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December 17, 2015

CUP & HANDLE MACRO

Greetings,

We tend to think of Japan as this demographic wasteland, where [adult diapers sell better than infant diapers] and growth is non-existent. However, Japan's labor market is sizzling at the moment, and employers are grappling with the most severe labor shortage in 25 years. The jobless rate in the world's third-biggest economy sank to a 20-year low of 3.1% in October and overall monthly earnings gained for a fourth straight month. This is a major development considering Japan's desperate efforts to push inflation above 2%, up from +0.3% Y/Y currently.

The latest Tankan Survey for 4Q showed solid growth in the non-manufacturing sector. A closer look into the details reveals that most of the growth is coming from construction and real estate, related to Tokyo's booming property market. Part of that is related to the Tokyo Olympics in 2020, but the other tailwinds include ultra-low interest rates (35-year mortgage rates are currently 1.55%), lots of cash, the formation of numerous REITs and strong demand from Chinese buyers. Loans extended by commercial banks totaled ¥10.1 trillion ($82 billion) this year for real estate investment alone. This is the first time in seven years that commercial banks lent more than ¥10 trillion to the real estate market.

Furthermore, new real estate loans by "shinkin" banks (credit banks) are at ¥2.1 trillion (about $17 Billion), the first time that has gone beyond ¥2 trillion. If you were to judge Japan's economy based on labor and real estate, it might look like animal spirits are alive and well. However, all of this optimism is being driven, at least partially, by huge QE purchases. And it's debatable whether or not those asset purchases can grow much from here.

With about ¥40 trillion ($330 billion) of notes maturing in 2016, the BOJ will need to increase total bond purchases by about ¥10 trillion next year to meet its goal of expanding the monetary base by ¥80 trillion annually. That's easier said than done now that the world's largest pension fund, GPIF, is essentially finished rotating from JGBs to stocks. There are other firms with substantial JGB holdings, like Japan Post Bank, but the list of potential sellers is shrinking rapidly, making QE expansion difficult.

At the same time, China's currency, CNY, has been accepted into the IMF's SDR basket, and suddenly the PBoC isn't shy about devaluing its currency. That's a huge problem for Japan, because it would lose a major competitive advantage in the export market if JPY can't weaken at the same pace. A further expansion of QE would weaken JPY, but, as mentioned, that's getting harder to accomplish and it simply isn't warranted by labor market conditions.

The Nikkei 225 is up around 6.4% Y/Y, the worst annual performance since Abenomics kicked off in late 2012. If the BoJ can't figure out a way to engineer an expanded balance sheet or weaker JPY, we could be looking at a precipitous fall in the Japanese stock market. Prime Minister Abe still has several options, including tax cuts and increased spending (creating JGB supply for the BoJ), but he's still talking about a tax hike in 2017. The economy is doing better and there are reasons to be optimistic on Japanese asset prices, but the risk/reward seems heavily skewed to the downside.

The **Cup & Handle Fund** is up around +5.0% YTD, and +6.0% Y/Y. Overall I'd say this year's performance was satisfactory. It was a difficult market to trade at times and others did far worse, but again, we're not here to make 5%. We're here to make outsized returns and that's what we'll be gunning for next year. I'll have my annual "5 Bold Predictions" letter out next week, but in the meantime happy holidays and thanks for a good year! **If you'd like to start receiving these letters click here**.

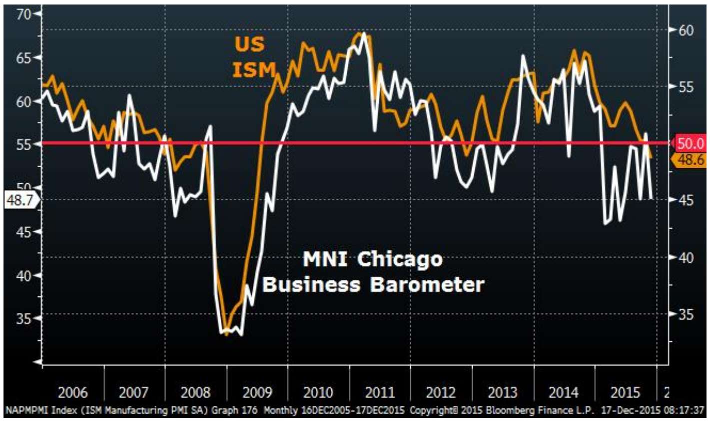
As always, if you have any questions or comments or just want to vent, please send me an email at mike@cup-handle.com.

