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April 30, 2015

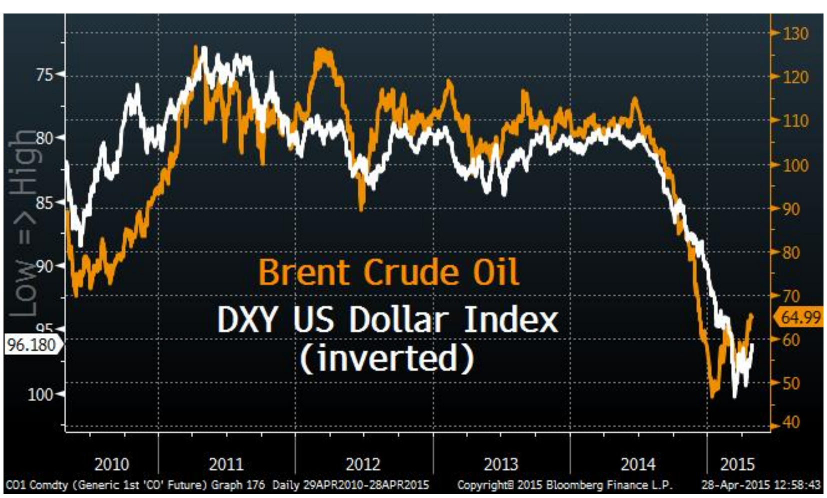
CUP & HANDLE MACRO

Greetings,

This week at the Milken Institute Global Conference the question on everyone's mind was: Which way is oil going? Hedge funds seem convinced oil is headed above $80/barrel, and they're placing big bets to back up their conviction. Exchange data show long exposure to Brent crude oil through futures and options is at an all-time high, worth 265 million barrels – enough for three days of global consumption.

At the same time, oil producers have hedged more than 500 million Brent barrels in order to protect against further declines. Rex Tillerson, CEO of ExxonMobil, the world's largest oil company, recently said the industry should expect lower prices for "at least a couple of years." In order to comfort investors many energy companies have slashed capital expenditures.

According to Baker Hughes, the number of oil rigs operating in the United States has fallen 53% YTD to 703 – the fewest since 2010. And yet, despite the massive cutbacks, the oil supply keeps growing. US crude inventories stand at the highest level in 80 years and have now risen for 15 consecutive weeks.



Despite a 40% rally from the bottom in January the oil market seems impervious to developments in the supply/demand fundamentals. Instead, it appears as though the US dollar, which precipitated oil's collapse last June, is still the biggest driver of prices. Unfortunately, oil investors are forced to become Fed watchers like the rest of us.

The market has now pushed back the timing of the Fed's first hike to early 2016. While the US economy is showing signs of momentum, it's incredibly difficult for the Fed to raise rates when the rest of the world is cutting. No fewer than 27 central banks around the world have eased monetary policy to some extent this year, notably China – the world's second largest economy.

As long as the Fed seems hesitant to tighten there's a good chance oil will move higher as USD weakens. However, Janet Yellen will inevitably have to face the music and raise rates for the first time since 2004. USD is likely to see a strong rally leading up to that announcement, at which point oil will face strong headwinds. It's very telling that forward prices, which are less susceptible to fast money and a good gauge of future demand in the real economy, remain depressed. The December 2019 Brent oil contract has rallied a mere 5% from the lows. Oil looks like it's improving but it's too soon to say the bottom is in place.

The **Cup & Handle Fund** is now up +1.0% on the year, and +15.5% since August (inception). I heavily reduced risk in the fund after some early losses to start the year, but now that we're back in positive territory it's time to be more aggressive. I've added two new "themes" (positions expressed via multiple stocks) this week. One is an extremely attractive risk/reward trade. The other is a position I'm willing to be patient with and hold for at least the next few months. It helps that my monthly investment selections have shot the lights out this year. My letter for May should be available in the next few weeks. **If you'd like to start receiving these letters click here**.

