THE CAPITAL OBSERVER

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the technical analyst
AWARDS 2018
WINNER

A DC&C publication,
featuring MJT's timing methodology

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THE CAPITAL OBSERVER

A Monthly Macro and Asset Review
Featuring MJT's Timing Methodology

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"The National Institution for Finance and Development (NIFD) said on Wednesday the 13th that China's economic growth rate will slow to 5.8% in 2020 from an estimated 6.1% this year, a number which is already quite ambitious, not to say artificially goalseeked. However, with few other levers to pull and despite the surge in debt, the NIFD called for a bigger central government budget deficit to allow for more expenditure to support the economy."

4/ Executive Summary

12 / **Waiting For The Other Shoe To Drop: Reversal In Fed Balance Sheet Growth Signals Onset Of A Temporary Bond Yield Correction In This Up Trending Phase** - The reasons for the previous bond massacre are now well-understood by now. But what explains this new, recent sharp 10Y yield move up? It appears to us that this time, there are three possible explanations for the phenomenon.
The first pertains to foreign capital inflows-- foreign money is playing a big role in this movement. Foreign money had flowed into the US bond market during Q2 this year, and bond prices rose (while yields fell) during the height of the budget spending caps, when the US Treasury was constrained from issuing new securities to fund new debt. With recent and more positive developments in the trade discussions, the US stock market has risen, and foreign money started to migrate to the US equity markets. The second factor contributing to the recent rise in bond yields is the signal from the Federal Reserve that there are no plans in the near future to lower further the Fed's policy rate of interest. In fact, Fed Chair Jerome Powell hinted that a moratorium on rate cuts may be in place until mid-2020. The capital migration from the bond market to equities, plus a sharp inflow of systemic liquidity from these new Fed stimulus programs caused a sharp run-up in both equities and in bond yields in the last several weeks. This significant inflow of systemic liquidity has been the primary factor in pushing up bond yields rapidly in the past few weeks.
There are two ways of illustrating the ongoing dynamic between systemic liquidity and the 10yr yield. One is via the Treasury Cash Balances (TCB), and the other is through the aggregated SOMA transactions. The 5yr average of SOMA transaction change rate tells us that we are probably looking at an intermediary peak in the SOMA model sometime soon and could lead to some consolidation in this yield up trending phase.
Finally Quantitative Easing does not make yields go lower. It did not happen in QE1, QE2, QE3-- and so yields will not fall in "Not QE" this time around. Only hapless economists believe that is what will happen. Anyone genuinely involved in the market will tell you "Not QE" will push up yields. And it will.

16 / **Timing and Tactical Insight** - **Initial late November / early December top for yields and related trades -** Treasury yields in the US, Europe or Japan have been bouncing dynamically since early September. We believe this first leg up is still underway, probably towards late November / early December. Following that, a period of retracement may materialize into late December, perhaps into early next year. Indeed, the recent rebound in yields in very much the result of the very accomodative FED policy since October. Going forward, we however believe the FED when it says that it won't indulge in further rate cuts this year. We would hence expect US3M Treasury yields to start bouncing from December, probably into Q1, perhaps even mid next year. Yields may continue higher during Q1 if economic conditions are strong enough and not QE4 is still underway, yet the US10Y-US3Y spread will eventually start flattening again (US3Y rising faster than US10Y), probably from December into late Q1, perhaps even mid next year. Value trades, including Financials should then give up their recent market lead and will probably underperform the wider indexes from December on-wards. Renewed funding pressures towards year-end and a concomitant new leg up in the US Dollar from late November, may also explain this change in leadership.

24/ **China: more of the same litany of missed opportunities; no significant uptick in activity expected before early Q2 2020 -** At The Capital Observer we have always considered the Total Social Financing to be a reliable leading indicator of economic growth and activity in China.
Since we last reviewed the Chinese situation, nothing dramatic has changed , when the latest data dumped at that time (August 2019) disappointed across the board. The reason then, as it is now is because the economy was still grappling with a drought in cash. Total Social Financing remains insufficient to kick-start the economy out of the doldrums. The primary mover of the TSF, central government expenditures is indicating that redress will only come by early Q2 next year. The growth in monetary aggregates left a lot to be desired. The stability in M2 growth is disappointing, given favourable base effects, leaving the rate in its channel from early 2018 and the downtick in M1 is worrying.
Overall, the slowdown in household credit growth also continues, with the authorities keeping the reins tight, while corporate credit growth is struggling to pick up. The central government and the Chinese central bank have simply not done enough.
However, Chinese authorities will likely maintain their gradual approach, partly for fear of derailing the trade truce. Another 5bp rate cut is likely this year, probably more. But the malaise will not reverse until Beijing injects another elephant-dose of credit and liquidity into the Chinese financial system. The powerful influence of the TSF, which we expect to decline until Q1 2020, remains a powerful constraint on activity. Unless the authorities in China breaks the mould, our next China piece in a few months will probably be a recitation of the same litany of things that were not addressed properly by doses of liquidity.

27 / **Timing and Tactical Insight - Chinese equities, deal or no-deal, should retrace down during Q1 -** Following their strong rally into April, Chinese equity markets did consolidate for about 4 months into August. They have since been bouncing and we believe this rebound could continue until early December. Following that, we expect Chinese markets to start consolidating down into early 2020, perhaps Spring next year. On a relative basis, the slump also seems quite clear and we expect Chinese Equities to also underperform Global market until late Q1, perhaps Spring next year (along with other Emerging markets). This underperformance could coincide with a further rally on USD/CNY into mid/late Q1, while we expect Industrial metals such as Copper or Nickel to also move lower into the Spring.

35 / **The EU courts technical growth recession, but a full benevolent circle in financial conditions awaits via the EUR common currency -** That the malaise has become EU-wide is significantly more problematical than a problem with, say, Germany. The only real agency that can address an EU-wide situation is the ECB, and the ECB doesn't really have any room left to loosen monetary policy. Fiscal policy remains the province of the nation-states. And there lies the rub-- coordinated fiscal responses aren't going to happen yet.
Germany has always been the workhorse that has pulled the European economy back from the brink time and time again, and pushed bloc-wide growth along despite internal and external pressures, as well as political crises, over the last decade. As the de facto economic and political leader of the bloc, the country has spearheaded and supported rescue plans for the Eurozone's weaker links. However, Germany's economic and political outlook has turned dark – there are now valid concerns over the potential knock-on effects of that darkened

outlook on the entire monetary union. It is also because Germany was specifically dependent upon China as a destination for exports. And China has been hurt hard by the trade brawl with the US. Trade tensions, the threat of a hard Brexit and weaker emerging markets growth have all played a part in dampening Germany's nine-year-long economic upswing. With the slow and steady deterioration of the Eurozone's nominal and real GDP, the EUR/USD pair has drifted slowly lower in favour of the US Dollar. And the signalling effect of the EUR currency suggests that growth may still deteriorate over at least the next quarter, or two. But there is a silver lining in those dark clouds. It harks to the benefits that a country gets from a slow depreciation of its domestic currency – the type of currency devaluation that the EU has, and still is, undergoing.
It turns out that weaker EUR translates into a stronger EU economy (in general) relative to the US nine months after such a slow devaluation. Asset price gains have a way of leading economic growth, at least in the US. That could also kick-start downtrodden economic sentiment among investors and businesses in the EU. And that would bring EU financial conditions around a full, benevolent circle. The EU economy should be a lot better (perhaps even vis-à-vis the US economy), 9 months from now.

38 / **Timing and Tactical Insight - Although still lagging for now, European markets could outperform for mid/late Q1 2020** - EUR/USD and GBP/USD have been good proxies for the underperformance of European markets vs the US and other developed markets over the last couple of years. We expect both, as well as the ratio of European markets vs US ones in US Dollars terms, to retest / retrace down once again from December into mid/late Q1. Following that, longer term, other elements are starting to look more positive for European markets. These include an uptrend, which still seems strong on the EuroStoxx 50 into Summer next year, the fact that European markets in local currencies terms are very much Oversold vs US ones, that cyclical Germany is also oversold vs the more growth oriented CAC, and that finally, the more defensive Europe Stoxx 600 could be starting to reverse down vs the more cyclical Euro Stoxx 600 (on our long term bi-monthly graph). We would hence remain prudent on Europe in relative terms for another few months, but do believe that by mid/late Q1, it could start to deliver positive surprises, probably until late next year. Interestingly, UK markets could also start outperforming European ones from mid/late Q1 in EUR terms.

46 / **Framing US Financial Systemic Liquidity For Portfolio "Tactical Investing"**- US financial system liquidity flows are highly seasonal, and tend to recur more or less around the same date every year. As we are discussing in this edition, a large percentage of risk assets prices move can be attributed to the influence of liquidity flows. The other segments of price movements very likely stem from daily news flow. These are the primary sources of the US financial system's liquidity: The Fed's Balance Sheet, Bank Reserves (Excess and Required), Treasury Cash Balances, and Commercial Bank Loans. For the most part, risk assets respond mostly to changes in the Fed's Balance Sheet, the bank reserves at the Fed and to Treasury Cash Balances. Credit creation is also important as a lead indicator of impending liquidity changes via the M2 Money Supply. As we have explained before, liquidity conditions do not cause asset price movement, but they create the base conditions. In the absence of compelling news flows, the market tends to go to the default setting provided by liquidity conditions. We can use the covariance of risk assets price with liquidity flows by noting the periods when liquidity conditions start to change. In normal condition, one should try to invest according to the next seasonal trend in liquidity flows.

50 / **Timing and Tactical Insight - Sector profiling -** Mapping correlations can be a moving target. To achieve more robustness, we, at The Capital Observer, tend to use Cyclical Analogs instead. Indeed, in addition to price, we also perform our correlation analysis on our cyclical oscillators as well as on our standard deviation envelopes. We believe their results are more stable over time. We would then typically match a universe of instruments to specific driving factors. In this article, we have mapped US and European sector relatives to the cross influence of two factors, the S&P500 and US10Y Treasury yields. This top down analysis delivered 3 distinctive profiles (Cyclical, Defensive and Growth sectors) which we were able to counter-check using our graphs. Yet, these graphs' and their projections also allowed us to confirm our cross asset scenario going forward, on the S&P500, on US10Y Treasury yields and on the sector rotation we expect. Hence, on a relative basis, we believe that Cyclicals could retest up into late November / early December, that Defensives could bounce while the market consolidates slightly during December, and that by late December / early January, Growth themes should take up leadership in what appears to be a US led recovery, and initially, a US decoupling story.

56 / **Splicing the markets - Commodity and Asian Growth currencies should weaken into early Q1 -** Cross Assets, we expect the cyclical rebound which started early September to finish a first leg up towards late November / early December. We then also expect the US Dollar to resume its uptrend vs most developed currencies into Q1. Emerging markets, Asian Growth and Commodity currencies should suffer against the Dollar during this period. Vs the EUR, Commodity currencies should also resume their downtrend during this period, while Asian Growth currencies should see a milder consolidation as EUR/USD should also be falling. Hence, from early December into early/mid January, Commodity currencies appear to be the weakest link. Thereafter, during Q1, the Euro and Asian Growth Currencies could be weaker.

6/ Mapping the markets

Last month, when we published on the 15th of October, we expected the rally on risk and cyclical assets to continue, into mid /late November, perhaps even December. We expected yields to rise and the yield curves to steepen, thereby benefiting Value, Cyclical and related Commodity trades. We also expected the US Dollar to see an intermediate correction, while precious metals would continue their own correction down, and Oil could start to resume its uptrend. All these projections have proven very correct, and although they have retraced slightly over the last few days, we do expect these trends to resume for another couple of weeks.

Indeed, going forward, we expect the current risk and cyclical rally to reach an intermediate top towards late November / early December. The S&P500 and the EuroStoxx 50 could climb 1-2% higher, US10Y Treasury yields could test above 2%, Gold could retrace down to the low 1'400s, Oil could reach the low 60s on WTI, above 65 on Brent. Value and Cyclical themes could also complete their rebound. Then from the end of the month / early December, equity markets could enter a short and rather shallow retracement period. Defensive assets such as Gold, Treasuries and Defensive sectors could then rebound slightly, while the US Dollar could resume its uptrend vs the EUR, Commodity, and more generally Emerging markets currencies. Cyclical Equity themes should also correct down during December.

From late December into Spring next year, the risk assets rally should then resume. Yet, leadership will probably shift to the US, the US Dollar and related Growth themes. Value and Cyclical profiles should lag, while Defensive ones underperform. The Dollar could be particularly strong, EUR/USD could break below 1.08, potentially down to 1.05. European, Chinese and Emerging Markets equities could widely underperform in US Dollar terms. On the Treasury front, the FED may turn less accommodative. US10Y yields may still push higher, possibly into the mid 2s % by next Spring, but the US10Y-US3Y yield curve spread could flatten again as the US3Y could also be rising quite dynamically. Gold probably falls to the low 1'300s USD/oz, while Oil reaches into the high 60s / low 70s USD /barrel.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	US Equity markets could still push higher towards 3'150 on the S&P500 into late November / early December. Following that, some consolidation may materialize during December.	From year-end / early next year, the uptrend on US equity markets resumes higher again into next Spring at least (3'400 - 3'500?)
	Europe EuroStoxx50	European Equity markets could still push higher towards 3'800 on the SX5E into late November / early December. Following that, some consolidation may materialize during December.	From year-end / early next year, the uptrend on European equity markets resumes higher again into next Spring at least (3'900 - 4'000?)
	EMs MSCIEM USD	Emerging markets could retest up to their year-to-date highs towards late November / early December, following that they correct down during December, perhaps into January.	Emerging Markets may hold up during Q1, yet on a relative basis, our graphs suggest that they underperfom developed ones during Q1
Treasuries	US10Y Bond prices	US10Y Treasury yields could test up towards 2.1% towards late November / early December. The move then retraces down into late December, perhaps early January.	From January, US Treasury yields then resume higher into next Spring, potentially towards the mid 2s % on US10Y.
	Germany 10Y Bund prices	German Bund yields could push slightly higher into late November / early December. Following that, they retrace down during December and perhaps into early January.	From January, German Treasury yields then resume higher into next Spring potentially into positive territory.

Legend: Strong Underweight | Underweight | Neutral | Overweight | Strong Overweight

Main Equities

World markets
p 40- 41, 52

Global Equity markets could push slightly higher into late November / early December. Then, following a short period of retracement during December, they should continue higher into next Spring at least. The S&P500 has pretty much reached our targets towards 3'150. The next levels of targets (our extended I2 Impulsive 2 targets) could justify 200 to 300 points of further upside over the next 6 to 12 months. Likewise, the EuroStoxx 50 could reach up towards 3'900 – 4'000 over the next 2 to 3 quarters.

Main Regional picks
p 39

From early December, we expect the US Dollar to resume its uptrend until mid/late Q1. In Dollar terms, the US should outperform most other regions during this period. On a hedged currency basis, Europe and Japan may however resist quite well. Indeed, most of their underperformance in US Dollar terms should be driven by currency movements, while their equity markets perform rather well.

Emerging markets
p 27- 31, 34

Along with their currencies, Emerging Markets should resume their downtrend vs developed ones from early December into Q1.

Volatility
p 16, 17, 18, 20

VIX is getting quite Oversold again and could bounce from late November / early December.

Government Bonds

US & European Benchmarks Treasury and Bund yields could rebound into mid/late Q1, perhaps Spring next year. Over the next couple of weeks, US10Y Yield could push up towards 2- 2.1%, while 10Y Bund yields could reach minus 0.2%. Following that, these should retrace into late December, perhaps early January. A second leg up on yields should then materialize into mid/late Q1. US10Y yields could reach the mid 2s %, while 10Y Bund yields could turn positive again.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	US Equity to Bond ratios should continue higher into late November / early December. Following that, they may see some consolidation during December.	From year-end / January, the ratio should resume its uptrend into the Spring.
	Europe	European Equity to Bond ratios should continue higher into late November / early December. Following that, they may see some consolidation during December.	From year-end / January, the ratio should resume its uptrend into the Spring.
Duration		Yield curve spreads could still push slightly higher into late November / early December. They should also consolidate down during December	While yields resume their uptrend, the US10Y - US3Y curve may continue to consolidate during Q1 as the FED turns less acomodative.
Credit		Credit spreads should continue to push lower although a slight rebound may also materialize at some point during December.	Credit spreads should continue lower towards Spring next year.
TIPs/Treasuries		Inflation expectations (TIPs / Treasuries ratio) could push slightly higher into late November / early December.They then retrace down into December.	The TIPs vs Treasury ratio could resume higher during Q1 with other risk-ON measures, although a stronger US Dollar may hold it back somewhat.
Oil		Oil probably continues to rise into late November / early December. It may then also see a short retracement period.	From late December / early January, Oil then continues higher well into 2020 and tests its 2018 highs.
Industrial metals		Industrial metals may hold up until late November, but then probably resume lower into year-end.	Industrial Metals and Copper probably continue to retrace during Q1 as China underperfoms developed markets. Copper may reach down back below 5'600 USD/ton.
Gold		Gold probably continues to retrace down towards the low 1'400s USD/oz into late November / early December. It may then see a slight bounce during December.	Gold should see a second leg down into late Q1 / the Spring, probably towards the low 1'300's USD/oz

Legend: Strong Underweight | Underweight | Neutral | Overweight | Strong Overweight

Equity to Bond Ratios

US & Eurozone Market Equity to Bonds ratios in the US and Europe could see a slight dip from late November / December, but then resume higher into Q1.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 19, 20

US Yield curve spreads should continue to widen into late November / December. They should then correct down along with yields during December, perhaps into early January. During Q1, US10Y-US3M and US3Y-US3M spreads may then attempt a second leg up towards mid/late Q1 as Inflation expectations could also see a second bounce. US10Y-US3Y is more driven by the US3M (inversely) which we expect to stabilize. The US3Y may then start to rise quite dynamically and the US10Y-US3Y could even flatten somewhat.

Credit
p 23

Credit spreads could also make an intermediate low towards late November / early December, and bounce into late December. We believe they should then resume their downtrend (positive for Credit) into Q1.

Rate Differentials

The US rate differentials vs the rest of the world should start to reverse up between now and year-end as US3M yields gradually stabilize and the growth differential between the US and the rest of the world starts to move up again. Indeed, we believe the US will lead the late cycle economic recovery we expect into 2020.

Tips
p 18

The TIPs / Treasury inflation breakeven ratio could also retrace down from late November / early December. They should however attempt another bounce from early next year.

Commodities

Oil
p 31

Oil could reach up to 60 USD/barrel on WTI and 65 USD/barrel on Brent over the next few weeks. It could then also see some retracement during December. It then probably continues higher towards the high 60s / low 70s during Q1.

Industrial metals
p 31-34

Copper could continue slightly higher into late November / early December potentially up to 5'950 – 6'000 USD/ton. Other Industrial Metals could hold up during this period. From December, we expect the Industrial Metals universe to resume lower into early next year at least, perhaps even the Spring, as China starts to underperform again. Copper may then dip to the 5'600 – 5'500 USD/ton range.

Gold & PMs

Gold and precious metals started to reverse down from early September. They had held up quite well into late October, but have since broken down. We expect them to continue lower towards late November / early December (probably to the low 1'400s USD/oz on Gold). Then, following a slight bounce during December, Gold and precious metals should then resume their correction to the downside during Q1, probably towards the lower 1'300s USD/oz on Gold.

Agriculture

Agriculture Commodities could push slightly higher into late November / early December. They should then correct down into December, and possibly during Q1, as the US Dollar strengthens again.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	EUR/USD could retest up into its 1.11 - 1.13 corrective range to the upside into late November / early December, it then resumes its long term downtrend.	EUR/USD continues lower towards mid/late Q1, breaking back below 1.10 and even potentially down to 1.05.
	GBP	GBP/USD may push slightly higher into the low 1.30s into late November / early December. It could then retrace down during December.	GBP/USD could see some retracement during Q1, potentially into the mid/high 1.20s. Yet, it should hold up much better than the Euro.
	JPY	USD/JPY probably tests above 110 towards late November / early December. It could then retrace down 1 to 2 figures during December.	USD/JPY then resumes higher from late December / early January into mid/late Q1, potentially towards 112 - 113.
	CHF	USD/CHF remains rather neutral until mid/late December as the Dollar gradually resumes higher.	USD/CHF should then accelerate higher as the US Dollar gains vs most currencies and the environment remains rather risk-ON. It may break above 1.02.
EUR vs	GBP	EUR/GBP continues down into the mid/low 0.80s until late November / early December. It could then see a slight bounce during December.	EUR/GBP remains under pressure until mid/late Q1 as the EUR seems to drop vs most developed currencies.
	JPY	EUR/JPY may hold up in the low 120s until late November / early December. It then starts to move lower during December.	EUR/JPY remains under pressure until mid/late Q1 as the EUR appears quite weak, even vs the very defensive Yen.
	CHF	EUR/CHF may hold up towards 1.09 until late November / early December. It then starts to move lower during December.	EUR/CHF continues lower until mid/late Q1, potentially towards 1.05.
GBP vs	JPY	GBP/JPY may still push into the low/mid 140s into late November / early December. It could then retrace down during December.	During Q1, GBP/JPY seems to hold up rather well as the Yen could also be quite weak vs the US Dollar.
	CHF	GBP/CHF may hold up in the high 1.20s into late November / early December. It could then retrace down during December.	During Q1, GBP/CHF seems to hold up rather well as Swiss Franc could also be quite weak vs the US Dollar.

Legend: Strong Underweight | Underweight | Neutral | Overweight | Strong Overweight

US Dollar
p 23

The US Dollar is finishing off its intermediate correction started late September / early Octover. It may see one last dip into late November. Following that, it resumes its uptrend, probably quite strongly, into year-end, and then probably into mid/late Q1. The Dollar Index should reach above 100 at least.

Euro
p 38, 41, 45

EUR/USD could still hold up / bounce over the next couple of weeks, possibly back into its 1.11 – 1.13 corrective target range to the upside. It then resumes lower quite strongly during December, probably breaking below 1.08 and then continues lower towards 1.05 into Q1. The Euros appears weak vs most major currencies. EUR/JPY, EUR/CHF and EUR/GBP all seem to drop into Q1. This would not necessarily be risk-off, but rather due to EUR weakness across the board.

Yen

USD/JPY could push slightly higher and test 110 by late November / early December. It then consolidates slightly during December before moving higher into mid/late Q1 as the US Dollar strengthens and becomes more pro-cyclical again. USD/JPY may reach towards 112 – 113 by then.

Sterling
p 38, 45

Sterling has seen a strong rally as the Brexit process may become clearer with the early December UK elections. GBP/USD may however retrace towards year-end and into Q1 as the US Dollar should be strong vs all currencies.

Oil & Commodities currencies
p 56

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) may hold up until late November / early December (especially if CLP is excluded, i.e. strong political uncertainty in Chile). From early December, they should sell-off into early/mid January next year vs the US Dollar and the Euro. Yet, they may stabilize thereafter.

Asian currencies
p 32-33, 57

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) could retest up vs the US Dollar and push slightly higher vs the EUR into late November / early December. It then corrects down vs both into late December / early January. During Q1, our Asian Growth currency portfolio continues lower vs the US Dollar, yet stabilizes vs the Euro, which should also be under pressure.

Equities Markets Segmentation

Core Sector Weightings — **Next 2 months** — **3 to 6 months ahead**

US Sectors - S&P500 (general comment)			**A transition phase where from early December, Cyclicals could retrace and Defensives could bounce. Growth is resilient.**					**From late December, the environment probably remains risk-ON until mid/late Q1. We would underweight Defensives again.**				
Sectors	Proxy ETF symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Technology	XLK	21%										
Healthcare	XLV	15%										
Financials	XLF	14%										
Discretionary	XLY	10%										
Communication	XLC	10%										
Industrials	XLI	10%										
Staples	XLP	7%										
Energy	XLE	6%										

			Next 2 months					3 to 6 months ahead				
European Sectors - Europe Stoxx 600 (general comment)			**A transition phase where from early December, Cyclicals could retrace and Defensives could bounce. Growth is resilient.**					**From late December, the environment probably remains risk-ON until mid/late Q1. We would underweight Defensives again.**				
Sectors	Index symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Banks	SX7P	13%										
Industrials	SXNP	12%										
HealthCare	SXDP	11%										
Pers. & HH Goods	SXQP	9%										
Food & Beverage	SX3P	7%										
Insurance	SXIP	6%										
Energy	SXEP	6%										

Main Sectors Allocation
p 21, 22, 53-55

Please read the detailed allocation comments in our time frame boxes above.

Cyclical and Value trades could still push up once more into late November / early December. They should then retrace down during December before stabilizing again from early Q1 on a relative basis. Inversely, Defensive sectors could see another dip into late November / early December and then bounce. From year-end / early January they should resume their downtrend during Q1 on a relative basis. Growth sectors should push higher into late November / early December, hold up rather well during December on a relative basis, and then take on leadership into Q1.

Countries allocation

Core Countries Weightings			Next 2 months					3 to 6 months ahead				
All World Country Index Currency hedged (general comment)			**More Cyclical regions could retrace from early December as Defensive ones bounce. The US remains resilient.**					**From late Q4, we will Overweight the US again, and underweight China and Defensive regions.**				
Countries	Index symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
US	S&P 500	52%										
Canada	TSX	3%										
Europe	SXXP	21%										
-UK	FTSE	6%										
-France	CAC40	3%										
-Germany	DAX	3%										
-Switzerland	SMI	3%										
Japan	N225	8%										
China	MSCICN	3%										

Main Country Allocation
p 27-31, 42-44

Please read the detailed allocation comments in our time frame boxes on the previous page.

China and Emerging Markets could rebound / hold up into late November / early December on a relative basis. They should then underperform in US Dollar (as well as in local currency terms) until mid/late Q1 as the US Dollar strengthens again.

In local currency, Canada, the UK or Switzerland, which have been rather defensive lately, could see a rebound during December vs the All Country World Index. They should then underpeform during Q1.

The US, or France, Germany and Japan in local currency terms, which should all benefit from a stronger US Dollar, could hold up well during December vs the All Country World Index, and then outperform into mid/late Q1. In US Dollars, European markets should however underperform during this period as EUR/USD moves below 1.08, potentially down to 1.05.

Note: the country and regional allocations in the table above are considered hedged for currency risk, ie. the relative performances are anticipated in local currency (except for the S&P500 vs the All Country World Index as both are denominated in US Dollars).

Core factors and Themes

Core Factor/Themes Weightings	**Next 2 months**					**3 to 6 months ahead**				
General Comment	**From early December, we expect Cyclical/ Value themes to enter a short retracement period, while some Defensive themes could bounce. Growth remains resilient.**					**From year-end, Growth should be back in leadership, while Cyclicals and Value are neutral, Defensive themes underperform again.**				
Themes	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Nasdaq 100 (vs S&P500)										
DJ Industrial (vs S&P500)										
Russell 2000 (vs S&P500)										
Wilshire REITs (vs S&P500)										
US Value (vs US Growth)										
Southern EuroZone (vs Stoxx EZ 600)										
EuroZone Small Cap (vs Stoxx EZ 600)										
Japanese Small Cap (vs N225)										
GDX - Goldmines										
XME - Diversified Mining										

Core factors and Themes
p 19, 44

Value and Cyclical trades could still push up / hold into late November / early December. Following that, they should correct down into December, while Defensive themes bounce. Growth profiles should live through December rather unscathed.

From late December / early January, growth profiles should take up leadership, Cyclical profiles may lag, while Defensive profiles underperform again.

12 / Waiting For The Other Shoe To Drop: Reversal In Fed Balance Sheet Growth Signals Onset Of A Temporary Bond Yield Correction In This Up Trending Phase

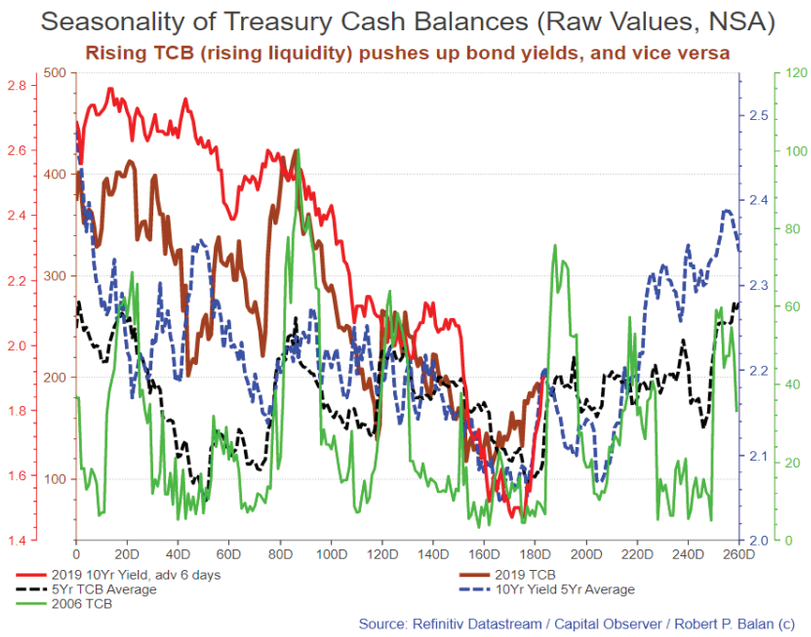
A lot of investors have been mystified by the recent surge in yields, which is still ongoing. The yield on the 10-year US Treasury note hit a low of 1.47 percent in early September, but here we are scant two months later, the 10yr yield is approaching 2.00 percent. This yield has not been that high since the end of July 2019. A lot of investors want to know what's going on.

This sharp run in yields is actually almost a repeat of what happened in early September, when there was also a sudden reversal upwards in the direction of yields. We explained that "bond massacre" in the September 2019 issue of the Capital Observer this way:

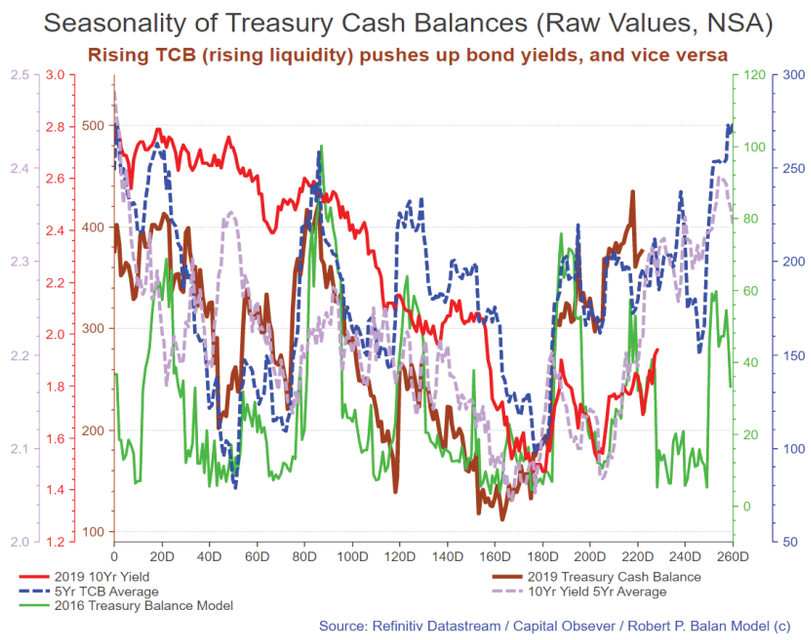
Many explanations have been forwarded for this shift, but the most direct and most cogent rational can be found in the shift in systemic liquidity conditions after the US debt ceiling crisis has passed, and the US Congress and the US Treasury/Mr. Donald Trump agreed on resumption of spending protocols. Also, Congress returned to work last week after their summer vacation. This means that they can start authorizing spending bills and also passed the budget deal that was agreed recently together with a two-year suspension of the debt ceiling.

Prior to first week of September, in effect, bonds were being sold, but the proceeds were not flowing into the broader economy. Therefore, systemic liquidity was abnormally tight, and was further exacerbated by the seasonal bottoming out of the Treasury Cash Balances, at this time of the year. The resolution of the debt crisis cap, and the return of the Congress from holidays effectively reversed that artificial cum seasonal liquidity drought – with spectacular negative consequences for many Money Managers who overstayed the long bond trade.(see 1st graph on this page)

Original chart in the september 2019 Capital Observer



This is how that September chart above looks now



The reasons for the previous bond massacre are now well-understood by now. But what explains this new, recent sharp 10Y yield move up? **It appears to us that this time, there are three possible explanations for the phenomenon.**

The first pertains to foreign capital inflows -- foreign money is playing a big role in this movement. Foreign money had flowed into the US bond market during Q2 this year, and bond prices rose (while yields fell) during the height of the budget spending caps, when the US Treasury was constrained from issuing new securities to fund new debt.

The bond market was preferred by investors at that time, as the stock market was being hit hard by uncertainty over the trade agreement discussions between the US and China. **With recent**

and more positive developments in the trade discussions, the US stock market has risen, and foreign money started to migrate to the US equity markets. Steven Russolillo reports in the Wall Street Journal that foreign money is a major contributing factor to the new records just hit by US stock markets. Mr. Russolillo wrote:

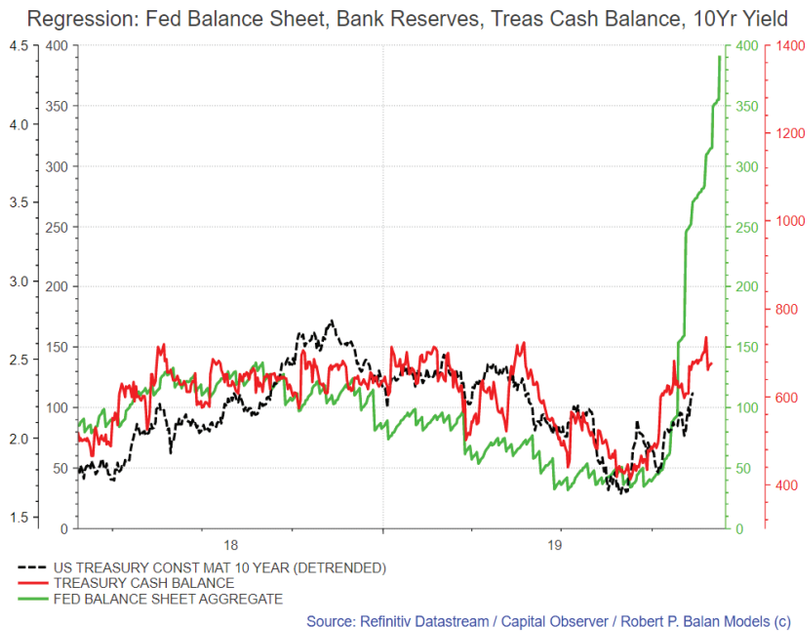
Even with US stocks rallying back to all-time highs, adding to the longest bull market on record, many foreign investors feel they have no choice but to pile in.

