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A DC&C publication,
featuring MJT timing methodology

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Diapason Commodities & Currencies

MJT

DIAPASON COMMODITIES AND CURRENCIES MACRO ANALYSIS

A Monthly Macro and Asset Review

Featuring MJT Timing Methodology

Contents

> ***"Car sales have been weakening, housing has been slowing down, the debt levels are extremely high, and short-term interest rates are going up, so it's hurting some sectors of the market which are interest rate dependent. And I think the economy by and large will disappoint in the next three months. Let's say the Fed realizes that the deficits for the U.S. go up and that interest rates increase and that the economy slows down, do you really think that they will increase the Fed funds rate three times in 2017? Never. What they will aim at, then, is to essentially bring interest rates down, especially if by then the dollar is still strong."***
>
> ***Marc Faber***

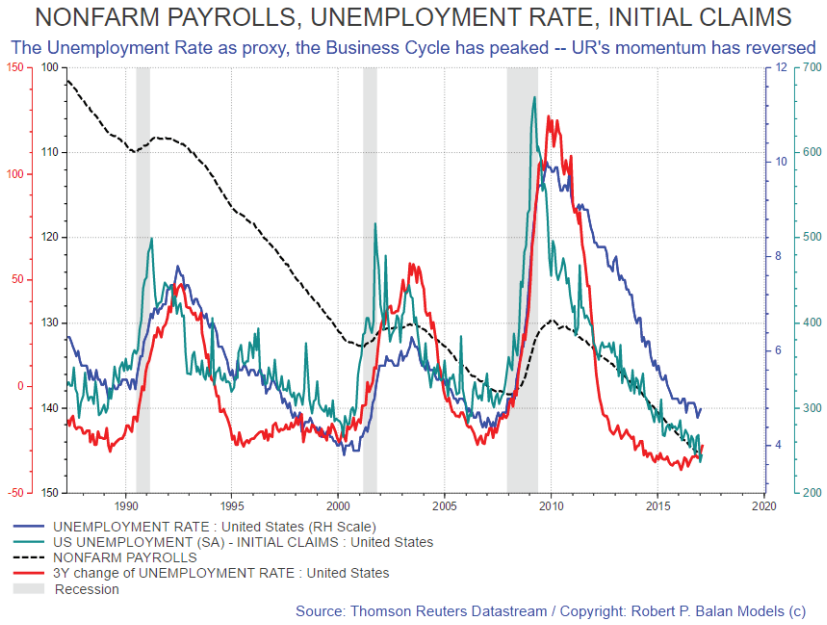
4/ Jobs Report Headlines Still Looks All Right, But The Internals Deteriorate As The Business Cycle Matures

The January jobs report on Friday stated that net non-farm payrolls increased by 227,000 jobs overall while the civilian unemployment rose to 4.8%. Comparative data have been good: the private non-farm payrolls sub-component added 237,000; net private sector jobs rose 0.19% month-on-month, increasing 1.80% from a year ago; employment in January was 6.30% higher than the previous peak level of employment reached in December 2007, just before the onset of the Great Financial Crisis (GFC).

Most of the news headlines have celebrated the fact that the January 2017 employment creation beat expectations (227,000 new jobs, versus 180,000 consensus). However, the January jobs report is more nuanced than a simple reading of the headlines, and contains some internal data which, taken collectively, suggest that the current Business Cycle may be starting to show signs of aging. Here are a couple of such nuanced details -- (1) if we incorporate the 39,000 total revisions to the November and December data, the average comes down closer to expectations, and the 3-month moving average becomes less impressive than what the headline numbers imply; (2) The Unemployment Rate ticked up to 4.8% from December's 4.7% ---seemingly inconsequential, but this looms large as it signifies a loss of momentum for the downward trend in the Unemployment Rate – a sign that the Business Cycle is becoming mature.

There are other developments which need to be monitored closely: (1) there was little upside progress on wages, with average hourly earnings increasing just 3 cents and 2.5 percent on an annualized basis. The average work week remain unchanged at 34.4 hours. Wage growth declined despite 19 states increasing minimum wage laws in January; (2) employment in the key working age group of 25-54-year-olds fell 305,000, but this was partially offset by a 195,000 increase in 55+ employment cohort. Normally, it should be the reverse --- so more near-retirement people working and fewer people in prime working years in the active labor force isn't a positive sign at all; (3) the pace of job growth continues to slow in relative terms -- total payrolls rose in January is up 1.6 percent year over year versus 1.9 percent in the Q1 2016, which is typical with an economic recovery that is getting long in the tooth; (4) there was an increase in those working part-time (by 232,000) because they cannot find full-time work. In a healthier jobs environment, the number of those working part time should be declining. In this regard, the underemployment rate (reference: the U6) rose to a three-month high of 9.4 percent from December's 9.2 percent. It is worthwhile watching the jobs data sets discussed in item number (4) because these are the metrics that Fed Chair Yellen's watches closely, and are supposed to influence her decisions regarding monetary policy.

Even data that appears benevolent at the surface has to be critically examined for possible adverse ramifications in the future. One such example is the growth in Civilian Labor Force (CLF). The BLS said that CLF increased by 584,000 in January, and the labor force participation rate rose by 0.2 percentage point to 62.9 percent. Total employment, as measured by the household survey, was up by 457,000 over the month, and the employment-population ratio edged up to 59.9 percent. That was taken as good news -- more people are joining the labor force. But in terms of metrics like the Unemployment Rate (UR), that is not so good a news -- the rise in CLF will mathematically start pushing the UR after a few quarters, all conditions remaining the same. With labor force participation rising, even as job openings become scarcer, employment conditions are actually being dealt a double negative whammy, and the UR could start reversing

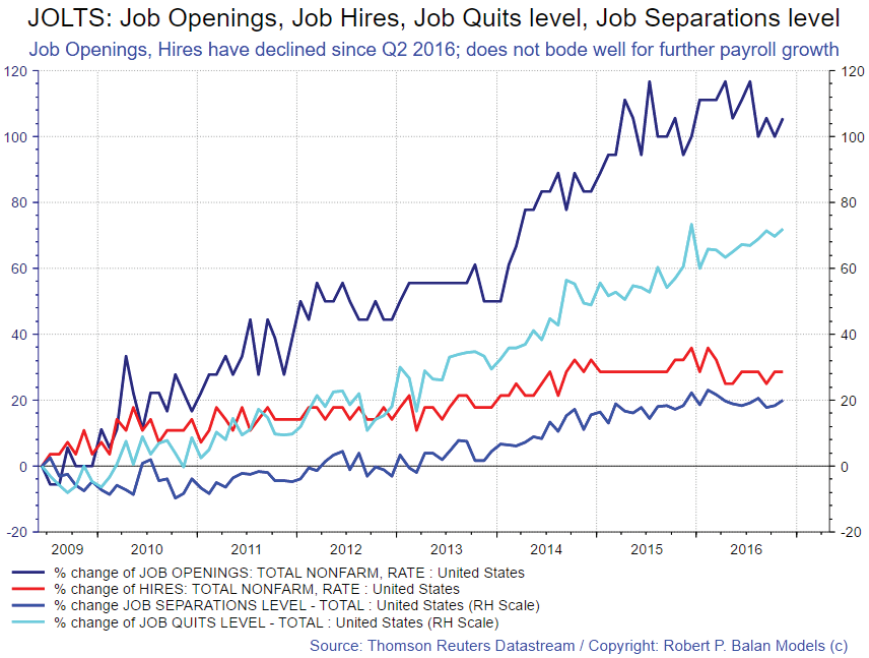


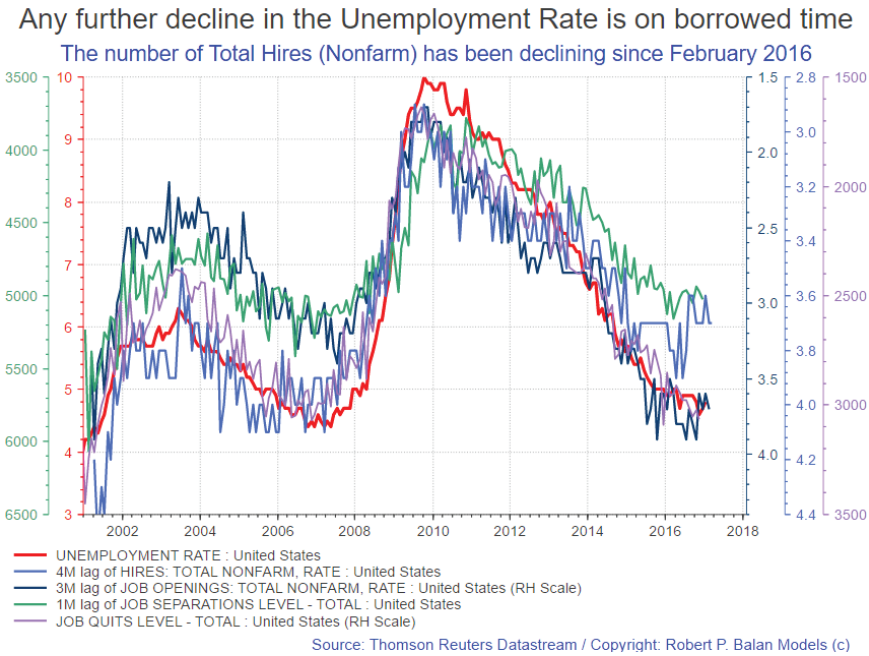
quickly to the upside, if both negative factors show up at the same time.

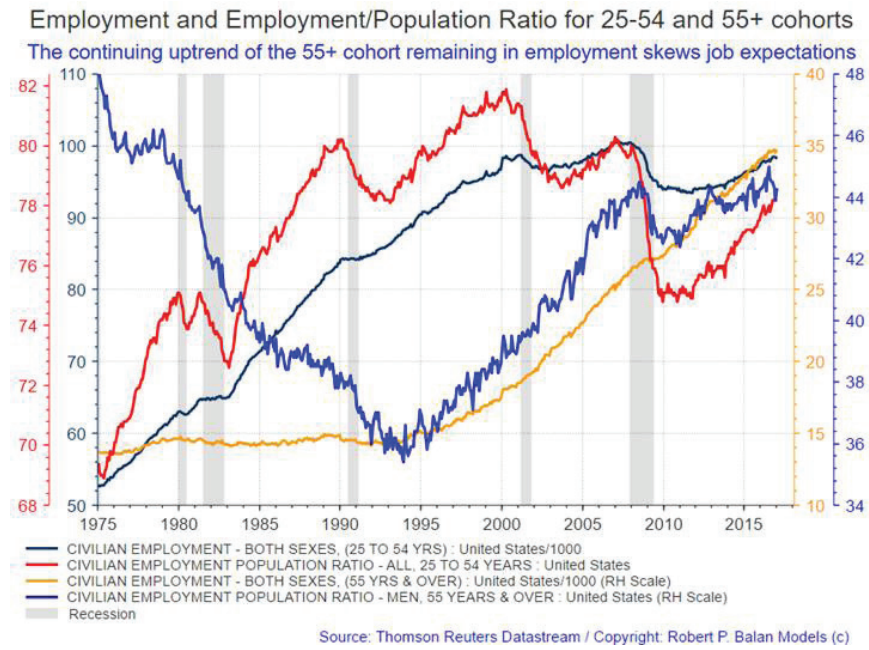
There is now a record spread between job openings and hirings in the monthly Job Openings and Labor Turnover Survey (JOLTS) report. This issue will continue to be a drag on employment growth, as well as a negative to domestic economic growth. This is happening even as the total jobs opening, and hires, as indicated in the JOLTS Report, are on the decline, and have been so since February 2016. This is hardly indicative of further growth in payrolls down the road. The separations data has also flattened, signifying that employees have gotten less sure about quitting their jobs now as they may not be able to find employment elsewhere, as job availability is starting to tighten.

The JOLTS Report is not the only worrisome metrics with regards to the labor market. We go back to First Principles and identify the crucial data sets which influence the jobs market at the outset, and there nothing more primary in this regard than credit extended by commercial banks, the steepness of the yield curve, and the banks' consequent Net Interest Margin (NIM), an important benchmark which motivates the banks to increase lending or not. NIM is a measure of the difference between the interest income generated by banks or other financial institutions and the amount of interest paid out to their lenders (for example, deposits), relative to the amount of their (interest-earning) assets -- Wikipedia.

Collectively, if the amount of banks' non-performing assets are high, their NIM will go down if the interest earning assets are steeply reduced by non-performing assets, and vice versa. A steeper yield curve provides better conditions for the banks' NIM to rise, which reduces the need for larger portfolios for riskier loans -- hence loan levels fall when the yield curve steepens. The linkage to the job sector flows





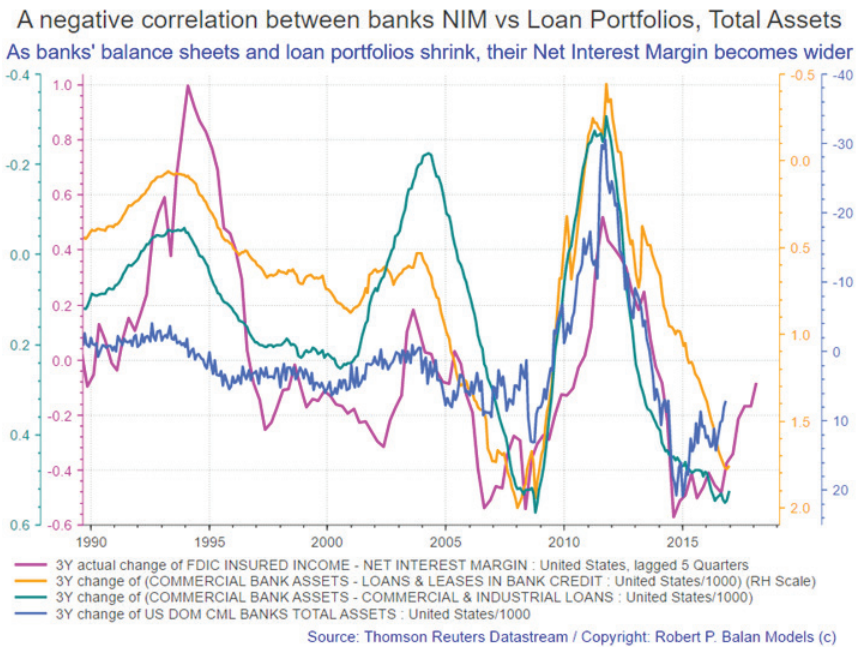


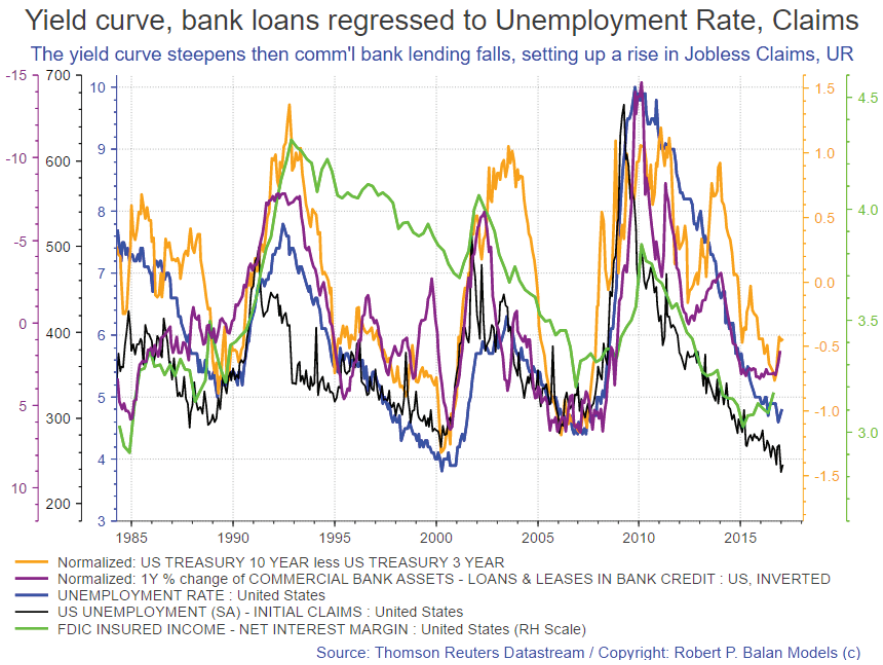
from the steepness of the yield curve to the amount of lending, then to the jobless insurance claims and the unemployment rate. Put another way, when the yield curve steepens, commercial lending volume falls, and the tighter credit situation impacts hiring and payroll growth after a lag, with concomitant effects on unemployment and jobless insurance claims.