Today's letter will cover several topics, including:

- Buyback For What?
- The United States of Renters
- Too Close To Call
- Chart of the Week

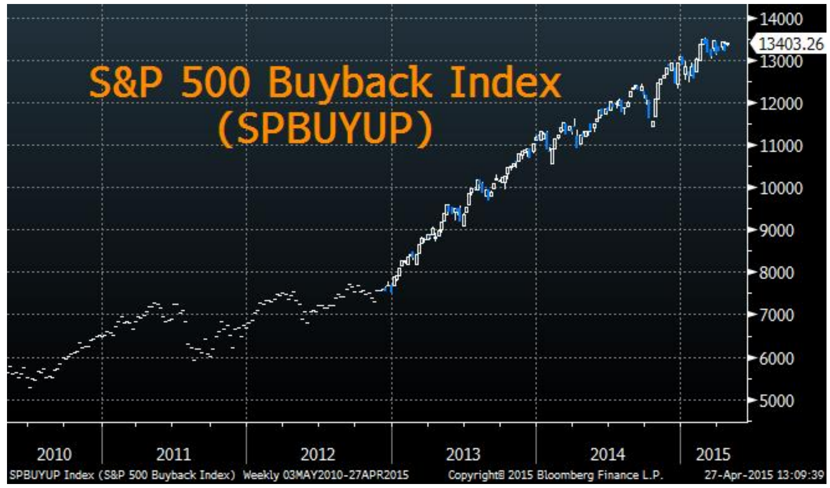
As always, if you have any questions or comments or just want to vent, please send me an email at mike@cup-handle.com.

Until next time, tread lightly out there,

Michael Lingenheld
Managing Editor – Cup & Handle Macro

Buybacks For What?

According to Bloomberg, the volume of share buybacks was $550 billion in 2014 versus just $85 billion of new capital coming into the stock market. The trend for 2015 is even scarier. Buybacks are continuing at a record pace, but outside investors have actually pulled money from the stock market in aggregate. [Last week] I intimated that strong "per-share" results could be masking underlying corporate trends that are deteriorating rapidly, and I received several emails asking why companies continue to pursue this strategy.



If you were to ask this question to executives, several would surely respond: "why wouldn't we pursue this strategy." Money is essentially free. Nestle's corporate bonds trade with a negative yield, meaning investors are paying to own their debt. Companies like Apple, which has more than $150 billion in cash on its balance sheet, have been issuing bonds in Europe and using the cash to fund buybacks because it avoids the repatriation tax. In many cases, it's not entirely clear that excess capital would be better spent expanding capacity considering the economy's lackluster recovery.

There are two other reasons why CEO's are seemingly so fond of their own stocks. First, the bulk of executive pay is often tied directly to share-price performance; incentivizing leadership to juice up the stock as much as possible.

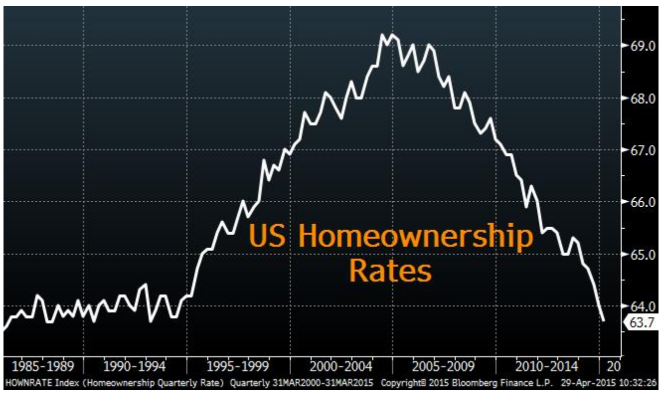
Second, corporations are terrified of activist investors. Even though most activist hedge funds lag the S&P 500, they are the strategy du-jour. In 2014, activists won at least a partial victory in 73% of all boardroom battles, and gained entry onto the boards of PepsiCo and Dow Chemical without having to wage proxy fights. By announcing buybacks before activists target their companies, many boards are waving the white flag instead of waging a war.

