

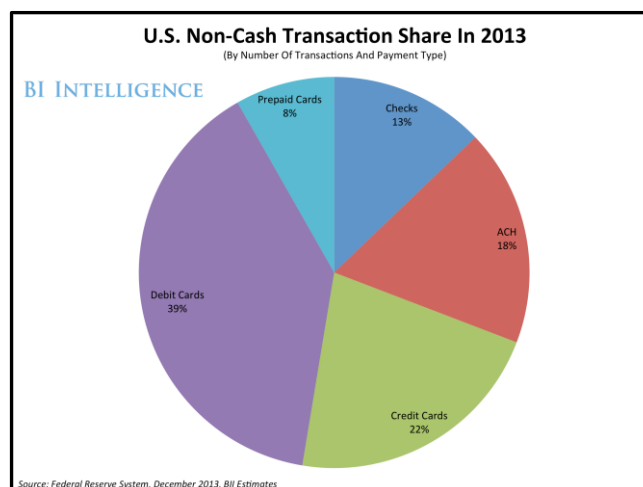


CUP & HANDLE MACRO

Greetings,

Forty-four years into Richard Nixon's fiat-money experiment, there's little evidence the financial system is more stable than it was under the gold standard. In 1971, [Nixon suspended the convertibility](#) of USD to gold partially in order to improve the country's balance of payments, which hasn't quite worked out as planned. Some policymakers in Europe are ready to double-down on the concept of fiat currency by banning cash altogether.

Earlier this month, the Danish government [proposed](#) getting rid of the obligation for retailers to accept payment in cash. Advocates believe going cashless would save shops money on security and time on managing change from the register. Critics, on the other hand, argue that a cashless society would see a massive uptick in fraud and loss of independence. German central banker Carl-Ludwig Thiele criticized the Danish government's proposal, saying that "abolishing cash would hurt consumer sovereignty – the free choice of citizens about their payment instruments," and cited Russian novelist Fyodor Dostoyevsky's famous line: "Money is coined liberty." Obviously, since Dostoyevsky's day there have been major advances in digital payments, but his point is still valid.



The “War on Cash” isn’t limited to Scandinavia. Switzerland, once known as a safe haven for currency, has proposed banning cash payments in excess of 100,000 CHF. In North Carolina, [a small business owner](#) had over \$100k seized after the FBI noticed he made two deposits totaling \$11,400 within a 24-hour period. Officials say he had a history of consistent cash deposits of less than \$10,000, which is illegal. While that story has more to do with the absurdity of “[civil asset forfeiture](#),” it’s another example of the crackdown on cash.

What are the implications of this “War on Cash” spreading throughout the financial system? For one thing it should ultimately benefit so-called SWAG assets (Silver, Wine, Art, and Gold) that have consistently maintained their value over time without a counterparty. The long-term viability of cryptocurrencies like Bitcoin would also increase.

Ninety percent of existing currency only exists electronically to begin with, but resides within the banking system. Bitcoin, and other digital currencies like [Ripple](#), do not, which is a major advantage for some. In the current dollar-based monetary system, we entrust banks and other fee-charging intermediaries to act as gatekeepers for nearly every transaction. A cashless society would give those gatekeepers even more power. That might be palatable in Denmark, but it’s unclear if the rewards would be worth the risk.

The [Cup & Handle Fund](#) is still up about 1.5% on the year, and +16.0% since August (inception). For an update, my investment pick for May was a basket of 3 stocks. Since that letter was sent out on May 18 those stocks have rallied 3%, 5 and 12%, respectively. So far they’ve performed as expected, and I’ll try to duplicate those results in June. [If you’d like to start receiving these letters click here](#).

Today’s letter will cover several topics, including:

- Keep Selling Yen
- FireEye Update
- I (opening) PO
- 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,

