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June 16, 2015

CUP & HANDLE MACRO

Greetings,

"I am of the opinion that the policy of having such low interest rates is certainly not a lasting state of affairs. This is a special situation that can be explained from a special circumstance – the danger of slipping into deflation - and this danger is now gone" – ***Ewald Nowotny, ECB Governing Council – May 19, 2015***

Nowotny has made cringe-worthy quotes like this before, but this statement seemed destined to leave egg on his face from the moment it left his lips. Ostensibly, the unprecedented volatility in German Bunds was sparked by a stronger-than-expected inflation print for May, but let's not forget that the Eurozone's core CPI was a mere 0.9% Y/Y vs. 0.6% in April. CPI in Germany was only 0.7% in May, which includes a bump from higher gasoline prices. The Weimar Republic this is not.

In fact, Germany's stagnant prices are even more alarming when you consider it's been using an artificially weak currency for over 15 years. The EUR has transformed Germany into such an export juggernaut that its trade surplus hit a record high in May – despite weak global demand. While the media still blames Greece for any price fluctuations in Europe, perhaps the real story is in Germany.

Last Thursday, as I was getting ready to short EWG (German ETF), some broker flow crossed my screens showing huge buying volume in the stock. Since 2012, EWG has only traded more than 15 million shares on 8 occasions, and on Thursday 18.25 million shares traded hands. Thinking that I had missed something, I took the flow into consideration, violating one of my cardinal rules and decided to hold off. It was a dumb move then and it looks even dumber now. EWG ended up finishing lower on the day (closing lower on high volume is usually bearish), and has since dropped nearly 4%.

Can't dwell on it for too long though, and I've since established a short position. The DAX, which surged nearly 30% after the ECB announced its QE program in January, still needs to fall another 6.5% before reaching its 50-week moving average – so there's still plenty of opportunity.

I still don't believe a "Grexit," in and of itself, would be a problem. Rumors of bank runs in Greece are irrelevant, because capital has been fleeing Greek banks for years. However, Greece leaving the Eurozone would set a tricky precedent for systemically important countries like Spain to bail as well. I suspect that Greece-related headlines will remain abundant, and they will be anything but supportive for German shares. On top of that, strong growth data is unlikely to boost German stocks if it translates into higher Bund yields. The DAX peaked around April 10, right as Bund's began their spiral because the German economy is not nearly strong enough to tolerate higher rates. The ECB might think it has conquered deflation, but that's hardly the only headwind facing Europe.

The **Cup & Handle Fund** is up around 0.5% on the year, and +15.0% since August (inception). The portfolio took a small hit last week betting on stronger retail sales through rates. My retail sales view was correct, but the market didn't respond as expected. I also sent out my monthly letter for June last week, but the pick has yet to move in either direction. **If you'd like to start receiving these letters click here**.

Today's letter will cover several topics, including:

- On the Home Front
- Seoul Searching
- The Magazine Cover Indicator
- Chart of the Week

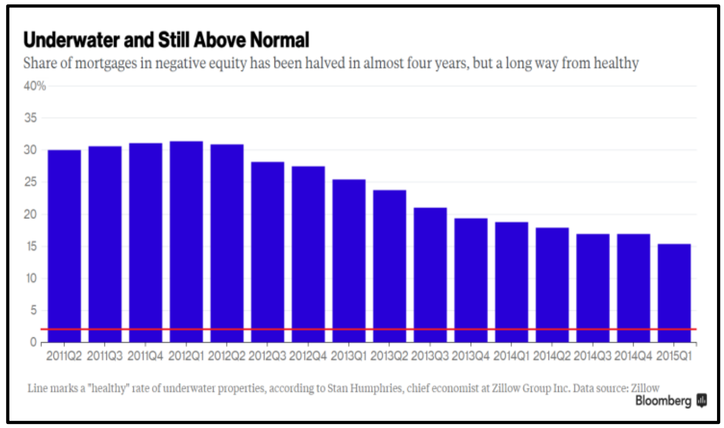
As always, if you have any questions or comments or just want to vent, please send me an email at mike@cup-handle.com.