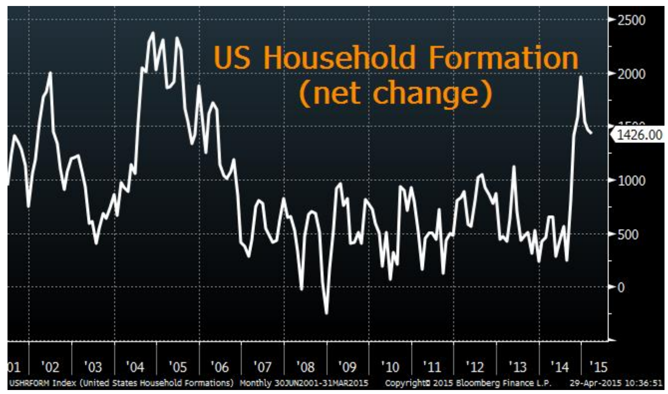
Just because it's explainable, doesn't make it a smart decision and this trend wreaks of groupthink. In his 2012 shareholder letter, Warren Buffett said he "*favors repurchases when two conditions are met: first, a company has ample funds to take care of the operational and liquidity* *needs of its business; second, its stock is selling at a material discount to the company's intrinsic business value*."

As corporations continue to hoard cash they almost certainly have the funds to operate, but there's no way these CEO's are buying their shares on the cheap. More than $1 trillion will be spent on buybacks and dividends this year, a figure that will exceed total profits. Investors with long exposure to the stock market may be cheering these repurchases now, but it's almost certainly going to end in tears.

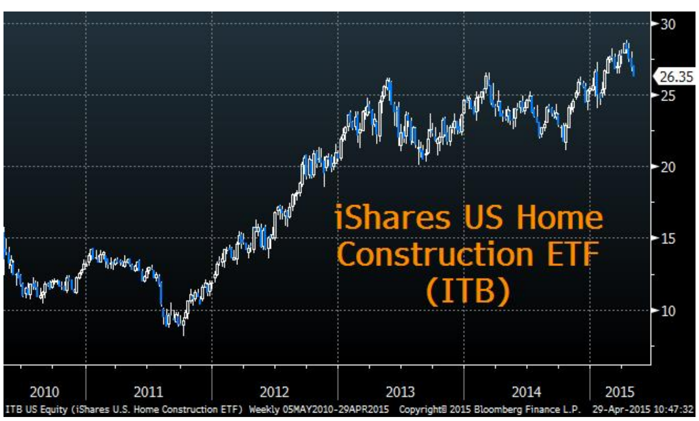
<u>The United States of Renters</u>

According to new US Census data, homeownership rates, which peaked in 2004 at 69.2%, extended their decline in the first quarter; dropping to 63.7%. After the housing bubble burst in 2008, new household formations flat-lined because the economy was terrible and young people were incentivized to move back with their parents. Now that the economy has stabilized, household formation is moving higher but owning a home is still unappealing for many.





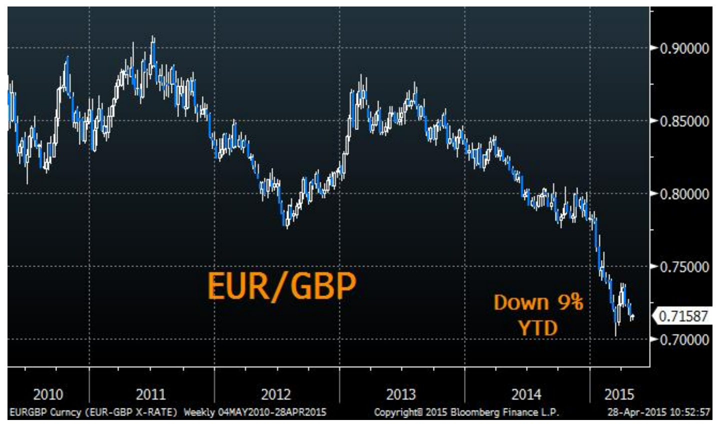
As a result, rental vacancy rates are now below 7%, or the lowest they've been since the early 1990's. The tightness in the rental market is why rent prices are soaring. During the first quarter, median US rent reached $799, up 4.5% from the previous quarter – the biggest Q/Q jump since 2006. Of course, there are numerous reasons why people prefer renting these days. Student debt, for example, has grown exponentially since the financial crisis, putting a serious dent in the ability of Millenials to afford homes.



Home construction stocks, notably the ETF (ITB), have performed reasonably well considering the lackluster environment. However, last week was a tough one for homebuilders as shares in DR Horton (DHI) dropped 6% on heavy volume despite reporting a 38% increase in second quarter home sales. This sector looks like it has been priced for perfection, and the negative macro trends in homeownership make ITB look like an attractive short at these levels.