Conclusion:

The deteriorating internals of the jobs report in January may be manifestation of the worsening of the macro data which have significant impact on jobs. Bank loan data is starting to fall, not only YoY but also on nominal levels, even as the US yield curve continues to steepen (the long-end is rising faster than the short-end). The banks' NIM is also rising, and so financial entities find other, more profitable, ventures (as in greater financial leverage) relative to outright lending to a riskier class of borrowers. Developments in lending usually take several quarters to manifest in the jobs market, so it may be that we have a few more months of jobs growth.

But it is increasingly becoming clear that the upswing phase of the current Business Cycle is starting to show signs of aging. While we remain upbeat about the prospects of risk assets into late 2017 –- after a pause in Q1-early Q2 --- it may be necessary thereafter to start rotating again into assets that do well during the late stages of the Business Cycle, like hard assets, including commodities.



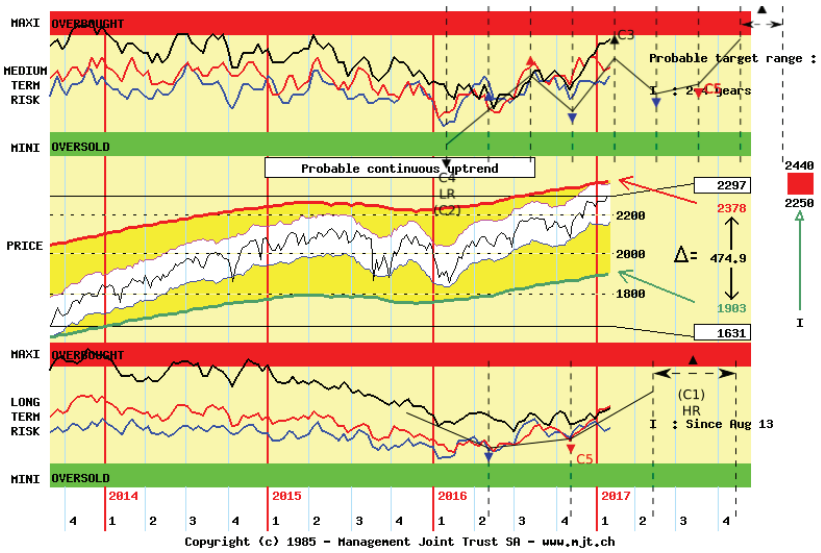


7 / MJT TIMING INSIGHT

While equity markets consolidate, Big Growth should outperform

US market indexes are making new all time highs. Yet a period of consolidation/correction is expected on the downside from the end of February as presented in our January newsletter. Indeed, we see it materializing from end February into April and possibly May. In this section, we look at US sectors rotation and their relative outlook as we approach this consolidation period.

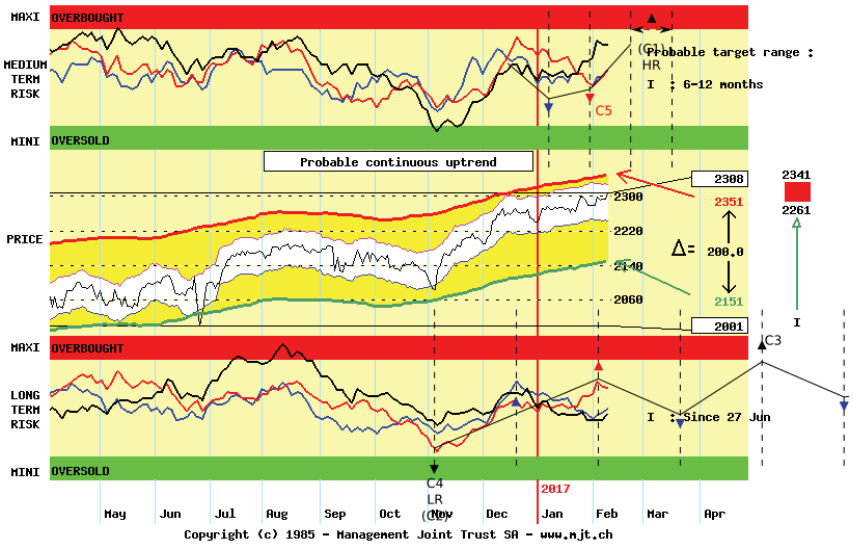
S&P500 Index
(Weekly graph or the perspective over the next 2 to 4 quarters)



Since its lows early last year, the S&P500 has followed a typical uptrend sequence on our medium term oscillators (upper rectangle). An intermediate top is expected over the next few weeks, which could trigger 2 to 3 months of consolidation on the downside. This configuration is especially visible on the following sectors: Energy, Materials, Industrials. On our long term oscillators (bottom rectangle), we project a stronger continuation trade into the second half of the year (Case 5) . It seems predominant on Financials and to a lesser extent Technology. The resultant of these two scenarios is probably one of a consolidation period into Q2 2017 before the market re-accelerates into H2 2017.

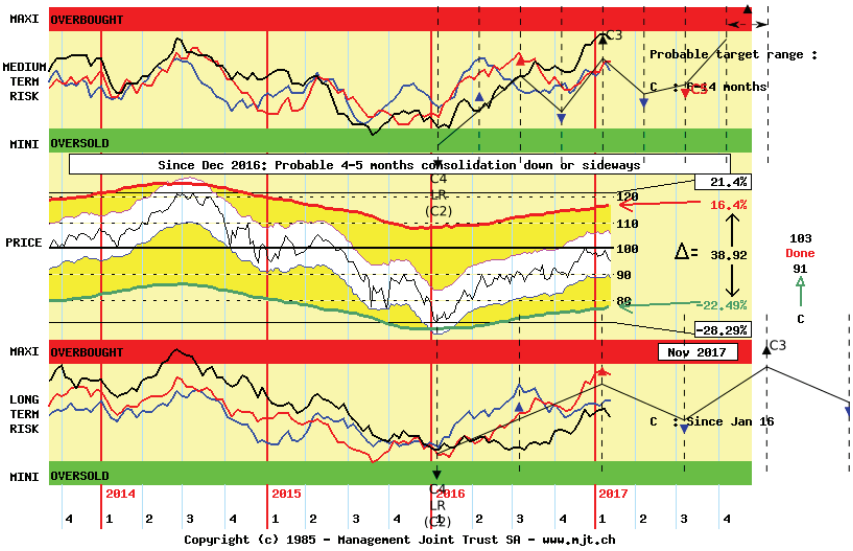
S&P500 Index
(Daily chart or the perspective over the next 2 to 3 months)

Following the intermediate top made in August 2016, the S&P500 Index has re-accelerated into a High Risk zone early this year (between January and February as mentioned in previous letters). As shown by the model on our long term oscillators (lower rectangle), a correction to the downside is expected from mid February to early April. The model on our medium term oscillators (upper rectangle) also shows a top towards the end of this month. The potential up left is very limited (targets shown on the right-hand scale).



To the downside, if we calculate corrective targets down, i.e. 0.5 to 0.8 times our delta (here at 200 points), in first instance the magnitude of this correction could be between 4% and 7%.

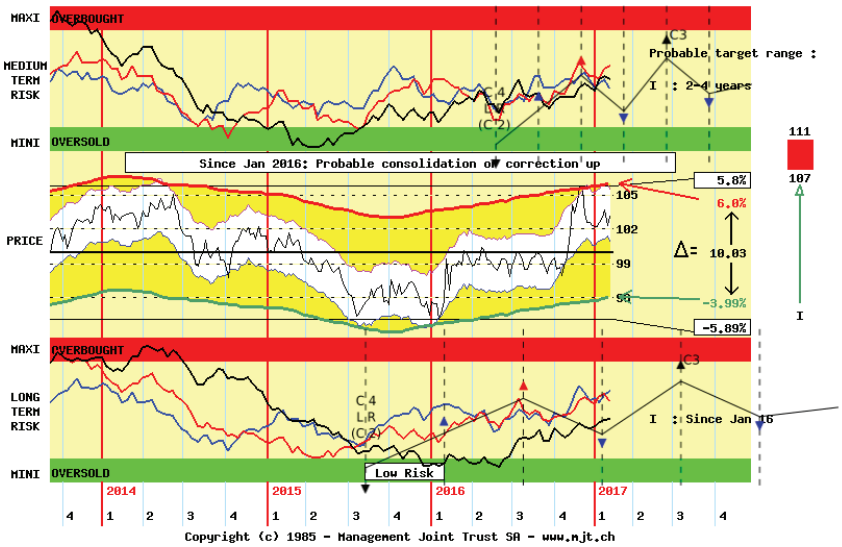
Commodity sectors, cap. weighted:
XLE (SPDR Energy ETF), XLB (SPDR Materials ETF)
(Weekly graph or the perspective over the next 2 to 4 quarters)



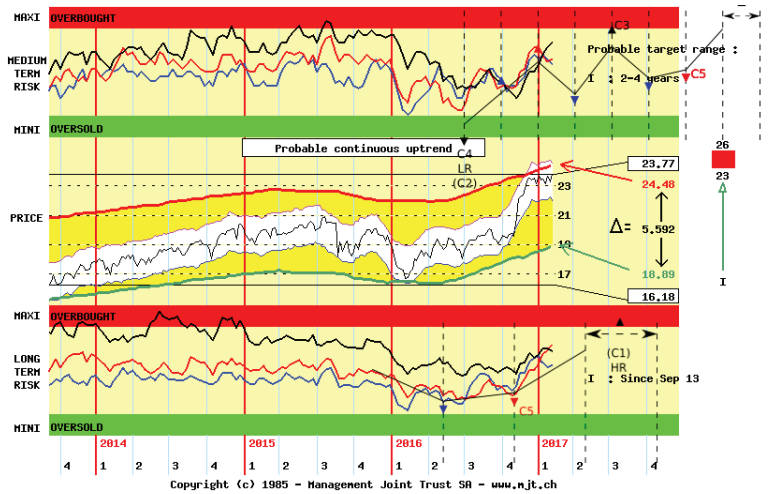
These cyclical commodity sectors show an intermediate top, which is very clear on both our oscillator series (upper and lower rectangles). Following a correction to the downside that could last between 3 to 6 months, prices should move up again towards year end and possibly early 2018. The relative graph of the Energy Sector vs the S&P500 Index (see page 21 in the Oil section of this document) is quite weak, suggesting that the underperformance of commodity sectors could last well into Q2 2017.

XLI (SPDR Industrials ETF) vs S&P500 Index
(Weekly graph or the perspective over the next 2 to 4 quarters)

Industrials are another cyclical sector. Their graph on a absolute basis (not shown) is quite similar to the one of the Commodity sectors above. However, on the relative basis vs the S&P500 Index, Industrials seem much stronger. On both our oscillators series (lower and upper rectangles), Industrials should hold and may start to outperform again from end March towards mid year.



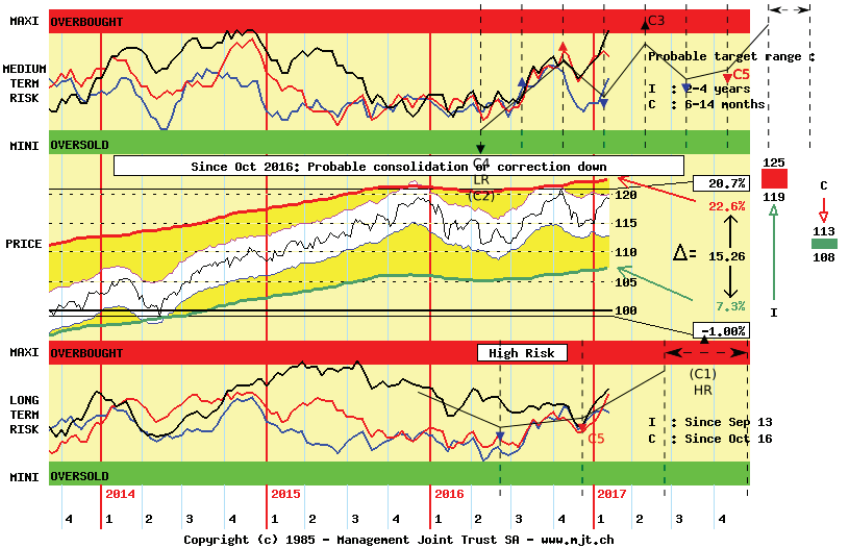
XLF (SPDR Financials ETF)
(Weekly chart or the perspective over the next 2 to 4 quarters)



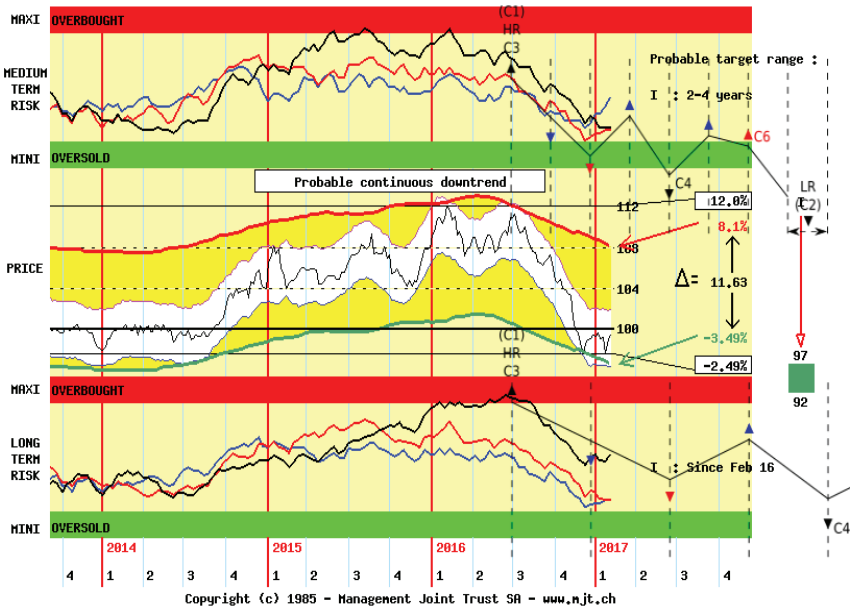
With rising interest rates, Financials have been very strong. Their absolute graph shows a strong Case 5 ('acceleration up') mid Q4 2016 on our long term oscillators (lower rectangle). On our medium term oscillators (upper rectangle), an intermediate top was made in December. A consolidation period could soon materialize into late March / early April before Financials accelerate up again towards mid year. The relative graph vs the S&P500 Index (not shown) is quite similar, so that Financials should remain strong outperformers towards mid 2017.

Nasdaq 100 vs the S&P500 Index
(Weekly chart or the perspective over the next 2 to 4 quarters)

Focusing on growth stocks, and Technology in particular, we look at the Nasdaq 100 index. It is used as a proxy for the sector and especially its larger stocks ('Big Growth'). On our longer term oscillators (lower rectangle), this relative graph has shrugged off a High Risk situation last October and now seems to be accelerating in a Case 5 configuration. The medium term oscillators (upper rectangle) are also following an uptrend sequence, possibly into mid Q2 2017 for a start.



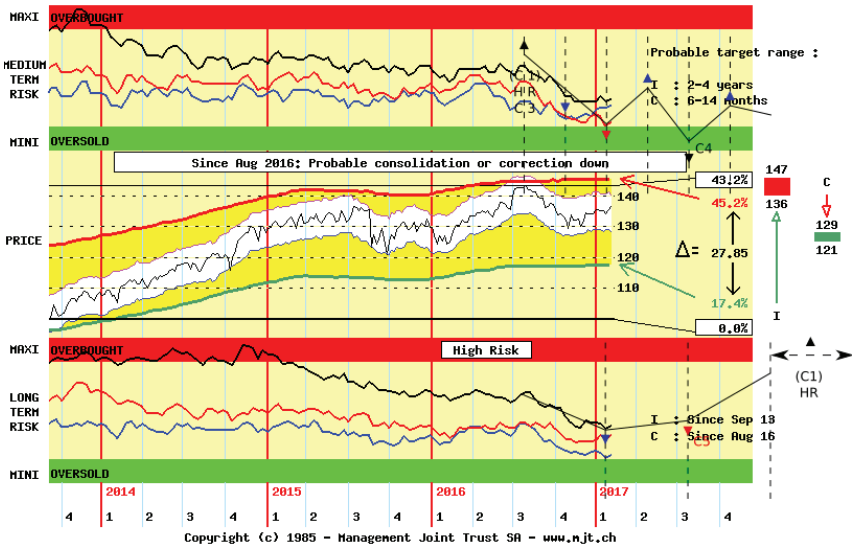
Defensive Sectors, cap. weighted, vs the S&P500 Index XLP (SPDR Staples ETF), XLV (SPDR Healthcare ETF), XLU (SPDR Utilities ETF) (Weekly graph or the perspective over the next 2 to 4 quarters)



Typically, as the business cycle matures, Defensive stocks should begin to perform better on a relative basis. Given the state of our current bull market, this could start happening during H2 2017. On a relative basis, the upward rebound of Defensive sectors already started in December. Up to now, it has been quite weak on relative basis, yet could last into late Q1 2017 before the downtrend resumes until mid year.

