



CUP & HANDLE MACRO

Greetings,

To the surprise of absolutely no one, the IMF decided on Monday to include Chinese Yuan in its Special Drawing Rights (SDR) basket of currencies. Inclusion in the largely ceremonial basket is a solid endorsement for China, as the world's second largest economy crawls towards an open capital account. It's the first change in the SDR's composition since 1999, when EUR replaced the Deutsche mark and French franc, and Beijing worked with the IMF for years to make it happen. The only controversy is whether or not CNY actually belongs in this group, or if the IMF is just appeasing the Chinese. Eswar Prasad, a former head of the IMF's China team, said that had the IMF review been applied to any other currency, it would not have qualified.

In August, the IMF said it expected the PBoC bring CNY "quite close to free-floating" within 2-3 years. In order for that to happen the central bank will have to increase liquidity, and it's already made some decent headway. CNY was the 5th most-used currency in payments this September. There are now 3.1 trillion CNY in bilateral swap lines between the PBoC and 32 other central banks. These are solid steps, but opening up Chinese equity and bond markets to foreigners is a necessity for sufficient liquidity.



And that's why this announcement is important. The potential for capital inflows into China is staggering. China's interbank bond market is the third largest in the world, and that's without foreign involvement. Eventually, we should expect to see CNY reach a double-digit share of global reserves — inflows on the order of \$800 billion to more than \$1 trillion. Even a conservative estimate of reallocating 1% of global reserves each year would mean about \$80 billion inflows annually. Last month, benchmark provider MSCI said it would add 14 U.S.-listed Chinese firms for the first time to indices that hold \$3.5 trillion in assets from passive investors. As a result, the firm estimates investors will buy \$99 billion in shares of the soon-to-be included Chinese firms. That's just 14 companies...

Theoretically, there should be more foreign involvement already. The launch of a stock-trading link between Hong Kong and Shanghai a year ago was meant to be a landmark in the opening up of China's financial markets, allowing more foreign investors than ever to own Chinese shares. But the anticipated flood of money hasn't materialized as expected. Just 120.8 billion CNY (\$19 billion) has been drawn into the scheme since last November, only 40.3% of the total permitted under the program. Why? Mainly the government's ill-advised involvement in the stock market this year, including encouragement of margin lending on the way up, heavy-handed stabilization tactics during the crash, and [punishing brokers](#) in the aftermath.

If the Chinese government can enter global capital markets smoothly without scaring-away investors, everyone stands to benefit. China could use the inflows, and investors would love the relatively high-yielding (if risky) investments. The real test will be how these reforms hold up during a crisis. It's easy to talk about embracing free markets, but they can be unforgiving.

The [Cup & Handle Fund](#) is up around +5.0% YTD, and +6.5% Y/Y. October was our second down month since inception, but we made that back in November. We're sticking with some relative value bets that have worked very well recently. I'm hard at work on the December letter, which should be out on Monday. [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.

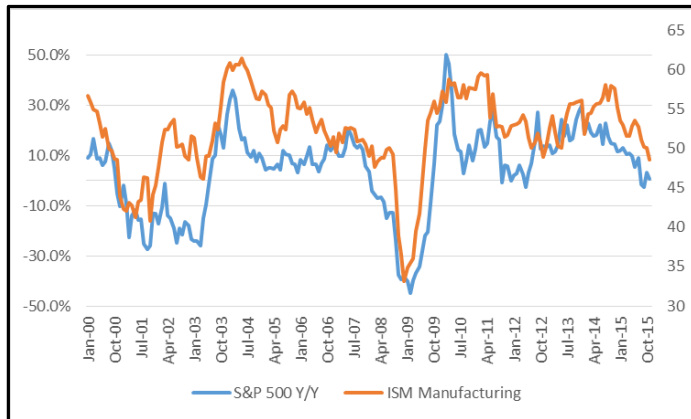
Until next time, tread lightly out there,

Michael Lingenheld

Managing Editor – Cup & Handle Macro

Contraction Has Arrived

I could make a very strong case that the ISM manufacturing index is the most important data point to track in the US. In November, ISM dropped to 48.6, its lowest level since June 2009, and only the second contractionary reading (below 50) since the crisis. Bonds, perhaps the most rationale market these days, ripped higher along with US equities, as USD continued to test highs. Presumably stocks got a boost from the perception that weak manufacturing data will force the Fed to lower guidance later this month. That's all well and good, but ISM tends to track the S&P 500's Y/Y returns pretty closely, meaning further weakness should start to penalize equities.



