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July 23, 2015

CUP & HANDLE MACRO

Greetings,

On July 14, Canada's central bank cut benchmark interest rates by 25bps for the second time this year, and slashed its growth forecast for 2015. The bank now expects GDP growth to be 1.1% Y/Y this year, down from its 1.9% forecast in April. That could prove to be optimistic because first quarter growth slumped -0.6% Q/Q, and weak economic data in April sets up the distinct possibility of a technical recession. Why is that a problem? Over the last 50 years, Canada has not had two consecutive quarters of negative GDP growth without a recession in the US.

The downward revision clearly reflects weakness in the commodity sector. Plummeting business investment in energy, as well as weaker than expected exports of non-energy commodities have jolted the Canadian economy. Bank of Canada Governor Stephen Poloz expressed his concern over the weak outlook in March saying the falling price of oil was having an "atrocious" effect on the local economy.

The Canadian Dollar (CAD) is now the second-worst performing G-10 currency this year, only New Zealand Dollars have been weaker. And the chart CAD against USD has developed a classic cup and handle formation.

An interest rate cut is reason enough for the currency to weaken, but there are broader reasons to be bearish CAD. Canada's bloated housing market might not be a "bubble," but the central bank's own calculation shows that home prices nationwide are roughly 20% overvalued. Canadian's household debt to disposable income ratio is already 166%, making them some of the most overleveraged consumers in the world. It's fair to ask whether two rate cuts in 2015 are a waste of valuable ammo if and when home prices do start to decline.

Property investors in Alberta are starting to wonder if the downturn is already underway. Calgary's luxury home market looks to be the epicenter. In June, there were more than 800 Calgary homes for sale worth more than $1 million, and for every 10 new home listings only 2 were sold. Home sales have fallen for six straights months and home prices have been down for five consecutive months. It's a similar story in Edmonton. Granted, Alberta is home to most of Canada's oil reserves and activity in cities like Toronto and Vancouver is still strong. But the potential for trouble is real.

Even if home prices gracefully fall to more realistic levels the BoC is unlikely to raise rates anytime soon. With the Fed getting ready to hike rates we'll see policy divergence between two heavily intertwined economies for the first time in a while. USD/CAD has already moved a lot but it looks like a runaway train that won't come back anytime soon.

The **Cup & Handle Fund** is up around 1.5% on the year, and +16.0% since August (inception). It's usually a quiet time of year, but there is a lot going on in the market. We're not doing much trading at the moment, but could be gearing up for high conviction allocations soon. I sent out my investment letter for July on Monday, which highlights a country with problems similar to Canada – but even more volatile! **If you'd like to start receiving these letters click here**.

Today's letter will cover several topics, including:

- The Baltic Stealth Rally
- Semi-Typhoon in Taiwan
- Google's $65 Billion Day
- 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.

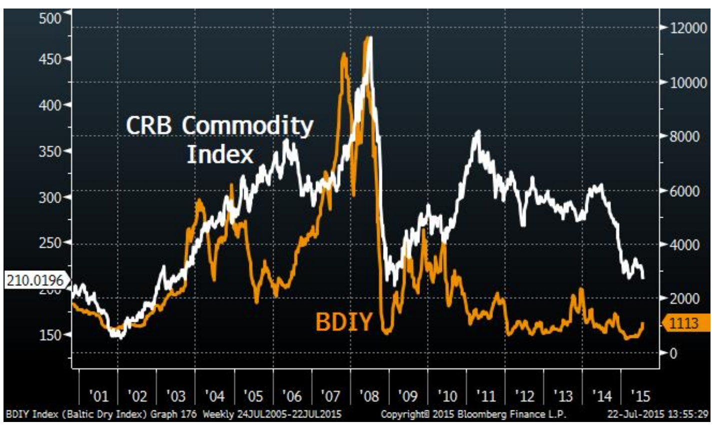
Until next time, tread lightly out there,

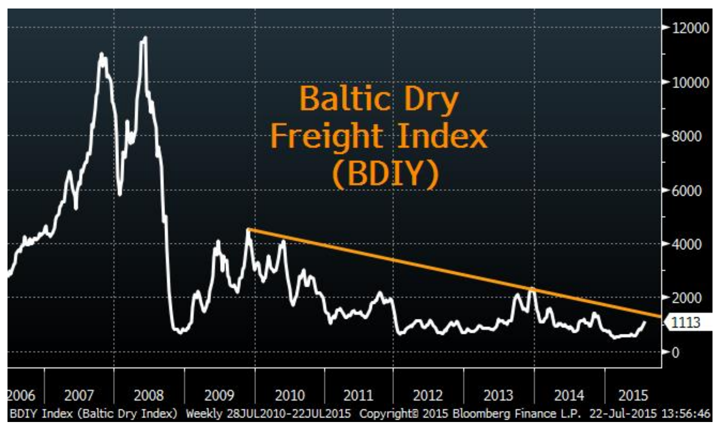
Michael Lingenheld
Managing Editor – Cup & Handle Macro

