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January 27, 2016

CUP & HANDLE MACRO

Greetings,

The upcoming reversal in global monetary policy will be a two-stage process. Phase one is really just about the Fed, which needs to signal a "timeout" on further rate hikes while it evaluates the collapse in oil and the stress that puts on emerging markets. That could come as early as today when Yellen & Co. release their statement from the January FOMC meeting. If they insinuate that this month's market volatility hasn't impacted the "four hikes in 2016" narrative, expect another material drop in the stock market. The market never came close to pricing in four rate hikes this year, but it needs some reassurance that policymakers are oblivious to what's going on.

The second phase will involve actively engaging in further stimulus. Last week, Mario Draghi intimated we should expect further action from the ECB in March. He gave few details, but that's probably because the easiest option is more QE, which has proven to be ineffective at best. On Thursday there's probably a 50-50 chance the BoJ expands its QE purchases. If not, they'll pull a Draghi and signal action in March or April. But phase two won't be complete until the Fed starts expanding its balance sheet again. Until then, the S&P 500 is capped at 2,100 on the upside and exposed to major declines on the downside.

I make the distinction between phase one and two because, unlike the other major central banks that haven't raised rates, the Fed can't backtrack so soon after a hike in December. It would be a major blow to their credibility and markets need time to price in the ramifications of such a shift. A pause from the Fed will be enough to lift the stock market closer to its 2,100 upper limit, but investors are tired of hearing "lowering for longer" from the Fed and the rally will get snuffed out after a month or two. On top of that, a Fed pause in conjunction with further ECB and BoJ easing is just going to make USD stronger – exacerbating all problems that sparked the sell-off starting January 4.

From there it will be up to markets to force the Fed's hand and choke financial conditions to the extent that Yellen is forced to do something. It could be QE4, but Bernanke has already said that they'll probably try negative rates before resuming further asset purchase because - as mentioned earlier – there's no evidence that QE does anything. However, to think this is the fall of Rome and Treasury's will start spiraling lower is a mistake. The Fed still has plenty of firepower to support financial markets, even if the 2016 election turns into a debacle.

This is really just an extremely broad playbook for how 2016 could play out. My monthly investment letter for February will have a lot more specifics with some trade ideas to make money in this environment, but if you're just looking for protection, gold looks awfully reasonable here. Size the position so that a move below $1,000 doesn't knock you out, because deflation is a fickle beast. But if you can hold the yellow metal for 2-3 years (maybe less) you should do more than fine.

The **Cup & Handle Fund** is up around +1.5% YTD, and +10.0% Y/Y. It's the same story here. My view is that this performance is disappointing, but I'm still reading that hedge fund indices are -3.5% YTD. As outlined above, I still think there are big time opportunities to profit this year, so we'll stay patient. As discussed, my February letter is going to be a little difference with several recommendations. We'll see how y'all like the format and make a decision for going forward. Your feedback, as always, is appreciated. **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.

Until next time, tread lightly out there,

Michael Lingenheld
Managing Editor – Cup & Handle Macro

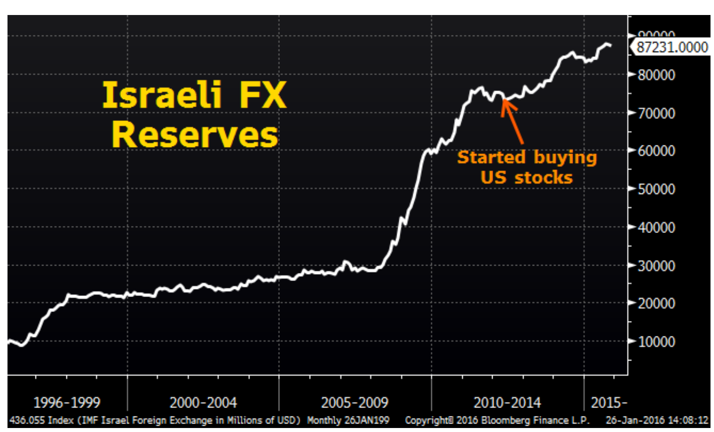
A New Kind of QE?

Part of the reason why markets are so weak is that major structural impediments to long-term growth are now starting to reveal themselves. China simply can't avoid a major downturn unless USD starts to weaken or at least levels off. The Chinese are almost ready to open up their stock and bond markets to foreigners, which would solve a big chunk of their capital outflow problem, but it will be hard to pull off without a market determined exchange rate.

The Fed could facilitate a weaker USD easily. Just mentioning that the currency is too strong in a FOMC statement would be enough to knock it down. That would buy the Chinese some time, but it wouldn't solve the structural problem. The transition from currency peg to a much weaker, free-traded CNY is going to cause major upheaval in financial markets. But without that transition, we'll continue to have huge imbalances with China, the world's fastest growing superpower.