Defensive Sectors, Cap. weighted XLP (SPDR Staples ETF), XLV (SPDR Healthcare ETF), XLU (SPDR Utilities ETF) (Weekly chart or the perspective over the next 2 to 4 quarters)

On an absolute basis, however, we may have already seen the lows for these sectors. This is what the model we show on our long term oscillators would suggest (lower rectangle). Given our bullish view for equities into late 2017 / early 2018, we believe this positive scenario is probably more likely than the one we show on our medium term oscillators i.e. new lows in Q3 2017 (upper rectangle). Hence, if your time horizon is quite long and your prerogatives favor absolute over relative performance, it might be time to start accumulating defensive stocks again on any dip.



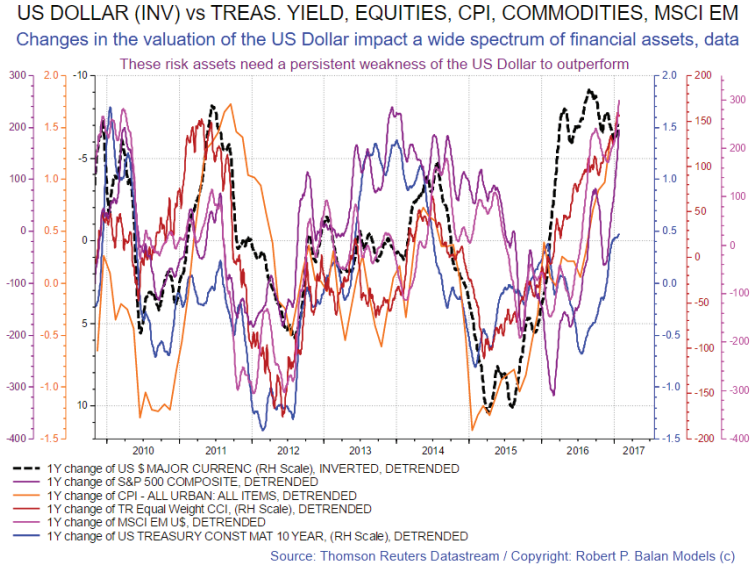
Concluding remarks:

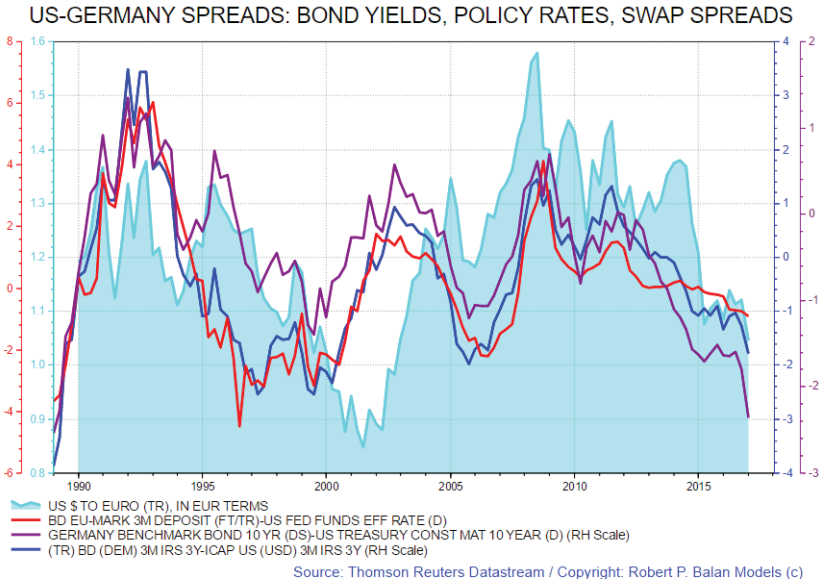
The S&P500 Index and more generally equity markets, should start to consolidate to the downside from end this month towards April/May. While it could affect all sectors, Commodity sectors should be impacted the most. On a relative basis, during this consolidation period, Financials and Big Technology (e.g. the FANGs) may prove particularly resilient.

11/ If Mr. Trump does what he promised to do, there's no way we will get a strong US Dollar

It is our view that the single most important factor impacting global markets in 2017 will be the value of the U.S. dollar. The currency's relative valuation impacts such heavyweight constructs such as US monetary policy, US corporate earnings, global trade flows, domestic capital budgeting decisions, the flow of capital into and out of emerging economies, and yes, global GDP growth, thereby global macro stability -- all of those are heavily influenced by the changes in the valuation of the dollar. Therefore, the primary driver of performance for almost any asset class in 2017 in both the Developed and Emerging Economies will be the Dollar. (see 1st chart on the right)

The overwhelming consensus view among global strategists is for another year of USD broad-based appreciation. We have trouble subscribing to this almost universal view, as that outlook primarily invokes the data set of short term interest rates and divergences in central bank monetary policy -- -- which unfortunately sometimes provide long-duration, false-positive signals in correlation tests (see 2nd chart on this page). There are other rationales invoked for a stronger US Dollar in 2017: further Federal Reserve tightening, supposedly leading to higher real interest rates in the U.S. which attracting assets away from competitor nations, the there-is-no-alternative meme (TINA), Brexit and populism weakening the standing of the pound and the euro, respectively, at a time when Japan is actively promoting a weaker yen in further attempts to boost domestic growth and inflation.

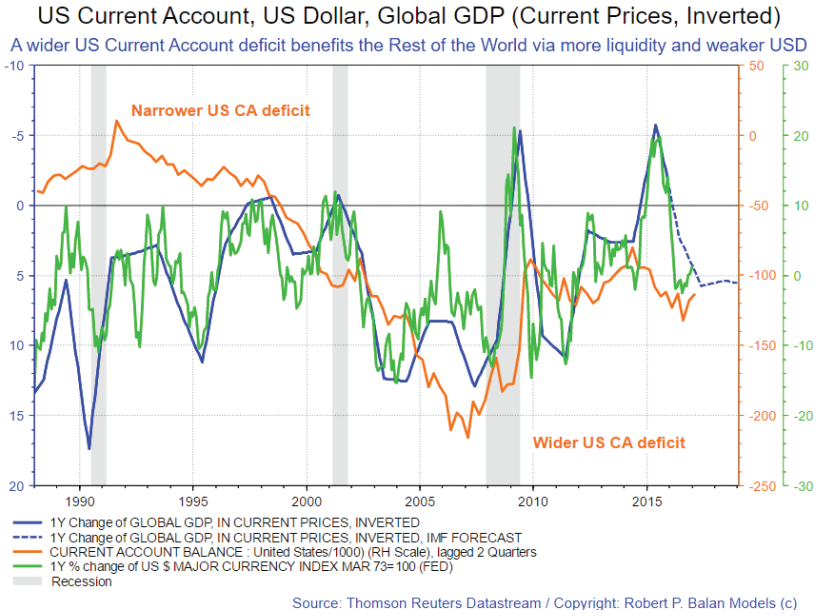




On top of all these, there's this persistent belief of some investors that the prospective effect of The Donald on the US economy (not to mention investor psychology) will continue to buoy the US currency (and other markets) against USD rivals. There are more nuanced and more sophisticated analyses, of course, and the most logical (to us) seek to provide answers to (1) what is the broader outlook for the US economy in 2017 as Mr. Trump implements his campaign promises which he said he will all do; (2) will President Trump policies seek to raise the growth profile and thereby push up the net returns on net capital stock (NCS) in the US economy by protectionist intervention (US stock of fixed assets grow at the expense of the Rest of the World (RoW)) ? (3) will he try to bump up growth and return on NCS through significant tax cuts and deregulation?; (4) will GDP and NCS returns growth come through massive infrastructure spending?

NCS, in this regard, is "physical capital" or capital which is a factor of production (or input into the process of production), consisting of machinery, buildings, computers, and the like. Wikipedia describes "physical capital" as fixed capital, a kind of real physical asset that is not used up in the production of a product. In economic theory, physical capital is one of the three primary factors of production, also known as inputs in the production function.
The others are natural resources (including land), and labor. "Physical" is used to distinguish physical capital from human capital (a result of investment in the human agent), circulating capital, and financial capital. Net returns on net capital stock in the economy is a metric worthwhile watching as Mr. Trump strong-arms domestic and foreign manufacturers into investing in the country in the form of factories, using the threat of significant duties for products built by US manufacturers abroad when exported into the country. Changes in net returns on NCS had historically tended to lead US growth changes by one year, and also has great influence on the growth of US private fixed investments by domestic businesses, and consequently, on the US Dollar valuation. There has been a long negative correlation between the net returns of NCS and changes in the value of the USD. Stronger NCS net returns have been followed by weaker value of the US Dollar, and also a stronger pick up in private, domestic fixed investments.

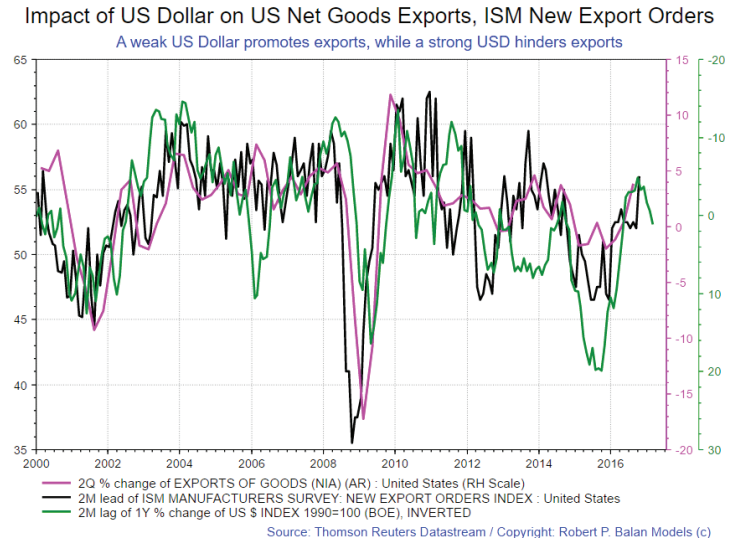
It is also important to understand which route he will take or which policy mixes he would eventually employ, as his choices can have very different impacts on asset classes. For instance, aggressive protectionist intervention rearranges the existing, post-World War II world order, as it suggests the US is no longer willing to provide excess liquidity to the Rest of the World (RoW) when needed through a wider current account deficit, and the concomitant global growth and weakening of the US Dollar that it brings.
(see chart above)

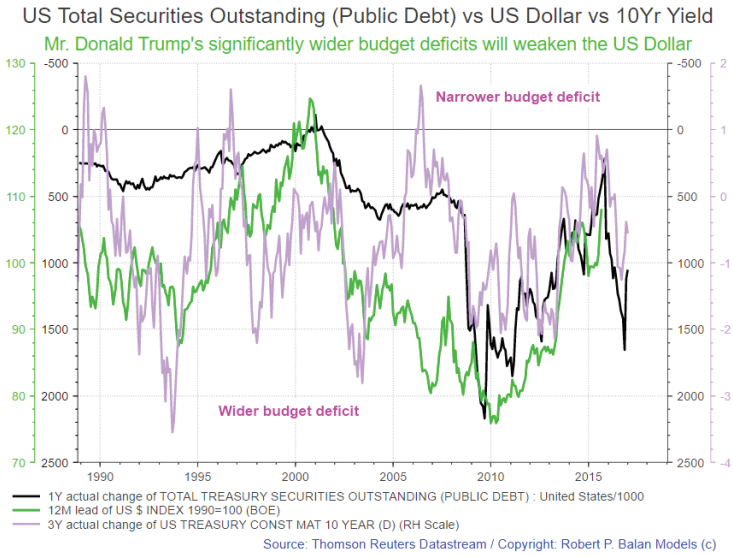


We all know what aggressive protectionism brought in the 1930s -- a global depression. That outlook has considerable implications for the attractiveness of long-dated treasuries in case Mr. Trump decides to go this route. Will growth come via significant tax cuts and deregulation? The implications here are of robust US and global growth, and rising real rates across the globe -- that underlines the attractiveness of cyclicals and financials everywhere. It also means the likely underperformance of hedged and financially-engineered assets, private equity, and assets that owe their value to scarcity (art, collectibles). So far, (and since Mr. Trump won the election) the market is clearly pricing in this particular scenario. Or will The Donald opt for that old, reliable standby -- massive infrastructure spending? This presents (to us) the most interesting option from an analytical point of view, as wider US deficit spending clearly brings about significant changes in the behavior and performance of all major asset classes, and above all, in the direction of the US Dollar.

Mr. Trump recently complained about the excessive value of the US Dollar (specifically against the Chinese yuan), an initial broadside in what we believe will be a constant refrain over the coming days. Mr. Trump has chosen the repatriation and the creation of new jobs in the US as the spearhead of his government policy thrust, and his recent Twitter tweets brings this beyond doubt. Now, if we are to believe Mr. Trump's mantra of bringing jobs back to the US, then his recent broadside (and more to come) against a strong US Dollar, totally makes sense. There is no way he can make that promise of bringing back those jobs to the US come true with a strong US Dollar. A manufacturing renaissance in the US is simply not sustainable with a strong currency, like the one we have now.
The fact is, a strong USD kills exports growth in the US (see first chart on next page), so Mr. Trump's government will want to engineer a weaker currency; and as we can see, he and his

ministers have already taken steps to undercut the US unit's strength. By killing exports, a stronger Dollar also negatively impacts GDP growth. The transmission of a strong US Dollar's effect runs through US net exports which are negatively impacted by a strong US Dollar, as we said. Weaker net exports therefore weaken US GDP growth. The negative effect flows from the US Dollar to GDP, not the other way around.





The market believes that tax cuts and deregulation will be the primary tools Mr. Trump will deploy to kick-start US growth. The market is still far from convinced that a Trump government, owing to a Republican-held US Congress, will go via the route of significantly wider budget deficits. This market belief could be misguided. There is this persistent post-financial-crisis myth that austerity-minded conservative governments always, or at least tend to, favor fiscal prudence. The myth also goes on to claim that on the other hand, redistribution-oriented progressives view large deficits as "free lunch" on a "tax-and-spend" agenda. This simplistic perspective, while perhaps containing a grain of truth, badly misses the true underlying political economy of deficits, according to the economist Kenneth Rogoff. Mr. Rogoff further claims that the truth is whenever one party has firm control of government, it has a powerful incentive to borrow to finance its priorities, knowing that it won't necessarily be the one to foot the bill.

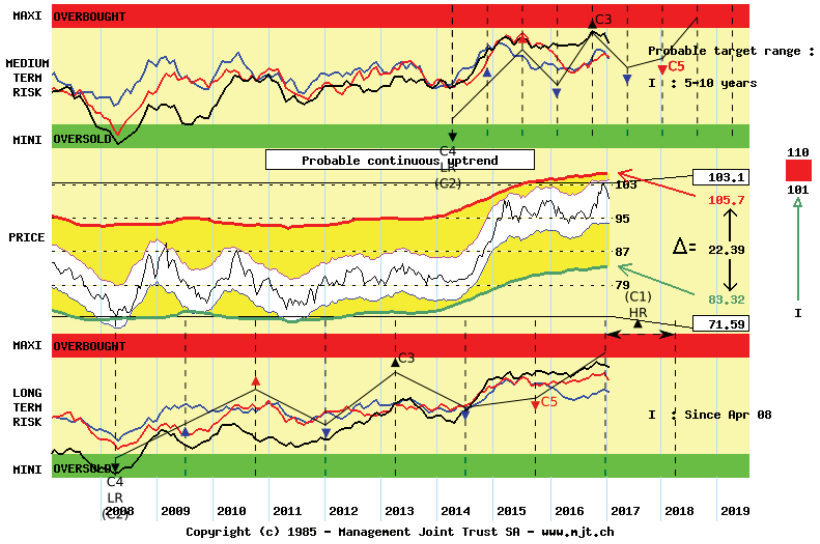
Significantly, if Mr. Trump makes true his promise to increase deficit spending for massive infrastructure rebuild, there is no way for the US Dollar to remain strong with that massive addition of US Dollars in the global system (the latest talk among Republican Congress leaders point to prospective 9 Trillion$ addition to the budget deficits over several years). Massive increases in US debt (resulting in wider deficits) kills the US currency, as a very large supply of US Dollars will reduce the currency's relative value (see 2nd chart on this page). This is almost a given, if seen from this perspective. Therefore, we suspect that the reason for some manufacturers are promising to take jobs back to the US is that they also see a future USD devaluation by massive deficits, thereby making goods manufactured in the US price-competitive again by a significantly weaker US currency. As we said, we already know the winner in a tussle between Mr. Trump and a strong US Dollar. Whoever believes that Mr. Trump's allusion to a strong US Dollar killing US companies in competing globally (especially against China) is just another impulsive rant, is totally missing the big picture.

