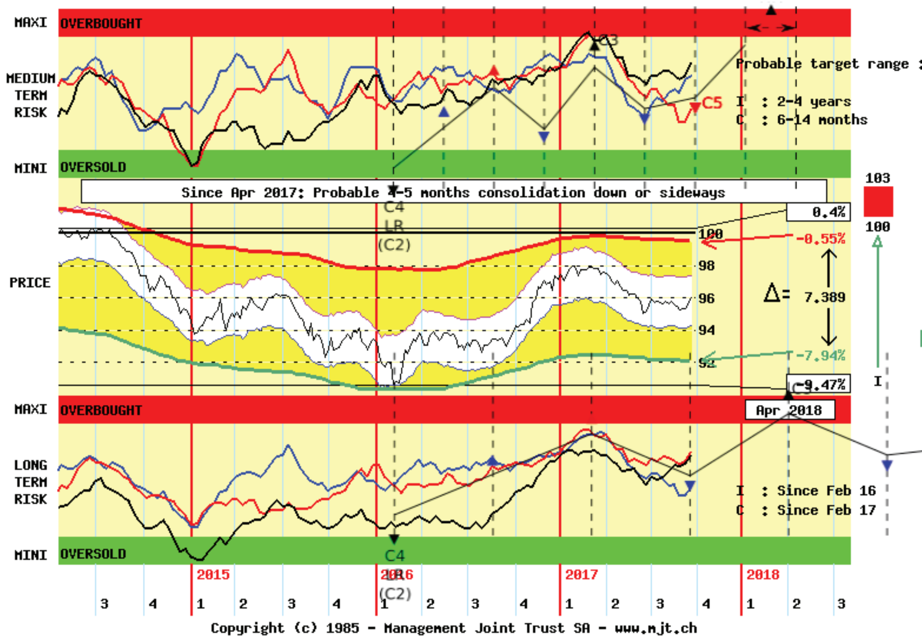
Reflationary assets may re-test down in October, but should re-accelerate upwards towards year-end

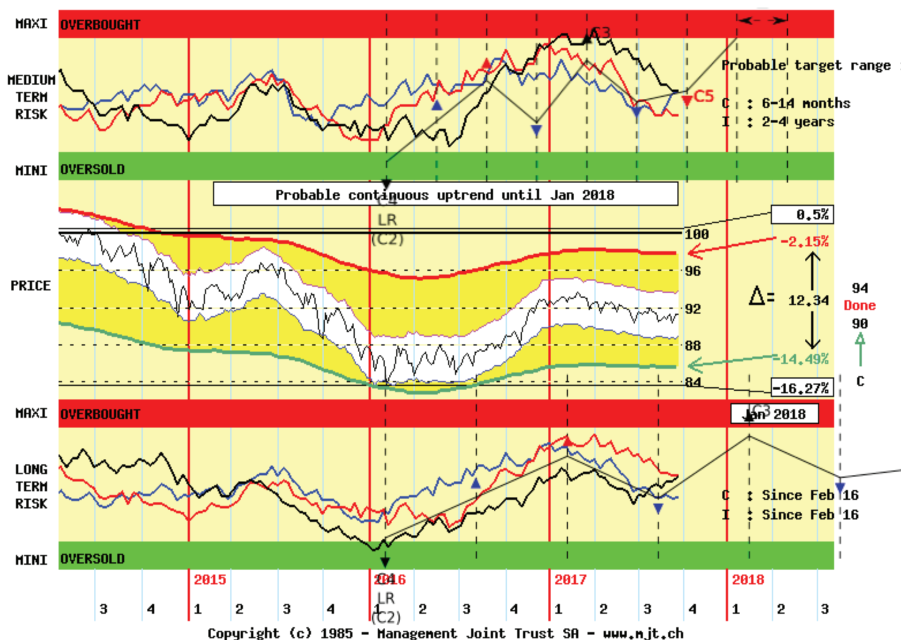
Over the last few weeks, many reflationary proxies and interest rates have started to move up again. Although these developments are promising for cyclical and reflation trades towards early 2018, shorter term, our Daily graphs are suggesting that a further re-test to the downside is likely into Q4, before the acceleration up really kick-starts.

