THE CAPITAL OBSERVER

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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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Recessions usually occur because the economy hits constraints, causing prices to rise and leading the Federal Reserve to raise interest rates. Today, the dominant constraint in the U.S. economy is the size of the labor pool.Labor shortages are already appearing in key parts of the economy, with about half of small businesses reporting few or no qualified applicants for job openings. For the first time since the government began tracking job openings in 2000, available jobs exceed available workers. This isn't just among highly skilled workers. For instance, homebuilders report a shortage of workers, especially in areas like framing and drywall, which is crimping the supply of new housing and helping to drive up home prices, reducing affordability.

Scott Minerd, CIO Guggenheim

4/ Executive Summary

12 / **No it is not different this time - when liquidity flows recede, risk assets get into trouble; when liquidity flows rise, risk assets perk-up and rise along** - Over the past three months we have been warning that summer could prove to be the high point for many risk assets and have been explaining why. The reality is that the Nasdaq possibly peaked on Thursday the 26th of July and the continuing sell-off is an event that few have been expecting, given the pre-season build up in earnings expectations. No, this time is not different. No, the current sell-off is not a special one-off event. When liquidity flows recede, risk assets get into trouble; when liquidity flows rise, risk assets perk-up and rise along. There is of course a lot of post-mortem analyses explaining the collapse of the FAANGs. It did not help that expectations for the tech sector was set very high. But of course, there is a reason for all these high-profile fails. When systemic liquidity recedes, the entire financial system, is weakened. Nothing more, nothing less. The fine-tuned systemic liquidity model set tells us that risk assets will likely be falling further until the first half of September.

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

23 / **What drive equity total returns? (Hint: Earnings Per Share is not one of them; EPS does not even come close) -** Earnings Per Share (EPS) in currently front and center in equity price analyses. After all, unexpected EPS data was responsible for the sharp gyrations in the US tech sectors last week. FaceBook (FB) lost circa 20% of its valuation when the company hinted of slowing earnings. The opposite side of the coin is the hyperbolic surge in the equity price of Apple (AAPL), which reported stellar EPS results, pushing up the total market valuation of the company to the trillion-dollar mark. It is so easy to arrive at the conclusion that EPS was THE factor that made all these things happen. But is a focus on EPS as a prime move mover of aggregate equity returns (indexes) justified? We have done a significant amount of work in the subject, and our conclusion is a flat "NO". At the risk of being derided by EPS stalwarts, we publish this report which offers evidence (at least to us) why EPS is an indicator which lags behind most equity metrics by a virtual mile. Ironically, the saga of EPS starts with another measure of US corporate profits – the NIPA Profits from the BEA.

28 / **Timing and Tactical Insight - Rather than a shift towards Value, we believe that the recent weakness in the Nasdaq is a Defensive warning -** We believe that while US markets are on the verge of topping out, other markets such as Emerging markets, Europe or Japan are getting ready to resume lower again. The fact that the ratio of the Nasdaq 100 vs the S&P500 Index is also topping out, is probably a consequence of the higher beta of the Nasdaq 100 vs the S&P500 rather than the beginning of a wider shift out of Growth and into Value. Indeed, when comparing both, our models do suggest that Growth continues to outperform Value probably into mid Q4 and even perhaps into early 2019. Hence, we expect equity markets to start a first leg down from now into late August / early September, then bounce into October, perhaps even until early November, before they start to sell-off again towards year-end and then Spring next year.

35 / **The US Dollar, trade spats, China: it may not end well short-term for commodities, but there should be a firm relief at some point in September 2018** - Markets reflect, and in fact anticipate, foreign and domestic political and economic events. Commodities are global assets, and are sensitive to geopolitical and economic developments. That makes them the barometer of global growth and activity trends and therefore tend to be the most volatile sector of the markets. Nonetheless, commodities in general, and the energy sub-sector in particular, have been the best performers among a wide range of asset classes this year on ytd basis. As we go into the middle of the sweltering hot summer season of 2018, a time when markets are typically quiet, the news cycle is increasingly focused on the US-China trade spat, and the fundamental strength of the U.S. dollar. The commodities markets promise to be everything but quiet. Furthermore China's leading economic indicators are not very encouraging. Total Social Financing expenditures (TSF) have been falling hard. As a consequence, China's Leading Economic Indicator (LEI) will also decline soon, as soon as the next few months . Finally, the fall in M1 Money Supply dropped precipitously from January this year, and no bottom is in sight, so far, while the (TSF) kept on falling. Dr. Copper is once again living up to its billing as the metal with a Ph.D degree. A combination of falling systemic liquidity flows, a rising dollar, higher interest rates, and fears of recessionary pressures caused by the trade issues, and diminishing demand (for crude oil) have created a potent bearish cocktail for many global commodities prices.

The Capital Observer editors team, London / Geneva, August 7th 2018
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5/ Executive Summary

39 / **Timing and Tactical Insight - The current sell-off in commodities may find some support towards September, yet overall, commodities probably remain under pressure into H1 next year at least** - The reflationary trend since 2016 in the commodity space probably reached exhaustion this Spring, and we believe it has now started to reverse. Many of these trades, and Industrial metals in particular, had been strongly correlated since 2016 with stronger Chinese growth momentum. That said, this trend may also be reversing as the effects of strong fiscal stimulus in 2015 and 2016 are gradually fading, and the reality of the current US vs China trade war settles in. The current Yuan devaluation is symptomatic of this deterioration, yet it is really its underlying causes that are concerning. These are leading Chinese Equities and Industrial Metals to sell-off. Following an intermediate low in mid July and a weak bounce since then, we expect Industrial Commodity trends (Oil, Copper, Industrial Metals and related sectors) to weaken again probably from early/mid August, until early and perhaps even mid/late September. Following that, we would expect a late September, October bounce, before these Industrial Commodities resume lower from November into next year. Gold on the other hand may bottom during September and start accelerating up as markets gradually enter a more risk-off environment from early/ mid Q4 into next year.

46 / **Why does the US yield curve continue to flatten? Taking the cue from Global Quantitative Tightening, and the collapsing US bond term premium** - The Fed is acting out its normal reaction function to rising growth and full employment (when job openings are more numerous than the number of unemployed, which is the case today). Since after World War II, that has consistently produced an inversion of the US yield curve, followed by an actual recession (two sequential negative quarterly growth) 6 to 7 quarters later. As we have pointed numerous times in previous issues of the Capital Observer, it is NOT the yield curve INVERSION that does the damage – it is the PROCESS to an inversion which kills growth and asset prices. The inversion is the symptom . But the harm has been done even before the damage is detectable – the situation is already deteriorating. "This time will not be different" – the Fed will overtighten (they always have done so) and we will get a recession sometime in H1 2020 (on this metric alone). And it gets worse. Global central banks are also doing QT, which by itself is also capable of inverting the US yield curve and those of other lesser economies. And global QT will accelerate during Q4 when the ECB starts to pare its balance sheet. It's a double whammy folks.

49 / **Timing and Tactical Insight - More Flattening to come on the US yield curve, possibly inversion by year-end** - While the last few weeks have seen quite a few comments about Bearish steepening, we believe that the next few months should see more Bearish Flattening and even Inversion on some spreads. Indeed, for now, the FED remains committed to normalize its monetary policy (potentially 4 more rates hikes and more QT), while medium to long term treasury yields should gradually start to retrace. We believe that the flattening could be particularly strong on the shorter end of the curve as 2 to 3 years Treasury yields have been bid up quite strongly since mid last year, probably because of the large amount of new debt issuance on that segment. More generally, net short positions against Treasuries across the whole yield curve are currently at record highs, which makes them vulnerable to a rapid short squeeze. In Europe, we also expect long term rates to continue lower, probably until Q4 at least. Not surprisingly, Financial sectors on both sides of the Atlantic are expected to continue to underperform, probably well into Q4.