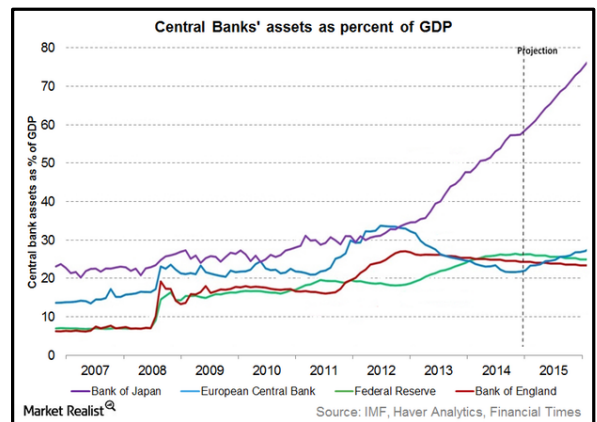
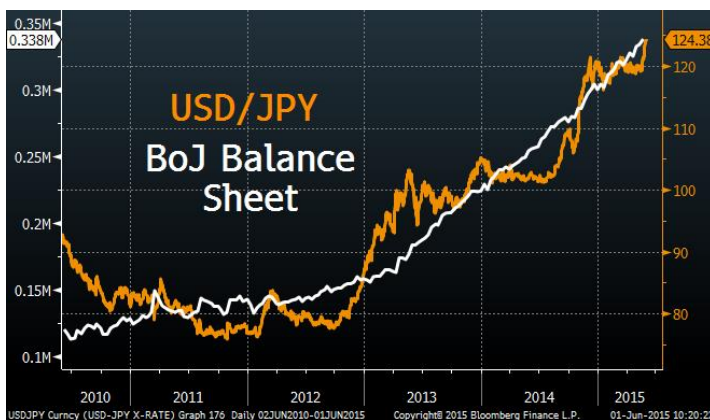
Michael Lingenheld

Managing Editor – Cup & Handle Macro

Keep Selling Yen

The Bank of Japan (BoJ) is running possibly the loosest monetary policy in financial history, and yet the IMF is saying it should be prepared to ease even further. The IMF doesn't think the central bank's radical easing has brought a "desired regime shift" towards 2% inflation, with CPI growth stalled around 1% Y/Y.

"This suggests that the BoJ needs to stand ready for further easing, provide stronger guidance to markets through enhanced communications, and put greater emphasis on achieving the 2% inflation target," according to the IMF's annual survey of Japan. In essence, the BoJ is being told to double-down on a policy that hasn't worked over the past 20 years – eliciting "definition of insanity" jokes from around the globe.



The BoJ is already buying assets at a pace of 80 trillion JPY or \$650 billion a year. To put Japan's QE scheme into context, it's buying nearly as much as the Fed at the peak of QE3, despite the US economy being almost three times the size of Japan's.

While BoJ officials have expressed some anxiety about easing further from here, the market has seemingly ignored the fact that USD/JPY and the BoJ's balance sheet have an extremely strong positive correlation. USD/JPY broke through a 30-year trend-line last November and looks poised to explode higher. Conveniently, the short JPY position that was extremely crowded earlier this year has thinned out considerably.

As JPY fell last week, long positions in the futures market fell by the most in three years. However, JPY speculative positioning is still largely flat, meaning

there's a lot of room to add shorts if further BoJ easing looks likely. I don't necessarily think the BoJ



will ease further anytime soon, but other factors like an increase in overseas purchases from Japan will continue to pressure JPY lower. Even if the BoJ does nothing from here on out, its balance sheet will continue to grow at an alarming rate and there's no reason to believe USD/JPY won't follow it higher.

FireEye Follow-Up

After first recommending FireEye [on February 10](#) the stock has performed nicely, rallying nearly 32%. Cyber-security is one of the few growth industries in today's market, but that doesn't mean these firms are profitable. Even though the stock is rallying sharply, FireEye is burning through cash, as it spends 95% of its revenues on marketing to fuel growth. Net losses were equal to revenues last year, and losses are growing as quickly as sales.

While that might sound troubling it's not unusual in Silicon Valley, where companies with no revenue achieve sky-high valuations. However, FireEye's effort to combat the deterioration in its balance sheet is unusual. Last week, the company launched an \$800 million "happy meal" bond offering. The convertible debt will be sold in two chunks, one at 1.0% and another at 1.6%, and \$150 million of the proceeds will be used to fund prepaid share buybacks in 2020 and 2022. Meanwhile, banks will buy those shares and lend them to bondholders – to help hedge their position.



I'll always prefer simple over complex, and this seems like an awfully complicated way to raise money. I suppose they're just making it easier (cheaper) for bondholders to hedge their position instead of borrowing shares at elevated rates in the open market – short interest is 13%. This development doesn't change my thesis in any way, but I suppose it does increase the downside risk if operating losses increase.

