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January 27, 2015

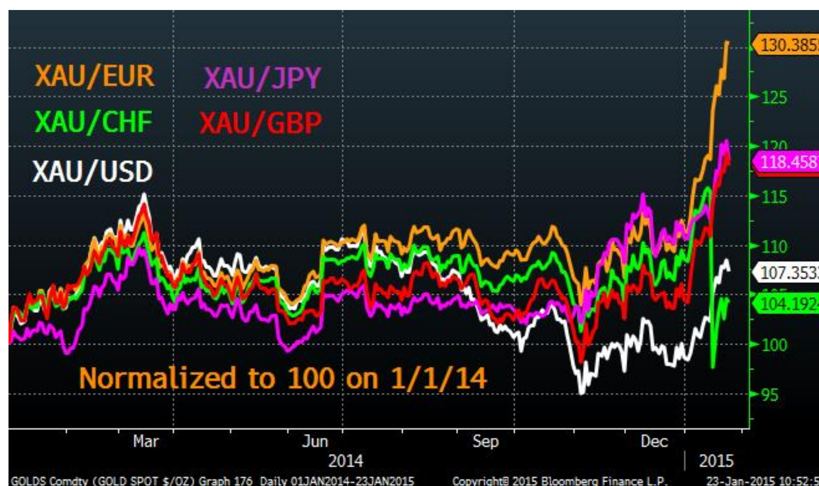
CUP & HANDLE MACRO

Greetings,

Former US Treasury Secretary Larry Summers perfectly summed up my thoughts on the recent spate of monetary stimulus saying, “I think we need to realize the era of central bank improvisation as the world’s principal growth strategy is coming to an end.” Last Thursday, investors cheered the ECB’s commitment to flood the market with more than 1 trillion EUR over the next two years, but I’m taking a more skeptical approach.

The ECB’s decision has been thoroughly dissected in the financial press, and I’ll give my thoughts below, but few have mentioned the incredible move in gold/EUR. Denominated in EUR, gold has rallied nearly 20% YTD. Contrary to popular perception, gold was actually the second best performing currency of 2014, bested only by the US Dollar. Obviously the Swiss Franc is leading so far in 2015, but gold is right on its heels.

Real 10-year interest rates in Germany, which have dropped 40bps this month, to -0.6%, are driving gold higher. Sentiment is improving, but positioning remains light. Over 2013 and 2014, total ETF demand for gold fell by more than 34 million ounces; equal to $45 billion at current prices.



Higher prices are giving a much-needed shot in the arm to gold miners. The GDX Senior Gold Miner ETF is up more than 20% YTD, even though several miners have issued fresh equity. Gold companies in North America, where more than half of the industry is based, have announced more than $800 million of stock sales this month - already the highest total since October 2013. It makes sense that these firms, which still trade like distressed assets, are raising capital, but it reinforces my belief that the ETF's offer the best exposure to gold miners – namely GDX and GDXJ.

Another under the radar development that caught my attention last week was the continued exodus from junk bonds. Sovereign yields across the globe are still trading with negative nominal yields, yet investors pulled $523 million from global high-yield funds and ETFs in the week ended January 21. Ray Dalio, who runs the $160 billion Bridgewater Associates, said in Davos last week, "We have a deflationary set of circumstances, which makes it appealing to just stuff your money under a mattress." Perhaps investors are starting to realize that QE isn't that panacea academics make it out to be.

The **Cup & Handle Fund** had its largest setback to date last week, losing -2.5%. Since launching in August I've either been directionally right with poorly sized positions or directionally wrong with good risk management. The fund is still up 10.5% from inception, so considering that I'm not meeting my own standards, things could be worse. I still feel good about the positions though, and we're in a bull market for global imbalances, so the future is bright. Thank you for all the feedback on my January investment pick, and I hope everybody can get in at attractive levels – **if you'd like to start receiving these letters click here**. It's $8.25/month or .04 Bitcoins.

Today's letter will cover several topics, including:

- The Jobs Problem
- Canadian Bacon
- QE in Practice
- 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

The Jobs Problem

I'm sure you've seen the statistics by now. The US economy added nearly 3 million jobs in 2014, the most since 1999. December was the 51st consecutive month of positive job growth – the best stretch since 1939. These numbers are central to the Federal Reserve's case for why interest rates should increase in 2015. Yet, anecdotal evidence suggests the job market is headed for a downturn.