Yet there are possible solutions that would at least mitigate the damage caused by this transition. For instance, all of the world's major central bank have tried QE with little success. You could argue that they need to do a larger QE, but the ECB and BoJ have a limited supply of domestic debt and other constraints. And, on top of that, the low interest rates that QE creates are marginally effective at stimulating demand. But what if these central banks coordinated to buy Chinese assets instead of their own? There are risks associated with this idea, but it could also have some major rewards.

Most importantly, it would add liquidity to China's financial markets and allow the PBoC to weaken CNY gradually without losing all of its FX reserves. The coordinated strategy wouldn't put much upward pressure on EUR, JPY or USD because they'd all be expanding their balance sheets simultaneously. In a sense this would be like a Plaza Accord agreement that also allowed China to open up its markets to foreigners;



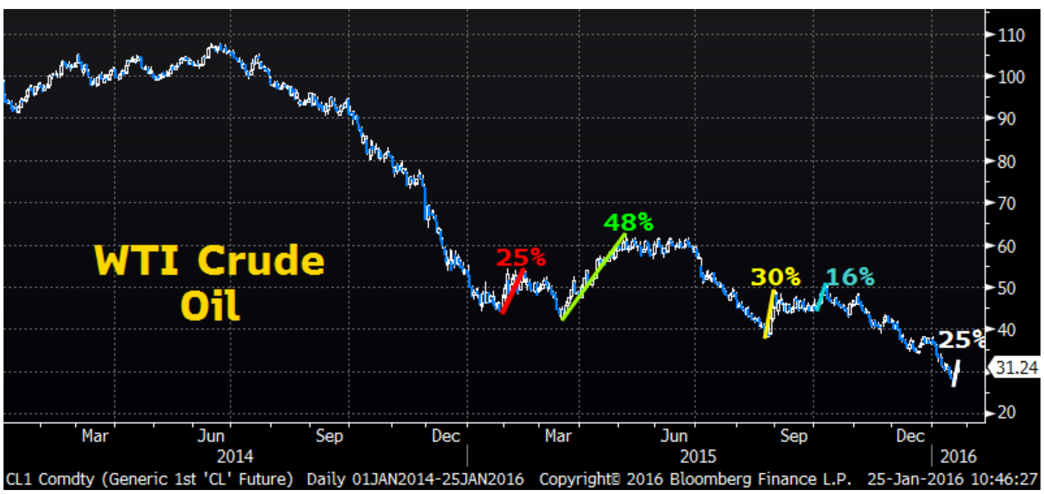
something that's desperately needed to balance out their excess savings.

It sounds a little far-fetched, but foreign QE has been tried before on a smaller scale. For example, the Bank of Israel, led by Stanley Fischer, started using its [FX reserves to buy US stocks] in 2012. Fischer, now vice-chair of the US Federal Reserve, and was formerly the Ph.D. thesis advisor to Ben Bernanke and Mario Draghi.

This plan might be impossible because it would probably also need to involve fiscal coordination between governments, which seems less likely every day. However, in a world with fiat currency, it shows that with enough creativity these central banks have almost unlimited firepower. It's really just a matter of securing enough political clout to use it.

The Dead Cats

Investopedia describes a "dead cat bounce" as: A small, temporary recovery from a prolonged decline or bear market, followed by the continuation of the downtrend. The problem is that they are only clear in hindsight, which makes trading through bear markets extremely difficult. Take oil for example. Over the past 12 months there have been five rallies of +15% or more, a few of which lasted less than a week. From January 20th to the 25th, four trading sessions, the front WTI contract rallied +25%. And yet, if you were short since 2014 crude declined -70%.



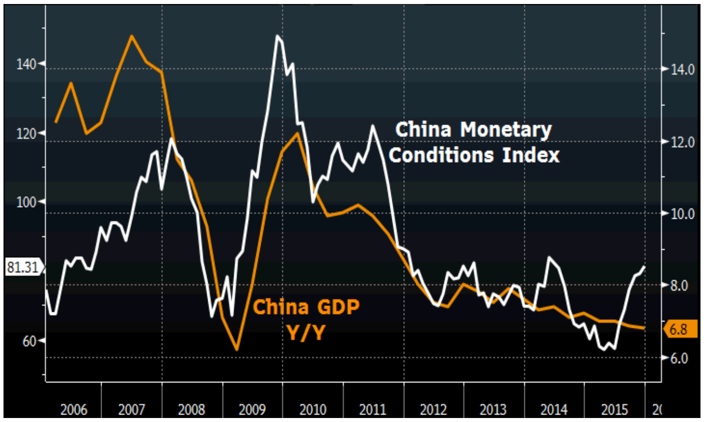
Such is the nature of bear markets. Crude isn't a great example in the sense that it's only tradeable through futures, which can be expensive to roll/carry, but it shows why a long-term, buy (or sell)-and-hold strategy results in the big scores. It takes a lot of conviction and it helps if the position goes in your favor from the start, because it's extremely hard to sit through those 5-day, +30% rallies that wipe away big unrealized gains.

