



## **CUP & HANDLE MACRO**

Greetings,

The implementation of exchange circuit breakers really picked up after the Flash Crash of 2010, when high frequency traders spun out of control. The idea is to give computers 15 minutes to recalibrate, creating a more orderly market. However, in China, where individuals drive more than 80% of trading volume, a 15 minute halt after a -5% decline really just gives investors extra time to place sell orders before the -7% threshold, where trading is stopped for the day, gets triggered. The Chinese circuit breakers were operational starting January 1 and were put to the test immediately.

Many pointed to weaker than expected December Chinese PMI data as the cause of this sell-off, but it's more complicated than that. PMI has been weak for a while, and wasn't much of a surprise. During June 2015, when the Shanghai Composite lost -35% of its value in three weeks, the Chinese government halted IPO issuance and restricted selling for large stakeholders. Over the holidays, those limitations were relaxed and January 4 was really the first day to see the market's response. It reacted very poorly and now the government is back intervening, flooding the market with liquidity, and probably threatening short-sellers covertly.



Unlike in June, when developed markets largely ignored the Chinese meltdown, global equities struggled mightily on Monday. Japan's Nikkei was -4% after two days of 2016, and the German DAX is down -4.5% YTD. Of course, there were other factors at play. Saudi Arabia and Iran are back to setting each other's embassies on fire, December US PMI was the lowest it's been since June 2009, and EU countries are closing down their borders again. Oil is still falling, yield curves are still flattening, and gold is starting to get a spring in its step.

But alas, China is really what's moving the needle these days. Authorities are walking a fine line as they attempt to prevent market disorder without simply postponing an inevitable correction. It's also a little alarming that Chinese stocks are so weak at a time when the Renminbi (CNY) is simultaneously declining. 1-Year CNY forwards are the weakest they've been since March 2009, which should go a long way towards supporting the country's export and manufacturing sectors.

We keep hearing commentary that China's slowdown is no reason to be bearish. That 5% GDP growth in China isn't the end of the world, even though it was growing 10%+ in 2010. It's simply a country transitioning from an export-driven model to one based around consumption. That analysis seems to ignore the fact that such a transition has never occurred seamlessly for any economy in history, let alone the world's second-largest economy. An economy that is largely still figuring out how to deal with market forces. China has seemingly limitless potential for growth and consumption, but that doesn't mean its financial markets are ready for the major leagues.

The [Cup & Handle Fund](#) is up around +0.5% YTD, and +6.0% Y/Y. It's that time of year again when returns are reset zero. It's always a little daunting to start all over again, but we're confident in our positions and off to a decent start. We finished 2015 up around +6.5%. That's fine, it beat the S&P 500 and all the hedge fund indices, but still seems like nothing to write home about. I'm getting back into the groove this week, and should have a monthly letter for January available shortly. [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*

## This is Saudi's Solution

The Saudi monarchy followed through on its threat to execute a prominent Shiite cleric over the weekend, along with 46 Sunni extremists. The news didn't come as a huge surprise and really just escalated an already simmering proxy-war between Saudi Arabia and Iran. The two countries cut diplomatic relations on Sunday, but it's hard to imagine there were relations left to cut, especially since Iran (via Yemen) started launching airstrikes towards Saudi oilfields last year. The monarchy knew what it was doing here, and it accomplished a huge goal for them: diverted attention from the local economy.

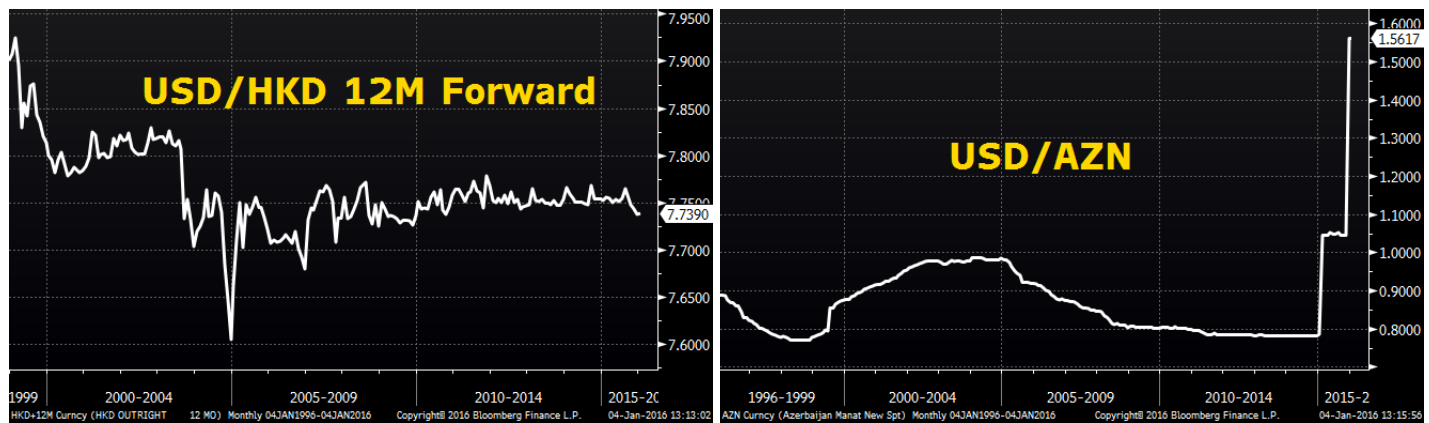
Gasoline is still cheaper than bottled water in Saudi Arabia, but the 50% hike in fuel prices on December 29 is a radical shift in a country where handouts bought political loyalty for years. The country's budget deficit hit 15% of GDP last year, prompting officials to cut subsidies dramatically. They will also curtail public sector wages, which account for half of spending, and implement some new taxes. The government was quick to point out that Saudis still pay much less for gas than some of their gulf peers, but the move undoubtedly ruffled a few feathers.