14 / MJT TIMING INSIGHT

The Dollar at crossroads, as it attempts a further leg up

The Dollar has been weak across the board since late December, retracing some of its H2 2016 gains versus the majors (EUR, JPY, GBP, CHF), and retesting recent lows vs Commodity currencies (NOK, CAD, AUD, NZD, ZAR, BRL, RUB). We will consider both spaces separately. Indeed, the USD remains the more reflationary currency among the majors. Against Commodity currencies, however, it has been weaker on average throughout 2016.

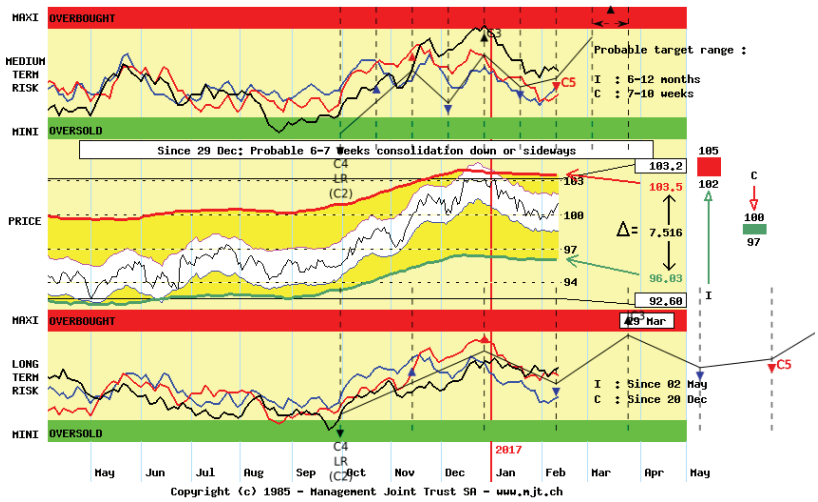
Dollar Index
(Bi-monthly graph or the perspective over the next 1 to 2 years)



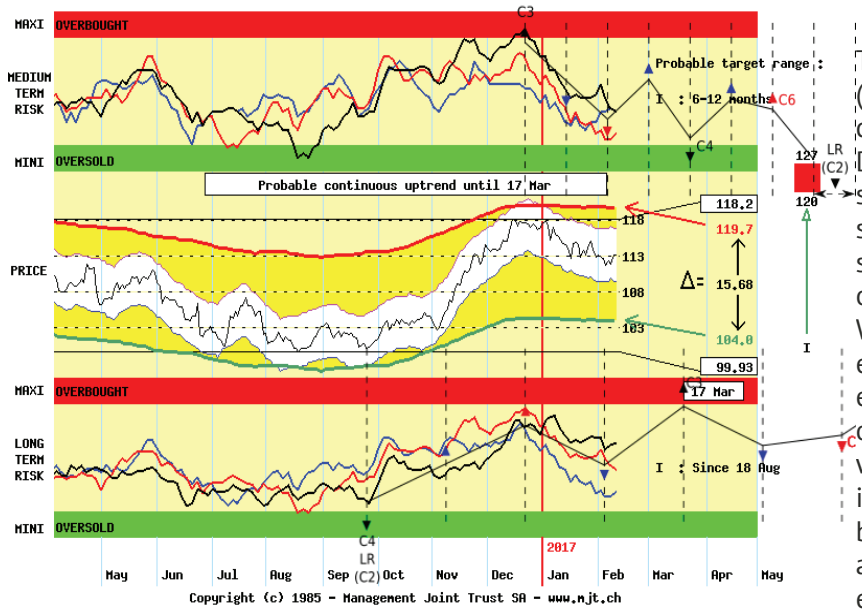
The long term uptrend of our bi-monthly graph has now lasted almost a decade. Our longer term oscillator series have entered a High Risk zone (lower rectangle), while our "I" impulsive targets up may have been achieved (right hand scale). A Case 3 top was made late last year on our medium term oscillator series (upper rectangle). Although, it may not be the final top, it potentially provides an important inflexion point down into H1 2017.

Dollar index
(Daily graph or the perspective over the next 2 to 3 months)

At first glance, the Dollar is moving up into March on both our oscillator series (upper and lower rectangles). Price potential up (right-hand scale) is still interesting ("I" Impulsive targets up between 102 and 105) and would imply that new highs can be achieved.



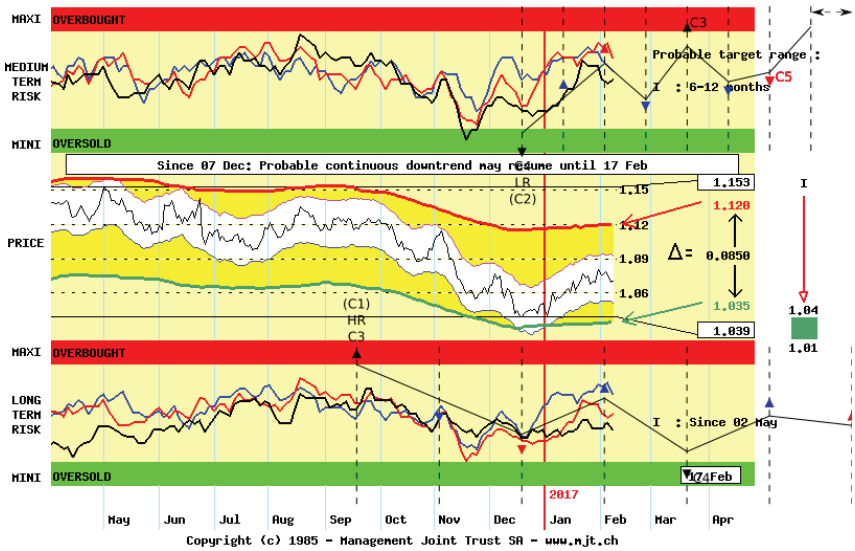
USD/JPY
(Daily graph or the perspective over the next 2 to 3 months)



This Daily graph of USD/JPY (the Dollar Index second largest component) is similar to the Dollar Index. It is however slightly weaker as a downtrend sequence may have already started on our medium term oscillators (upper rectangle). With its recent bottom, we now expect it to correct up into early March. On our long term oscillators (lower rectangle), we could extend this move up into mid March. Combining both, we expect that USD/JPY attempts a last move up towards early March. Considering our "I" Impulsive targets up (right-hand scale), it could make new highs, while a failure to do so would imply a stronger correction to the downside into end March and April.

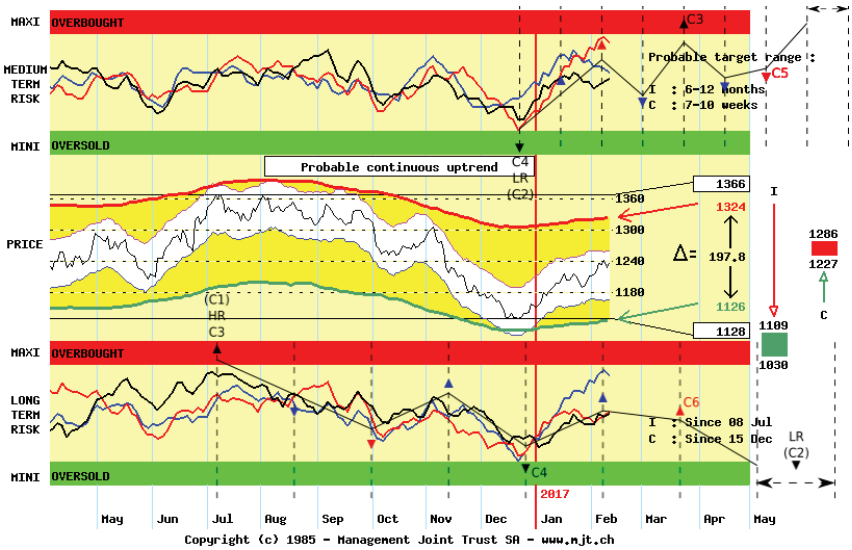
EUR/USD
(Daily graph or the perspective over the next 2 to 3 months)

Invertedly, the correction up on EUR/USD since mid December has been quite resilient. It has been strong enough to create an initial uptrend sequence on our medium term oscillator series (upper rectangle). With its recent top, we now expect it to correct down into late February. On our long term oscillators (lower rectangle), we could extend this move down into mid March. Combining both, we expect that EUR/USD retests down towards end February / early March and possibly makes new lows ('I' Impulsive down targets, right-hand scale), before it bounces back up towards April. The month of May could see further weakness as the French election unfolds.



Gold
(Daily graph or the perspective over the next 2 to 3 months)

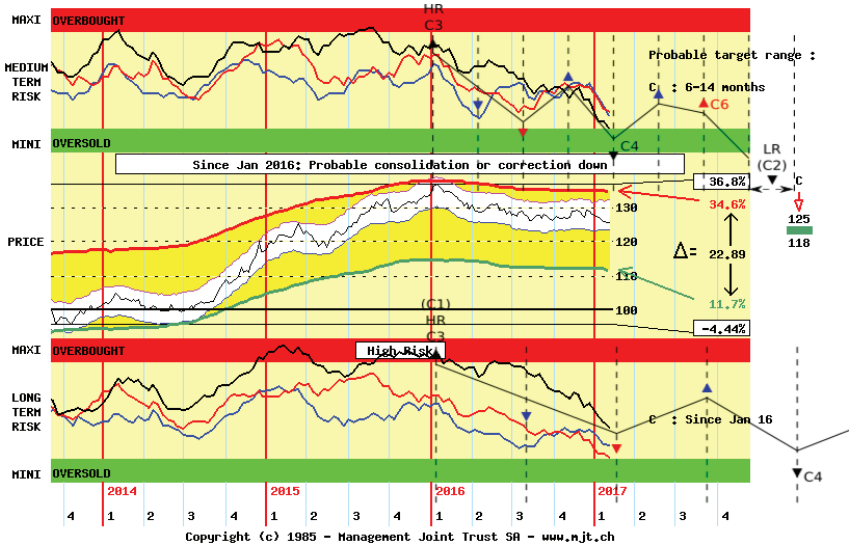
Since interest rates bottomed in July 2016 major currencies vs the US Dollar have been strongly correlated to Gold. Indeed, the USD has been the more reflationary of the major currencies, surfing on the interest rate differential between the US and the Eurozone and Japan, while Gold has been suffering from the rising interest rate environment.



Since December, together with the Euro and the Yen, Gold has been in a bounce vs USD. It is now in an uptrend sequence on our medium term oscillators (upper rectangle). While it should retrace now into early March, a second leg up could then materialize into end March and possibly May. Our longer term oscillators (lower rectangle) and our target projections (right-hand scale) provide a more negative alternative: the bounce is still only a correction (within our corrective targets, i.e. below USD 1'286/oz) and a failure to push higher during March could create a 'Case 6' or the start of a rapid move lower.

USD vs Commodity Currencies
(Weekly chart or the perspective over the next 2 to 4 quarters)

This portfolio shows the USD vs Commodity currencies (NOK, CAD, AUD, NZD, ZAR, BRL and RUB equal weighted). Versus these, the USD has been on the wrong side of the reflation trade. While we expect oil and materials to correct to the downside from end February to Q2 2017, invertedly, the Dollar should correct to the upside. Our medium term oscillator sequence (upper rectangle) shows this projection. Following that, the USD should resume its downtrend into end 2017 / early 2018 vs these Commodity currencies.



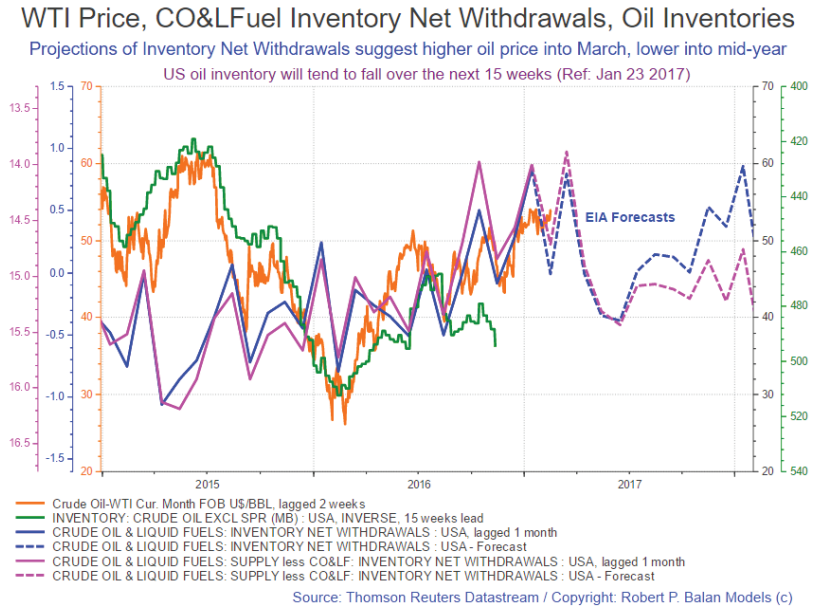
Concluding remarks:

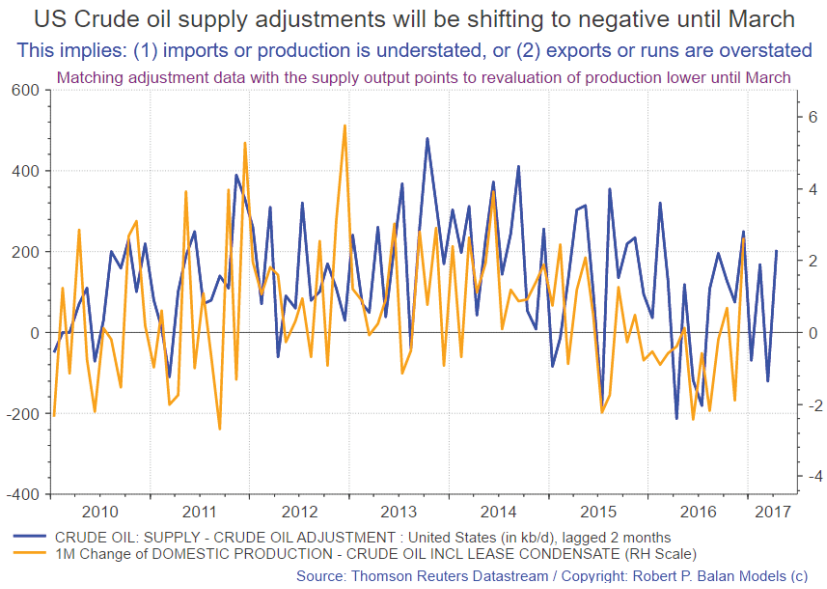
Longer term the USD could be approaching an important top vs the Euro and the Yen. It could materialize over the next month as a last move up (down for EUR/USD) comes to an end between end February and mid March. Vs commodity currencies, the Dollar follows an opposite dynamic: it should correct to the upside from end February into mid Q2 2017.

17/ Fundamental oil data, on balance, suggest lower crude oil prices in H1 2017, but show likely higher prices by year-end

So far, we see that rising inflation in the US has been driven by the rapid rise in energy costs during the past four quarters of 2016. But this trend may not last long -- we see some indications of lower energy prices during the latter part of H1 2017. One basis is the extrapolation of Crude Oil and Liquid Fuel Inventory net withdrawals by the US Energy Information Administration (EIA), and projected difference between net withdrawals and existing supplies. The implied price profile is of range-bound to firmer price during the rest of Q1, but followed by lower oil prices going into mid-year, and then sharply rising prices during H2 2017 (see 1st chart on this page).

What could also support oil prices into March is the likely adjustment lower of US domestic production data based on the history of US crude oil supply adjustments. The EIA oil supply model has historically overstated or understated output projections, which were then corrected or modified by a series of subsequent monthly adjustments, as shown by the model below. It appears that oil production data have been slightly overstated over the past several months, and so the next few month-on-month output data corrections will tilt towards the weak side, creating positive output surprises which will tend to help oil prices in the very near-term (see 2nd chart on this page). However, this will be followed by a tilt towards the opposite direction (stronger output), hurting prices toward mid-year.





Clearing the deck: relationship between inventories, Cushing stocks and oil price.

