May 28, 2015

CUP & HANDLE MACRO

Greetings,

It's fair to say that Greece is now essentially a third world country. Since its first bailout in 2010, the Greek government has been forced to cut spending by $30 billion - a sizable amount for a $195 billion economy. That's the equivalent of a $2.6 trillion cut to the US budget. In Greece, the trash is being collected but that's pretty much the only public service in operation. Hospitals and schools are prohibited from hiring, even though the unemployment rate is above 25%.

Unfortunately, it looks like the situation might deteriorate even further from here. On June 8, one of several IMF loans will be due and Greece's cash deficit will quadruple. It's conceivable that the EU could step in and grant further concessions, but German Chancellor Merkel said that "greater [austerity] efforts were needed" last Friday. This could be the end of the road for Greece, which has suffered under austerity for over five years. The European commission is preparing contingency plans for the Greek banking system in case a new bailout agreement can't be reached. A "[Grexit]" from the Eurozone won't have systemic implications because its economy is so small. Regulators are more worried about precedent in case a systemically important country like Spain heads for the exit.

It's hard to think about financial opportunities in what could turn out to be a humanitarian crisis, but as the benevolent Rahm Emanuel once said, "Never let a crisis go to waste." If the Eurozone allows Greece to file the sovereign equivalent of Chapter 11, their first priority should be to rehabilitate the banking system. This would be much easier to accomplish if the Greek Drachma was reinstated as the local currency. German Finance Minister Schauble already mentioned the possibility that Greece may need a parallel currency alongside the euro if talks fails.

A devalued currency would allow banks to be recapitalized, which is desperately needed. The National Bank of Greece (NBG) is wholly dependent on the ECB and Bank of Greece for funding at the moment – meaning it's entirely shut out from capital markets. Many believe a Greek default wouldn't ignite a bank run because so many funds have already left the country.

In fact, owning shares of NBG before a potential default seems to offer decent risk/reward. Shares already trade as though the company is bankrupt, but the introduction of a weaker currency could inject animal spirits into Greece's moribund economy. Interestingly, short interest in NBG dropped 45% between April 15 and April 30. The future is too murky for distressed investors to build major positions, but the market is well-aware of the potential for a squeeze higher. It's a risky investment and it should be treated like a call option, one that Greek citizens hope is exercised.

The **Cup & Handle Fund** is still up about 1.0% on the year, and +15.5% since August (inception). I turned bearish on the Yen last week and went short in a big way, which has helped offset some losses in unrelated positions. My investment picks for May are still rallying on little news, implying further gains to come. **If you'd like to start receiving these letters click here**.

Today's letter will cover several topics, including:

- The Fundamentals of Stocks
- Timing a Bubble
- The Danger of Illiquidity
- 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,

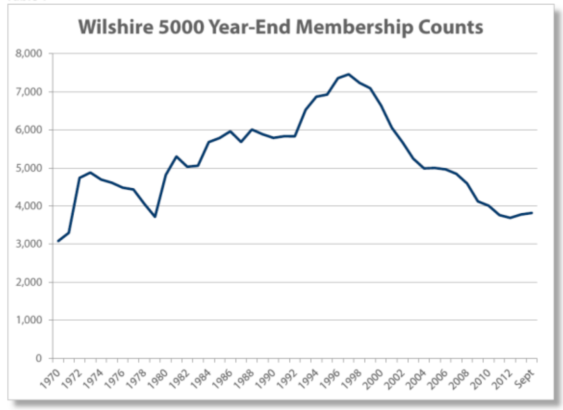
Michael Lingenheld
Managing Editor – Cup & Handle Macro

The Fundamentals of Stocks

I've written numerous times, mostly recently on May 7, that bullish supply-demand fundamentals for collateral will support the bond market for some time. It's increasingly apparent that the same argument can be made for stocks.

The Wilshire 5000 Index is the broadest index of equities, including 98% of all stocks traded in the US. You might think the Wilshire contains 5000 stocks, but the membership count fluctuates constantly. Between 1971 and 1998, membership more than doubled from 3,069 to 7,562. However, the number of companies trading on the Wilshire has collapse since then, down to 3,818 in September 2014. The last time there were more than 5,000 companies was 2005.