Too Close To Call

1-month volatility in the British Pound (GBP) against USD surged to its highest level since 2011 earlier this month, as the UK prepares for an election on May 7th. The hotly contested Prime Minister race between incumbent David Cameron and Ed Miliband is perhaps less important (for markets) than the coalition formed in parliament. As always, the outcome will likely come down to voter turnout.

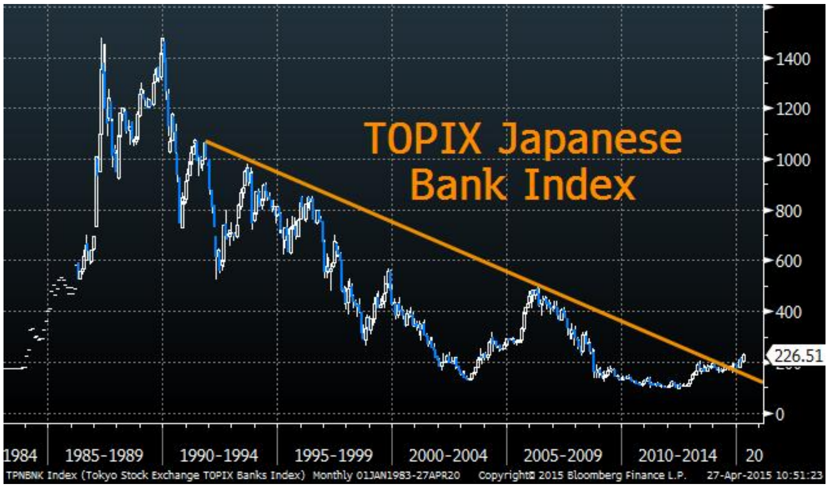


David Cameron's re-election campaign was dealt a blow on Tuesday after first quarter GDP grew just 2.6% Y/Y, well below the 3.0% growth from the previous quarter. Despite talk of tighter monetary policy, the Bank of England is still holding rates at 0.5% - where they've been since March 2009. While GBP has obviously declined relative to USD over the past year, it's much stronger compared to the Euro-bloc, its largest trading partner, which is a big reason why CPI growth came in at 0.0% Y/Y in March.

The GBP (and UK generally) is a clear "stay away" in my opinion. A Labor-led government could boost public spending, forcing the BoE to considering tightening policy. Conversely, a victory by the Conservatives could set the stage for referendum on whether the UK should leave the EU. Volatility is at the highs for a reason: the UK is a minefield for investors.

Chart of the Week

Japanese banks are once again the world's largest international lenders, a status last achieved during the asset bubble of the late 1980s. Unlike the 1980's, however, Japanese lenders are in a much more stable. They're some of the world's best capitalized banks, and the country's weakening currency makes loans denominated in JPY very attractive. While growth and inflation measures continue to come in below expectations, several signs show Japan's economy is turning around – notably the country's first trade surplus in nearly three years.



Japanese corporations are posting record profits and several large conglomerates have even raised wages. As loan demand, both foreign and domestic, picks up, banks should be the primary beneficiaries – especially if interest rates, which still hover around record lows, rise. Higher interest rates help improve profit margins for banks, which have struggled with falling interest rates for decades. The confluence of these factors have pushed the TOPIX bank index to its highest levels since 2008, and it recently broke through a 25-year trend-line. It's still way too early to call Abenomics a success, but at least the performance in bank stocks shows progress.

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: Can you update your view on uranium? – CM

A: The first piece I ever wrote for Cup & Handle was a bullish note on uranium miners (*here*) in February 2014. The investment hasn't worked out yet (although spot uranium prices are higher), but I emphasized in that piece that it would take a few years. I would even say uranium miners have held up well considering the collapse in oil prices. In fact, the rebound in oil and several micro developments have pushed the ETF (URA) to a 6-month high. On April 15, Cameco (CCJ) signed a deal to sell 7.1 million pounds of uranium concentrate to India over the next five years. It's a very bullish signal that China and India, the world's two largest populations, are rapidly turning to nuclear power to meet electricity shortfalls. Even Saudi Arabia, the world's largest oil exporter, is building nuclear facilities – although the Kingdom is also exploring nuclear warheads. Analysts believe we're inevitably headed for a supply deficit, possibly as soon as 2017. As I said from the beginning, it may take a while to play out, but uranium prices should rise significantly from current levels.

That's all, see you next week!

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

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