Greetings,

We’ve been hearing about this OPEC output freeze for months now. Kuwait’s OPEC governor says the freeze will take place ahead of an April 17th summit, but Iran has already said it won’t participate and neither will the US. We knew this agreement was just noise back in January when oil prices shot up $7 in a matter of days, and the recent posturing is no different. Not only is OPEC a largely irrelevant organization, but oil’s problem is not excess supply; it’s lack of demand.

The market narrative in both oil and stocks has turned quite bullish over the past few weeks with good reason. China, the epicenter of global weakness, looks better, PMI data from the US and Europe is back in expansion and, most importantly, Janet Yellen didn’t stand in front of the rally. But just as sentiment was overly negative in early February, it’s overly optimistic today. Trading volumes on stock exchanges have been light throughout this +13% rally, indicating a lack of conviction that fundamental conditions are improving. A weaker US dollar is the rising tide that floats all boats, but it’s unclear if the juice is worth the squeeze in that trade (more below). Prime brokerage data shows that short covering in ETFs could be exhausted, and oil looks like it’s the leading asset in the upcoming move.
Beyond overly bullish positioning many investors are fretting about Japan. The Yen is at its highest level relative to USD since October 2014. Last Friday we saw manufacturing data from across the globe, and it was almost universally improved except for Japan. Japanese PMI came in at 49.1, which wasn’t all that surprising considering industrial production dropped -6.1% Y/Y in February. This slowdown is starting to filter into sentiment, which is evident in the latest Tankan Business outlook. Japanese businesses are as pessimistic as they’ve been since June 2013.

This is all against the backdrop of NIRP in Japan, which has been an unmitigated disaster. The unexpected jolt of negative rates has almost shut down credit markets. Public opinion of NIRP is extremely negative, bank lending has collapsed and not even the BoJ is buying commercial paper anymore. Instead of serving as an important source of cash for borrowers, the credit market has become a profit center for dealers looking to buy securities from investors and sell them to the central bank. By making the trade with the BOJ the only source of profit, markets are exposed to unexpected volatility when that trade ends – which is what we’re seeing in commercial paper.

Japanese officials are undoubtedly panicked about these developments, and scrambling to come up with a solution. But if we’ve learned anything about Japan over the past 25 years, it’s that the response will be too timid to turn the economy around. They’ve painted themselves into quite a corner, and there’s no obvious move to relieve the pressure. Resurgent growth in China would help, but the Chinese would simply be reclaiming market share they lost during Abenomics. A substantial drop in Japanese stocks wouldn’t be the end of the world, but should be enough to drag down the S&P 500 appreciably.

The Cup & Handle Fund is up around +2.0% YTD, and +8.5% Y/Y. The portfolio is having a good week after holding steady over the past month. We added a new relative value bet last week, and so far it’s performing just as expected. As some stocks start to establish trends we’ll be adding more directional positions. Our April letter went out last week, and has proven to be spot on thus far. I’ll be taking a few days off coming up, so if C&H appears next week it will be in abbreviated form, but please keep your messages and feedback coming. 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
**Dollar Direction**

The US dollar’s (USD) worst quarter in more than three years has finally come to an end. Coming into this year long USD was one of the world’s most crowded trades, but once the Fed backed off its hawkish language in February the selling was large and rapid. Positioning in IMM futures, a reasonable proxy, has now fallen to a 26-month low. The dollar’s dominance in global trade gives it a high profile; one that has only grown since a +20% rally began in late 2014. The big question in the market right now is: buy USD here at attractive levels or abandon ship before the real avalanche begins?

There are three main reasons to believe USD is just taking a break here, and will continue to appreciate going forward. The first reason is US oil imports. Many analysts get hung up on the price of oil, but price is much less of a factor than US imports because that’s a main driver of the trade balance – one of the biggest components in FX moves. There’s no longer a premium/discount between WTI and Brent crude, and US growth isn’t extraordinary so there’s little reason to believe US imports will suddenly jump higher. On balance that’s supportive of USD.

The second reason is interest rates. Most of the USD selling took place after the March FOMC meeting when Fed officials intimated they’ll only raise rates twice this year, as opposed to the market expecting them to say three. It’s important to make the distinction between what the market is pricing, and what the market is expecting the Fed to say. Even before the March FOMC meeting markets were pricing in much less than three hikes, but were expecting the Fed to forecast that many. Currently, the
market is pricing in a less than 60% chance of one hike occurring this year. But interest rate differentials are a two-sided coin. Which developed countries will want to push rates higher? In fact, a weaker USD puts heavy pressure on Europe and Japan to weaken their currencies or risk further stagnation. The March FOMC meeting whacked USD and normalized positioning in US Treasury's, but that tailwind is gone for now and should be USD neutral-to-bullish going forward.