57 / **Splicing the markets - Is the US Dollar risk-on or risk-off? -** Currently, the US Dollar is moving up vs both the Euro and the Yen. We believe that during the next few months, this relationship may change. Indeed, the Yen should first strengthen and then weaken again vs the US Dollar (risk-off, then risk-on), while the EUR/USD continues to weaken until late August before it rebounds into October (defensive/growth extension). These dynamics, if true, should trigger a rally in EUR/JPY from end August, and according to our tables, this cross usually correlates quite well with a flattening yield curve and a tightening of the US to Europe interest differential. During such periods, Defensive and Growth profiles usually also outperform. Not surprisingly, these are the basic tenants of our scenario from September into October. It remains to be seen however if we are correct in calling a worthwhile risk asset correction until the end of August, and then, following that, how strong the September/October recovery/extension actually turns out to be.

The Capital Observer editors team, London / Geneva, August 7th 2018
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6/ Mapping the markets

Last month, we expected the ongoing rally on equity markets to push higher until late July / early August, yet we concluded our introduction by stating that having followed the risk asset rally up for the last 18 months, we were getting ready to pull the "Take-profit" trigger towards end July. We could not exclude a further Growth extension into the Fall, but believed that by now, the risk/reward perspectives would certainly be worth adopting a more defensive stance. Today, we confirm all of the above and reiterate our cautious warning. Indeed, our long term graphs on the S&P500 Index, on defensive sectors vs the market, on Oil and on the US Dollar suggest that the reflationary environment in place since early 2016 may be coming to an end and that we are indeed probably on the verge of a defensive cross asset shift: Long Term Yields are topping out, the Yield Curve continues to flatten, Equity to Bond ratios seem stretched, Credit has already started to deteriorate and Defensive Equity Sectors seem to be getting ready to outperform over the next 3 to 5 quarters.

Shorter term, we expect a first sell-off on equities between now and late August / early September, then a new upside retest probably led by Growth and Defensive sectors, possibly into October, at the latest into early November. Defensive sectors should make new highs, while we are not convinced the rest of the market will. This will depend on the depth of the upcoming August sell-off and the strength of the subsequent rise into the Fall. For now, we re-iterate our view that at current levels, the risk/reward on risk assets seems stretched and that profit taking and shifting to more defensive profiles is probably justified.

As for reflationary assets, including Emerging markets, Financials or Commodities, we believe they are still in sell-off mode. Indeed, the US Dollar remains strong for now, probably for another 2 to 3 weeks. Coming late August/September, we expect the EUR/USD to bounce. This could trigger relief rallies in the reflationary assets mentioned above. Yet, these profiles are not leaders in the market any more, and their rebounds will probably be limited.

Finally, longer term, we don't believe the extension on Growth and Defensives profiles during the Fall will be as strong and long as the one we experienced in H1 2017. By November, we would expect a true risk-off environment to settle in, probably until next Spring at least. Treasuries, the Yen, Gold, the US Dollar and defensive assets in general should then widely outperform the risk assets space.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	Following the strong rally during July and early August, we expect US equity markets to initiate a first leg down, possibly towards end August / early September.	From early September, into October and perhaps early November, US Equity markets attempt to restest their highs. Following that, they should sell-off towards 2019.
	Europe EuroStoxx50	We also expect European markets to correct down towards end August, early September.	As in the US, European markets may attempt to retest their highs during the Fall, yet should sell-off again from November into next year.
	EMs MSCIEM USD	EMs are rather Oversold already, yet they should also follow developped markets lower again, probably towards end August, early September.	During the Fall, EMs may find some relief as the USD retraces a bit, yet we don't expect much more than rebound.
Treasuries	US10Y Bond prices	US Treasuries are bottoming and US10Y yields should probably start to reverse down over the next few weeks.	10Y Yields may retrace 60 to 100 bps into 2019.
	Germany 10Y Bund prices	Bund Futures Continue higher until late August, early September, they may then retrace a bit during the Fall.	While equity markets attempt to restest up during the Fall, the Bund may consolidate. That said, we believe any correction is a opportunity to accumulate.

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

Main Equities

World markets
p 15, 28, 29, 30, 33, 34

Equities are reaching the last stages of their Bull market since early 2016. We expect them top out and enter a first leg of correction to the downside over the next few weeks. Following that, they may bounce/ retest up during the Fall, yet should resume lower again from mid Q4 towards year-end and Spring next year. Theoretically, the Bear market we expect could last between 12 and 18 months.

Main Regional picks
p 33, 57, 58

Until late August / early September, we expect equity markets to start correcting down, while EUR/USD remains under pressure and USD/JPY retraces. In this rather risk off environment, Europe may resist slightly better, while Japan underperforms. We expect these currency moves to reverse during September and October. Europe should then underperform, while Japan could be stronger.

Emerging markets
p 31,32,58

Emerging markets should remain under the pressure of a strong US Dollar until late August / early September. They may bounce from September to October, but then resume lower again and underperform from mid Q4 towards year-end and Spring next year.

Volatility

Volatility is approaching the lows it made last year and during January. Yet, it may start to bounce soon, at least into early September in first instance.

Government Bonds

US & European Benchmarks
p 49, 53, 57

US 10Y yields are in the process of topping out for this cycle. We expect them to retrace 60 to 100 basis points towards Spring next year. European long term yields topped in January and have since been trending lower. This downtrend may pause during September and October, yet then resumes lower towards year-end and Spring next year.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	The ratio is topping out and should initiate a first leg down into late August / early September.	As Equities attempt to retrace up, the ratio may bounce into October, but it then resumes its downtrend on risk-off considerations into next year.
	Europe	The ratio, which topped-out in January, should now resume lower towards end August/early September.	The ratio may bounce a bit during September and October, but should resume lower from November into next year on risk-off considerations.
Duration		US and European yield curves should start flattening again as long term yields in the US top-out and continue lower in Europe. Longer Durations can be considered.	In general, yields curves continue to flatten, while long term yields continue to retrace. The environment is favorable for defensive long Duration trades.
Credit		Following a bounce during July, all credit spreads start to widen again towards late August, early September.	Although credit spreads may bounce at some point during the Fall, we believe the Credit cycle has turned, and will stick to High Quality issuers over the next few quarters.
TIPs/Treasuries		TIPs vs Treasuries have probably topped out for this cycle and could see further weakness into late August, early September.	TIPs/Treasury ratio probably continues to lose momentum towards the Fall, as inflationary pressures gradually subside.
Oil		Oil probably corrects down into the mid/high 60s USD/barrel on Brent towards end August, early September.	Oil may rebound a bit during the Fall (political risk?), yet in general, the current retracement continues into 2019 (back to the 47-55 range on Brent?).
Industrial metals		Industrial metals and Copper continue to be under pressure on risk-off considerations, probably into late August, early September.	Industrial metals and Copper may attempt a bounce during the Fall, yet we don't believe it will gather much strength. They resume lower from October/November into 2019.
Gold		Gold is Oversold, yet its downtrend is not quite over yet, we expect it to continue lower, possibly into late August, early September.	From September into October, Gold starts to stabilizes as the US Dollar retraces. From November, it gathers momentum as the risk-off environment worsens.

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

Equity to Bond Ratios

US & Eurozone Markets
p 17

The US Equity to Bond ratio should top out soon as we expect equity markets and yields to top-out. In Europe, they resume lower during August, may pause during the Fall and then move down again towards next Spring.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 50- 53

We expect Yields curves in the US and Europe to flatten, while long term yields start to reverse down. This is a rather friendly environment for Duration.

Credit
p 18, 54

Over the next few months, we expect all measures of Credit to start topping out. Corporate and Sovereign spreads should start to widen across the board.

Rate Differentials
p 50- 53

The uptrend on the US rate differential vs other regions is getting stretched. It should retrace some from late Summer into the Fall.

Tips
p 39, 57

TIPs should bottom out, along with Treasuries over the next few weeks. Inflation expectations (TIPs/ Treasuries ratio) remain in an uptrend for now, yet this trend is losing upside momentum and could reverse down during H2 2018.

Commodities

Oil
p 15, 43

Oil has probably topped out for this cycle. We expect it to continue lower during August (Brent could fall into the mid/high 60s USD/barrel), possibly retest up in the 70s USD/barrel during September and October, and then resume lower towards next year and the 47-55 range.

Industrial metals
p 39, 41, 42

Industrial metals should remain under pressure during August, could bounce slightly during September and October and then resume lower again towards year-end and Spring next year. We believe they have probably turned down for this cycle.