TIP - iShares TIPS Bond ETF vs IEF - iShares 7-10 Year Treasury Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



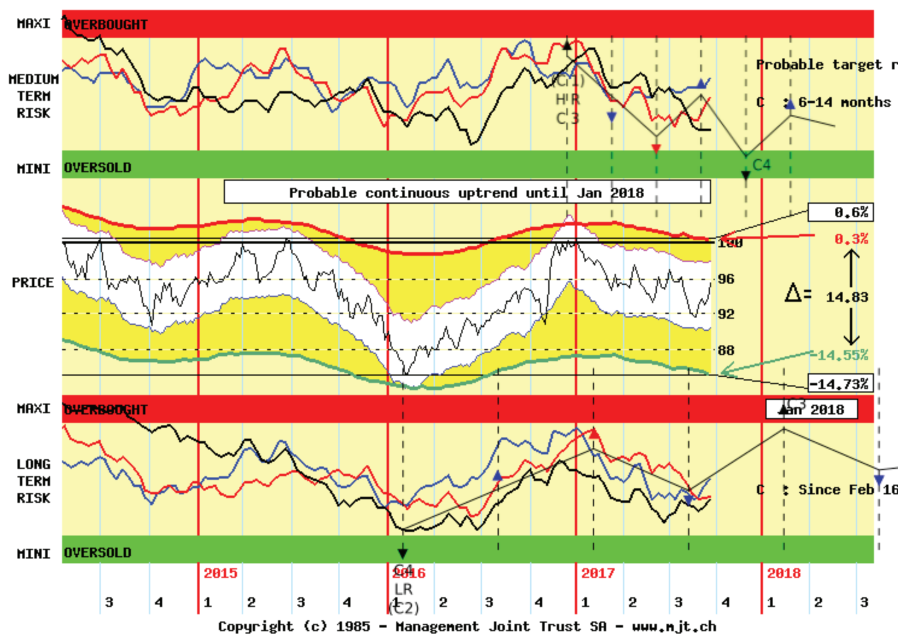
The ratio compares inflation protected Government Bonds to traditional Treasuries of similar duration. It translates investors' appetite to seek inflation protection beyond the inflation that is already priced into Treasuries: when it is trending up, investors are seeking more inflation protection and vis-versa. On both our oscillators (upper and lower rectangles), following some retracement during Q2 and Q3 2017, **the ratio is getting ready to move up again, probably towards the Spring of 2018.**

HYG - iShares iBoxx $ High Yield Corporate Bond ETF vs LQD - iShares iBoxx $ Investment Grade Corporate Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



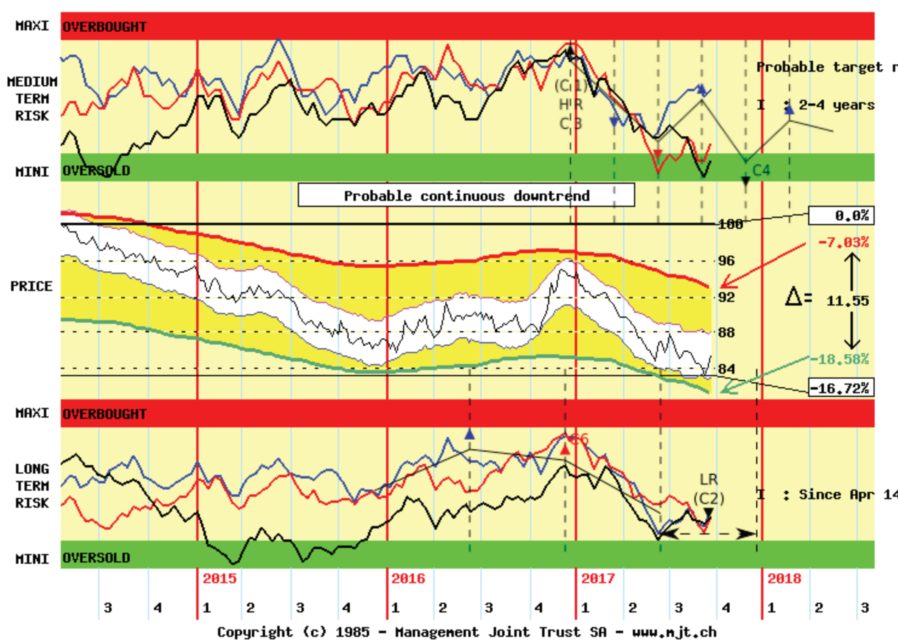
Investing in High Yield is also a way for investors to protect their bond portfolios against inflation and rising yields. It allows them to lock in a credit spread, which will likely increase in value as the cycle accelerates up and credit spreads decrease. It serves to compensate the potential losses, from which a bond portfolio could suffer, in a rising interest rates environment. **As with the TIP/IEF ratio above, HYG/LQD may be getting ready to resume its uptrend towards early 2018 as shown on both our oscillator series (lower and upper rectangles).**