The final reason is precedent. A trade-weighted dollar index from the Fed has had two previous sustained rallies in the past five decades, starting in 1979 and 1995. The previous advances lasted an average of 74 months and boosted the dollar by about 40-50%. If we’re saying the current rally started in July 2014 it has only been on the move for 21 months and rallied less than 20%. Each of these bull markets is different and it’s hard to make apple-to-apple comparisons. And yet, USD is such a liquid market that only structural forces create a rally on the scale we’ve seen. The Fed downshifting from a three-hike to two-hike forecast is not a structural shift. The chart looks a little scary, newspapers are telling you the rally is over, but that’s often the best time to buy.

**Getting Real With Rates**

Yellen’s decision to walk back the FOMC’s previously hawkish language in the face of strengthening consumer prices means one thing: lower real rates. The ISM Prices Paid index for March jumped the most since 2012, albeit from extremely depressed levels. Judging from the chart, we should see gasoline prices continue to move higher, which could crimp retail sales but will almost certainly lower real 10Y interest rates. And that bodes well for gold.

A reading of 51 on the Prices Paid index is nothing to get excited about. Even the core PCE reading of +1.6% Y/Y is encouraging, but far from runaway inflation. And it could actually be counter-productive if rising prices put downward pressure on real GDP. The FOMC might not acknowledge it publically, but they would love to see an inflation overshoot. It’s a problem that’s manageable, and helps to reduce the country’s real debt burden. The missing piece in this goldilocks scenario is an upturn in growth, which is still nowhere to be found.
**Cellebrite Good Times**

The stock market bottomed on February 11 after Yellen acknowledged that negative rates were an option in testimony before Congress. A few days later, on February 16, Apple (APPL) published its letter refusing to help the FBI hack into the phone of a terror suspect. The dual catalysts have been a boon to cyber security companies, none more so than Sun Corp, a mobile data company that owns Cellebrite – the Israeli outfit that ultimately hacked into the suspect’s iPhone. Since February 12, Sun Corp shares have rallied +150% despite the overall decline in Japanese stocks. Cellebrite hasn’t even acknowledged that they were able to access the iPhone, but it’s telling that the FBI bought $15,000 worth of IT merchandise from the company right after its lawsuit with Apple was dropped.

![Graph showing Cyber Security ETF (HACK) and Sun Corp (6736 JT)](image)

Cellebrite aside, this story has benefited the entire sector. From bottom to top, the S&P 500 squeezed out a +13% rally since February 11, but HACK – a cybersecurity ETF – more than doubled those returns. In a way it’s not surprising that such an immature market moves with higher beta. At the same time, there are so few growth sectors at the moment that maybe cybersecurity deserves another look. Worldwide cybersecurity spending reached $75 billion in 2015, and is expected to reach $170 billion by 2020. The demands of digital business, particularly cloud, mobile computing and the Internet of Things combined with the sophisticated and high-impact nature of targeted attacks makes this an industry worth watching on the long-side.

**Chart of the Week**

We’re all just trying to buy-low and sell-high. Technical analysis can be made extremely complicated, but sometimes simple metrics like moving averages are the most effective. They’re key in understanding the market’s psychology, provide risk/target levels and show which direction is the path of least resistance. It seems insane that investors could look at this chart and want to buy stocks here. Since 2011, every time the S&P 500 has been this far away from its 50-day moving average a temporary top was put in place.
The key to that sentence is “since 2011.” It’s important to realize that we’re trading in a different world post-2008, and historical indicators might not be as effective as they used to be. But this one is noteworthy because it’s working in the new world. Remember, the divergence can get wider like it did in late 2011 and then decline. The key takeaway is that buying here would be fighting momentum and psychology, which does not make for a good risk/reward investment.

**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 are not 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! **

What Happened When Venture Capitalists Took Over the Golden State Warriors – NYT Magazine

Comment: With the NBA playoffs upon us we take a look at the intersection of basketball and venture capital. It’s impossible not to love the Warriors, but owner Joe Lacob comes across as out of touch. Synergies and lessons from launching numerous successful start-ups is great, but so is Stephon Curry. Morgan Stanley estimates Curry’s impact on Under Armor’s bottom-line at $14 billion. Surely he’s having a similar impact on the Warrior’s valuation, not a networking bar.

That’s all. See you next week!

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

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