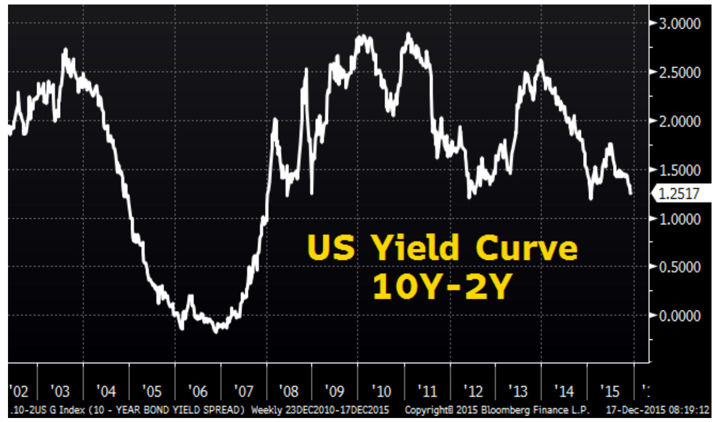
Until next time, tread lightly out there,

Michael Lingenheld
Managing Editor – Cup & Handle Macro

Fed Reaction

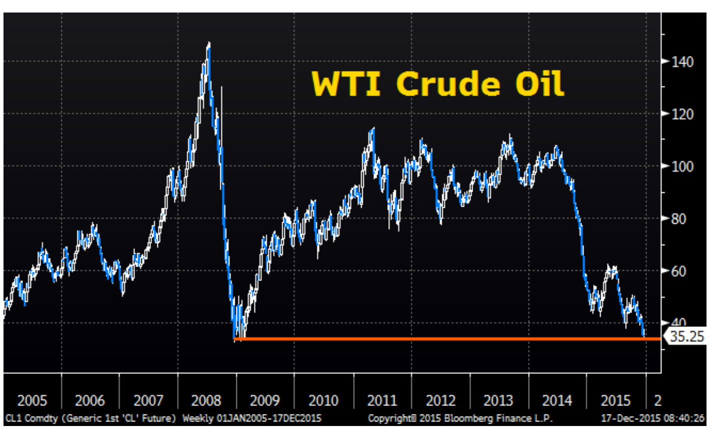
Watching the market's orderly reaction to the Fed rate hike on Wednesday, it seemed as though Yellen's confidence about the economy's upward trajectory was entirely justified. On the margin it was a mildly hawkish announcement. The much ballyhooed "dot plot" was only lowered marginally and primarily far off into the future. Markets reacted calmly because yesterday's actions were meticulously telegraphed to investors, who priced in higher short-term rates well in advance.





What the market hasn't priced in is a rapidly deteriorating manufacturing sector. At 9:45 AM EST yesterday, we got our first look at December data with US flash PMI, which came in below expectations at 51.3. Similar indicators like US ISM, MNI Chicago Business Barometer and Empire Manufacturing data indicate PMI should drop below the magical 50 threshold in the coming months. Of course, the Fed cares more about non-farm payrolls, but this should at least make them nervous. The Fed hasn't hiked rates with ISM below 50 since 1986, and even then they were forced to cut rates a few months later.

Also, while the stock market continued its "Santa Claus" rally (seems to be short covering) after the announcement, oil quietly re-tested the 2008 lows, down -4% on the day. Oil is a little tricky to forecast here because sentiment is already negative and the major technical resistance at $35 will be hard to overcome, but a further decline would surely make the Fed very nervous. And it's worth noting that Goldman Sachs believes [$20 oil could be a possibility] in 2016.



The market now shifts its attention towards 2016 where the Fed is looking to hike four times. Yellen will certainly prefer to make changes at meetings accompanied by a press conference, meaning March, June, September and December. Currently the market is pricing in a 43% chance of a hike next March, but those odds will almost certainly improve if December's non-farm payrolls come in at-or-above trend. And if that drives up the US dollar from current levels, it will put immense pressure on oil, high-yield debt, EM and other markets that have struggled mightily this year.

And all of this analysis ignores the world's other influential central banks. The ECB, SNB, and BoJ would all like to see their currencies depreciate further, and could actively pursue that goal next year. And the elephant in the room is China's PBoC, which has pushed the Renminbi (CNY) to its lowest levels since 2011 – a clear response to higher US rates. If they press the issue and weaken CNY further in 2016, yesterday's Fed decision could look awfully foolish.