IWM - iShares Russell 2000 ETF vs SPY - SPDR S&P 500
Weekly graph or the perspective over the next 2 to 4 quarters



On the equity side, investing in small caps also offers protection against inflation and a rising interest rates environment. Indeed, small caps are usually less levered that Blue Chips and often more pro-cyclical. On our long term oscillators series (lower rectangle), small caps may have just started to resume their uptrend vs the S&P500 towards early 2018. Our medium term oscillators (upper rectangle) however show that **a last retest to the downside is still possible, before small caps really start to accelerate up vs the market.**

IVE - iShares S&P 500 Value ETF vs IVW - iShares S&P 500 Growth ETF
Weekly graph or the perspective over the next 2 to 4 quarters

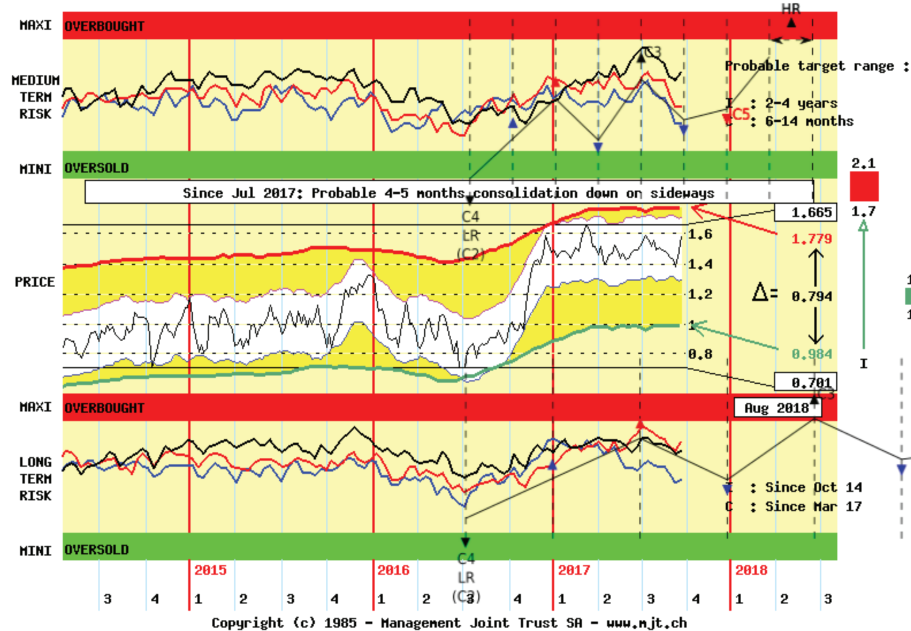


Over-weighting Value profiles vs Growth ones also offers protection against inflation and rising interest rates as Value play are usually more cyclical and "short duration" than typical Growth profile. This year, Value also suffered from the strong outperformance of Big technology in H1 (typical Growth stocks). On our long term oscillators (lower rectangle), **Value is getting Oversold vs Growth and has probably entered a "Low Risk" zone. Our medium term oscillators (upper rectangle) are getting very Oversold too, yet a last retest seems still likely in mid Q4. Following that we would expect a bounce of Value vs Growth into early 2018.**

