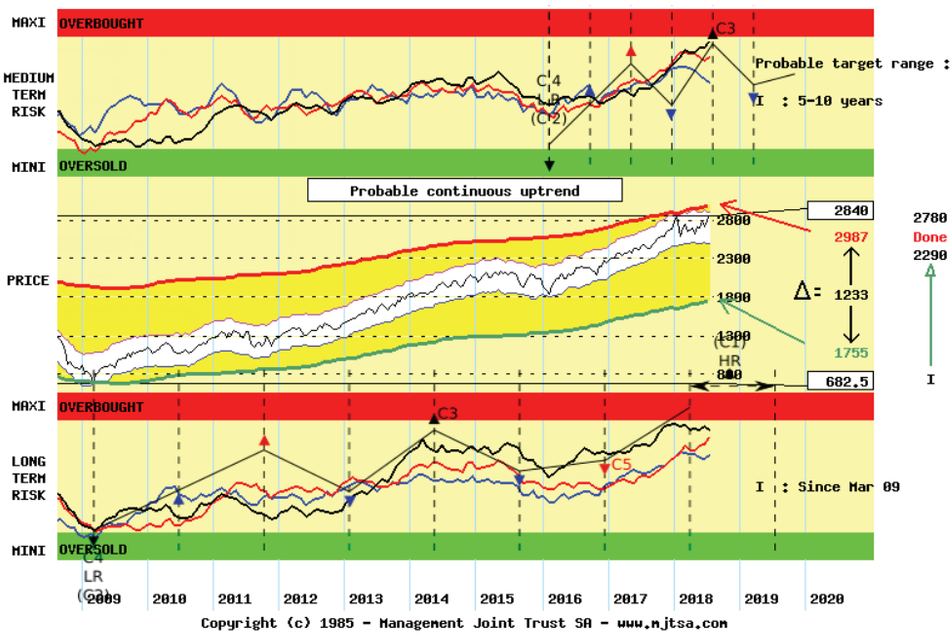
15 / MJT - TIMING AND TACTICAL INSIGHT
Weighting up the building blocks of a defensive strategy

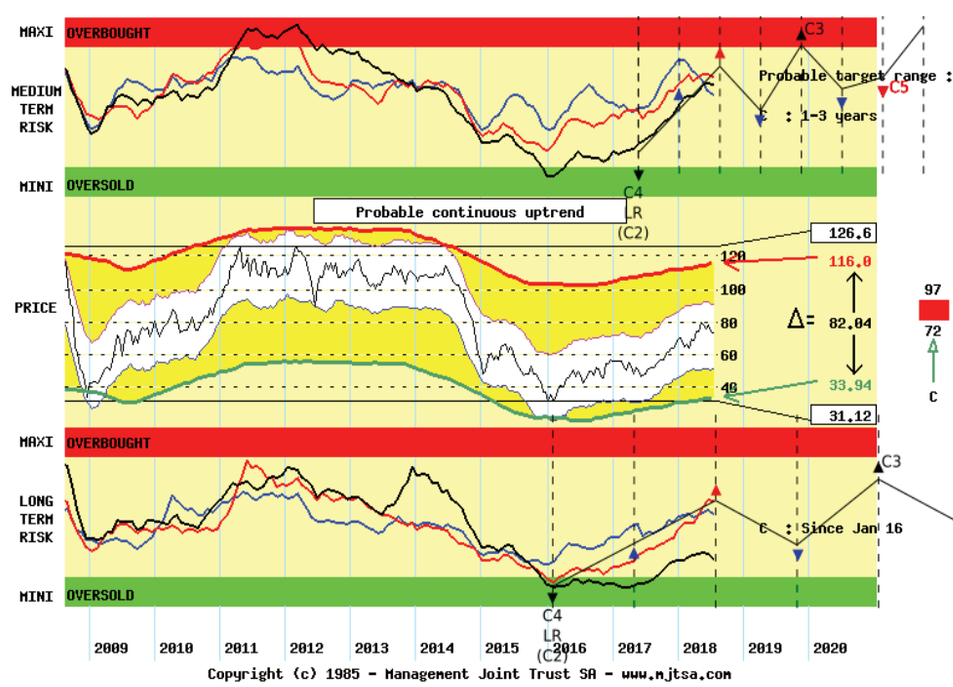
Following the sell-off in January, The Capital Observer turned constructive again on risk assets towards late March and outright positive from late April. Since then, equity markets, and US equity markets in particular, have been climbing a wall of worry, amid the Italian political crisis, endless ups and downs on Brexit, the end of the Iranian trade deal, more sanctions imposed on Russia, the Trade War with China, trade tensions with Europe and Canada and the recent Yuan devaluation. Nevertheless, the Nasdaq and the Russell 2000, recently made new all time highs and most other markets have managed a decent retest. At the The Capital Observer, we feel that we brought you this far, yet now believe that its is time to start shifting towards a more defensive cross asset strategy. In this article, we explain why, and which building blocks we are considering to implement this shift.