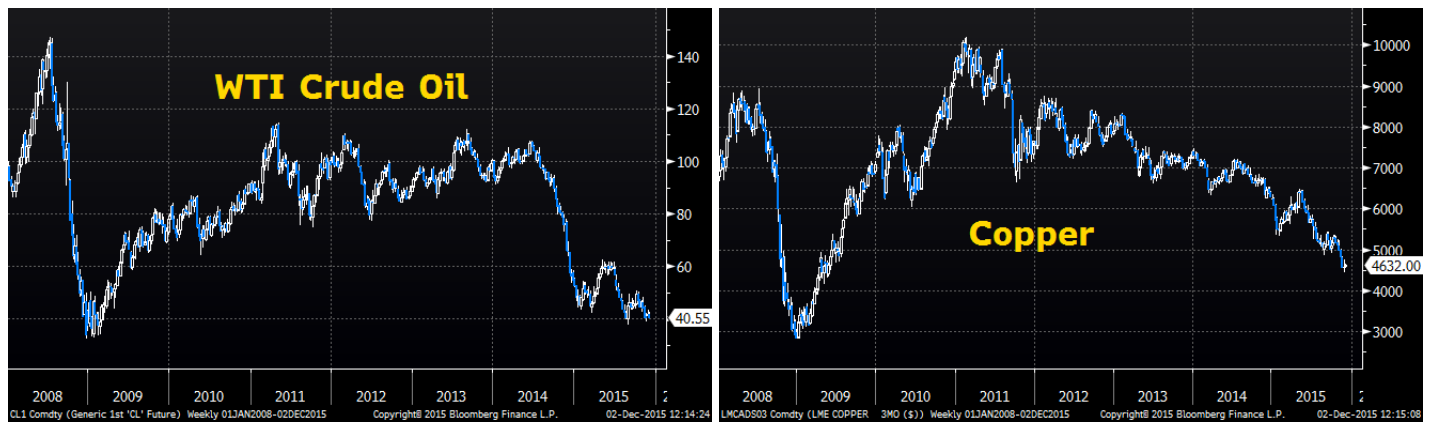
While investment banks are [tripping over themselves](#) to warn that inflation is coming next year, the ISM details showed no signs of rising prices. In fact, at 35.5 (down from 39 in October), prices paid was far and away the weakest component of ISM. Only the employment component, at 51.3, offered reason for optimism. That seems to fit with the November ADP employment change, released yesterday, which indicated we should see reasonable job growth from non-farm payrolls on Friday.

The dilemma here is that the Fed is surely nervous about the ISM print, and they've never hiked with the index below 50. However, their mandate says nothing about manufacturing, just employment, which looks strong. Fed officials seem to agree with Wall St. that inflation will pick up going forward, so they have little reason not to hike in two weeks. And yet, seemingly this is occurring right as the business cycle peaks.

There are also signs that the US credit cycle has turned. The booming leveraged-loan market, which is fueling blockbuster growth in M&A deals, has declined materially even before the first hike. These companies can borrow from other sources to fund deals going forward, but this seems like a