First of all, participation in the labor force is the lowest it's been since 1978, ruling out the possibility [that we've hit](https://) "full employment." Secondly, several large US-based corporations are currently undertaking massive layoffs. American Express (AXP) said last Wednesday that it planned to cut 4k in the coming months. On the same day, eBay (EBAY) announced plans to axe more than 2k workers and sell its enterprise division. IBM, Time Warner (TWX) and John Deere (DE) have made similar announcements.

I've mentioned this before, but it's worth reiterating. The oil industry has created millions of jobs since 2009. Direct employment in the oil and gas sector rose 40% from 2007 through 2013, compared to a decline of 3% in the overall US economy. In every one of the 10 states where hydrocarbon production is on the rise, overall employment growth has outperformed the nation. That source of jobs is essentially gone now that oil prices have cratered. Last week, Baker Hughes (BHI) announced plans to cut 7k employees, while Suncor Energy (SU) intends to layoff 1k workers.

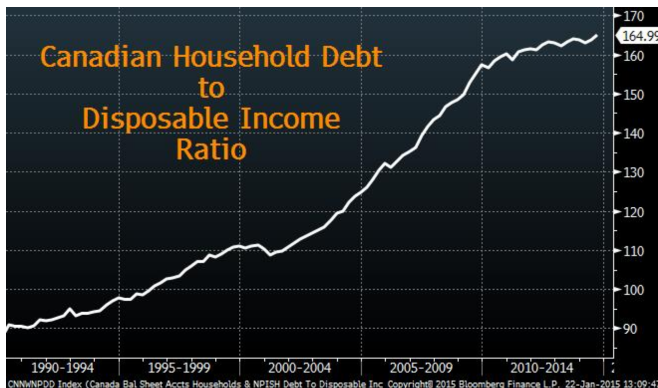
Admittedly, this weakness has not showed up in the data yet. Initial jobless claims are still low, and the unemployment rate is below 6.0%. However, I continue to believe that the Fed won't raise interest rates until wages pick up. Not including The Great Recession, average hourly earnings are the lowest they've been since 1986.

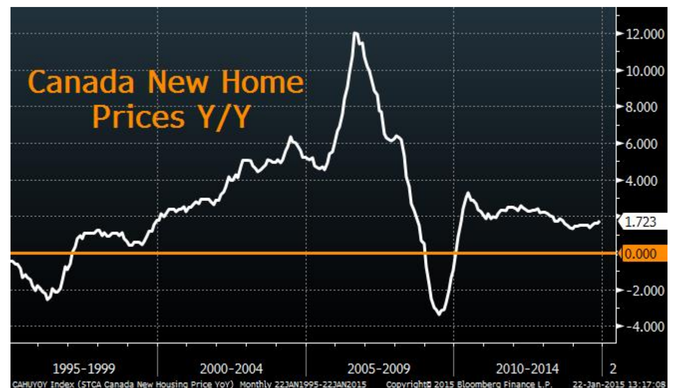
Wages are the best metric to gauge tightness in the labor market, and all the signs point to excess capacity at the moment. The Fed is still talking like they're hell-bent on hiking rates sometime in 2015, but if these mass layoffs continue, that would be a mistake.

Canadian Bacon

If you need further proof the US economy isn't running as hot as economists would have you believe, take a look at Canada. Often used as a proxy for US demand, the Canadian Dollar (CAD) is down more than 6% YTD. You could argue that everything is declining against USD, but CAD has declined nearly 8% versus the Mexican Peso – another proxy for US demand. Last Wednesday, the Bank of Canada (BoC) surprised the market by delivering a 25 bps interest-rate cut, becoming the first G7 country to slash rates in response to lower oil prices.

Even if oil was back around $100/barrel, the BoC would have a hard time raising interest rates because Canadian households have an enormous debt burden. The latest figures show household total credit-market debt (mortgages, consumer credit and non-mortgage loans) is now 165% of disposable income - an all-time high. The BoC has said they believe home prices are between 10-30% overvalued.