S&P500 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



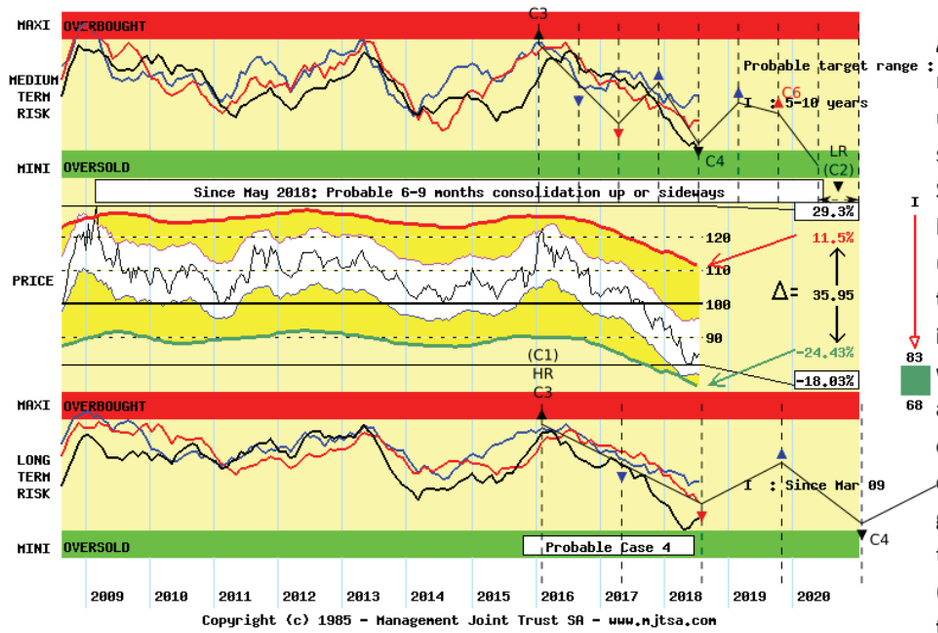
We first start with 4 long term bi-monthly graphs which summarize our view about reflation and why we believe this trend is about to retrace. On this S&P500 graph, our long term oscillators (lower rectangle) have completed a full sequence up since 2009 and have now entered a "High Risk" position. Such situations are usually followed by 5 to 10 quarters of retracement to the downside. Since early 2016, our medium term oscillators (upper rectangle) have completed their own sequence up and are now standing on an important intermediate top. Such configuration usually justify between 3 and 5 quarters of downside correction. Hence, combining both, **we believe that the S&P500 is at risk of correcting down, at least towards Spring 2019 and possibly into late 2019 and 2020**. On the price target front, risk/reward is also extended. Our I Impulsive targets to the upside have been achieved, while the corrective targets to the downside we can calculate point to between **25 and 35% of potential downside risk** (i.e. minus 0.5 to 0.8 times our historical volatility measure "delta", here at 1'233 subtracted from the recent tops – middle graph, right-hand side).

Brent Oil
Bi-monthy graph or the perspective over the next 1 to 2 years



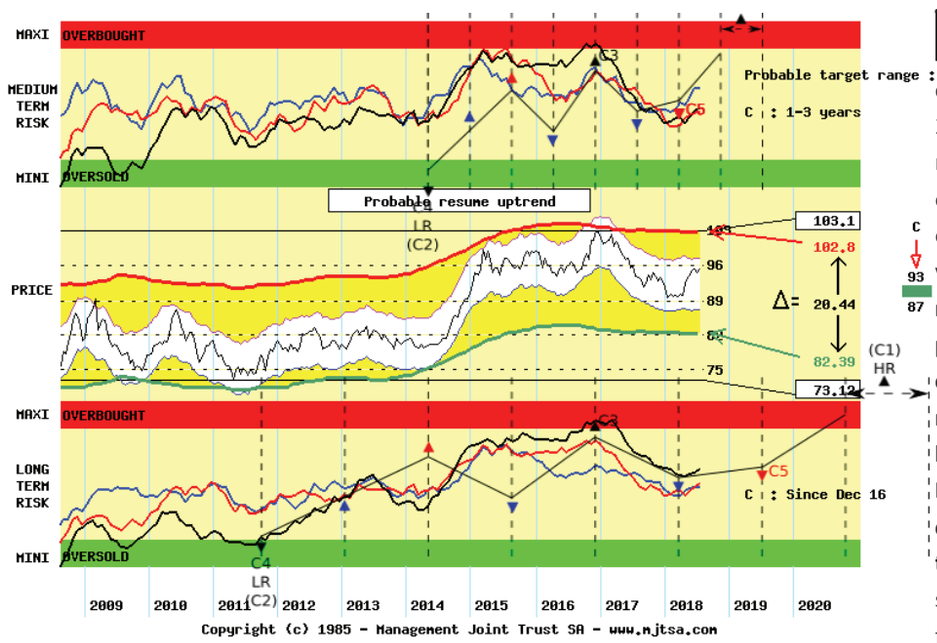
Since early 2016, Oil has been the emblematic commodity of the reflationary recovery. The Oil market first started to rebalance during 2016, retraced some in H1 2017 and then re-accelerated up again into this year. From its lows, below 30 US Dollars a barrel, Brent has managed to more that double, and it recently topped 80 US Dollar a barrel right in the middle of our C Corrective targets to the upside (right-hand scale). **Both our oscillators series (lower and upper rectangles) have now reached intermediate tops and could start to retrace, probably during 3 and 5 quarters**. As mentioned above, Oil's long term bounce since 2016 is still within our Corrective targets to the upside. The recovery is hence in its early stages, and in such situations, retracements can be compelling: **possibly back to the 45 – 57 range in this case, as these levels served as a strong support and resistance back in late 2016 and early 2017.**

US Staples sector vs the S&P500 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



Another indicator, which has been a one way trade since reflation started in 2016, is the underperformance of defensive sectors, and in this case US Staples vs the S&P500 Index. On both oscillators series (lower and upper rectangles), **we believe this trend is currently reaching an important intermediate bottom, which could see Staples bounce and outperform vs the market over the next 3 to 5 quarters. The downside risk is now rather limited** given that our I Impulsive targets to the downside have been reached (right-hand scale), **while the long term rebound potential of Staples vs the market could be above 20%.**