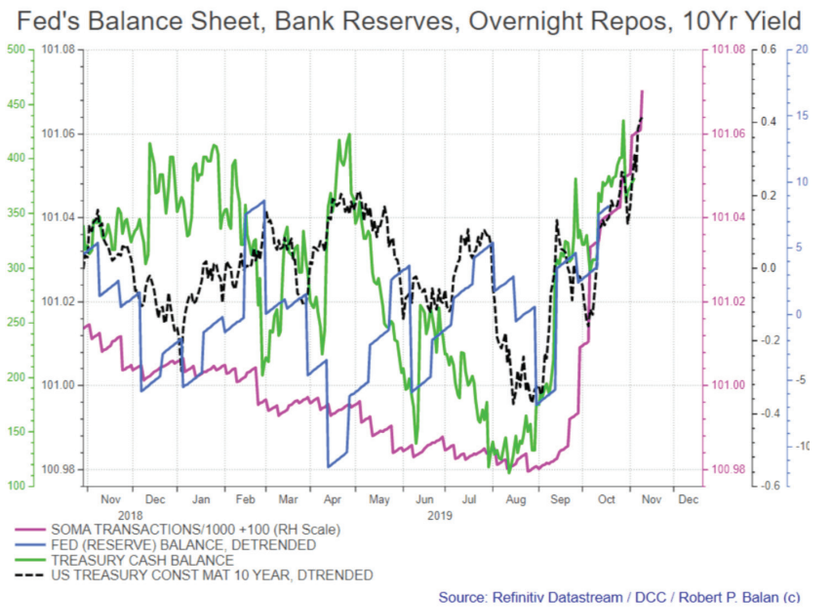
Foreign private holdings of US stocks hit a record high of $7.7 trillion as of July, the most recent data available, according to Treasury Department figures. The data for foreign funds excludes holding from sovereign-wealth funds and central banks, meaning overall international holdings are likely substantially higher. (see 2nd graph on previous page)

The second factor contributing to the recent rise in bond yields is the signal from the Federal Reserve that there are no plans in the near future to lower further the Fed's policy rate of interest. In fact, Fed Chair Jerome Powell hinted that a moratorium on rate cuts may be in place until mid-2020.

To offset the negative market impact of this tighter policy, the Fed had earlier announced the implementation of quantitative easing program which the Fed denied as such, earning it a moniker as "Not QE". This is what we consider as the third reason for the new sharp move up in yields. Bond investors have started taking the Fed by its word, and are leaving the bond market in droves.

The capital migration from the bond market to equities, plus a sharp inflow of systemic liquidity from these new Fed stimulus programs caused a sharp run-up in both equities and in bond yields in the last several weeks.





However, the larger impetus of those rallies has come from the new growth in the Fed balance sheet after "Not QE", which has now grown to $314 billion since its inception on September 17, or circa $183 billion a month. That's about 50% more than old QE at its peak, but the balance sheet growth will likely come down. The pace is likely to eventually level off at $80-120 billion per month, to keep pace with Treasury issuance.

This significant inflow of systemic liquidity has been the primary factor in pushing up bond yields rapidly in the past few weeks.

It behoves therefore that if there is any disruption in the ongoing liquidity inflows, the yield rally should pause or take a breather. As we have noted a few times at Capital Observer, it is not the change in the nominal amount (stock) in liquidity that counts; it is the change rate in systemic liquidity (flow) that is of importance to risk assets. The Treasury Cash Balances data fell last week, and the remaining prop for rising yields is the still surging Fed Balances Sheet. Thus, we are waiting for the other shoe to drop, so to speak. **If liquidity inflows from the Fed's balance sheet falter, then yields may start to consolidate, after a short lag.**

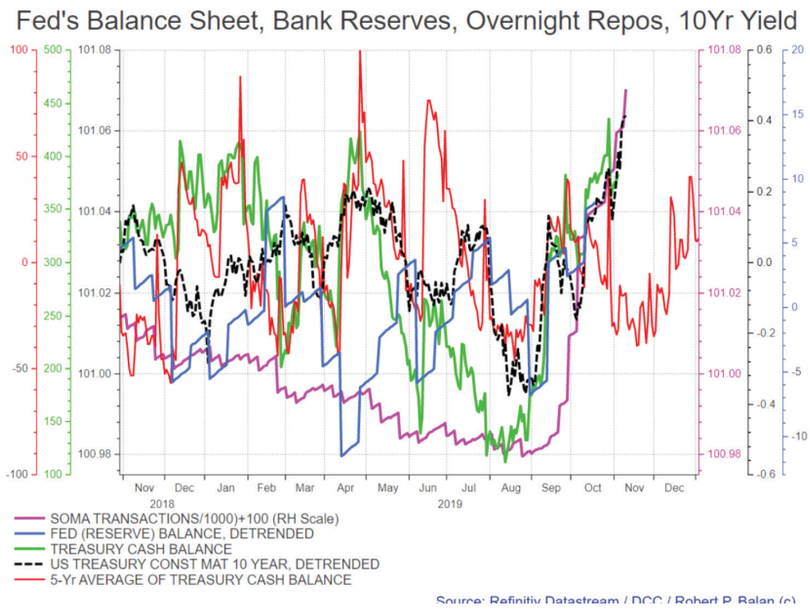
There are two ways of illustrating the ongoing dynamic between systemic liquidity and the 10yr yield. One is via the Treasury Cash Balances (TCB), and the other is through the aggregated SOMA transactions. We show these dynamics between the TCB and equities (proxy: S&P 500) in the last chart of the previous page.

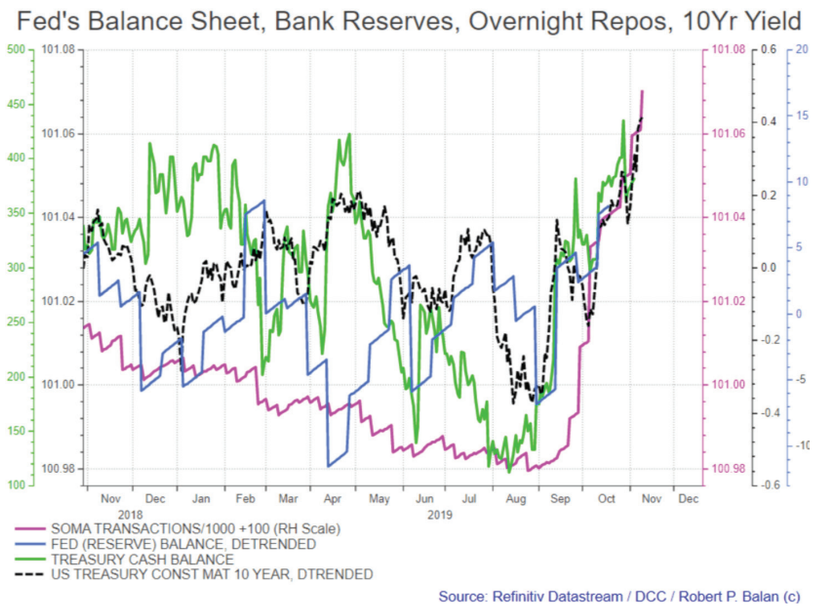
The 10yr yield (black dashed line) frontruns the TCB (green line) by a week. This puts the 10yr yield in the trajectory of the aggregated SOMA transactions (pink line), which leads the TCB by a few days due to reporting lags. The 10yr yield line was detrended in the chart, so it is easier to see the synchronized inflections points (*see last chart on previous page*).

We have written before at Capital Observer about the over-arching impact of investment banks' pre-emption of the changes in Treasury Cash Balances. In previous careers, we have witnessed and participated in efforts by gaggle of bank analysts and accountants to project the future profile of the disbursement of the US Treasury through its account at the Federal Reserve (the TCB). These disbursements to non-bank recipients of the US government's largess is pure injection of liquidity to the US financial and economic system. This is what concerns the bond market the most.

On the other hand, the equity markets focus on aggregated SOMA transactions (a major component of the Fed's balance sheet) via the bank reserves created by the Fed's purchase of securities from Primary Dealers and the second-tier bond markets. But this is a different story, which Capital Observer will discuss in length in another, future article.

If we have an idea of what this year's TCB incremental additions will be, that allows us to make educated guesses of how the investments banks will move ahead of the TCB series. The investment banks have gaggles of analysts and accountants combing Treasury internal data to make these educated guesses.





We don't have that payroll, so we take an educate guess, by taking the 5 yr average of the TCB (red line). What we get in this exercise is the 1st chart above.

Actually, the 5yr average is not a bad guess. We noted a few times at the Capital Observer that Treasury expenditures that are disbursed through the TCB are recurring month to month every year, and so TCB expenditures should be fairly the same month-on-month, year-on-year.

We see that by comparing the 2019 TCB (green line) and the 5Yr average of the TCB (red line). They are practically the same in terms of seasonality, and differ only in their nominal amounts. The only caveat of course is that the new two-year federal government budget agreed upon by Mr. Trump and Congress does not contain special, huge disbursements that are occurring in November. If it does, then we will have to do more incisive analyses.

In the graph above, right after the first drop in TCB (green and red lines), we see an uptick in liquidity until the November 11 – 14th week. Then the TCB drops until early December, followed by a sharp updraft in liquidity. In yield terms, we should see a pause in the yield rally very soon, and could see yields falling or going sideways until early December. Then a sharp rally in yields should take place until early January (the bond counterpart of the Santa Rally in equities).

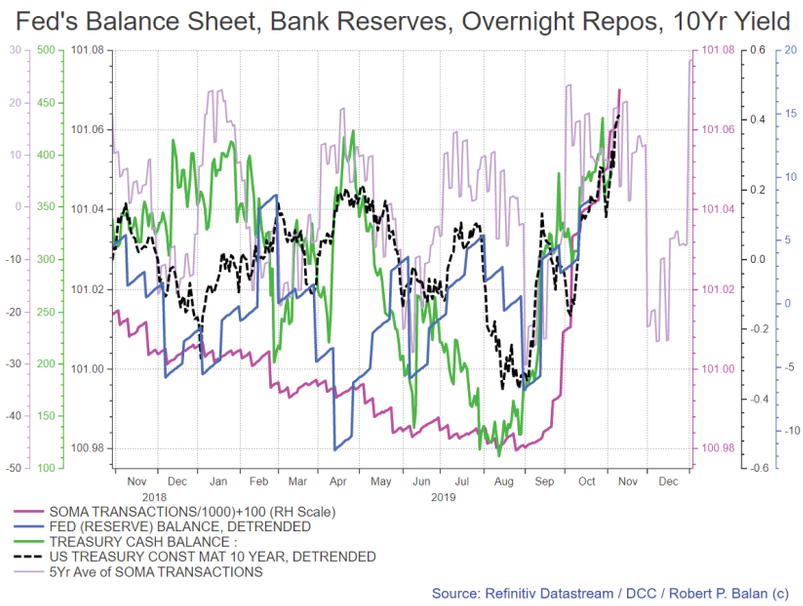
Another way is to analyse the issue via the Fed's SOMA transactions.

Let's look at that base graph again. (*see 2nd graph a previous page*)

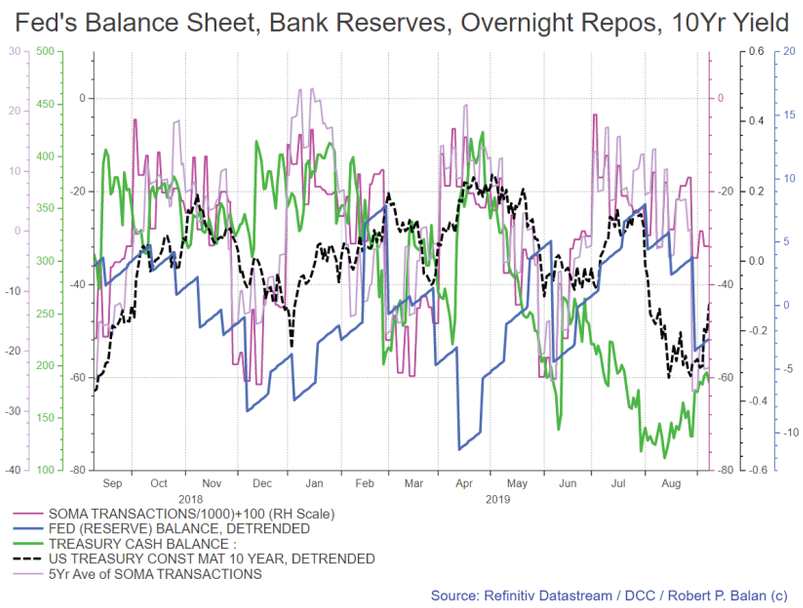
Yields have been ratcheting higher in cadence with the recent rise in SOMA transactions. So much for the meme that Quantitative Easing makes yields go lower. It did not happen in QE1, QE2, QE3 -- and so yields will not fall in "Not QE" this time around. Only hapless economists believe that is what will happen. **Anyone genuinely involved in the market will tell you "NoT QE" will push up yields. And it will.**

Nonetheless, we make allowances for the possibility that yields are currently responding to SOMA transactions, rather than to TCB distributions. That is unlikely because the frontrun yields are almost in lock step with the recent changes in the TCB. That shows how diligent those gaggles of investment bank analysts have been. But let's assume that SOMA is having a large influence on the yield rise.

So far, SOMA transactions are on a tear, sharply rising over the past few days. But what if we can show that SOMA transactions are about to fall? Again, we rely on the seasonality of SOMA transactions. We add the 5yr average of SOMA transaction changes (purple line) in the base chart, and the 1st graph on this page is what we get.



Source: Refinitiv Datastream / DCC / Robert P. Balan (c)



Source: Refinitiv Datastream / DCC / Robert P. Balan (c)

The 5yr average of SOMA transaction change rate tells us that we are probably looking at a peak in the SOMA model sometime soon, perhaps soon as this coming week or next. The SOMA transactions should also fall until early December. If that happens, then yields lose a key support for further rallies. And yields should fall until early December, followed by a significant rise until early next year (which mirrors the historical Santa Rally during Q4 of any year).

How do we confirm the efficacy of that 5-year SOMA average? Simple. We remove the portion of the current SOMA aggregate that goes hyperbolic, and compare the two, truncated series. Here is how it looks in the 2nd graph above. The caveat of course is, again, if there are special disbursements from the Treasury that the Fed needs to process through SOMA operations in November. We don't believe so. We at Capital Observer therefore believe that we are looking at an intermediary top in yields in the making.

This should however be followed by higher yields. As we cautioned before, liquidity creates the base conditions, but adverse news flow could derail prospective liquidity events temporarily. Perhaps that won't be the case this time. Recurring market positive news flow, like Mr. Donald Trump's market-positive tweets about the US-China trade discussions seem likely to abate for a while until Mr. Trump and President Xi Linping meets sometime in December.

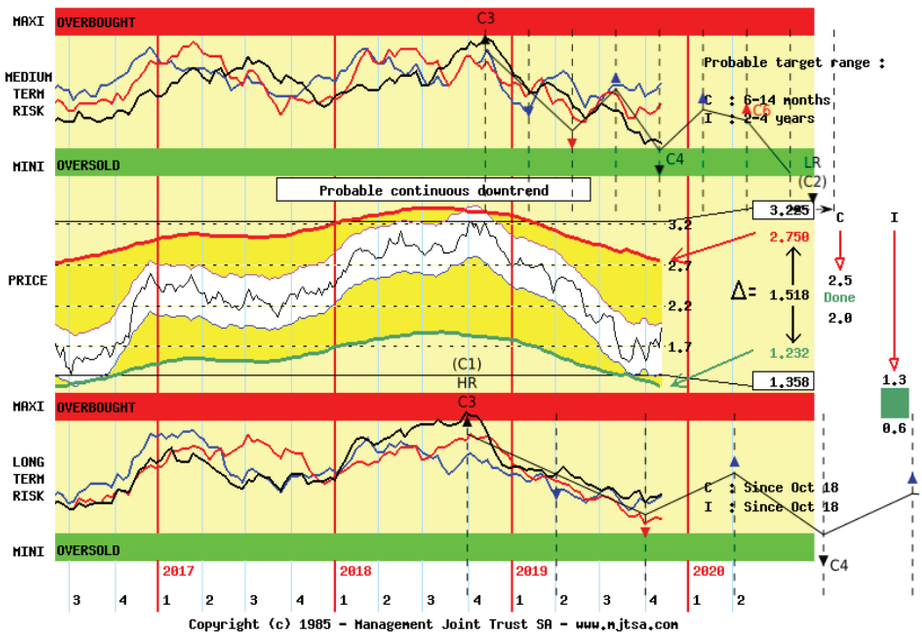
For now, we have structural reasons to look at the seasonality of US systemic liquidity to drive US bond yields and other risk asset prices.

16 / MJT - TIMING AND TACTICAL INSIGHT

Initial late November / early December top for yields and related trades

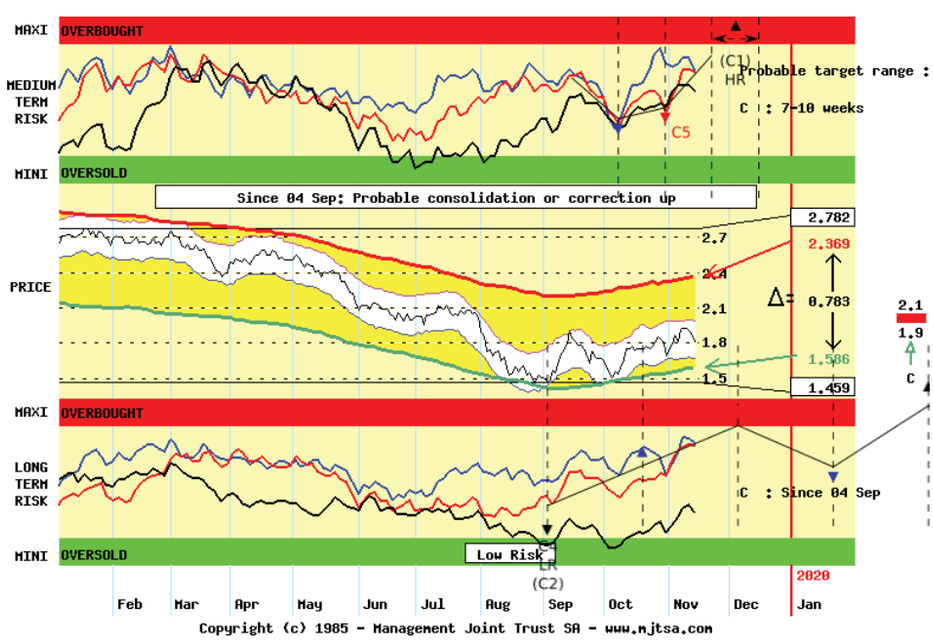
The bounce in bond yields which we have been calling for for the last couple of months is well under way. It started following their August climax sell-off, early September, when Treasuries, Precious Metals and Momentum trades all reversed on the same day. We believe this move is probably counter-trend. These usually last 3 to 6 months. In this article, we will review the state of the rebound in terms of future timing and scope.

US10Y Benchmark Bond yields
Weekly graph or the perspective over the next 2 to 4 quarters



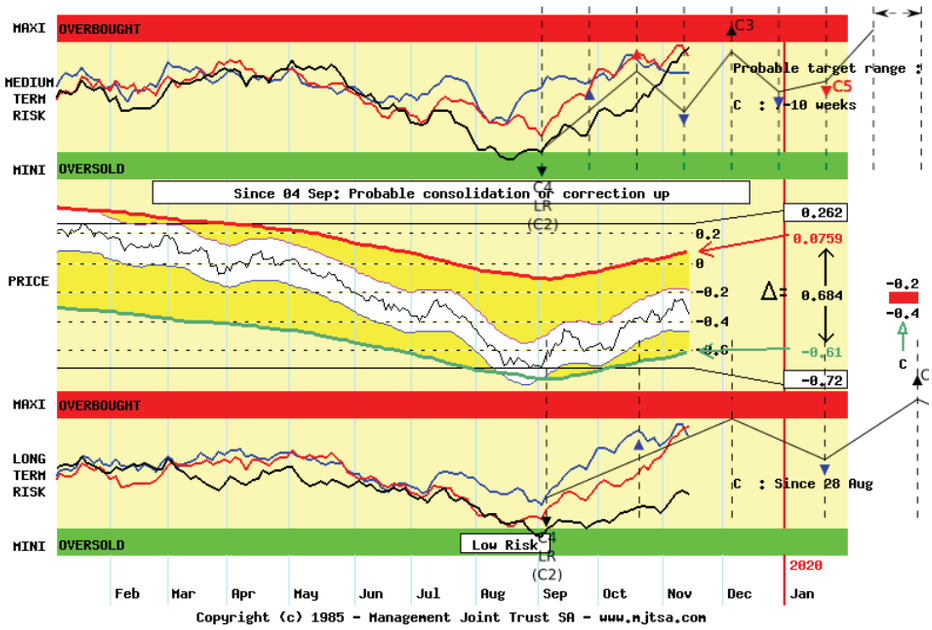
Following almost a year of aggressive sell-off, **US10Y Benchmark Bond yields found support early September and started to build a base**. The bottom has since been reconfirmed by both our oscillator series, early October on our long term ones (lower rectangle), just recently on our medium term ones (upper rectangle). **For now, we consider this move as counter-trend**. Indeed, during the sell-off, earlier this year, US10Y yields did make it below the support of our C Corrective targets to the downside, thereby opening the door to our I Impulsive targets to the downside (right-hand scale), with lower targets in the 1.3% – 0.6% range. These could be achieved over the next 12 to 18 months. In the meantime however, as shown on the graph, **we expect US10Y yields to bounce into Q1, possibly into the Spring.**

US10Y Benchmark Bond yields
Daily graph or the perspective over the next 2 to 3 months



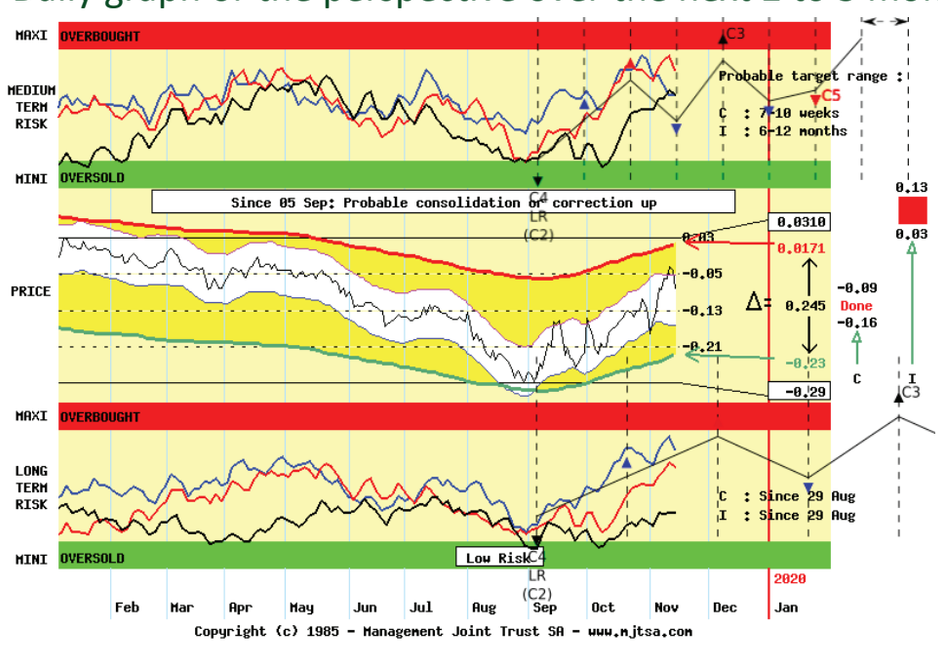
We now turn to the Daily graph for a more precise timing estimate and to get a sense of the price potential this rebound may achieve. Shorter term, US10Y yields have broken above their base since early November. They now seem to be accelerating higher and on both oscillator series (lower and upper rectangles), we expect several weeks of acceleration to the upside before an intermediate top materializes towards late November / early December. By then, **the resistance of the higher end of our C Corrective targets to the upside should be tested, around 2.1% (right-hand scale). Once US10Y yields can make it above this mark, the next level of targets we can calculate are towards the 2.5% – 2.8% range, or back to the levels which prevailed during Q1 this year. Ideally, we would expect US10Y yields to break above 2.1% towards late November / early December, then retrace down somewhat during late December, perhaps into early January, before they accelerate up again towards mid/late Q1 2020.**

German 10Y Bund Yield
Daily graph or the perspective over the next 2 to 3 months



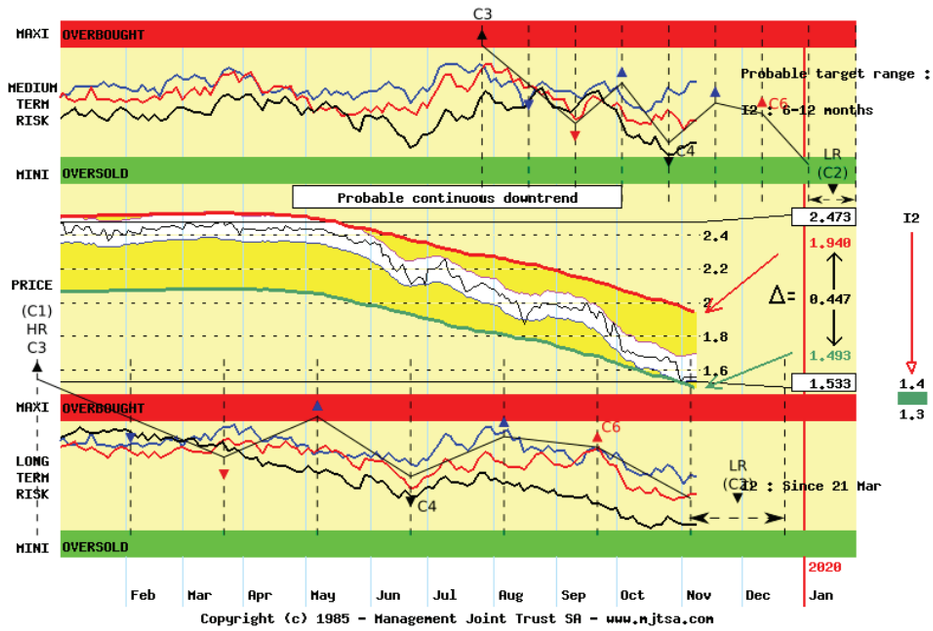
German Bund yields offer a similar picture, yet in terms of their progression since September, they seem more advanced in terms of trend. Indeed, the volatility of German 10Y Bund yields is lower than the one of US10Y yields, and hence, although in terms of basis basis points the rebounds are quite similar, **German Bund Yields are closer to testing the resistance of their C Corrective targets to the upside around -0.2% (right-hand scale). Above these, the next level of targets we can calculate are into the 0.15% - 0.40% range**, or also towards the levels last seen earlier this year, even late last year. Here also, both oscillator series (lower and upper rectangles) would suggest **a late November / early December intermediate top, some retracement during late December and perhaps into January and then a new move higher into mid/late Q1 2020.**

Japanese 10Y Government Bond Yield
Daily graph or the perspective over the next 2 to 3 months



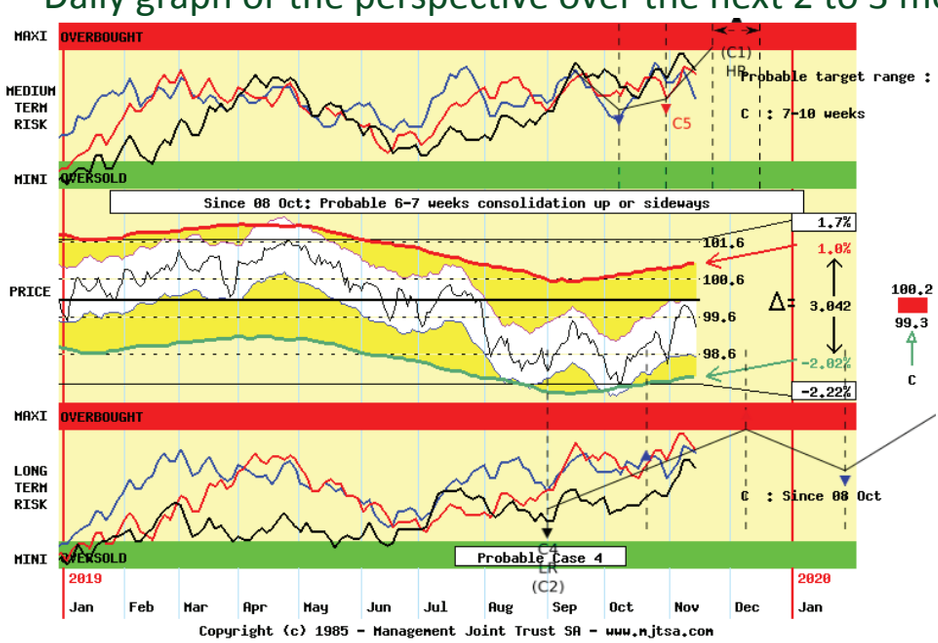
Japanese 10Y Government Bond Yields are even more advanced in their rebound. They have recently shot up above their C Corrective targets to the upside (above -0.1%; right-hand scale) into Impulsive territory. Our I Impulsive targets to the upside now suggest further upside into the 0.02 – 0.12 % range. **In terms of speed and scope, this is the strongest rebound since H2 2016, and if these targets are achieved, the 2018 highs may be tested**. Again, on 10Y Japanese Government Bonds, both our oscillator series (lower and upper rectangles) would suggest a **late November / early December intermediate top, some consolidation during late December and perhaps January and then a further rebound into mid/late Q1 2020.**

US 3M Benchmark Bond Yields
Daily graph or the perspective over the next 2 to 3 months



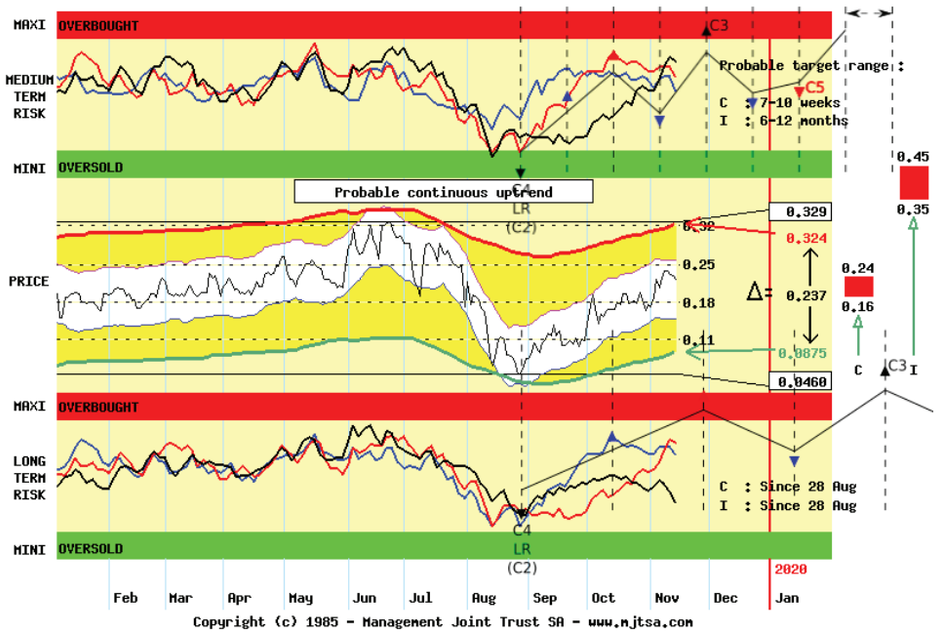
At The Capital Observer, we do believe that some green-shoots are starting to appear in the US economy. Yet, since September, much of this rebound in yields is more probably attributable to recent FED accommodation, and indeed, for now, **our graph of US3M Treasury yields remains in a downtrend. Both oscillator series (lower and upper rectangles) suggest that it could continue to push lower for another month or so**, potentially towards the 1.4% – 1.3% range (I2 extended Impulsive 2 targets tot he downside; right-hand scale). **Following that, US3M Treasury yields should start to bounce towards year-end and into Q1**. Logically, by then, the US economy will have shown further signs of recovery. If so, long term yields may continue to move higher, despite the fact that US3M yields may be starting to bounce.

TIP - iShares TIPS Bond ETF / IEF - iShares 7-10 Year Treasury Bond ETF
Daily graph or the perspective over the next 2 to 3 months



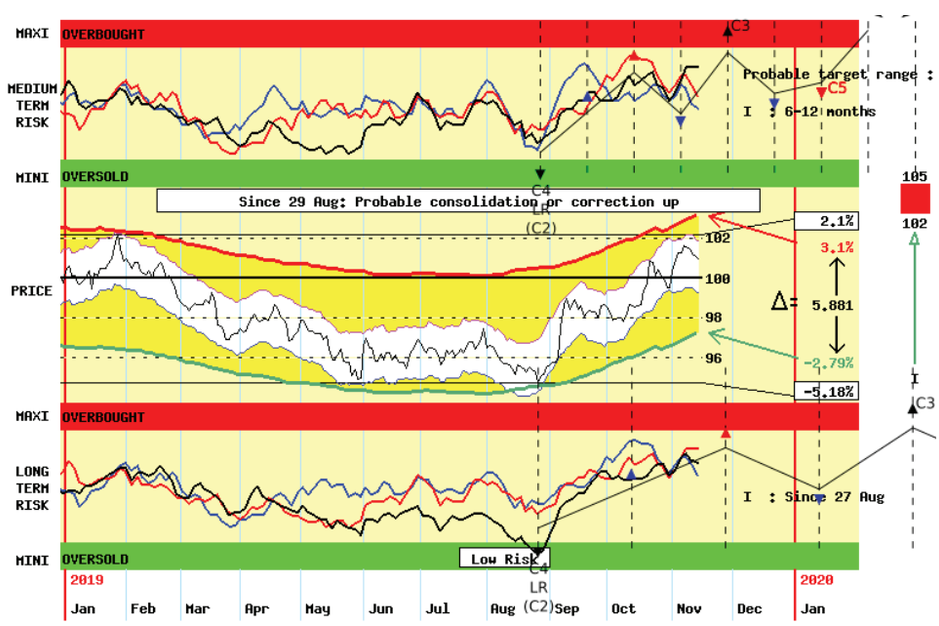
Rising Inflation Expectations may play their role in this process. Between early September and early October, they have built a base. They now seem underway to move higher on both oscillator series (lower and upper rectangles). **An initial top is expected late November / early December. Following that, some retracement may materialize into late December, perhaps into January, before the ratio starts moving higher again towards mid/late Q1**. Over the next few weeks, we expect the resistance of the upper end of our C Corrective targets to the upside to be tested (right-hand scale), thereby opening the door to much higher targets over the next 3 to 6 months.

