Greetings,

It took two US Cabinet secretaries, three Governors, the Mayor of Los Angeles and several Congressional leaders to resolve the dispute between shipping lines and the dockworkers’ union that stalled transportation at 29 West Coast ports for over nine months. The ports, which handle 50% of all US maritime trade and more than 70% of the country’s imports from Asia, are back working at full speed, but it will take months for the backlog to clear.

Meanwhile, the East Coast continues to be pounded by extreme winter weather. The Boston-Washington corridor, home to 18% of Americans, produces more economic activity than Germany. This winter’s blizzards are having a material drag on economic activity and straining budgets. Snow removal alone has cost Boston more than $30 million. Of the 52 snowstorms rated as “high-impact” on the NESIS scale since 1956, five have occurred this winter.

Goldman Sachs estimates US GDP will take a -0.5% hit due to weather in the first quarter. Which isn’t a disaster considering last year’s “polar vortex” sent first quarter GDP growth into negative territory at -2.1% Y/Y.
The combination of the West Coast labor dispute and East Coast weather won’t send the economy into recession this year, but it’s a great excuse for the Fed to hold off on its first rate hike. While journalists seem fixated on whether or not the Fed will hike in June, the market is pricing in the first increase around September – October (chart above).

Janet Yellen takes center stage today as part of her semiannual “Humphrey-Hawkins” testimony, although the Fed’s January minutes already showed she’s willing to wait and see what the first quarter data looks like before making any decisions. In the meantime, the US dollar, which is still around its highest level since 2003, is actively tightening monetary policy for the Fed. The stock market is setting up for a sizable correction within the next 18 months, but that doesn’t mean ultra-stimulative monetary policy in the developed world can push prices substantially higher before then.

The Cup & Handle Fund was roughly flat again last week, up 11% since inception. Two of my new positions were actually +5% within 24 hours, but those gains were offset by losses in longer-term holdings. Foreign currency seems to be the go-to market for trending moves these days, so that’s where much of my attention is focused. With that being said, my February investment letter focused on a commodity stock, which has already rallied 6% since the recommendation went out – if you’d like to start receiving these letters click here.

Today’s letter will cover several topics, including:

- The Gas Trade
- Chicken Fingers Are Back!
- Israel Strong
- 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 Gas Trade

It’s incredibly difficult to hold a position in the $27 billion natural gas market because of the astounding volatility. I know traders who routinely buy gas when it’s up 2% on the day because momentum players will inevitably push it up 5+% on the day. Realized volatility hit an 8-year high between December and January. And yet, if you can stomach the volatility, now is probably as good a time as ever to buy natural gas. This is for two reasons:

1.) **Seasonality** – Half of US homes use gas for heat, which is why traders constantly monitor weather forecasts looking for cold spells. Last February’s “polar vortex” across the northeast spurred record demand, pushing prices to a five year high. Gas producers subsequently set monthly output records over 11 consecutive months, pushing prices back to a 2.5 year low – where we stand today.

   Extreme weather varies from year to year, but temperatures follow a tight seasonal pattern. The same can be said of natural gas prices. Once the worst of the cold is over, gas prices typically see strong rallies over March and April. It looks like this year will be no different.

![Natural Gas Futures Seasonal 17 Years](image1)

2.) **Positioning** -- Even the most sophisticated hedge funds can get burned in natural gas. Amaranth Advisors went under after a trader lost $6 billion on gas trades in 2006. With that being said, most of the traders in this market are professional, and, at the moment, they’re almost universally bearish. Net positioning of non-commercial CFTC traders is at the second lowest level in history. After positioning bottomed in 2011, gas prices rallied 20% over the next month before resuming their cyclical decline.

   With a tight stop, I think it makes sense to own natural gas here as a trade. UNG is the most liquid ETF, but don’t be afraid to
realize profits if they materialize. Even if this trade goes in your favor, inevitably you’ll get burned by holding it for too long.

