# 4/ Executive Summary

08 / **Risk assets are reaching a trough as financial conditions ease further; cyclical sectors should lead the way into Q1 2018 -** US financial conditions reached their loosest point since May 2015, offering a mixed blessing and a conundrum for the Fed as the easing occurs even as it tightens monetary policy. Easier financial conditions have been accompanied by falling long-term yields, weaker US Dollar, low market volatility (as proxied by the VIX), and still tight credit spreads. With the jobless rate already near levels that many economists see as consistent with the historical onset of strong consumer inflation, the easier conditions will naturally provoke questions whether the Fed can manage to keep the economy from overheating. The combined impact of rising growth in the US and the Eurozone would be sufficient to provide tailwinds for the cyclical assets. On top of that, continued improvement in China's outlook was especially beneficial for the base metals (as proxied by copper, zinc and lead). The TSF indicator suggests that base metals may rise into Q2 next year.

11 / **Timing and Tactical Insight - Equity markets are still favorable, probably until late February / March** - US markets are still trending up, probably until late February / early March for now. European markets should follow suit as they resume their uptrends over the next few weeks. Indeed, since early November, they had been suffering from a strong Euro and Pound, and we believe that these trends are about to turn. More generally, these developments favor the re-acceleration of the reflation trades, which should start to materialize over the next few weeks. Along with equity markets, it should benefit the Dollar, US Yields, Value plays such as Financials and Energy, as well as Commodities. This last reflationary push could last into February/March.

17 / **At this stage, is a tactical steepening of the US curve nonetheless possible? -** Much like in previous policy tightening cycles, the yield curve has been flattening as a direct consequence of the corresponding rise of short-term rates as the Fed tightened policy rates.
But the flattening in recent weeks has some differences from previous episodes in that the 3-year yield has been rising, at the same time that the 10-year yield has been steadily falling. This has accelerated the flattening of the yield curve recently. The consensus, group-think is that the yield curve can only become flatter as the Fed carries out the policy regime set out in their Summary of Economic Projections (SEP) during their last FOMC meeting in September. However, further flattening of the yield curve beyond December is not a given.
In effect, the liquidity reduction coming from the Fed's balance sheet and bank reserves essentially tightens financial conditions and will subsequently be detrimental to economic growth. This is especially significant in the light of the Fed program of reducing its balance sheet gradually. The cumulative effect, we believe, will soon translate into lower GDP growth impulse and tighter financial conditions. That can trigger some tactical steepening of the yield curve.

20 / **Timing and Tactical Insight - The Yield Curve is temporarily Oversold, it should bounce into Q1 2018, at the latest from early January -** The Yield Curve and the Value to Growth relationship are heavily Oversold, and our Weekly and Daily graphs suggest that an intermediate low is currently being made. We would expect a bounce that could last into February / March. It may take until early January to really get started. Indeed, both US3Y and US10Y Treasury yields should make an intermediate top towards mid December and then retrace towards early January. However, during the uptrend that follows US10Y Treasury yields have more potential up left than US 3Y Treasury yields. They could accelerate further thereby steepening the Yield Curve.

26 / **US jobs data shows late business cycle-stage symptoms; the Unemployment Rate decline looking terminal -** We revisit the October report released on November 2 to get some sense of what to expect for this month's data from the BLS. It was an excellent report in terms of labour utilization, decent in terms of jobs growth, and poor in terms of wages.
What is not to be liked: (1) The total gain in employment, this is no better than mediocre or average (2) Hourly wages for nonsupervisory workers – that was simply awful this late into an expansion (3) Disposable Personal Income and Personal Income are barely getting above 2% on the Y/Y basis (4) Average hourly earnings ,which are part of the employment report, are still weak on a historical basis.
The October jobs report was considered good, but in reality, it was more nuanced than a simple reading of the headlines suggests. It added more data, which when linked to previous unfavourable data, collectively suggest that the current Business Cycle may be starting to show signs of aging.

29 / **Timing and Tactical Insight - Looking towards 2018 and a late cycle environment for financial assets -** Our current strategic allocation views into 2018 paint a picture, where financial assets are entering the later stages of a Bull market. We would first expect a last and brief reflationary push into mid Q1 2018. The Dollar, interest rates may achieve a bounce, European markets could outperform. Following that, during Q2 2018, a further Growth extension should materialize, which could benefit the Nasdaq, Emerging markets and possibly Industrial Commodities. More generally however, from Q2 2018, we believe that equity markets will have started their distribution and that they should probably top-out before mid-year. H2 2018 should see equity markets start to correct, while Gold and Treasuries gain upside momentum, and Defensive sectors outperform again.

**The Capital Observer editors team, London / Geneva, December 4th 2017**
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37 / **Japanese equities continue to rally on improving fundamentals and abundance of liquidity being provided by the Bank of Japan -** The best prospects for Japan's economic recovery seems to be a continuation of «Abenomics,» which has led the economy to expand for six straight quarters. Unemployment has gone below 3%, the lowest rate in 23 years. The "flash" manufacturing output index rose to 54.2, the strongest rate of expansion for since March 2014 . And Japan's manufacturing sector may have grown at its fastest pace in more than three years in November, according to a preliminary reading. The Abenomics policy consists of three «arrows»: ultra-easy monetary policy under the leadership of Bank of Japan Governor Haruhiko Kuroda, fiscal stimulus, and structural reform. The first two arrows have been pursued aggressively over the past several years, and this will continue. On the other hand, Abe has kicked much-needed but unpopular structural reforms, down the road.
Capital is again flowing back into Japan, encouraged by the recent Yen weakness and the significant improvement in exports it has generated. So, It's no wonder then that Japanese stocks have risen sharply in recent months. More importantly, Japan's central bank is printing more money than any other but there is no inflation in Japan. The massive balance sheet of the Bank of Japan, instead, seems to have laid the groundwork for today's economic and equity market performance.

39 / **Timing and Tactical Insight - Japanese Equities remain strong, while the USD/JPY has started to move higher -** Since September, the Nikkei has been extremely strong despite the little progress that has been made on USD/JPY and EUR/JPY. Both pairs reached their resistance levels around 114 and 133 respectively and have since been retracing. That said, the Yen has been weaker vs Asian currencies, and this weakness itself may justify the Nikkei's strong performance. Going forward, we expect most currencies vs the Yen to find a low and bounce early December. Following some retracement into end December, we expect them all to accelerate up during Q1 2018 and then possibly Q2. The Dollar could be an early leader into mid Q1, while the Euro and Asian growth currencies could then follow through more aggressively into Q2. If these currency dynamics are correct, the Nikkei should continue to outperform during much of H1 2018.

46 / **Splicing the markets - The «Cyclicity» of Bitcoin -** From our statistical analysis, it appears that Bitcoin is following the dynamics usually attributable to Growth and Defensive stocks. Its de-trended correlation coefficients are for example especially high with US Utilities or the Nasdaq 100. Similarly to our projections on these, we would expect Bitcoin to extend up further during December, before it consolidates back to the downside into February. Following, that, we expect it to make a last acceleration up towards late Spring when it will eventually top out for 2018 along with Equities. Indeed, our study, hasn't shown any significant correlation between Bitcoin and true risk-off assets (Gold or Treasuries). Once Risk assets start to correct, Bitcoin should follow suit. These cyclical features of Bitcoin would imply that at some point Bitcoin prices should really start to fluctuate. Note: please be reminded that the above analysis is based on current correlations and future extrapolations of these.