US10Y-US3Y Benchmark Bond Yield Spread
Daily graph or the perspective over the next 2 to 3 months



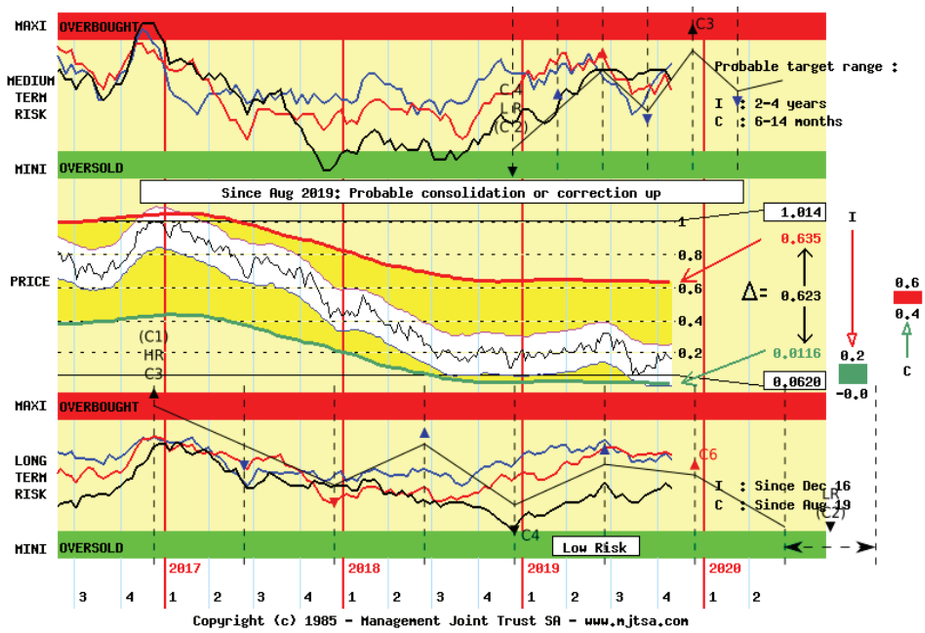
The middle portion of the yield curve shows similar dynamics. It is usually positively impacted by lower US3M rates as the US10Y yields are more reactive to related increases in inflation expectations than the US3Y ones. Basically, this middle portion of the yield curve is very sensitive to the market's assessment of monetary policy. It rises when policy is deemed rather accomodative, while it drops when the FED is considered to be too restrictive. Here also, both oscillator series (lower and upper rectangles) are pointing towards **a late November, perhaps early December intermediate top**, while the resistance of our C Corrective targets to the upside (right-hand scale) is on the verge of being taken out. **We would then expect some retracement from early December, into year-end / early January at least**. Indeed, our Weekly graph on the next page suggests that the spread may remain under pressure during Q1.

Value to Growth relationship within the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



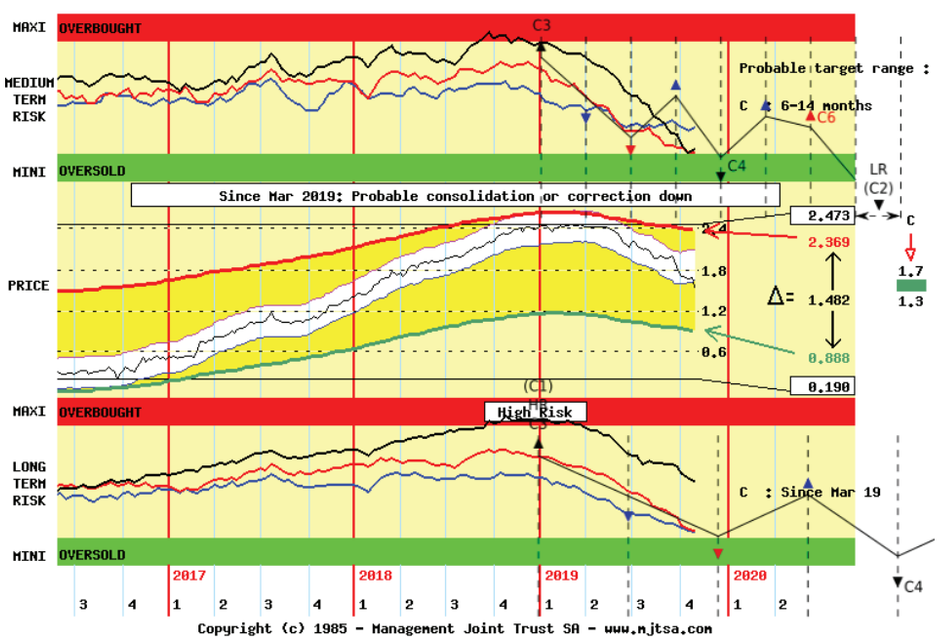
In terms of equity profile, the Value to Growth relationship in the US (IVE vs IVW ETFs) is very much synchronized with the US10Y-US3Y yield curve spread. On both oscillator series (lower and upper rectangles), it is also pointing to **further upside into late November / early December. Following that, some retracement may materialize into late December / early January at least**. This current uptrend is already quite stable, having already made it into impulsive territory. It could reach another 1 to 3% higher over the next few weeks. i.e. into our I Impulsive targets to the upside (right-hand scale).

US10Y – 3Y Benchmark Bond Yield Spread
Weekly graph or the perspective over the next 2 to 4 quarters



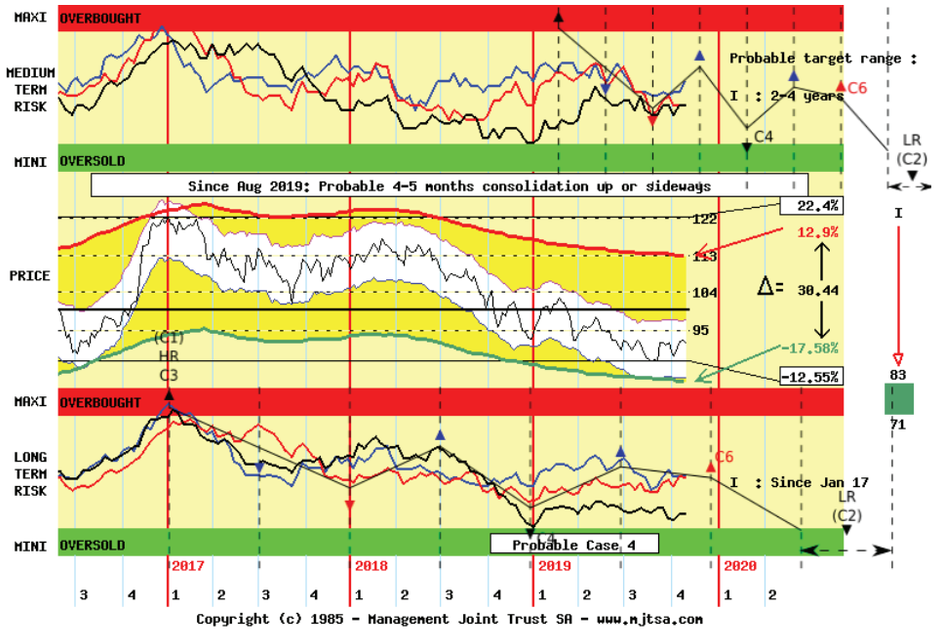
Longer term, the picture is more mixed, and may suggest a change in leadership on equities from year-end on. Indeed, while we expect the US3M to start bouncing (see graph above in this article), **the US10Y-US3Y spread may start to flatten again from Q1 (into late Q1, perhaps mid-year)** as shown by both oscillatorts series (lower and upper rectangles). **This retracement on the spread does not necessarily mean that yields will drop, but rather that the US3Y may start to rise quicker than the US10Y. This usually corresponds to more restrictive actions taken by the FED** (e.g. FED on halt), keeping rising inflation expectations at bay. This suggests an equity environment more prone to Growth themes into Q1 and perhaps Q2, while Value probably gives up its recent lead.

US3M Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



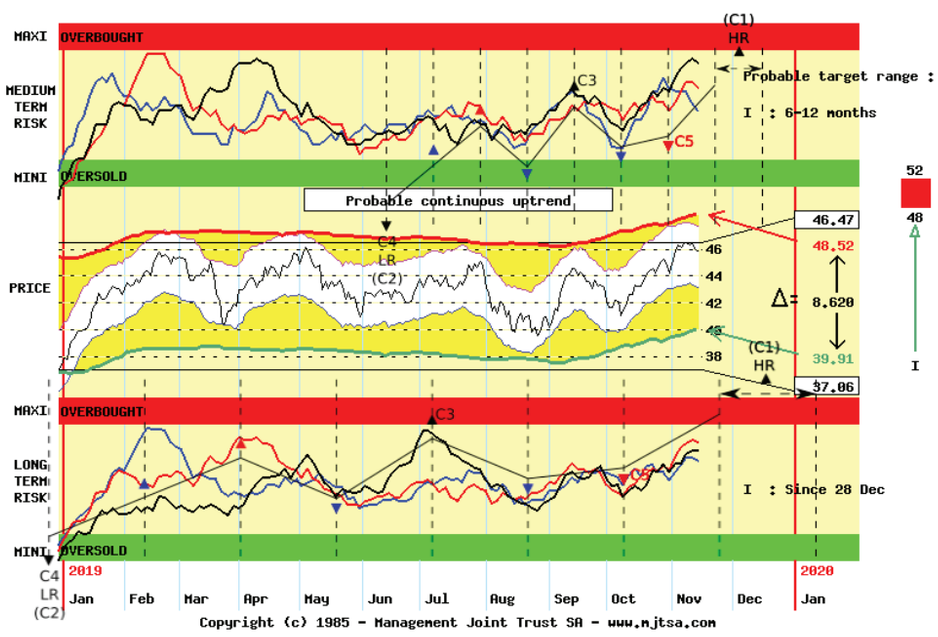
Indeed, as also shown on the Daily graphs further above in this article, the US10Y-US3Y spread is quite well inversely correlated to the US3M Treasury yield. Again, on this Weekly graph, **we expect US3M Treasury yields to find support towards year-end, possibly between current levels and 1.3%** (within our C Corrective targets to the downside; right-hand scale). **Following that, US3M Treasury yields should bounce into Q1, perhaps even towards midyear, which probably implies a more restrictive/neutral FED policy from early next year.**

US Banks vs the S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



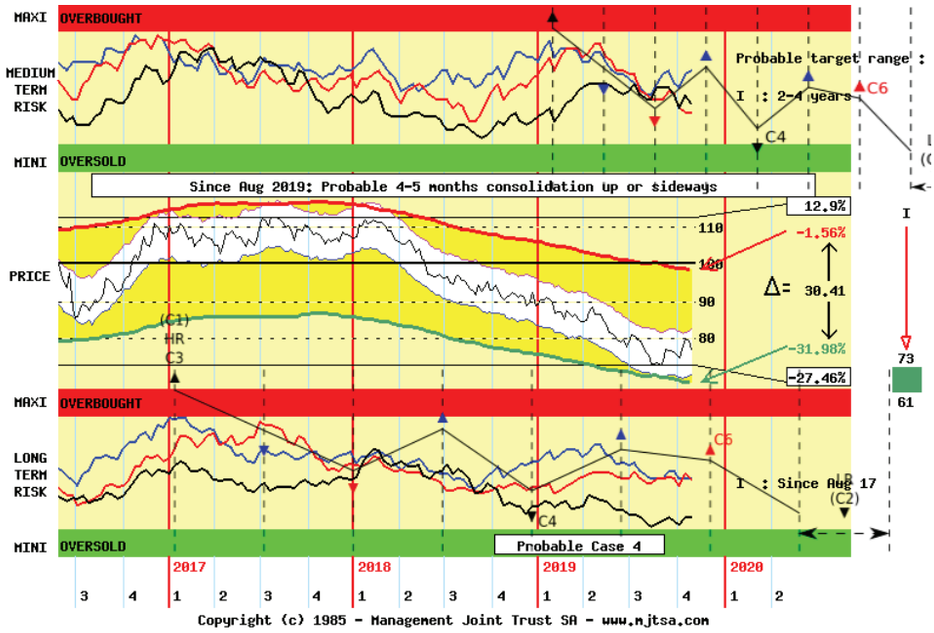
The ratio of US Banks (KBE ETF) vs the S&P500 Index is very much correlated to movements in the US10Y-US3Y spread. Banks are indeed a core component of the US value space and hence very sensitive to the short vs long duration equity trade. Both oscillators series (lower and upper rectangles) suggest that **the current bounce probably dies out at some point between December and year-end. Following that, US Banks should retrace down vs the market into mid/late Q1 according to our medium term oscillators (right-hand scale), perhaps even into midyear, according to our long term ones (lower rectangle). The downside risk for the ratio is still quite compelling, between 10 to 20% on a relative basis according to our I Impulsive targets to the downside (right-hand scale).**

US Banks
Daily graph or the perspective over the next 2 to 3 months



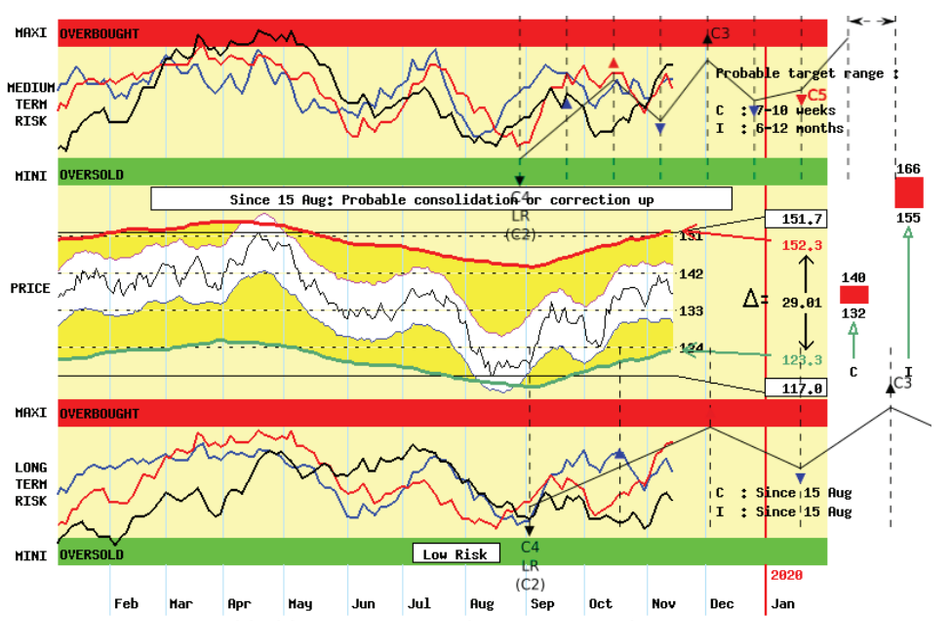
On an absolute basis, along with rates or inflation expectations, we expect **US Banks to make an intermediate top towards late November / early December** according to both our oscillator series (lower and upper rectangles). Our I Impulsive targets to the upside (right-hand scale) suggest that **in the meantime these could still rise between 2% and perhaps even 10%**. Following that, we initially expect between 3 to 6 weeks of consolidation to the downside, perhaps more if US Banks really start to underperform the wider market.

European Banking Sector vs the Europe Stoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



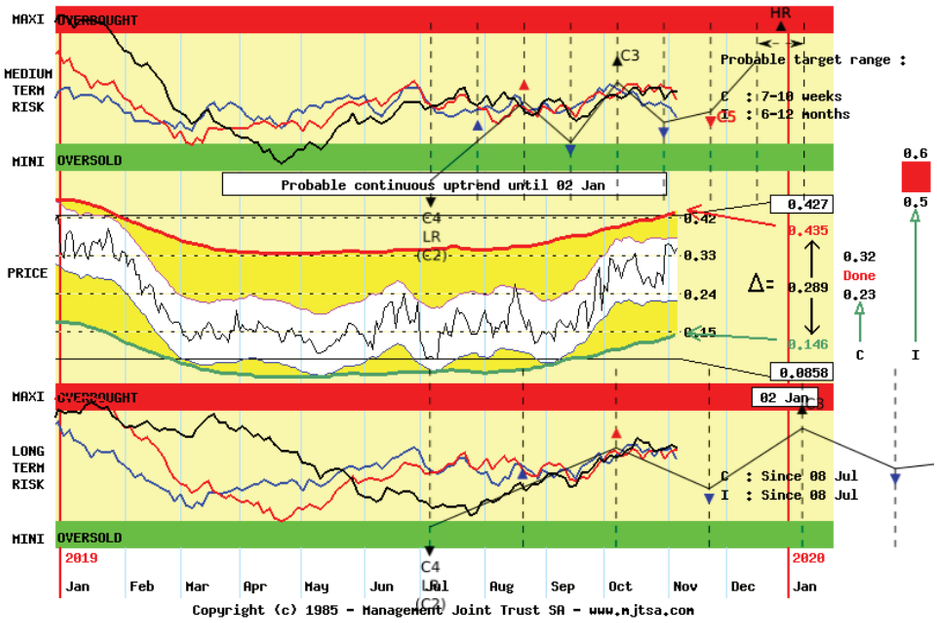
In Europe, the Weekly relative ratio graph between European Banks and the Europe Stoxx 600 Index is similar to the US ratio presented above, perhaps even weaker. Both oscillator series (lower and upper rectangles) also suggest that **European Banks could start to underperform again from late Q4 (probably from December), towards late Q1 at least, perhaps until mid next year. Here also, our I Impulsive targets to the downside (right-hand scale) indicate between 5 and 20% of further downside risk on a relative basis.**

European Banking Sector, SX7P index
Daily graph or the perspective over the next 2 to 3 months



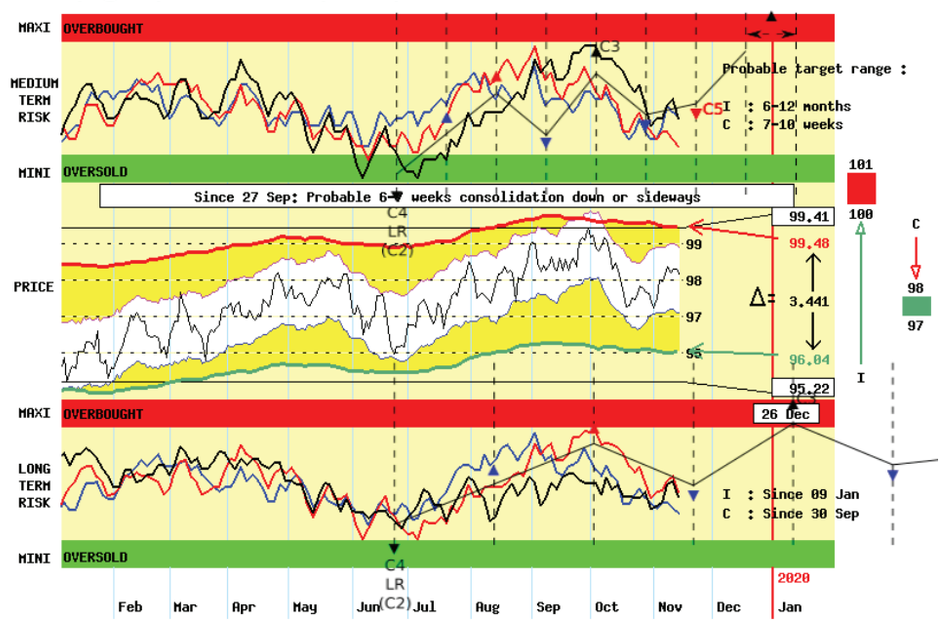
Similarly to US banks, the Daily graph of European Banks on a standalone basis confirms the timing of an intermediate top late November / early December on both oscillator series (lower and upper rectangles). On the target front (right-hand scale), prices are now above the resistance of our C Corrective targets to the upside (above 140, right-hand scale), and **could potentially rally towards our I Impulsive targets to the upside in the 155 – 166 range. This is potentially another 10% above current levels**. Following that, from late November / early December, we expect European Banks to start retracing down into late December, perhaps into January in first instance.

US3M Libor minus US3M Benchmark Bond Yield Spread
Daily graph or the perspective over the next 2 to 3 months



One scenario that may explain the dynamics above (i.e. banks underperforming from early December, US 3M yields gradually bottoming out towards year-end, the US10Y-US3Y spread resuming its downtrend), could be related to renewed USD funding pressures for banks towards year-end. Indeed, it is probable that the FED will have to indulge in increased repo operations during December, but will it prove sufficient? Especially if, as they suggested, they refrain from cutting rates a fourth time this year. This may create a period of Financial stress, Banks may underperform, equities and yields could consolidate. Then, from early next year, equities could resume their uptrend, yet banks and more generally value trades could then give up their lead as the yield curve eventually starts flattening again with rising US3M Treasury yields. **From what we can read on this Daily graph of the 3M Libor to US3M Treasury spread (similar to the Libor to IOS spread), funding pressures on banks in the US could indeed rise from late November into late December / early January according to both oscillators series** (lower and upper rectangles).

Dollar Index
Daily graph or the perspective over the next 2 to 3 months



The US Dollar Index may confirm this theory. For now, its correction to the downside since late September (the top corresponded with the last period of funding stress), is probably still under way. Indeed, both our oscillator series (lower and upper rectangles) seem to suggest **some retracement of the recent rebound into late November. Following that, the Dollar Index probably rises into late December / early January**. Over the next few weeks, support should be found once again towards the lower end of our C Corrective targets to the downside (i.e. around 97, right-hand scale). Then during December, and into January, the Dollar Index probably rises again towards our I Impulsive targets to the upside above 100 (right-hand scale), or towards new YTD highs.

Concluding remarks

Treasury yields in the US, Europe or Japan have been bouncing dynamically since early September. We believe this first leg up is still underway, probably towards late November / early December. Following that, a period of retracement may materialize into late December, perhaps into early next year. Indeed, the recent rebound in yields in very much the result of the very accomodative FED policy since October. Going forward, we however believe the FED when it says that it won't indulge in further rate cuts this year. We would hence expect US3M Treasury yields to start bouncing from December, probably into Q1, perhaps even mid next year. Yields may continue higher during Q1 if economic conditions are strong enough and not QE4 is still underway, yet the US10Y-US3Y spread will eventually start flattening again (US3Y rising faster than US10Y), probably from December into late Q1, perhaps even mid next year. Value trades, including Financials should then give up their recent market lead and will probably underperform the wider indexes from December on-wards. Renewed funding pressures towards year-end and a concomitant new leg up in the US Dollar from late November, may also explain this change in leadership.

24 / China: more of the same litany of missed opportunities; no significant uptick in activity expected before early Q2 2020

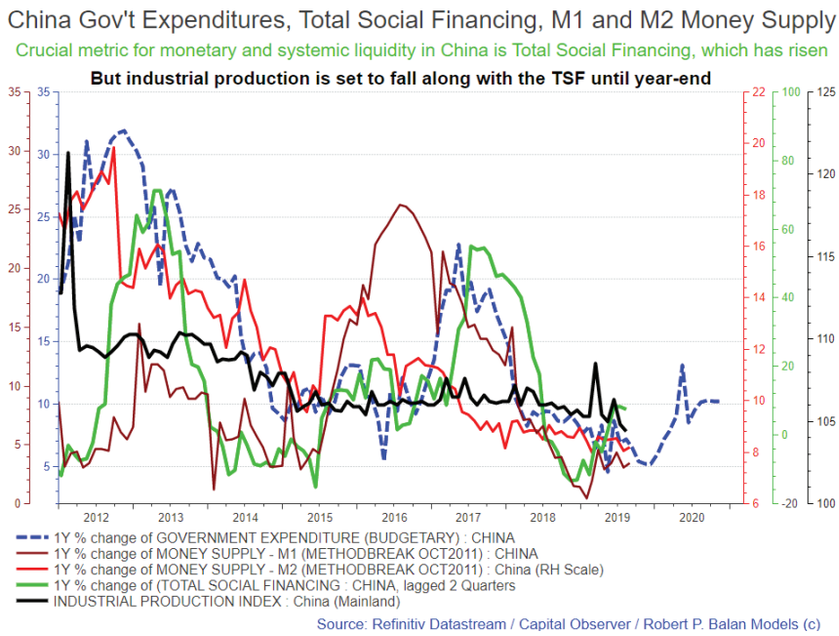
We did a long review of China in the September 2019 issue of Capital Observer, including the long history of Total Social Financing as a leading indicator of economic growth and activity in China over the past 10 quarters. This is what we said in September 2019:

The TSF is derived from the changes in China's government expenditures, and so the combination provides a window into the process which stems from China's fiscal policy, through the TSF, and to the monetary aggregates and economic activity. This is what we see in those indicators today:

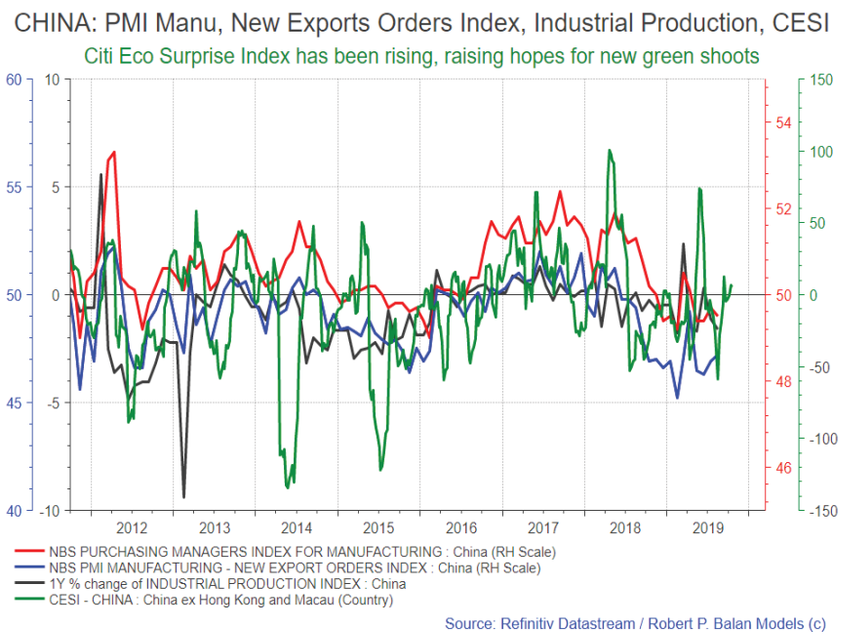
Finally, monetary aggregates are responding higher after the TSF reversed to the upside a few months ago (see chart below). But we expect the TSF to make a downturn over the next few months, and that should stunt whatever initial "green shoots" that may appear from the recent upturn in monetary aggregates and in the Citi economic surprise index. That will likely be ascribed to the trade spats that China and US are having at this time, and the consequential slowdown in industry. But the reality is that the systemic liquidity situation in China's economy is still very low – the economy is simply being starved of monetary grease.

We expect monetary aggregates and economic activity to decline again during Q4 this year, which may hit bottom by year-end. The outlook for industrial production is not very encouraging in the short-term – it is already heading lower following the expected trend of the TSF until year end (see 1st graph on this page). Nonetheless, by early next year the TSF should rise again and there should be relative fast growth during H1 2020.

Original chart from the September 2019 Capital Observer



Original chart from the September 2019, The Capital Observer



Indeed, nothing dramatic has changed since September, when the latest data dumped at that time (August 2019) disappointed across the board. There were "green shoots" expectations, as indicated by the Citi Surprise Economic Index (CESI – China) at that time, as shown by the 2nd chart above shown in September.

Over the subsequent weeks, however, those "green shoots" wilted as macro data reversed course and started to disappoint once more. Today, this is how that CESI graph looks like (*see 1st graph on the next page*):

We were fairly downbeat in September, saying that "whatever "green shoots" hope for China, as indicated by the Citi Surprise Economic Index (CESI – China), will likely be squashed, and better outcome may have to wait until early 2020."

The reason then, as it is now is because the economy was still grappling with a drought in cash. Total Social Financing, as illustrated in

the first graph in the article, remains insufficient to kick-start the economy out of the doldrums. This is how the TSF picture presented in September 2019, looks like today. (*see 2nd graph on this page*)

True, the TSF made a slight uptick, but that too will likely wilt away going into the year-end and into Q1 2020. **The primary mover of the TSF, central government expenditures (dashed blue line), is indicating that redress will only come by early Q2 next year.** As in September, the most recent data dump (China's October money and credit data) was simply awful, and mocked the recent measly 5bp PBoC rate cut.

- M2 growth was unchanged, at 8.4% y/y in October, in line with the consensus
- M1 growth slowed to 3.3% y/y in October, from 3.4% in September, below the 3.8% consensus
- New yuan loans fell to RMB 661B in October, from RMB 1,691B in September, and below the RMB 800B consensus.
- Aggregate financing (TSF) fell to RMB 619B in October, from RMB 2,272B in September, below the RMB 960B consensus.

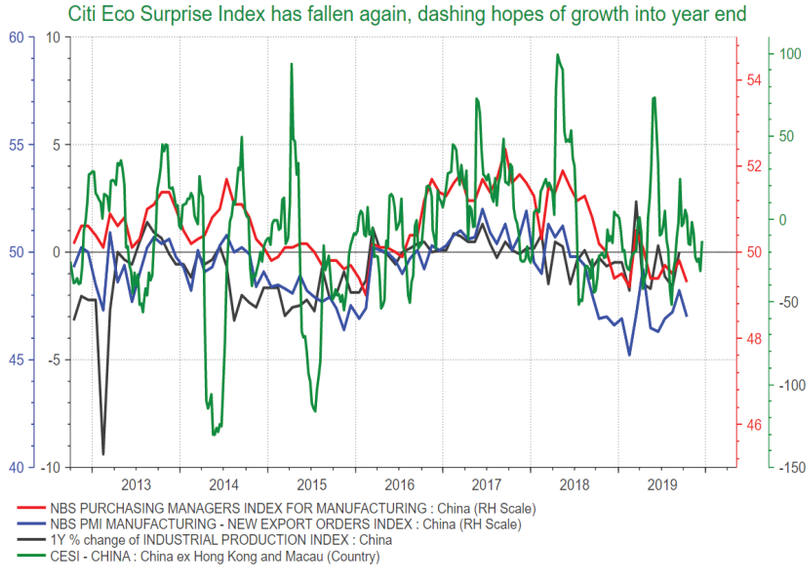
October's TSF print was the lowest in the revised series history which goes back to the start of 2017, and only a slightly lower print in the old series prevents October's total credit injection from being the lowest since 2016.

The growth in monetary aggregates left a lot to be desired. The stability in M2 growth is disappointing, given favourable base effects, leaving the rate in its channel from early 2018. The downtick in M1 growth is worrying, though to be expected; three-month annualised rates have been slowing, meaning a strong m/m rise was needed to keep the y/y rate stable. Instead, it fell 0.4% after a 0.8% rise in September. (*see 3rd graph on this page*)

We had high hopes for the shadow banking sector's quasi-

CHINA: PMI Manu, New Exports Orders Index, Industrial Production, CESI

Citi Eco Surprise Index has fallen again, dashing hopes of growth into year end

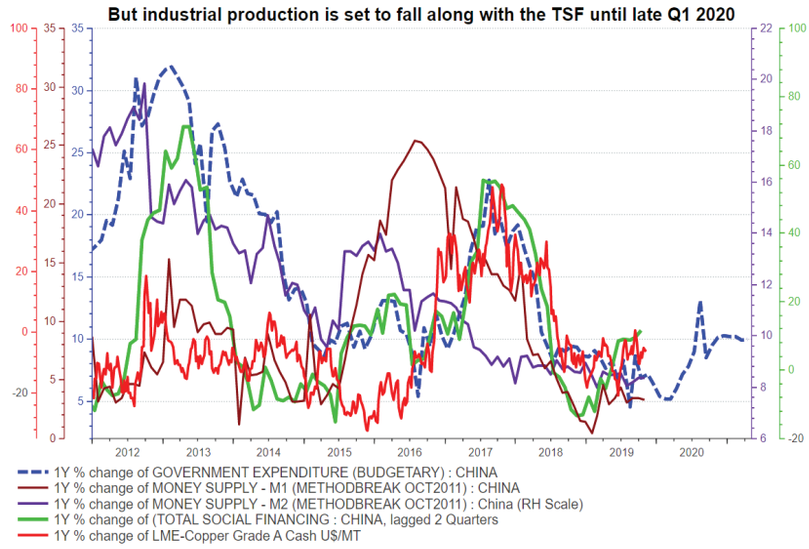


Source: Refinitiv Datastream / Capital Observer / Robert P. Balan Models (c)

China Gov't Expenditures, Total Social Financing, M1 and M2 Money Supply

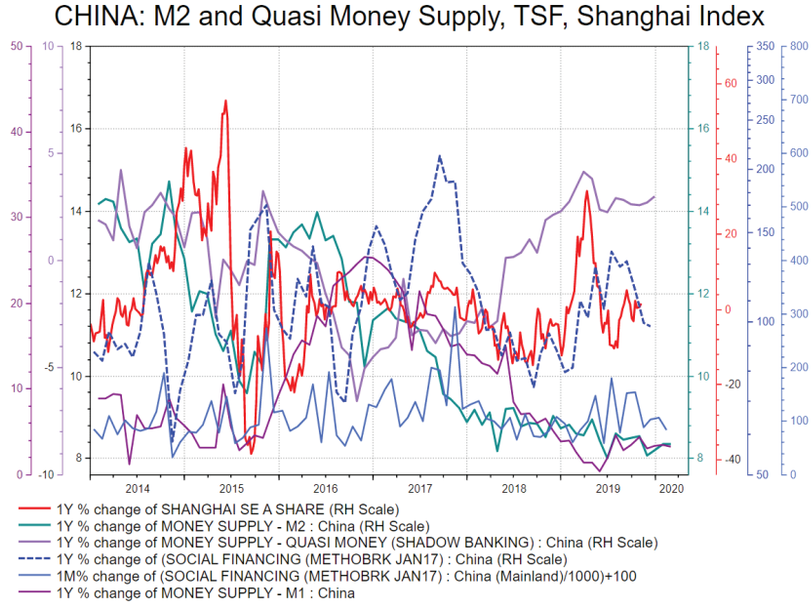
Crucial metric for monetary and systemic liquidity in China is Total Social Financing, which has risen

But industrial production is set to fall along with the TSF until late Q1 2020



Source: Refinitiv Datastream / Capital Observer / Robert P. Balan Models (c)

CHINA: M2 and Quasi Money Supply, TSF, Shanghai Index



Source: Refinitiv Datastream / Robert P. Balan Models (c)

money supply, but the October data just marginally rose. This data is crucial because it has become a leading indicator for the Shanghai Index. Also, China's shadow banking was the main culprit for October's steep total credit drop, which tumbled by 234 billion, the second biggest one month drop of the year, and the 7th drop in a row as well 18th of the past 20 years.

Overall, the slowdown in household credit growth also continues, with the authorities keeping the reins tight, while corporate credit growth is struggling to pick up. The slowdown in new loans growth was partly seasonal, but adjusted corporate new loans duly slowed to RMB 609B in October, after a spike to RMB 1,038B in September.
(*see 1st graph on this page*)

The central government and the Chinese central bank have simply not done enough. Admittedly, they have effectively raised the local government special bond issuance quota, which help monetary conditions in Q4. Banks can buy these bonds, which will push liquidity out into the real economy. **But the PBoCs 5bp rate cut was so inconsequential in addressing October's much more substantial deepening of PPI deflation, which pushed up rates in real terms**. Wholesale inflation, or PPI, which is so critical for corporate profits and in sparking benign, demand-driven inflation in the economy, tumbled in October to a three -year low.