Let us begin the exercise by laying a conventional wisdom to rest – the power of the oil inventories to predict the future level of oil prices. Conventional wisdom says that the higher oil inventories go, the weaker oil prices should be. This notion is wrong, and the error starts with oil inventories being conflated with total oil supplies. The fact is, oil which goes into storage is not "supplied" to the market – it is kept in storage. Investopedia suggests that "Inventory levels affect the price of oil, with higher inventories leading to lower prices," but offers proof to support the claim. The notion is that as inventories rise, total supplies rise as well, and we

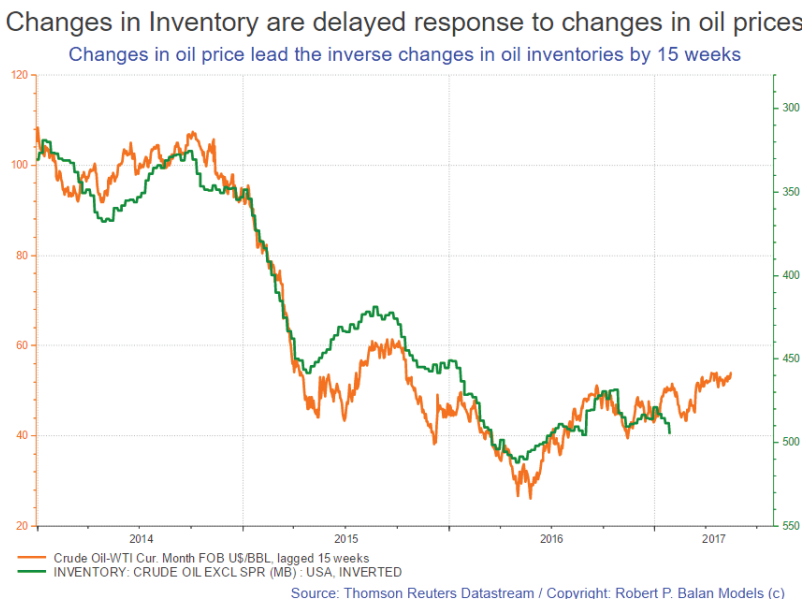
all know that increased market supplies of any commodity tends to lower the market price per unit of that commodity. However, inventories do not really add to total oil supplies. This is how it works – inventories rise 15 weeks after a fall in oil prices, and vice versa: inventories tend to fall as oil prices rise, after a 15-week lag (see 1st chart on this page).

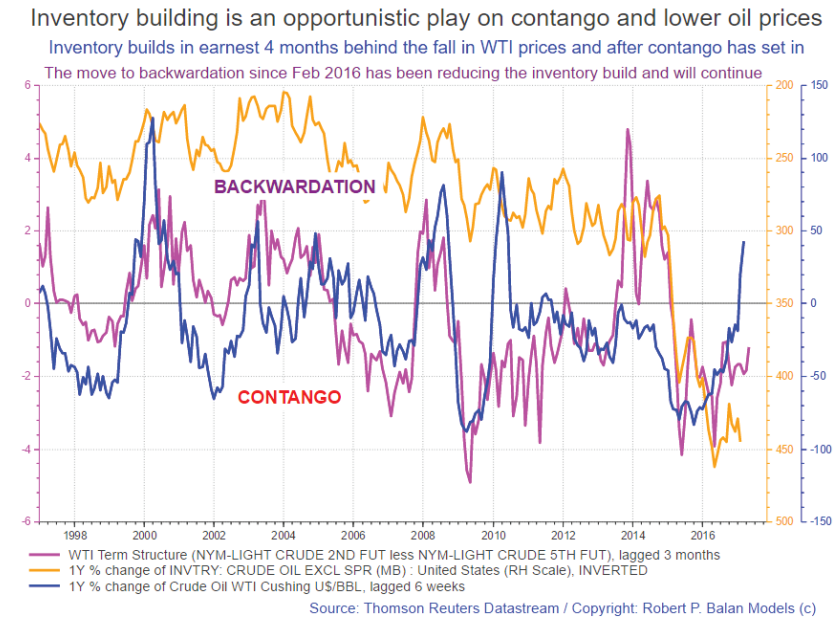
Subjecting the relationship to a coefficient of determination test (R-Squared) yields a respectable R^2 of 0.505, suggesting that more than half of the changes in Oil Inventories can be explained by the changes in WTI oil prices. The other half of inventory changes can probably be explained by supply-demand fundamentals that are being reflected in the oil term structure, primarily the WTI front spread. The chart below shows the lead impact of the front spread on both oil price and inventories, especially the latter. The C2-C5 spread has 3-month lead over inventories, and a good 6-week lead over the direction of oil price (see 2nd chart on this page).

A regression of the spread versus inventory yields a significant R^2 of 2.58, suggesting that more than half of the 40% of changes in oil inventories not explained by the evolution of oil prices may be the impact of storage decisions of oil users and speculators who are guided by the evolution of the front (C2-C5) spread. We actually believe that investors' reaction function to both term spread and price changes primarily drive the course of oil inventory builds.

What makes this relationship even harder to accept for some economists is that it violates the law of supply. The law of supply is a fundamental principle of economic theory which states that there is a direct relationship between price and quantity: quantities respond in the same direction as price changes. Put another way, all else equal, an increase in price results in an increase in quantity supplied. If this economic principle applies in the case of inventories vs price, then inventories should be increasing with the rise in oil prices. That the inventory-price relationship conundrum is shown to work the opposite way is a tell that oil inventories (as defined) should not be conflated with total oil supplies (as defined).

In fairness, oil inventories have been classified as "crude stockpiles," which were defined by Investopedia as "reserves of unrefined petroleum, measured in numbers of barrels. Oil producers use crude stockpiles to smooth out the impact of changes in supply and demand." The major storage center for crude stockpiles in the United States is in Cushing, Oklahoma. If crude stockpiles have indeed the same functionality as inventories, then there should be good, if not excellent, comovement (or correlation, if you will) between the two data sets – and indeed, that is the case. And here is what we are getting at . . . if oil inventories comove or correlate with Cushing stocks, then changes in Cushing builds should also follow the inverse lead of the changes in oil prices after a lag, as is the case with inventories. And we definitely see that to be true in the juxtaposition of the changes in the data sets.





Simple Oil Output-Consumption Models

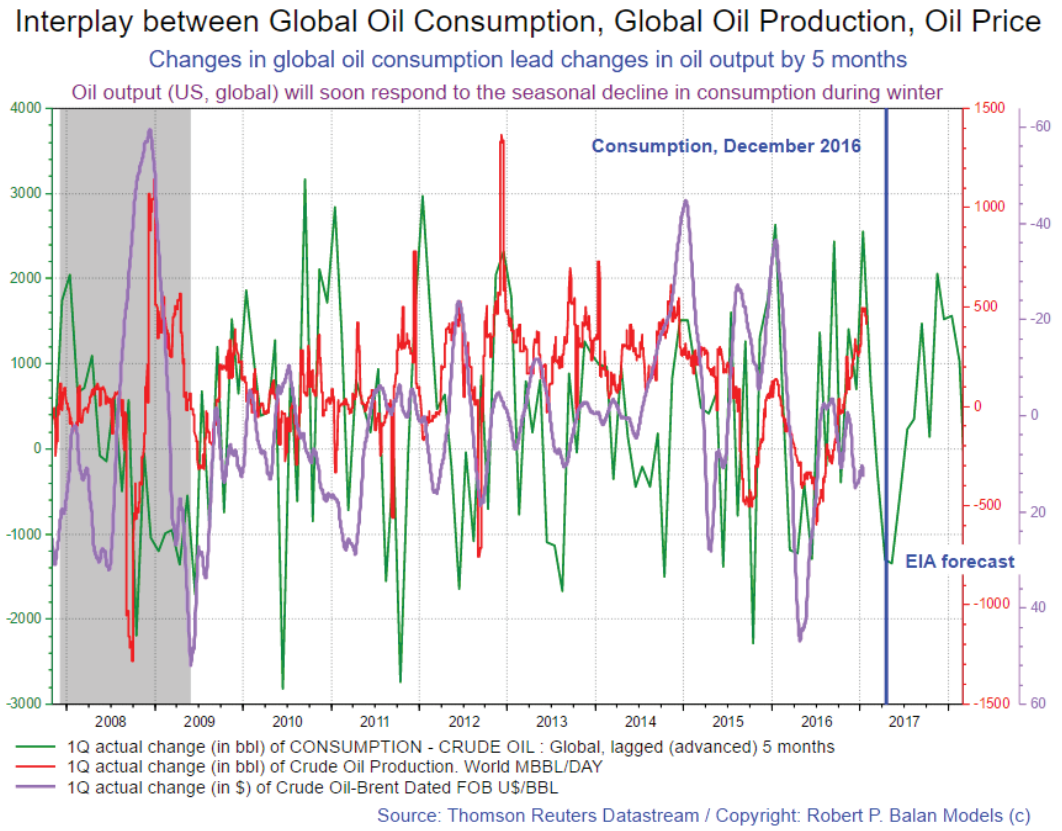
The other pitfall to watch out for is the oft-made error of making a linear comparison between oil output and oil consumption; e.g., today's oil consumption is deducted from today's oil production to derive a delta which could provide a data set which may have a bearing on the evolution of oil prices. That methodology will likely provide an erroneous vector because global (as well as US) changes in oil consumption are, on average, 5 months ahead of the changes in the response from the output side. Said another way, changes in oil output lag behind consumption changes by about 5 months on average.

Off the bat, this relationship tells us that focusing solely on global and US oil output (which, by correlation and by logic, merely follow the trend in global consumption) is particularly counter-productive, as in many cases (as in the past few months) consumption has already been falling but output is still on the rise.

In this case, a linear summation to arrive at the delta between output and consumption will likely provide misleading values. What is more useful (and procedurally correct) method is to advance the consumption data by 5 months before summing up the production—consumption equation. The delta derived this way has very good predictive properties over the short term. (see chart below)

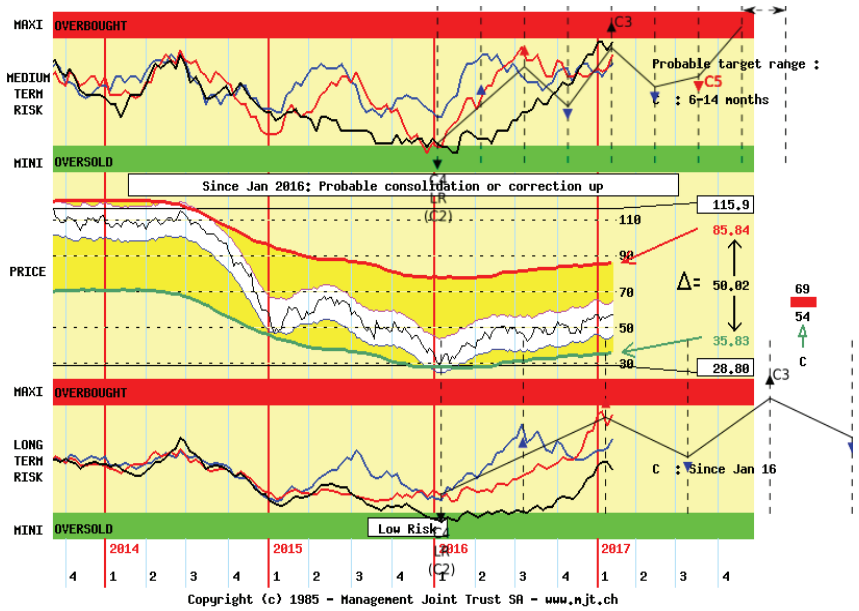
The oil term structure suggests a 3-point pivot for the year (up-down-up)

A weaker oil price profile for H1 2017, as suggested by the interplay between supply and consumption as shown in the earlier charts shown above, is also supported by the month-on-month oil term structure for 2017. This construct shows narrowing contango coming close to backwardation into late Q1 2017 (encouraging firmer prices), followed by sharply wider contango into mid-year 2017 (see July-Aug/2017 spread) – which provides another hint of lower prices going into mid-year. This is also pretty much in consonance with the price profile obtained from the simple consumption-supply models shown above. However, from mid-year up to year-end, the contango narrows considerably and the Jul-Aug spread goes into backwardation by year-end. This could lead to sharply higher oil prices going into 2017 year-end . The 2018 time spreads are distinctly oil price-friendly. By Q4 2017, all 2018 month-on-month time spreads are firmly backwardated, especially at the far end. The market seems to believe that by then, over-supply issues will be less dire, and improved demand and/or more moderate inventory builds could underpin oil prices. Those are speculations on our part, but the fact remains that H1 2018 time spreads are a whole lot more constructive than those of H1 2017 , so the odds are higher that 2018 prices will be higher than 2017.



Oil should correct to the downside into Q2 2017

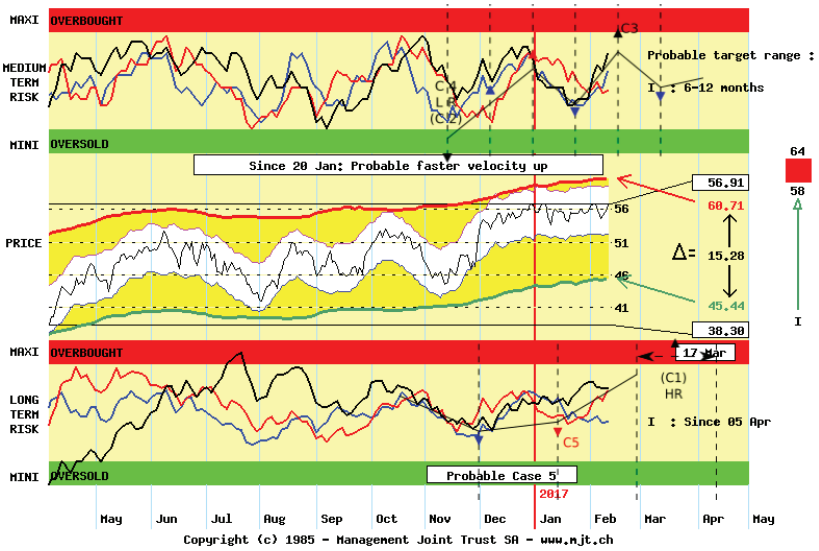
Brent Oil
(Weekly graph or the perspective over the next 2 to 4 quarters)



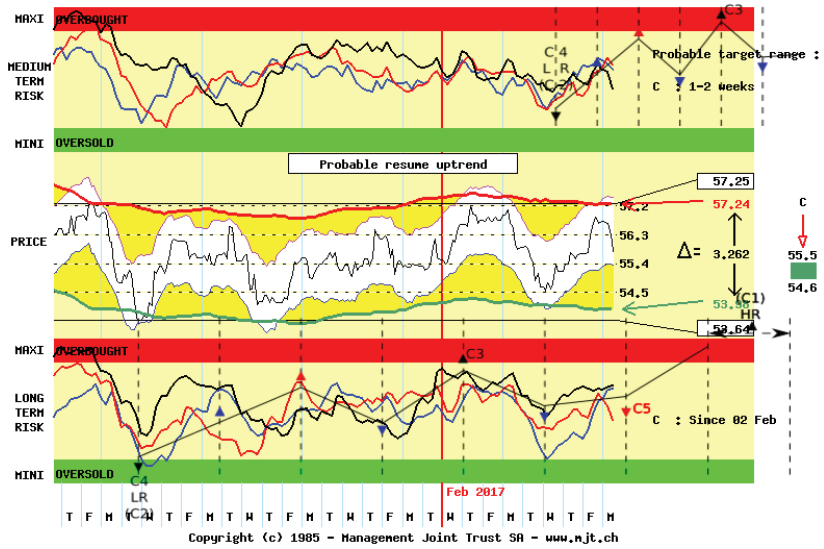
Since it bottomed in January last year, Brent Oil has followed a typical uptrend sequence on both our oscillator series (upper and lower rectangles). It has now reached its 'C' corrective targets up (right-hand scale) and should start a period of correction to the downside towards mid Q2 2017, possibly into mid year.

Brent Oil
(Daily graph or the perspective over the next 2 to 3 months)

From its lows in November, Brent is now approaching an important top. On our longer term oscillator series (lower rectangle), we expect a High Risk zone ('HR') to start end February / early March, while on our medium term oscillators (upper rectangle), a top may materialize even earlier, from next week. Our preferred scenario would be that Brent accelerates up into its 'I' Impulsive targets between USD 58 and 65 a barrel (right-hand scale) before the end of the month and then starts to correct to the downside. Given our current measure of historic volatility (delta = 15.28), the correction potential to the downside is between 8 and 13 USD a barrel.