Basket	All Countries	Base	USD	Term	1Y
Highest Volatilities					
Argentine Peso	ARS				30.02
Palladium	XPD				28.00
Silver	XAG				25.15
Brazilian Real	BRL				21.90
Platinum	XPT				21.00
Russian Ruble	RUB				20.48
Colombian Peso	COP				20.00
South African Rand	ZAR				19.65
Gold	XAU				16.60
Turkish Lira	TRY				15.25
Indonesian Rupiah	IDR				14.00
Lowest Volatilities					
Indian Rupee	INR				8.27
Bhutan Ngultrum	BTN				8.27
Israeli Shekel	ILS				8.20
Offshore Chinese Renminbi	CNH				7.55
Chinese Renminbi	CNY				7.20
Thai Baht	THB				7.20
Taiwanese Dollar	TWD				7.15
Singapore Dollar	SGD				7.07
Philippine Peso	PHP				7.00
Saudi Riyal	SAR				4.25
Hong Kong Dollar	HKD				1.60



And yet, by the New Year nobody was talking about subsidies, they were talking about Iran burning down the Saudi embassy. Iran and Russia both have a bone to pick with the Saudi's over their decision to maintain oil production, and surely they smell blood in the water now that the economy is clearly slowing. Whether or not any of these players ramp up the rhetoric remains to be seen, but investors are now watching the Saudi Riyal (SAR) closely.

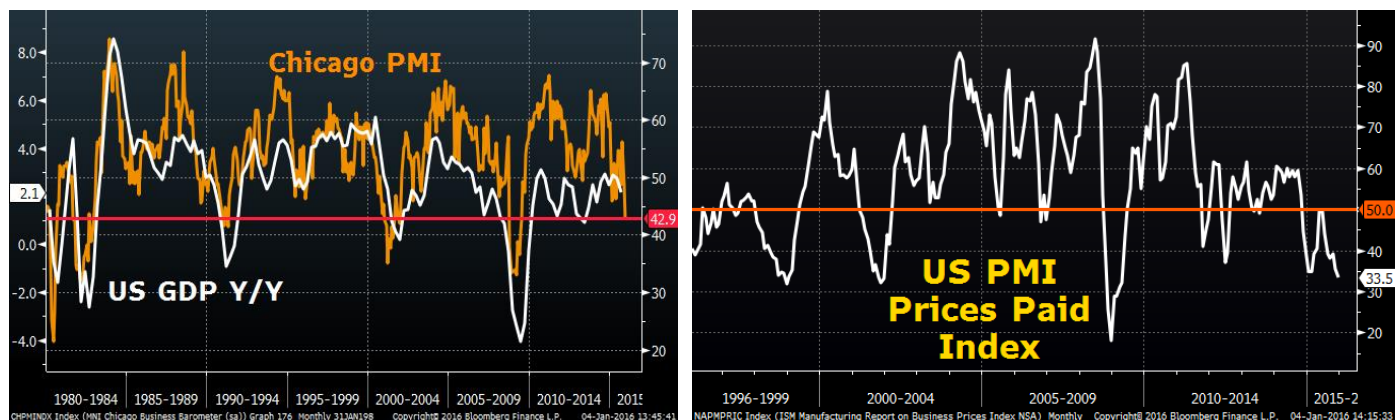
The building tension could actually buy Riyadh some time. Geopolitical conflict is theoretically bullish oil, which would help the Saudi's restock their cash coffers. At the same time, it also supports US shale players, who are still the long-term threat to Saudi's crude influence. While it's still pegged to the dollar, SAR forwards are weakening rapidly. If you're an investor (with a prime brokerage account) that subscribes to this "Saudi going bust" scenario, it makes sense to load up on USD/SAR calls. But the opportunity with more upside might lie in Hong Kong.



SAR forwards really started coming under pressure two weeks ago when Azerbaijan devalued the Manat (AZN) by 50%. This gave credence to the idea that oil producers won't be able to hold their pegs for long, and SAR suffered. Hong Kong's (HKD) currency peg doesn't have much to do with oil, but bringing down the SAR peg would surely turn the market's attention HKD. It just so happens that 1-year HKD option volatility is 1/3 of SAR. And 1/4 of 1Y volatility for China's Renminbi that's in the news so much these days. If the SAR peg were to break, the volatility jump alone in HKD could make for a very profitable position. HKD will probably be the last domino to fall, and it will be big news if and when it does.

