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October 15, 2015

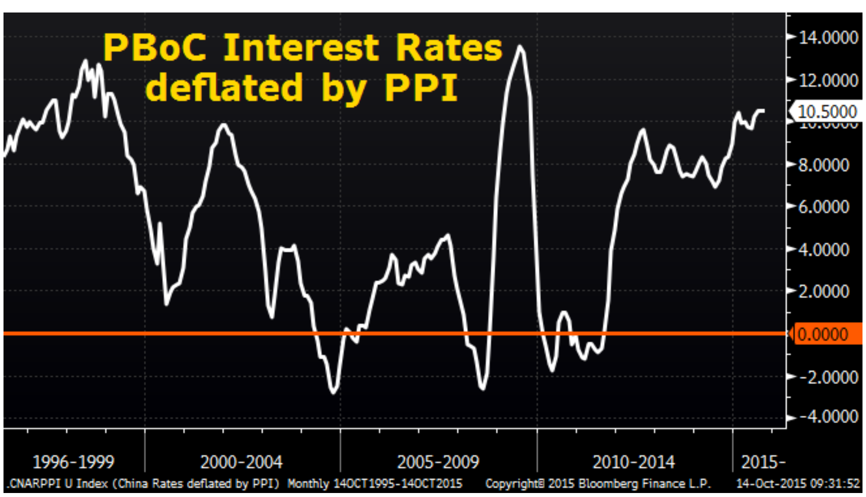
CUP & HANDLE MACRO

Greetings,

We're seeing macro funds drop left and right. It's debatable whether or not most of these are truly macro funds in the classic sense, but the low interest rate environment has certainly made trading difficult. Some were caught flat-footed when the SNB removed the floor under EUR/CHF in January, but, for the most part, it seems like many failed to appreciate how quickly China is slowing. September inflation data confirmed that Chinese PPI fell for the 43rd consecutive month at -5.9% Y/Y, while CPI barely stayed above zero at +1.6% Y/Y – well below expectations.

It's been well documented that China is transitioning towards a consumption-led economy, but exports are still the main driver for now. On Monday, September trade data showed exports contracting at -3.7% Y/Y, which is actually a slight improvement from August. However, imports continued to collapse at -20.4% Y/Y, well below expectations and a significant drop from August.

The sharp contraction somewhat reflects the decline in commodity prices, and also suggests weakening domestic demand. That's not surprising when you consider that real interest rates, deflated by PPI, are currently 10.5%. Is that appropriate policy for an economy that is clearly slowing?



Typically, real interest rates are calculated using CPI, but in the macro world PPI is more appropriate for China because of its outsized impact on the manufacturing sector globally. The massive contraction in PPI over the last 3.5 years implies that China's main export has been deflation, and it's starting to show up in developed markets. Data on Tuesday showed that the UK joined the EU in recording CPI growth below zero. US CPI for September will be released this morning with expectations for a below zero reading, but yesterday's PPI data was already negative at -1.1% Y/Y.

It's amazing that the VIX is back below 20. The conditions that led to the sell-off in August have not changed, and look like they're getting worse. Policymakers are responding, especially in Asia. On Wednesday, the Singapore Monetary Authority announced it will ease monetary policy for the second time this year after narrowly avoiding a technical recession in the third quarter. Even Fed officials are starting to waver about a hike this year, after repeatedly insisting each meeting is "live." Fed governor Tarullo said in an interview, "right now my expectation is – given where I think the economy would go – I wouldn't expect it would be appropriate to raise rates" this year. Fed governor Lael Brainard offered similar remarks on Monday.

These ticky-tack stimulus measures and commentary from economists do little to support the economy and make it extremely difficult to trade this market, which is partly why these reputable funds are closing down. It's increasingly clear that until, or unless, we see a major turnaround in China things will continue to deteriorate, and we could be looking down the barrel of secular stagnation on a global level.

The **Cup & Handle Fund** is up around 7.0% YTD, and +25% Y/Y. We were actually adding longs last week, and decided to hedge a bit yesterday. I would really like to load up on one position, but it's important to maintain a balanced portfolio. I'd hate for one outsized position to bring down a fairly balanced portfolio, regardless of my conviction. The October investor letter went out two weeks, and it's still not doing much of anything. **If you'd like to start receiving these letters click here**.