Initial remarks

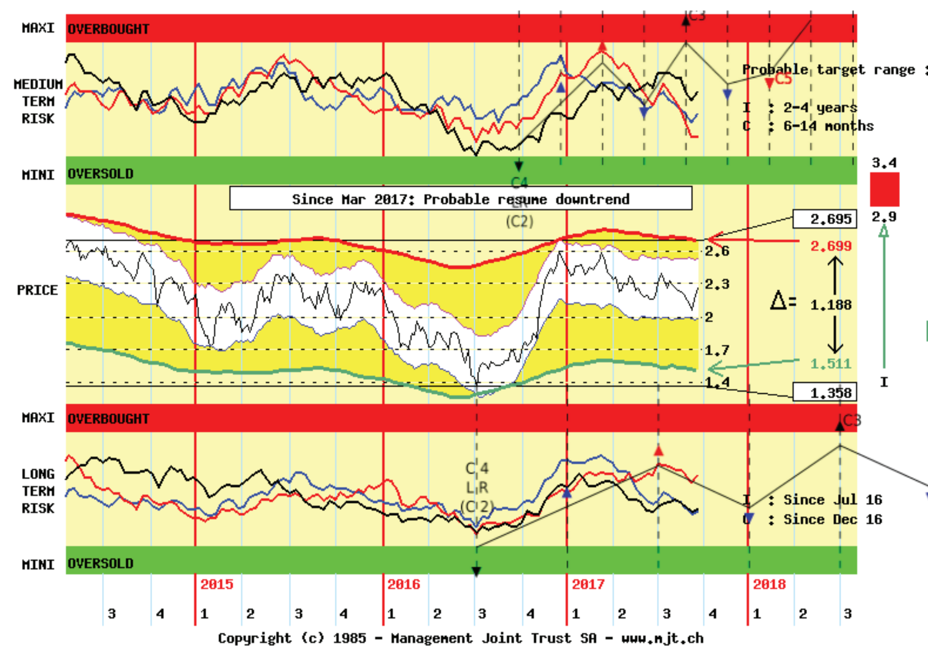
On the fixed income side, instruments which offer protection against rising inflation and rising interest rates seem to be ready to resume their uptrend into early 2018. On the Equity side however, a last re-test for Small Caps and Value still seems likely towards mid Q4, before they finally start to correct up vs the general market and Growth profiles. Bearing in mind, that the average equity portfolio probably has a much longer duration than the average bond one, we will turn to US yields and their Yield Curve to explain some of these differences.

US 3 Years benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



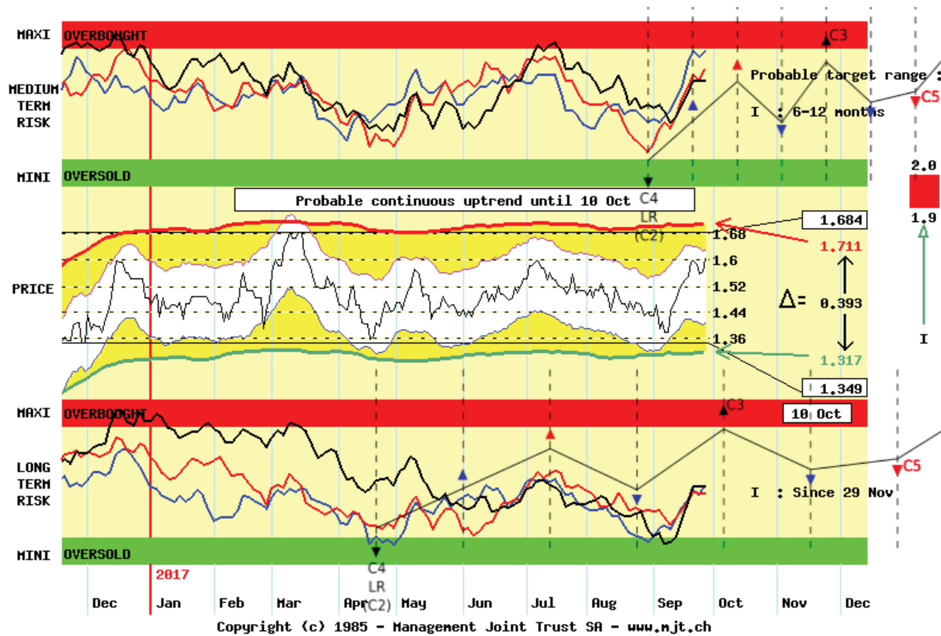
We first turn to Yields on shorter term Treasuries (3 Years tenure). This is where most of the action is currently happening, as shorter term yields are rising as quickly as the usually more volatile longer term yields. This phenomenon has a sense of "déjà vu" as it already happened during the Summer of 2016 following the bottom on yields in early July. Back then, it took the curve about three months to start steepening again. **Focusing back on our 3Y Treasury yields, our medium term oscillator series (upper rectangle) seem to have started their move up towards Spring next year, yet a further set-back, probably at high levels, is still possible during Q4**. Our longer term oscillators (lower rectangle) would confirm that a set-back is still likely during Q4 before 3Years rates continue up. If our current 'I' Impulsive targets up (right-hand scale; middle rectangle) are fulfilled, 3Y Treasury yields could rise another 50 bps by Spring next year.