US Dollar Index
Bi-Monthly graph or the perspective over the next 1 to 2 years

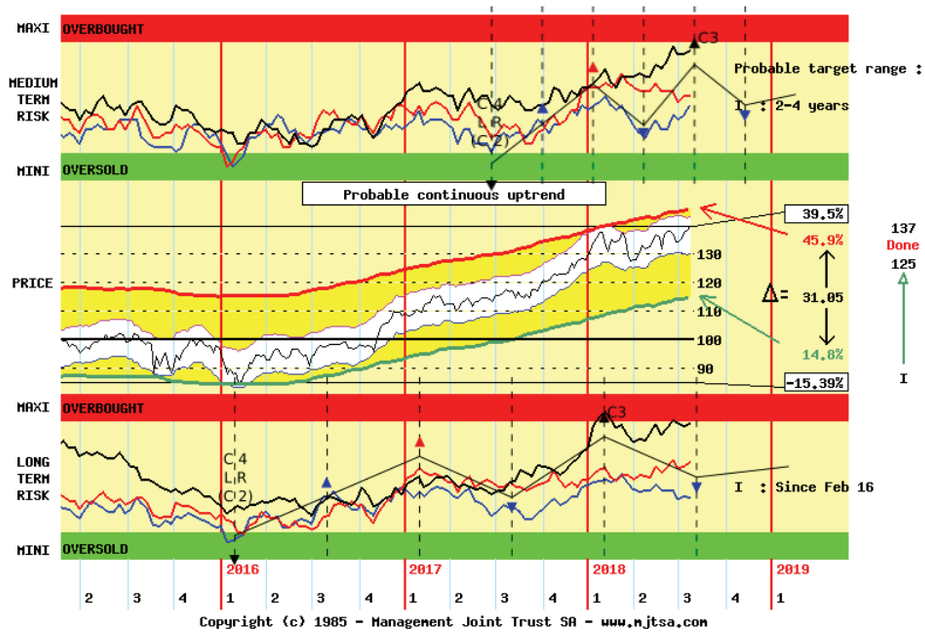


Finally, the US Dollar has had a schizophrenic relation with the recent reflationary trend. Throughout 2016, reflation was mainly a US story, culminating with the economic euphoria around the Presidential election. The US Dollar gradually reversed up and accelerated. **In 2017, many of the upbeat post-election projections were momentarily deceived. At the time, Europe entered its own period of recovery and hence the Euro firmed and the US Dollar corrected. We believe this correction to the downside ended this Spring**, when both our oscillator series (lower and upper rectangles) found support points while the Dollar Index held above the lower end of our C Corrective targets to the downside (right-hand scale). **We now expect the US Dollar to continue higher possibly into early / mid 2019 on our medium term oscillators (upper rectangles) and perhaps even into end 2019/2020 on our long term oscillators (lower rectangle).**

Initial remarks:

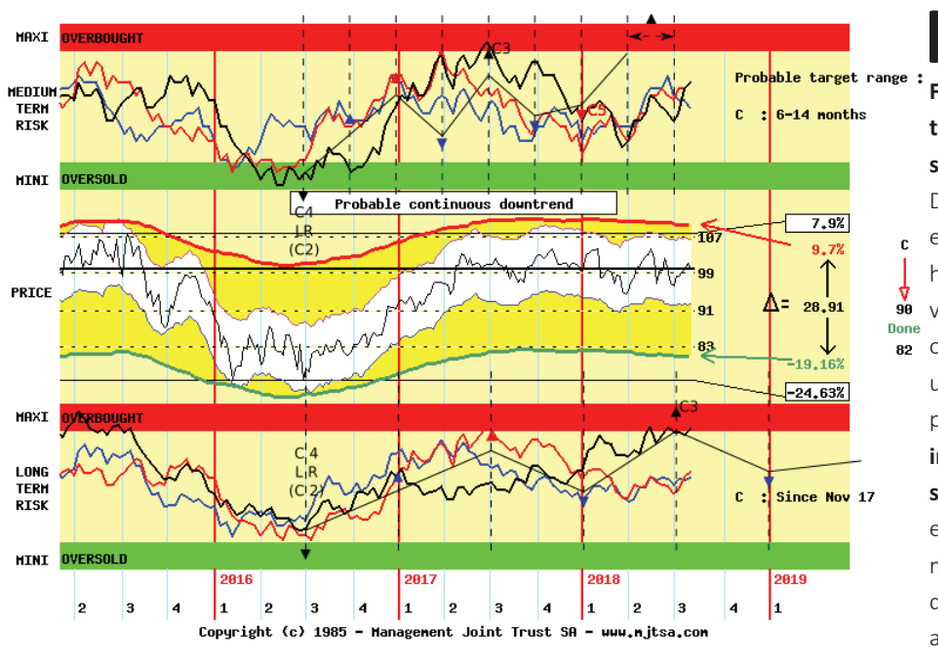
The 4 graphs above hence summarize our cross-asset views towards year-end and then 2019. While we expect the uptrend on the S&P500 to be reaching exhaustion, Defensive sectors should start to rebound vs the market, possibly over the next 3 to 5 quarters. In the meantime, cyclical Commodities, and Oil especially, have probably reached an important intermediate top and should correct down, while the US Dollar continues higher, possibly on Flight to safety concerns. These projections may experience transitory counter-trends, yet should generally remain in place, probably at least until Spring next year and possibly towards end 2019. Given the above, we believe that over the coming months, investors should start to gradually shift to more defensive, less pro-cyclical investment strategies.

