

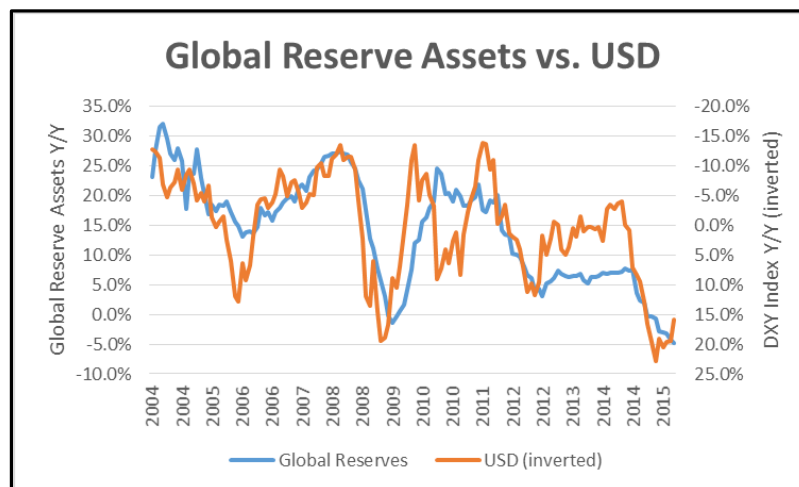


## **CUP & HANDLE MACRO**

Greetings,

On August 11, the PBoC shocked the market with a CNY devaluation that, while still relatively small, was the biggest drop in twenty years. China is slowly transitioning to a consumption-led economy but remains heavily dependent on the manufacturing sector for growth. A weaker currency makes Chinese goods more competitive on the global market, meaning the devaluation was essentially a form of stimulus. In economics, a strengthening local currency acts to tighten domestic monetary policy, and this principle is largely responsible for the ongoing [Currency Wars](#).

Investors understand that a weakening local currency is supportive of domestic asset prices. What they don't seem to understand is that a strengthening reserve currency tightens monetary policy on a global level. Just because global interest rates are near their lowest levels in history and QE programs continue in Europe and Japan, does not mean monetary policy is loosening. In fact, the chart below shows that global reserve assets, a good proxy for liquidity in the financial system, are in outright contraction. Of course, it's no coincidence this decline has been mirrored almost perfectly by a historic rally in USD – the world's reserve currency.



As with everything these days, the contraction in global reserves has been driven almost entirely by China. By pegging CNY to USD for the past two decades, the PBoC was able to accumulate several trillion dollars in FX reserves. Because USD was depreciating for much of that period, it always acted as a tailwind for global growth. However, the DXY Index has rallied 21% over the past 16 months and China's FX reserves have declined by \$350 billion.

To be clear, China still has \$3.7 trillion worth of reserves to defend CNY from excess weakness, and the PBoC could reverse those outflows by simply opening up the economy. While China still has the capacity to boost its economy during a crisis, this USD rally shows no signs of slowing down. This week USD set new highs against local currencies in Australia, New Zealand, Thailand, Singapore, Indonesia, South Africa, Turkey, and Brazil. And those are just the tradeable currencies.

This is all related to the collapse in oil, which has been covered ad nauseam, but many fail to realize its impact on monetary policy. The price of oil is the dominant variable in the calculation of CPI. Since crude started falling in 2014, US CPI growth has dropped from +2.0% Y/Y to +0.2% Y/Y currently, and it should go negative in the coming months. That's important because it means real interest rates are rising, tightening monetary policy.

Instead of studying the (ridiculous) notion that lower gasoline prices support the economy, policymakers need to realize they're passively allowing monetary policy to tighten as the stock market rolls over. Forget about a September vs. October hike, the real debate should be when the next wave of stimulus is coming.