Chinese Optimism

It's now en vogue to be negative on China. In retrospect, Chinese growth peaked in 2011, which is reflected in the price of commodities. The economy is still slowing, but demand was pulled forward into

2010-11 due to massive stimulus measures and now they're operating in a vacuum. It was always going to be impossible to maintain that growth, and the ultra-strong CNY has really compounded the effects of a stagnant economy.

However, the PBoC is starting to let CNY depreciate, and they're now keeping the currency tied to a basket as opposed to USD. USD is still the basket's largest component at 27%, but EUR makes up 22% - not an insignificant number. And considering that Europe (Germany) competes against China in manufacturing, a stronger EUR relative to CNY should boost China's prospects. The chart below shows that EUR/CNY has decent correlation with Chinese GDP, and a bottom could be in place.



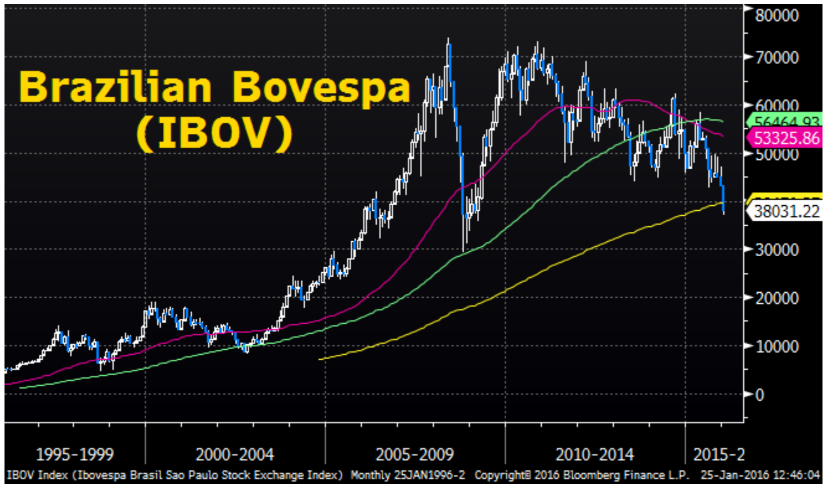
On top of that, the PBoC's stimulative efforts from last year look like they're finally starting to bear fruit. Monetary policy always operates with a lag, typically 9-12 months. The PBoC has been cutting rates steadily since November 2014, so that easing should start to show up soon. And wouldn't you know it, China's monetary conditions index is starting to rally (implying easier conditions). Again, this has solid correlation with GDP.

Now, don't expect a weaker currency and looser monetary conditions to drag the economy higher. China, like any country, can't significantly increase economic activity if the rest of the world is slumping, but it can be less of an impediment to global growth. This also doesn't mean that Chinese stocks are now worth buying, because the government is still purging excessive leverage from equity markets. But individual companies, especially those like Alibaba (BABA) that cater to increasingly wealthy Chinese consumers, shouldn't be thrown out with the bathwater. The Chinese economy is still ugly, but there are valid reasons for optimism.

<u>Chart of the Week</u>

I looked at the chart of Brazil's IBOV last week and thought there was an error. As a US-based investor, the easiest exposure to Brazilian stocks is via iShares ETF (EWZ), which has declined steadily since 2011. The difference between EWZ (USD) and IBOV (BRL) is currency exposure, which accounts for the difference. But it's startling that the IBOV, unlike commodities, hasn't even tested its 2008 lows.

However, IBOV is now below its 200-month moving average, the last technical resistance before fresh lows come into range.



Between 2003 and 2008 IBOV rallied 800%, so a decent correction could be healthy. Having said that, Brazil continues to look like a dumpster fire. GDP is contracting -4% Y/Y, inflation is now 11% Y/Y and headed higher, the central bank just reversed course, the government is trying to impeach the President, there's a mosquito virus disabling newborn babies, and a mining flood is destroying a huge ecosystem. Other than that things are just ok. The world will turn its eyes towards Brazil starting in August when the Olympics come to town, and it has all the makings of a fiasco.

****Editor's note: We're going to try something new this year. I love interacting with readers and responding to questions, but the vast majority aren't fit for public consumption – i.e. often regarding positions or strategies within somebody's portfolio. Instead, I'm going to link a timely, macro-related, long-form article every week. To be clear, keep the questions coming, send me an email at info@cup-handle.com and I'll get back to you in short order! ****

Silicon Valley's $585 Billion Problem – Fortune

Comment: One of my "5 bold predictions for 2016" was that a Unicorn would fail. I'm increasingly confident that will happen, but this article highlights the problem many of these overvalued companies are facing: they can't realize gains. Tech IPOs are synonymous with newsworthy offerings, but they haven't delivered consistent returns in a while. Twitter (TWTR) and GoPro (GPRO) were both companies you'd heard of before going public, but if you got in on the IPO you wish you hadn't.

That's all. See you next week!

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