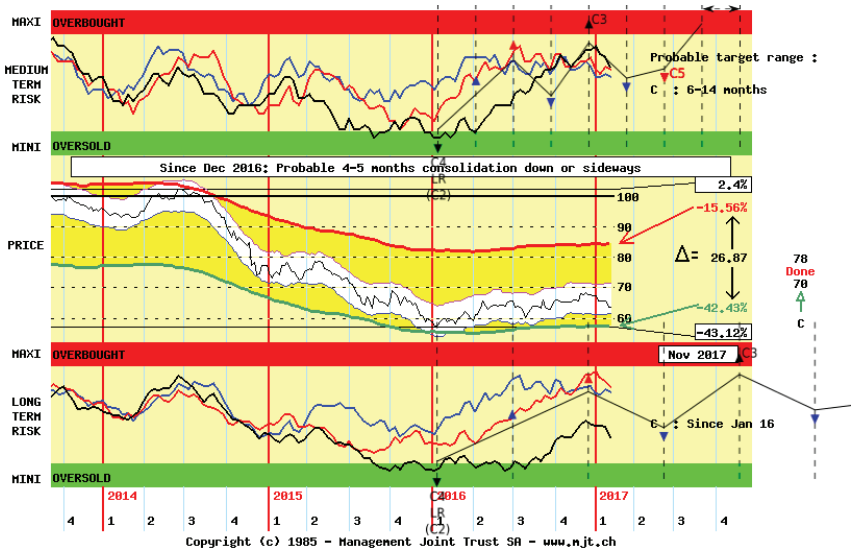


Brent Oil
(Hourly graph or the perspective over the next couple of weeks)



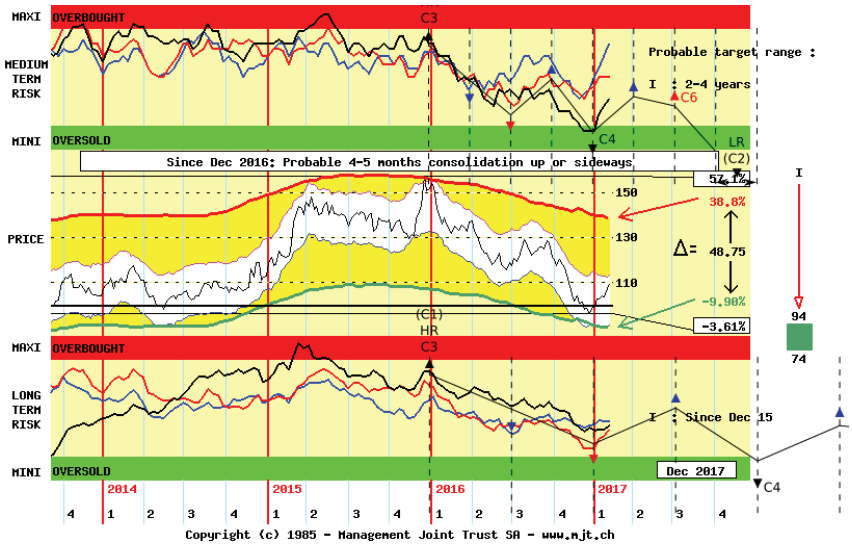
Despite trading in a range since mid January, Brent has followed our uptrend model quite nicely on our longer term oscillator series (lower rectangle). We would now expect it to make a higher low over the next few days and then accelerate up towards the end of the month. This positive scenario holds as long as price can stay above their 'C' corrective targets down (above USD 54.6 per barrel; right hand scale). A move below these levels would imply that the period of correction to the downside, we expect on our Weekly and Daily graphs, has probably already started.

XLE (SPDR Energy ETF) vs SPY (SPDR S&P500 ETF)
(Weekly graph or the perspective over the next 2 to 4 quarters)



On a relative basis, the Energy sector has been in a correction to the upside during most of 2016 vs the S&P500 index. In December last year, however, it reached an important intermediate top on both our oscillator series (upper and lower rectangles). The timing of this top was a bit early compared to what we would ideally expect from such an uptrend sequence. Furthermore, compared to the strong under-performance registered during 2014 and 2015, the rebound has been relatively weak. Hence, the current correction phase to the downside might prove quite damaging and retrace a large portion of its 2016 relative gains. We would remain prudent on the sector, probably until late Q2 2017. The European Energy sector vs its reference index shows a similar dynamic.

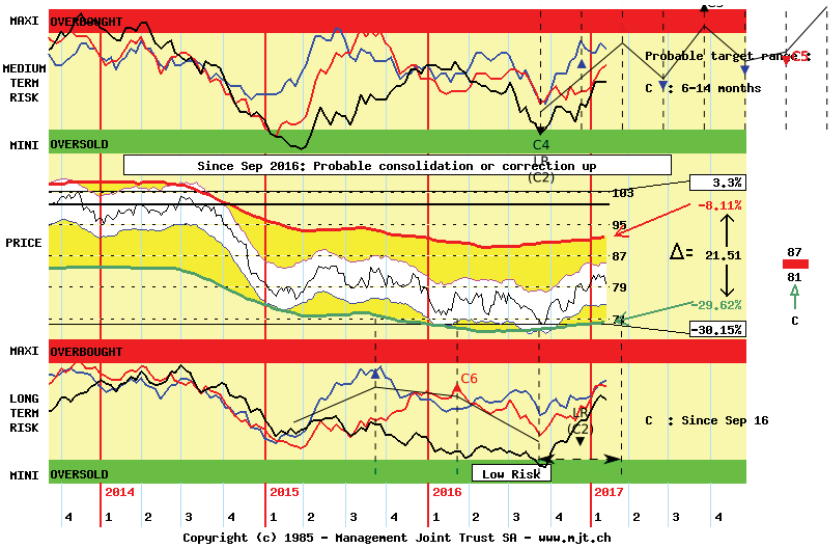
ICLN (iShares S&P Global Clean Energy Index Fund) vs IXC (iShares Global energy ETF) (Weekly graph or the perspective over the next 2 to 4 quarters)



Alternative/Clean Energy are considered a defensive segment within the global Energy space. It is interesting to note, that they have started to bounce vs the wider sector. On both our oscillator series (upper and lower rectangles), we can expect this rebound to last towards early Q2 2017, possibly into mid year. Main subsegments include Wind Energy (FAN ETF) and Solar Energy (TAN TF). We would prefer the former as it is more defensive (large government projects vs many retail projects for Solar).

OIH (Market Vectors Oil Services ETF) vs XLE (SPDR Energy Sector ETF) (Weekly graph or the perspective over the next 2 to 4 quarters)

Investment in infrastructure was late to come back when Oil started to correct up during 2016. The segment finally reached a Low Risk situation vs the wider Energy sector (lower rectangle) at the end of the Q3 2016 (the Alger conference). We believe that it is now positioned in an early uptrend on our medium term oscillators (upper rectangle).Oil Services could be one of the main beneficiaries of the second leg up we expect on Oil, which should start late in Q2 2017.



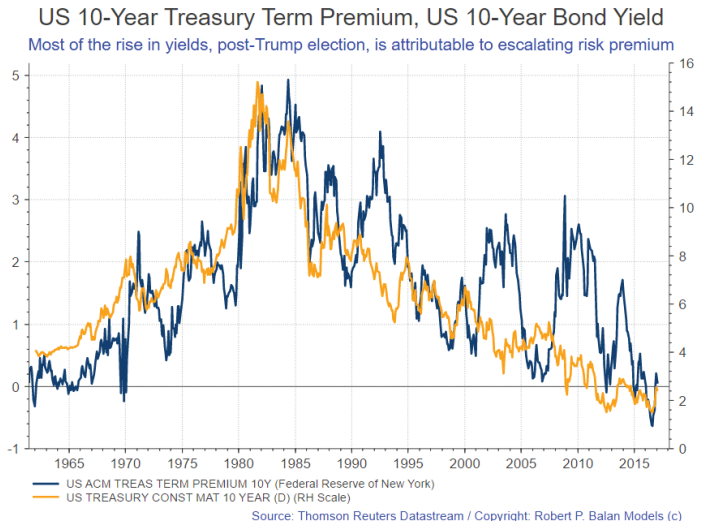
Concluding remarks:

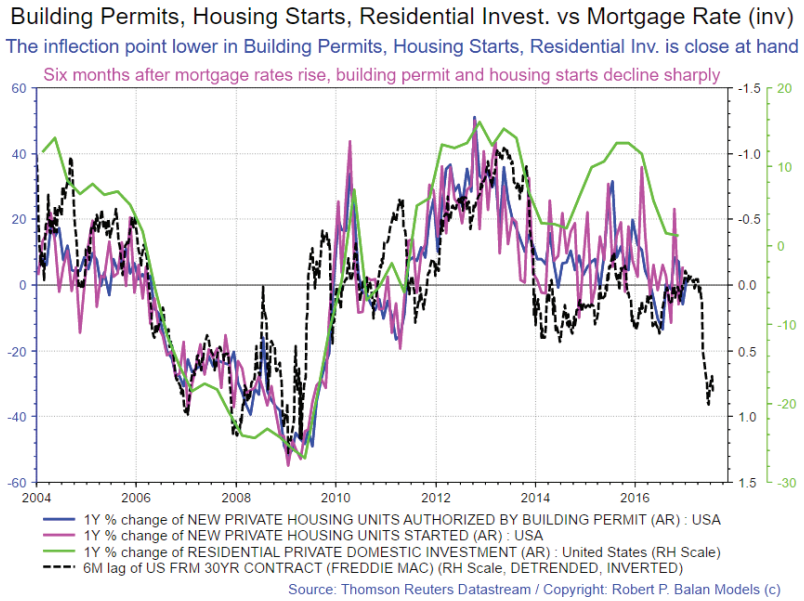
Oil is approaching an important intermediate top, which should see it correct to the downside from end February / early March into late Q2 2017. Over the next couple of weeks, Brent could reach into its Daily Impulsive targets up (between USD 58 and 65 per barrel), yet the correction period to the downside that follows could retrace between 8 to 13 USD. Since December, the Energy sector seems to have anticipated this period of weakness and over the next 3 months could remain one of the worst sectors overall.

23/ Housing: expect a final frenzy of good news as last-minute buyers lock-in still low rates, but it will not last

The Federal Reserve Bank of New York reported that the 10-year term premium moved above zero for the first time in 10 months on November 14, less than a week after Mr. Donald Trump's surprise election. And here we are, three weeks after Trump's took power, the yield on the benchmark 10-year Treasury bond at 2.42%. That's 1.05 percentage points higher than July 11 yield of 1.366%, an all-time record low posted in the wake of the Brexit vote. And most of these gains are attributable to a sharp surge risk premia over such a short period. The bond market sees the world as binary outcomes: events are either inflationary or deflationary. The incoming Trump administration was (and still is) unquestionably viewed by investors as a reflationary catalyst. Talks of spending $1 trillion on infrastructural projects across the country would require a big increase in the supply of Treasury notes to fund the venture. In investors' minds, such a large fiscal shot in the arm would also be expected to place strong upward pressure on bond yields, as well as prices across the real economy. Investors therefore pre-supposed that the Federal Reserve would respond to an uptick in inflation with a regime of interest rate hikes; yields soared as a consequence. The largest adjustments to the sharp upmove in bond yields came from the housing sector --- mortgage rates have been sharply higher as well. Housing is one, if not the, most sensitive sector of the economy to rising interest rates as it negatively impacts those home buyers who have to go to the credit markets to finance their house purchases – which is to say, just about everyone who enters the market. The reason is self-evident -- mortgage rates follow Treasury yields. The 30-year mortgage rate has soared from 3.36% to 4.32% at the end of the year, moderating somewhat during the first week of February to 4.20%. The sharp upmove from the 2016 low of 3.42% on the 30-year mortgage benchmark, to 4.20% attained this week, nonetheless suggest a strong directional signal for higher mortgage rates. Remember – the mortgage rate has been rising since July and accelerated upwards in late October, with a sharp vertical surge after Mr. Trump's victory.

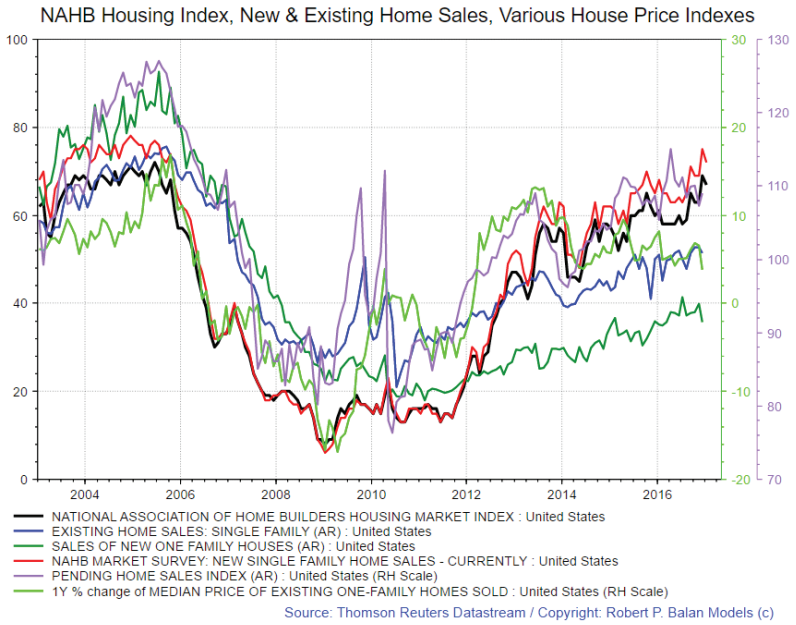
However, you will not know it from the way the housing market actually responded to the escalating mortgage rate. Anecdotally, housing activity notched up the buzz, and we expect it to culminate in further frantic attempt by BUYERS of existing homes in need of financing to try and lock-up lowest interest rates available in this environment. In reality, 4% mortgage is still historically





very low, but may no longer be available after a while. The same phenomenon could also ignite housing starts and building permits for a while, in bids to lock in lowest available rates. But not too long from now, starts and permits should decline in earnest. Residential investment has declined in each of the last two consecutive quarters, falling 7.4% in the Q3 in the Q4 2016, and will likely decline further over the next 6 months. (see 2nd chart on previous page)

On the other hand, rising interest rates are likely dishing up strong disincentives for SELLERS (homeowners) to part with their current homes, placing downward pressure on the inventory of homes for sale, and pressuring the trade-up markets across the country. This is how those disincentives to sell are currently affecting the internals of the housing market, which are sending homeowners to hog heaven -- sellers are putting off sales in the hope of one last surge in price revaluations.



HOUSE PRICE

- In December 2016, despite average 30-year mortgage rates jumping to 4.2% --- the highest they've been since April 2014 --- preliminary median and average new home sale prices set almost new records. The first estimate of the median new home sale price in the U.S. came in at $322,500, which was just $1,200 shy of the final record high of $323,700 that was set in September 2016.

- The first estimate of the average new home sale price in the U.S. was $384,000, which ties the all-time record that was set back in October 2014. Based on historical trends, analysts say there is a very high chance that when the estimates for December 2016 are finalized three months from now, they will set new record highs.

- Geographically, all four regions posted double digit gains with the national house median price for all housing coming in at $234,900, up almost 7% on a year-over-year basis. Single family home prices were up 6.8% to $236,500 while condominium prices were also up 5.8% to $222,600, year-over-year.

SALES VOLUME

- New Home Sales fell sharply in December 2016, from a seasonally-adjusted annual rate of 598k in November to 536k. That wasn't unexpected given that mortgage rates have been up since October.
- New home sales were weaker than expected in December, the first sign that higher mortgage rates may be keeping marginal home buyers out of the market. There are reasons for optimism, though, as DR Horton, the largest US homebuilder, reported a 15% rise in orders.
- Contracts to buy previously owned U.S. homes fell in November to their lowest level in nearly a year, a sign rising interest rates could be weighing on the housing market.

The new trend of rising rates are pressuring property valuations as homeowners wait for the new surge in demand to peak at some point, and that holds true for refinancing deals. Mortgage lenders are also anticipating the demand for refinancing existing home debt to rise to levels last seen in 2000. Trading up market entails swapping out an historically low mortgage for a new higher rate loan. The economics should spur more homeowners toward home improvement projects than entering the homebuying market, padding house valuation even higher, at least for a short time.

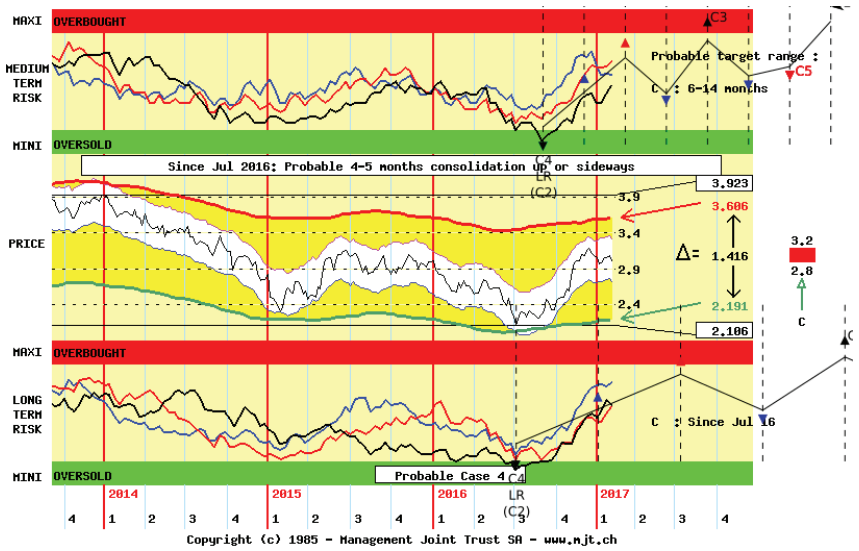
However, the surging valuations are sowing the seeds of the next housing market price downturn – as interest rates rise and affordability becomes an increasing headwind. Wage growth in January has been flat. Moreover, home price growth remains almost twice that of wage growth through January posted by the 20-city composite S&P Case Shiller Home Price Index. There's another side to this equation: Those homebuyers willing and able to stretch to make those higher payments cannot spend this money on other things – a negative impact to growth. Falling mortgage rates have been a huge boon to home prices and the entire economy. But that process is going to get reversed. The housing picture is not brightening and most likely will not because the benefits of historically low interest rates are mainly behind us.