The Baltic Stealth Rally

The Baltic Dry Freight Index (BDIY) is an enigma in the investment landscape. It's volatile, opaque and confusing, yet investors have used it to gauge global activity for years. The BDIY is a composite of three sub-indexes that measure different sizes of dry bulk carriers (merchant ships) - Capesize, Supramax and Panamax for multiple geographic routes. Historically, changes in the BDIY gave investors insight into global supply and demand trends. This change was often considered a leading indicator of future economic growth (if the index is rising) or contraction (index is falling) because the goods shipped are raw, pre-production material, which is typically an area with very low levels of speculation.

Everything changed in the early 2000s when China kicked off its construction boom. The Chinese started hoovering up raw material across the globe. Iron ore from Australia, copper from Chile, grains from the US… The demand for shipping skyrocketed as BDIY rallied 540% between 2005 and 2008. Beginning around 2005, shipbuilders started getting numerous orders for huge cargo vessels. These ships take several years to build, but, by the time they were ready for delivery in 2008, the rug had been pulled out from under the global economy. There was a huge surplus of shipping capacity and little demand. BDIY rates dropped 95% between July and December 2008.





It's not easy to get rid of a shipping surplus. Those boats are durable goods designed to stay afloat. The overhang in capacity has kept BDIY rates depressed for the past six years. In 2014, many thought capacity had reached manageable levels and demand was starting to pick up. But the 50% decline in oil negated the move. Oil is the biggest input cost for shippers, meaning lower fuel prices actually increase shipping capacity. Many believed BDIY had become an irrelevant indicator, until a recent rally.

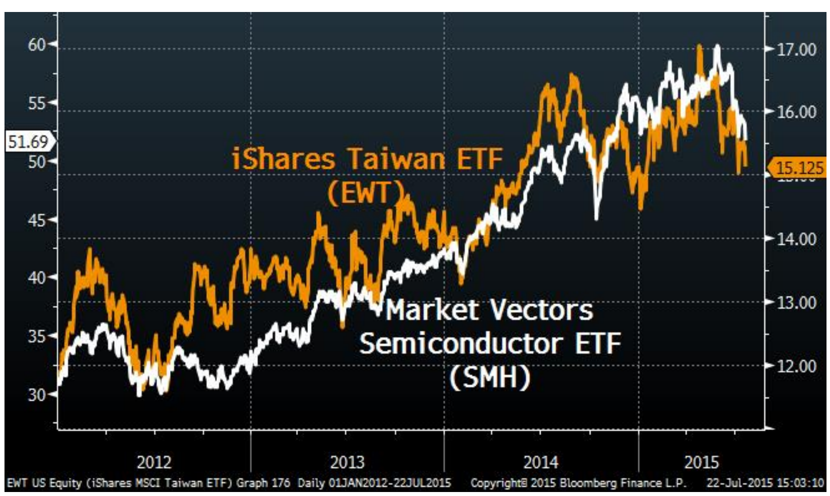
BDIY rates have jumped 115% since February. They're still 90% below the all-time high, but it's noteworthy nonetheless. The trick is figuring out what drives these moves because research on the sector is minimal. As far as anyone can tell, China is again behind this rally, this time importing corn. China's corn imports in June were up nearly 30-fold from a year ago to 872,919 metric tons. In the first half this year, China imported 2.65 million tons, almost double the volume this time last year.

If it sustains this pace of buying, Beijing is on track to post its biggest annual corn import ever. For a time, around 2010, it looked like China was poised to become the world's biggest importer of corn, as annual imports were rising by quadruple digits. Suddenly imports slowed around 2012, but it's back to gobbling up grain from all over. The bulk of the massive increase in China's imports came not from the US, but from Ukraine. Imports from the eastern European country in the first half this year were up 852%, or about eight-fold, from a year ago. Ukraine accounted for 88% of China's corn imports in the period.

Imports of property-related commodities might be slowing but Beijing can't let its population go hungry. This is likely an attempt to refill Chinese grain warehouses, meaning the BDIY rally might not be sustainable. If oil perks up, maybe shipping rates will gather some momentum and set new highs but it could take decades before we see BDIY back at 2008 levels.

Semi-Typhoon in Taiwan

Taiwan has prospered over the past decade mainly as a component supplier (i.e. middleman) for semiconductor companies sending their goods to China and the US. Between 2012 and 2014, smartphone shipments in China nearly quadrupled, making it the world's largest smartphone market. But the rate of annual growth in the Chinese market is expected to slow to 10% this year. There are still untapped markets like India, where less than 10% of mobile users have a smartphone, but the heydays are over.

