

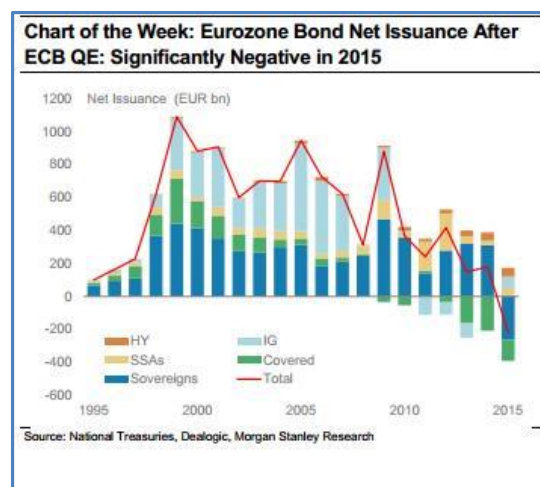


## CUP & HANDLE MACRO

Greetings,

The latest employment data for February showed continuing labor market strength, sending the US dollar to its highest level in 12 years. Some would even say the USD move looks parabolic, which is synonymous with bubbles. The dollar could peak here, but I doubt it. Currencies are inherently relative value bets, and, at the moment, I don't see what USD will depreciate against. The Euro? Take a look at the chart below. Net bond issuance from the Eurozone is negative for the first time in the currency-bloc's history. At the same time, the ECB is buying a fixed amount (60 billion EUR) of debt every month until September 2016. Increased demand combined with shrinking supply means Eurozone rates are headed lower regardless of the economic environment.

The prospect of higher rates in the US has many investors nervous about the stock market, but legendary investor Stan Druckenmiller isn't worried. In [an interview last week](#), Druckenmiller made the astute point that if rates are going up, you should short bonds – not necessarily stocks. The stock market is facing several headwinds at the moment, mainly a stronger dollar, but the Federal Reserve has maintained the loosest monetary policy in its history for several years.



India and China, home to 35% of the world's population, both cut interest rates within the past 10 days for the second time in 2015 – and they have plenty of room to ease further. Monetary easing is an incredibly powerful tool for policymakers, and it often impacts the economy with a 9-12 month lag. Therefore it's entirely plausible that we could see the stock market rally appreciably from these already expensive levels, even with higher rates.

However, as history has taught us, the bigger the boom – the bigger the bust. The fact that there's a debate over a 25bps hike tells us that while low interest rates boost asset prices, they've failed to deliver a robust recovery. Savers are being deprived of interest income and it's very difficult to invest in these markets. At some point the tide will turn, volatility will pick up and there will be mouth-watering opportunities. Unfortunately, six years into this monetary experiment, it looks like we still need to be patient and wait for asymmetric opportunities.

I made [my podcast debut](#) last week on the American Monetary Association's weekly show. It was recorded in February, but most of the content is still pertinent. The [Cup & Handle Fund](#) was roughly flat last week, still up 10% since inception. I'm going to start my writing my March investment letter soon, and subscribers should expect to see the finished product within the next two weeks – [if you'd like to start receiving these letters click here](#).

Today's letter will cover several topics, including:

- Getting Real in Brazil
- Buybacks Keep Booming
- Denmark's FX Gamble
- 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](mailto:mike@cup-handle.com).