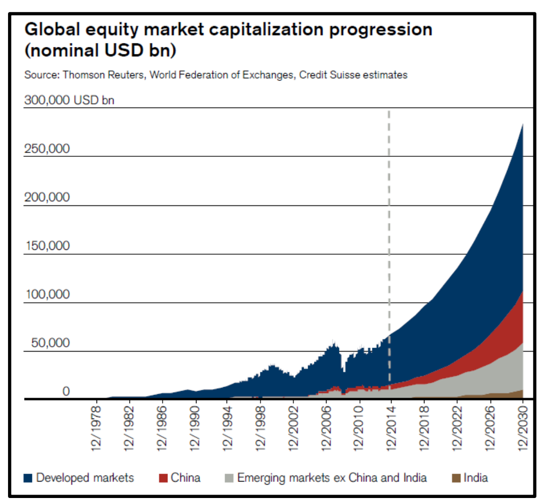
Table 1



Source: Wilshire 5000

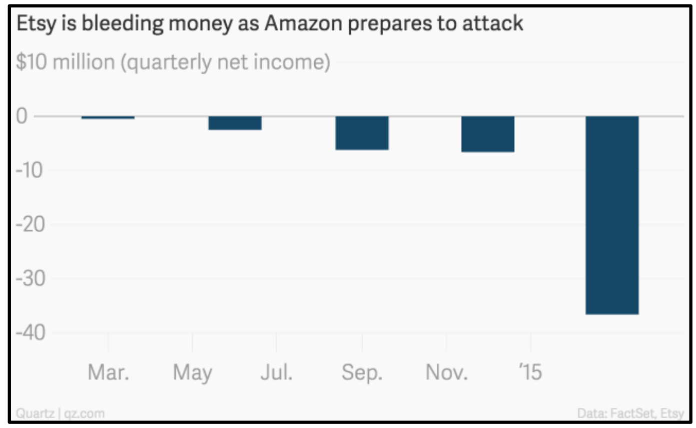
There are several explanations for the rapid decline. M&A transactions have exploded over the past few years and smaller businesses have been closing up shop more frequently – something the media has largely ignored. There's also the fact that more companies are remaining private. On average, between 1980 and 2000 there were roughly 300 IPOs issued every year. Since then, that number has dropped to 150. Many blame Sarbanes-Oxley, created after the Enron collapse in 2002 for the increase in red-tape; making publically traded shares less appealing.

Unless this trend can reverse itself we'll inevitably see a shortage of high quality stocks. Pension fund projections are based on the average life expectancy being somewhere around 70. However, the baby-boomers and younger generations will live much longer. Global GDP will have to grow substantially along with the population, which implies the stock market will grow as well. The World Bank projects global stock market capitalization quadrupling between now and 2030. Those are powerful arguments for the long-term equity demand, and it's unclear whether the supply will be enough to match it. The introduction of China and India to the world's capital markets will help, but the fundamentals point to higher prices over the long-term.



Timing a Bubble

As SnapChat CEO Evan Spiegel weighs the pros and cons of launching an IPO, the current market environment is giving him pause. Speaking to reporters this week, Mr. Spiegel said that years of near-zero interest rates have created an asset bubble that has led people to make "riskier investments" than they otherwise would. While I applaud his ability to grasp "the macro" there is no way I would touch a SnapChat IPO. The company already has a rich valuation in the private market, and has not proven its ability to generate revenue. Think of Etsy as a cautionary tale…



Online marketplace Etsy (ETSY), which made a name for itself selling handcrafted goods, launched its IPO on April 16 at $31. Even though the company had yet to post a profit, the IPO was oversubscribed and shares immediately climbed above $35. However, after the initial surge, cooler heads prevailed and the stock came to grips with reality. Today, after 28 days of trading, shares of ETSY are going for $17 – 43% below the IPO price.

Etsy is hemorrhaging cash and Amazon (AMZN) is about to launch a rival platform that will effectively eat Etsy's lunch. First quarter results provided no relief with a $36.5 million loss – compared to a $463k loss in 2014. Timing an IPO for the right market conditions is very important, but if the company doesn't have the fundamentals to back up its valuation it's probably best to remain private. Don't get swept up in the hoopla, cash flow is still king.