25 / MJT TIMING INSIGHT

Housing and Real Estate may make a temporary comeback

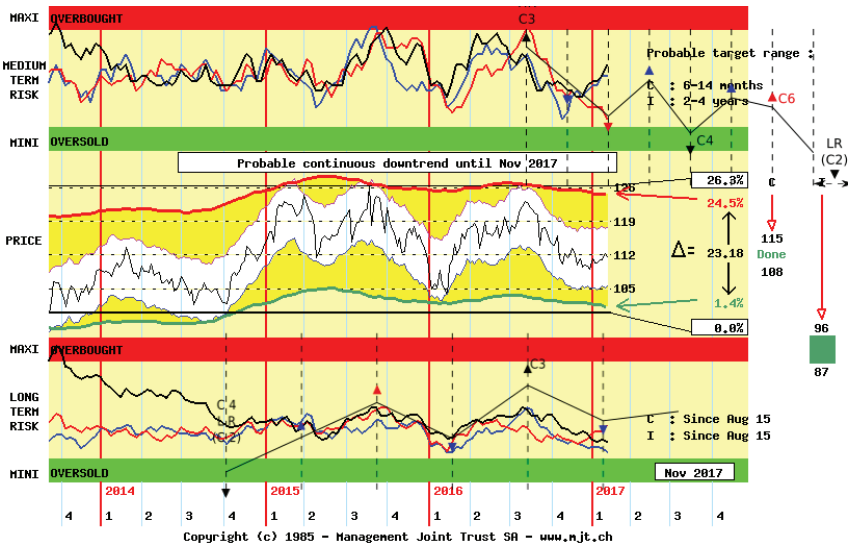
For both these sectors, Interest rates are like a time bomb, as the cycle matures and rates move up, they usually start to underperform. Shorter term, over the next couple of months, even a mild consolidation in interest rates could offer temporary relief.

US 30 Year Treasury Yields
(Weekly graph or the perspective over the next 2 to 4 quarters)



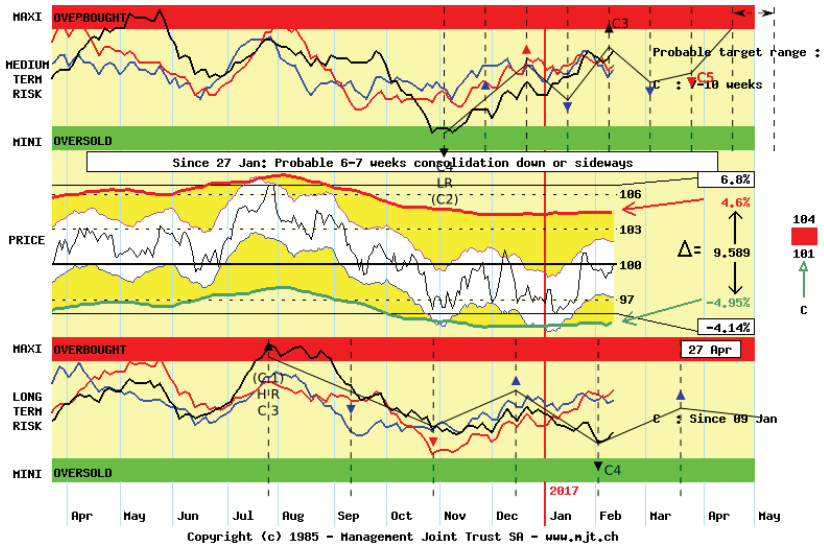
US 30 year yields have reached our corrective targets up (right-hand scale). Typically, such levels would imply some resistance and possibly several months of consolidation to the downside. Following that, both our model projections (upper and lower rectangles) would suggest that from mid Q2 2017, long term rates resume their uptrend. Possible targets we can calculate using our historic volatility measure (delta = 1.416) could reach above 4% towards late 2017 or early 2018.

S&P Household Durables sector vs the S&P500 Index
(Weekly graph or the perspective over the next 2 to 4 quarters)



Housing and Homebuilders are part of the Consumer Discretionary sector and the Household Durables sub-sector. They are typically early cycle performers. As with other Consumer Discretionary, Household Durables performed strongly between mid 2014 and mid 2015. In our view, that's when our current business cycle may have started to turn up. More recently, in H2 2016, Household Durables on relative basis corrected down with rising interest rates. On both our oscillator series (upper and lower rectangles), however, they may have reached an intermediate bottom. We would now expect them to enter a mild correction period to the upside towards mid Q2 2017, on a relative basis. After that, the downtrend vs the S&P500 Index should resume until late 2017 at least.

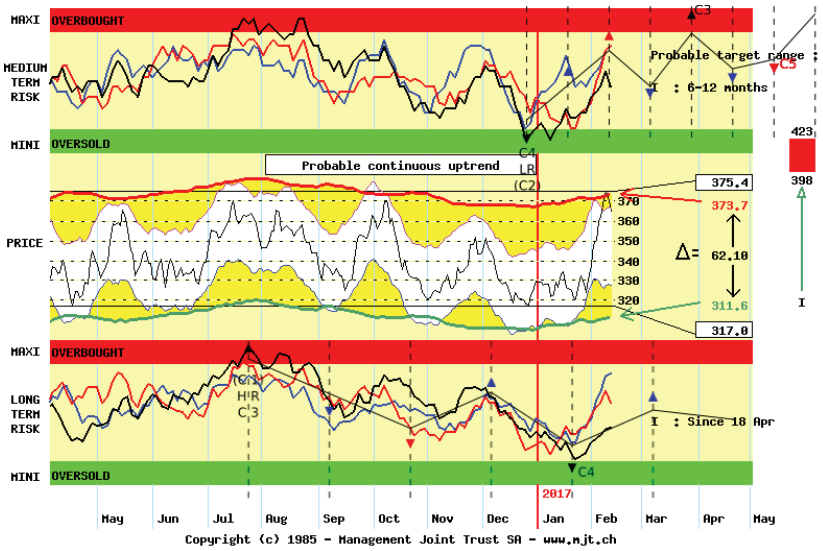
The PHLX Housing Sector Index vs the S&P500 Index (Daily graph or the perspective of the next 2 to 3 months)



Looking more specifically at Housing since July 2016, the sector has followed a sequence down vs the S&P500 . It has now reached a Case 4 bottom situation on our long term oscillators (lower rectangle). Such situations usually result in periods of 2 to 3 months of consolidation to the upside. As shown on our medium term oscillators (upper rectangle), the uptrend could extend into late April / early May.

3M Lumber Futures (Daily graph or the perspective over the next 2 to 3 months)

As a further confirmation, we look at Lumber, which is often considered a leading indicator to the Housing sector. The Daily graph is very similar to the relative chart of Housing above with the same sequence coming through on our longer term oscillator series (lower rectangle). The sequence on our medium term oscillators (upper rectangle) could also extend into April or May.

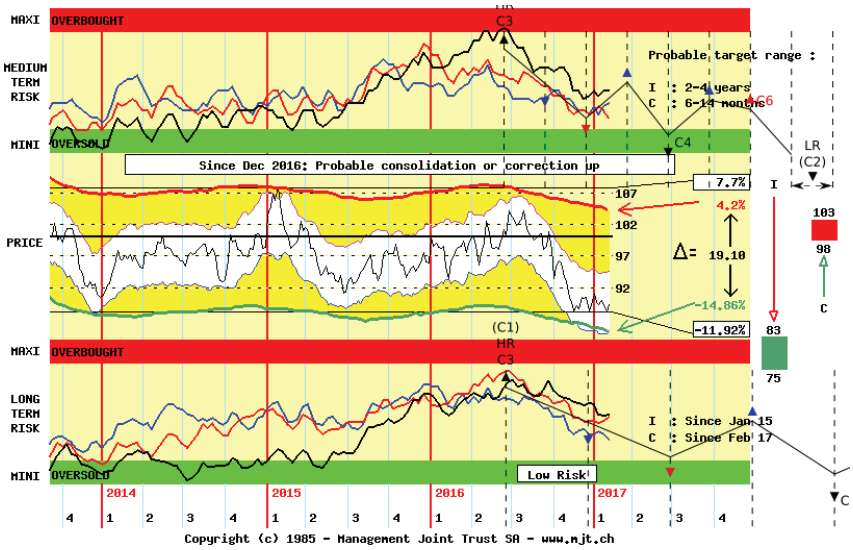


Concluding remarks:

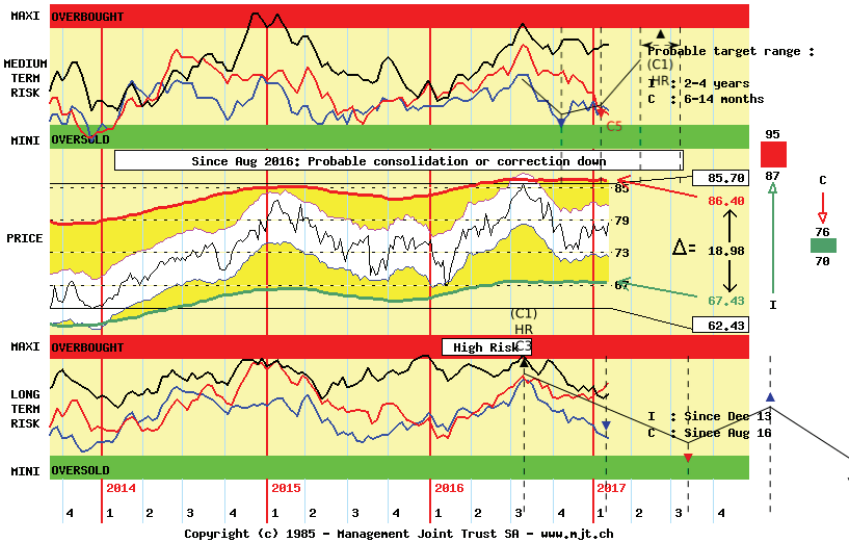
As mentioned above in this document, we expect that over the next few months, Cyclical sectors could retrace some of their 2016 gains. At the same time Defensive Sector still look quite weak. Early cycle movers such as Consumer Discretionary and Housing may offer a temporary alternative and outperform on a relative basis (weaker, yet similar to the case around Growth and Technology).

IYR – iShares US Real Estate ETF vs the S&P500 Index (Weekly graph or the perspective over the next 2 to 4 quarters)

On a relative basis, Real Estate is clearly a defensive sector. It is also strongly and negatively influenced by the rising trend in interest rates. On our medium term oscillators (upper rectangle), it could consolidate to the upside a bit towards the end of Q1 2017, before moving lower again on our long term oscillators towards mid 2017 and then 2018 (lower rectangle).



IYR – iShares US real estate ETF (Weekly graph or the perpective over the next 2 to 4 quarters)



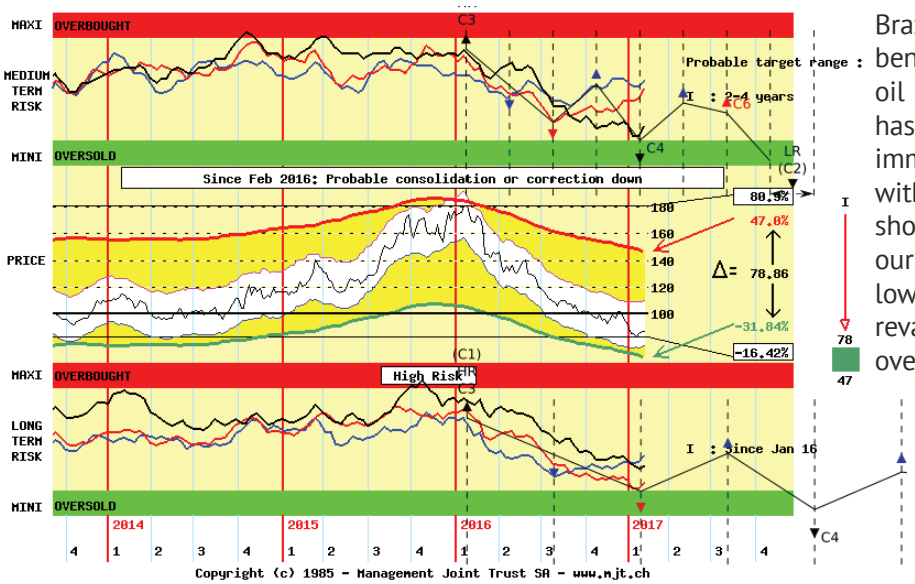
On an absolute basis, the rebound may last a while longer, possibly into mid Q2 2017 on our medium term oscillators (upper rectangle). It is interesting to note that during the sell-off to November 2016, the support of our corrective targets down has held (76 – 70, right hand scale). Theoretically, although unlikely given the High Risk situation which materialized last July, new highs cannot be excluded as shown by our 'I' Impulsive targets up.

Concluding remark:

Although quite weak on a relative basis, Real Estate may surprise in absolute terms during Q2 2017, a situation that could provide a timely exit opportunity.

Our section of US sector rotation concluded that in the upcoming consolidation, the Energy sector should suffer the most. As a further confirmation, we review several related country pair trades, which over the coming months may affect country allocation and performance in the various regions.

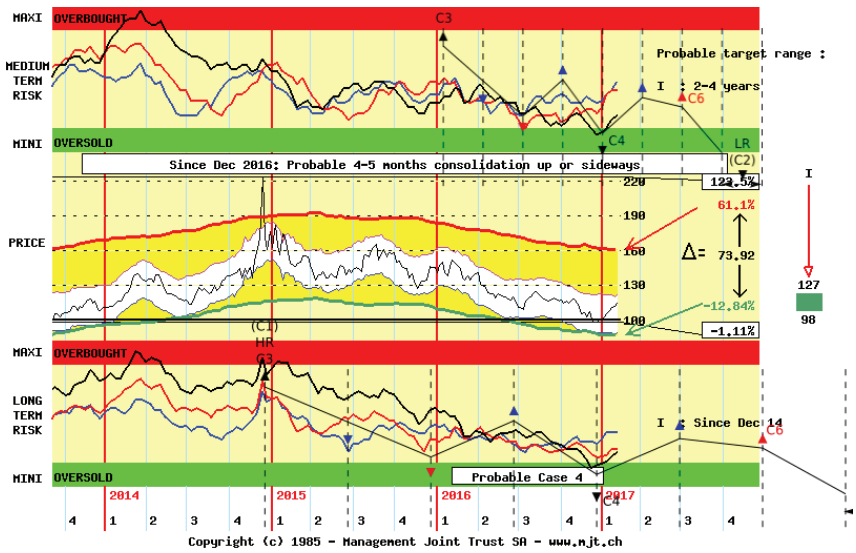
EWW - iShares MSCI Mexico Capped Investable Market Index Fund vs EWZ - iShares MSCI Brazil Capped Index Fund (Weekly graph or the perspective over the next 2 to 4 quarters)



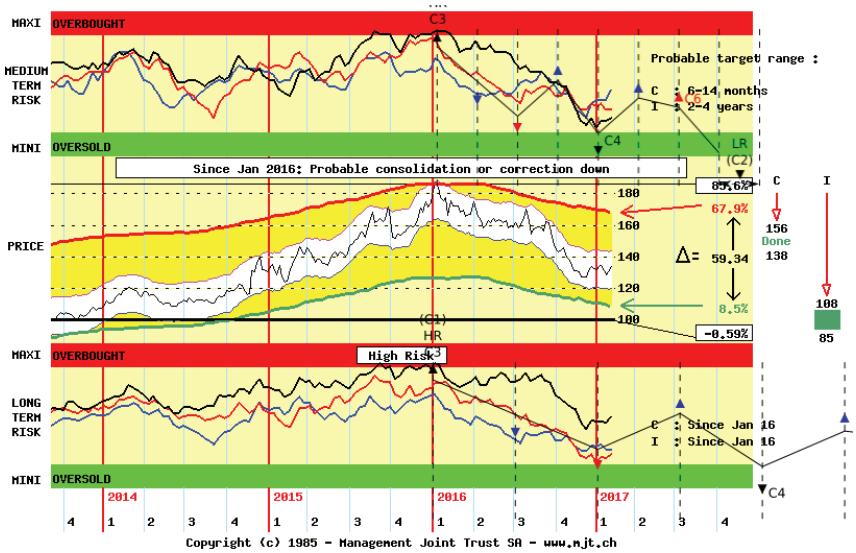
Brazil was one of the strongest beneficiaries of the rebound in oil prices in 2016, while Mexico has been entangled in its immigration and trade dispute with President Donald Trump. As shown by our models on both our oscillator series (upper and lower rectangles), we expect a revaluation of Mexico vs Brazil over the coming 3 to 6 months.