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

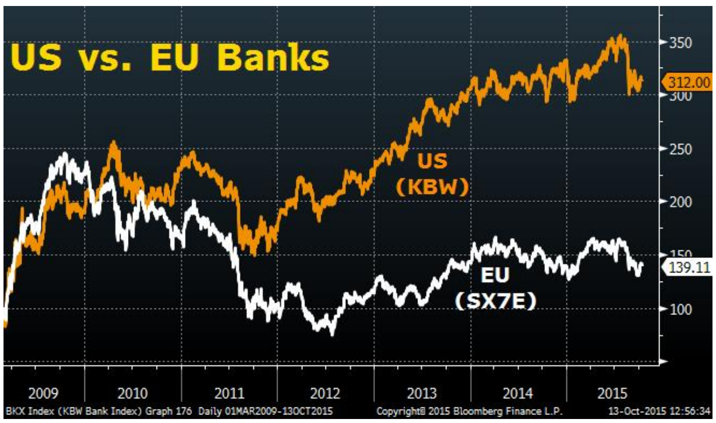
Until next time, tread lightly out there,

Michael Lingenheld
Managing Editor – Cup & Handle Macro

Relative Banking

Last week, Deutsche Bank (DB) took a $6.5 billion charge on assets in its investment bank and retail operations while intimating a dividend cut is likely. As a result, the German lender said it expects a loss of $7.1 billion on October 29 when it discloses third-quarter results and sweeping strategy changes. The stock rallied 3% the next trading day, giving a glimpse into just how low expectations have fallen.

Few investors, especially Americans, realize how badly European banks are struggling. Since the stock market bottomed in March 2009, the value of US banks has more than tripled, while EU banks are up just 39%. In other words, they're still trading like distressed assets. Lending institutions on both sides of the Atlantic have been damaged by regulatory fines totaling hundreds of billions, and yet American banks have seemingly brushed them off. Leaving many to wonder: why?



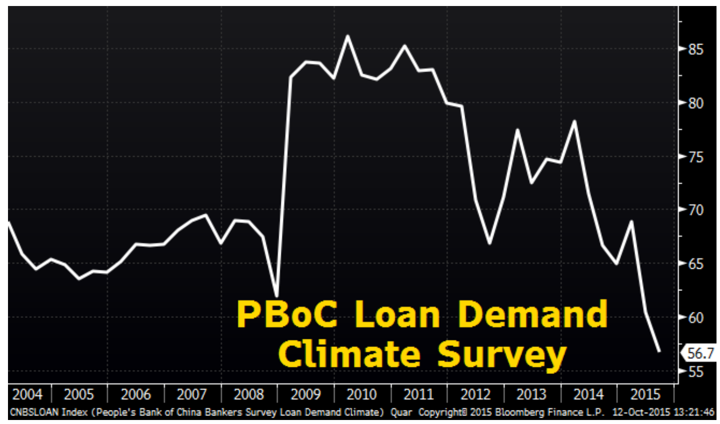
The main reason is that US banks benefited from an earlier and more aggressive policy response to the financial crisis. The Fed conducted stress tests in 2009, prompting a massive round of capital raising. The Fed estimates that since 2009 the top 30 US bank holdings companies have raised $511 billion in tier-1 capital. European regulators, on the other hand, were much slower in forcing banks to bolster their balance sheets.

Even the EU stress tests that were conducted failed to inspire confidence. In 2011, Belgium-based Dexia and Spain's Banxia earned passing grades on a stress test but dissolved within months, requiring multibillion-EUR government bailouts. The situation didn't stabilize until the ECB got involved last year, forcing institutions to raise billions in fresh capital. The debt crisis has also hamper EU competitiveness. For the most part, US consumers stopped deleveraging in 2013, corporate earnings have been growing, and capital markets activity (bond and IPO offerings) have gone through the roof – all of which has helped US banks regain profitability.

No bank represents the struggles of operating in Europe more than DB. In June, the bank was fined $55 million to resolve allegations that it inflated the value of its derivative positions at the height of the financial crisis. Weeks later, the company's CEO, Ashu Jain, resigned. The new CEO, John Cryan, is expected to undertake massive restructurings and warned that large-scale layoffs are expected. For starters, he'll need to do something about DB's massive $75 trillion derivate book. That's $5 trillion larger than JPMorgan's (a much healthier bank) and 20x the size of Germany's GDP. It's been tough sledding for EU banks since 2008, but if DB is any indication, things could still go down from here.

Money For Nothing

Just a quick reminder that even without a Fed hike monetary conditions are tightening. Not much tighter, but the trend is clearly higher. The National Financial Conditions Index is what the Fed uses to gauge lending conditions in the market. We tend to get caught up in this "will they / won't they" debate about the Fed, but there are other factors at play. For instance, the USD rally tightens financial conditions on a global scale. Same with volatility, which has seen an uptick since August.



