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May 21, 2015

CUP & HANDLE MACRO

Greetings,

We're only a few weeks away from the one year anniversary of the US launching military attacks against ISIS, and it continues to dominate the headlines. Just this week ISIS took control of Ramadi, only a 1.5 hour drive from Baghdad (according to Google Maps), while a team of Delta Force soldiers killed ISIS's "CFO" in Syria. What has gone unmentioned is Turkey's apathetic efforts to combat instability in the region, even though it shares a border with both Syria and Iraq. Instead, President Erdogan spends his time silencing the media and "purging" political opponents.

The market has taken notice. Unlike other emerging markets that saw strong growth over the past decade behind China's consumption of commodities, Turkey used its strong demographics and educated workforce to grow through domestic demand. Unfortunately, much of that progress has been undone under Erdogan's leadership. Nationwide, consumer confidence is at a five-year low and unemployment has risen to 11%. Erdogan believes the economy is stagnating because of high domestic interest rates (10.75%) and the parliament voting down large investment projects. He has called the central bank's governor a traitor for not cutting rates more aggressively.

Of course, domestic interest rates are high for a reason. Specifically, CPI is running well above trend at 8% Y/Y and the Turkish Lira continues to spiral lower. Turkey also runs a sizeable current account deficit at 6% of GDP, even though the value of its oil imports have declined dramatically.

Instead of shoring up his country's weaknesses Erdogan has instead relied on conspiracy theories and threats. The President's chief economic advisor believes a malicious "interest rate lobby" is holding Turkey back, and has suggested Erdogan's opponents tried to kill him via telekinesis. Another advisor warned President Obama of "serious and undesirable political consequences for humanity" if the Fed raises rates.

I've been bearish on Turkey for some time now, mainly because of its repugnant leader, but I don't see any reason to turn bullish now. The Middle East is still mired in chaos and it seems as though things are only getting worse. My investment pick from last October was buying the Israeli ETF (EIS) and selling Turkey (TUR), which has since produced 5% gains. Israel has its hands full with Palestine, Hezbollah and Iran, but at least the country's vibrant tech sector and natural gas reserves offer some tools for the invisible hand.

The **Cup & Handle Fund** is up about 1.0% on the year, and +15.5% since August (inception). I turned bearish on crude oil last Thursday, which provided a perfect hedge for some of my other energy-related positions. Next week should see a lot of fireworks as several of my holdings report first quarter results. I sent out my May letter on Monday, and the recommendation has already rallied 5%. My picks have been spot-on this year, but I wish they could wait a little while before rallying so that my readers can establish a position. **If you'd like to start receiving these letters click here**.

Today's letter will cover several topics, including:

- Digging for a Bottom
- Retail Rollover
- The Squeeze Continues
- 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

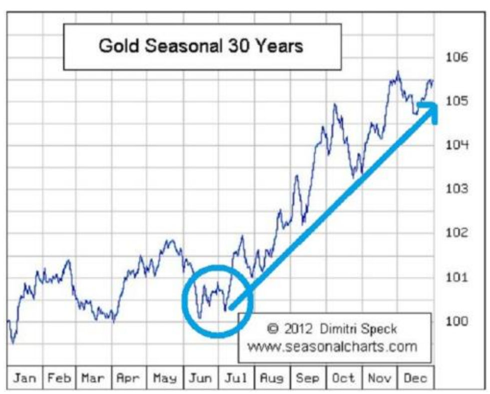
Digging for a Bottom

The Russian Ruble is the world's best performing currency in 2015, rallying 27% YTD. The third strongest currency is the Swiss Franc, up 10%, after the SNB removed the floor underneath EUR/CHF in January. Think you know the second best performer? I'd be very surprised if you did because it's silver, up 15% so far. Silver has tripled the return of gold, the 7th strongest currency, as global monetary policy continues to loosen.

The financial press is saying this metals rally is entirely due to a weaker US dollar. To a certain extent that's true, but it ignores how resilient these metals were during 2014 when the DXY soared 15% between May and December. Gold, as you'll recall, was the second best performing currency last year; outpacing every currency on earth except USD.

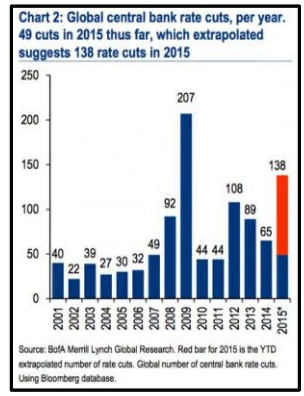
Ironically, precious metals are rallying just as negative demand data is being released. The World Gold Council's latest report showed that global demand fell 1% Y/Y in the first quarter. Total bar and coin demand in China actually grew by 3% Y/Y, but it was offset by a 6% Y/Y decline in India.