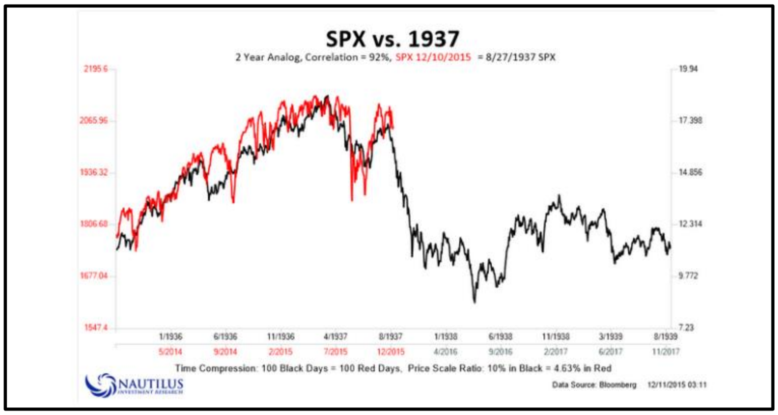
<u>FANG Leaders</u>

The combined market capitalization of Facebook, Microsoft, Amazon and Google is higher than the combined market cap of every energy company in the S&P 500. Microsoft had a good year, but when you swap MSFT out for Netflix you get the F.A.N.G. stocks, which carried the S&P 500 in 2015. Since June, these four stocks are up +40% on average, versus the broader index's performance of -5%. As we approach 2016 there are valid reasons to expect these leaders to fall back. Since 2005, the top 10 stocks underperformed the following year by an average of 2.9%.

This is especially noteworthy considering how weak market breadth has been. Only 25% of the S&P 500 is trading above its 50-day moving average (MA), and only 50% are above their 100-week MA. The NASDAQ is even worse with 33% trading above their 100-week MA – only the Brazilian IBOV has worse market breadth. FANG stocks shouldered their share of the burden in 2015, but for stocks to stay with reach of all-time highs they'll need to double their effort in 2016.

1937 All Over Again

Eight years after the 1929 stock market crisis and at the end of four years of money printing that had led to surge in equity valuations, premature tightening by the Fed led to a -33% decline in the Dow Jones Industrial Average in 1937. A sell-off continued into the following year. Ray Dalio highlighted the similarities between 1937 and 2015 in August, and it's a comparison that seems increasingly apt. The big benefit we have today is that our policymakers theoretically learned lessons from the Great Depression. Ben Bernanke is famously one of the foremost authorities on the subject. While this week's rate hike plays into the comparison, the Fed is really only half of the equation.



In 1937, FDR instituted drastic spending cuts and tax increases to try and balance the budget. Needless to say it backfired, and the country sank back into recession. Nobody (prominent) is screaming for a balanced budget these days, but spending has been constrained for several years. This is an issue we've discussed several times this year so I won't elaborate here, but I'd say fiscal policy is the best comparison between 1937 and today. The chart above is certainly looks ominous, but the S&P 500 at 1,500 wouldn't be the end of the world.

Chart of the Week

You really need to follow China closely in order to track what's going on. The scale of development going on over there is something Americans can't comprehend, especially in terms of infrastructure. The Chinese probably have 10-15 projects under way that would equate to the Hoover dam's construction. Many of these projects were undertaken ahead of schedule to offset the slowdown taking place in other areas of the economy, which doesn't necessarily show up in monthly data. However, it looks like the PBoC's litany of monetary stimulus efforts this year are starting to gain some traction.

As an example, this month, the PBoC increased the size of its Local Debt Swap program to 15 trillion CNY ($2.3t USD), up from 3 trillion CNY previously. The program frees up capital for local government to spend, while also strengthening the balance sheets of local banks. This program and others like it, combined with 6 rate cuts over the past 12 months are finally starting to support lending. The chart above shows that monetary conditions still equate to GDP around 7%, still relatively mild for China, but it looks like things are finally on the right path. Whether or not that can be maintained is still unclear.

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: *Favorite book of the year? - TM*

A: Too hard to pick just one. I'll give you my top 5 in no particular order: The Spy's Son by Bryan Denson, The China Mirage by James Bradley, Against Football by Steve Almond, Age of Ambition by Evan Osnos, and Johnny Carson by Henry Bushkin.

That's all. See you next week!

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

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