The [Cup & Handle Fund](#) is up around 6.5% YTD, and +26% Y/Y. I'd like to be up much more, but nothing about our thesis, which has been spot on so far, has really changed. I still like our positions and feel comfortable sitting with them (with small tweaks) until something changes. The monthly picks for July and August have been home runs. The September letter went out on Wednesday and it's already 2% in our favor. [If you'd like to start receiving these letters click here.](#)

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

Until next time, tread lightly out there,

**Michael Lingenheld**

*Managing Editor – Cup & Handle Macro*

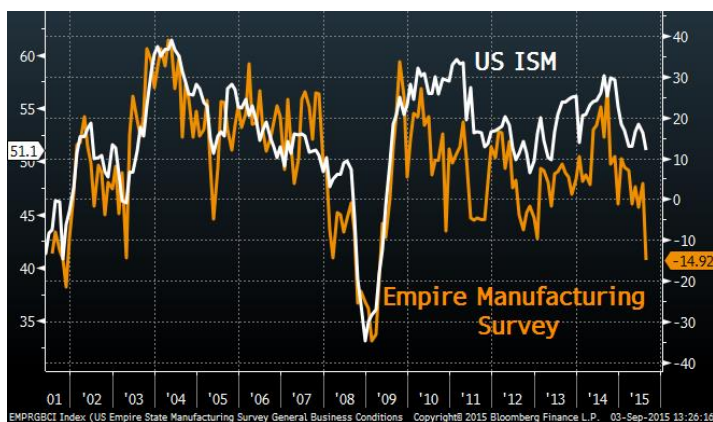
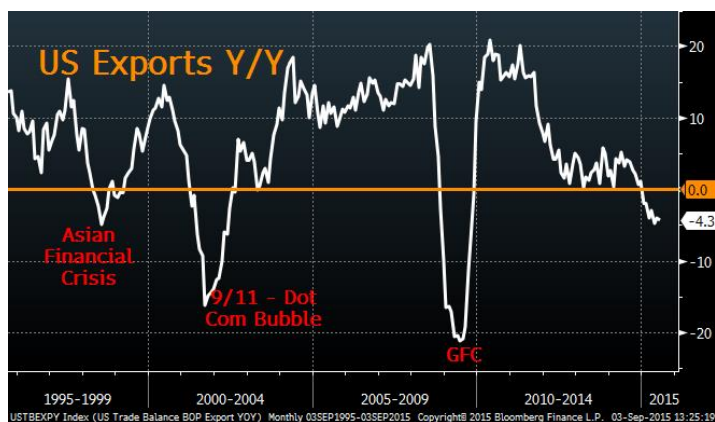
## Why This Is Far From Over

If you have money invested in the stock market, please ignore CNBC, Fox Business and other sources of “noise” talking about buying this dip. Let us remember the S&P 500 is less than 8% below its all-time high, and yet you have commentators pointing out “value” in the market. The trading on Monday, August 24 was indisputably chaotic and the major reversal on Tuesday led many, including myself, to believe the rest of the week would be a bloodbath. Instead, volatility died down after comments from a Fed official and stocks rallied more than 5% from the lows to end the month.

In retrospect, the rally into August 31 was nothing more than window dressing. Fund managers typically release their performance on a monthly or quarterly basis, and the end of August was time for everybody to show their cards. Sentiment wasn't especially bullish heading into the correction, but investors with structural longs had every incentive to push up the value of their holdings into month-end – making returns look better. And it was easy to do with volumes so low. Therefore it wasn't surprising that stocks got slammed again on September 1 when the slate was wiped clean.



It looks more and more like we're headed for the first recession of the QE-era. Markets are forward looking, so expect them to price this in before economic weakness shows up in the data; there's a good chance that August 24 was merely a warning flare to investors. The structural factors slowing global growth at the moment are not even close to resolved, and these imbalances could be a problem for the next few years.



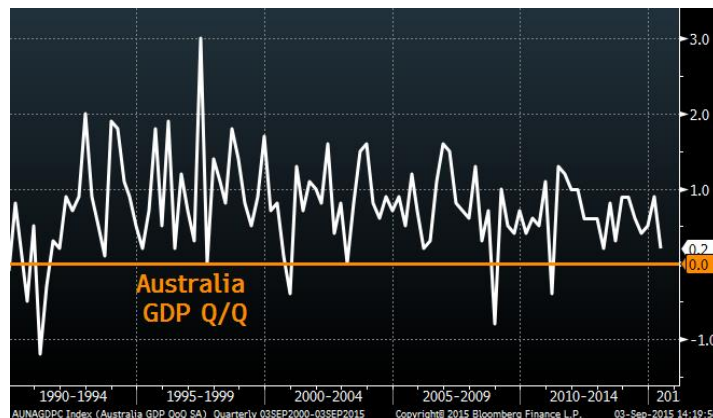
It's worth noting that we probably won't see "the Big One" or "Great Recession Part 2" in the next six months. Confidence in the ability of central banks to manipulate the price of assets is still strong. On Thursday, Bunds rallied and the EUR got clobbered after ECB President Mario Draghi hinted at the possible expansion of QE. Lost in the headlines (again, ignore CNBC) was that the ECB cut GDP and inflation forecasts for 2016 and 2017. It was a curious announcement considering Eurozone PMI posted 52.3 in August – better than the US and Asia. The prospect of additional QE was enough for investors to ignore the ongoing political and humanitarian crises roiling the continent, and push the DAX 3% higher on the day.