American buyers have also been absent from the market. The US Mint reported that American Gold Eagle coin sales fell 37% M/M in April, and sales for the first four months of the year were down 3.6% Y/Y. Interestingly, gold demand from Germany was one of the few bright spots, up 20% Y/Y. European demand more generally hasn't been this strong since 2011 – when the EU sovereign debt crisis reached its peak.



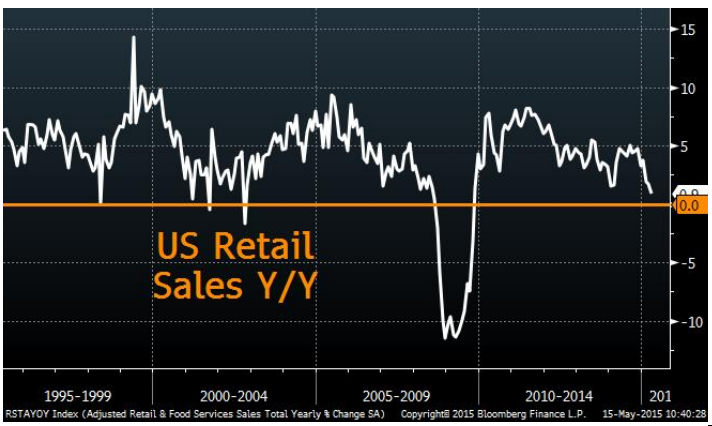
Ostensibly, the weaker US dollar and subsequent rally in gold have been driven by poor economic data in the US, but there's more to it than that. The dollar sell-off has been exacerbated by positioning, which was wildly long before this correction occurred.

There's also more to the move in gold. Commentators tend to correlate gold movements with changes in the US economy, but the yellow metal is much more attuned with what's happening in Asia and the EM world generally. There have been 49 rate cuts thus far in 2015. If you extrapolate that over the course of a year, it would be 138 – the most since 2009 at the peak of the financial crisis. Gold has been dragged through mud for the past three years as it lags financial assets like stocks and bonds, but this excess liquidity will eventually flow into hard assets. We're always instructed to buy when assets rally on bad news, and it looks like that's what is happening here.



Retail Rollover

Throughout the second half of 2014 economic pundits were adamant the 50% decline in oil would embolden consumers to hit the stores and put their disposable income to work. I was skeptical at the time and highlighted [as recently as February]() that excess savings were not filtering into the real economy. Instead, the vast majority of Americans are taking that money and throwing it in a bank or paying down debt. This trend is starting to show in economic data and it's ugly.



Retail sales grew 0.9% Y/Y in April, the smallest annual gain since 2009. Even though gasoline averaged $2.47 last month, down from $3.66 a year ago, gas-station sales were down 22% Y/Y. Most economists believe spending will hold up as long as the job market is still doing well, but first quarter data from some retailers says otherwise.

Macy's (M) stock slipped last week after it reported weaker-than-expected sales and earnings in the first quarter. Similarly, shares in Ralph Lauren declined significantly after poor results. With more retailers reporting earnings in the weeks ahead, be prepared for more disappointments. The Retail ETF (XRT) has held up reasonably well, but if the stock market corrects around the Fed's first hike XRT will bear the brunt of it.

The Squeeze Continues

Foreign currency traders are obsessed with the timing of the first Fed rate hike, and with good reason. Over the past two years, the difference in expectations between the Fed and Bank of England's first hike explains more than 85% of the moves in GBP/USD. Comparing the Fed and ECB, rate expectations explain 60% of the variation in EUR/USD. The aforementioned weak US retail sales in April makes it very unlikely that the Fed will raise rates before September.

