



CUP & HANDLE MACRO

Greetings,

Over the next five years, film studios are scheduled to release 26 [“comic-book”](#) movies. At some point studios will run out of characters, and when they do, I think they should launch a new team of superheroes called “The Central Bankers.” Sent from planet Academia, The Central Bankers are here to protect financial markets from the ferocious Bears. The opening scene could be Janet Yellen’s press conference from last Wednesday.

All jokes aside, it’s remarkable how addicted asset prices have become to monetary stimulus. According to Bank of America, **83% of world equity market capitalization is supported by 0% interest rate policy**. The US stock market had its best two-day rally since 2011 after the FOMC press conference, finishing +4.5% higher. In my opinion, it wasn’t so much that stocks rallied, rather the market simply cooled-off leading up to the press conference fearing Yellen would put a timetable on rate hikes. Once the Fed confirmed it was willing to be “patient,” stocks resumed their record-setting rally.

The S&P 500 continues to look bullet-proof, but other regions are struggling mightily:



In Germany, Europe's economic powerhouse, 5-year inflation breakevens have fallen below zero – pricing in outright deflation. Greece, Europe's problem-child, failed to elect a President in their first round of voting last week. Early elections [with the potential to destabilize the Eurozone](#) will be called in January.

It's the same story in Asia. December Manufacturing PMI in China fell below 50 for the first time since June – signaling a contraction. Australia, which was also hit by a lone-wolf terrorist attack last week, saw 3rd quarter GDP grow a measly 2.7% Y/Y, compared to economist expectations of 3.1%.

And then there's Russia. While the developed world is desperately trying to combat deflation, Russia's currency crisis will likely push CPI into double-digits early next year, despite a 6.5% rate hike last week. [Food inflation is already a major problem](#), and there are fears of a nationwide food shortage. More on Russia below...

My Marketfy portfolio rallied ~3% last week. Very disappointing results, in my opinion. I had the Mon-Tues selloff followed by a Wed-Thurs rally called perfectly, but poor position sizing negated most of the gains. Frustrating, but it's hard to cry about profits. We'll get 'em next time. Now that most December catalysts have passed, I expect the market to quiet down into year end. My December Investment Letter went out yesterday and it's a very high-conviction bet – [if you'd like to start receiving these letters click here](#). It's \$8.25/month, which would buy you more than 2 bushels of corn. Except that corn won't improve your portfolio's returns.

Today's letter will cover several topics, including:

- Houston, You Have a Problem
- Saudi's Get Slammed
- Russian Commie's
- 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.

Until next time, tread lightly out there,

Michael Lingenheld

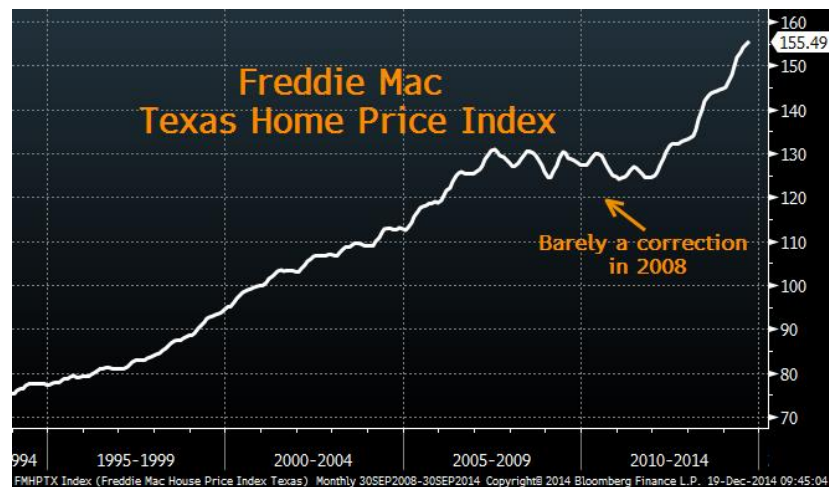
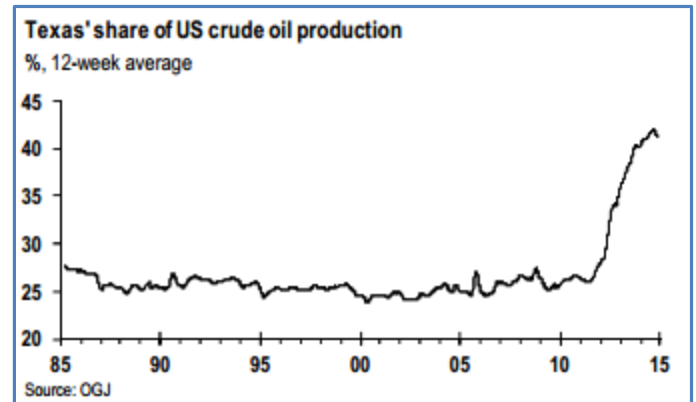
Managing Editor – Cup & Handle Macro