US 10 Years benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 3 months



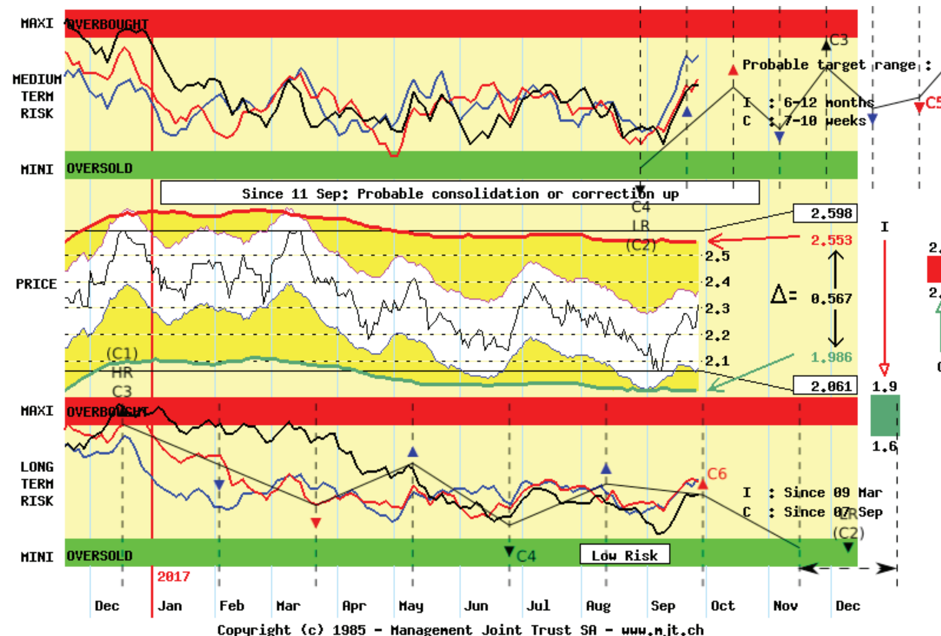
Longer term 10 Years Treasuries rates have suffered a stronger retracement than the 3 Years rates since they topped out in the Spring. They are also finding it more difficult to re-accelerate up at this stage. Our medium term oscillators (upper rectangle) would suggest a sequence, where **they re-test once more, before accelerating up towards the Spring of 2018.** Our longer term oscillators (lower rectangle) would suggest that 10Y Yields are still under pressure over the coming months. For now, the upper end of our 'C' Corrective targets down around **2.0% has served as strong support** (right-hand scale). **We expect that this should by and large continue to be the case. If and when, long term yields really start to accelerate, our 'I' Impulsive targets do show strong potential into next year, possibly above 3.0%.**

US 3 Years benchmark Bond Yield
Daily graph or the perspective over the next 2 to 3 months