Until next time, tread lightly out there,

**Michael Lingenheld**

*Managing Editor – Cup & Handle Macro*

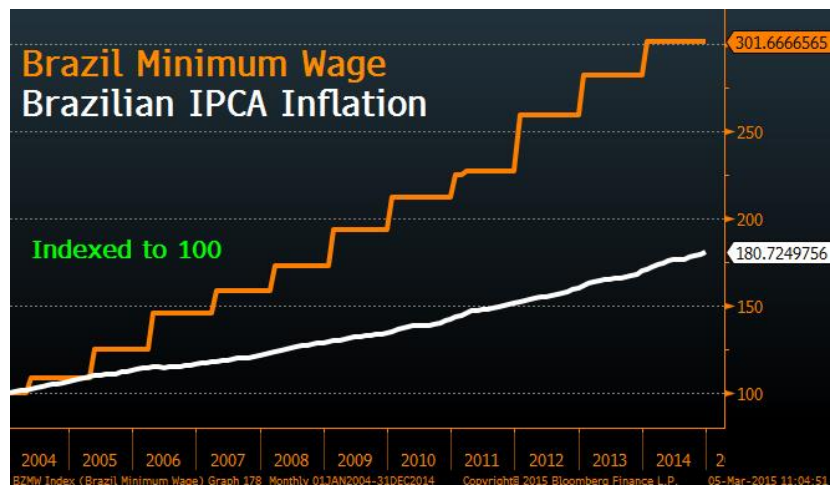
## Getting Real in Brazil

Whenever there's a sell-off after bullish news it's typically a sign of more pain to come. Brazil's central bank raised benchmark interest rates to 12.75% last Wednesday in order to quell inflation, but the Real (BRL) dropped even further. BRL has now declined more than 11% YTD relative to the US dollar – the worst performing currency in the world outside of Ukraine. Inflation in Brazil was running above 2,000% Y/Y as recently as 1994, so it's rationale for the central bank to make taming prices their priority #1, but the rapidly slowing economy is desperate for a boost.

Inflation above 7% Y/Y has eroded purchasing power in a country that relies on private consumption for 50% of GDP. Economists are currently projecting a -0.5% contraction in GDP this year followed by 1.5% growth in 2016 – hardly the stuff of a burgeoning superpower. Global investors are taking notice, and have already pulled \$1.3 billion from Brazilian stock and bond funds since the start of this year. The stagflationary environment could get worse before it gets better.

Despite lackluster growth, local prices keep rising for two reasons. First, the minimum wage in Brazil is adjusted annually depending on economic conditions. At this point the minimum wage is really just a political tool used to buy votes since it has outpaced inflation dramatically over the past decade. Last June, President Dilma Rouseff increased wages 8.83% for 2015. Conveniently the announcement was made three months before her re-election.

The second force boosting CPI is an acute water shortage. Brazil, known as the Saudi Arabia of H<sub>2</sub>O and home to 1/8 of the world's fresh water, is in the midst of its worst drought in history. Taps in Sao Paulo, the country's largest and wealthiest city, are starting to run dry. It's an even bigger problem when you consider that 75% of the country's electricity comes from hydroelectric dams. To avoid blackouts the government is raising prices 30% to deter consumption. The government could import fuels, but the deteriorating currency increases costs even more.



To make matters worse the finance minister is tightening fiscal policy to avoid a credit downgrade, and the attorney general is pursuing several senior politicians implicated in a kickback-and-bribe scheme involving state-controlled Petrobras (PBR). Brazil's rise to BRIC status was fueled by a commodity boom, and they'd surely like to see the Chinese economy pick up some steam. Unfortunately, Premier Li Keqiang lowered China's growth forecasts last week, meaning Brazilian investors need to buckle up for a rocky road ahead.

### **Buybacks Keep Booming**

If it wasn't already clear that corporate America is still awash in cash, the record \$104.3 billion in planned share buybacks in February should clear things up. That's nearly double the \$55 billion in purchases from a year ago. S&P 500 companies have spent more than \$2 trillion on their own stock since 2009. As of last October, large cap companies were on pace to spend 95% of their aggregate earnings on repurchases and dividends.