**Chicken Fingers Are Back!**

The latest WASDE report from the USDA on February 10 showed a major glut of chicken supplies in the US, leading many to believe that prices would tumble. The chicken industry has been profitable for the past three years, but import restrictions in China and shipping issues at West Coast ports increased the potential for oversupply. Fortunately, McDonald’s (MCD) has come to the rescue, announcing they are bringing “Chicken Selects” (chicken tenders) back to the menu.

![US Beef Prices vs US Chicken Prices Graph](image)

McDonald’s recently introduced a new CEO who is looking to jumpstart growth as the company struggles to compete with upstart fast-food chains like Chipotle (CMG). Even when it’s mired in a sales slump, McDonald’s can easily move the needle for the meat industry with a single menu item. However, this move has little to do with stronger consumer demand for poultry. Instead, chicken is very cheap relative to beef, which continue to get more expensive.

I’ve written about the bull market in beef several times already, but chicken is a much different market – mainly due to the bird’s shorter life-cycle. McDonald’s and Burger King (BKW) are already in the midst of a price war over chicken nuggets. McDonald’s started offering 50 McNuggets for $9.99 recently, and Burger King countered by selling individual nuggets for 15 cents. The USDA forecasts production of chicken broiler meat to grow 3.6% this year to 39.5 billion pounds, and with two fast-food titans in a poultry-showdown, expect demand to grow as well.

**Israel Strong**

Even as its Arab neighbors slip further into chaos, Israel’s economy keeps humming along. The government reported last week that fourth quarter GDP growth hit 7.2% Y/Y, the most since 2007. Economists noted that the growth represented a rebound after the sluggish third quarter when
economic activity slumped during the Gaza War last summer. The data sent Israel’s stock market back to all-time highs.

![Tel-Aviv 100 Stock Exchange](image)

Few people realize that Israel is on the verge of becoming an energy superpower. Thirty-five trillion cubic feet of gas have been found in Israeli waters, worth some $500 billion at today’s (historically low) prices. To give that some context, the 2013 Israeli nation budget totaled $114 billion. Not only does this have the potential to make Israel energy-independent for the first time in history, but they'll likely be a major exporter. The government has already signed a $15 billion gas contract with neighboring Jordan, and is expected to ink deals with other neighbors – assuming they can get along.

**Chart of the Week**

Last May I noted that 10-year JGB bonds didn’t trade at all on April 14, 2014, highlighting illiquidity in one of the world’s largest debt markets. The Bank of Japan is buying more than 70% of all new issuance, and currently holds more than 25% of the country’s outstanding sovereign debt. The nearly non-existent trading volumes amplify all moves when traders do enter the market, which is why volatility is at records highs.
JGB yields have been moving higher so far this year, along with Treasury’s. However, there is concern that such wild swings could force risk managers at financial institutions to dump their long positions – creating a spiral. In November, Japan’s $1.2 trillion Government Pension Investment Fund (GPIF) announced plans to reduce its holdings of domestic bonds to 25% from 60%. The reallocation will take place over several years, but that’s a lot of money flowing out of a fragile market. The government would likely step in, but JGB’s look like they’re at risk of a flash crash.

**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: If you’re bearish Uber, I assume you don’t think SnapChat is worth $19 billion? - DS

A: Correct. Although, I’ll put it to you this way: What is the value of anything when money is essentially free? Venture capital investors are in a tricky spot because, historically, they’ve always been able to gauge metrics like cash flow relative to interest rates. With rates near zero, or even negative in some places, how can they determine value? SnapChat is even more difficult because it doesn’t have any material revenue.

Hedge Funds and financial conglomerates (like Fidelity) have entered the VC space, because they can’t beat their benchmarks anywhere else – pushing up values across the start-up landscape. According to the WSJ, at least 73 private companies world-wide are valued above $1 billion. In 2014, 48 companies entered this rarified air. During the dot-com bubble, only 35 companies were valued above $1 billion, adjusting for inflation.

As companies like GoPro are finding out, maybe it’s just better to stay private. When you’re forced to report quarterly earnings, all of the skeletons come out of the closet and it’s much easier to value overhyped companies.

**That’s all, see you next week!**

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

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