Until next time, tread lightly out there,

Michael Lingenheld
Managing Editor – Cup & Handle Macro

On the Home Front

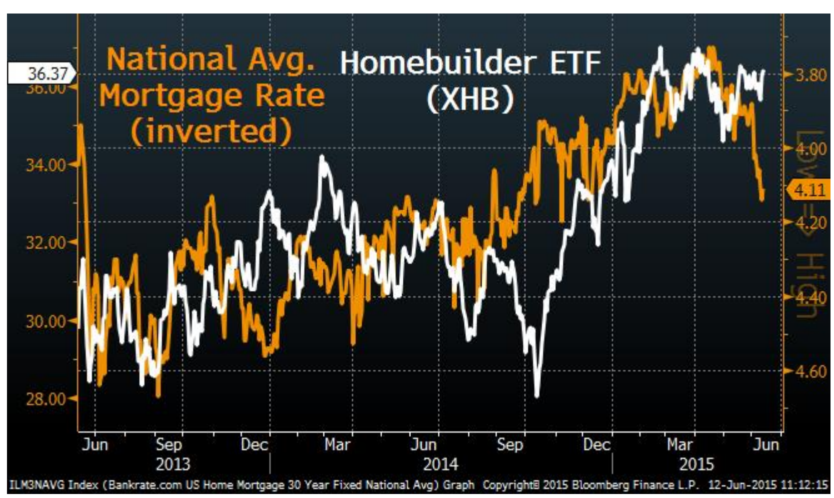
By almost any metric, the US housing market looks as strong as it's been since 2007. Housing starts jumped 20% M/M in April to a seasonally adjusted annual rate of 1.135 million, the highest level since before the recession hit and the biggest percentage gain since February 1991. New applications for building permits, a bellwether for construction, jumped 10% in April. US home prices rose 4.2% in the 12 months ended in February. Back-to-back harsh winters have created pent-up demand and set the stage for a flurry of activity. Even lumber prices have awoken from their long slumber, up nearly 30% since early May.



Here's the bad news. A sell-off in Treasury's has spilled over into the mortgage market, and 30-year rates vaulted above 4.0% for the first time this year. In the first quarter, lenders refinanced $221 billion worth of mortgages – more than twice the volume of the same period a year ago. They also made $139 billion in loans to buy homes, up 1.2% from the previous year.

Ideally, in a strong housing market, more loans would be made to new home buyers, rather than refinancers. Given the historically low interest rates, it's not necessarily surprising that homeowners are refinancing, but the trend is slowing. Last Wednesday, the Mortgage Bankers Association said refinance applications last week dropped -8.9% from four weeks ago, and -4.8% Y/Y. This implies higher mortgage rates are starting to have an influence.

On top of that, the number of underwater homes is alarming. A decade after US home sales peaked, 15.4% of owners owed more on their mortgages than their properties were worth in the first quarter. While that's down from a high of 31.4%, it's well above the 1-2% level that marks a healthy market.



In my estimation, it's still way too early to ring the alarm bells over housing, but it's a development worth monitoring. There's little doubt that housing is still heavily dependent on low interest rates, and it appears that tailwind could disappear. A 25bps increase to the Fed Funds rate won't have much of an impact on anything, but a jolt higher to the long-end of the yield curve might. If and when the Fed does hike, they'll use extremely cautious language to keep the yield curve in check, but that doesn't always work – see the Taper Tantrum of 2013. If you're looking for a way to play this theme, I'd recommend shorting XHB – the homebuilder's ETF. The day-to-day correlation between mortgage rates and XHB isn't perfect but if rates move high enough it would have a catastrophic impact on the stock.

<u>Seoul Searching</u>

The Bank of Korea (BoK) cut interests rates to a new low of 1.5% last Thursday in a move that wasn't a shock to analysts. The economy had been slowing due to general weakness in China, necessitating lower rates, but the bank's rationale for easing was surprising. The BoK's governor said, "We judged that it was desirable to act pre-emptively in order to ease the negative effects of MERS on economic sentiment and the real economy."

The MERS virus (Middle East Respiratory Syndrome) arrived in South Korea a few weeks ago, and has already infected more than 120 in the country. But is that enough to warrant lower rates? Korean consumers do appear to be sensitive to negative events that impact sentiment. The [Sewol ferry disaster in 2014] crimped spending dramatically, forcing the government to roll out a stimulus package. During the first week of June, as fears about MERS gathered steam, sales at department stores were down -16.5%.

Since MERS arrived in Korea, the country's stock market, the KOSPI, has been sliding – down 12%. Economic data from the peninsula hasn't been great, but hasn't been awful either. GDP growth looks fairly stable around 2.5% Y/Y, and prices seem to be heading higher from 0.5% Y/Y in May. Considering the recent performance of other Asian countries, Korea looks like a bright spot.