Gold & PMs
p 39, 41, 42

Gold remains under pressure until end July, early September as the US Dollar continues to strengthen. Gold should then benefit from a retracement in the US Dollar from early September, and then could start to accelerate up vs all currencies and most assets towards late Fall, as financial conditions start to deteriorate.

Agriculture

Agricultural Commodities are typical late cycle commodities. They are more defensive than Energy or Industrial Metals and should perform better than them in the upcoming environment. For now, following their June sell-off (Chinese devaluation) and their subsequent bounce, we would expect them to remain under pressure until mid/late August. From September, they should resume higher, until early/mid Q4 at least.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	EUR/USD continues to slide, probably towards late August / early September and our 1.14 – 1.10 downside target range.	From late August, early September, EUR/USD may start to stabilize and could bounce into the Fall
	GBP	GBP/USD continues to resume lower, probably topwards end Augut, early September in first instance and into the 1.29- 1.24 range.	During September, GBP/USD may see a slight bounce, but appears to remain under pressure into late Fall.
	JPY	USD/JPY could correct down again towards the 110 – 108 range towards late August.	From late August, it attemps to resume up again, possibly towards recent highs (112) and perhaps towards 115. From October/November, it reverses down towards 2019.
	CHF	USD/CHF could continue to push slightly higher into late August, early September (above parity)	From late August / early September, the Dollar could start to retrace down into October (back to the 98-99 range). From November, it starts to move up again towards 2019 (1.05?).
EUR vs	GBP	EUR/GBP is now in an uptrend, possibly towards late August, early September and the low 0.90s.	Although it may retrace a bit during September, EUR/GBP continues highers towards year-end and 2019.
	JPY	EUR/JPY continues to slide into late August / early September towards 127, perhaps below.	EUR/JPY may attempt a last bounce back during the Fall, possibly retesting 132, and perhaps slightly above. From late October/November, it reverses down towards 2019.
	CHF	EUR/CHF probably continues to slide towards late August, early September (1.14?)	EUR/CHF may bounce back towards the 1.17-1.18 range during September and into October. From October/November it reverses lower towards 2019.
GBP vs	JPY	GBP/JPY coninues to slide towards late August / early September and the low 140s.	From September, GBP/JPY may bouce slightly, but in general it remains under pressure throughout the Fall and then towards next year.
	CHF	GBP/CHF continues to slide towards late August, early September at possibly towards the 1.26-1.25 range.	From September, GBP/CHF may bouce slightly, but in general it remains under pressure throughout the Fall and then towards next year.

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

US Dollar
p 16, 40

We believe the US Dollar has turned up for this cycle and that it will gradually strengthen in successive stages towards mid/late 2019. Shorter term, we expect the US Dollar to continue higher towards late August / early September. Following that, the US Dollar could retrace into the Fall, before it accelerates up again in towards year-end and into 2019 on Flight to Safety concerns.

Euro
p 57

The upside momentum on EUR/USD that prevailed throughout 2017 has reversed. Over the next few weeks, we believe that EUR/USD could continue to slide towards the 1.14 – 1.10 range. Following that, from late August / early September, it rebounds back up towards the high teens during the Fall. Towards year-end and into 2019, EUR/USD weakens further as economic, financial and political problems accumulate and the US Dollar rises on Flight to Safety concerns. Vs CHF, the upside momentum seems to have been broken, EUR/CHF should remain under pressure until late August / early September, yet could attempt to retest up during the Fall, but then starts to reverse lower again towards year-end on risk-OFF considerations. EUR/GBP is now back in an uptrend, probably towards year-end and well into 2019. Indeed, the Euro is more Defensive that GBP and the difficult Brexit talks are not helping. Sterling could bounce a bit during the Fall, yet in general remains under pressure.

Yen
p 58

The rebound on USD/JPY is currently retracing and could continue to do so during August. Following that, we expect one last attempt to the upside towards October (1.12, perhaps 1.15). From October/November, as financial conditions start to deteriorate towards year-end, we expect that the Yen regains its risk-OFF profile and that USD/JPY starts to reverse down towards 2019. Vs the Euro and Sterling, the Yen probably retraces up during August. It then weakens again during September and October vs the EUR (and less so vs GBP), before it regains strength towards year-end and into 2019 on Flight to safety concerns.

Sterling

Sterling seems quite weak across the board. Cable (GBP/USD) should continue to move lower into the 1.29 – 1.24 range during August. During September and October, GBP may bounce slightly vs USD and other majors, but probably resumes lower from mid Q4 into 2019.

Oil & Commodities currencies

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) topped out in early February against the Dollar and have been consolidating down since. This initial leg down could continue into mid/late August. Following a slight bounce during September and October, Commodity currencies should weaken again vs the US Dollar from late 2018 and well into 2019. Against the Euro, Commodities currencies could start weakening again from September, probably towards year-end and 2019.

Asian currencies
p 40

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) should continue to resume lower vs the USD and the EUR towards late August / September. From September into October, it may bounce vs the US Dollar (less so vs the Euro). From mid Q4, Asian Growth Currencies will probably start to resume lower vs both the US Dollar and the Euro, probably until Spring next year at least.

Equities Markets Segmentation

Core Sector Weightings			Next 2 months					3 to 6 months ahead				
US Sectors - S&P500			**Until late August, early September : Underweight Technology (extended vs the market), Cyclicals & Financials and Overweight Defensive sectors.**					**From early September, we continue to underweight Cyclicals and Financials, neutralize Growth and Overweight Defensives.**				
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	26%										
Financials	XLF	15%										
HealthCare	XLV	14%										
Discretionary	XLY	12%										
Industrials	XLI	10%										
Staples	XLP	8%										
Energy	XLE	6%										

European Sectors - Europe Stoxx 600			Next 2 months: **Until late August, early September : Underweight Cyclicals & Financials and Overweight Defensive sectors, expect for Healthcare which is neutral.**					3 to 6 months ahead: **From early September, we continue to underweight Cyclicals and Financials and Overweight Defensives.**				
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 16, 19, 20, 21, 31, 44, 45, 55, 56

We expect equity markets to start correcting in August, probably towards late August, early September. During this period, we will avoid Cyclical sectors and Financials as well as technology which we feel is stretched to the upside on a relative basis. We will overweight Defensives, except for Europe Healthcare (neutral) as it has already performed quite well.

During the Fall, we expect markets to bounce and attempt a further retest of highs. Growth and Defensives Sectors should continue to lead over Cyclicals and Financials.

Countries allocation

Core Countries Weightings: All World Country Index Currency hedged			Next 2 months: **We are Underweighting Canada, China and Japan, while Overweight Switzerland**					3 to 6 months ahead: **From early September, we will Underweight Europe, Overweight the US and Switzerland and Neutralize China and Commodity producers**				
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
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 22, 31, 32, 33, 34

During the correction we expect on equity markets over the next few weeks (until late August / early September), we have neutralized the US and Europe, underweighted China and Canada for their links to the Commodity/Emerging markets space, underweighted japan as we expect USD/JPY to retrace down a bit, and overweighted Switzerland due to its defensive sector mix.

By September, we expect that EUR/USD could start to stabilize and are planning to underweight Europe, given the negative relative impact that a EUR/USD rebound could have on European markets during the Fall. Commodity producers and China could bounce during the Fall, but by mid Q4, they could start to underperform again. Switzerland remains overweight as a defensive position in the portfolio.

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.

Core factors and Themes

Core Factor/Themes Weightings	**Next 2 months**					**3 to 6 months ahead**				
General Comment	**Until late August, early September, our factor allocation mostly avoids high beta risk.**					**From early September, our theme allocation avoids cyclicality and is tilted towards the EUR/USD rebound**				
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)										
Goldmines										
Diversified Mining										

Core factors and Themes
p 22, 30, 43, 44, 52

As we expect equity markets to initiate a first leg down into end August / early September, our themes and factors allocation until then will avoid any high beta, or cyclical market positioning while attempting to overweigh defensive profiles.

From September into mid/late October, we will skew our factors and theme allocation to profit from a rebound in EUR/USD, As we expect growth and defensives themes to lead, we will overweigh them, while underweighing cyclical profiles. From November into Spring next year, our focus will shift even more defensive.