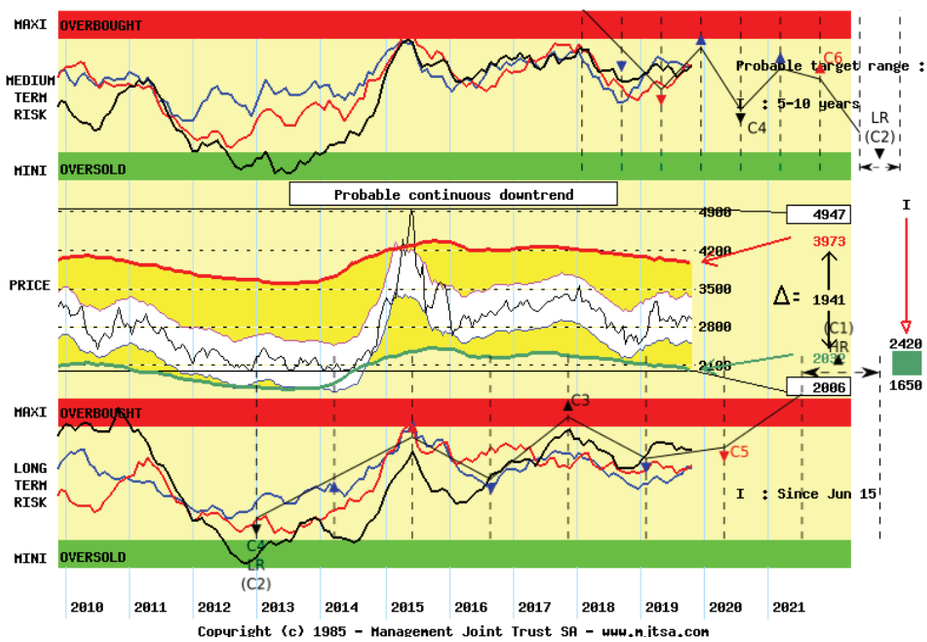
However, Chinese authorities will likely maintain their gradual approach, partly for fear of derailing the trade truce. Another 5bp rate cut is likely this year, probably more. But the malaise will not reverse until Beijing injects another elephant-dose of credit and liquidity into the Chinese financial system. Nonetheless, economic weakness is also "baked in the cake" so to speak. The powerful influence of the TSF, which we expect to decline until Q1 2020, remains a powerful constraint on activity. Unless the authorities in China breaks the mould, our next China piece in a few months will probably be a recitation of the same litany of things that were not addressed properly by doses of liquidity.

27 / MJT - TIMING AND TACTICAL INSIGHT

Chinese equities, deal or no-deal, should retrace down during Q1

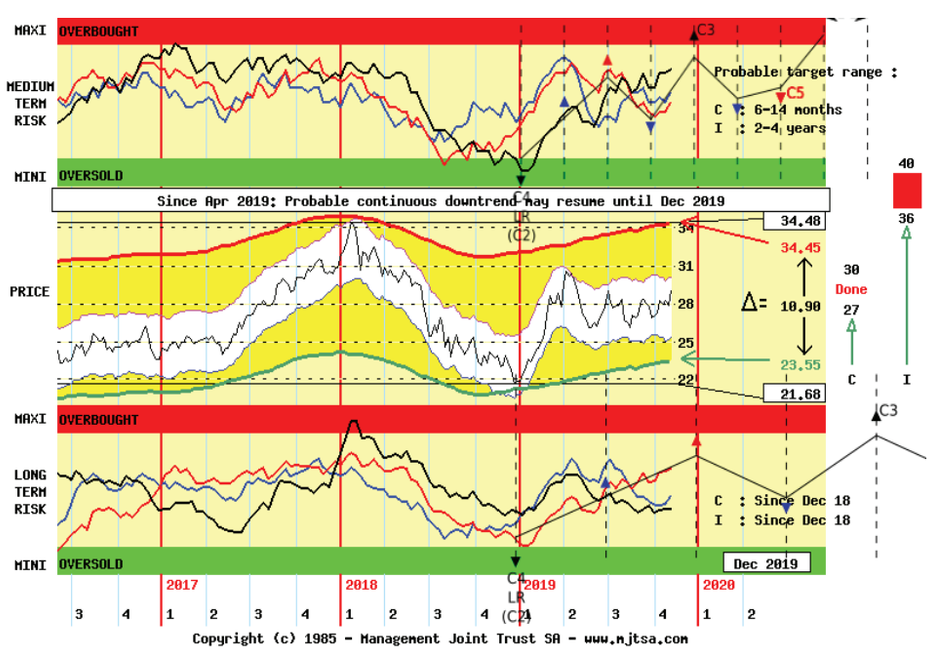
As we start this second full week of November, a protester was just shot down in Hong-Kong, Chinese CPI is rising on rising pork prices related to the African swine disease, Chinese PPI and Chinese Credit creation are slowing, while the conclusion of the phase one deal with the US is still uncertain. In this article, we attempt to understand this imbroglio and its consequences for Chinese equities and related trades over the next couple of quarters.

Shanghai Composite
Bi-monthly graph or the perspective over the next 1 to 2 years



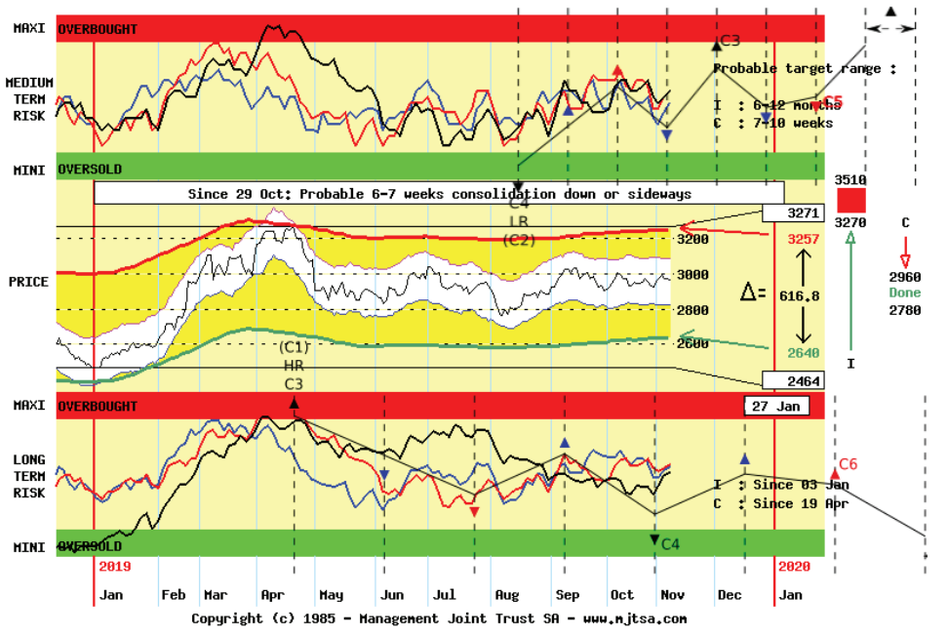
Following its strong rally earlier this year, the Shanghai Composite has for now failed to confirm its new uptrend. **Long term, both oscillator series are still consolidating from their 2015 (lower rectangle) and their early 2018 highs (upper rectangle). Support is probably expected towards next Spring, perhaps mid next year.** Following that, we would tentatively expect new upside potential into 2021. In the meantime, however, our I Impulsive targets to the downside (right-hand scale) are still menacing. We would hence remain quite prudent on the Shanghai Composite for now.

ASHR - db X-trackers Harvest CSI 300 China A-Shares
Weekly graph or the perspective over the next 2 to 4 quarters



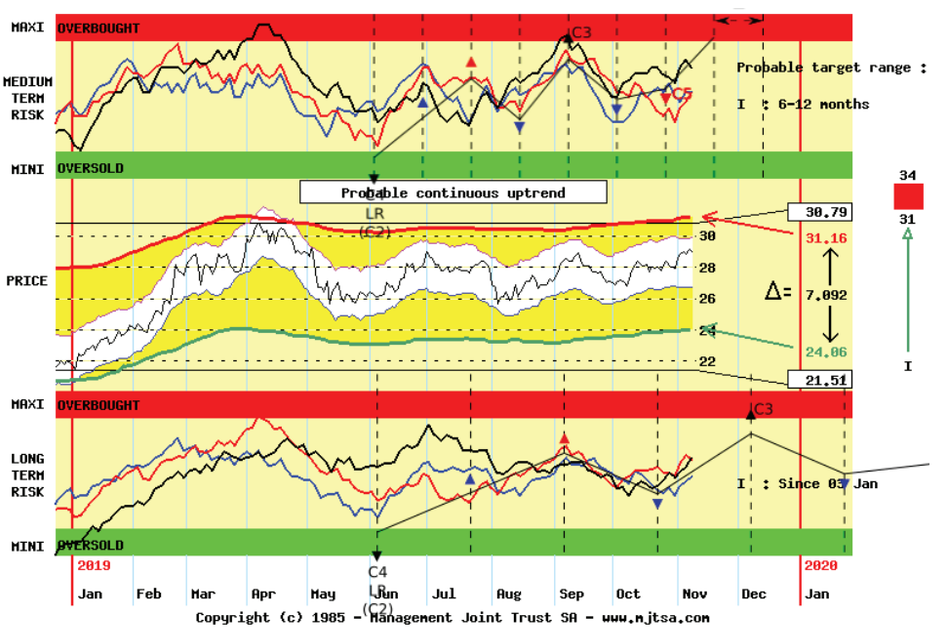
The CSI300 Index in US Dollars has been stronger (ASHR ETF) and prices have been holding up quite well since April. Both oscillator series (lower and upper rectangles) suggest that we may still see more upside between now and year-end. Yet, following that, we expect some retracement into Q1, perhaps mid next year. **The pivot point for a stronger move higher, in our view, would be if prices can break above the resistance of the upper end of our C Corrective targets to the upside around 30. Yet again, according to our oscillator series, they may break above this level and then pull-back again into Q1. We would hence probably remain prudent on China from December onwards.**

Shanghai Composite
Daily graph or the perspective over the next 2 to 3 months



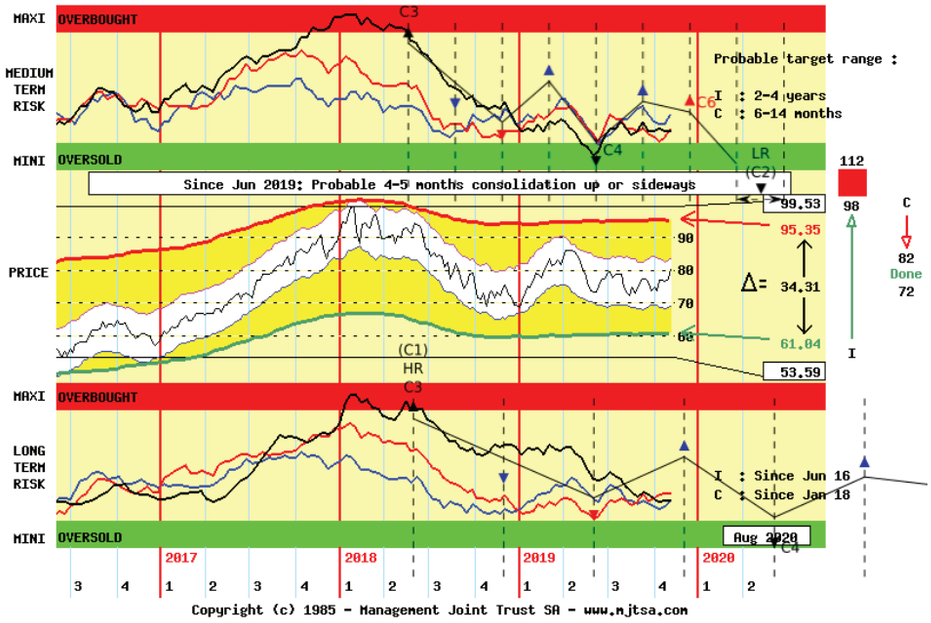
The Daily graph of the Shanghai Composite has been amazingly flat since May. Both oscillator series (lower and upper rectangles) here would also suggest that **a further leg up is possible into December. Following that, the Shanghai Composite will probably retrace down into January at least, perhaps even into late Q1.** It is still unclear for now if prices will first visit their I Impulsive targets to the upside above 3'300 or rather test down towards the support of the lower end of our C Corrective targets to the downside (right-hand scale). Here also, **we would probably turn quite prudent from early December, especially if prices cannot reach back towards their April highs.**

ASHR - db X-trackers Harvest CSI 300 China A-Shares
Daily graph or the perspective over the next 2 to 3 months



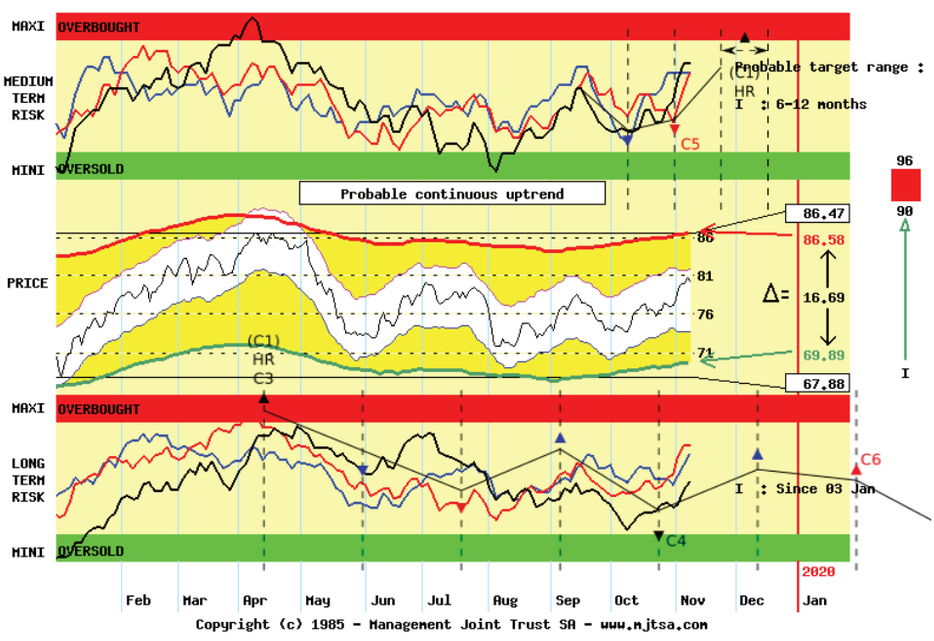
The daily graph of CSI 300 in US Dollar (ASHR ETF) is also more positive than the one of the Shanghai Composite. On both oscillators series (lower and upper rectangles), **it probably continues higher into late November / early December. By then, it could reach into its I Impulsive targets to the upside into the 31 to 34 range** (right-hand scale). This could be quite positive for future upside potential, yet will probably not avoid ASHR retracing down into early Q1 at least. **We would hence probably take profit during December based on risk/reward considerations.**

MSCI China
Weekly graph or the perspective over the next 2 to 4 quarters



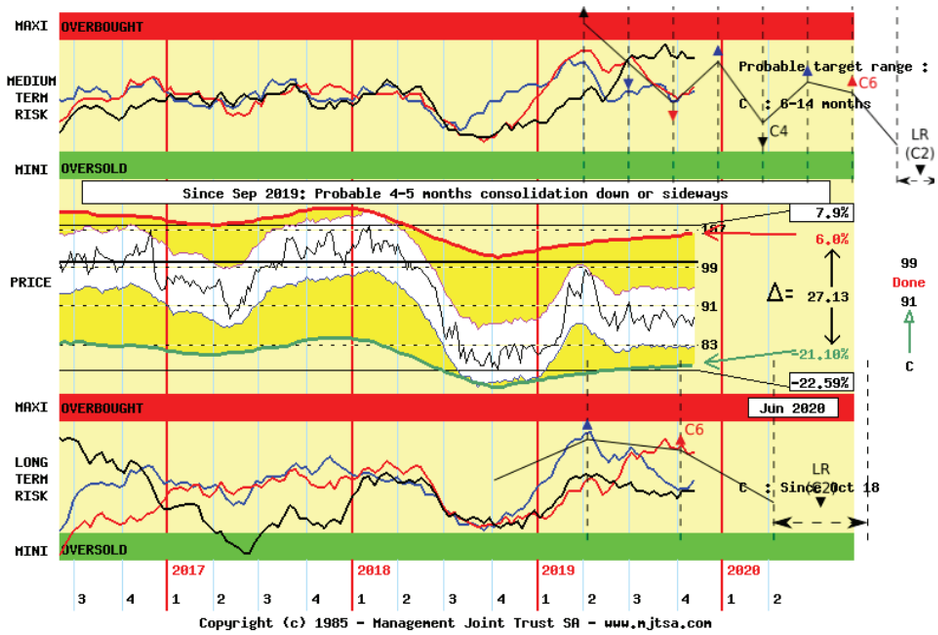
The more international, and Big Tech laden MSCI China index (which is heavily weighted towards the BATs, i.e. Baidu, Alibaba, and Tencent) could also continue to bounce into December according to both our oscillator series (lower and upper rectangles). Yet, here too, we expect the index to resume lower from year-end into the Spring, perhaps even mid-year. During this period, it will be crucial to hold support, i.e. hold above the lower end of our C Corrective targets to the downside around 72 (right-hand scale).

MSCI China
Daily graph or the perspective over the next 2 to 3 months



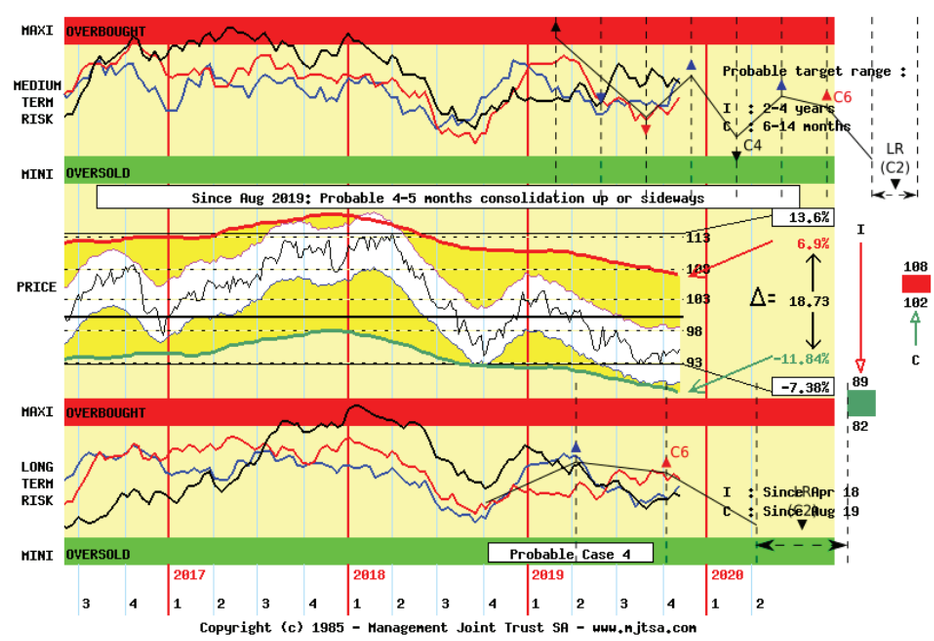
Shorter term, the Daily graph of the MSCI China Index also consolidated down into August. Similarly to other Chinese Indexes, it has since been bouncing. **We believe this bounce, could last into late November / early December** on both our oscillator series (lower and upper rectangles). **Thereafter, we expect the index to resume lower, probably towards early 2020, perhaps even into late Q1.** This more negative option would be in line with our scenario on the Weekly graph above.

ASHR - db X-trackers Harvest CSI 300 China A-Shares vs All Country World Index
Weekly graph or the perspective over the next 2 to 4 quarters



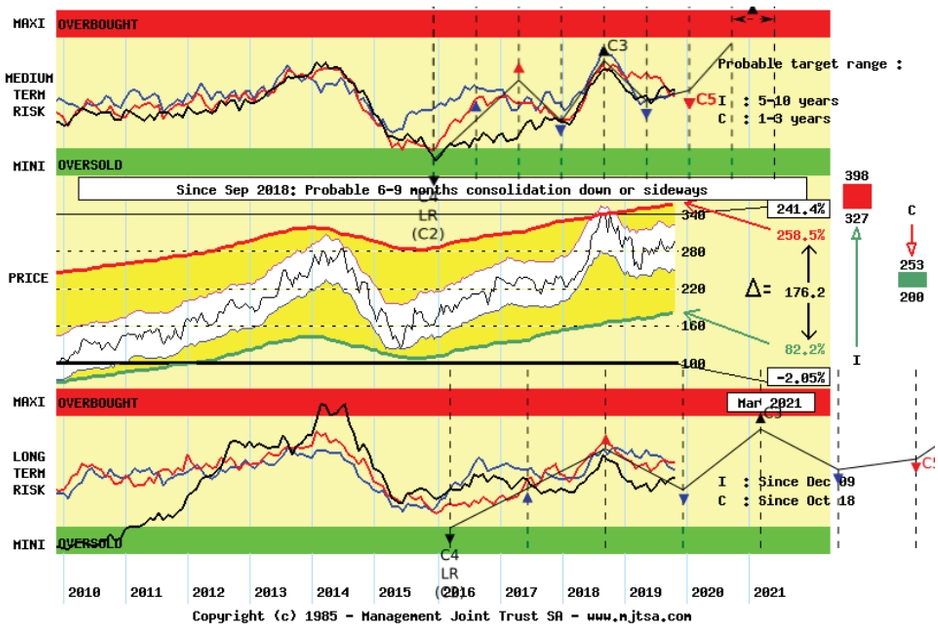
The relative graph of China (ASHR ETF) vs the All Country World Index shows similar dynamics. Indeed, Chinese markets are extremely volatile in comparison to the World Index, and hence usually underperform at the same time on an absolute and relative basis. **Here also, we may expect the current rebound to continue into late Q4** on our medium term oscillators (upper rectangle), yet the sequence we show on our long term ones (lower rectangle) has already reached the timing of a lower top compared to the one made in April. This configuration is usually bearish and implies **further downside potential into next Spring, perhaps even until midyear 2020.**

EEM - iShares MSCI Emerging Index Fund vs the All Country World Index
Weekly graph or the perspective over the next 2 to 4 quarters



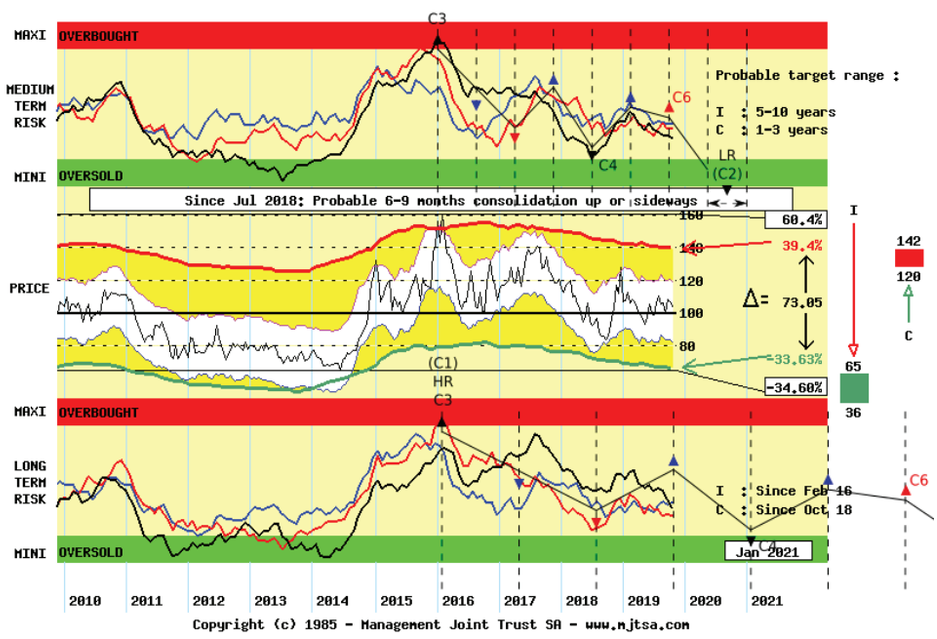
The graph of Emerging Market vs the All Country World Index is slightly different in terms of price (it topped out in late January instead of April). Yet, both our oscillators series (lower and upper rectangles) do show a similar profile. Here also, our medium term oscillators (upper rectangle) would suggest that **the current bounce probably extends until December**, while thereafter, our long term oscillators (lower rectangle) would confirm **renewed underperformance towards the Spring**, perhaps even mid next year. Note: compared to the graph above (China vs the World), this ratio does seem to resume lower slightly earlier though. As we explain in the last article in this issue of The Capital Observer, this may result from the fact that Commodity Currencies (i.e. the currencies of most emerging countries ex Asia) may resume lower more strongly/rapidly than Asian Growth ones during December (including CNY), once the US Dollar begins its next leg up from late November.

Russell 2000 Index vs the Shanghai Composite Index (in US Dollars)
Bi-monthly graph or the perspective over the next 1 to 2 years



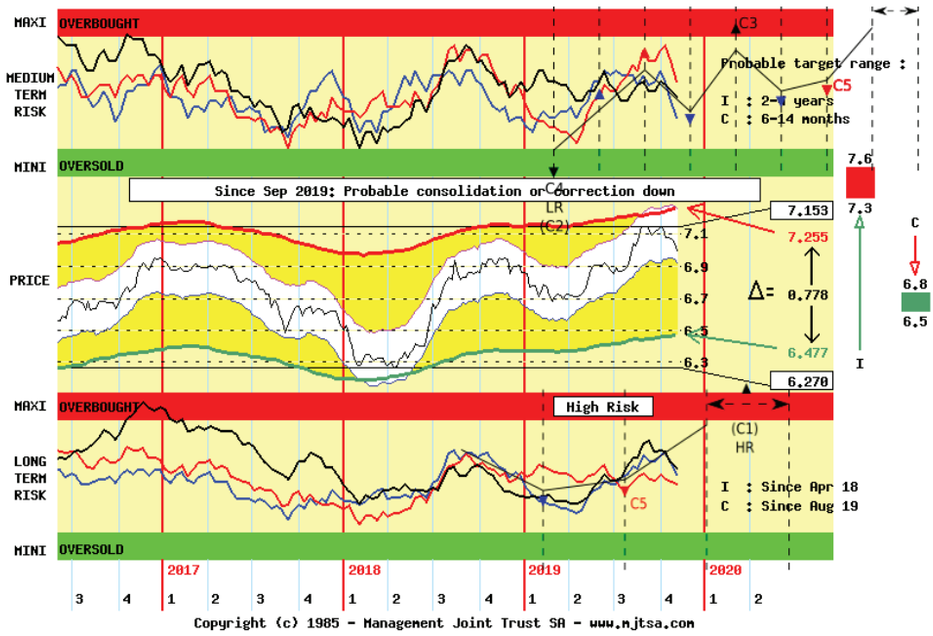
For further confirmation, **we now make a long term comparison of the Russell 2000 index, which represents US Small Caps and is hence quite cyclical, with the Shanghai Composite, which is also very cyclical, yet a different type of risk.** On both oscillator series (lower and upper rectangles), we expect **the ratio to continue to resume higher, probably from late this year into late 2020 / early 2021. The upside potential is quite compelling** somewhere between 15 and 30% above current levels. This comparison may seem esoteric, yet it **highlights our current preference for US Cyclical risk rather than China**, especially as we move into year-end and into early next year.

Copper Spot (LME, USD/ton) vs Brent Oil (USD/barrel)
Bi-monthly graph or the perspective over the next 1 to 2 years



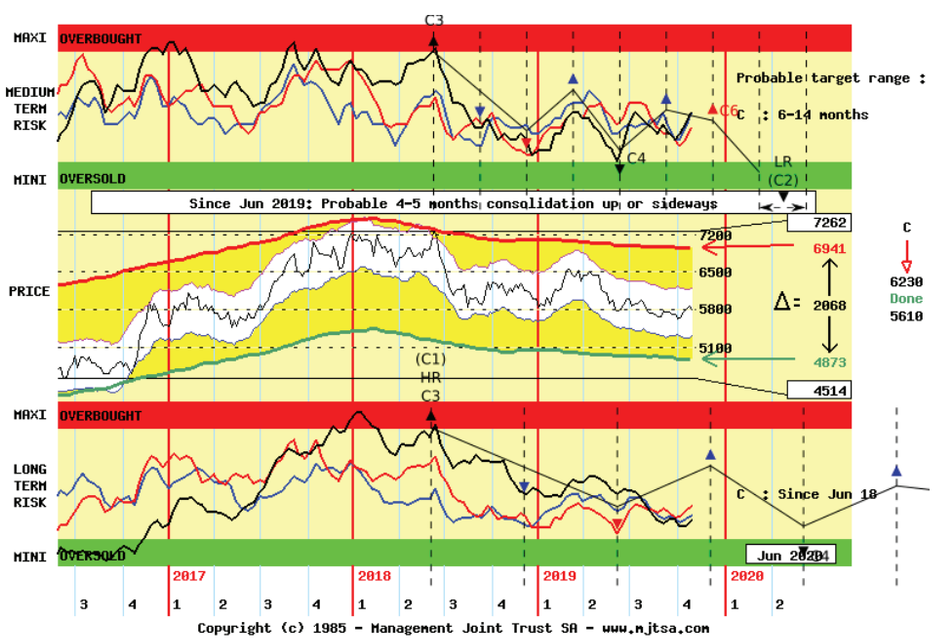
Another comparison which we feel is quite interesting is the one **comparing Copper (which relies heavily on Chinese demand) with Oil (which prices are very much driven by US demand**). The ratio, which has been consolidating since early 2016 has been a good indicator of periods of Chinese relative weakness vs the US (e.g. early 2016 sell-off, Summer 2017 top and 2018 sell-off). Both oscillators series (lower and upper rectangles) now suggest **that the ratio could be resuming its downtrend towards H2 2020, perhaps even into early 2021. Hence here again, over the next few quarters, we would probably privilege themes related to the US and Oil, rather than China and Copper.**

USD/CNY
Weekly graph or the perspective over the next 2 to 4 quarters



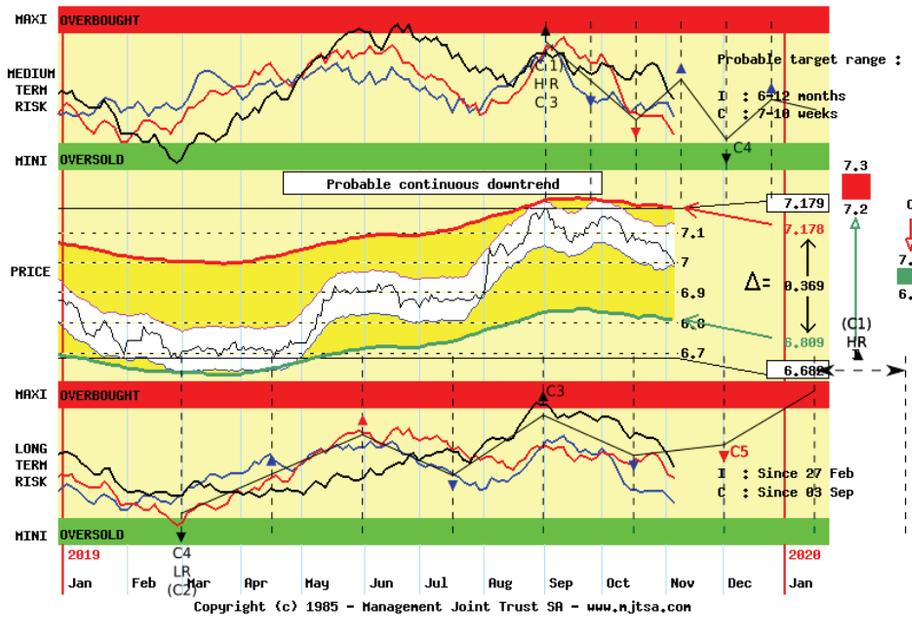
We now turn to the US Dollar vs the Chinese Yuan, which over the last couple of years has been very much inversely correlated to Chinese equities. The uptrend is already quite mature as shown by the "High Risk" indication on our graph mid Q3. Yet, as shown on both oscillator series (lower and upper rectangles), **we would expect the US Dollar to perform one last rally, probably from December into mid/late Q1, perhaps the Spring**. These periods of strong USD/CNY **are often associated with Chinese capital flight (or less foreign direct investments into China) and hence with weaker Chinese equities.** Our I Impulsive targets still suggest that this uptrend could reach into the 7.3 to 7.6 range by then (right-hand scale).

Copper Spot (LME, USD/ton)
Weekly graph or the perspective over the next 2 to 4 quarters



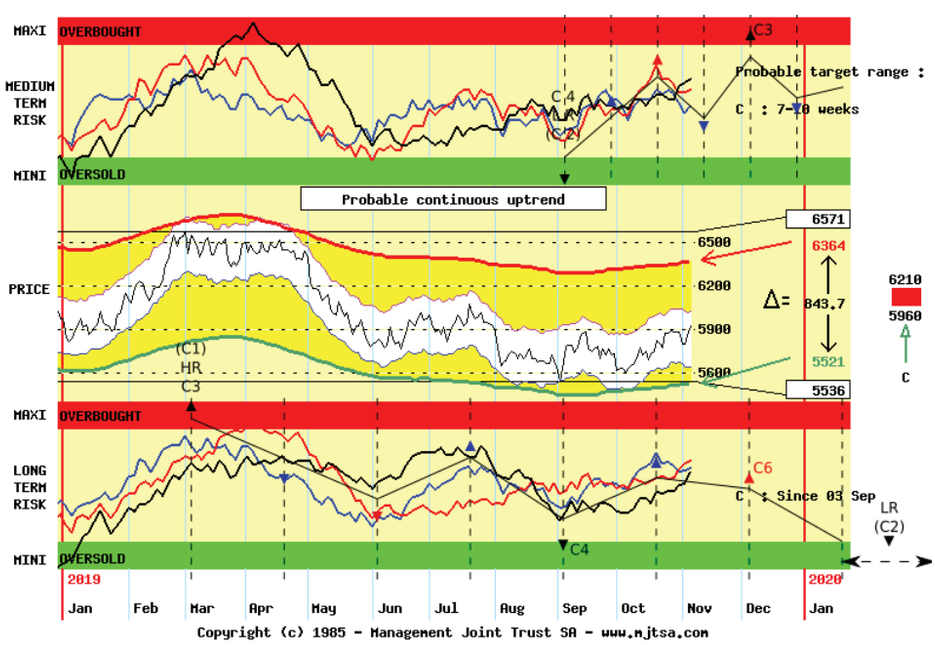
Focusing back on Copper, we can notice quite a strong inverse correlation to USD/CNY. The graph is also very similar to the MSCI China vs the All Country World Index ratio featured further above in this article. On both oscillator series (lower and upper rectangles), we expect **Copper to finish its current bounce (which is quite weak) towards December, and then probably resume lower into next Spring, perhaps midyear.** The sell-off may be quite strong, especially if prices break below the support of our C Corrective targets to the downside (i.e. below 5'610, right-hand scale). This would theoretically imply further slowdown in the Chinese economy.

USD/CNY
Daily graph or the perspective over the next 2 to 3 months



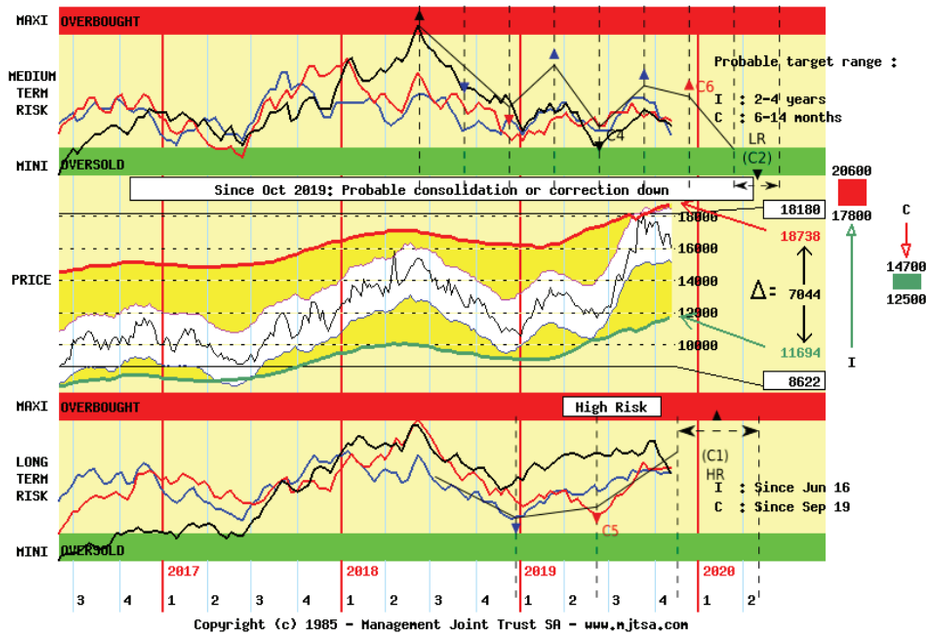
Shorter term, the current correction to the downside in USD/CNY may reach support towards late November / early December according to both our oscillator series (lower and upper rectangle). **The pair may then bounce towards year-end at least (upper rectangle), but probably resumes higher into mid/late Q1 (lower rectangle)**. On the target front (right-hand scale), support is probably towards 6.9 as suggested by our C Corrective to the downside. Following that, USD/CNY could then resume higher **to new highs in the 7.2 – 7.3 range** (our I Impulsive targets to the upside).