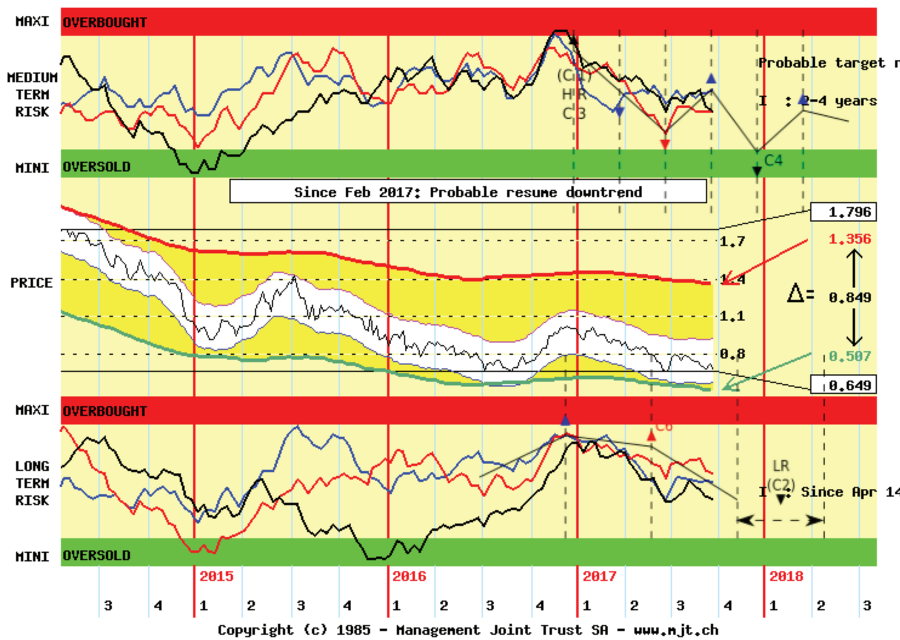
Scoping into the daily graphs, the 3 Years Treasury Yield started a promising bounce in early September and is already approaching its YTD highs made in March. Yet, on both our oscillator series (lower and upper rectangles), we would expect **potential tops between now and early October**. Both would indicate that following a bit more upside momentum, 3 Years Treasury Yields should top out for now and start retracing towards late October, early November. There is probably too little time left to reach our 'I' Impulsive targets to the upside (right-hand scale; middle rectangle) at this point in time, and we would consider such targets for the next leg up. **The 'C' Corrective targets to the downside we can calculate into early November are between 1.5% and previous lows at circa 1.36%** (using our historical measure of volatility "Delta", here at 39.3 bps, times 0.5 to 0.8, subtracted from the graph's highest point, 1.684).

US 10 Years benchmark Bond Yield
Daily graph or the perspective over the next 2 to 3 months



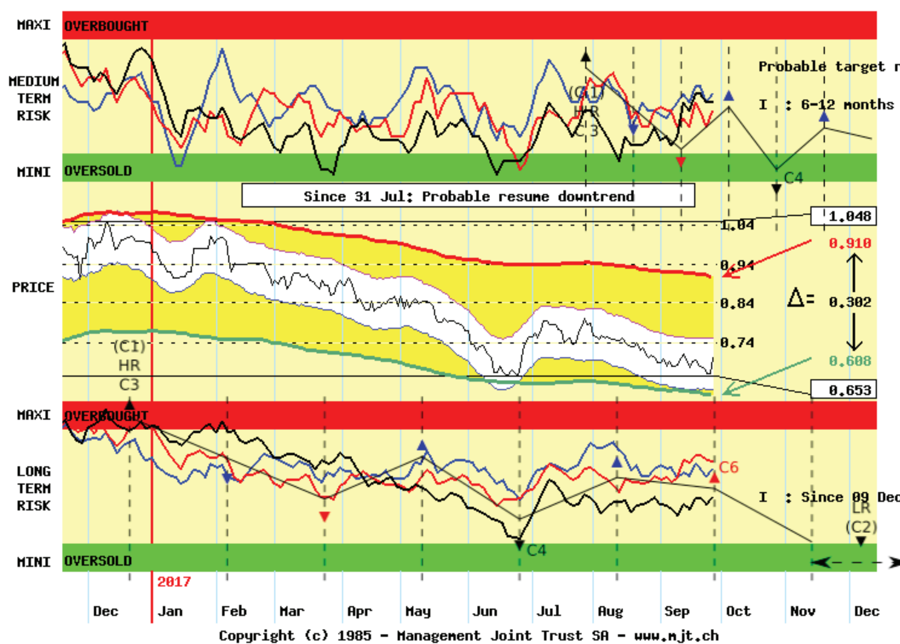
10 Years Treasury Yields are also bouncing, yet there are still far below their YTD tops. On both oscillators series, **we are expecting tops between now and early October, which could retrace into early, even late November.** Our 'I' Impulsive targets to the downside (right-hand scale; middle rectangle) are still menacing as they point to below the **2% mark, which has provided strong support up to now. We believe that the 2% mark may be challenged, but not substantially.**