12 /No, it's not different this time – when liquidity flows recede, risk assets get into trouble; when liquidity flows rise, risk assets perk-up and rise along

This time it is different?

*"Many investors have said **'it's different this time'** about Tech stocks over the last few years, and so far they've been right – despite numerous warning signs of Tech, growth, and momentum being crowded, these stocks have continued to go up and dips have meant to be bought. Looking over the last 5 years, selloffs like that seen over Thurs/Fri last week (-2.8 sigma event) have been a good signal to buy Tech, momo, etc. **But it's likely different this time."***

That's from Christopher Metli, Executive Director in Morgan Stanley's Institutional Equity Division, in a very good summary of the situation for the Nasdaq 100 (July 30, 2018). But that is looking back at what had happened in the market with a perfect 20-20 vision. **The reality is that the Nasdaq possibly peaked on Thursday the 26th of July and the continuing sell-off is an event that few have been expecting, given the pre-season build up in earnings expectations**. At the risk of becoming immodest, as early as April, we have been talking about, and have been expecting, this possible outcome. At that time, we wrote at the April 2018 Capital Observer about early May as likely trough of risk assets prior to a rally into a late July-early August peak.

This is what we said in the April Capital Observer:

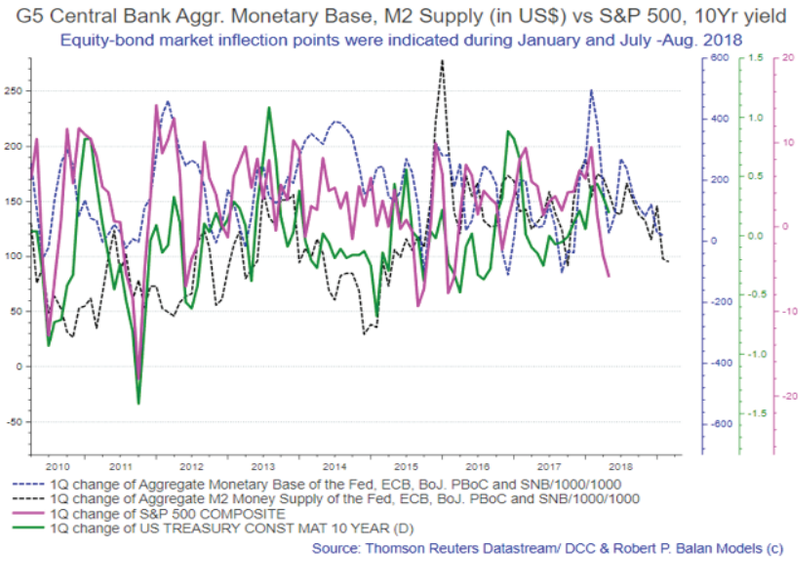
"The grand-daddy of systemic liquidity is, of course, the aggregate stimulus provided by the leading global central banks (the Fed, European Central Bank, Bank of Japan, People's Bank of China, and Swiss National Bank). Their aggregate balance sheets have been feeding the markets since late 2008. Due to their relatively large volume, the aggregate G5 central bank stimuli (in the form of bank reserves) have also become their de facto Monetary Base (MB). Due to the small percentage of the cash percentage (notes and coins) to the whole, banks reserves being held by central banks have become their MB. The aggregate global central bank balance sheet has been credited with pushing up the valuation of equity markets around the world. The models suggest a low in early May and a rally into late July-early August."

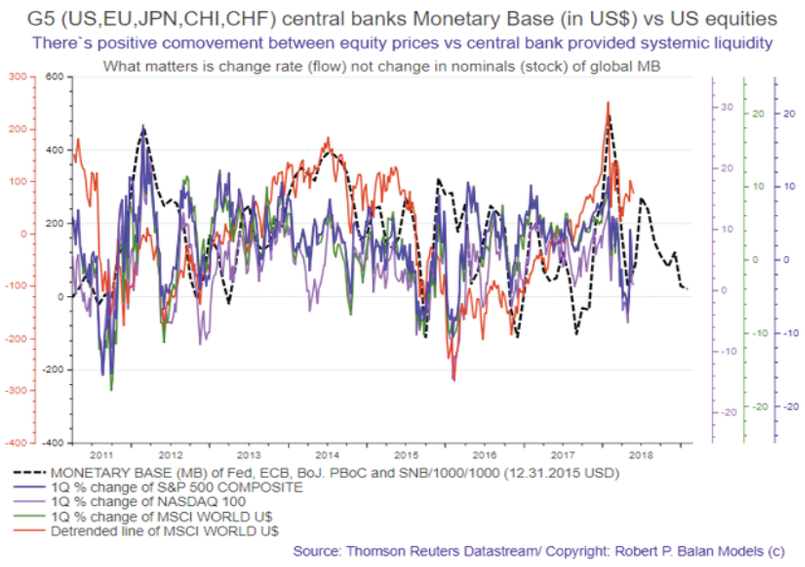
Then in the June issue of the Capital Observer, we went one step even further and described, then illustrated, a final rally in risk assets in late July-early August *(see "Systemic Monetary Liquidity: A Top-Down Look To Understand Where We Came From, Where We're Going")*. This is how we discussed the concept in the June 2018 Capital Observer issue:

"The impact of those aggregate global reserves on financial assets was, and is, enormous. During the time global central banks were adding to their balance sheets, financial assets have become beholden to the flow of that global aggregate systemic liquidity. The prices of financial assets have risen as the flow of the aggregate Monetary Base rose, and opposite is also true. This is especially true of the US stock market and US bond markets (see graphs below)."

"In the graphs provided below on this page, for 2018, the flows peaked in January, which coincided with the peak in the S&P 500 Composite, and in the 10-year US Treasury Bond Yield. There is another peak in the liquidity flow being shown in late July – early August,

Original charts in the June Capital Observer issue





this year. We therefore expect financial assets, especially equities, to make significant peaks at that time.

In last month's issue of the Capital Observer (July 2018), we revisited the situation that was being warned about by the systemic liquidity models, and we updated the two previous charts on the previous page.

Our conclusions in last month's Capital Observer (July 2018): *"It is highly apparent that risk assets are in their last push higher before the withdrawal of liquidity world-wide undercuts the equity bull market thesis, at least in the near-term. If the distributed lag effect does its job, equity markets should peak in late July-early August, and be in a world of hurt until early Q2 2019 (see the first two graphs on this page)."*

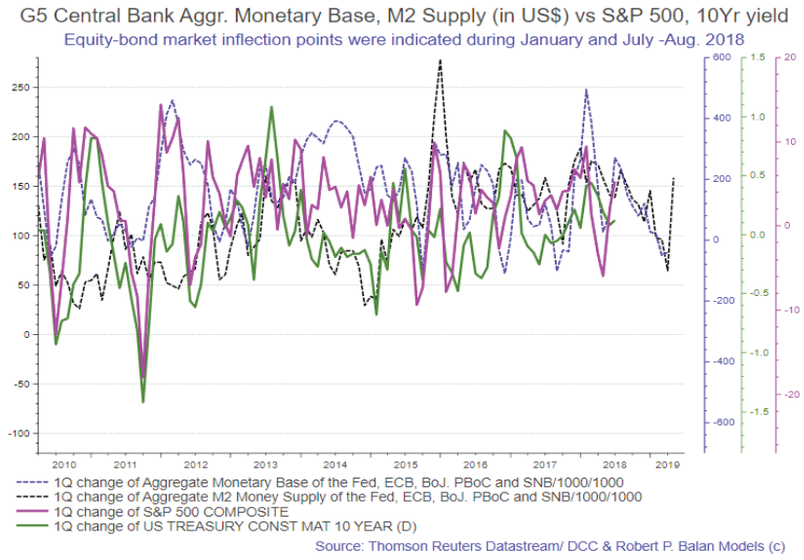
Today, this is how the two charts look like (zoomed version):
(see 3rd graph on this page & 1st graph on next page).