Copper Spot (LME, USD/ton)
Daily graph or the perspective over the next 2 to 3 months



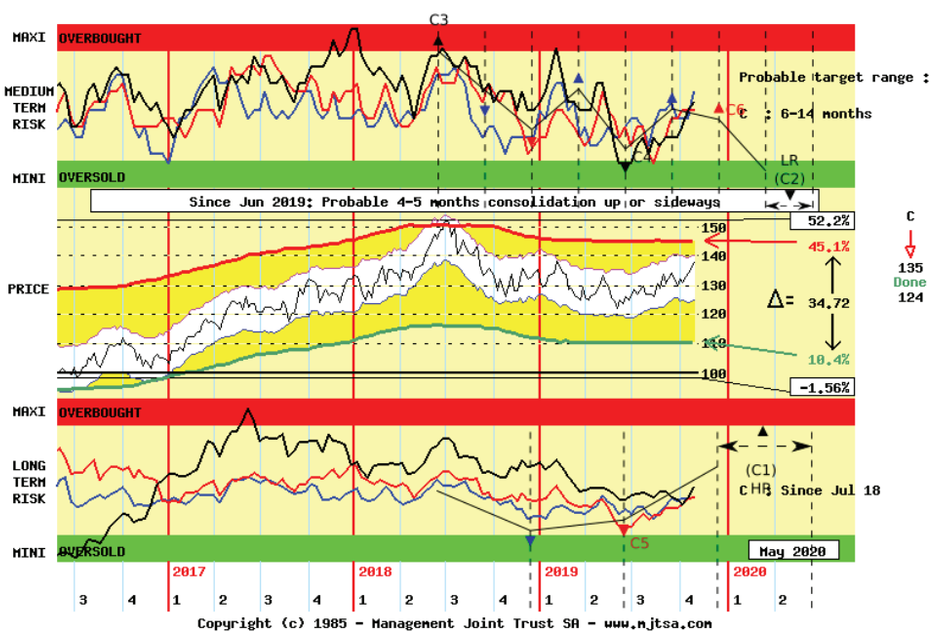
Again, Copper is showing a similar profile in reverse, with **a top expected towards early December** on both oscillator series (lower and upper rectangles). We believe this top will conclude the bounce started in early September and that following that, **Copper will at least correct down during December (upper rectangle), but will probably continue to move lower into mid/late Q1** (lower rectangle), as already suggested by our Weekly graph above. In the meantime, until early December, Copper may continue to bounce towards our C Corrective targets to the upside in the 5'950 – 6'210 USD/ton (right-hand scale).

Nickel Spot (LME, USD/ton)
Weekly graph or the perspective over the next 2 to 4 quarters



Nickel has been much stronger than Copper this year, registering a 75% rise into early September. It did reach into our I Impulsive targets to the upside (right-hand scale) and our Automatic messaging is now pointing to the possibility of a "High Risk" situation. On our long term oscillators (lower rectangle), this High Risk situation is also expected towards year-end, while on our medium ones (upper rectangle), **we expect Nickel to roll-over between now and December, and retrace into late Q1, perhaps next Spring**. Our C Corrective targets to the downside would suggest a retracement potential towards the 14'600 – 12'500 USD/ton range (right-hand scale).

CHIQ - Global X MSCI China Consumer Disc ETF / ASHR - db X-trackers Harvest CSI 300 China A-Shares
Weekly graph or the perspective over the next 2 to 4 quarters



We believe that Nickel is particularly interesting in monitoring the state of the Chinese manufacturing industry and consumer market. Indeed, while Copper is mainly used in infrastructure, Nickel is used in Consumer Goods (for exports goods, but also for Chinese consumption). Alongside Copper, China is also by far the biggest importer of Nickel worldwide. **We hereby relate the price of Nickel to the Chinese Consumer Discretionary sector and compare it to the broader Chinese market. Although less dynamic than Nickel, the graph does seem very much related. It probably suggests a softening of Chinese Consumer related industries from late this year into late Q1, perhaps next Spring**. Indeed, the recent bounce may reach a "High Risk" situation on our long term oscillators towards year-end / early next year (lower rectangle), while on our medium term ones (upper rectangle), we expect the ratio to start rolling over during December into late Q1.

Concluding remarks:

Following their strong rally into April, Chinese equity markets did consolidate for about 4 months into August. They have since been bouncing and we believe this rebound could continue until early December. Following that, we expect Chinese markets to start consolidating down into early 2020, perhaps Spring next year. On a relative basis, the slump also seems quite clear and we expect Chinese Equities to also underperform Global market until late Q1, perhaps Spring next year (along with other Emerging markets). This underperformance could coincide with a further rally on USD/CNY into mid/late Q1, while we expect Industrial metals such as Copper or Nickel to also move lower into the Spring.

35 / The EU courts technical growth recession, but a full benevolent circle in financial conditions awaits via the EUR common currency

The last time The Capital Observer wrote about Europe was in March, this year. We said then:

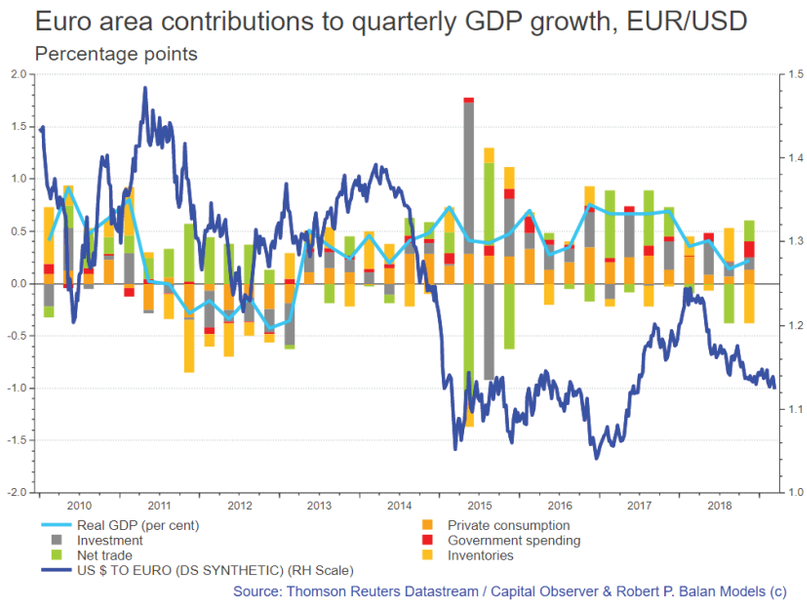
"Rising employment, high levels of positive sentiment and a loose monetary policy stance should continue to underpin domestic demand in the entire Eurozone last year. Low inflationary pressures allowed the ECB to maintain its ultra-loose monetary policy stance, while robust global growth supported the exports sector. The ECB's ultra-accommodative monetary policy stance also bore fruit, corporate lending in the bloc hit a post-crisis high in December in Germany. So the ECB's mission to shunt money to corporates largely succeeding, and is still going strong (see the 1st graph on this page)".

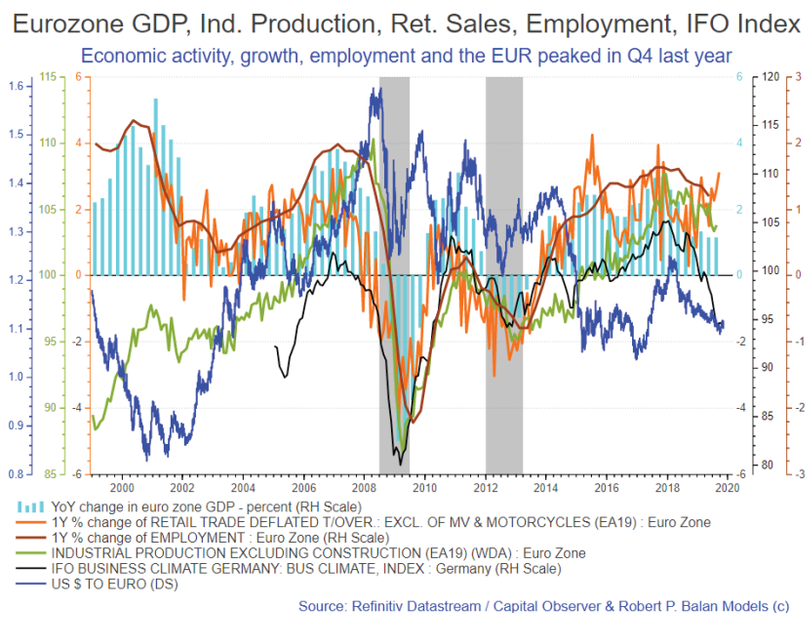
Since then, something went horribly wrong -- forward looking statistics for the eurozone and show likely technical recession in this coming quarter. **We should distinguish between recession -- two quarters of falling output, and technical recession -- a recorded fall in output in any quarter**. The eurozone as a whole - not just German industrial production - looks like it will meet that second definition in the near future. Manufacturing already is, Germany probably already is; it's the extension of this to the whole eurozone which is new this time around.

That the malaise has become EU-wide is significantly more problematical than a problem with, say, Germany. The only real agency that can address an EU-wide situation is the ECB, and the ECB doesn't really have any room left to loosen monetary policy. Fiscal policy remains the province of the nation-states. And there lies the rub -- coordinated fiscal responses aren't going to happen.

(see 2nd graph on this page)

Original chart in the March 2019, The Capital Observer





Germany has always been the workhorse that has pulled the European economy back from the brink time and time again, and pushed bloc-wide growth along despite internal and external pressures, as well as political crises, over the last decade. **As the de facto economic and political leader of the bloc, the country has spearheaded and supported rescue plans for the Eurozone's weaker links. However, Germany's economic and political outlook has turned dark – there are now valid concerns over the potential knock-on effects of that darkened outlook on the entire monetary union.**

German manufacturing has been in the doldrums for some time now. This is partly just because of the general decline in international trade. **But it is also because Germany was specifically dependent upon China as a destination for exports. And China has been hurt hard by the trade brawl with the US.**

Trade tensions, the threat of a hard Brexit and weaker emerging markets growth have all played a part in dampening Germany's nine-year-long economic upswing. Recently released figures also cast large

shadows over Germany's formidable manufacturing sector, with industrial output much lower than expected (*see 1st graph on this page*)

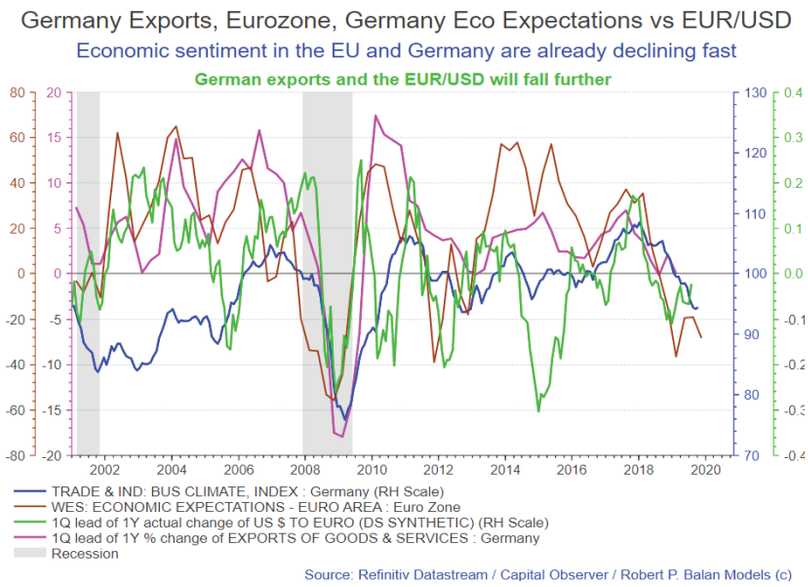
German industrial production was worse than expected in September, decreasing by 0.6% m/m following an upwardly revised 0.4% increase in August. **Production also fell in yearly terms by 4.4%; this was the 11th month in a row of year-on-year declines.** With September's data, the third quarter finished on a negative note, decreasing 1.1% q/q. These are backward looking indicators -- a recording of what has already happened. Forward-looking indicators are worse.

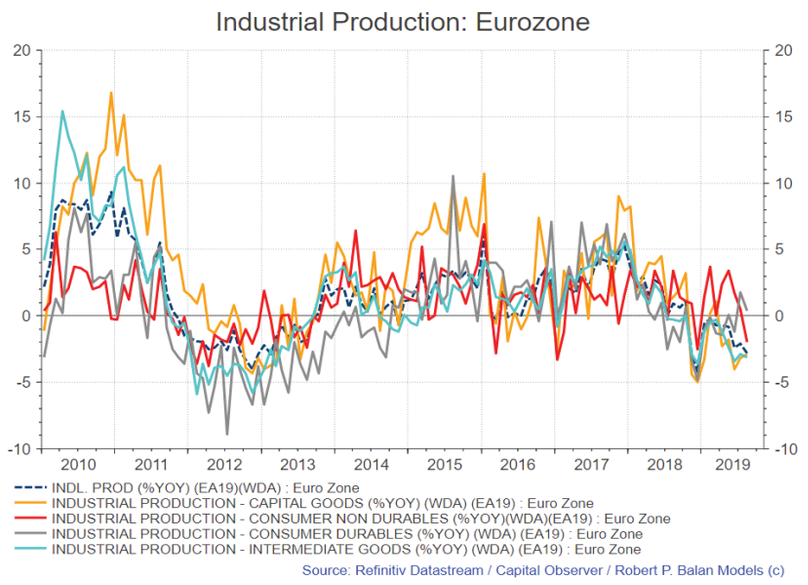
The headline IHS Markit/BME Germany Manufacturing PMI - a single-figure snapshot of the performance of the manufacturing economy derived from indicators for new orders, output, employment, suppliers' delivery times and stocks of purchases - registered 42.1 in October, up slightly from 41.7 in September but still the second-lowest reading since June 2009. (*see 2nd graph on this page*)

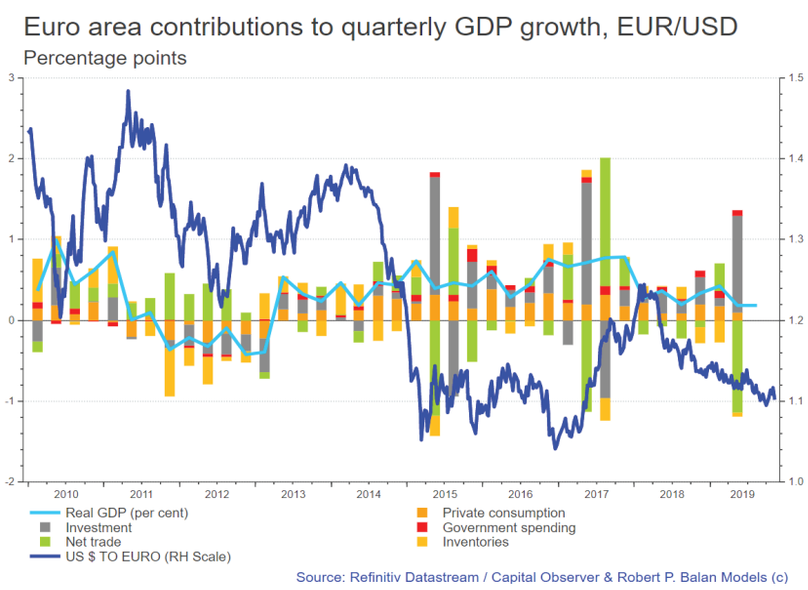
The discussions above brings us to one graph (*see 3rd graph on this page*) that capsulizes the situation in the eurozone:

With the slow and steady deterioration of the Eurozone's nominal and real GDP, the EUR/USD pair has drifted slowly lower in favour of the US Dollar. This is hardly a surprise, given the slow-bleeding economic conditions in the common currency area. **And the signalling effect of the EUR currency suggests that growth may still deteriorate over at least the next quarter, or two. But there is a silver lining in those dark clouds. It harks to the benefits that a country gets from a slow depreciation of its domestic currency – the type of currency devaluation that the EU has, and still is, undergoing.**

We can show this graphically with a graph which basically asks: what happens to an economy which undergoes such slow devaluation over the country on the other side of the exchange rate? For instance, in EUR/USD, the EUR vs the US Dollar. It turns out that there could be a pot of gold, as after a while, the tables are turned. We show this thesis in the first graph on







this page.

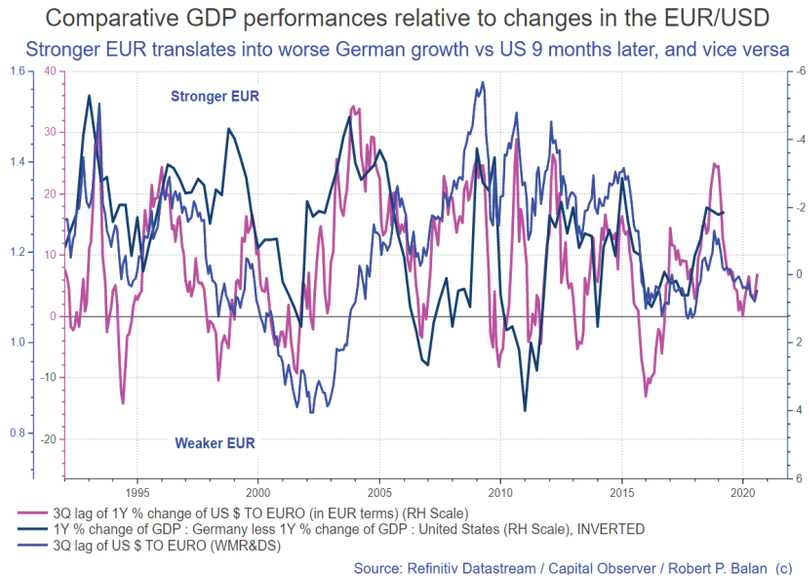
It turns out that weaker EUR translates into a stronger EU economy (in general) relative to the US nine months after such a slow devaluation. And the opposite is also true – stronger EUR gives rise to a weaker economy nine months after the onset of currency strength.

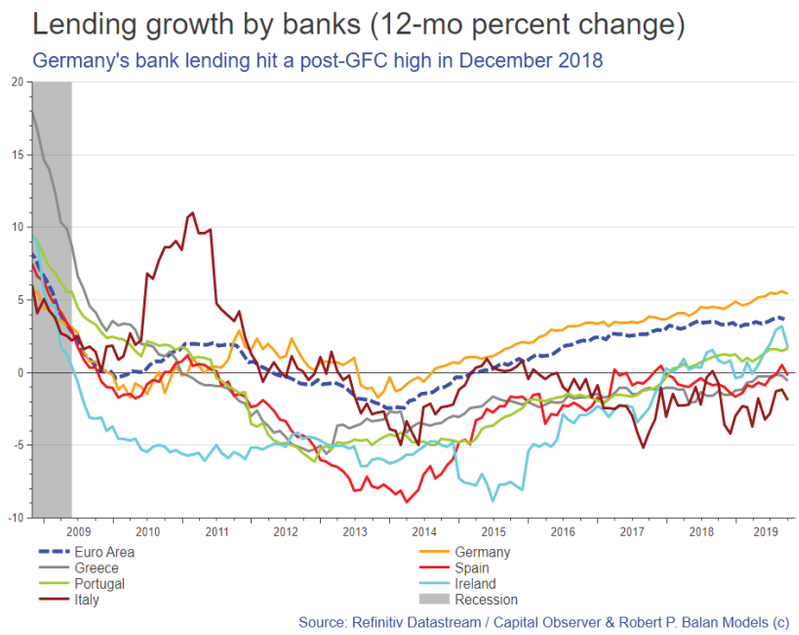
The EU economy is at the floor of such a comparison today. But the table will be slowly turned over the next nine months. How is this possible? The key element may be ECB action that they have initiated this month. **The ECB restarted QE in November with purchases of sovereign and corporate bonds. If history is any guide, the central bank's private asset purchases will be a game-changer.**

It's also worth re-emphasising the point than private debt purchases take place in the primary market too. This means that the ECB often will buy more than the total supply of new debt in any given month, crowding out private investors, directly financing corporates' capex and capital allocating decisions. That may just drive EU firms to mimic their U.S. counterparts by levering up to fund share buybacks.

And all that is happening as lending growth is ratcheting up Eurozone-wide, lead by Germany's banks, which had hit highest levels of loans issues since the Great Financial Crisis of 2008 (*see 2nd graph on this page*).

History shows that buybacks can be a powerful engine for equity market gains, though EU corporates may not be as aggressive as their counterparts in the US. **Asset price gains have a way of leading economic growth, at least in the US. That could also kick-start downtrodden economic sentiment among investors and businesses in the EU. And that would bring EU financial conditions around a full, benevolent circle. The EU economy should be a lot better (perhaps even vis-à-vis the US economy), 9 months from now.**



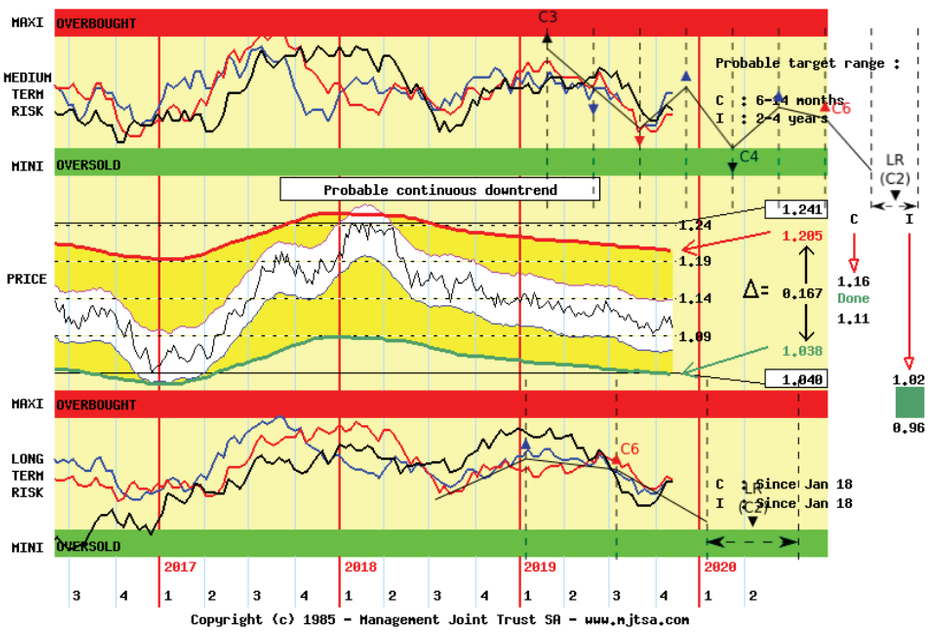


38 / MJT - TIMING AND TACTICAL INSIGHT

Although still lagging for now, European markets could outperform for mid/late Q1 2020

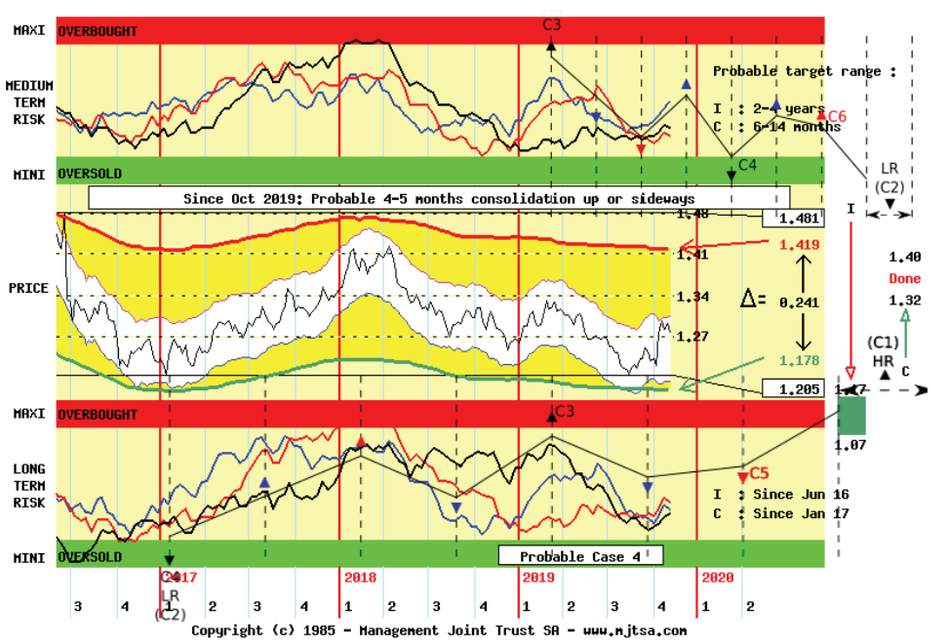
Europe's economy, its currencies and its equity markets have underperformed their US and Asia counterparts over the last 3 years, not mentioning the last 10 years. Indeed, since 2016, the European Union has been embroiled in its complicated Brexit divorce with the UK, while over the last 2 years the US to China trade war has taken its indirect toll on German manufacturing. Yet, there are some anticipations of a stronger Europe going forward, European equity markets have been relatively strong this year (on a local currency basis at least), while the geopolitical issues mentioned above may find some closure in the near future. These developments may hold the promise of a European recovery in 2020, yet patience is probably still required.

EUR/USD
Weekly graph or the perspective over the next 2 to 4 quarters



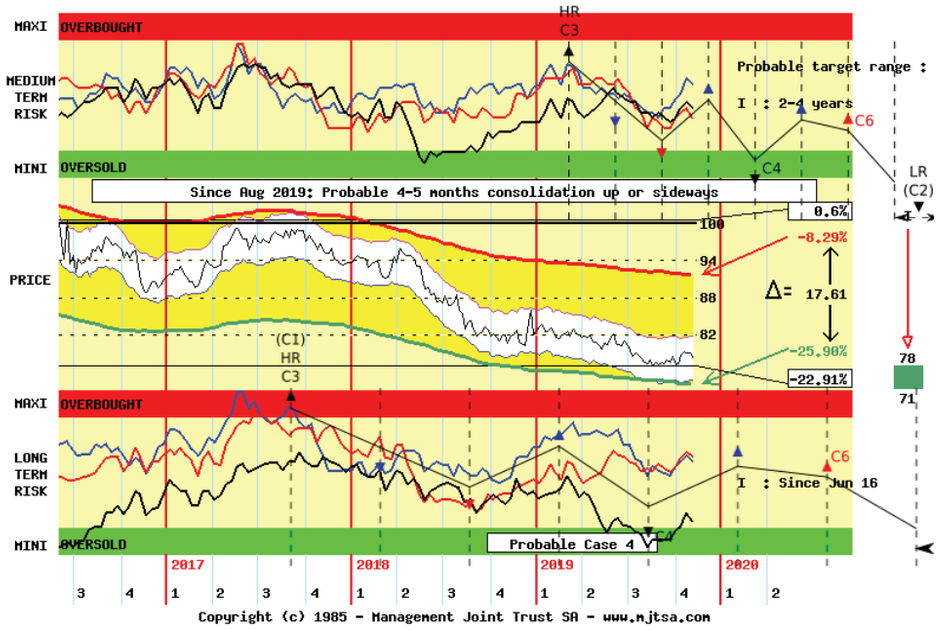
EUR/USD has been a good proxy for European underperformance over the last couple of years. It topped out in early 2018 with the European Economic Surprise Index, which marked the end of the 2017 European re-coupling story. Since then, Europe and the EUR have seen sustained erosion on a relative basis. For now, it is still too early to call for a reversal to the upside of EUR/USD though. Indeed, while our long term oscillator (lower rectangle) are pointing to further downside into Q1 next year, possibly the Spring, our medium term ones (upper rectangle) indicate that **the current weak bounce in EUR/USD probably ends in December, before the pair sees a further downside retest into mid/late Q1. The risk could still be quite compelling** as on the price target front, we are now below the support of our C Corrective targets to the downside (right-hand scale) and potentially eyeing our I Impulsive ones dowards towards parity. Following that, EUR/USD could rebound well into H2 2020.

GBP/USD
Weekly graph or the perspective over the next 2 to 4 quarters



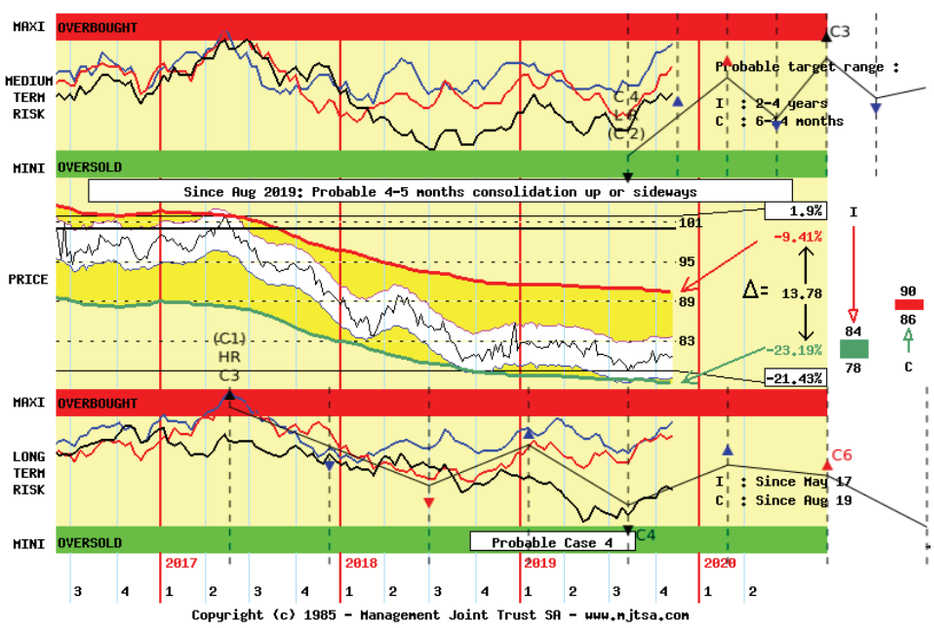
To understand the link between the painful Brexit process and the underperformance of Europe and EUR/USD over the last couple of year, we consider the Weekly graph of Cable. Although it is more volatile than EUR/USD, it has followed the same inflection points since 2016. Here also, although Cable may be starting to stabilize on our long term oscillators (lower rectangle), **we would expect a further downside retest (or some retracement at least) into mid/late Q1 on our medium term ones.**

Europe Stoxx 600 vs the S&P500 Index (both in US Dollars)
Weekly graph or the perspective over the next 2 to 4 quarters



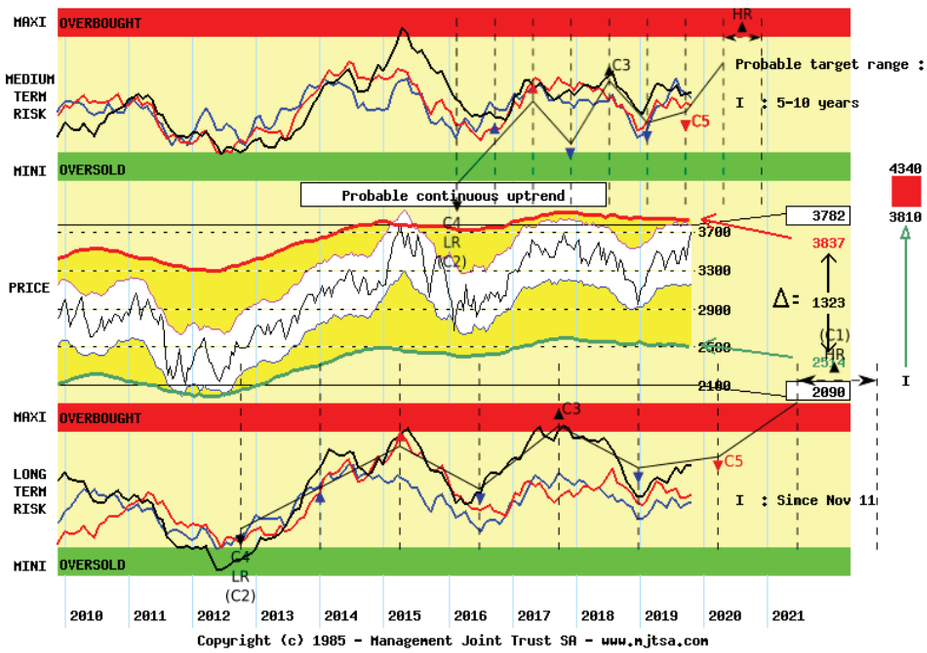
We now compare European markets vs the US ones on a US Dollar denominated basis. The ratio was very Oversold in August on our long term oscillators (lower rectangle), yet the bounce has been weak. Going forward, our medium term oscillators (upper rectangle) suggest that **a further leg down will probably materialize from December into mid/late Q1. According to our I Impulsive targets to the downside (right-hand scale), the risk could still amount to 5 to 10% of underperformance until then. Considering our scenario on EUR/USD above, we believe a weaker EUR/USD will probably be responsible for much of this underperformance.** Finally, from late Q1 next year, we expect the ratio to start bouncing, probably well into H2 2020.