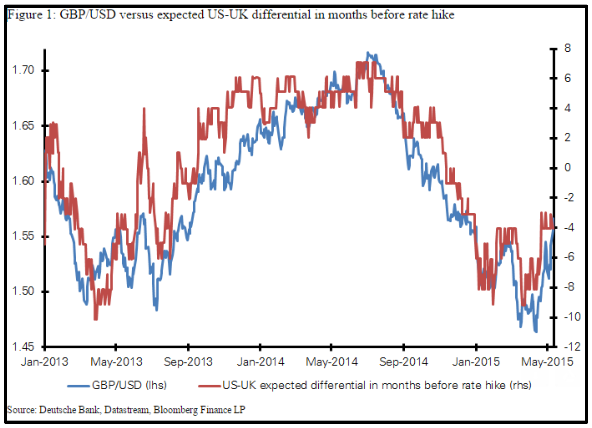


Figure 1: GBP/USD versus expected US-UK differential in months before rate hike

Source: Deutsche Bank; Datastream, Bloomberg Finance LP

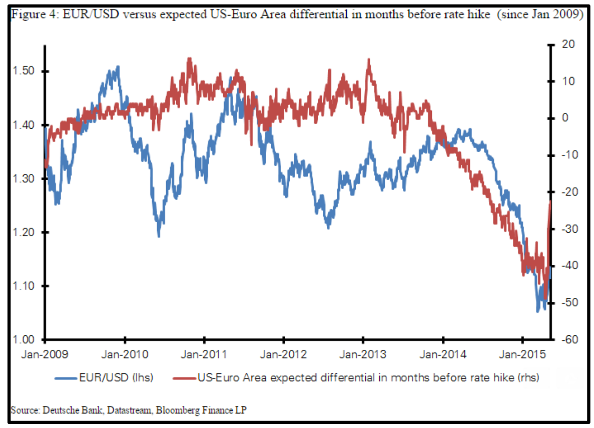


Figure 4: EUR/USD versus expected US-Euro Area differential in months before rate hike (since Jan 2009)

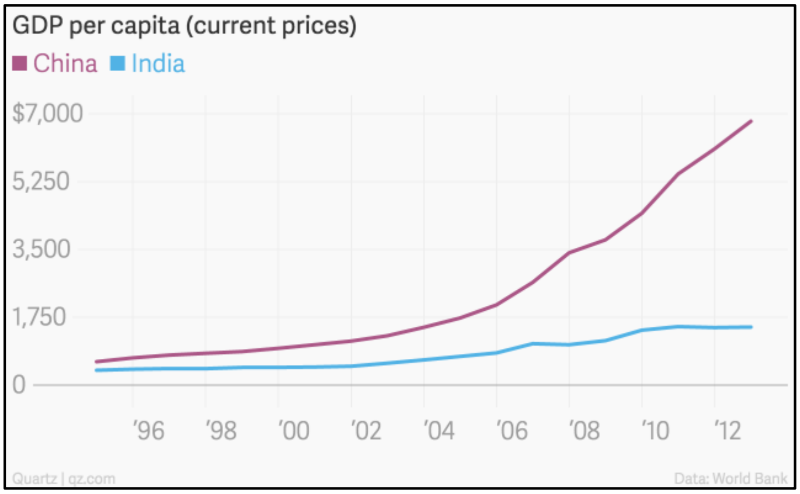
Source: Deutsche Bank; Datastream, Bloomberg Finance LP

The market is currently pricing in the first Fed hike sometime in early 2016, which seems reasonable to me. The stock market and economy could certainly handle a 25bps rate hike as long as the back-end of the yield curve is well behaved. In last week's speech at the IMF Mario Draghi made it clear the ECB won't be tightening anytime soon.

That leaves the BoE as the outlier among the major western central banks. BoE Governor Mark Carney says it's possible that British rates will be higher in a year's time, although the comments came a day after the bank lowered its growth forecast. If these banks stick to their guns, selling EUR against GBP or USD could be attractive at these levels. Much of the EUR's strength over the past month is the result of a major short squeeze in positions – similar to what happened in Bunds – but the fundamentals are still extremely bearish.

Chart of the Week

Chinese President Xi Jingping and Indian Prime Minister Narendra Modi got together in China last week ostensibly to sign some business deals, but also defuse tensions surrounding territorial disputes. Although the Indian economy is currently growing faster than China's, over the past twenty years the Chinese have pulled off something India can't even fathom at the moment: making its population wealthier. As it stands now, China's per capita GDP is nearly six times larger than India's.



The United Nations predicts India will overtake China to become the world's most populous country by 2028. India is also forecasted to be the third largest economy by 2030, behind only the US and China. Creating a mammoth population and economy is one thing, but improving living standards is quite another. China has made reforms to transition away from a manufacturing led economy, and towards a consumption driven model. That's only possible because of the increase in household wealth. In India, where more people have access to a cellphone than a toilet, that transformation will be difficult. Modi has made efforts to streamline his country's oppressive bureaucracy, but there is still a lot of work to be done.

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: Interesting comments on Alibaba. Do you think BABA will eventually overtake Wal-Mart as the world's dominant retailer? – BT

A: Absolutely. As I mentioned last week, Alibaba's biggest advantage is the scale of its potential user base. Wal-Mart has been trying to expand overseas for several years with little to show for it, especially in China. For one thing it's difficult to scale cost-advantages in regions with different consumer tastes. Some countries, like France, are vehemently against the concept of a big-box retailer.

At the same time, you can't say BABA is "the Wal-Mart of China." Alibaba is more like the Wal-Mart/EBay/Amazon/PayPal of China. It's a very diverse business that relies heavily on online retail. Wal-Mart is expanding quickly into the online space, but it's playing catch up. I didn't realize this until researching this question, but BABA and WMT actually announced last week that they're teaming up.

Wal-Mart customers in China will now be able to make purchases using Alipay Wallet, Alibaba's mobile payment service. Now that mobile phones are ubiquitous globally, retailers are racing to make online-payment easier. This is also why Bitcoin has a bright future.

That's all, see you next week!

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

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