Houston, You Have a Problem

For the most part, Texas made it through the Great Recession unscathed. By virtually any measure, the Lone Star state outperformed nationally in terms of GDP, employment, income, tax collection and consumer spending throughout 2008-2009. The Brookings Institute ranked the performance of all metropolitan areas in 2009, and [six of the top 10 were from Texas](#). However, with the price of oil down 50% since June, Texas could become a laggard and a recession is very possible.

Over the last five years, more than two-thirds of the growth in US crude oil output came from Texas. On a nominal basis, Texas accounts for 40% of total US production; up from 25% in 2011.

The situation is actually comparable to 1986, when crude fell 50% over a matter of months. The unemployment rate in Texas jumped 2% higher over the first quarter of 1986. From there, the distress spread from the labor market to housing, and by 1988 Texas home prices had fallen 14% from their peak. The icing on the cake was a banking crisis, as several hundred Texan banks failed during 1988 and 1989.



The chart above shows Texas real estate barely felt the effect of the national housing bubble in 2007-2008. However, now that oil has dropped, expect real estate to cool off. Shorting local home prices is an attractive bet, but it's hard to find a liquid investment vehicle to target specific geographies.



Instead, if you're looking to play this theme, I'd recommend shorting regional bank stocks with heavy exposure to Texas. For example, BOK Financial Corp (ticker: BOKF) is based in Tulsa, OK but 20% (or \$2.5 billion) of its total loan portfolio is exposed to energy investments in Texas. If you want to hedge that short position, buying shares of the KBW Regional Bank Index (ticker: KRE) makes the most sense. Many Texan oil drillers can temporarily deal with oil prices below \$60/barrel, but if prices stay there for a sustained period of time, they'll be in big trouble.

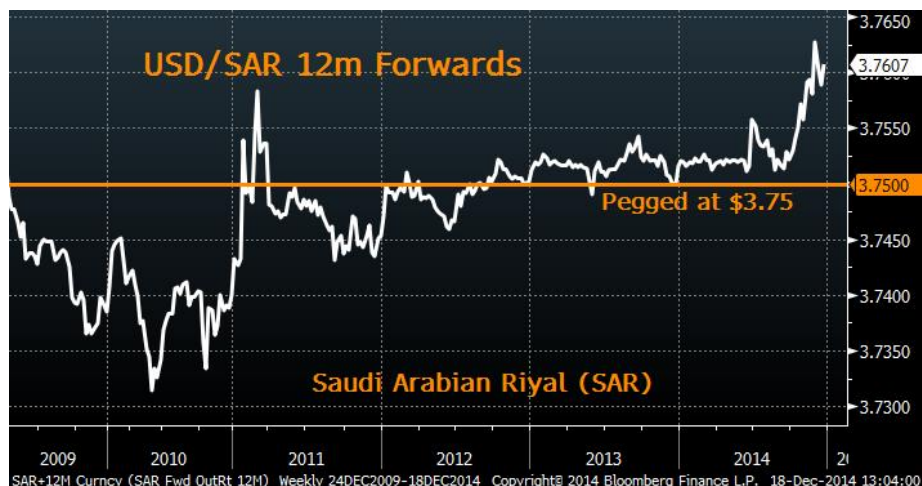
Saudi's Get Slammed

Saudi officials [have been very open](#) about regaining market share in the oil market by increasing supply and shaking out the weak-handed producers. But at what cost? From September to the middle of last week the Saudi stock market was in freefall, down 35% from peak to trough. Shares only rebounded on Wednesday after the country's finance minister implied the government would not cut spending on development projects or social benefits in 2015, despite falling oil revenues.