S&P500 Index vs US 10Y Treasury Bonds
Weekly graph or the perspective over the next 2 to 4 quarters



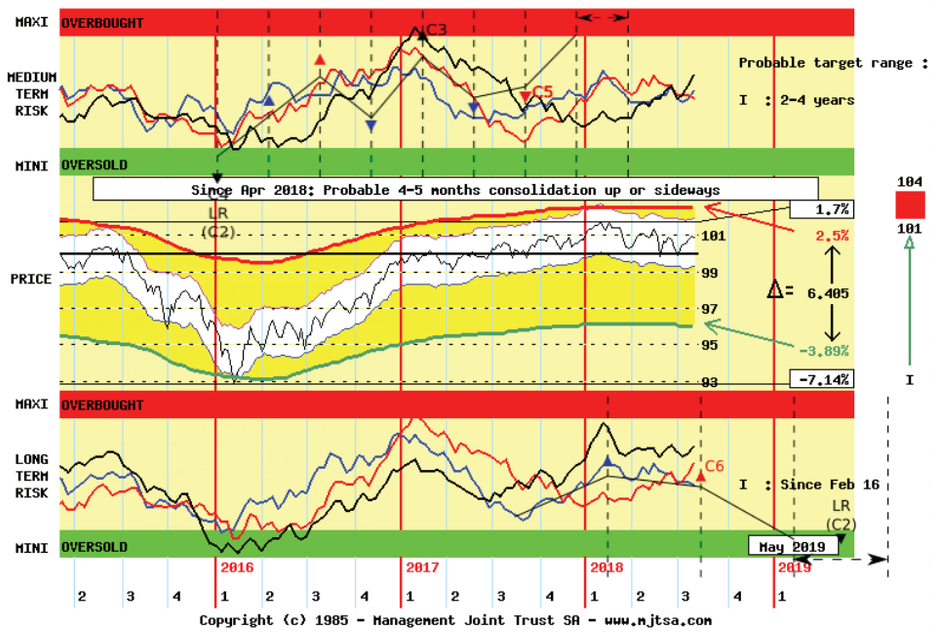
We first consider the relative performance of the S&P500 vs US 10Y Treasuries. Since mid 2016, while the S&P500 was racing to new highs, Treasuries have corrected quite substantially. Indeed, over this period, long term rates in developed countries have managed to pretty much follow short term rates up, as economic and inflation perspective gradually normalized. According to our I Impulsive targets to the upside (right-hand), the ratio has now reached its upside potential. On the timing front, our long term oscillators (lower rectangle) signalled an important top in Q1, while our medium term oscillators (upper rectangle) are probably pointing to the end to the current upside retest. Hence, **we now expect the ratio to start correcting down, first into the Fall, and then into 2019. This would favour long term US Treasuries over the S&P500**, a scenario which matches our views in the article on the US Yield Curve further down in this issue of The Capital Observer (pages 49 to 56).

EuroStoxx 50 Futures vs Bund Futures
Weekly graph or the perspective ove the next 2 to 4 quarters



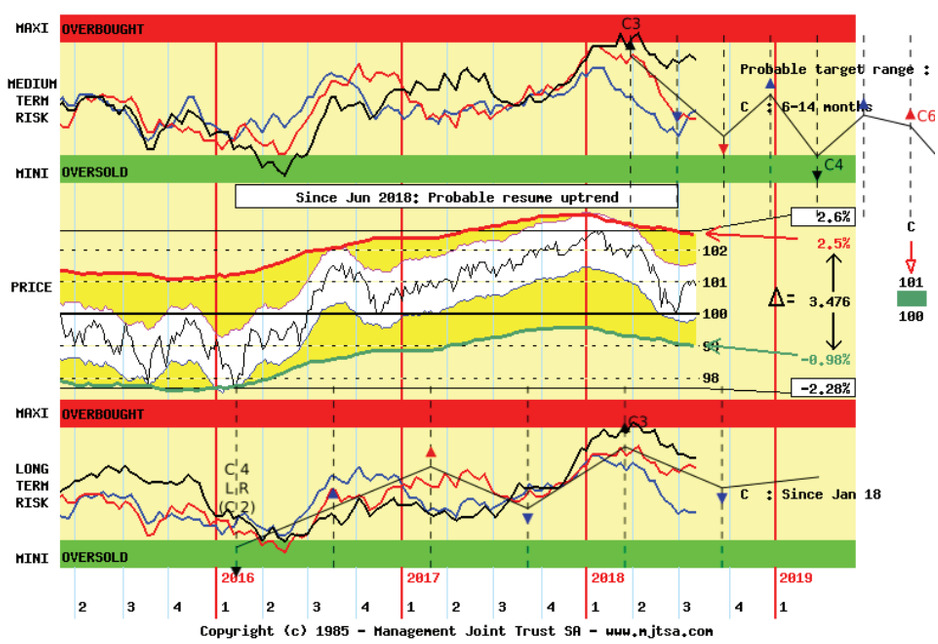
In Europe, the ratio of the EuroStoxx 50 Futures vs Bund Futures lost upside momentum in Spring last year and has since been moving sideways. During this period, our trend envelopes (middle rectangle) have gradually started to reverse down, while both our oscillators series (lower and upper rectangles) have now probably reached **important inflection points to the downside.** Going forward, we hence expect that European equity markets should start to underperform the German Bund again. Our C corrective targets to the downside (right-hand scale) suggest that **over the next few quarters, the ratio could drop back down towards its 2016 pre-reflation lows.**

US and European High Yield vs US and German Government Bonds
Weekly graph or the perspective over the next 2 to 4 quarters



We now turn to Credit and especially High Yield. This portfolio we show attempts to capture the performance of **High Yield vs Government Bonds on both sides of the Atlantic** (equal weighted Long US and Europe High Yield, combined with equal weighted Short US Treasuries and German Bunds). Both our medium term oscillators (upper rectangle) and our I impulsive targets to the upside (right-hand scale) suggest that **the move up since 2016 reached its timing and price target potential in Q1 this year.** On our long term oscillators (lower rectangle), we show the recent upside retest and its failed attempt to reach new highs. We believe this failure confirms the **reversal down we are expecting, probably towards Spring next year** (as suggested by our automatic messaging which is pointing towards a low in "May 2019" - lower rectangle). The ratio could retrace back towards the support of its Q2/Q3 2016 tops.

