum on November 30 that would require the Swiss National bank to hold 20% of its assets in gold (up from 8% currently) and force it to repatriate reserves held in the UK and Canada. While [the referendum looks unlikely to pass](#), these are the type of news stories that gold bugs live for. Russia and the West don't see eye-to-eye on many issues these days, but keeping bullion local is one of them.

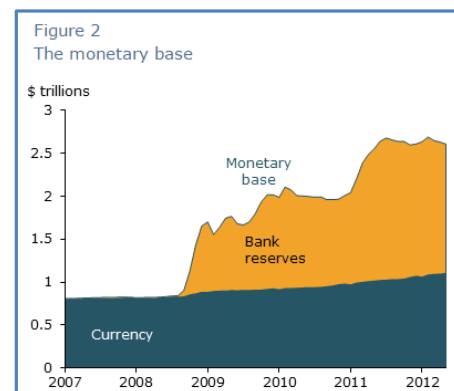


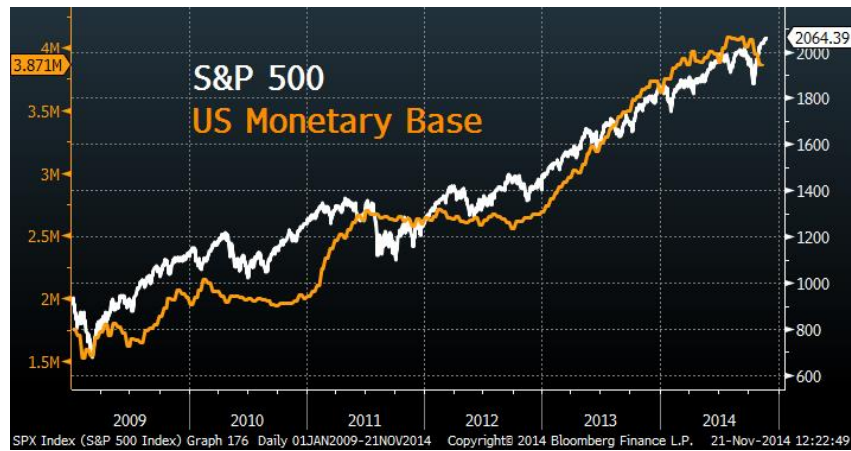
## Monetary Base – The Only Thing That Matters?

I usually go to great lengths to avoid wonky, Economics 101 type discussions, but hear me out on current trends in the US monetary base.

The monetary base is defined as the total amount of currency that is either circulated in public or held as commercial bank deposits in the central bank's reserves. Up until 2008, the monetary base primarily consisted of currency in circulation (chart right). Since then, the monetary base has risen dramatically because of a huge increase in bank reserves – a direct result of QE's 1, 2 and 3.

However, QE3 has been tapered out of existence and the monetary base has now declined by over \$200 billion, or 5%, from its peak. Why is that important? Since 2009, when the Fed began experimenting with extreme policies, the monetary base has maintained incredible correlation with the stock market.

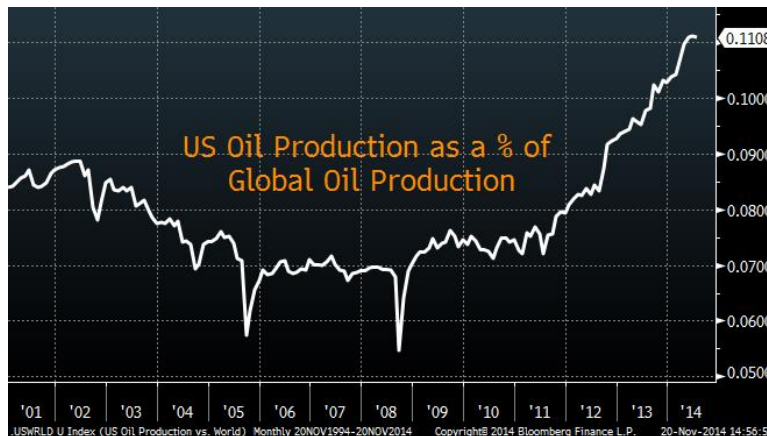




For now, the Fed is done pumping up bank reserves, and the amount of currency in circulation is entirely determined by demand from people and businesses. It's too early to say that the declining monetary base is a problem, but if it keeps declining, it will be.

### Chart of the Week

In addition to huge quantities of natural gas, the emergence of fracking has produced nearly 4 million barrels of incremental oil per day in the US. Over the past eight years, close to 100% of the increase in global oil production has come from the US; which now accounts for more than 11% of total global production. Experts predict that US supplies will increase by another 2-3 million bpd in the coming years.



However, production from the average shale oil well declines by 50-75% after its first year, creating a situation where new wells have to be drilled constantly in order to maintain production. This fracking revolution could be short-lived. In the meantime, traditional oil production is not getting any cheaper. In 2013, the oil industry spent \$700 billion globally (up from \$250 billion in 2005) and found just 4.5 months' worth of current oil production levels – a 50 year low. Saudi Arabia can punish its OPEC brethren by depressing oil prices in the short-run, but ultimately the cost of energy will rise. And when it does, some of these offshore drillers like Seadrill (SDRL) with its 19.6% dividend yield will look awfully attractive.



## **Reader Question:**

**\*\*Editor's note: Every week we'll try to answer at least one reader question. If you would like to submit a question, please send us an email at [info@cup-handle.com](mailto:info@cup-handle.com). We'd love to hear from you! \*\***

*Q: What book did you recommend on (last) Wednesday's webinar? - PH*

A: [Lords of Finance: The Bankers Who Broke the World by Liaquet Ahamed](#). I read this book 3-4 years ago, and started re-reading it again last week. Extremely well written, it's a narrative-based book that follows central bankers from the US, France, Great Britain and Germany between 1917 and 1940 as they deal with the Great Depression.

The parallels between that period and today are startling. Central banks operated under the gold standard back then, so the monetary tools were different, but their attitudes towards austerity and debt look very familiar today. The intra-Europe animosity built-up during the Great Depression culminated in World War II. Hopefully we can avoid such devastation this time around.

**That's all, see you next week!**

For any questions or comments, please email us at: [info@cup-handle.com](mailto:info@cup-handle.com)

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