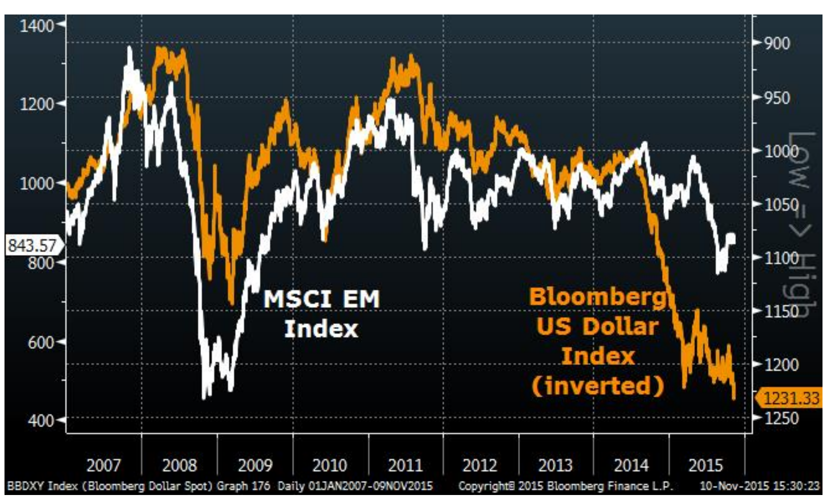
November 12, 2015

CUP & HANDLE MACRO

Greetings,

It's tough to poke holes in the October jobs data. The +271k gain in non-farm payrolls appears to have sealed the deal for the first Fed rate hike in 9.5 years. The market is now pricing in a 70% chance of higher benchmark rates in December, but the real action is taking place further out on the yield curve. Since July 1, the spread between 10Y and 2Y US Treasury yields has dropped from 1.75% to 1.45%, currently. If the US economy is so healthy, why is the yield curve flattening? Because the US dollar looks like a wrecking ball destined to destroy global demand.

At 1.70%, the spread between 2Y rates in the US and Germany is the highest it's been since 1989 – when the Berlin Wall came down. Rate differentials indicate EUR should re-test 1.05 against USD within the next month or two, which is a nightmare for China. The Chinese compete against Germany in the export market, and the weaker EUR gives a boost to Deutschland. The currency effect takes a few months to appear in economic data, but, even before this latest USD surge, Chinese exports were alarmingly weak at -6.9% Y/Y in October. Even though a stronger currency should boost consumption, Chinese imports were similarly disastrous at -18.8% Y/Y. The trade balance is improving, just for the wrong reasons.



Dragged down by weak performances in China, emerging markets and Europe, the global economy is this year set to post its deepest US dollar recession since records began in the 1960s, according to the IMF. They project global GDP to be $73.5tn in 2015, down $3.8tn from last year. In percentage terms, this year is set to show a fall of -4.9% Y/Y, not quite as deep as the -5.3% contraction in 2009. Adjusting for purchasing power, which strips out the USD impact, the IMF forecasts global GDP to grow +3.1% Y/Y this year, although that's down from their +3.5% forecast in April.

According to Factset, a blended rate of reported results and estimates shows third-quarter revenue for companies in the S&P 500 with less than 50% of sales in the US fell -13% Y/Y compared with a rise of about +1% for those with more than half of sales in the US. At the end of the day, in today's globalized world it doesn't matter that the US economy is strong if the rest of the world is in freefall. And a freefall is what we should expect if USD keeps rallying.

In her FOMC statement on September 17, Janet Yellen noted, "Developments since our July meeting—including the drop in equity prices, the further appreciation of the dollar, and a widening in risk spreads—have tightened overall financial conditions to some extent." Since then, the stock market has improved but risk spreads remain wide and USD is plowing higher, which directly tightens monetary conditions for 35% of global GDP (US and China). Yellen needs to smother the December rate hike with dovish language, or risk watching the USD sink financial assets.

The **Cup & Handle Fund** is up around +4.0% YTD, and +11% Y/Y. We made some pretty substantial changes to the portfolio this week. Some relative value bets, and different expressions of existing themes. Still have a decent amount of cash to deploy, so we're waiting patiently for some solid risk/reward opportunities. The November investor letter went out two weeks ago. **If you'd like to start receiving these letters click here**.