Saudi equities could be very attractive at these levels, as long as oil stabilizes. The opening of Saudi Arabia's stock market to direct foreign investment is only months away, and demand is

expected to be strong. BlackRock (ticker: BLK) even has [plans to launch an ETF](#) for Saudi shares sometime next year. However, if oil prices continue to fall, there could be a serious economic crisis.



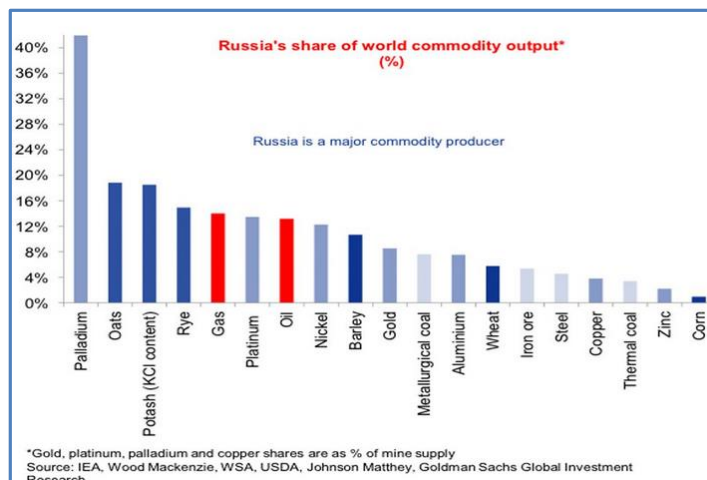
The Saudi's have pegged their currency, the Riyal (SAR), to USD since 1986, meaning the rapid appreciation of USD is tightening domestic monetary conditions. 12-month USD/SAR forwards are trading at their highest levels since the financial crisis. If USD continues to rise and oil continues to fall, the country's monetary policy would be entirely inappropriate, and stocks would suffer.

The government is rapidly trying to diversify the economy because over 90% of its revenues come from oil, but that will take years. While the Kingdom has huge financial reserves to withstand temporary turmoil, a permanent drop in oil prices would be problematic. I don't have a firm view either way, but Saudi equities are one of the world's most intriguing markets to watch in 2015.

Russian Commies

The market has been laser-focused on the Russian crisis spreading to currencies and equities, but don't sleep on commodities. More than 40% of global palladium supply comes from Russia, and it's also major producer of nickel, potash, natural gas and, obviously, oil. On top of that, Ukraine and southern Russia are known as "the breadbasket of Europe," exporting huge quantities of corn and wheat.

Last Wednesday, Russian news agency Interfax reported the government was issuing export certificates for wheat to only four countries: Egypt, Turkey, India and Armenia. Russia, one of the world's largest wheat exporters, typically ships grain to dozens of countries. Wheat futures finished the day 4.1% higher as traders bet the news could boost overseas demand for US inventories.