A "happy meal" bond offering is much more appealing than raising money through a secondary offering equity market, which is what torpedoed the stock in March 2014. FireEye says it will be profitable by 2018 and there's little reason to believe it won't. The company offers an extremely

compelling product in a market with extremely high demand, but let's hope these bonds don't end up on the dollar menu anytime soon.

I (opening) PO

China National Nuclear Power (CNNPC), a unit of one of the country's two state-backed nuclear reactor builders, on Monday said it plans to raise \$2.13 billion in potentially the largest Chinese IPO in four years. CNNPC is the largest of the 23 companies that will launch IPOs in China this week, which could lock up 5 trillion CNY of liquidity, and put pressure on a stock market already facing headwinds from tougher margin requirements.



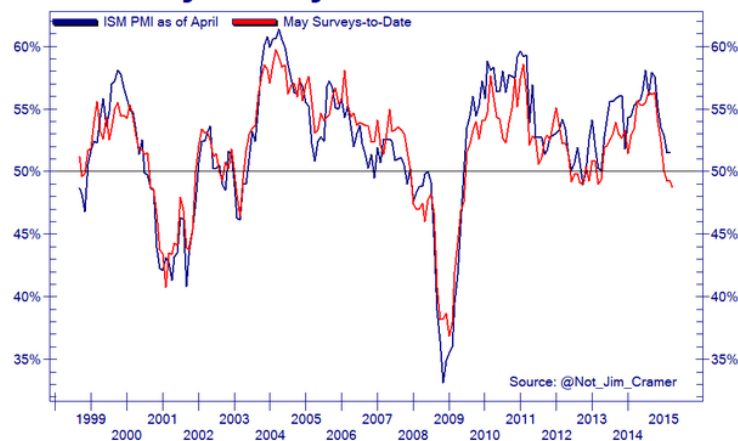
China's IPO Index, which measures the performance of Chinese stocks during their first publicly traded year, is up 91% over the past 12 months. With domestic interest rates falling, companies are racing to go public and capitalize on the world's hottest stock market. Chinese equities have benefitted from a boom in margin trading by domestic citizens, which has clearly played a role in this massive rally.

However, as with everything in China, the government is firmly in control and stands ready to choke off liquidity if the stock market's exuberance gets too irrational. It will be interesting to see if demand will be enough to match the wall of supply coming from the IPO market, but the risk/reward for buying shares here doesn't look attractive. I've maintained a bullish outlook on CAF and other expressions of the "long Chinese shares" theme, but now could be the time to lock in profits.

Chart of the Week

After a solid 52.3 reading in April (above 50 indicates growth) the Chicago PMI plunged to 46.2 in May – indicating economic contraction in the Midwest. The index previously dropped below 50 in February, which was largely attributed to the brutal winter weather. The May decline was led by a fall in new orders, but all five components of the index came in below 50. The ISM report released Monday showed reasonable growth, but surveys indicate weakness ahead.

May Surveys-to-Date vs. ISM



The Fed has never raised interest rates with ISM below 50. Even though Janet Yellen and her team at the Fed keep vocalizing their desire to see higher rates in 2015, negative data points like this make that unlikely. In my opinion, the growth slowdown can be attributed to the resurgent US dollar and weakness from China. Lately, USD has been surging against JPY and EM currencies despite the weak data – effectively tightening monetary policy. The Citi Economic Surprise Index is near the lows, so presumably the data will turn around, but conditions could get ugly if it doesn't.

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: Did you read the NYT on Fiat's CEO and do you think a merger would work? – FB

A: I did [see that piece](#) and I would encourage everyone to read it. Mr. Marchionne's bravado is remarkable and it's amazing to think that chief executives casually send emails inquiring about merger possibilities. M&A isn't my area of expertise, but Marchionne is on point when he says that Fiat needs more exposure to China.

China is the only game in town at the moment, because it's home to all the growth in auto demand. Since overtaking the US in 2010, China has established itself as the world's largest car market. Although the slowing Chinese economy has weighed on consumer demand, auto sales posted robust growth of 7% Y/Y in 2014 – totaling 23.5 million cars. Auto sales in the US were 16.5 million, matching the tally from 2006 – i.e. growth is still stagnant. An acquisition of Fiat would be attractive to several buyers at the right price, but they'd have to make sure Marchionne's role is diminished in the new company. His ambition seems to have no bounds.

That's all, see you next week!

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

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