Emerging Markets and European Sovereigns vs US and German Government Bonds
Weekly graph or the perpective over the next 2 to 4 quarters

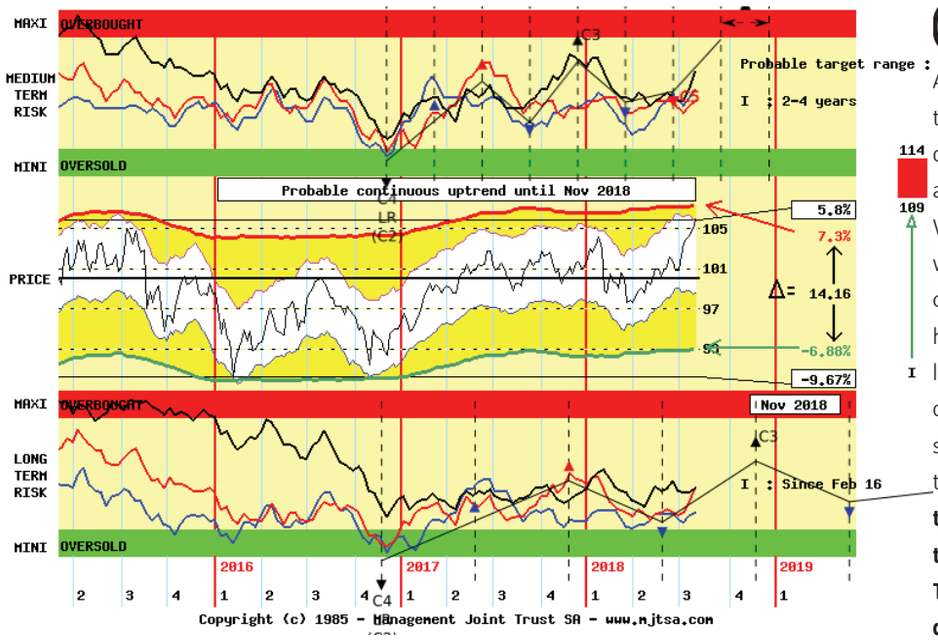


In this graph, we simulate a similar portfolio, which compares equal weighted Long positions in Emerging Markets and diversified European Sovereigns vs equal weighted Short positions in US and German Government Bonds. On our long term oscillators (lower rectangle), **the model we show confirms that a reversal down (Sovereign Credit deterioration) started in Q1 this year.** On our medium term oscillators (upper rectangle), **we expect further downside pressure into late Summer, then a bounce into the Fall, followed by further weakness into Spring next year**. Any break below the recent June lows (i.e. below our C Corrective targets to the downside), would open the door towards much lower targets, probably retracing to whole move up since early 2016.

Equity to Bonds ratio and Credit spreads – initial remarks:

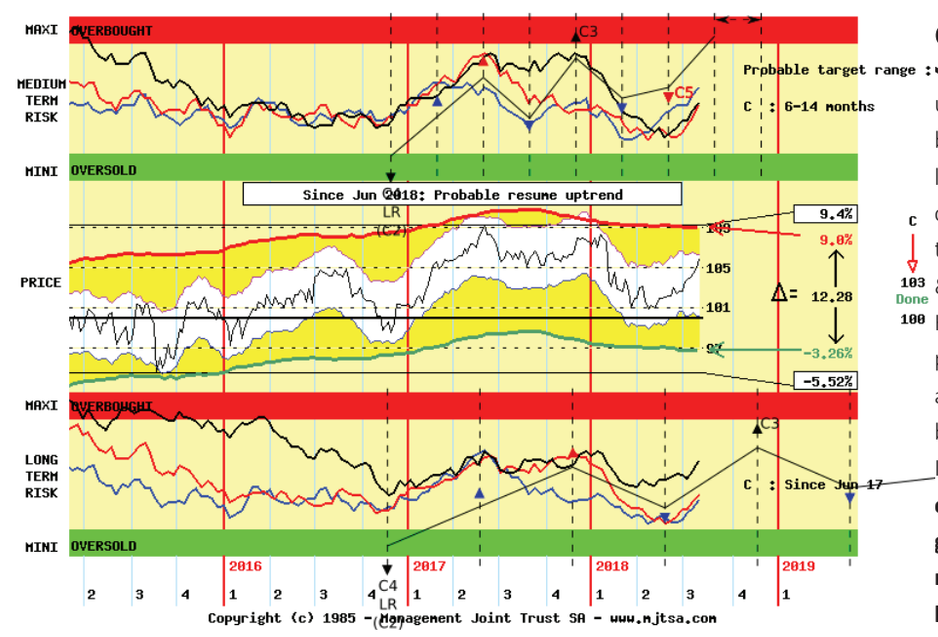
We believe the reflationary uptrend in place since 2016 is coming to an end and that following strong equity outperformance, US Treasuries and German Government Bonds should make a come back vs Equities over the next 3 to 5 quarters. We also expect that Credit and Sovereign spreads continue their recent reversal up (Credit continues to deteriorate), so that we would recommend to concentrate any bond investments on the highest quality of issuers.

US and European Healthcare sectors (equal weighted portfolio)
Weekly graph or the perspective over the next 2 to 4 months