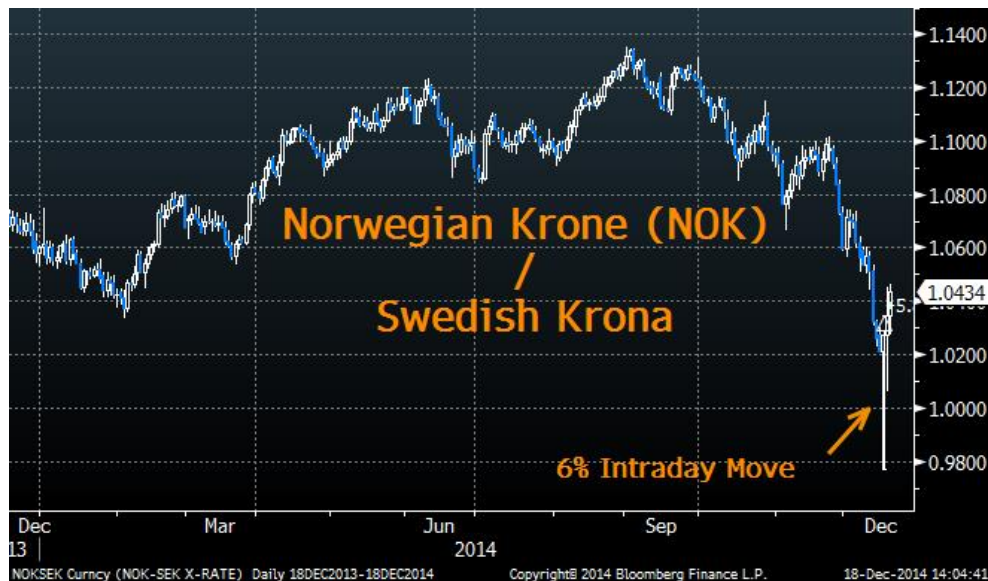




The price jump may be short-lived with global grain supplies at a 15-year high, but it highlights Russia's importance to the commodity complex. ETF's like Market Vectors Russia (ticker: RSX) and Direxion Daily Russia (ticker: RUSL) have been trending for several days on [StockTwits](#), but they're relatively illiquid and dangerously volatile. If you're looking to trade around Russian news, keep commodities in mind. The implementation of capital controls or export restrictions would have major implications.

Chart of the Week

This chart is incredible for two reasons. First, even though I always preach about the importance of fundamentals, the "hammer" candle formed in NOK/SEK last Tuesday was remarkable. The cross moved 6% intraday as the spiraling Ruble sent currency volatility soaring. The result was a technical signal that all but guaranteed NOK/SEK would finish the week higher – and it did.



Second, as these currencies whipsawed on Tuesday, for a brief moment the Swedish Krona was worth more than the Norwegian Krone for the first time since 2000 – making front page news in

Scandinavia. As the smaller of the two Nordic nations, Norway has long taken pride in NOK being worth more than SEK. However, more than a quarter of Norway's economy is tied to oil and gas, and the currency has been hurt as a result.

Norway's central bank unexpectedly cut interest rates last week, and signaled a 50-50 chance it will cut them again early next year. Sweden, on the other hand, cut interest rates to zero in October and is considering negative deposit rates or even a QE-program of its own in 2015. Both countries are desperately looking to reinvigorate their respective economies, but it doesn't appear the market is ready for parity in NOK/SEK.

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. We'd love to hear from you! ****

Q: Worth investing in Cuba now? - DG

A: Not unless you think Republicans will agree to lift trade embargoes with Cuba, which appears extremely unlikely. In fact, Jeb Bush and Marco Rubio will likely use President Obama's move to thaw relations with the Communist island as a rallying cry for their 2016 Presidential campaigns. The Cuban economy is small. With GDP of only \$70 billion, it's comparable to Hawaii.

Shares of the Herzfeld Caribbean Basin Fund (ticker: CUBA) soared by as much as 47% to a seven-year high after reports of the breakthrough. Trading volume in CUBA reached 24 million shares on Wednesday, roughly 50% of the cumulative volume the fund had experienced since listing in 1994. However, CUBA is a closed-end fund (fixed number of shares) so I'd expect the stock to cool off once the headline-chasers back away.

Instead of buying CUBA shares at the highs, take a look at Sherritt International (ticker: S CN) based in Toronto, Canada. Sherritt is the largest independent energy company in Cuba and operates a nickel mine on the eastern shore. The company derives 75% of its revenue from operations on the island. Nickel prices have been rising and the "oil crash" should be priced into the stock already. It's a low-conviction view, but if I had to pick a stock for this theme that would be it.

Happy Holidays, be on the lookout for my "5 Bold Predictions for 2015" next Tuesday!

For any questions or comments, please email us at: info@cup-handle.com

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