There isn't an identical indicator in China, but the PBoC's Loan Demand Climate Survey is probably as close as we're going to get. As with most data in China it's not very timely, coming quarterly, but the chart above reflects tighter monetary conditions (above 50 = expansion, below 50 = contraction). At the G-20 meeting in Lima, Peru last week, EM officials advocated a Fed hike to remove uncertainty. Yet, the Chinese minister advised Yellen to hold off. Perhaps he realizes what the underlying lending conditions are like. It would seem counterproductive to hike rates as growth slows, conditions tighten, and equity markets fluctuate.

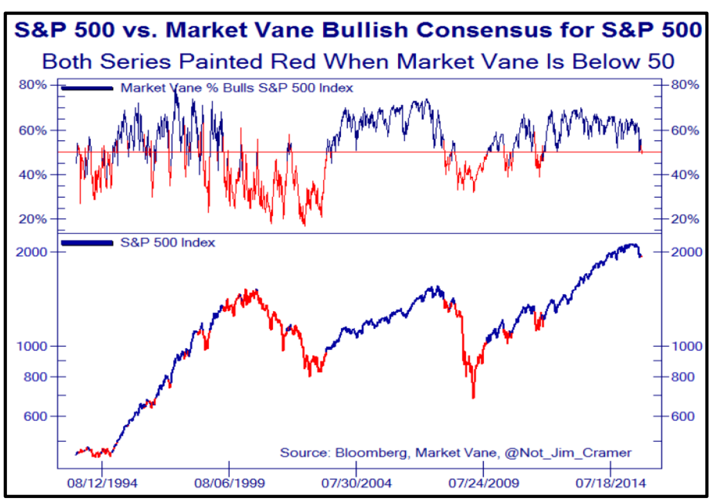
The Tale of Two USDs

We've covered the difference between DXY (mainly USD vs. EUR and JPY) and the Fed's trade-weighted USD before, but it's time for an update. Since September 17, when the Fed decided to pass on raising rates, there's a perception that USD has lost its mojo – but that's simply not true. EUR has benefitted from the unwinding of short position, primarily against long EM FX trades that were getting slaughtered. Beyond that, EUR has traded in a fairly tight range. USDJPY hasn't gone anywhere, and the Bollinger Bands are as narrow as they've been in 35 years.

Trade-weighted USD, on the other hand, continues to power higher as weakness in major trading partners like Mexico and Canada becomes apparent. At the end of the day, there simply aren't other liquid capital markets with better prospects than the US and it doesn't look like that will change anytime soon. Of course, there will be fluctuations based on sentiment, positioning and technicals, but I don't see any currency gaining significant momentum against USD over the next 9-12 months, except maybe gold. Trade-weighted USD is closing in on a very important 30 year trend-line, which DXY punctured earlier this year. If that chart keeps screaming above 100, it's safe to assume that asset prices will be much lower than they are today.

Chart of the Week

This chart really says it all. The market has had months, even years for commodities, to digest the clear slowdown in China and reprice assets. We've seen some real damage done to emerging markets, but the S&P 500 decline has really only made investors more cautious. In other words, there hasn't been any pain. There are numerous metrics to gauge positioning in sentiment, but this chart of Market Vane Bullish consensus shows unbelievable correlation with stocks.



And here we are, bullish consensus is sitting squarely on the 50% threshold. Looking at charts there's nothing to suggest a big decline in the next week or so, but there was also no major driver behind the rally over the last two weeks. Investors are clearly sitting on the fence, looking for a direction to take shape. Personally, I still think that direction is lower, but it's much too soon to call this a trend – in either direction. However, if October data from China or the US is weak or Q3 earnings undershoot expectations, this chart shows how quickly stocks can decline if sentiment turns negative.

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: *Do you think this drop is the big one for TSLA? - LH*

A: I get more question about this stock than any other. To be clear, I'm rooting for Tesla. All of their products are insanely cool. I saw The Martian in theaters last weekend, and want Elon Musk to take SpaceX to Mars. TSLA has been overpriced for a long time, but there's no clear reason why now is the time for mean reversion. I understand they're having delivery problems, nothing new. Auto stocks in general have been struggling due to Volkswagen. I've given up trying to understand the day-to-day, or even week-to-week, fluctuations of TSLA. If you think TSLA should be lower, as I do, my only recommendation is to use puts – limiting your downside. Volatility is expensive in this name, but that's what it is. It's just not worth it to day trade because there's too much attention on the company.

That's all. See you next week!

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

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