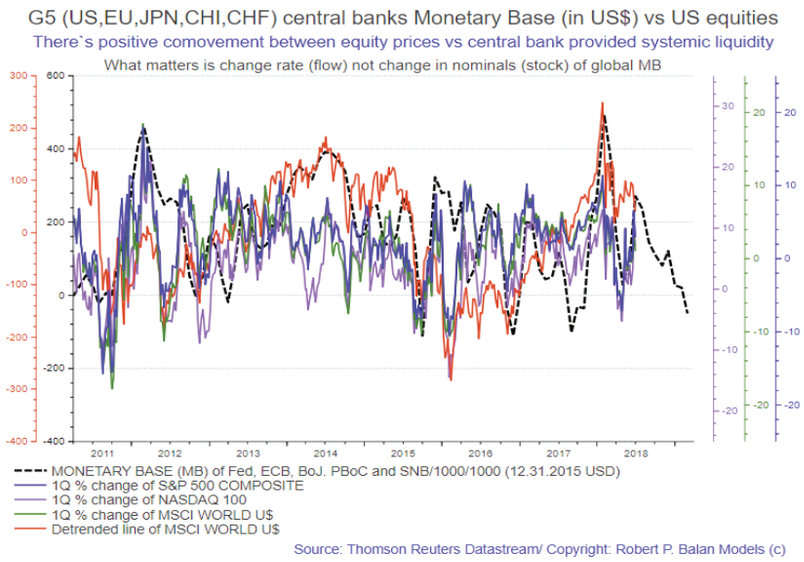
No, this time is not different. No, the current sell-off is not a special one-off event. Market fails like the one we are seeing is a recurring situation that we have been hammering on since the Capital Observer started publishing on December 2016: when liquidity flows recede, risk assets get into trouble; **when liquidity flows rise, risk assets perk-up and rise along. Nothing more, nothing less.**

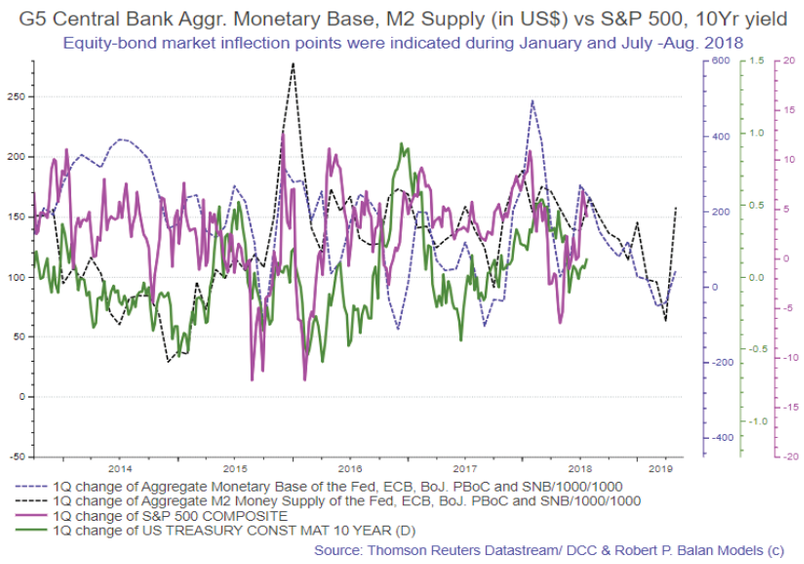
Our approach at the Capital Observer in fine-tuning the impact of systemic liquidity on risk asset prices, asset trend analysis and sequential macro analysis has progressed to a point that we have now attained the capability of identifying some of the key inflection points in markets in a fairly precise way. Our constraints come more from the lack of granularity in the liquidity and fundamental data being used in the analyses (which are in weekly and monthly increments).

Nonetheless, we have managed to interpolate data successfully to a point where we can now derive a zone that are optimal for inflection points, versus the actual risk asset price turning points.

Original charts in the July Capital Observer issue







This is how the systemic liquidity-asset price relationship looks today: *(see 2nd graph on next page)*

The fine-tuned systemic liquidity model set tells us that risk assets will likely be falling further until the first half of September. Then we will reassess the over-all situation.

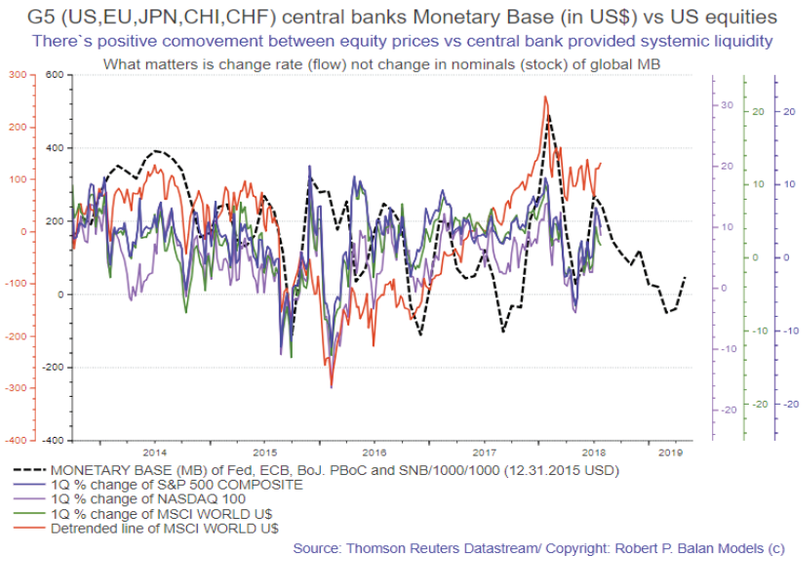
Post-mortem analyses

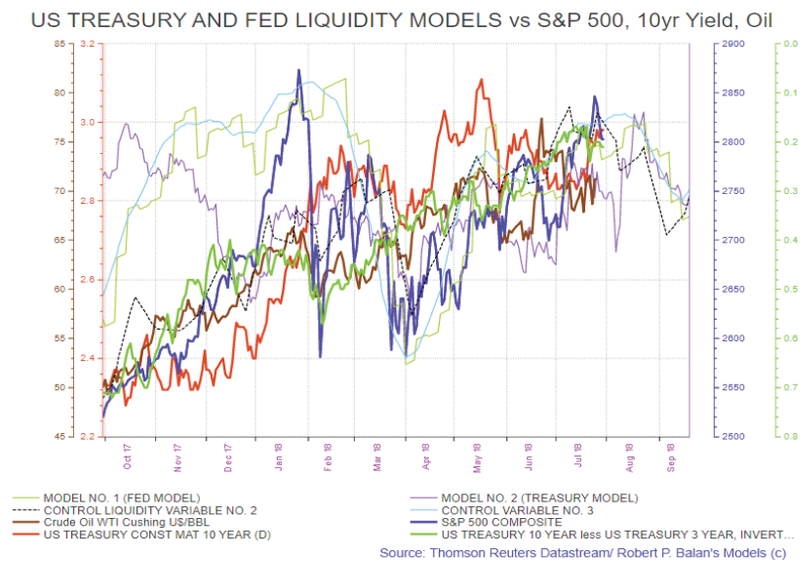
There is of course a lot of post-mortem analyses explaining the collapse of the FAANGs. It did not help that expectations for the tech sector was set very high.

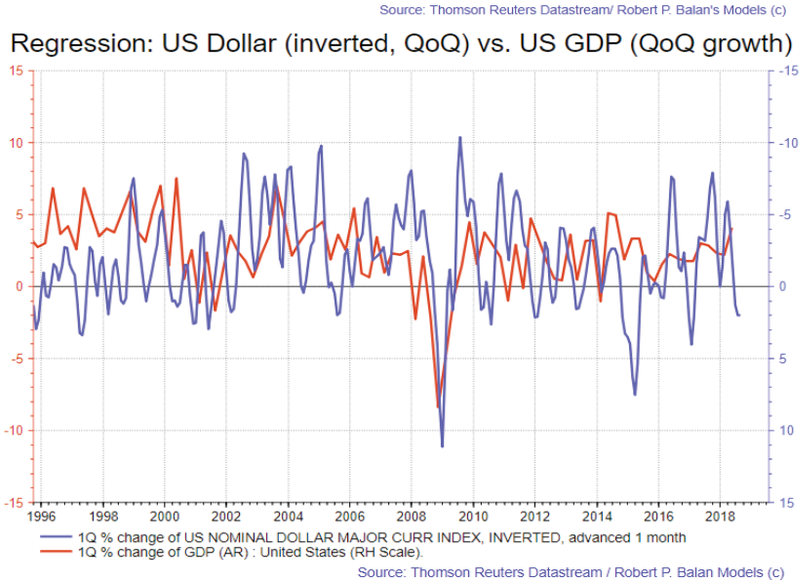
With earnings season in full swing, investors have been focused squarely on the FAANGs. Most recently it was Amazon's turn in the spotlight (AMZN) last week. AMZN got up as high as 4% in early trading on Friday but weakened as the day progressed and managed to close just 0.5% higher for the day after a sequence of weak numbers for other tech names.