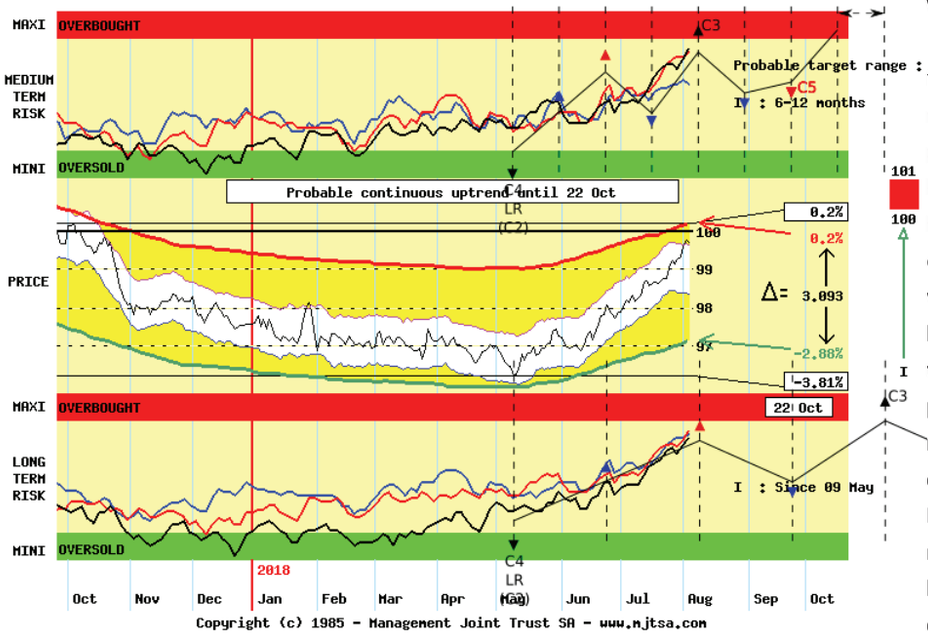
Over the coming pages, we perform similar cross Atlantic simulations to assess the profiles of the various defensive sectors on a stand-alone basis and vs the markets. We first start with Healthcare, which has had a strong run over the last few months and has been one of the market leaders since this Spring. According to both our oscillator series (lower and upper rectangles), **the Healthcare sector probably continues higher towards late Q3/early Q4. The upside potential is still quite important, somewhere between 5 and 10 %** according to our I impulsive targets to the upside. Healthcare is a typical late cycle performer and this cycle is no exception.

US and European Staples sectors (equal weighted)
Weekly graph or the perspective over the next 2 to 4 quarters



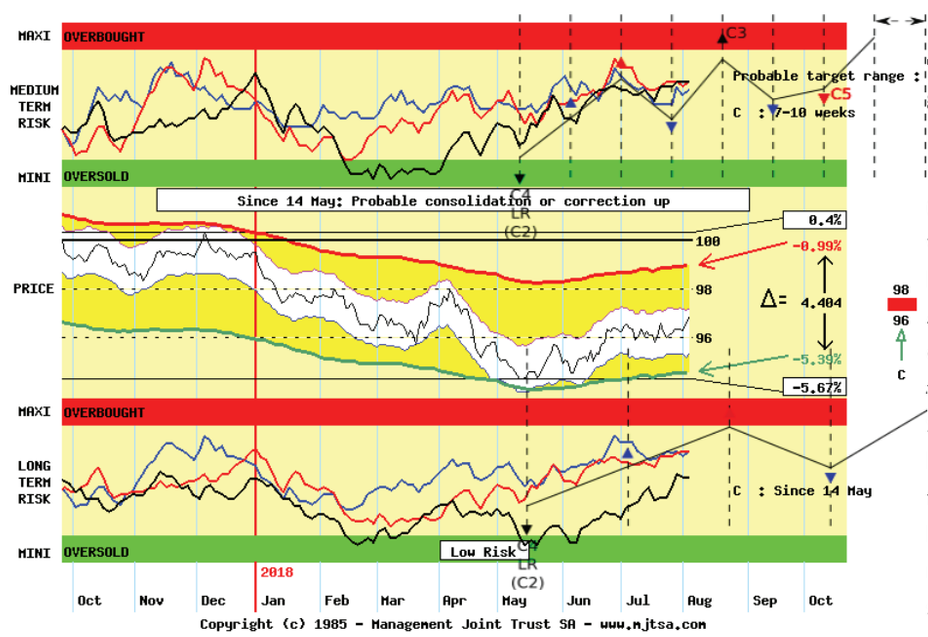
Staples show a similar profile as Healthcare, yet their uptrend since this Spring has been less strong. To simulate this portfolio, we have combined the US Staples sector with the European Food & Beverage and Personal & Household Goods sectors. The portfolio is USD denominated and European positions have been hedged for currency risk. Indeed, as with Healthcare, **we expect Staples to continue higher, possibly towards marginal new highs in late Q3 / early Q4** (both oscillators series - lower and upper rectangles).

US and European Healthcare vs their markets (equal weighted)
Daily graph or the perspective over the next 2 to 3 months



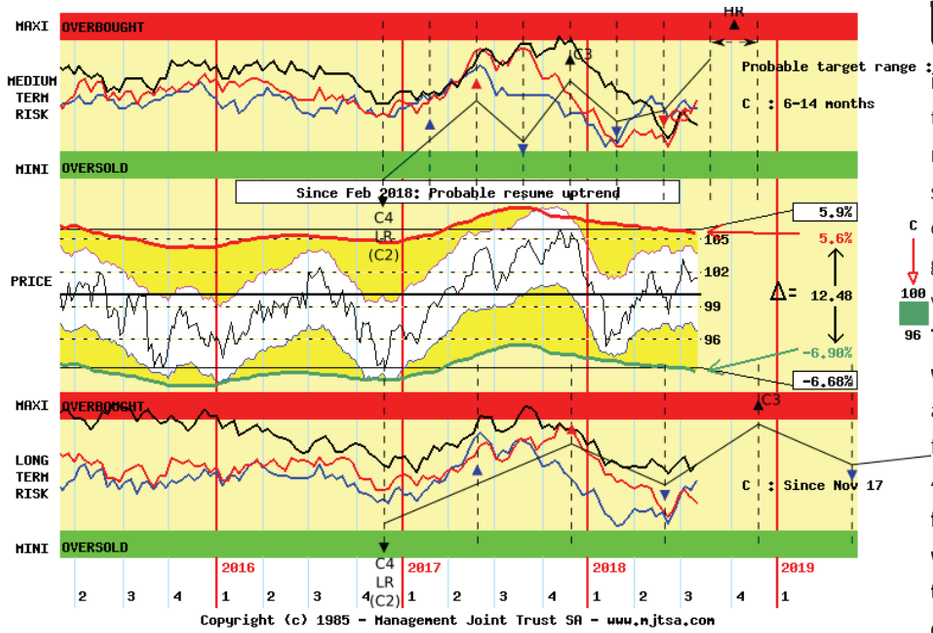
We now turn to the Daily graphs of these 2 defensive sectors and benchmark each element of the portfolio vs its respective market index. This particular graph hence compares Healthcare on both sides of the Atlantic vs the wider market. **Recently, Healthcare's correlation to the market has been quite positive. Hence, if the wider market does start to correct over the next few weeks, Healthcare may not profit much on a relative basis. Following this soft patch and according to both our oscillator series (lower and upper rectangles), Healthcare continues to outperform the market, probably towards late October in first instance.** Overweighting the sector may hence work best from late August into late October.