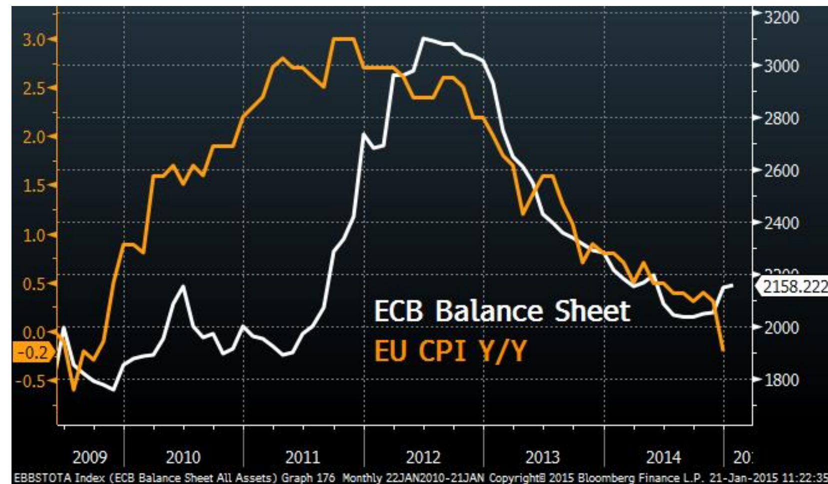


While the rate cut may give a short-term boost to home buyers, but it also heightens the risk of a more severe housing correction when interest rates eventually rise – the key word being eventually.

Regardless of interest rates, the collapse in oil prices poses a serious threat to some of the country's more bloated regional housing markets. It's unclear whether the impact can be restricted to a region without spreading across the country.

QE in Practice

Now that anxiety surrounding the ECB's asset-purchase program is dying down (for now), it's important to remember that interest rates are already historically low. Around 25% of the Eurozone's $5.8 trillion government bond market now pays a negative yield – compared to 10% in October.



Interest rates at rock-bottom (even underground) levels have proven to be ineffective at boosting CPI. The market is now wondering whether or not increased money supply will be able to raise prices. Eurozone CPI Y/Y and the ECB's balance sheet have shown a remarkable correlation over the past five years. However, if they diverge from here, the Mario Draghi will have to revise his playbook yet again.

Chart of the Week

With ISIS and AQAP terrorizing the Middle East and Europe, it's easy to forget that Boko Haram has now claimed territory larger than Belgium in northern Nigeria. Boko Haram, which roughly translates into "Western Education is Sin," has slaughtered thousands of civilians across Nigeria and is threatening neighboring countries. On top of that, the Nigerian economy is reeling from the 60% decline in oil, which accounts for nearly 70% of government revenues.

On February 14, President Goodluck Jonathon will square off against former military commander Muhammadu Buhari in the most divisive and closely fought elections since the end of military rule in 1999. Even if serious bloodshed follows the election, as many expect, the worst-case scenario of a breaking-up Africa's most populous country remains unlikely. However, none of this bodes well for the local stock market, which has declined more than 30% since early 2014. If you're looking play this market, the Nigerian ETF (NGE) is an option, but Exxon (XOM) and Chevron (CVX) both have a large presence in the country. A new government unfriendly towards foreigners could easily drag down shares of XOM and CVX.

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: Can you give more color on whether or not Bitcoin is a buy here? - RK

A: That's a tricky question. (Side note: I covered the reasons for Bitcoin's collapse last week). Obviously, it's more attractive now than it was at $350, but there's no precedent for this market, so it's tough to make buy/sell recommendations. Keep in mind that Bitcoin is still essentially the Wild West of finance. It's unregulated, there are no insider trading rules, and some investors believe collusion is taking place.

However, the fact that some "mining" operations shut down because they're unprofitable is very bullish. Remember, Bitcoin is a finite commodity, so restricted supply should boost prices higher assuming demand stay the same. The CEO of a prominent "miner" says Bitcoin needs to trade above $320 to achieve profitability. The Bitcoin "platform" is still maturing and there's still huge investment in the space. Last week, Coinbase became the industry's most well-funded company after landing a $75 million investment from backers, including the New York Stock Exchange. So, in conclusion, I don't know whether Bitcoin will rally over the next week, but if you intend to hold them for 5+ years, now is probably a good time to buy.

That's all, see you next week!

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

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