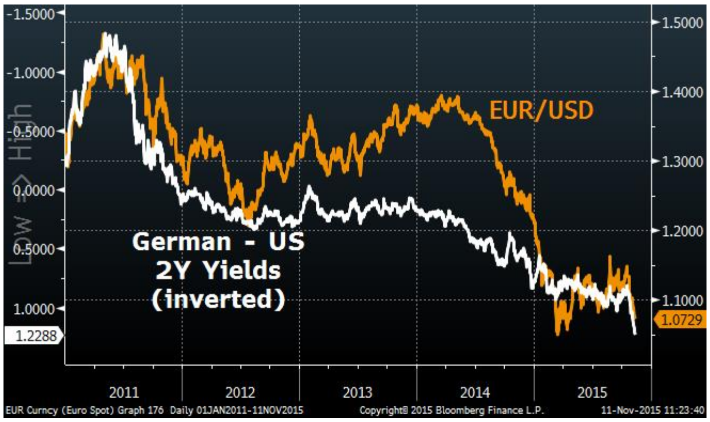
As always, if you have any questions or comments or just want to vent, please send me an email at mike@cup-handle.com.

Until next time, tread lightly out there,

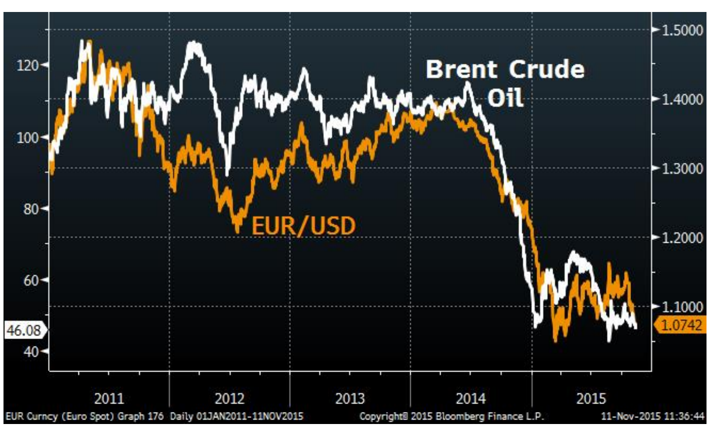
Michael Lingenheld
Managing Editor – Cup & Handle Macro

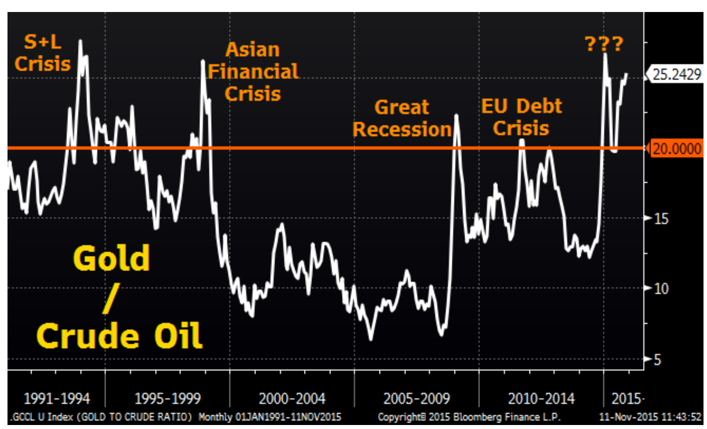
The Denominator

Expanding on the opening section, it's important to realize that not only does a stronger USD effect trade and prices, but also serves as the denominator for financial assets globally. Year-to-date, the S&P 500 in the traditional sense is down slightly but essentially flat. Denominated in EUR, that same index is +15% on the year. It's fairly easy to hedge this risk but USD is increasingly impacting market psychology, which is much harder to protect against. The Daily Sentiment Index (0=max bearish, 100=max bullish) for EUR and CHF are both in single digits, so a bounce from these levels is entirely reasonable, but, longer term, the USD bull market is far from over.



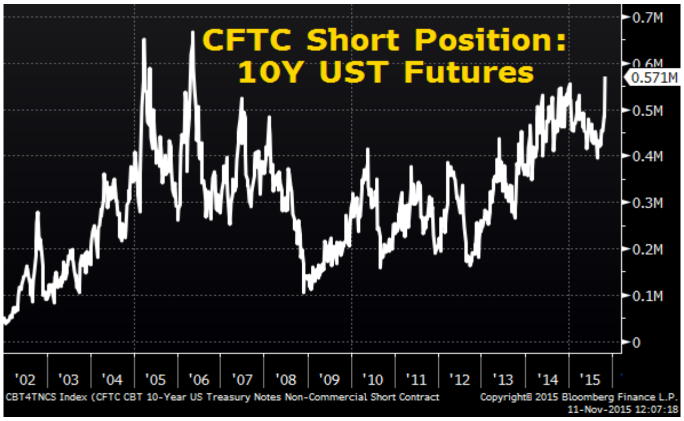
In their latest comments regarding monetary policy, the Fed, ECB, BoJ, and BoE all expect the impact of energy prices on CPI to be transitory. They're confident because the Y/Y base effect is starting to become supportive of CPI; oil's decline started in June 2014, but picked up momentum in November – December 2014. However, crude completed that move in January around $60/barrel. It's currently $46/barrel, or -20% lower than January. That's still a significant drag on CPI and the chart looks like oil could still decline a fair amount from here – especially if EUR keeps dropping.