The implication is that when the Fed fires up its stimulus machine, US stocks, and global assets more generally, will be off to the races. That's probably true, but I still think we get another shot across the bow before September is over. A close below 1820, the October 2014 low, would be a game-changer, but that might be a stretch. At the very least, I see the S&P 500 closing below 1900 at some point this month. Here are three reasons why:

### **-Economic Data is only getting worse:**

On the previous page, the chart of IBD/TIPP Economic Optimism shows that weak economic activity is starting to impact sentiment. Weak sentiment shrinks credit demand, falling credit demand equals less consumption, less consumption hurts sentiment even more – it's a vicious cycle. Last Sunday, South Korea revealed that exports fell -14.9% Y/Y in August. Weak Korean exports have been highlighted previously in this newsletter and it's not surprising with the slowdown in China. This is really bad for Korea because the country is a key part of the global supply chain, and exports make up 50% of GDP.

However, exports are not a big part of the US economy. And yet, export growth in the US is now negative for the first time since 2009, signaling a severe lack of demand in the global economy. Each of the last three instances of US export contraction, there has been a "crisis" of some form.



Canada's economy contracted in the first two quarters of this year. In Brazil, another country closely tied to China, the recession is only getting worse. Even Australia, a country that has avoided

technical recession for 24 years, looks to be on the verge of contraction. If you think the US is immune to all this weakness because consumers benefit from lower gasoline prices, you need a refresher course in globalization.

### **-Volatility:**

It looks like the volatility dragon is out of the bag. It's often overlooked that perhaps the biggest impact of QE was the suppression of volatility. However, once vol spikes in one asset class, it typically spreads into others. Currency volatility was already on the rise, and the recent moves in oil could give you whiplash.



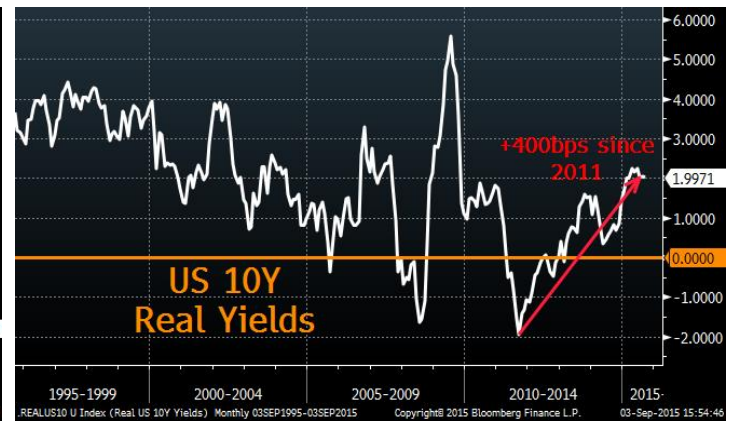
It seems like only a matter of time before this seeps into equities. VIX made all kinds of headlines on August 24, but it never closed above 30. Equity volatility was much higher during the European sovereign debt crisis of 2011. The upcoming turbulence won't have as much systemic risk because banks are so well capitalized now, but these gyrations indicate a bigger move is coming soon.

### **-The Fed Is Not Nervous (Enough):**

Notice how a September Fed hike hasn't been mentioned until now? The financial press will obsess over the decision until September 17<sup>th</sup>, but it seems largely irrelevant at this point because even a decision to raise rates would be accompanied by extremely dovish language. Except that's not what the market is looking for at this point. [Ray Dalio and Larry Summers](#) are not the only bigshots waiting for QE4. Yet, the Fed seemingly wasn't fazed by the August meltdown.