Europe Stoxx 600 Index vs the S&P500 Index (currency hedged ratio)
Weekly graph or the perspective over the next 2 to 4 quarters



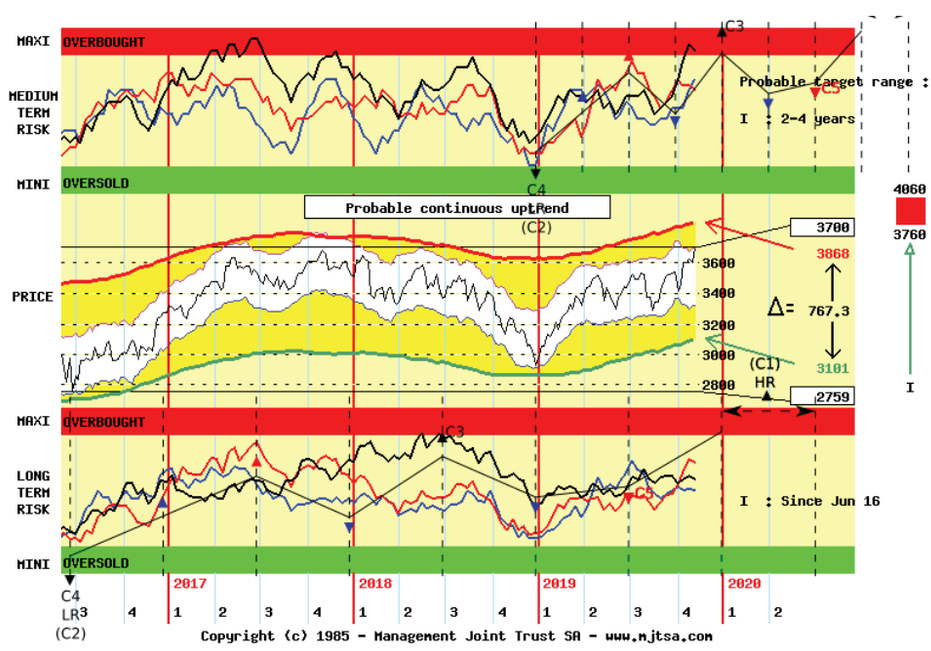
Considering the above, we now attempt to separate the incidence of the negative EUR/USD translation effect from the performance of the Europe Stoxx 600 in EUR terms. This hedged currency ratio of Europe vs the US was also Oversold in August on our long term oscillator series (lower rectangle), yet the continuation of the sequence down on our medium term ones (upper rectangle) is less clear here than on the ratio above, where both indexes were denominated in US Dollars. Furthermore, on this graph, it does appear that our I Impulsive targets to the downside (right-hand scale) have been reached, and that the scope for further underperformance of Europe in its local currency vs the US is probably limited. **We hence believe that European markets may have bottomed vs the US on a hedged currency basis, and that they could now enter an uptrend which could last well into H2 2020** (the sequence we show on our medium term oscillators; upper rectangle). Until mid/late Q1, however, a weaker EUR/USD should overcompensate for this nascent relative strength (see graph above).

EuroStoxx 50 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



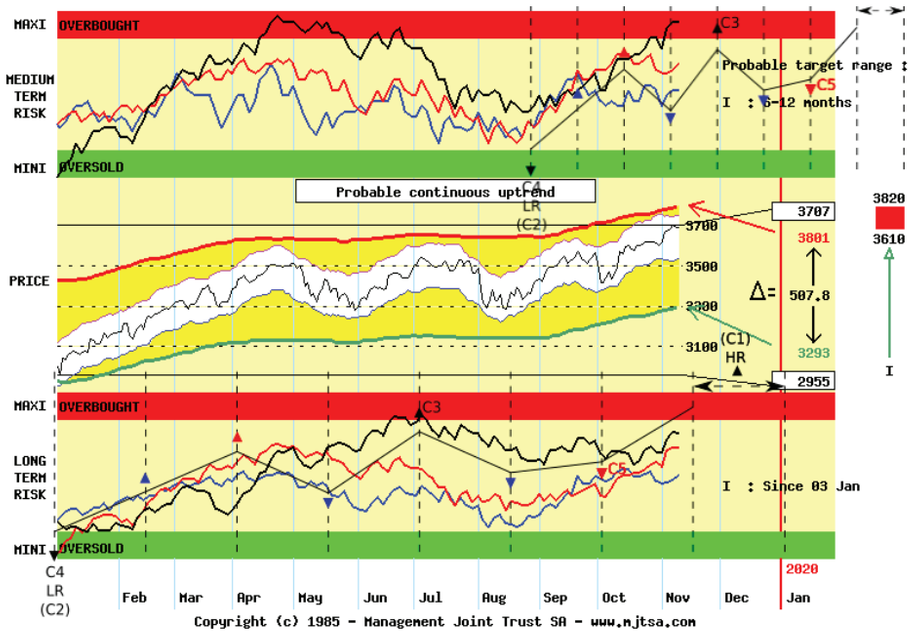
We now analyze the EuroStoxx50 Index on a standalone basis. Following its strong 2018 correction (more than 20% drawdown), it has since resumed its uptrend and recently made new highs above its 2017 ones. Both our oscillator series suggest that **this uptrend should continue (lower and upper rectangles), probably towards mid/late 2020 in first instance (upper rectangle). Our I Impulsive targets to the upside indicate possible upside targets in the 3'810 – 4'340 range (right-hand scale), or well above its 2015 highs.**

EuroStoxx 50 Index
Weekly graph or the perspective over the next 2 to 4 quarters



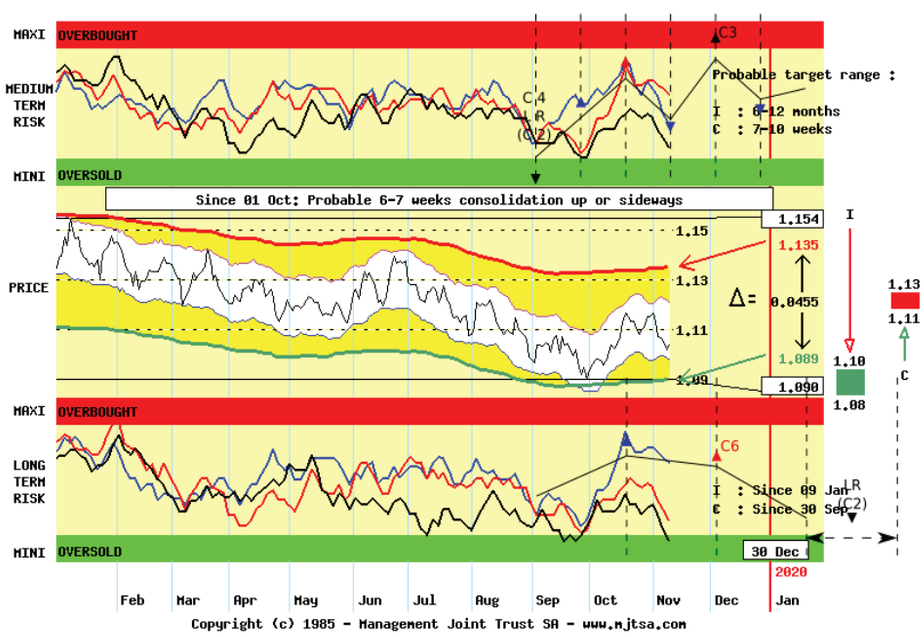
On our Weekly graph, the Eurostoxx50 is also in a strong uptrend. Although, our medium term oscillators (upper rectangle) suggest that it may reach an intermediate top towards year-end, our long term ones (lower rectangle) indicate **a continuation of the uptrend into mid next year at least. Our I Impulsive targets to the upside (right-hand scale) are also promising. They suggest further upside potential in the 3'760 – 4'060 range over the next 6 to 12 months.**

EuroStoxx 50 Index
Daily graph or the perspective over the next 2 to 3 months



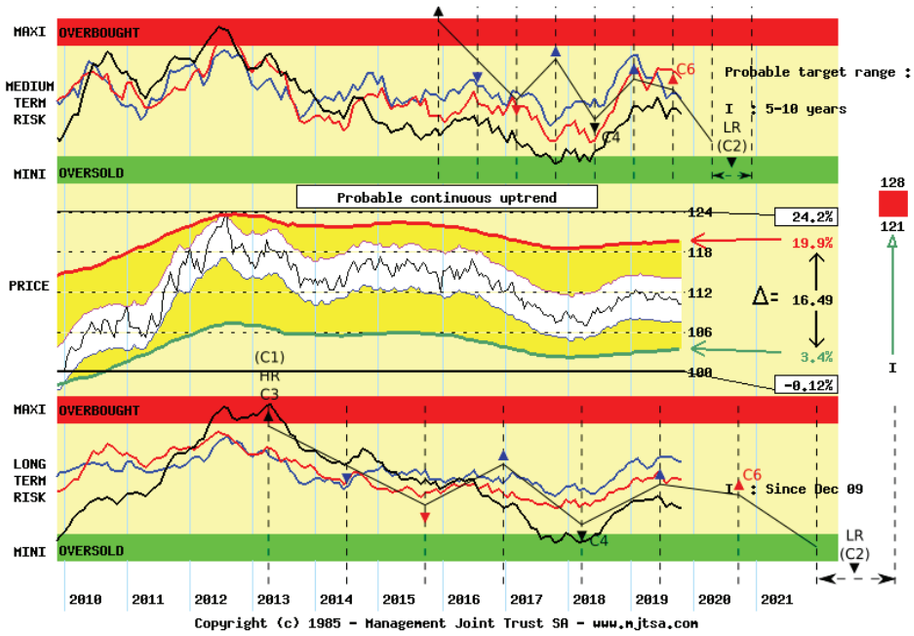
For shorter term timing, we will use the Daily graph of the EuroStoxx50 as our reference. Our long term oscillators (lower rectangles) will probably reach a High Risk situation towards late November / December. More precisely, our medium ones (upper rectangle) suggest that the index probably **continues higher into late November / early December, then retrace down during December, before resuming higher into mid/late Q1**. Our I Impulsive targets to the upside (right-hand scale) do leave some **potential for further progression over the next few weeks, possibly up to the lower 3'800s.**

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



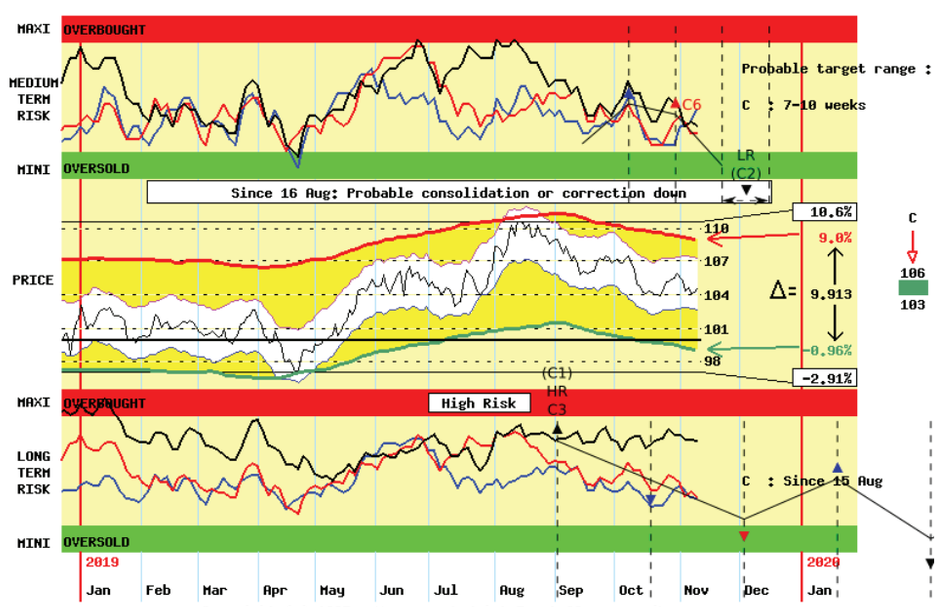
Our timing above, which calls for a late November / early December intermediate top on the EuroStoxx50 may coincide with a further rebound on EUR/USD and a late November / early December top. This is what both our oscillator series are suggesting (lower and upper rectangles). EUR/USD may hence retest up in the 1.11 - 1.13 range over the next few weeks (our C Corrective targets to the upside; right-hand scale). **Yet, following that, it should then resume its downtrend probably into mid/late Q1 2020** as shown on our long term oscillators (lower rectangle). Our I Impulsive targets to the downside (right-hand scale) suggest initial support towards 1.08.

Europe Stoxx 600 Index vs Euro Stoxx 600 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



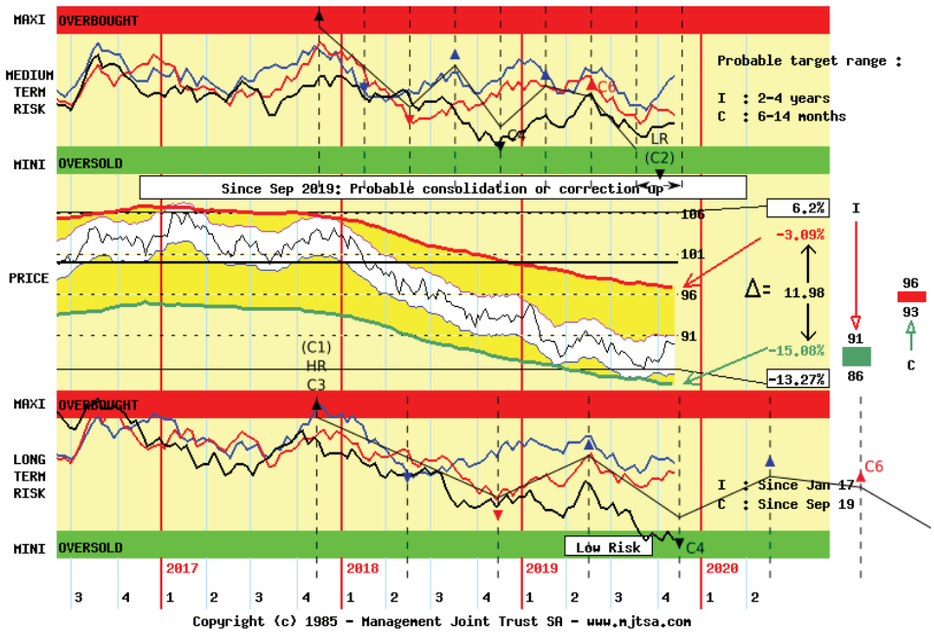
Intra Europe, we now compare the Europe Stoxx 600 vs the Euro Stoxx 600 Index. **Traditionally, the Europe Stoxx 600 has been more defensive than the Euro Stoxx 600,** with Switzerland and Denmark more than compensating for the more cyclical UK, Sweden or Norway. Indeed, the ratio did bounce between Spring last year and this Summer. It now seems to be **on the verge of resuming its downtrend on both oscillator series (lower and upper rectangles), probably into mid/late 2020 in first instance. This, in our view, is rather positive for European markets over the next few quarters.**

Swiss Market Index vs the Euro Stoxx 600 Index
Daily graph or the perspective over the next 2 to 3 months



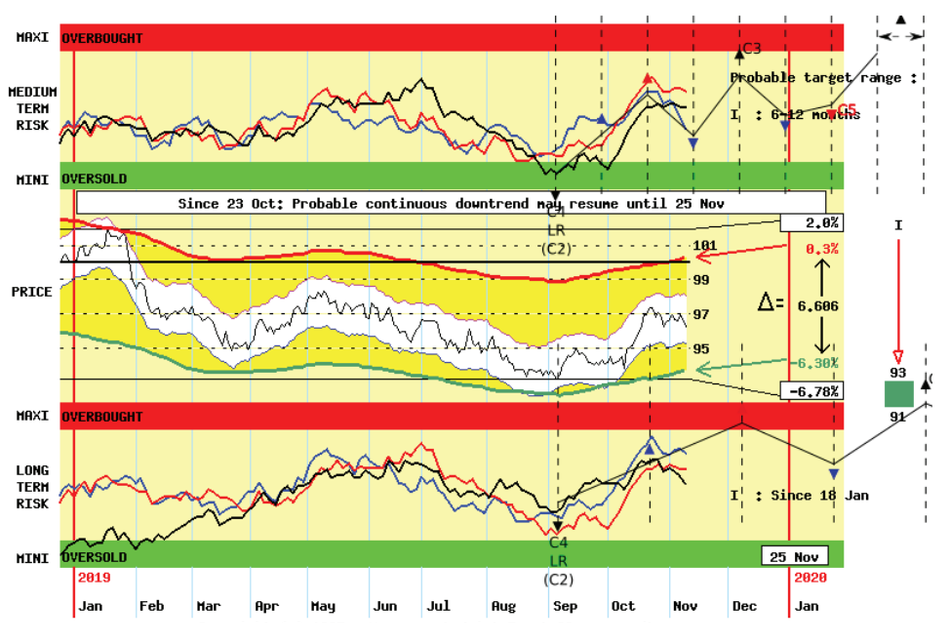
Shorter term, the defensive Swiss Market Index has been correcting down vs the Europe Stoxx 600 since August. The sequences we show on both our oscillator series (lower and upper rectangles) are still pointing to **further downside for the ratio, probably towards late November / early December, when we expect it to find support. Following that, the ratio may bounce during December (i.e. the defensive Swiss Market Index may outperform), before it resumes lower towards mid/late Q1 next year.**

German DAX30 Kurz (Price) Index vs the French CAC40 Index
Weekly graph or the perspective over the next 2 to 4 quarters



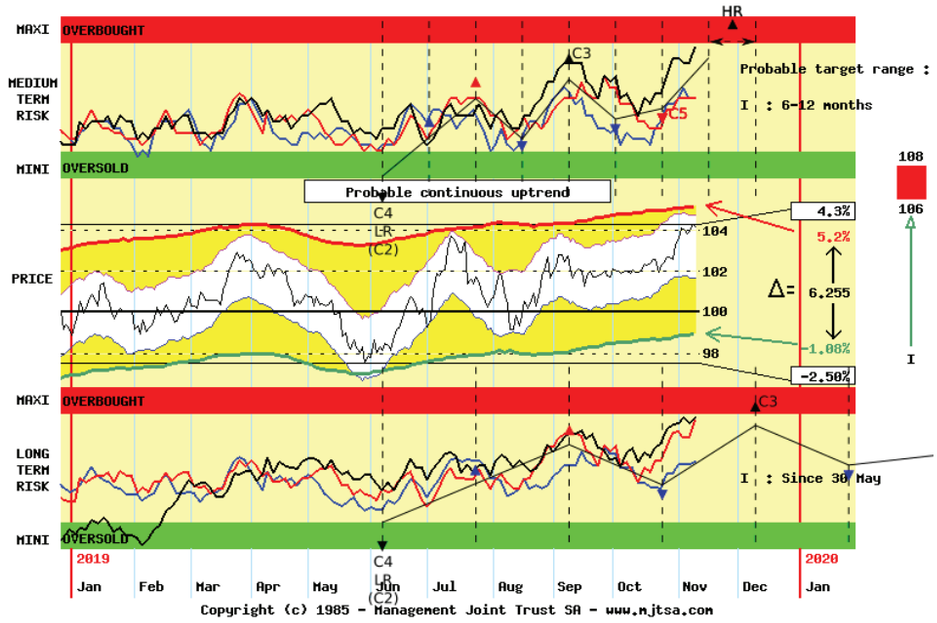
Within the EuroZone, it is interesting to compare the more cyclical/value driven DAX with the more Growth oriented CAC Index. Following several years of underperformance, the DAX has now reached a Low Risk position vs the CAC on both oscillator series (lower and upper rectangles). In terms of targets, the downtrend also seems exhausted as the ratio has achieved our I Impulsive targets to the downside (right-hand scale). **We now expect the DAX to bounce vs the CAC well into H2 2020. The rebound potential is between 3 and 6%** over the next 6 to 12 months (our C Corrective targets to the upside; right-hand scale). This is also quite promising for the more cyclical/value driven markets in Europe.

German DAX30 Kurz (Price) Index vs the French CAC40 Index
Daily graph or the perspective over the next 2 to 3 months



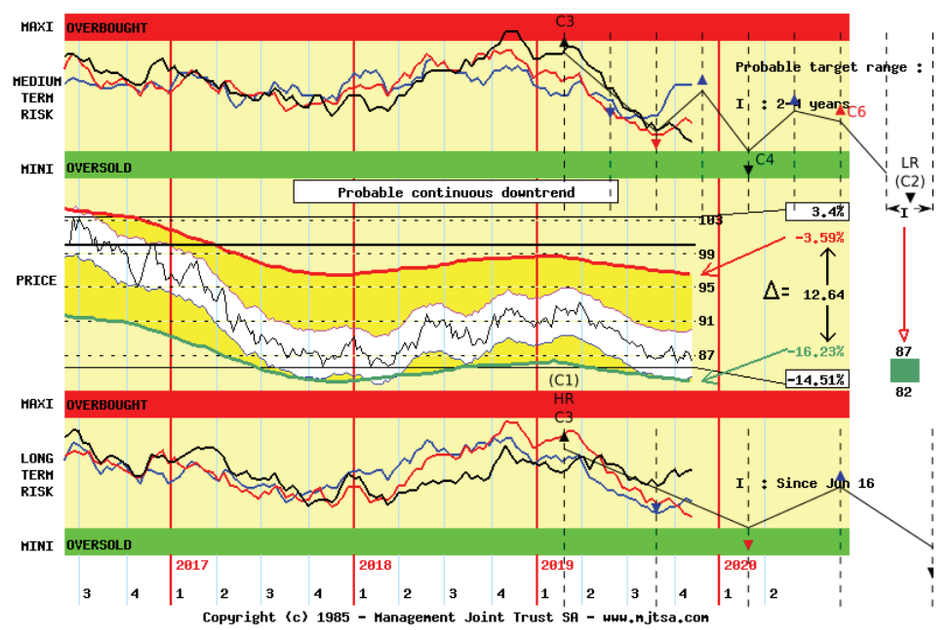
Indeed, shorter term, the comparison resembles many other cyclical ratios. On both oscillator series (lower and upper rectangles), **we expect a further leg up between now and early December. Following that, the DAX may retrace down again during December**, perhaps into early January, before it resumes higher vs the CAC into mid/late Q1.

FTMIB vs the EuroStoxx 600 Index
Daily graph or the perspective over the next 2 to 3 months



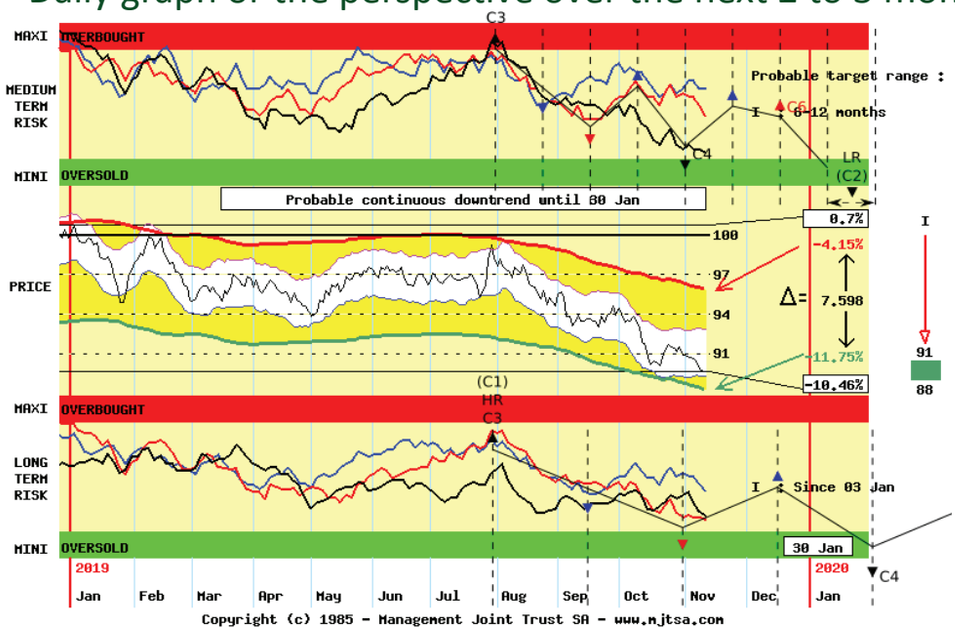
Looking to Southern Europe, we now compare the Italian FTSE MIB Index to the EuroStoxx 600 Index. **Italy has performed strongly this year, especially during risk-ON periods and it can be considered as one of the higher betas in the Eurozone**. Going forward, both oscillator series (lower and upper rectangles) are suggesting that **the current uptrend continues until late November / early December. Our I Impulsive potential to the upside (right-hand scale) may still justify 2 to 4% of outperformance** over the next few weeks. Following that, Italy probably underperforms until early next year.

UK Market vs Eurozone Markets (both denominated in Euros)
Weekly graph or the perspective over the next 2 to 4 quarters



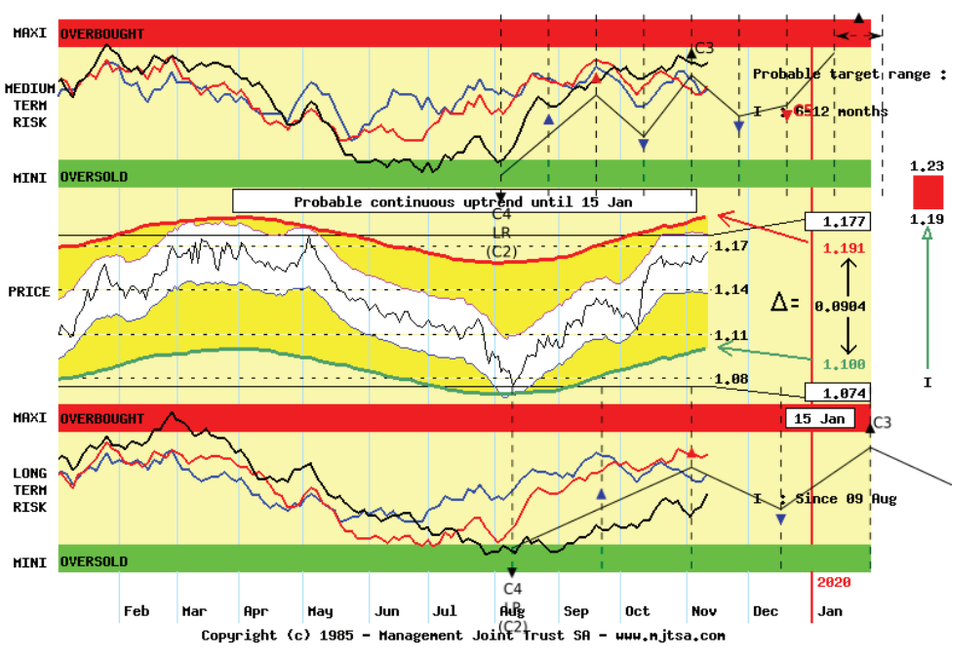
We finally turn to the UK and its ratio vs the Europe Stoxx 600. **For this comparison we have used the EWU (UK) and EZU (EuroZone) ETFs. They are both nominated in US Dollars which equates to comparing them without any currency hedging (i.e, or to compare them in EUR terms).** Interestingly, it seems quite clear from both oscillator series (lower and upper rectangles) that **the UK's underperformance could extend into mid/late Q1 2020 in EUR terms**. For international investors, we would hence favor Europe over the UK into mid/late Q1. The downside potential left according to our I Impulsive targets to the downside (right-hand scale) is however limited (minus 5%). Following that, UK equity markets probably outperform into next Summer in EUR terms.

UK FTSE 100 Index vs Euro Stoxx 600 Index (currency hedged ratio)
Daily graph or the perspective over the next 2 to 3 months



We now look into this FTSE 100 Index vs the EuroStoxx 600 on a hedged currency basis (Daily graph). The ratio has been underperforming since late July, or just before the GBP/EUR exchange started to reverse up. This is no surprise as **over the last few years, UK markets in local currency have usually underperformed European ones when the GBP/EUR exchange rate has been strong**. This relation probably highlights the close trade relationships between the UK and the EuroZone, and also the international / pan-European profile of many FTSE100 components. Hence, when the Pound rises, FTSE100 companies are rapidly devalued in GBP terms as 1. it decreases their competitive position 2. their cash flows generated abroad have less value in GBP terms (and visa-versa). **Both our oscillator series (lower and upper rectangles) suggest that the ratio may bounce at some point until early/mid December, before it resumes lower in mid Q1.**

GBP/EUR
Daily graph or the perspective over the next 2 to 3 months



We relate the graph above to the GBP/EUR exchange rate. It confirms these dynamics as the pair has been in an uptrend since early August. **We now expect some consolidation on both oscillator series (lower and upper rectangles) into late November / early December, a timing, which pretty much coincides with the run-up to the UK elections. Then, from mid December at the latest (i.e. perhaps following the election), we believe GBP/EUR could resumes its uptrend, probably into mid Q1**. Until then (mid Q1), we hence expect a rising GBP/EUR and a falling FTSE 100 vs Europe Stoxx 600 ratio (on a hedged currency basis). Thereafter, as mentioned two charts above, the FTSE 100 may start to outperform in EUR terms. For now, it is still hard to say if this relative strength in EUR will be driven by a stronger Pound or a stronger FTSE100, but at least their inverse relationship will probably diminish.

Concluding remarks:

EUR/USD and GBP/USD have been good proxies for the underperformance of European markets vs the US and other developed markets over the last couple of years. We expect both, as well as the ratio of European markets vs US ones in US Dollars terms, to retest / retrace down once again from December into mid/late Q1. Following that, longer term, other elements are starting to look more positive for European markets. These include an uptrend, which still seems strong on the EuroStoxx 50 into Summer next year, the fact that European markets in local currencies terms are very much Oversold vs US ones, that cyclical Germany is also oversold vs the more growth oriented CAC, and that finally, the more defensive Europe Stoxx 600 could be starting to reverse down vs the more cyclical Euro Stoxx 600 (on our long term bi-monthly graph). We would hence remain prudent on Europe in relative terms for another few months, but do believe that by mid/late Q1, it could start to deliver positive surprises, probably until late next year. Interestingly, UK markets could also start outperforming European ones from mid/late Q1 in EUR terms.

46 / Framing US Financial Systemic Liquidity For Portfolio "Tactical Investing"

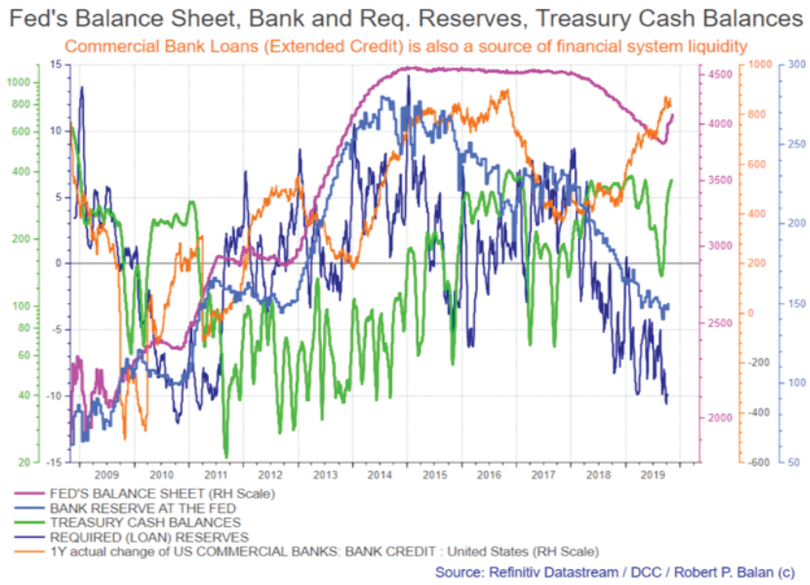
These are the primary sources of the US financial system's liquidity: The Fed's Balance Sheet, Bank Reserves (Excess and Required), Treasury Cash Balances, and Commercial Bank Loans. *(see 1st graph on this page)*

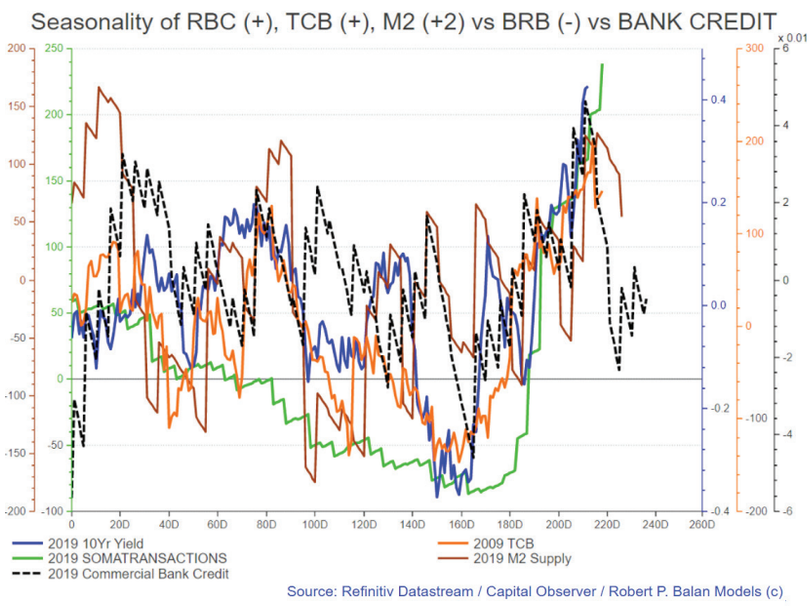
Some definitions:

Fed's Balance Sheet -- The Fed's balance sheet is a weekly report presenting a consolidated balance sheet for all 12 Reserve Banks that lists factors supplying reserves into the banking system and factors absorbing reserves from the system. The report is officially named Factors Affecting Reserve Balances, otherwise known as the "H.4.1" report.

Bank Reserves (Excess and Required) – bank reserves for commercial banks are held in part as a credit balance in an account for commercial banks at a regional Fderal Reserve banks. This credit balance used to be separated into separate "required reserves" and "excess reserves" accounts. But that distinction stopped after the Fed started to pay interest on all bank reserves. The total amount of FRB credits (bank reserves) held in all FRB accounts for all commercial banks, together with all currency and vault cash, form the M0 monetary base.

Treasury Cash Balances - The Daily Treasury Statement summarizes the US Treasury's cash and debt operations for the Federal Government on a modified cash basis. Deposits are reported as received and withdrawals are reported as processed. This account is maintained at the Federal Reserve. The US treasury pays all non-bank transactions through this account.





The dynamic between these liquidity sources and risk asset prices:

For the most part, risk assets respond mostly to changes in the Fed's Balance Sheet, the bank reserves at the Fed and to Treasury Cash Balances. Credit creation (black, dashed line) is also important as a lead indicator of impending liquidity changes via the M2 Money Supply (brown line); *see 2nd graph above.*

Required Reserves have been subsumed into the rubric of Bank Reserves, and so we do not focus on it anymore. The modelling work that we have done has been focused mainly on the Fed's balance sheet, bank reserves, and the Treasury Cash Balance (TCB). Nonetheless, RRs are a potent addition to the liquidity tool kit as a means of obtaining future TCB trends (*see 1st graph on the next page*).

Note in the graph above the prevailing regime in the Fed's balance sheet, bank reserves and TCB has been very stable since 2015 -- flat or trending lower. No large changes. That has been beneficial with regards to modelling because the parameters do not have to change every year since 2015.

The basic framework of the models has shown very stable seasonality among all the major sources of liquidity since 2015.