US and European Staples vs their markets (equal weighted)
Daily graph or the perspective over the next 2 or 3 months



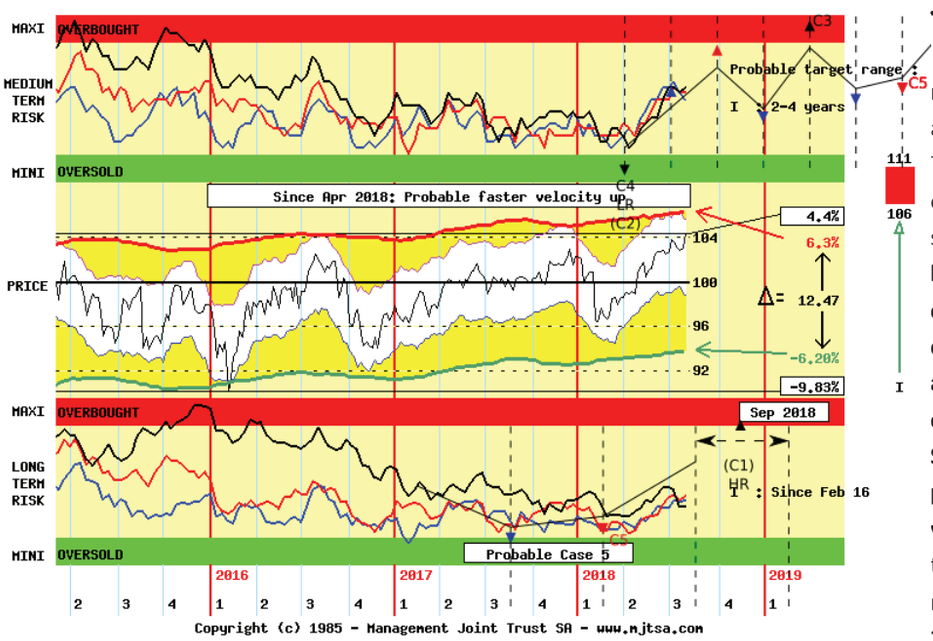
Staples on the other hand are still very much negatively correlated to the markets on a relative basis. On both our oscillator series (lower and upper rectangles), we expect them to outperform between now and the end of August. Following that, they could retrace down again vs the market, probably into late September, perhaps mid October. Their outperformance vs the market is indeed in its early stages (i.e. below our C Corrective targets up – right-hand scale), and we cannot exclude that Staples retest down vs the market during the Fall. **We would hence consider Staples as a pure relative play: they may outperform over the next few weeks (Overweight), but will then retrace as the market attempts to retest up into October. Following that, from mid/late October into next year, Staples should really start to outperform (Overweight).**

US and European Utilities sectors (equal weighted)
Weekly graph or the perspective over the next 2 to 4 quarters



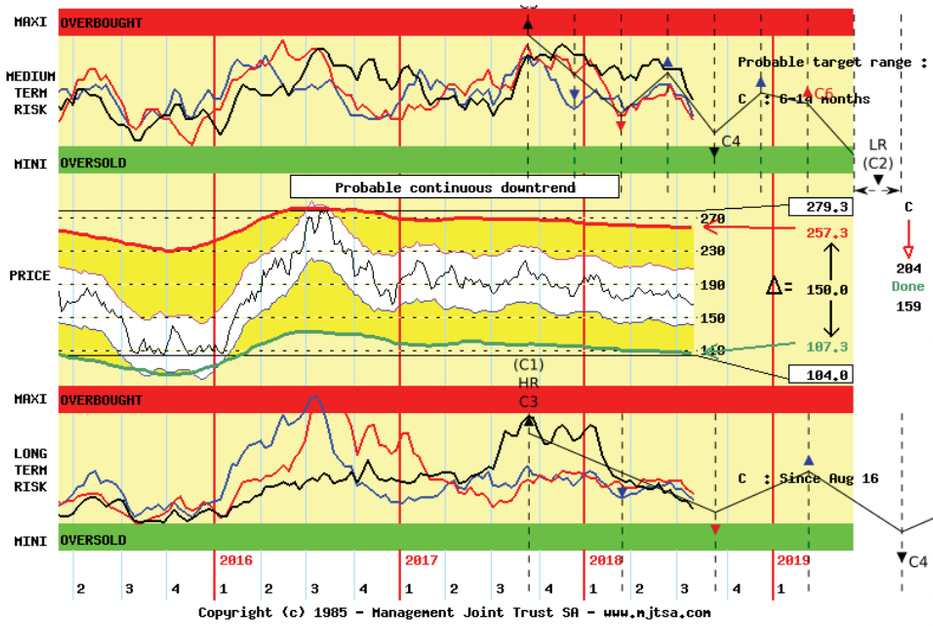
Utilities are also a pure defensive play. The sector is also particularly sensitive to any rise and fall in interest rates. It's a Bond proxy, which since early 2016 has followed equities up, but corrected aggressively each time long term yields have accelerated up. **The flattening environment we expect until year-end** (our article on the US Yield Curve further down this issue, pages 49 to 56) **should be beneficial for Utilities, and indeed, as with Staples, we expect them to move up towards late Q3/ early Q4 on an absolute basis** (both our oscillator series – lower and upper rectangles). On a relative basis, we would hence expect them to outperform over the next few weeks, retrace down during September/October, and then outperform again towards next year.