Stanley Fischer, who might have more clout within the Fed than Janet Yellen, said in Jackson Hole that he's optimistic about inflation. Other Fed officials have indicated they too believe the US economy could tolerate higher rates – even after August 24. Apparently the Dow Jones opening 1,000 points lower wasn't enough of a warning sign.





It appears as though the Fed is walking into a no-win scenario. A September hike would kill stocks, and a pass with “we’ll hike sometime this year” language would probably produce the same result. Markets have only started pricing in weakness going forward, and they’re looking for more stimulus – not less, or no change. In fact, the collapse in oil (and therefore CPI) has actually tightened monetary conditions substantially through higher real interest rates.

Only after a much larger and volatile decline will the Fed change its tune and prepare for more balance sheet expansion. When will we know this shift occurs? Watch gold. It’s no coincidence that gold peaked in 2011 at the same time real interest rates bottomed. Gold is amazingly prescient when it comes to pricing in monetary tightening/easing. Gold caught a decent bid in the aftermath of 8/24, but that was more of a short squeeze and the price has since dropped along with volatility. When the yellow metal starts to rally, we’ll know that the Fed is willing to meet the market’s expectations.

### Chart of the Week

As if you needed another reason to be nervous heading into September/October here’s a table showing the average season returns by week. We are about to enter the 36<sup>th</sup> week of 2015, so there’s reason to be optimistic in the short-term. Over the past decade, the 37<sup>th</sup> week of the years has been the strongest, returning 1.74% and rallying 9 of 10 years. However, things tend to get rockier after that.

Again, it’s worth reiterating that trying to “time” market moves is a fool’s errand. Have a 3-6 month view for all your positions, and try to size them appropriately so that you won’t get shaken out during corrections or swings in positioning. This table is important in that regard, because it tells you we’re entering a dangerous period seasonally.

Weekly Returns for SPX Past 10 Years (2005-2014)					
Week	Avg Return	% Higher	Week	Avg Return	% Higher
1	0.14%	60%	27	0.63%	50%
2	-0.59%	50%	28	0.73%	70%
3	-0.93%	30%	29	0.97%	70%
4	0.38%	50%	30	-0.47%	60%
5	0.89%	70%	31	-0.29%	60%
6	0.08%	70%	32	-0.50%	50%
7	0.10%	60%	33	0.08%	50%
8	-0.59%	50%	34	0.26%	40%
9	-0.69%	60%	35	0.23%	50%
10	0.76%	50%	36	0.48%	60%
11	0.73%	60%	37	1.74%	90%
12	0.99%	50%	38	-1.23%	20%
13	0.85%	70%	39	-1.13%	30%
14	0.13%	60%	40	-1.05%	70%
15	0.05%	40%	41	1.29%	70%
16	1.06%	80%	42	-0.48%	60%
17	0.77%	80%	43	1.62%	80%
18	-0.22%	50%	44	0.10%	60%
19	-0.34%	40%	45	-0.70%	60%
20	-0.94%	40%	46	-0.94%	60%
21	0.86%	70%	47	1.07%	60%
22	-0.43%	50%	48	1.25%	60%
23	-0.16%	40%	49	-0.03%	70%
24	0.04%	60%	50	0.30%	60%
25	-1.16%	10%	51	0.87%	80%
26	0.42%	70%	52	-0.02%	30%
			53	0.02%	50%

## **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](mailto:info@cup-handle.com). We'd love to hear from you! \*\***

*Q: What happens to the markets if Donald Trump is President? - DJ*

**A:** That's a great hypothetical question. It's a little too soon to tell because he's only put forth one formal policy position thus far. It's hard to imagine the reaction would be bullish with such a wildcard holding office. I imagine the stock market will get pounded between now and November 2016, so Presidential candidates might not matter as much as they would typically. The President has much less of an impact on asset prices when interest rates are zero. And, to be clear, it's still extremely unlikely that Trump is the nominee. Jeb Bush's super PAC has the most money, so he's still the favorite. Although, a Rubio-Fiorina ticket would help Republicans in their weakest demographics – Hispanics and Women.

**That's all. See you next week!**

For any questions or comments, please email us at: [info@cup-handle.com](mailto:info@cup-handle.com)

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