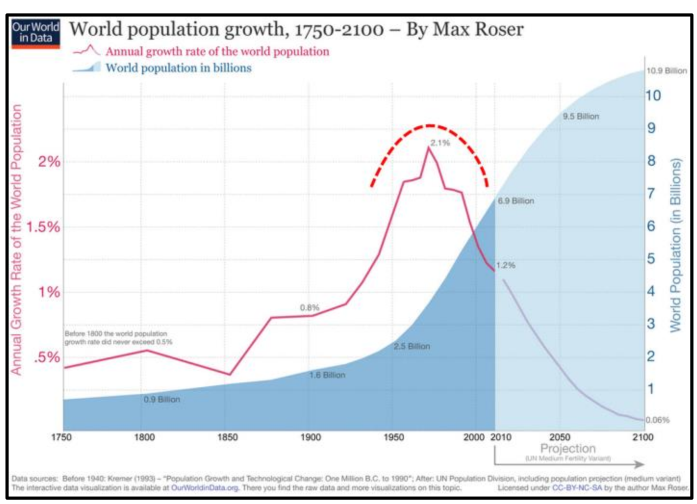
The Danger of Illiquidity

May 21 was a tough day for Pan Sutong. Mr. Sutong is chairman of the Goldin Group, who personally owns 70% of the firm's subsidiary, Goldin Financial. Goldin Financial, hardly a penny stock, has a market cap of $15.7 billion even after last week's collapse. The company's operations include factoring (which sounds a lot like loan-sharking), wine production and property development. It wasn't necessarily surprising that the stock collapsed, because it had rallied 356% YTD up until Thursday. The cause of this crash? Nobody knows. There was no earnings announcement, resignation or scandal of any kind. The bubble simply burst.

While Chinese equities are available through Hong Kong and appealing for many reasons, stories like this should give you caution. Hong Kong does not limit single-day share price moves, and stocks can be suspended for months – in effect trapping investors. The exchange also doesn't provide information on short-sellers, making dramatic moves like this all the more mysterious. The Securities and Futures Commission declined to comment, as it does for all individual companies, but it did warn in March that Goldin Financial shares "could fluctuate substantially" given the high concentration in ownership. This should be exhibit A of "why liquidity matters."

Chart of the Week

From 1900 to 2000, the increase in world population was 3x larger than the increase during the previous history of humankind. Much of the growth can be attributed to the increase in life expectancy. A baby born today can expect to live 78 years. In 1900, newborns only lived to be 31 years old on average. The progress has been incredible, but what's coming in the future might be even more impressive. Dr. Aubrey de Grey believes the first person to live to 1,000 will be born in the next two decades.



What does this have to do with investing? A lot. At this point, life expectancy is increasing not because of food supply but rather huge leaps in medicine. The 1,000 year old that Dr. de Grey is talking about will likely capitalize on monumental advances in regenerative medicine. Perhaps we shouldn't be surprised that biotech shares (IBB) have tripled since 2012.

While the population will continue to grow, the growth rate peaked around 1970. This will have huge implications for markets going forward, although conclusions are difficult to draw with such a long-term theme. If you have a young child, try to steer them away from a career as a midwife, because income in prenatal care is sure to decline over the next century.

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: What's going on in Puerto Rico? Why are hedge funds so interested all of a sudden? – CS

A: Puerto Rico is a self-governed US territory, but it's also poorer than the poorest state, Mississippi. It runs a sizeable budget deficit, which was mainly financed through the US municipal bond market until 2006 when a key US tax break expired. Puerto Rico's debt, which at $72 billion is more than every state except California and New York, has been downgraded to CCC+ and a bailout is nowhere in sight.

Puerto Ricans don't have a lot of choice in who funds their debt. The IMF can't help because it's not a sovereign country. It can't abandon a currency-bloc like Greece. And it can't seek protection in US bankruptcy court. Enter hedge funds, who are buying these bonds for pennies on the dollar looking to secure future revenues, or to put it bluntly IOUs. These distressed-credit hedge funds are lawyers more than they are investors. Hedge funds are often clever in snuffing out opportunities early, but in this case I would avoid copying them in your personal account – it's too complicated.

That's all, see you next week!

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

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