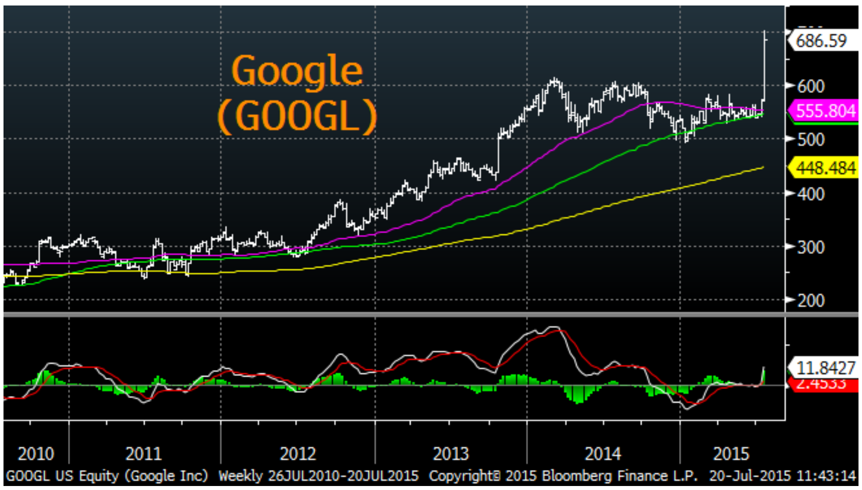


This week we saw Linear Technology Corp (LLTC) not only miss earnings expectations in the second quarter, but guidance for the third quarter suggests a relatively large sequential sales decline.

Weakness in LLTC is evident across the entire sector, as the semiconductor ETF (SMH) has declined -15% since June 1. That spells trouble for the Taiwanese stock market, which tracks SMH very closely. Investors looking to short Taiwan can get exposure through EWT. Up until June, semiconductors looked as bulletproof as biotech stocks – but these charts look like those days are over.

Google's $65 Billion Day

At the end of June, Google had nearly $65 billion in cash reserves or roughly 15% of its market cap. Historically the company has done little to appeal to investors. Co-founders Larry Page and Sergei Brin own a special class of shares that gives them a majority of the voting rights and they've never distributed dividends or bought back shares. However, during last week's earnings call, new CFO Ruth Porat indicated such stubbornness could be changing.



The market's response to the hint was astounding. Google added nearly $65 billion in market value in Friday's session, slightly more than the market cap of Lockheed Martin Corp. and nearly three times the value of Twitter. The increase was the second largest ever for a NASDAQ stock, trailing only the $66 billion that Cisco Systems Inc. added on April 17, 2000, near the peak of the dot-com bubble.

To give you a scale to measure this one-day rally, here's what Google could buy with its new found $65 billion:

- Google could buy Yahoo, Twitter, Etsy and Yelp – with cash left over.
- Google could own every NFL and NBA team – with cash left over.
- Google could buy the entire economic output of Sudan for one year.

Chart of the Week

Australia's fall from economic grace has been well-documented, most recently in [my monthly investment theme] for July. Sluggish commodity demand from China has caused a collapse in iron ore, the material much of Australia's growth has been built on. Over the past few years, the market was much more optimistic about New Zealand. Growth bounced back after the terrible 2011 earthquake in Christchurch, and the central bank was thought to have a hawkish leaning – both in tone and action.

That all changed in June when the Royal Bank of New Zealand (RBNZ) suddenly shifted course, cutting rates by 25bps (to 3.25%) and said the market should expect more in the future. Of all the things to cause a slowdown, milk, New Zealand's main export, is the leading suspect in New Zealand's troubles. Milk prices are down 60% over the past 18 months as Chinese consumption slows. The RBNZ has listened to the farmer's cries and is now taking action. The sudden shift has sent Aussie Dollars (AUD) surging against New Zealand's version (NZD). Interest rates in Australia are already 2%, meaning the RBNZ's capacity to ease is much greater. This chart looks incredible and we could be waiting until the cows come home before the April 2015 low is re-tested.

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: How does one calculate the market priced in bps regarding the fed hike? Also, what is your probability of a September liftoff and what are your reasons behind it? - VK

A: Calculating what the market prices in rates can be pretty complicated. In short, you measure can in the yield curve between now and a certain date. Instead of using Treasury yields (where there are larger duration gaps), traders use the LIBOR curve, which measures the interest banks charge each other to borrower (effectively mimics T-bills). You can use LIBOR to calculate the pricing on specific dates, like Fed meetings.

This is just a gut instinct guess, but I'd say there's a 75% chance the Fed hikes in September. Weak data between now and then could change that. I also think it will be VERY clear whether or not they'll hike before the meeting takes place. Yellen will do everything in her power to telegraph her moves. I don't think the hike itself will mean much of anything to the bond or stock market, however, it's impact on the US dollar could be significant.

That's all, see you next week!

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

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