Wall Street had hoped that Amazon's consensus-beating Q2 earnings report could restore some faith in the FAANG names- But Facebook's (FB) 20% earnings-related tumble last week was the latest high-profile hit to some of Wall Street's most widely followed Internet companies. FAANG member Netflix (NFLX) lost 11% in the last two weeks after missing subscriber addition projections for the first time in five quarters. Also taking a big hit last week was Internet darling Twitter Inc. (TWTR), which tumbled 20% on Friday the 27th after reporting a decline in monthly active users as well as disappointing guidance. Adding to the negative sentiment was a 9% plunge in leading chip maker Intel Corp. (INTC). Intel's sell-off occurred despite impressive earnings, as quarterly revenue growth came in below the Wall Street consensus.

But of course, there is a reason for all these high-profile fails. When systemic liquidity recedes, the entire financial system, is weakened. Systemic liquidity flows may be likened to gravity. If is a pervasive force, diffuse but inexorable. It is analogous to someone clinging to a branch. When she loses her grip, gravity will take over and pulls her relentlessly to the ground. It just needed something to make her release her grip. That analogy extends to the FAANGs fail last week which is continuing. It might also be that the demise of FAANG is the event that will cause the entire equity market to lose its grip, and likewise fall to the ground.





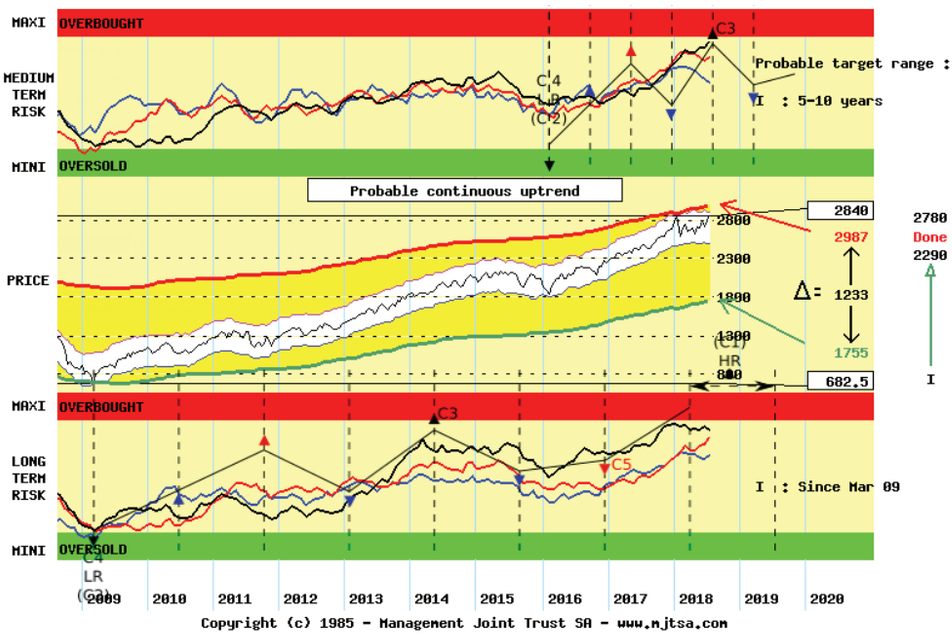


However, it is not the end of the world. Sometime in the first half of September, the aggregated liquidity flows bottom, and the price of risk assets should find support and start to rebound. Even if actual GDP growth in Q3 2018 will be lower than that of Q2 (primarily due to the impact of a previously strong US Dollar *(see last chart above)*, the synergies ignited by a QoQ GDP growth rate above 4.00% should be capable of supporting risk assets prices until early Q4 2018. Then, at that time, it is really time to worry as both liquidity and growth should have a negative impact on risk assets.

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

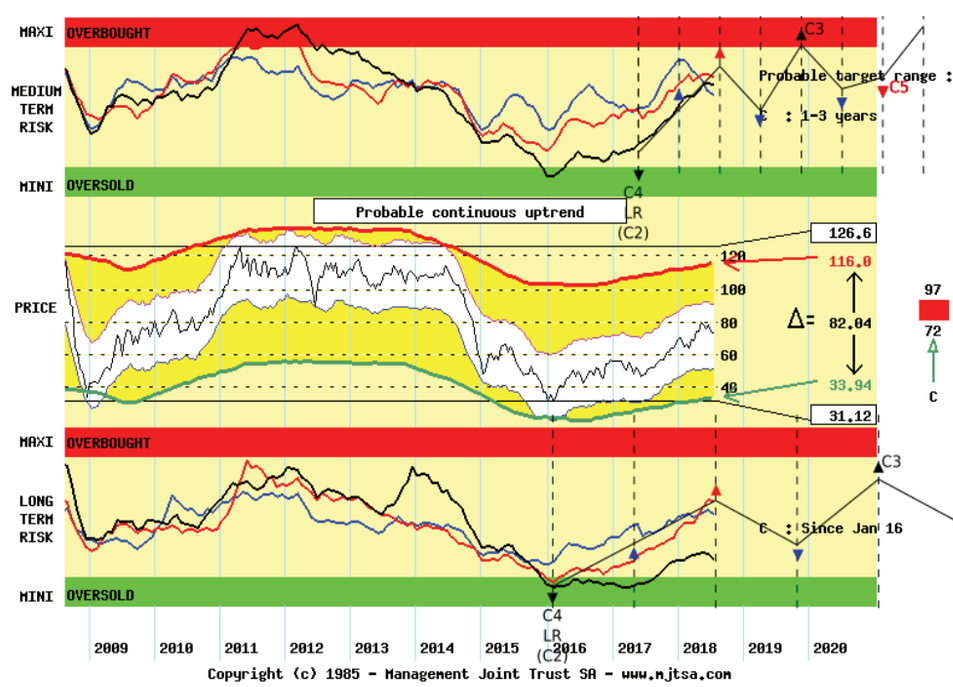
Following the sell-off in January, The Capital Observer turned constructive again on risk assets towards late March and outright positive from late April. Since then, equity markets, and US equity markets in particular, have been climbing a wall of worry, amid the Italian political crisis, endless ups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

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



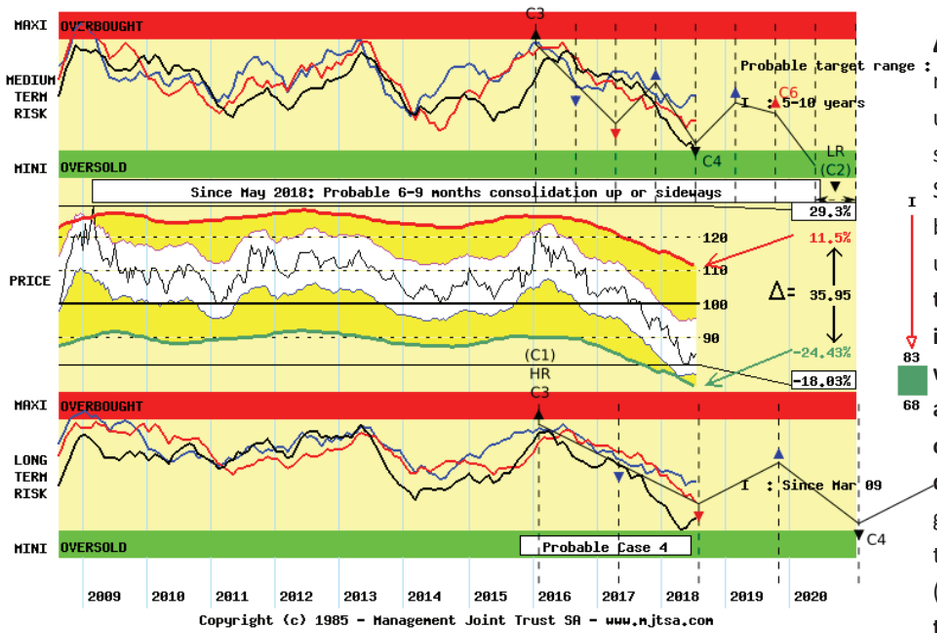
We first start with 4 long term bi-monthly graphs which summarize our view about reflation and why we believe this trend is about to retrace. On this S&P500 graph, our long term oscillators (lower rectangle) have completed a full sequence up since 2009 and have now entered a "High Risk" position. Such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