US 10 years Benchmark Bond Yield vs US 3 years Benchmark Bond Yield Weekly graph or the perspective over the next 2 to 4 quarters



As shown above, it seems that the trend on the 3 Years Treasury yields is showing more upside momentum at the moment, than the one on the 10 Years yields. It is also likely to retrace less if the correction we expect into November materializes. These dynamics are captured by the persistence of the downside momentum of the spread. On this graph, both our oscillator series suggest that the **10/3Years spread is likely to continue lower towards mid-end Q4**. Following that, we would expect a bounce and that the yield curve finally starts to steepen again. On the positive side, our 'I' Impulsive targets down (right-hand scale; middle rectangle) has pretty much been achieved, i.e. **this downtrend is slowly reaching exhaustion**.

US 10 years Benchmark Bond Yield vs US 3 years Benchmark Bond Yield Daily graph or the perspective over the next 2 to 3 months



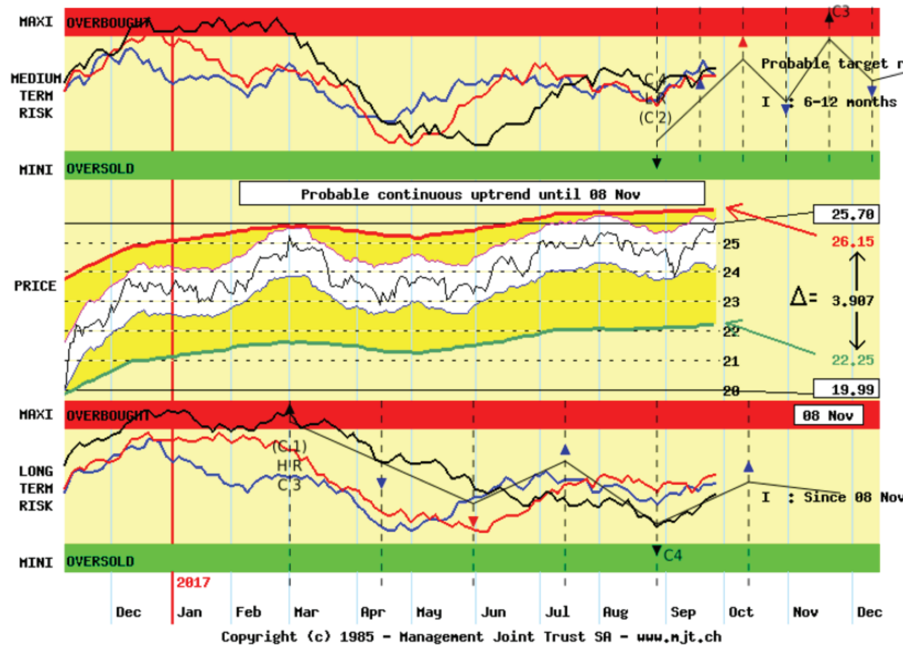
The Daily graph of the 10/3Y spread confirms our longer term view. Both oscillator series (lower and upper rectangles) suggest that **following a short bounce now, the spread should narrow again from early October into late October, possibly even mid November. Here too, the potential to the downside does however seem limited** as we are getting nearer to our 'I' Impulsive targets down (right-hand scale; middle rectangle). **Hence, the flattening of the US yield curve may slowly me getting exhausted, yet it may take another month or so to turn.**

Concluding remarks

While both shorter and longer term US Treasury Yields have bounced since early September, the longer term is still showing less upside, and more downside momentum. In the retracement period we expect during October (which could possibly extend into mid November), we would hence expect the yield curve to flatten a bit further. As for the price targets we expect, we believe that previous lows should probably hold on both tenures (or be slightly broken) and that the flattening potential of the Yield Curve is getting closer to exhaustion.