US average hourly earnings came in at +2.5% Y/Y in October, the highest reading since July 2009, which gives bond bears some credibility. 2Y UST's are yielding more than 0.85% for the first time since 2011, and bonds have been selling off across the curve. CFTC data shows that short positioning in 10Y

UST futures has only been greater twice in history. Both instances marked medium-term lows in 10Y UST bonds. It's a contrarian indicator that seems to be fairly reliable.



We've previously looked into how a strong USD tightens monetary conditions in China via the currency peg. The Chinese are essentially importing tighter monetary policy from the Fed, even though it's not warranted. The PBoC has cut interest rates six times over the past 12 months, but that's done little to improve trade competitiveness because CNY is ultra-strong. This is evident in the Big Mac Index where McDonald's (MCD) signature sandwich is 43% cheaper than in the US. Yet, as mentioned earlier, Chinese imports are falling rapidly. That's a troubling sign and indicates we should expect more stimulus from China going forward. It's possible the PBoC could even further devalue CNY – the most deflationary catalyst imaginable.

The Economist Big Mac Index

	Current		Previous		Pct Change	Over/Under versus US
1) Americas						
4) United States	$ 4.79	15	$ 4.80	14	-.21%	.00%
5) Canada	$ 4.54	15	$ 5.25	14	-13.52%	-5.30%
6) Brazil	$ 4.28	15	$ 5.86	14	-26.96%	-10.59%
7) Mexico	$ 3.11	15	$ 3.25	14	-4.31%	-35.01%
8) Argentina	$ 3.07	15	$ 2.57	14	+19.46%	-36.01%
2) Europe/Africa/ME						
9) Switzerland	$ 6.82	15	$ 6.83	14	-.15%	42.42%
10) Denmark	$ 5.08	15	$ 5.15	14	-1.36%	6.02%
11) Sweden	$ 5.13	15	$ 5.95	14	-13.78%	7.05%
12) Eurozone	$ 4.05	15	$ 4.95	14	-18.18%	-15.37%
13) United Kingdom	$ 4.51	15	$ 4.93	14	-8.52%	-5.79%
14) Russia	$ 1.88	15	$ 2.55	14	-26.27%	-60.68%
3) Asia/Pacific						
15) South Korea	$ 3.76	15	$ 4.00	14	-6.00%	-21.50%
16) Australia	$ 3.92	15	$ 4.81	14	-18.50%	-18.12%
17) Japan	$ 2.99	15	$ 3.64	14	-17.86%	-37.67%
18) Thailand	$ 3.17	15	$ 3.12	14	+1.60%	-33.86%
19) China	$ 2.74	15	$ 2.73	14	+.37%	-42.84%

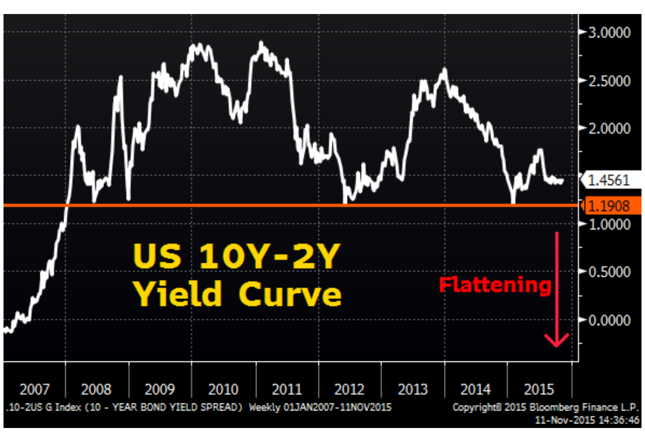
But China is not the only country importing US monetary policy through a currency peg. Hong Kong, which derives most of its economic activity from China, has maintained a USD peg since 1983. The twin headwinds of a slowing China and stronger USD have knocked the local stock market down -21% since May. And if these headwinds keep blowing, we should expect further declines.