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



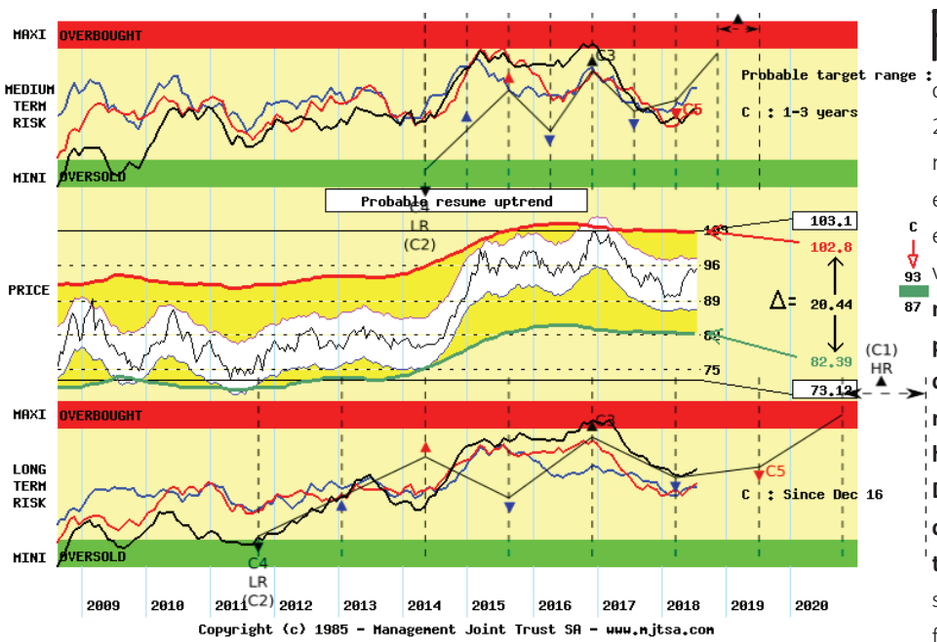
Since early 2016, Oil has been the emblematic commodity of the reflationary recovery. The Oil market first started to rebalance during 2016, retraced some in H1 2017 and then re-accelerated up again into this year. From its lows, below 30 US Dollars a barrel, Brent has managed to more that double, and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

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



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

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

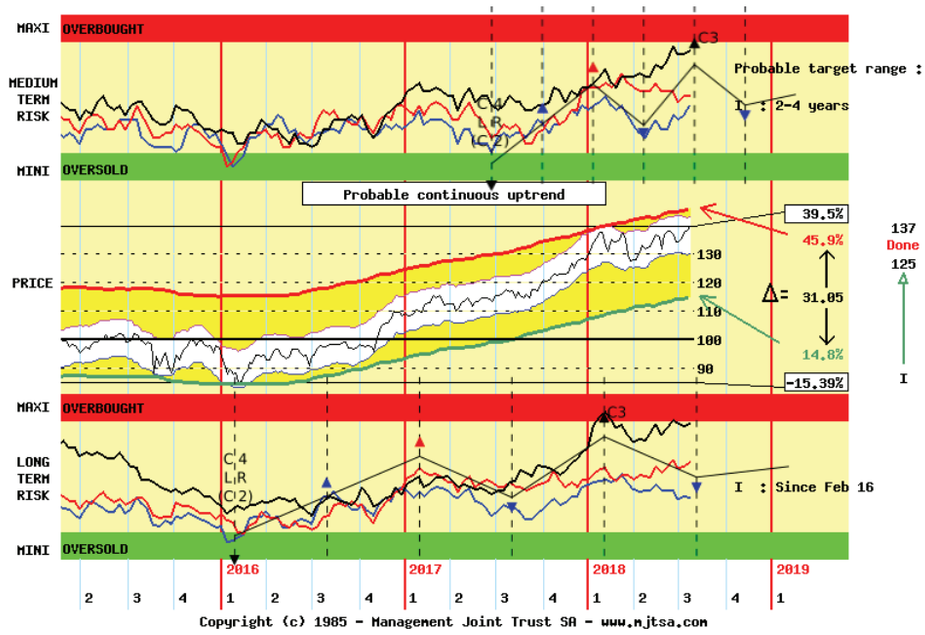


Finally, the US Dollar has had a schizophrenic relation with the recent reflationary trend. Throughout 2016, reflation was mainly a US story, culminating with the economic euphoria around the Presidential election. The US Dollar gradually reversed up and accelerated. **In 2017, many of the upbeat post-election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

Initial remarks:

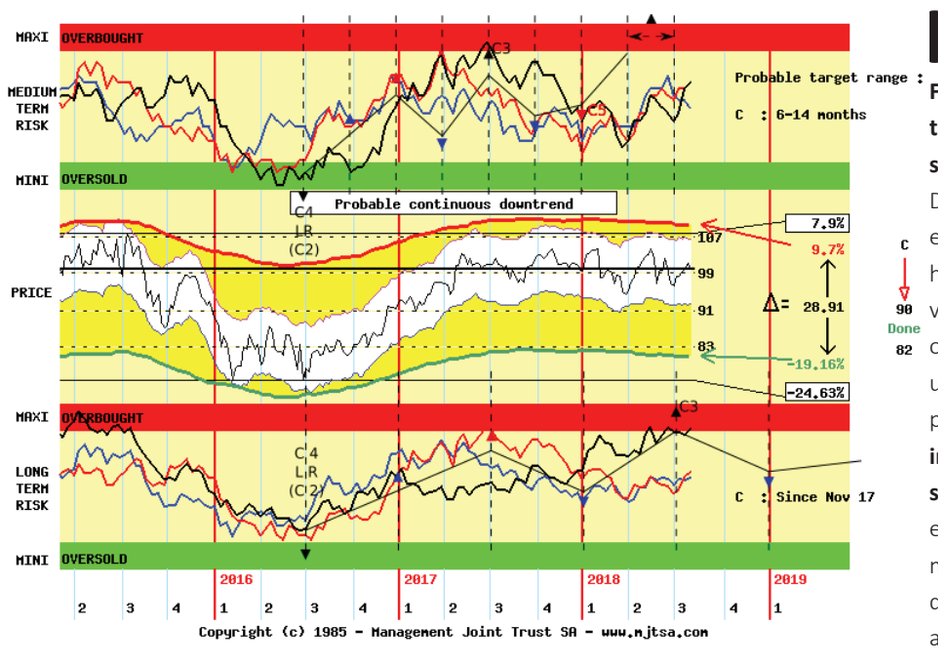
The 4 graphs above hence summarize our cross-asset views towards year-end and then 2019. While we expect the uptrend on the S&P500 to be reaching exhaustion, Defensive sectors should start to rebound vs the market, possibly over the next 3 to 5 quarters. In the meantime, cyclical Commodities, and Oil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