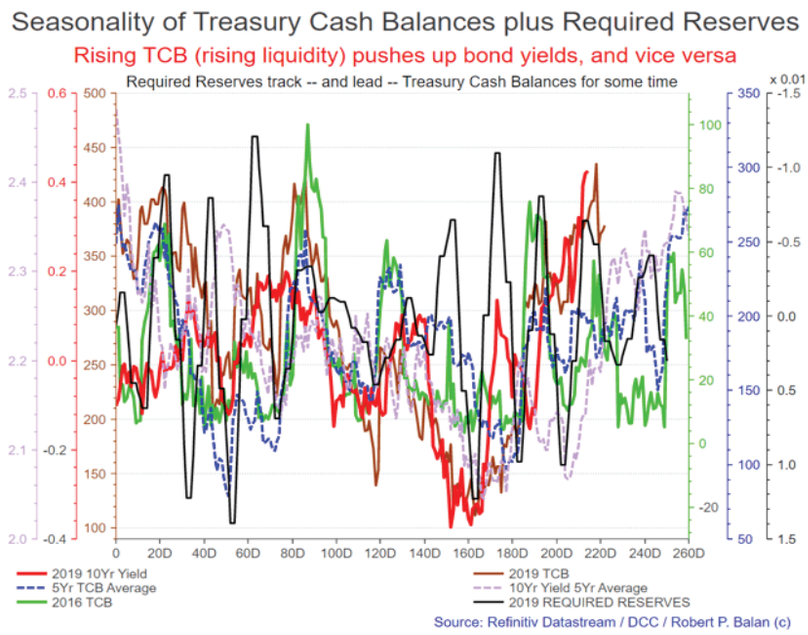
This is how the basic framework looks like since 2015. *(see 2nd graph on this page)*

The very distinct seasonality profile has provided us the basic framework for our so-called "tactical strategies" which is basically following the 8 major risk asset price swings in a year, which are identified by the models as shown in *the 2nd graph on this page***.**

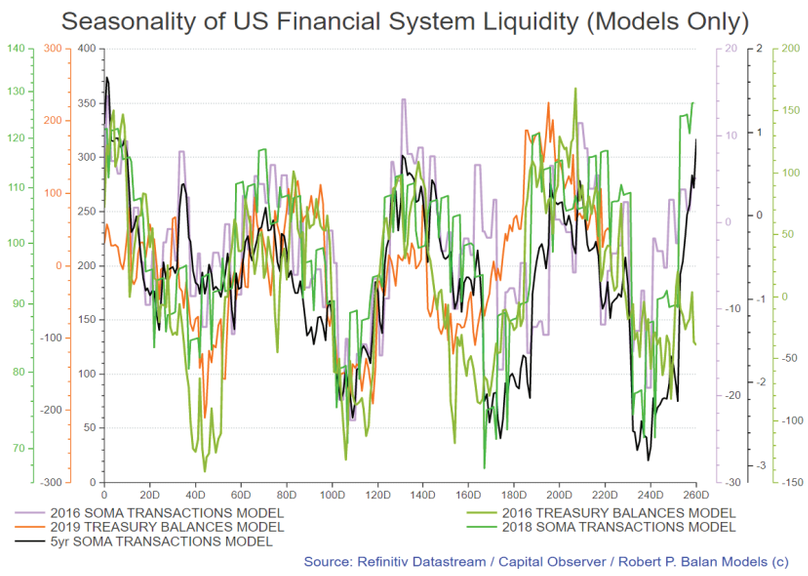
How did the risk assets perform vs the stylized price profiles provided by the models? We start with bond yields and show how the 10yr yield has performed vs the stylized liquidity flows over the past few years.

This is how 10Yr Yields performed against the Liquidity Models since 2015 (2019/2017/2015 as examples - *see 3 graphs on next page***)**

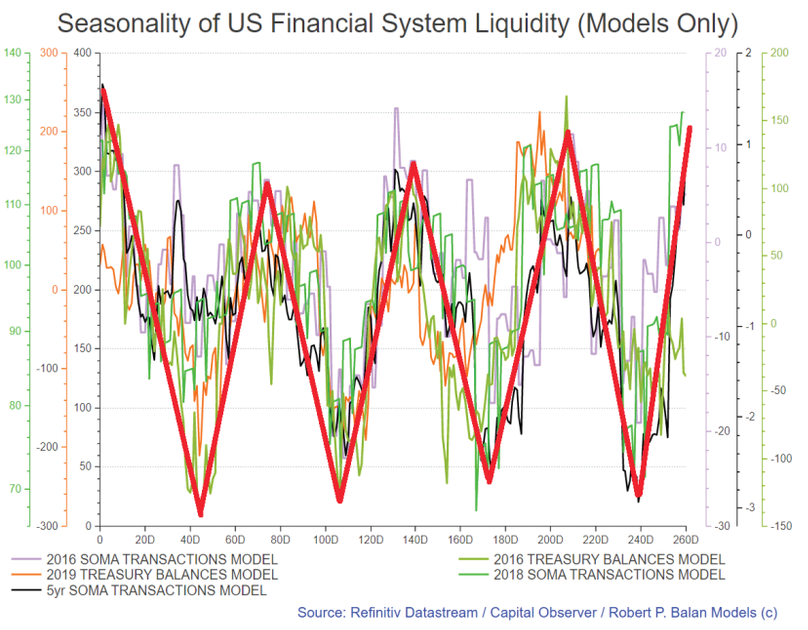
Note that we had to adjust the inflection points of the yields to make up for the advance move by investment banks. These banks routinely anticipate the changes in liquidity flows stemming from the Fed's SOMA transactions and disbursements from the Treasury's Cash Balances at its Fed account.



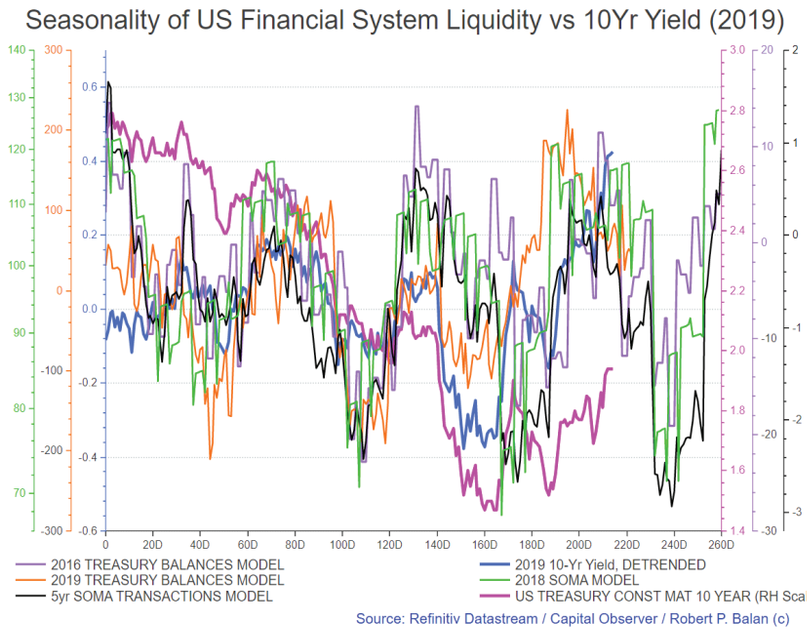
The Basic Framework



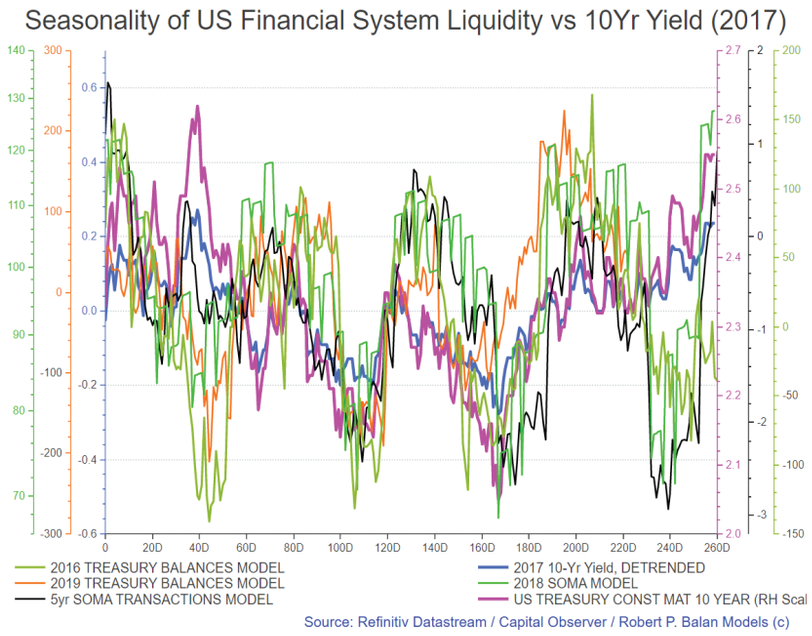
"Tactical strategies" from systemic liquidity framework



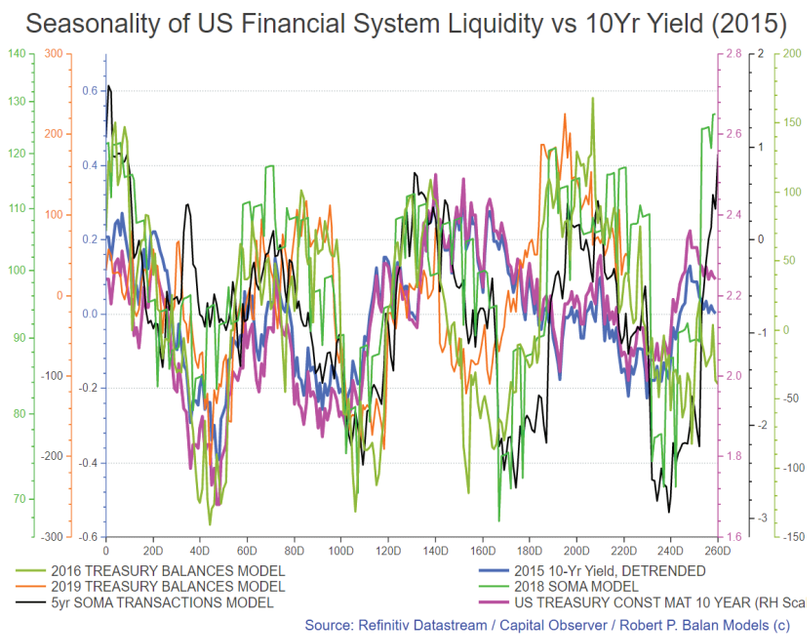
2019 10yr Yield vs Liquidity Models



2017 10yr Yield vs Liquidity Models



2015 10yr Yield vs Liquidity Models



The lead of those banks can be as long as 5 days to more than two weeks.

This is the performance of SPX against the models since 2015 ((2019/2017/2015 as examples - *see 3 graphs on this page*).

Summary:

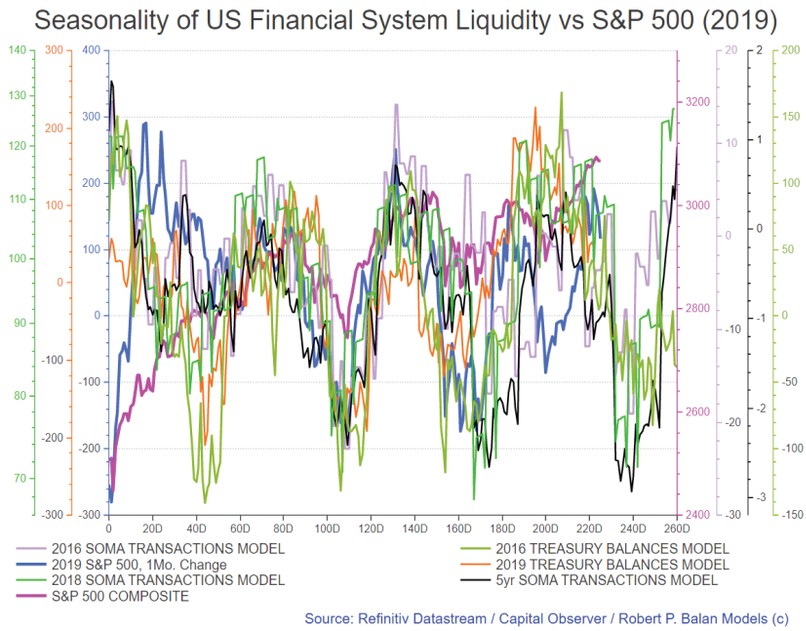
US financial system liquidity flows are highly seasonal, and tend to recur during the same date every year. As we can see from the illustrations, a large percentage of risk assets prices move can be attributed to the influence of liquidity flows. The other segments of price movements very likely stem from daily news flow.

As we have explained before, liquidity conditions do not cause asset price movement, but they create the base conditions. In the absence of compelling news flows, the market tends to go to the default setting provided by liquidity conditions.

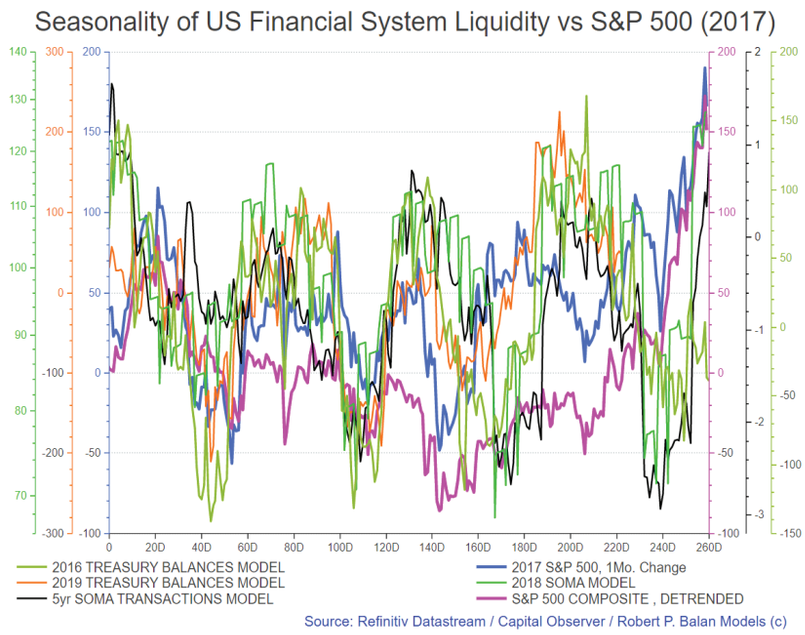
We can use the covariance of risk assets price with liquidity flows by noting the periods when liquidity conditions start to change. That also requires that we take into account the anticipations from investment banks and other large investors over the liquidity data. One should invest according to the next seasonal trend in liquidity flows.

That framework may offer up to 8 time window a year, which, if confirmed by other indicators can offer optimal positioning.

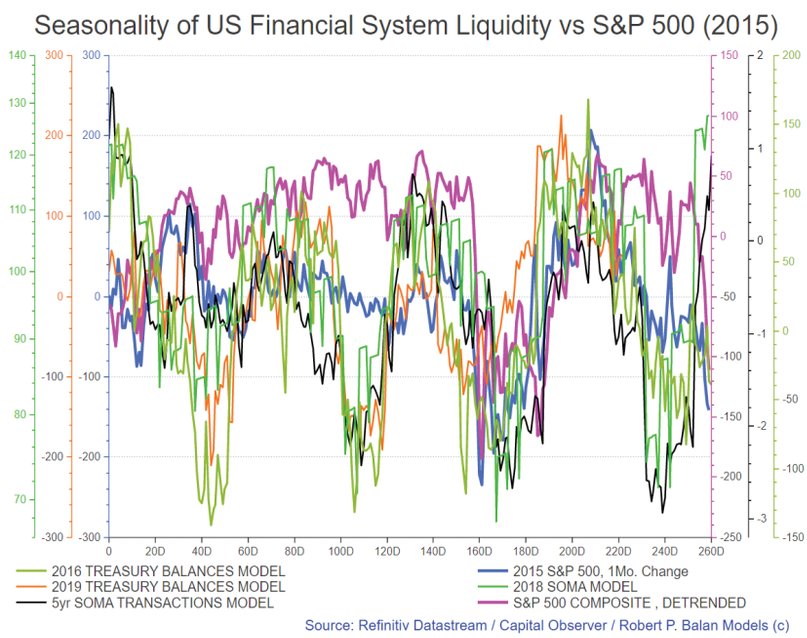
2019 SPX vs Liquidity Models



2017 SPX vs Liquidity Models



2015 SPX vs Liquidity Models

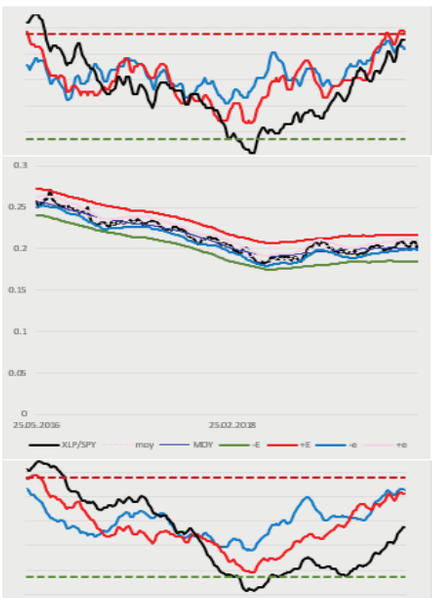


50 / MJT - TIMING AND TACTICAL INSIGHT

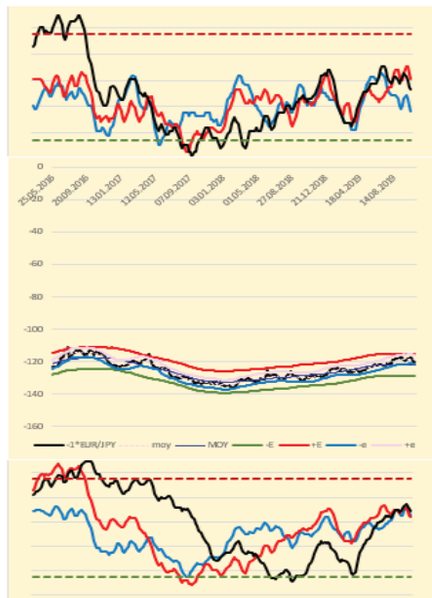
Sector profiling

In this article we lift the hood on some of our cross-asset confirmation tools. These methodologies are homegrown and stem from our constant need to cross reference our projections on different assets and asset classes, in order to maintain a coherent cross asset scenario. Following a brief explanation of the tools on this first page, we analyze the various sectors in relation to two specific factors (the S&P500 and the US10Y Treasury Yield). We could also apply such analysis to map any asset class / selection, e.g. Currency pairs, Commodities, Equities Indexes in different geographies, interest rates or even single stocks.

Cyclical Analogs : e.g. US Staples vs the S&P500 Index
Comparisons based on Weekly graphs



Source: The Capital Observer (www.thecapitalobserver.com)



EUR JPY	Price	MT	LT	Total
	-0.53	-0.29	-0.60	-0.46

Our analysis starts with understanding what any instrument may correlate to in terms of cyclicity. The methodology doesn't use simple price correlations as we believe these are often erratic and deliver many "false brothers" (i.e. prices correlate for a while and then diverge). To achieve more stability in our comparisons, we benchmark the full array of the cyclical indicators available on our graphs. What we are trying to capture is cyclical likeliness, which we feel in much more robust than price. We call these comparisons "Cyclical Analogs". In this illustrative example, we have benchmarked the ratio of US Staples vs the S&P500 to a universe of currency pairs. Interestingly, the closest match is the inverse of EUR/JPY. This is quite logical as the ratio of US Staples vs the S&P500 is rather defensive, while EUR/JPY is one of the most pro-cyclical currency pairs. Detailed results show that price (the benchmarking of price and our envelopes) was well inversaly related (-0.53), our Medium Term oscillators (upper rectangle) less so (-0.29), while our Long Term oscillators (lower rectangle) showed a strong negative relation (-0.60). Total score was-0.46, which by experience is quite robust.

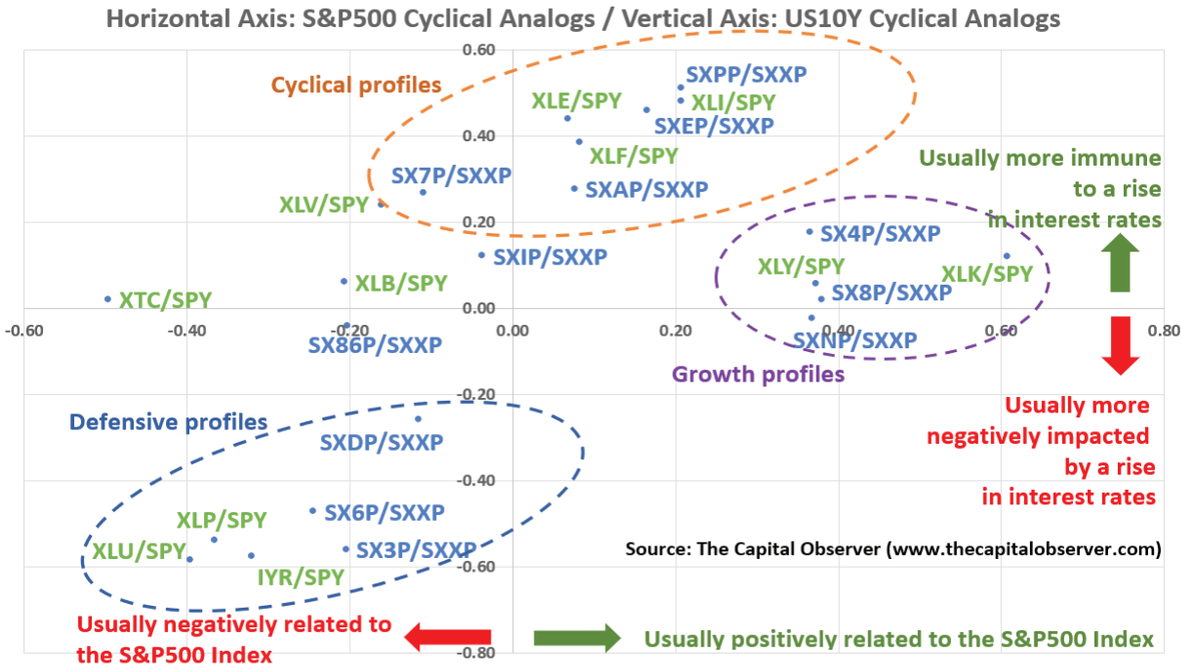
Dependents analysis: e.g. US 10Y yields
Comparisons based in Weekly graphs

US10Y Source: The Capital Observer (www.thecapitalobserver.com)

	Symbol		Price	OMT	OLT	Total	0.1
1	XME	HUI	0.91	0.38	0.61	**0.60**	**0.60**
2	XLU	SPY	0.71	0.48	0.60	**0.58**	**0.58**
3	IYR	SPY	0.77	0.47	0.55	**0.58**	**0.58**
4	SX3P	SXXP	0.74	0.48	0.51	**0.56**	**0.56**
5	XLP	SPY	0.62	0.49	0.52	**0.54**	**0.54**
6	SXPP	SXXP	0.80	0.39	0.42	**0.51**	**0.51**
7	IEO	XLE	0.65	0.45	0.46	**0.51**	**0.51**
8	MOO	XLP	0.69	0.39	0.47	**0.50**	**0.50**
9	HUI	SPY	0.69	0.37	0.48	**0.50**	**0.50**
10	IYT	XLI	0.76	0.31	0.46	**0.49**	**0.49**
11	FAN	XLE	0.65	0.48	0.37	**0.49**	**0.49**
12	XLY	XLP	0.33	0.61	0.56	**0.48**	**0.48**
13	XLI	SPY	0.37	0.56	0.55	**0.48**	**0.48**
14	IYR		0.64	0.41	0.42	**0.47**	**0.47**
15	SX6P	SXXP	0.59	0.49	0.37	**0.47**	**0.47**
16	IYT	DJII	0.53	0.41	0.48	**0.47**	**0.47**
17	ICLN	SPY	0.74	0.39	0.32	**0.46**	**0.46**
18	ICLN	XLE	0.66	0.49	0.28	**0.46**	**0.46**
19	SXEP	SXXP	0.64	0.38	0.39	**0.46**	**0.46**
20	IWM	SPY	0.61	0.41	0.37	**0.45**	**0.45**
							0.50

This approach can also be used to identify dependents of a certain factor. In this table, we've performed the analysis by using the US10Y Treasury yield as a factor and benchmarked it against a selection of sector relatives. The best match is XME/HUI (Diversified Metals & Mining vs the Gold Bug Index) at 0.60. This ETF ratio is usually very correlated to the Copper/ Gold ratio, which is one of the widely used inflation/deflation indicators. Hence, it is only logical that XME/HUI is positively related to the US 10Y Treasury Yield. The second one on the list is XLU/SPY (US Utilities vs the S&P500) at minus 0.58. Here also, it is quite clear that Utilities are negatively related to yields on a relative basis. The blue box at the far-right lower-end of the table is the average score of the 20 top Cyclical Analogs. It measures the influence this factor has on the universe to which it is benchmarked. Any value above 45 is usually quite robust.

Sector profiling: Cross factor influence (S&P500 and US 10Y yields) Comparisons based on Weekly graphs



We can now take the analysis a step further and benchmark a selection of the main sector relatives in the US and Europe vs a dual factor structure, in this case vs the S&P500 (on the horizontal axis) and the US10Y Treasury yield (on the vertical axis). This analysis allows us to map the various sector relative profiles in terms of their relation to rising or falling equity markets and to rising and falling interest rates.

Note: in this case, these relations are based on historical Weekly data with 3.5 years of history. They are subject to change over time, yet gradually, given the lower frequency that we are using (i.e. Weekly). For more dynamic updates, one can also use Daily or even Hourly data as well as analyze how these relations compare across the different frequencies of observations or evolve over time. In the table above, we can identify three main profiles:

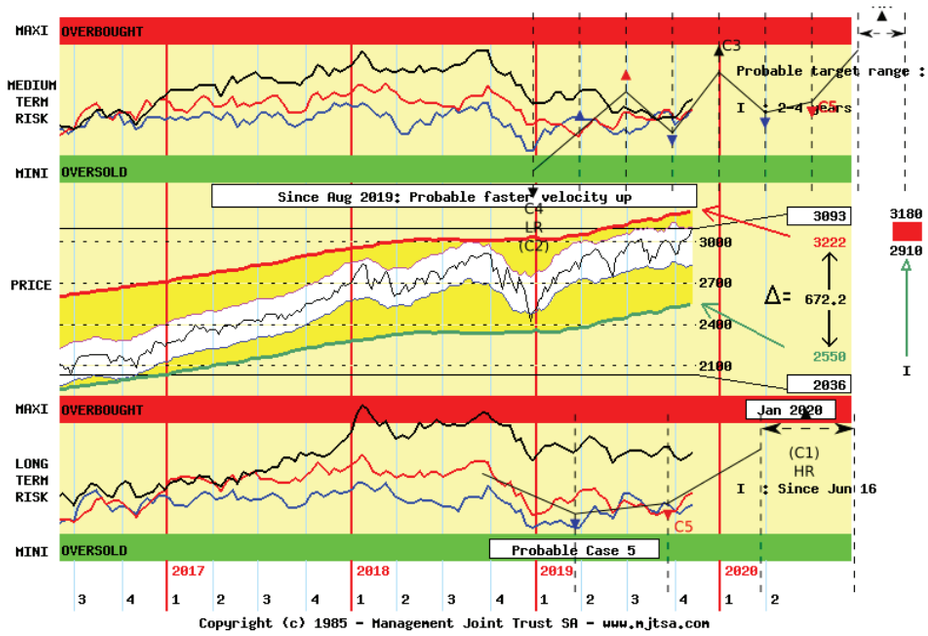
Growth profiles, which are relatively immune to rises in interest rates, yet are strongly related to movements in the S&P500, e.g. SX4P/SXXP (European Chemicals), XLK/SPY (US Technology), XLY/SPY (US Consumer Discretionary), SX8P/SXXP (European Technology) and SXNP/SXXP (European Industrials)

Cyclical profiles, which usually benefit from rising interest rates and are fairly neutral to slightly positively related vis-à-vis the S&P500, e.g. SXPP/SXXP (European Natural Resources), XLI/SPY (US Industrials), SXEP/SXXP (European Energy), XLE/SPY (US Energy), XLF/SPY (US Financials), SXAP/SXXP (European Autos), SX7P/SXXP (European Banks)

Defensive profiles, which usually underperform when the S&P500 and the US10Y Treasury yield are rising, e.g. SXDP/SXXP (European Healthcare), SX6P/SXXP (European Utilities), SX3P/SXXP (European Food & Beverage), IYR/SPY (US Real Estate), XLP/SPY (US Staples), XLU/SPY (US Utilities).

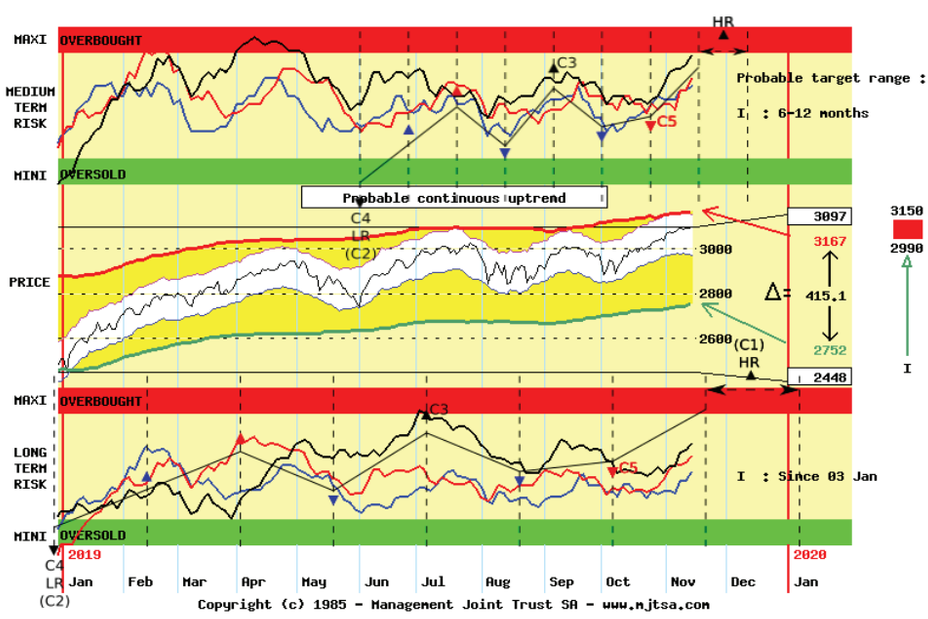
This dual profiling exercise is not an exact science, yet an initial indication. At different stages in the cycle one or the other factor will often have the strongest influence, e.g. the 2019 defensive rally benefited from falling interest rates, yet wasn't really held back by the rise in the S&P500.

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



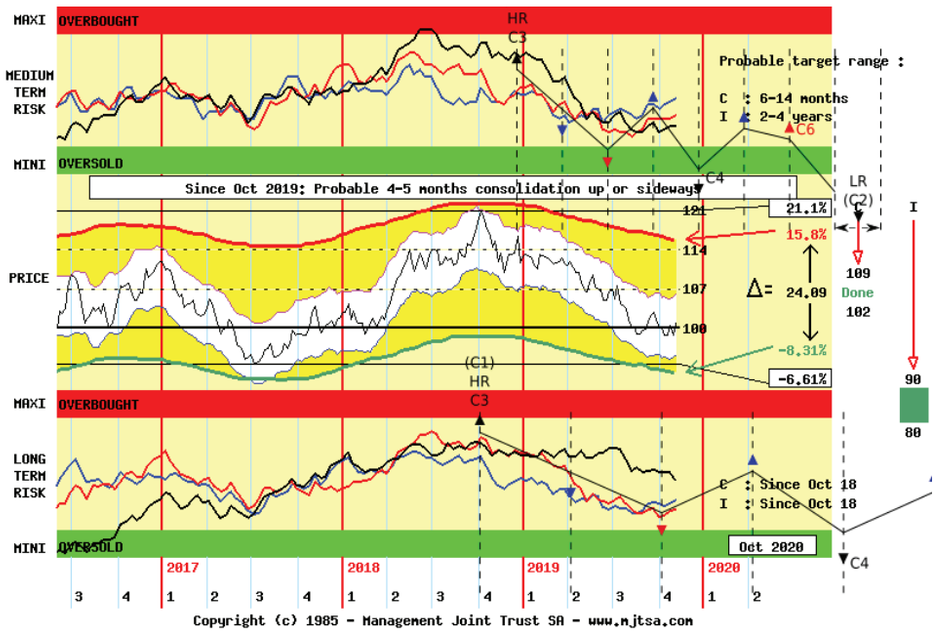
Before we go into the analysis of the different sectors using our graphs to counter-check their relative profiles to the two factors mentioned above, we first lay-out our scenario on the S&P500 Index (our scenario on US10Y yields was already laid out on page 16 of this issue of The Capital Observer). For now, on this Weekly graph, the S&P500 is still uptrending. An intermediate top situation may materialize between now and year-end on our medium term oscillators (upper rectangle). Yet, our long term ones (lower rectangle) still point **to strong momentum into Spring, perhaps Summer next year. In terms of targets, we may reach the upper end of our I Impulsive targets to the upside in the mid/high 3'100s over the next couple months**. If, as our long term oscillators suggest, the S&P500 then continues higher into Spring/Summer next year, the next level of targets we can calculate (our extended I2 Impulsive 2targets to the upside) could reach up into the 3'400 – 3'500. Although aggressive, this projection is possible.