Assuming the MERS virus is contained, which looks likely, and China keeps adding stimulus, now could be a good time to buy Korean shares on the cheap. The MSCI South Korea ETF (EWY) is denominated in US dollars, but does a nice job of tracking the KOSPI. Keep in mind that the local economy is very tech-centric, and should respond positively to stronger consumer spending in the US. If the KOSPI can hang in here and doesn't break below 2,050 the chart would actually look pretty good, even after the downdraft.

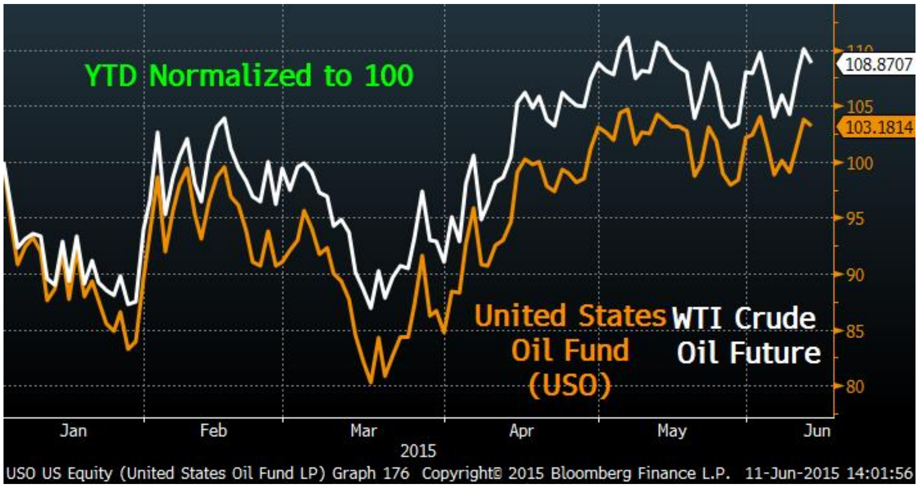
The Magazine Cover Indicator

One of the more infamous and misunderstood market signals is the magazine cover indicator. This contrarian signal is supposed to indicate when some investment theme has reached a crescendo. The thinking goes that by the time magazine editors catch onto a hot trend, it's all over. In my opinion, this indicator is essentially irrelevant because there are so many editorials and covers available today, you could find a new contrarian indicator every week. With that being said, there was a lot of discussion regarding the cover of last week's Economist:

This cover, in my view, does a nice job of highlighting the market's complacency at the moment. Few economies have ever gone more than a decade without slipping into recession, and growth in the US turned positive in 2009. The Fed is really hoping the economy can withstand rates above 1%, if only because it gives them a tool to combat the next downturn. I doubt The Economist cover will mark a tipping point where growth magically accelerates despite market pessimism, but I also don't think their foresight is wrong.

Chart of the Week

Oil is an extremely difficult commodity to trade. The futures market allows for the best exposure, but contracts need to be rolled forward to avoid delivery, which gets expensive in a "contango" – as it is currently. While Oil ETFs don't require rolling, the underlying assets of those ETFs are futures, so the cost is eventually passed on to the investor. While spot oil prices have risen nearly 9% so far this year, the forward curve continues to steepen – raising costs for popular oil ETFs like the United States Oil Fund (USO).



USO has rallied slightly more than 3% this year, highlighting the excessive fees that erode profits. However, if you have a bearish outlook for oil prices, as I do, USO becomes a very attractive vehicle. By shorting shares of USO, the trade inherently comes with a "positive carry" that enhances profits when the curve steepens. It's tough to have a high-conviction short position in oil considering what's happening in the Middle East, but a reasonably sized position with a built-in cushion seems awfully attractive in this market.

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: I'm in a stock picking contest at work, which ends at the end of the year. Any picks for me? - JM

A: The beauty of these contest is that the losses are fictional, so you need to really ramp up the risk. Singles and doubles never get it done in these contests, you need to go for home runs. If you can trade options, I'd buy out-of-the-money puts on the ETF of some over-extended sector like IBB or XRT. Shorting Chinese tech companies (CNXT) is intriguing. The bullish case is still reasonably strong, but it's guaranteed to be volatile.

If you're not in contention, say by mid-November, you need to start looking for short-term catalysts: data releases, earnings, etc. From there, lever up on one side or the other and you've got a 50-

50 chance of catching up quickly. It's easy to look smart in these contests and hard to look foolish, you just need to increase your odds with a strategic game plan.

That's all, see you next week!

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

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