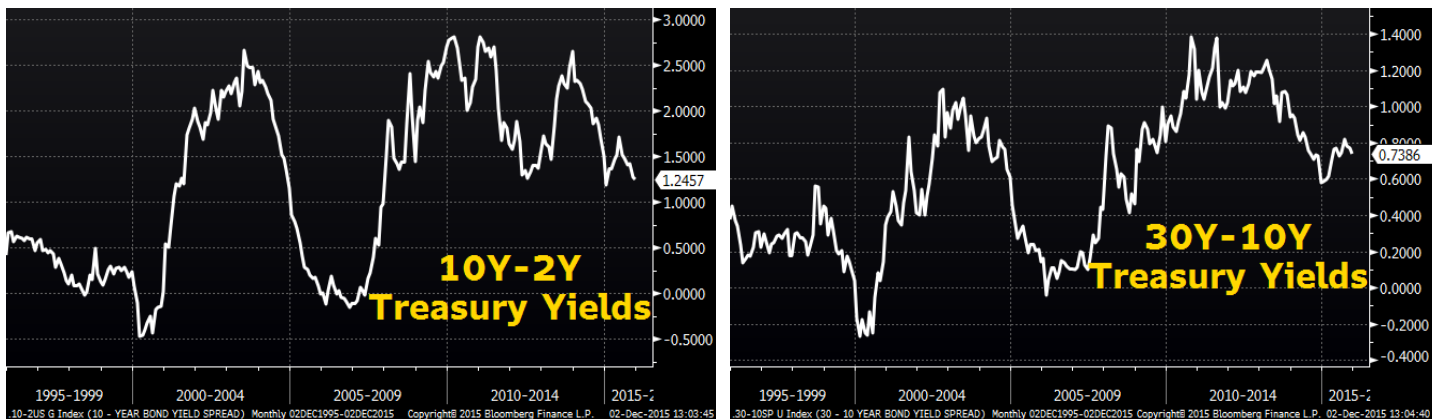
noteworthy signal. If the S&P 500 loses the tailwind of M&A deals, it could correct very quickly.



I'd also like to point out that much of this inflation narrative is driven by the assumption that oil has bottomed, or at least won't drop much from here. The chart seems to indicate that if prices fall below \$40/barrel, they'll keep going lower. There's also [a theory floating around](#) that global oil storage capacity is running low. It's really impossible to know whether or not that's true, but it doesn't sound bullish. Similarly, copper, historically a great indicator of economic health, trades like a dumpster fire. It looks awful and there's no reason to suspect the bottom is near. Rising inflation in 2016 is more likely than 2015, but it's hardly a sure thing. Something the Fed should consider as it tightens policy.

Debt Dynamics

Even if you believe the US economy is on a sustainable path towards economic growth, it will be exceedingly difficult for US Treasury yields to go screaming higher. Primary dealers estimate the net issuance of US notes and bonds will shrink 26% Y/Y in 2016. The \$433 billion of new supply would be the least since 2008. A narrowing US budget deficit and inactive Congress have reduced the US's funding needs and post-crisis regulations have focused the Treasury's attention on short-term debt issuance. This environment, as we've discussed numerous times, promotes a flat yield curve, which has accelerated of late.



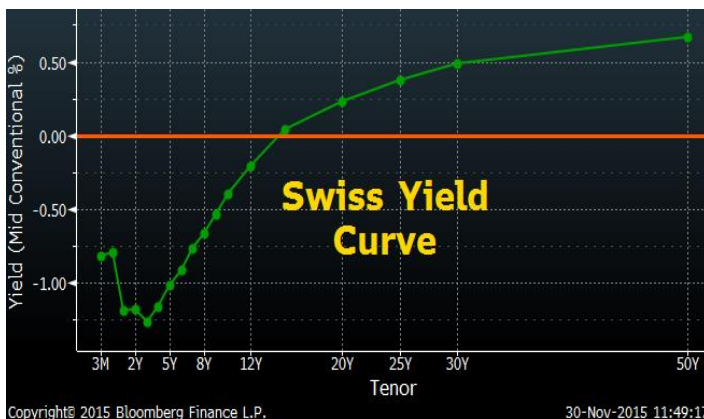
There's nothing wrong with a flattening yield curve. Historically, it hasn't precipitated major crises. But it is a little alarming that massive amounts of monetary stimulus have failed to boost

expectations to a degree where long-term yields start rising. It gives the [secular stagnation](#) thesis more credibility than an optimist would be comfortable with.

The big question is how the market will respond to a Treasury shortage during a crisis. Obviously Treasury's will rally, but the lack of high quality collateral could cause big problems for banks. In April, [JPMorgan CEO Jamie Dimon warned](#), "In a crisis, everyone rushes into Treasuries to protect themselves, and that will be even truer in the next crisis." The fundamentals of German debt are even more bullish, since they have to keep pushing austerity. It wasn't that surprising to see German 2Y Bunds issued on November 18 yield -0.38%. Perhaps that level of yield is what we should be expecting in the US before too long.