S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



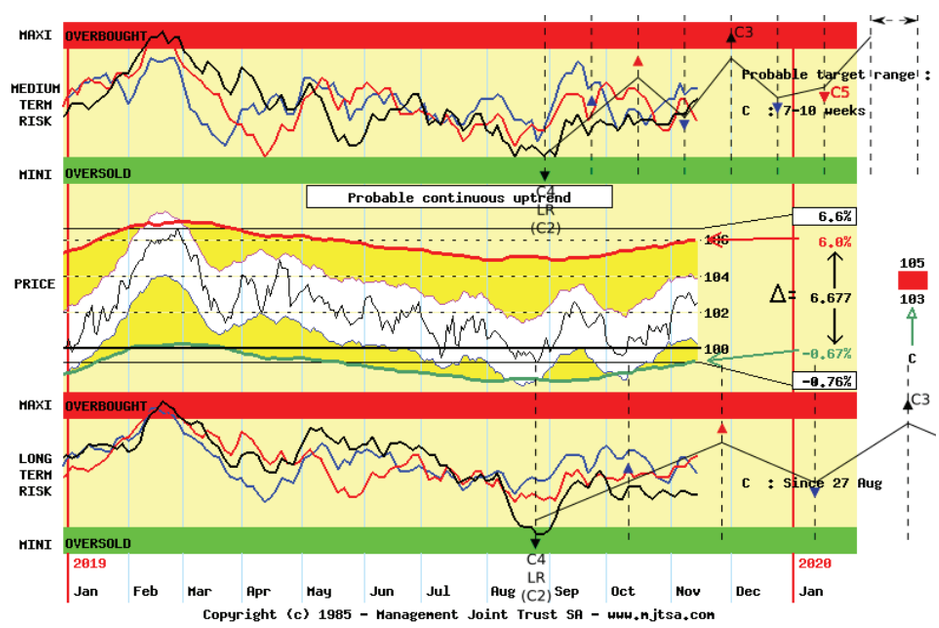
Considering the Daily graph, both our oscillator series (lower and upper rectangles) are suggesting that an intermediate top could materialize towards late November / early December. Following that, we would expect some consolidation to the downside, probably towards mid/late December, perhaps into January. We are however still rather positive for the S&P500's prospects during Q1 and towards the Spring. Our I Impulsive targets to the upside towards the mid/high 3'100s (which we've been pointing to over the last 3 to 4 months) could be reached over the next couple of weeks. **Bottom line, we are still rather positive on the S&P500 into Spring next year, although it may experience a slight intermediate correction during December. As a reminder, our scenario on US10Y yields (on page 16 of this issue of The Capital Observer) was also calling for some retracement during December, and perhaps into early January. Following that, we believe that a second leg of rebound could materialize towards mid/late Q1, potentially into the mid 2s %.**

Cyclical profile: e.g. SXEP/SXXP (European Energy vs the Europe Stoxx 600)
Weekly graph or the perspective over the next 2 to 4 quarters



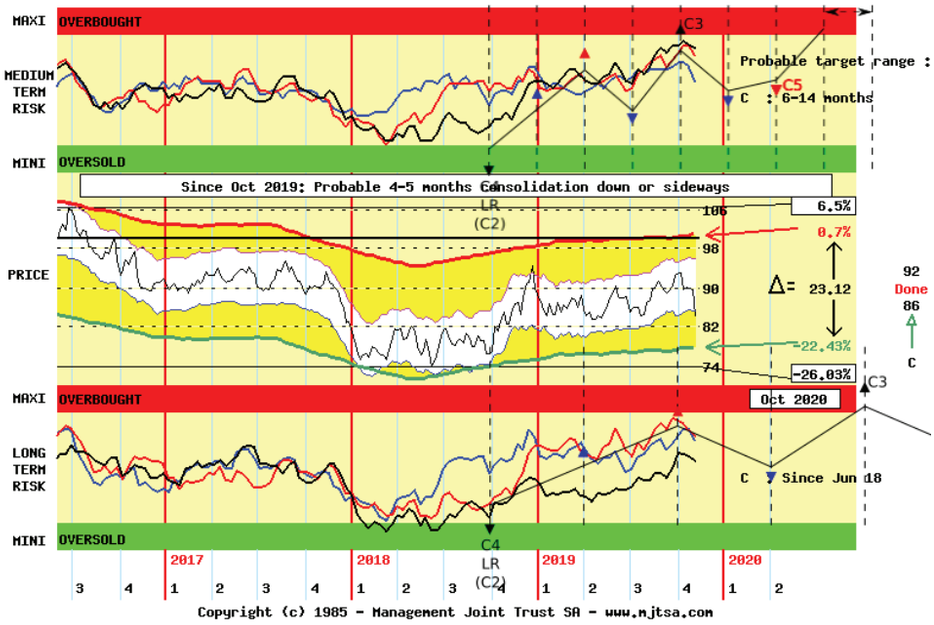
We first look at an example of Cyclical profiles (Weekly graph of European Energy vs the Europe Stoxx 600), which on the table above are slightly positively related to the S&P500, but strongly positively related to rising US 10Y yields. If our scenario is correct over the next 6 months, this profile should rebound into the Spring. This is pretty much what both our oscillator series (lower and upper rectangles) are suggesting with a rebound that extends into early Q2 on our long term ones (lower rectangles), and, on our medium term ones (upper rectangle) **a further downside retest and then a new rebound during Q1. The graph's profiles seems very much skewed to US10Y yields (rather than the S&P500) and the scenario we outline does indeed match our scenario on it over the next 6 months.**

Cyclical profile: e.g. XLI/SPY (US Industrials vs the S&P500)
Daily graph or the perspective over the next 2 to 3 months



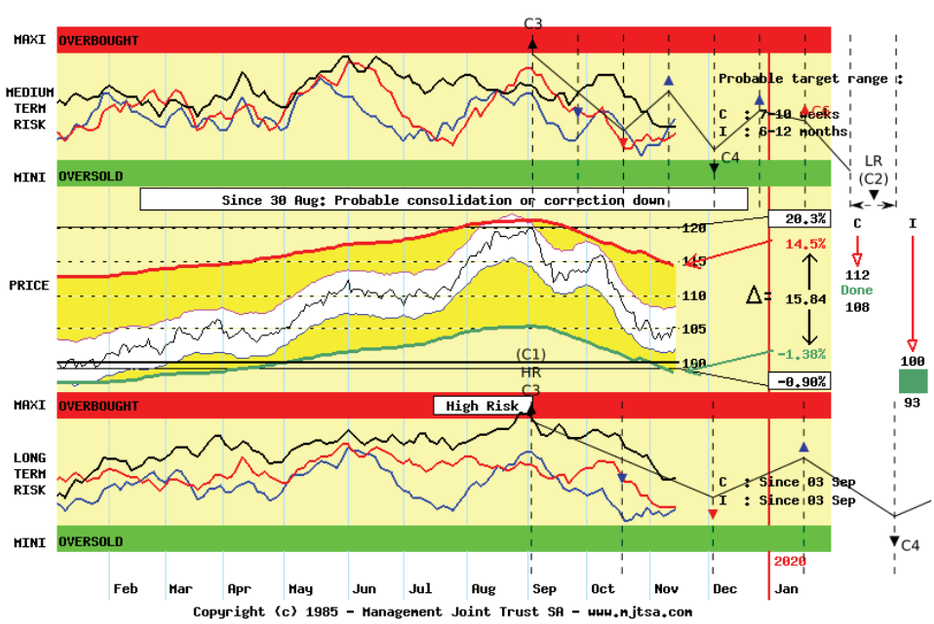
We now consider another Cyclical ratio (US Industrials vs the S&P500 Index), on a Daily graph, in order to counter-check its shorter term profile. Both our oscillators series (lower and upper rectangles) suggest that **the ratio could still push higher into late November / early December when it could make an intermediate top. It then corrects down into December, perhaps into early January. This is also what we expect on the Daily graph of US10Y Treasury yields. Such comparisons allows us to counter-check the theoretical profiles fed by our factor analysis, but they also enable us to confirm our scenario on the factors themselves. This top-down, then bottom up approach is one of the corner-stones of our cross asset approach.**

Defensive profile: e.g. XLU/SPY (US Utilities vs the S&P500)
Weekly graph or the perspective over the next 2 to 4 quarters



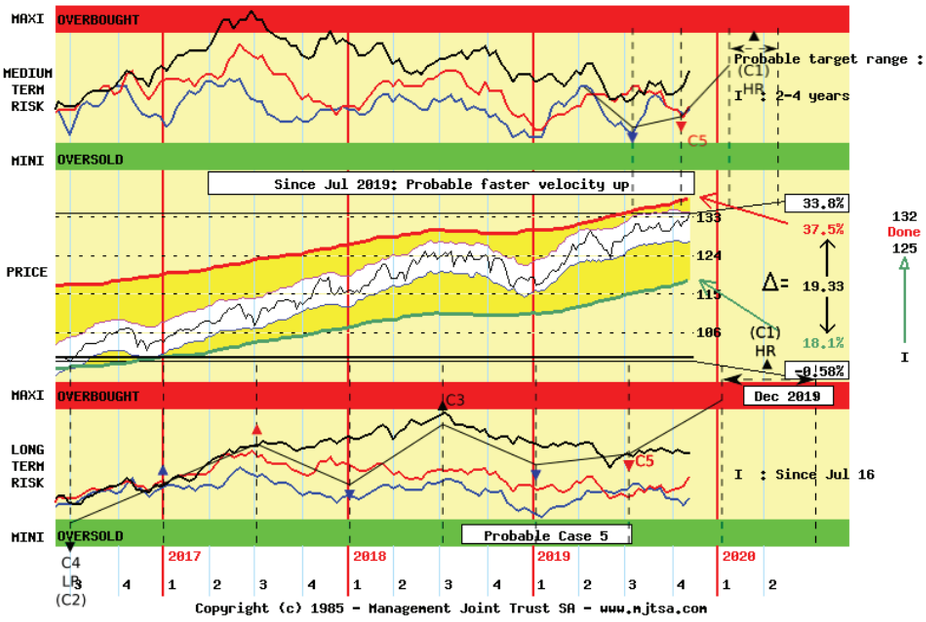
We now switch to Defensive profiles and to the Weekly graph of US Utilities vs the S&P500. Although several uptrend sequences are underway here, we believe the ones we show on both oscillators series (early October 2018 to early October 2019 top) are a good correspondence. **They suggest 3, probably 6 months of retracement ahead into late Q1 / Spring next year. This would match our scenario on US yields in reverse**. Interestingly, when looking at price, we can note that this defensive ratio was influenced by equity markets prices over the last 18 months. It started to strengthen towards Spring last year as the correction in Global Markets (ex US) started to accelerate and did not make new highs this year (while Treasuries did) as equity markets have remained strong. **Hence, it does indeed seem negatively related to a mix of US10Y Treasury yields and the S&P500.**

Defensive profile: e.g. SX3P/SXXP (European Food & Beverage vs the Europe Stoxx 600)
Daily graph or the perspective over the next 2 to 3 months



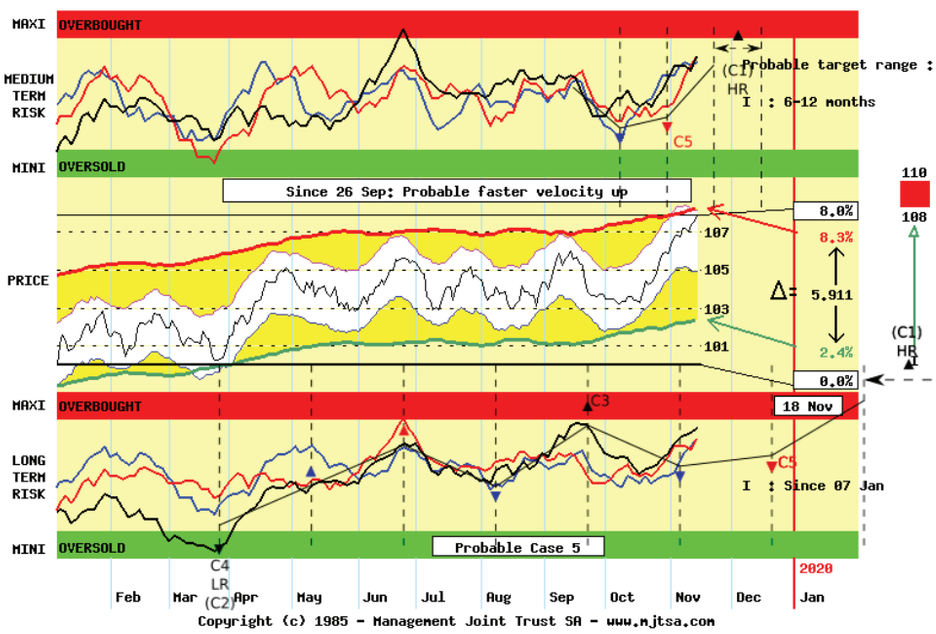
Shorter term, we look at the Daily graph of European Food & Beverage vs the Europe Stoxx 600 index. It seems very much inversely related to US10Y Treasury yield, and indeed on our table above, it is much more negatively related to it than to the S&P500 Index. Both our oscillators series (lower and upper rectangles) suggest **that the ratio could continue to slide short term into late November / early December, before it eventually finds support and bounces into late December, perhaps early January. This is pretty much the inverse of our scenario on US Treasury yields, and to a certain extent on the S&P500.**

Growth profile: e.g. XLK/SPY (US Technology vs the S&P500)
Weekly or the perspective over the next 2 to 4 quarters



We move to Growth profiles and to the Weekly ratio of US Technology vs the S&P500. From our mapping above in this article, the sector's relative profile should be very much positively related to the S&P500, and rather neutral versus US10Y Treasury yields. And indeed, this relative graph does resemble the one of the S&P500 above. Our long term oscillators (lower rectangle) are even a better match for our uptrend model as the full uptrend sequence since 2016 is very clear. It suggests that **the uptrend extends into H1 2020, which adds some comfort to our bullish scenario on the S&P500, especially when we consider that US Technology is a high beta sector**. The model on our medium term oscillators (upper rectangle) is also more aggressive than the sequence we show on the S&P500, with further acceleration into mid/late Q1. **We hence believe that between now and early Q1, Growth profiles should take up market leadership again, possibly into mid/late Q1 at least.**

Growth profile: e.g. SXNP/SXXP (European Industrials vs the Europe Stoxx 600)
Daily graph or the perspective over the next 2 to 3 months



On a Daily basis, we consider the ratio of European Industrials vs the S&P500 as our European Growth profile. Indeed, on our mapping table, it does rank very positively vs the S&P500 and is slightly negatively related to the US10Y Treasury Yield. This could be slightly surprising when talking about "Industrials", as in the US, these show a very Cyclical profile. Yet, looking to the components of the sector, we can note that it comprises largely big international European exporters with very strong global franchises. Hence, when the US is the Growth trade (as it was during the 2018 decoupling theme), the US Dollar is strong, and this sector then widely outperforms. **While our medium term oscillators on this graph (upper rectangle) suggest an intermediate top (similar to the S&P500), our long term ones point to a rather shallow consolidation period into mid December, and then to further acceleration to the upside into mid/late Q1**. This would match our scenario on the relative graph of US Technology above, probably point to renewed Dollar strength and perhaps to a new US decoupling trend. We believe it could materialize as the US economy stabilizes and starts improving, while the recovery in other geographies could lag.

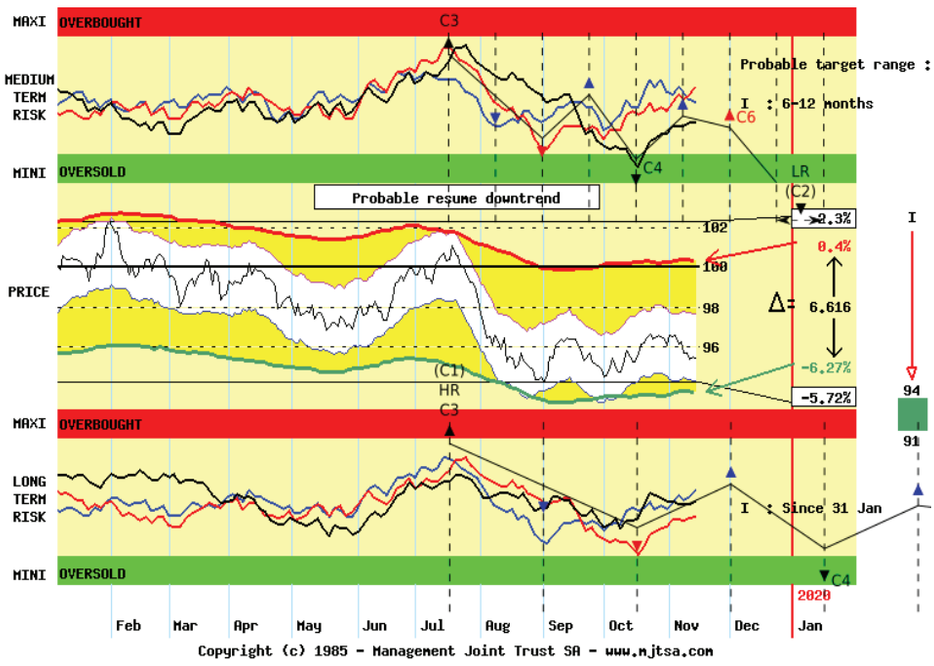
Concluding remarks :

Mapping correlations can be a moving target. To achieve more robustness, we, at The Capital Observer, tend to use Cyclical Analogs instead. Indeed, in addition to price, we also perform our correlation analysis on our cyclical oscillators as well as on our standard deviation envelopes. We believe their results are more stable over time. We would then typically match a universe of instruments to specific driving factors. In this article, we have mapped US and European sector relatives to the cross influence of two factors, the S&P500 and US10Y Treasury yields. This top down analysis delivered 3 distinctive profiles (Cyclical, Defensive and Growth sectors) which we were able to counter-check using our graphs. Yet, these graphs' and their projections also allowed us to confirm our cross asset scenario going forward, on the S&P500, on US10Y Treasury yields and on the sector rotation we expect. Hence, on a relative basis, we believe that Cyclicals could retest up into late November / early December, that Defensives could bounce while the market consolidates slightly during December, and that by late December / early January, Growth themes should take up leadership in what appears to be a US led recovery, and initially, a US decoupling story.

56 / Splicing the markets – Commodity and Asian Growth currencies should weaken into early Q1

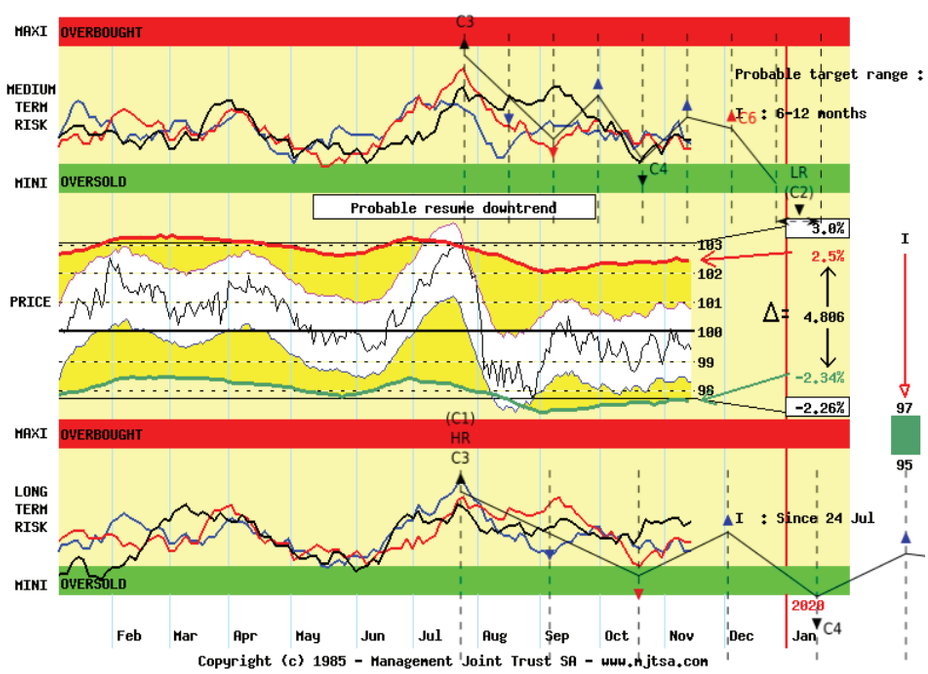
The cross asset scenario we consider throughout this issue of The Capital Observer is calling for a stronger Dollar from late November / early December into early Q1 at least. We believe Commodity and Asian Growth currencies could be the weakest link if this scenario comes true. We hereby consider them in this article vs the USD and the EUR.

Commodity Currencies vs US Dollar
Daily graph or the perspective over the next 2 to 3 months



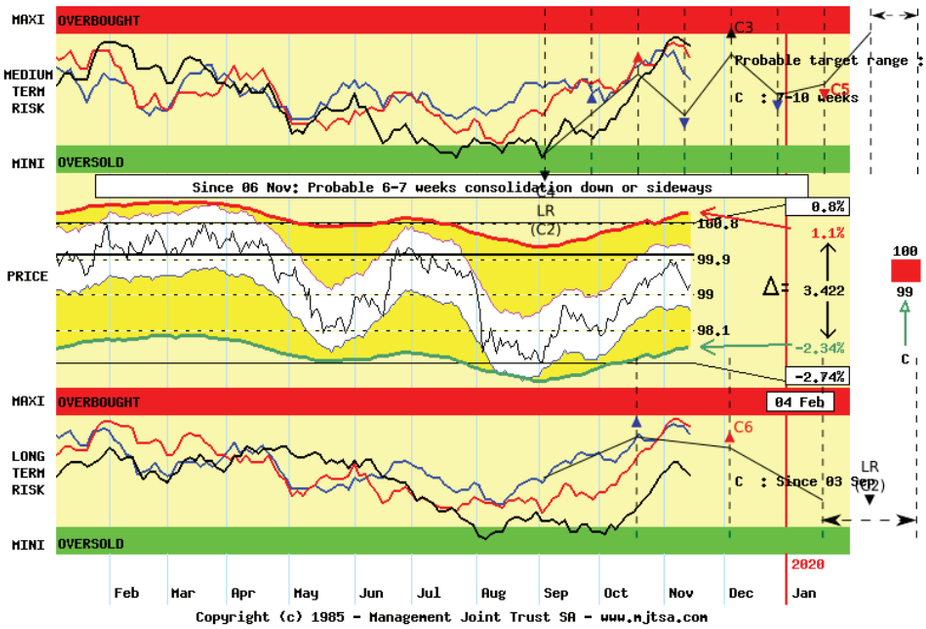
Our Commodity Currency portfolio is equal weighted across AUD, NZD, CAD, BRL, RUB and ZAR. We have excluded CLP, the Chilean Peso, from this version (we usually included it) considering that the country has its own specific political issues at the moment. For now, Commodity Currencies are still in a strong downtrend vs the US Dollar. The portfolio did bounce slightly in September, and then again in October, but for now these bounces have achieved little. Going forward, both oscillator series (lower and upper rectangles) suggest that **Commodity Currencies may hold up until late November, but that thereafter they should probably resume their downtrend towards early/mid January next year.** Our I Impulsive targets to the downside (right-hand scale) indicate that **their downside potential vs the US Dollar is probably between 2 and 5% until then.**

Commodity Currencies vs Euro
Daily graph or the perspective over the next 2 to 3 months



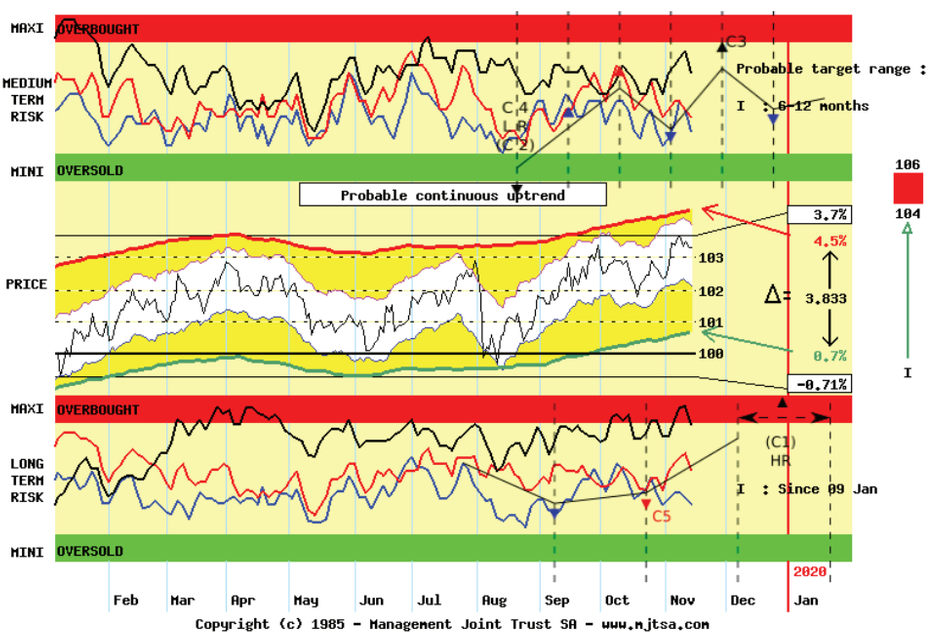
Vs the EUR, the situation is quite similar as our Commodity portfolio could also hold up until late November, but then probably resumes lower until early next year on both oscillator series (lower and upper rectangles). Our I Impulsive targets to the downside (right-hand scale) suggest 3 to 4% of downside potential until then. Hence, **Commodities Currencies could be weak across the board into early / mid January next year, even against the EUR, which we believe could also quite weak vs the US Dollar.**

Asian Growth Currencies vs US Dollar
Daily graph or the perspective over the next 2 to 3 months



Asian Growth Currencies (our equal weighted portfolio composed of CNY INR KRW THB TWD) have seen a stronger rebound vs the US Dollar since early September than Commodity currencies. From a targets perspective (right-hand), our portfolio has now reached the resistance our C Corrective targets to the upside. Going forward, both oscillator series (lower and upper rectangles) suggest that **Asian Growth Currencies could hold up into late November / early December, before they resume their previous downtrend towards late December, and probably into January, in first instance. Indeed, our Weekly graph (not shown here) suggests that Asian Growth Currencies could remain weak vs the US Dollar for the next 3 to 6 months.**

Asian Growth Currencies vs Euro
Daily graph or the perspective over the next 2 to 3 months



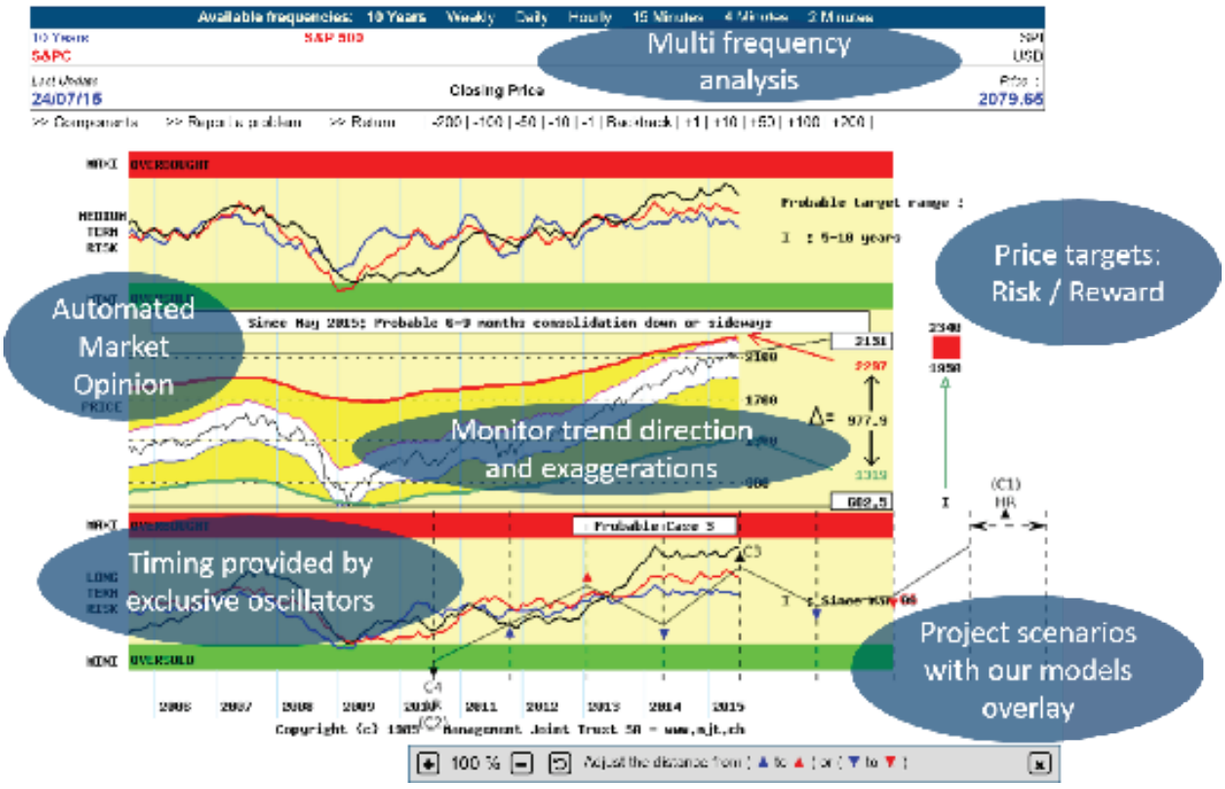
Vs the EUR, our Asian Growth Currency portfolio has remained in an uptrend throughout the year, except for the rapid Yuan devaluation (and concomitant Asian currency sell-off) early August as the Trade War was reignited. Both oscillator series (lower and upper rectangles) suggest that this uptrend probably extends into late **November / early December. Following that, we would expect some consolidation into late December / early next year,** yet nothing compared to the more durable sell-off we expect vs US Dollar. Indeed, EUR/USD should also suffer during this period. **From early next year, Asian Growth Currencies may even resume their uptrend vs the EUR,** possibly towards our I Impulsive targets the upside, 1 or 2% higher than today (right-hand scale).

Concluding remarks:

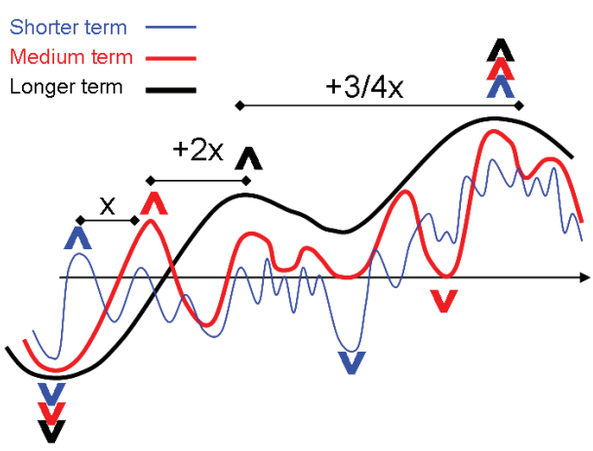
Cross Assets, we expect the cyclical rebound which started early September to finish a first leg up towards late November / early December. We then also expect the US Dollar to resume its uptrend vs most developed currencies into Q1. Emerging markets, Asian Growth and Commodity currencies should suffer against the Dollar during this period. Vs the EUR, Commodity currencies should also resume their downtrend during this period, while Asian Growth currencies should see a milder consolidation as EUR/USD should also be falling. Hence, from early December into early/mid January, Commodity currencies appear to be the weakest link. Thereafter, during Q1, the Euro and Asian Growth Currencies could be weaker.

58/ METHODOLOGY

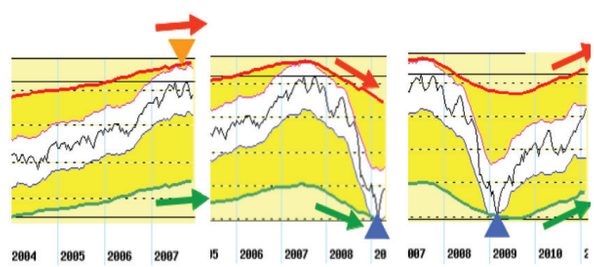
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative 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.mjtsa.com)



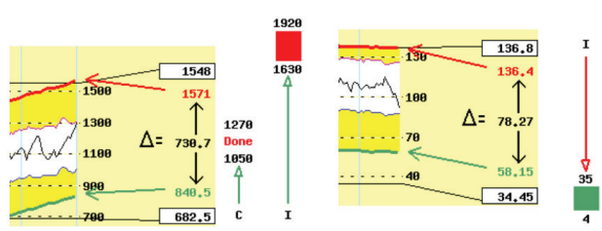
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)



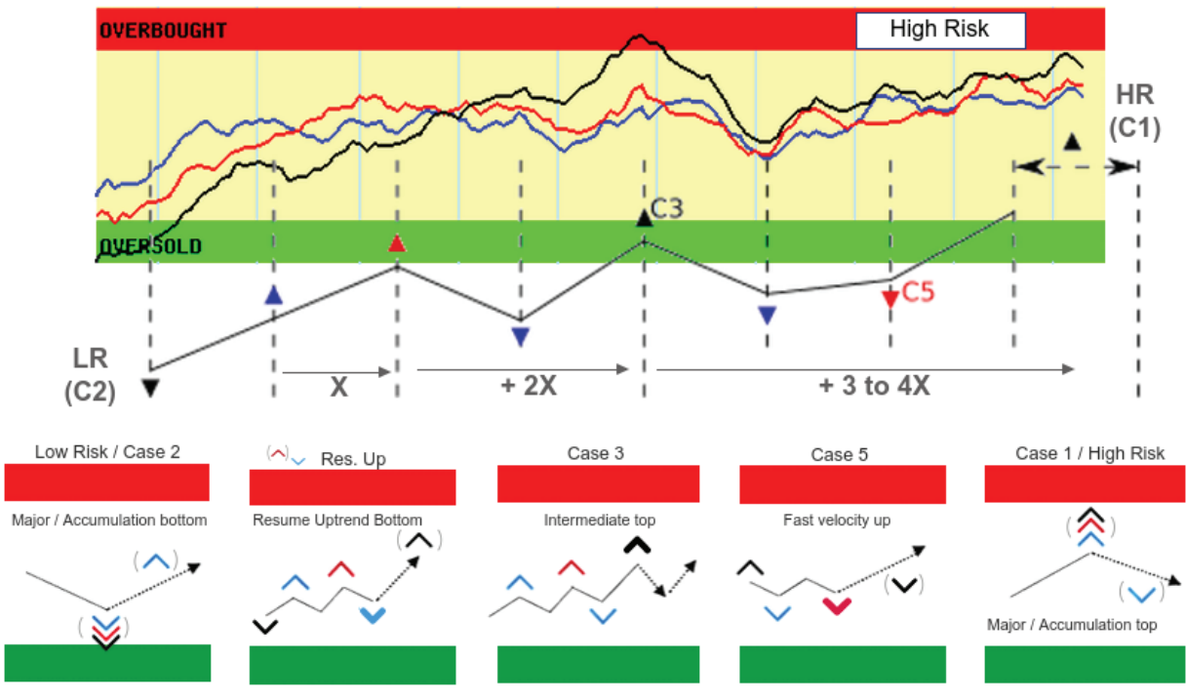
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



Price targets: based off historical volatility, 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).

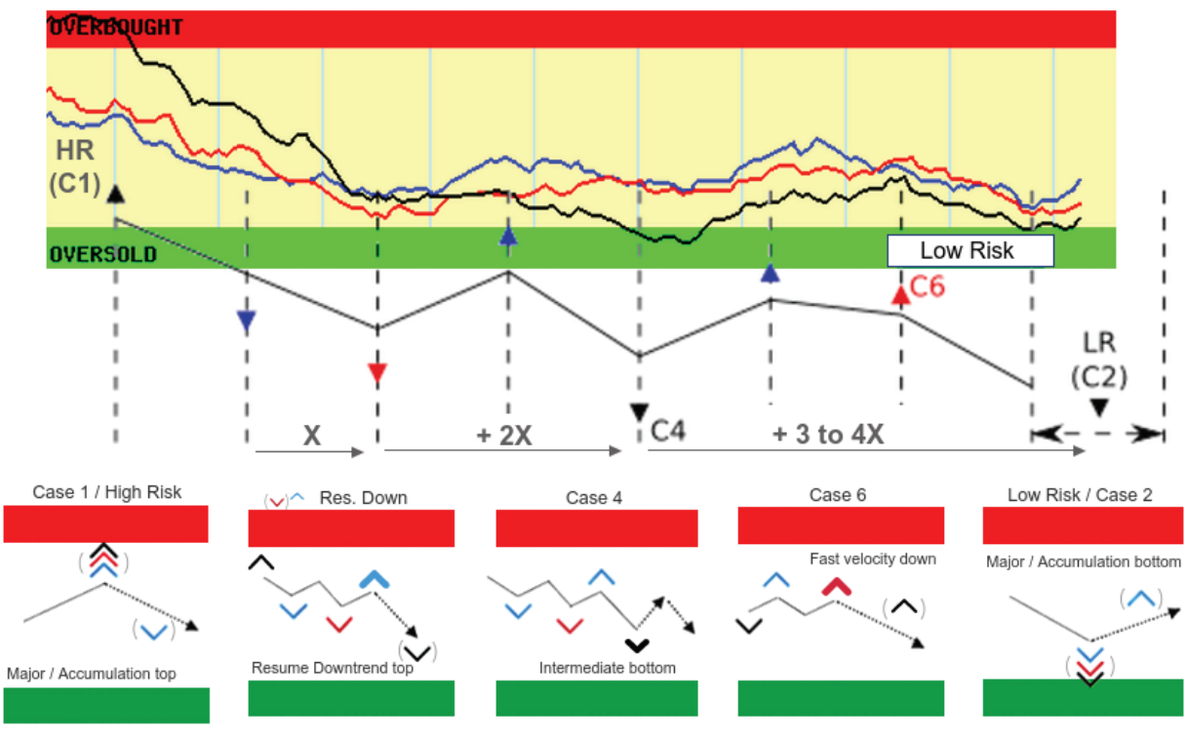


Ideal Uptrend Model



(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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