US and European Real Estate sectors (equal weighted)
Weekly graph or the perspective over the next 2 to 4 quarters



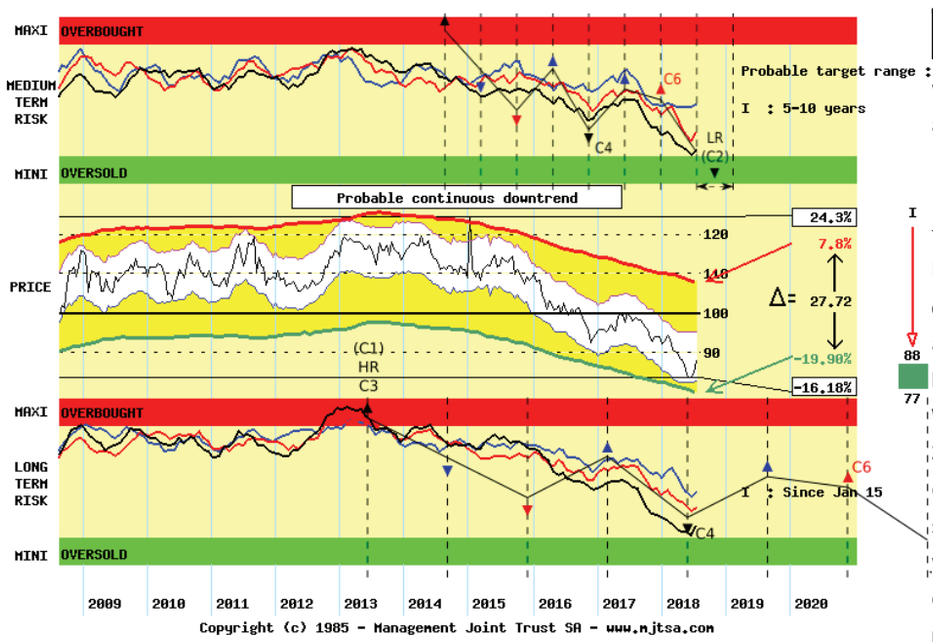
The Real Estate sector is also very sensitive to interest rates and as such shows a similar profile than Utilities. That said, in this late cycle environment, it seems to be stronger. Indeed, **it recently made new highs for this cycle and according to both our oscillator series (lower and upper rectangles) should continue to do so into late September, and then again possibly even into early next year**. Our I Impulsive targets to the upside (lower and upper rectangles) point to between **2 and 6% of additional performance until then**. On a relative basis, it should outperform the market over the next few weeks, then retrace a bit during September and October, and then outperform again towards year-end and early next year.

Gold Bug Index
Weekly graph or the perspective over the next 2 to 4 quarters



Traditionally, Gold mines are often viewed as a defensive sector. Their profile is however slightly different from the sectors above. Indeed, Gold mines mostly correlate with Gold, declining interest rates and the last stages of equity market sell-offs (or the very early stages of an equity market rally). Currently, both our oscillators series (lower and upper rectangles) are suggesting that **Goldmines could bounce from September into the the Fall**. We believe that during this period, the Dollar may retrace a bit, while long term yields start to move lower and equity markets attempt a further upside retest. This may prove positive for Goldmines for a couple of months. **That said, from late Q4, at the latest during Q1, we expect Goldmines to resume lower again as the US Dollar makes a comeback (Flight to Safety) and equities sell-off.** During this period, we believe that physical Gold will probably be a much safer defensive alternative than Goldmines.

Swiss Market Index vs the MSCI World Index
Bi-monthly graph or the perspective over the next 1 to 2 years



Finally, looking at possible defensive geographies, we naturally circle in on Switzerland, where together Food & Beverage and Healthcare account for more than 55% of the Swiss Market Index weighting. We've compared it here vs the MSCI World without hedging for currency risk as the Swiss Franc traditionally also has a defensive bias (i.e. **defensive sector mix plus a defensive currency**). On both our oscillator series (lower and upper rectangles), we believe that **the SMI Index has reached important lows vs the MSCI World and that it may now correct up between 3 to 5 quarters**. Our I Impulsive targets to the downside (right-hand scale) have been reached signalling exhaustion of the recent downtrend, while the C Corrective targets to the upside we can calculate would suggest **15 to 25% rebound potential into next year** (0.5 to 0.8 times our historical volatility measure "Delta" - middle rectangle, right-hand side – added from the lows).

Concluding remarks

Our long term graphs on the S&P500, on Defensive sectors vs the market, on Oil and on the US Dollar suggest that the reflationary environment in place since early 2016 may be coming to an end and that we are probably on the verge of a defensive cross asset shift. Indeed, Equity to Bond ratios are stretched and could be reversing down soon, while Credit has already started to deteriorate and should continue to do so over the next few quarters. Hence, high quality bond issuers now represent an interesting alternative to equities which we believe are at the end of an extended uptrend. Similarly, defensive sectors could outperform over the next 3 to 5 quarters. On an absolute basis, they represent a safer bet that general market indexes into a first market correction which we believe could materialize over the next few weeks, and given the uncertainty around the strength of a last equity rally into the Fall (i.e. safer risk/reward). Healthcare looks particularly strong and it could continue to perform on a stand-alone basis while also outperforming the market over the next few months. Finally, geographically, we like Switzerland given its defensive sector profile and its defensive currency. International investors should consider it, while it may be time for Swiss Investors to repatriate some funds into their domestic market.