Swiss Mystery

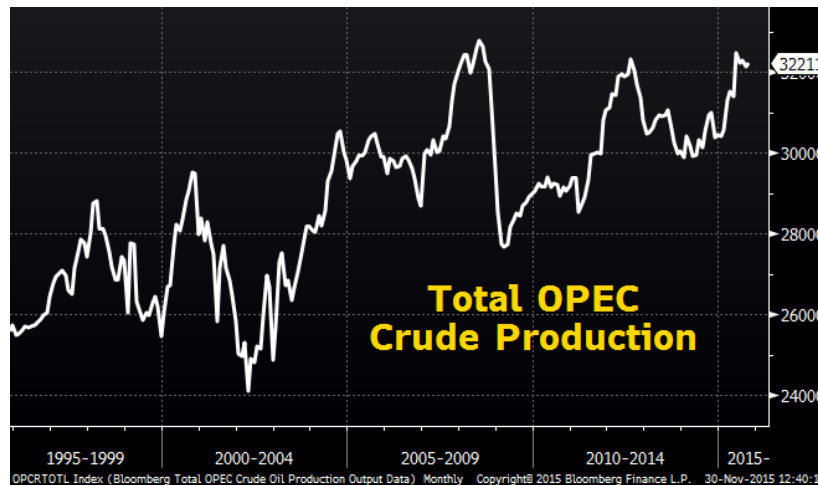
The market is laser-focused on the ECB, NFP, and Fed over the next few weeks, but the SNB's meeting on December 10 is flying under the radar. Unlike the ECB and Fed, investors have very little sense for what the Swiss central bank will announce, but it's unlikely that policy will remain unchanged. If the ECB eases policy as expected this week, the SNB will want to at least match stimulus. Chairman Thomas Jordan has called CHF significantly overvalued, and wants to keep rate differentials supportive of a weaker currency relative to EUR. You'll recall in January the SNB front-ran the ECB by removing the EUR/CHF floor just days before the ECB made its QE program official.



The problem is that the bar for a weaker CHF is already incredibly high. Rates are negative out to 15 years. Overnight deposit rates are -0.75%, lowest in the world. A survey of economists showed that the charge on sight deposits could go as low as -1.25% over time, but that doesn't mean much. My guess is that Jordan will actively start intervening (or ramp up his threats to intervene) in FX markets to weaken rates while lowering rates slightly. The SNB is conducting possibly the greatest monetary experiment in history, and nobody knows the next ingredient.

Chart of the Week

In addition to all the data and central bank meetings this week, we're likely to see the most contentious OPEC meeting in years. 12 months ago, OPEC surprised markets with a Saudi-sponsored strategy of increased production to squeeze shale production in the US. It's a strategy that largely backfired. Shale drillers are going out of business, but overall US production has been strong as productivity keeps output elevated. Not surprisingly, the other members of OPEC aren't pleased with the results, and they're going to start turning up the heat on Saudi Arabia to cut production.



Still, the Saudi's are unlikely to change course until it's clear how much oil Iran – their arch nemesis - brings to the market in 2016. The most likely outcome of the meeting is an increase in the group's production target to about 31 million bpd, up from 30 million bpd, to accommodate the re-induction of Indonesia to the cartel —a move that won't dramatically change the world's supply-demand balance. The organization is targeting prices between \$60 and \$80 a barrel, but that's easier said than done. Global investment in exploration and production has fallen by 20% this year, reaching levels last seen in 2011, and American production has declined almost 500k bpd since April. Despite the improved fundamentals crude prices are still testing lows around \$40. Unless the Saudi Kingdom decides to play ball, perhaps the more feasible target range will be \$40-\$60.

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: *How do you structure trades?* - CG

A: There are a lot of variables that go into it. It really depends on the type of portfolio you're running, and 100 other factors. But, at a baseline level, I really try to find bets that provide a risk/reward profile of at least 3-to-1. It's also important to express the bet in a way that matches the timeline of your thesis. If it's a

theme that will play out over 3 years, you don't want to establish your max position right away, it's easier to build it up over time. Beyond that it really depends on what you're trying to achieve within the portfolio.

That's all. See you next week!

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

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