### Don't Sleep on Chicago

On Monday the sell-off in stocks accelerated after surprisingly weak PMI data revealed the second consecutive month of contraction in the US. Even worse than the 48.2 PMI reading was the "Prices Paid" index at 33.5 – the lowest it's been April 2009 and the third lowest since 1950. However, if you were at your desk on New Year's Eve, you would have noticed the startlingly weak PMI reading from Chicago, which came in at 42.9.

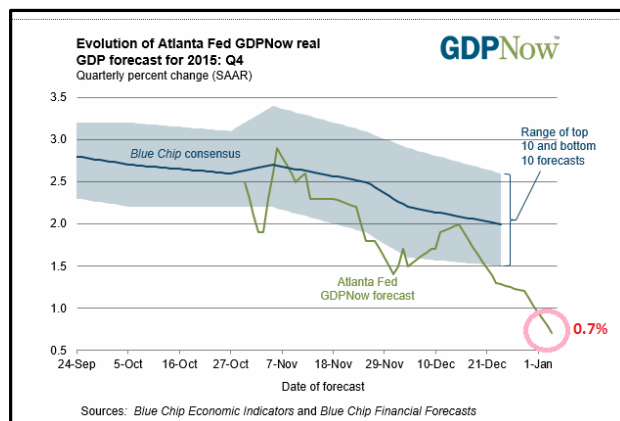
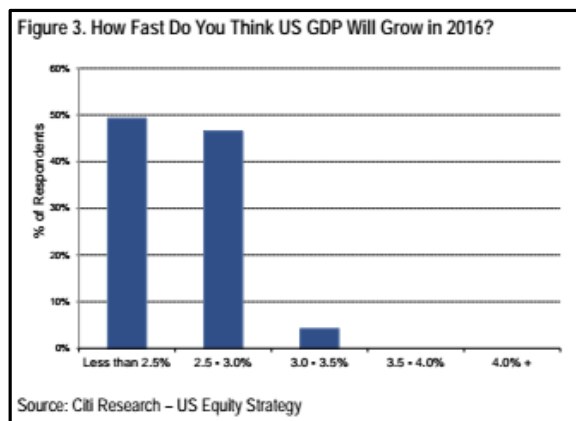


The chart above shows that this level of Chicago PMI is typically associated with GDP growth at or below 0% Y/Y. The Atlanta Fed's real-time GDP index currently reads +0.7% Y/Y, but that could be revised lower considering the state of manufacturing in the US. Optimists point to the more resilient

service sector (released today, expected to be above 50), but that has little historical correlation with GDP and sounds like bulls are grasping at straws.

### Pricing in Weak Growth

Even if our weaker US growth thesis proves to be correct, it won't be a profitable if it's already a consensus view. It's always important to know how your outlook compares to expectations, because contrarian views always make the most money. The two charts below show that economists and investors aren't exceedingly optimistic on growth for 2016, but they're also not predicting an outright recession.



The Atlanta Fed GDPNow is thought to be the best real-time gauge of GDP, and the latest readings seem to confirm the PMI weakness. Just yesterday, JPM lowered its 4Q US GDP forecast from +2.0% to +1.0%. Yet more than 50% of respondents to a Citi survey believe 2016 GDP will come in above +2.5%. Not a huge majority, but enough for a repricing of assets if growth fails to meet those optimistic goals.

### Chart of the Week

I understand that some of the world's greatest investors ignore them altogether, but charts might in fact be the most important tool in my trading style. However, there's a difference between intraday trading charts and long-term momentum indicators. I've long advocated moving averages (MA) as the best tool for gauging momentum. They're simple, they make common sense, and increasing the duration of the chart makes signals more important.



The chart above shows 5-week, 20-week and 50-week MA's for the S&P 500. It's hard to see the individual lines on this chart, but the red circles indicate incidents when the 5 and 20-week MA both broke below the 50-week. On October 1, 2015 this signal was triggered for only the fourth time since 1990. Two of the three previous instances preceded major declines in the stock market. The third did occur before a notable drop (2011), but Draghi bailed out the market with his "bumblebee" speech – preventing a rout. It remains to be seen whether the signal holds this time around. No technical signal is 100% accurate, but I've got conviction about this one.

**\*\*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](mailto:info@cup-handle.com) and I'll get back to you in short order! \*\***

[Michael Burry, Genius from 'The Big Short,' Thinks another Financial Crisis Is Looming](#) – New Yorker

**Comment:** This is especially interesting if you've seen "The Big Short" or read Michael Lewis's book. I agree with his view on water 100%, but it's a very hard to get exposure there. My view is that arable farmland is the best expression, although that's easier said than done. Burry doesn't have an optimistic view of the future, but he's never been known as a bull.

**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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