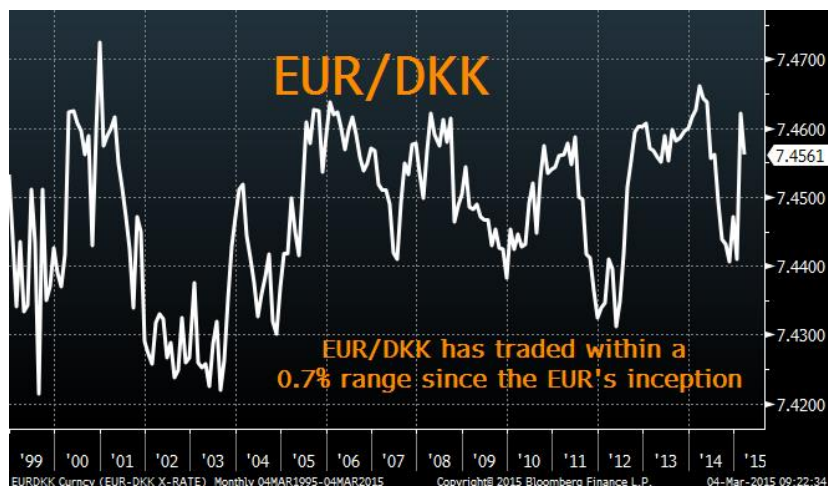


Alarmingly, buybacks are increasing just as quarterly profits post their first consecutive contractions since 2009. Many executives are feeling pressure to use their excess cash in a productive manner, and repurchases seemingly always keep investors happy. Even if corporations don't have cash, they can issue debt in Europe essentially for free. Berkshire Hathaway, which already has upwards of \$63 billion of cash on its balance sheet, [is issuing European debt](#). CEO's may not think of themselves as investors, but their goal is still to buy-low, sell-high. With P/E multiples already elevated, it's hard to believe these executives are buying their own stock at discounted levels.

### **Denmark's FX Gamble**

Denmark has maintained a currency peg for more than three decades; first relative to the German Mark and currently against the Euro. Now that the ECB has slashed interest rates below

zero and started buying sovereign debt, Denmark's Krone (DKK) is under heavy pressure to appreciate – similar to the Swiss Franc before the SNB capitulated in January.



Denmark's central bank, the Nationalbanken, has already cut its key policy rate four times this year; certificates of deposit now yield -0.75%. The Nationalbanken has also been intervening in currency markets at a historic rate. Net purchases of FX amounted to 168.7 billion DKK (\$25 billion) in February – equal to 9% of GDP. The country has also suspended government bond issuance and rejected bids at treasury auctions in order to avoid foreign inflows. Thus far Denmark has done a decent job of keeping hedge funds at bay, but if Eurozone turmoil escalates again, protecting their 33-year old peg might be irresponsible.

### Chart of the Week

Bitcoin, the much-maligned cryptocurrency, is staging an impressive comeback after a rough start to 2015. Barry Silbert, one of Bitcoin's biggest advocates, appears ready to list Bitcoin Investment Trust (GBTC), which would become the first publicly traded Bitcoin fund in the world. Silbert had been racing against the Winklevoss twins to obtain regulatory approval for such an offering.





However, that might not be the most important Bitcoin-related development to occur last week. Tera Group, which became the first regulated platform for Bitcoin derivatives in September, will also be going public through a reverse-merger. The development of swaps and options trading in Bitcoin is critical because hedging vehicles like this allows traders to offset FX losses. These new offerings are bound to improve liquidity, which should go a long way towards reducing the volatility that scares off many investors. While Bitcoin struggled mightily in 2014, down -57%, Bitcoin-related firms raised more than \$300 million last year – more than the \$250 million invested in internet startups through 1995. Digital currencies have been through a bumpy ride so far, but there is a lot of capital still betting on their long-term potential.

### **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](mailto:info@cup-handle.com). We'd love to hear from you! \*\***

*Q: Just read your note on banks charging for deposits ([from last week's letter](#)). Why is the banking sector struggling so badly? - RT*

A: Bank margins have a strong positive correlation with interest rates (borrow short, lend long), so they've been struggling for some time. The bigger question: is the banking system outdated? Digital currencies like Bitcoin (where transactions are free) may not pose an existential threat to banks, but their business model is becoming more and more obsolete. Why, for example, do banks still issue paper statements? How have we not come up with a superior method of transferring large sums than writing checks?

Poland, [which prides itself on banking innovation](#), is at the forefront of digital banking. Checks are almost non-existent, wireless transfers are the norm and many retail banks are slashing the number of operating branches. Interest rates will likely be low for some time, meaning the successful banks going forward will be those that embrace new technology.

**That's all, see you next week!**

For any questions or comments, please email us at: [info@cup-handle.com](mailto:info@cup-handle.com)

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