Poland Wig Index vs RTS Moscow Index (Weekly graph or the perspective over the next 2 to 4 quarters)

In Eastern Europe, Oil dependent Poland has underperformed oil producing Russia since 2014. The move which started as the Russian crisis subsided, actually accelerated in 2016 as oil prices rebounded. Poland's stock index is now in a Case 4 position (intermediate bottom) versus Russia's on our long term oscillators (lower rectangle). It could now outperform its oil & gas producing neighbor for the next 3 to 6 months.



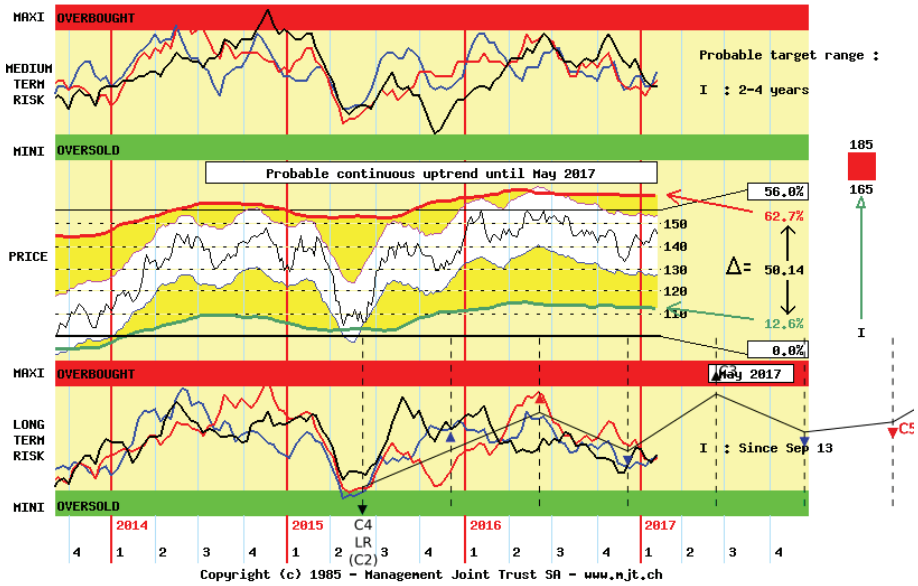
Copenhagen SE All-Share Price Index vs Norway Oslo Obx Index
(Weekly graph or the perspective over the next 2 to 4 quarters)



Arbitraging Northern Europe, the Copenhagen Index which is mainly focused on Biotechs, Financials and Consumer Goods has reached an intermediate bottom vs the the Oslo Boers Obx Index mainly focused on Oil & Commodity Industries (upper and lower rectangles). It is meant to correct to the upside over the next 3 to 6 months.

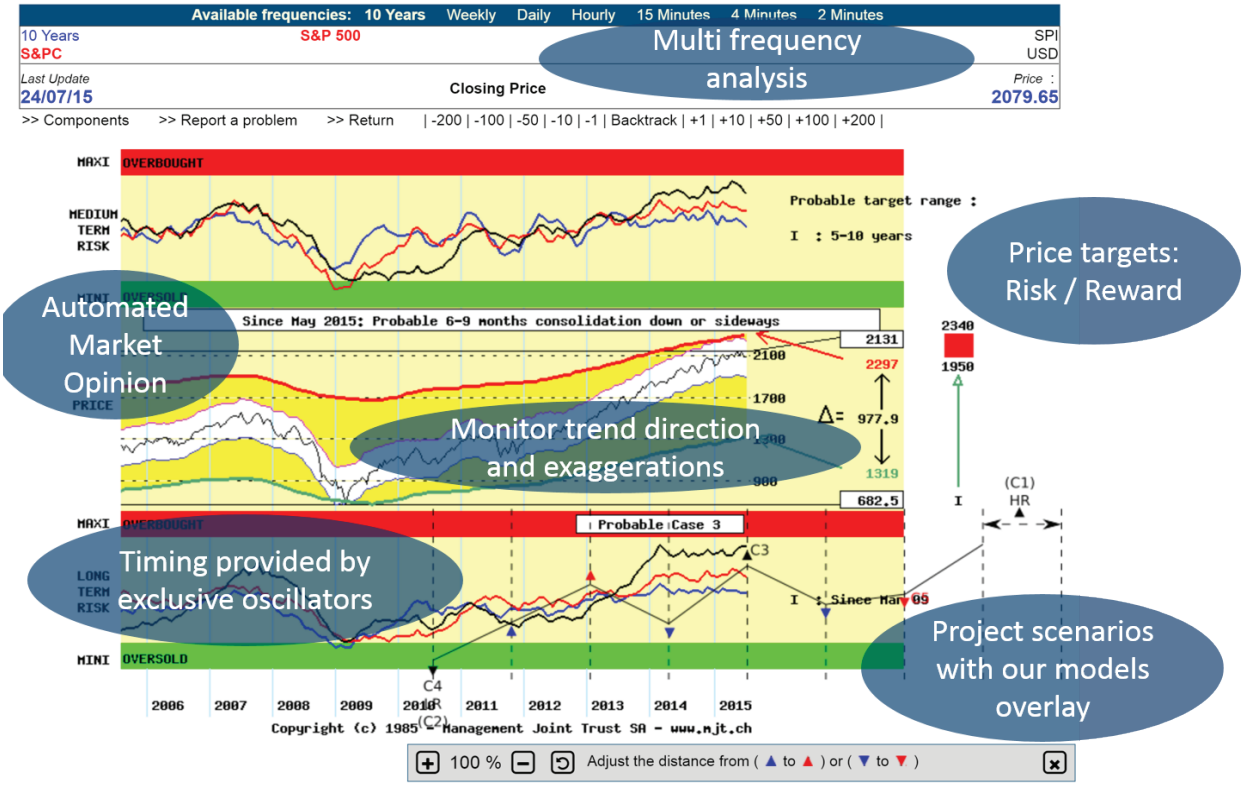
INDY - iShares S&P India Nifty 50 Index Fund / FXI - iShares FTSE China 25 Index Fund
(Weekly graph or the perspective over the next 2 to 4 quarters)

"In the energy world, India is becoming the new China ... It will be the fastest-growing crude consumer in the world through 2040, according to the IEA, adding 6 million barrels a day of demand, compared to 4.8 million for China" (Bloomberg, April 2016). Indeed while oil is expected to correct to the downside, we believe India's stock market should outperform China's, possibly into late Q2 2017 as shown from the model projection on our long term oscillators (lower rectangle).

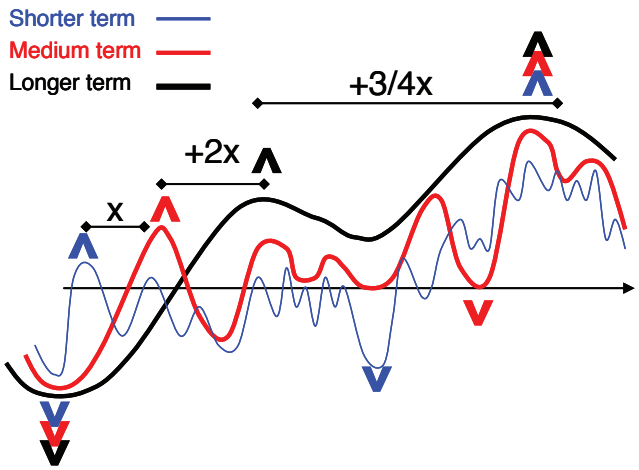


30 / METHODOLOGY

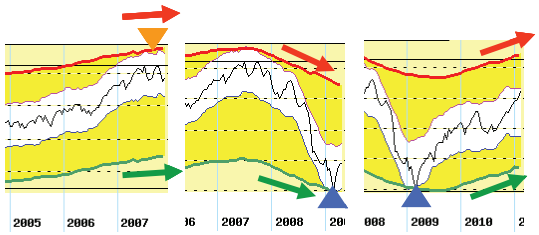
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative charts, Opportunity filters, Multi charts monitoring screens and a Portfolio Simulation tool complete the functionality set. See below a description of What's on the Chart, a Methodological brief and an outline of the ideal Uptrend/Downtrend Models (read more on www.mjt.ch).



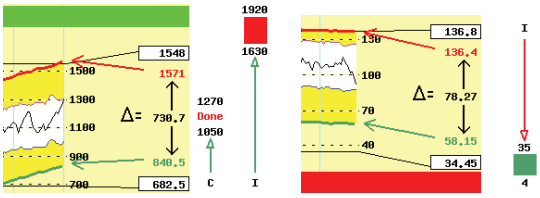
Timing oscillators: different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)

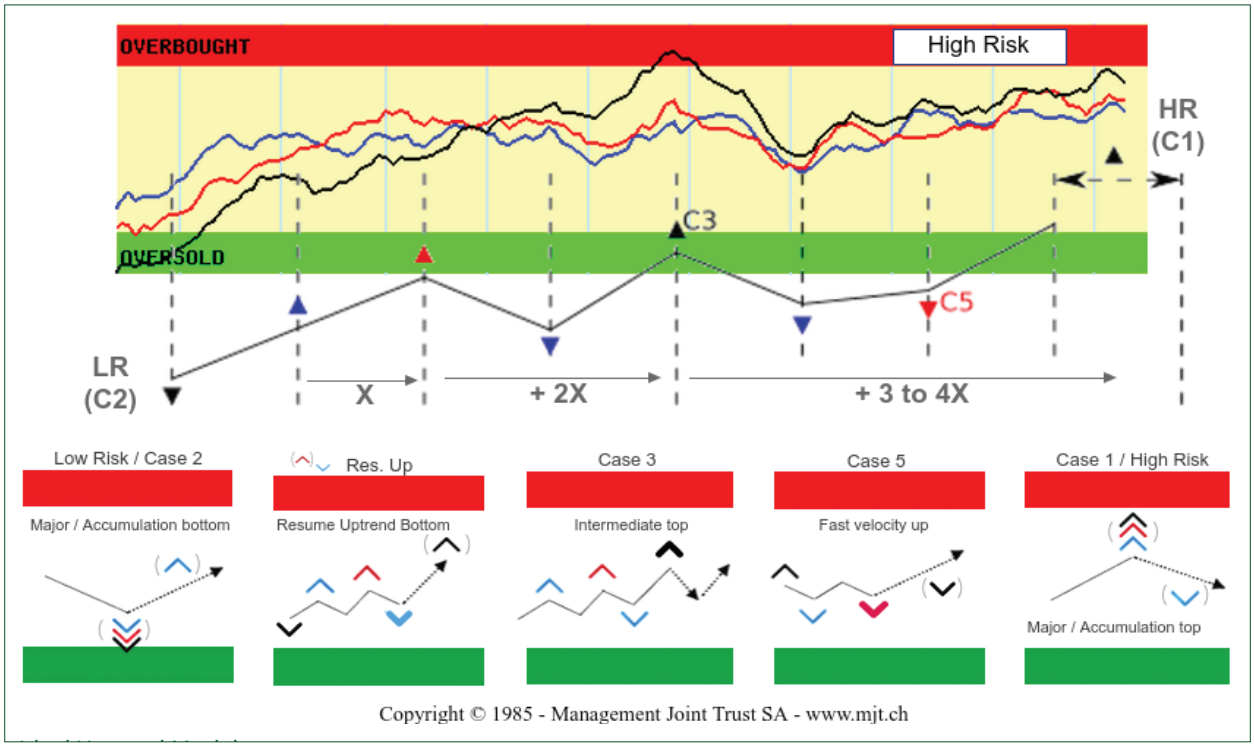


Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



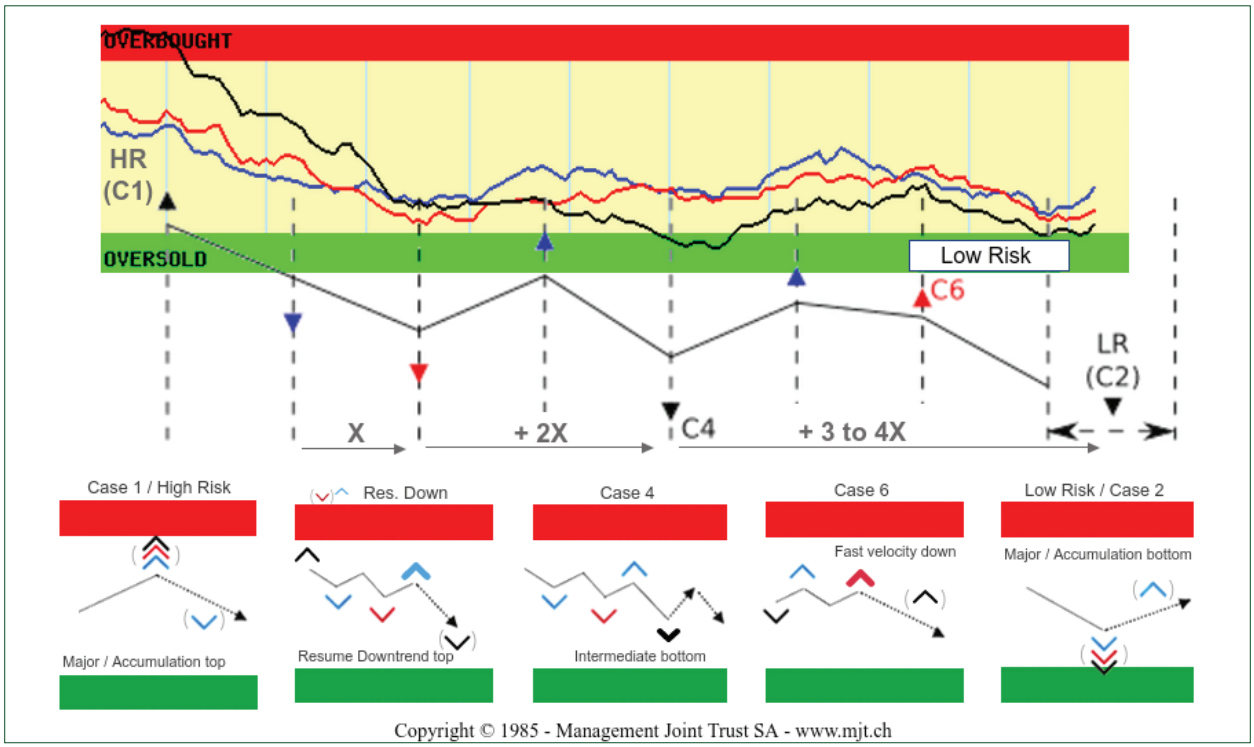
Price targets: based off historical volatity, they can highlight price potential or risk and, once achieved, define take profit or stop loss areas (e.g. below S&P500 in early 2011, Brent in October 2014).





Ideal Uptrend Model

(left to right) from an oscillator black bottom (usually a Low Risk or a Case 2), the oscillators and prices will start moving up. An uptrend is confirmed once a red top can be made above a blue one. The correction down that follows delivers a buying opportunity ("Resume Uptrend") followed by an intermediate top (Case 3). A new period of consolidation down or sideways then starts, ending with a Case 5 acceleration up towards an important top (usually a High Risk or a Case 1). For each time frame, a fixed time unit separates each timing incidence, so that the distance between a blue and red top is usually X, the distance from the red to the black top is then 2X and the distance between the first and second black top is 3 to 4X.



Ideal Downtrend Model

(left to right) from an oscillator black top (usually a High Risk or a Case 1) the oscillators and prices will start moving down. A downtrend is confirmed once a red bottom can be made below a blue one. The correction up that follows delivers a selling opportunity ("Resume Downtrend") followed by an intermediate bottom (Case 4). A new period of consolidation up or sideways then starts, ending with a Case 6 acceleration down towards an important bottom (usually a Low Risk or a Case 2). For each time frame, a fixed time unit separates each timing incidence, so that the distance between a blue and red bottom is usually X, the distance from the red to the black bottom is then 2X and the distance between the first and second black bottom is 3 to 4X.

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