Similarly, Middle Eastern oil producers like Saudi Arabia and United Arab Emirates have accumulated petrodollars through a currency peg for decades. We've discussed Saudi Arabia at length before, but Dubai (UAE) looks like it's really starting to suffer. The UAE government likes to point out that it has a diversified economy, where only 2% of revenue comes from oil and gas. While the economy may not be directly tied to oil prices like Saudi Arabia, indirectly it still has huge exposure. Tourism, real estate and trade receipts in the UAE have all collapsed since oil started falling last year. Not surprisingly, the local stock market is suffering and could be one of the ugliest charts in the world.

So what should you be watching to monitor this USD theme going forward? It's much easier for USD to bowl over less liquid EM currencies like ZAR, BRL, MXN, etc., but if it pushes liquid currencies like EUR to new lows, there will be major declines in financial assets eventually. So EUR is the most important chart to watch, but that's obvious and everyone will have their eye on it.

If USD is strong enough to bring down long-term growth prospects in the US, it will start to show up in the 10Y-2Y area of the yield curve. Since December 2013, when the Fed started tapering QE3 purchases, the yield curve has flattened fairly steadily. QECB caused a slight steepening earlier this year, but the trend still looks lower. Breaking below 1.20% would be a major technical hurdle, and also indicate weak US and global growth going.

The gold/silver ratio, a chart we've seen many times before, will also be important. Since the employment data last Friday gold has started outperforming silver again, which implies CPI will continue to be under pressure. Unlike these other metrics, which just reflect prices, gold/silver has acted as a leading indicator for several years. If the correlation holds, we can expect CPI to be around -1.5% Y/Y in six months, suggesting USD will maintain its stranglehold over financial markets for the foreseeable future.



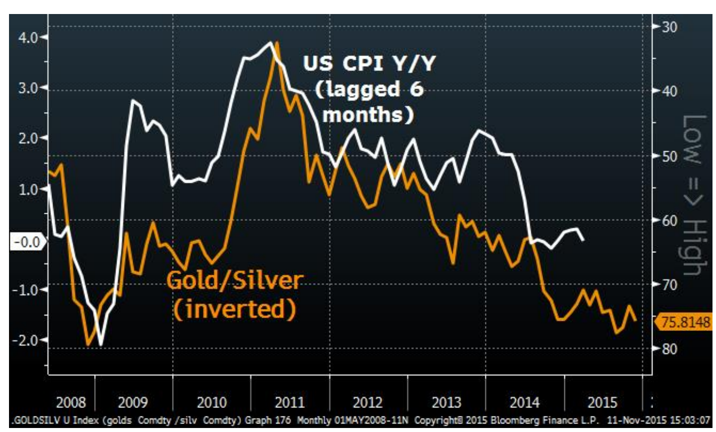


Chart of the Week

In theory, swap spreads should never go below zero but today's distorted financial markets have broken that rule. Swap spreads represent the difference in rates between a bank loan and US Treasury's of matching duration. Essentially, they represent counterparty risk in the market, because Treasury's are thought to be "risk-free." In 2008, short-end swap spreads spiked higher after Lehman Brothers showed the banking system's vulnerability, causing a re-pricing of counterparty risk. TARP and other emergency measures recapitalized banks, pushing spreads lower, but the recent decline is unprecedented. Why? Ultra-low interest rates have caused record issuance of corporate debt in the US. US multinationals have raised more than $132bn in so-called jumbo-deals — debt offerings above $10bn in size — in 2015, more than a fourfold increase from a year earlier. Those companies hedge their rate exposure via swaps, which pushes spreads lower.

At the same time, new banking regulations have raised costs associated with the repo market, making it difficult to arbitrage negative swap rates. Emerging market central banks are also selling Treasury's to protect local currencies against USD, pushing up yields. Some say swaps are a broken market and the most visible example of post-2008 regulation of the banking system that entails serious consequences for investors, banks, companies and even the US taxpayer. The more immediate implication is liquidity being sucked out of the system when financial markets are looking vulnerable for the first time since 2009.

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 still think short Asian equities is a good bet? - SS*

A: I do. The economic data from the region can be characterized as "not as bad as it was before," but it's still not great. Exports from Taiwan, an electronics manufacturing hub, fell -11.0% Y/Y in October. PMI readings were below 50 in China, Taiwan (EWT), Korea (EWY) and Indonesia (EIDO). Asian stocks caught a bit of a reprieve after the meltdown in late-August, boosted by lower VIX, the stabilization of Chinese stocks, the promise of more stimulus from the ECB, hesitation from the Fed, rally in US stocks, among others factors. However, this theme is really driven by excess USD-denominated debt, which will only get harder to re-pay as USD rallies. Positioning should be cleaner now, and I expect the downward trend to reassert itself soon.

That's all. See you next week!

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

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