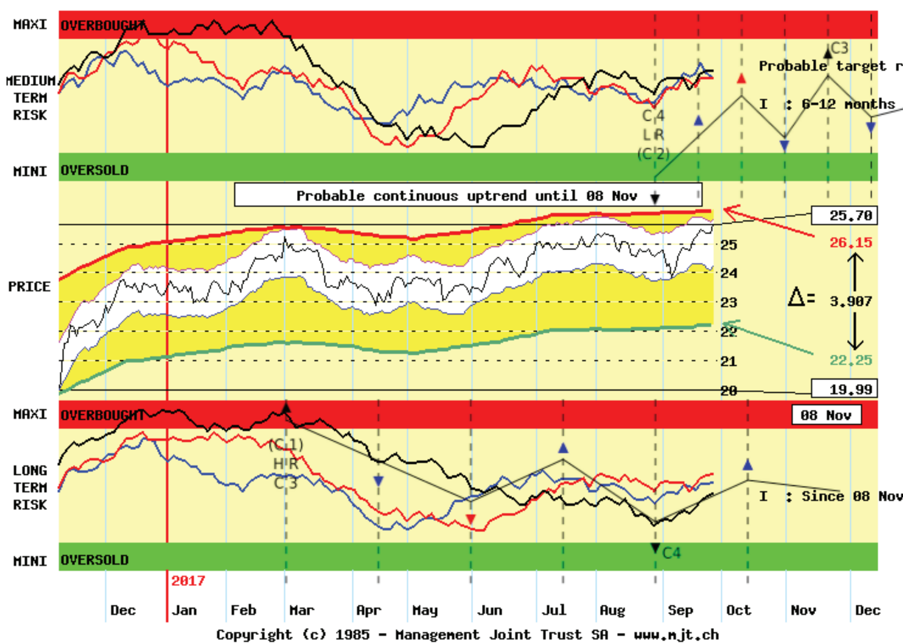
We conclude this section with a review of daily graphs of the US Financials and European Banks. Indeed, these relate quite closely the yields dynamics mentioned above:

XLF - Financial Sector SPDR Fund
Daily graph or the perspective over the next 2 to 3 months



The US Financial sector has recently made new year to date highs. **Yet, it is currently reaching its 'I' Impulsive targets to the upside (right-hand scale; middle rectangle). Both our oscillator series (lower and upper rectangles) are also showing intermediate tops early October. We hence believe that the move is gradually reaching exhaustion**. Following that, we expect that US Financials start to retrace, probably towards late October, early November. Using our current historical volatility measure "Delta" (right-hand side; middle rectangle), the corrective potential to the downside we can calculate is between 2 and 3 USD or between 8 and 12% ("Delta" at 3.907 USD times 0.5 to 0.8).

SX7P - BANK - Dow Jones STOXX
Daily graph or the perspective over the next 2 to 3 months



European Banks are in a similar position. We are approaching our 'I' Impulsive targets to the upside (right-hand scale; middle rectangle) and both our oscillator series (lower and upper rectangles) also suggest that an intermediate top is imminent (between now and early October). Using our current historical volatility measure "Delta" (right-hand side; middle rectangle), the corrective potential to the downside we can calculate is between 13 and 21 EUR or between 7 and 11% ("Delta" at 26.55 USD times 0.5 to 0.8).

Concluding remarks

Similar to what we expect on yields and equity markets, we believe that we are approaching intermediate tops early October on US Financials and European Banks. The corrections to the downside should last into late October, early November with a downside risk of 7 to 12%.