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



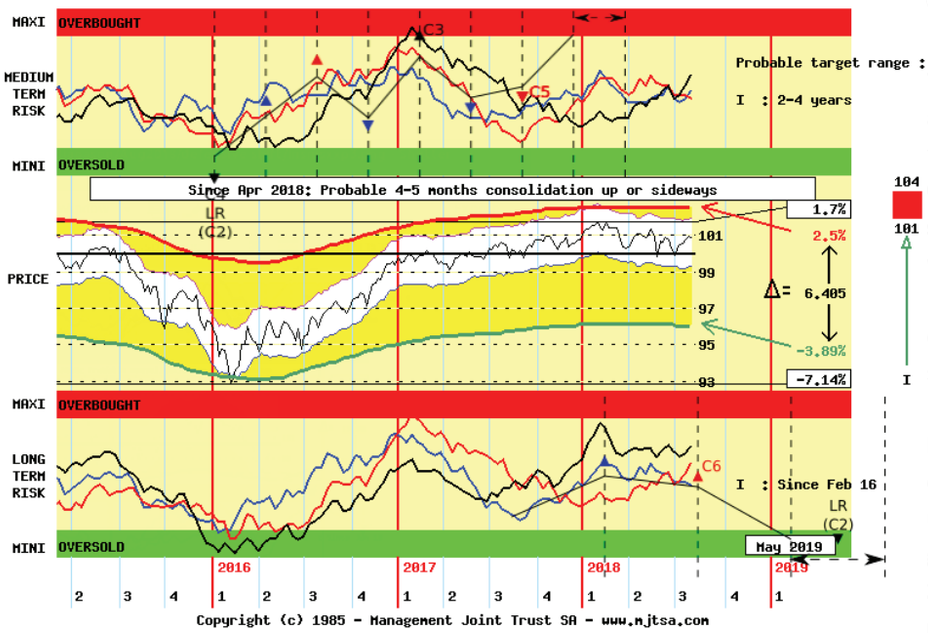
We first consider the relative performance of the S&P500 vs US 10Y Treasuries. Since mid 2016, while the S&P500 was racing to new highs, Treasuries have corrected quite substantially. Indeed, over this period, long term rates in developed countries have managed to pretty much follow short term rates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

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



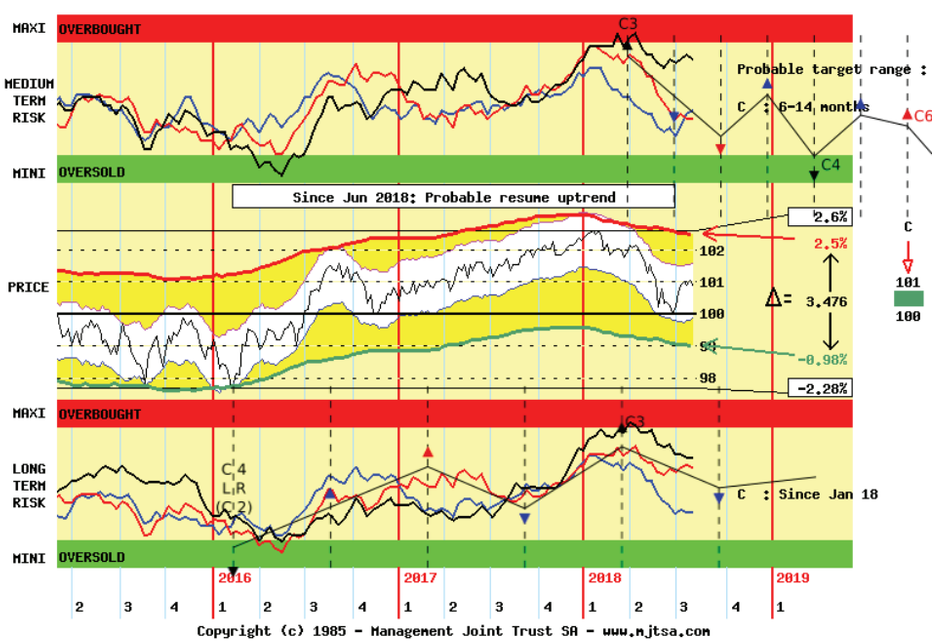
In Europe, the ratio of the EuroStoxx 50 Futures vs Bund Futures lost upside momentum in Spring last year and has since been moving sideways. During this period, our trend envelopes (middle rectangle) have gradually started to reverse down, while both our oscillators series (lower and upper rectangles)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

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



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

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

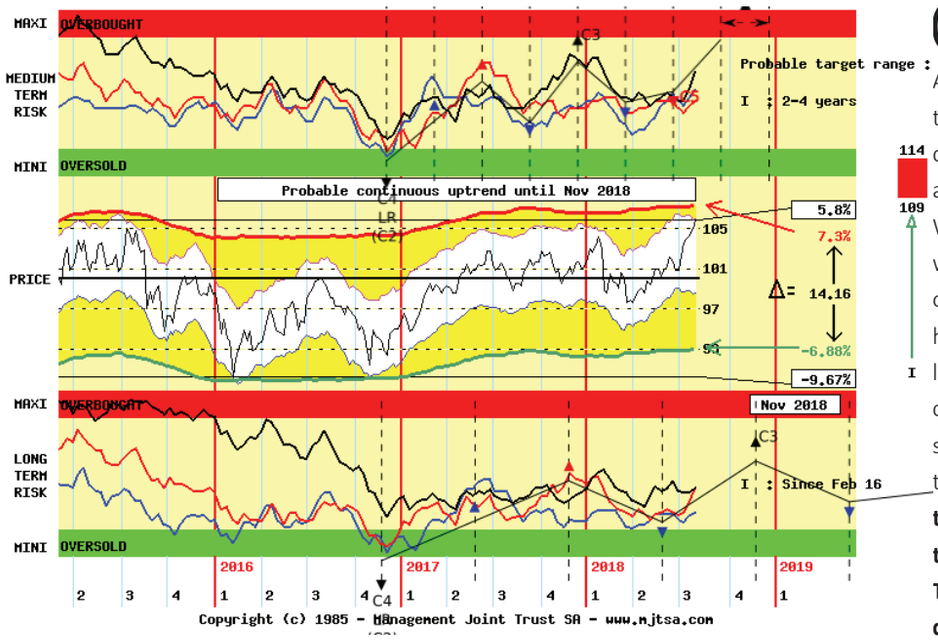


In this graph, we simulate a similar portfolio, which compares equal weighted Long positions in Emerging Markets and diversified European Sovereigns vs equal weighted Short positions in US and German Government Bonds. On our long term oscillators (lower rectangle), **the model we show confirms that a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

Equity to Bonds ratio and Credit spreads – initial remarks:

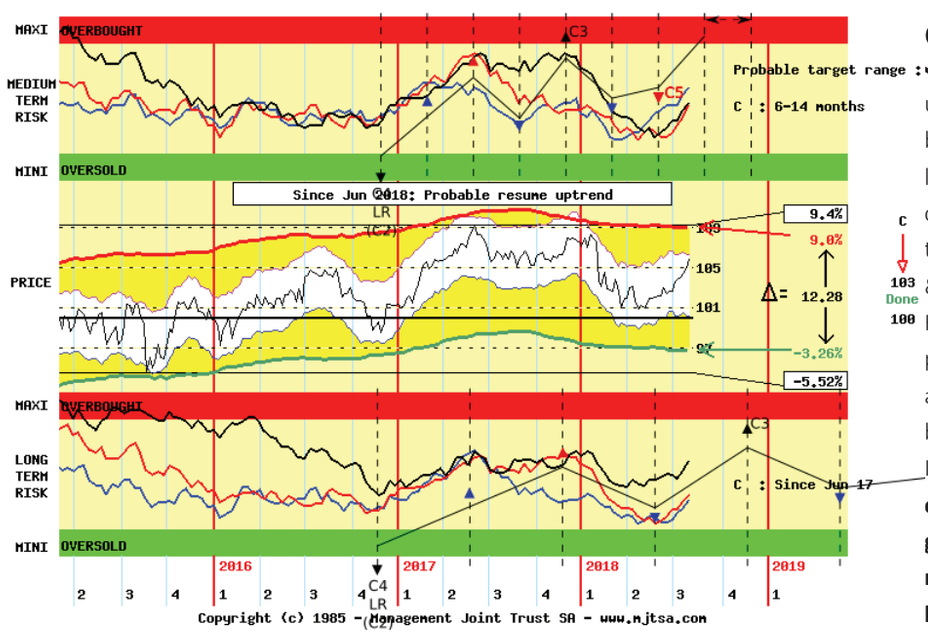
We believe the reflationary uptrend in place since 2016 is coming to an end and that following strong equity outperformance, US Treasuries and German Government Bonds should make a come back vs Equities over the next 3 to 5 quarters. We also expect that Credit and Sovereign spreads continue their recent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

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



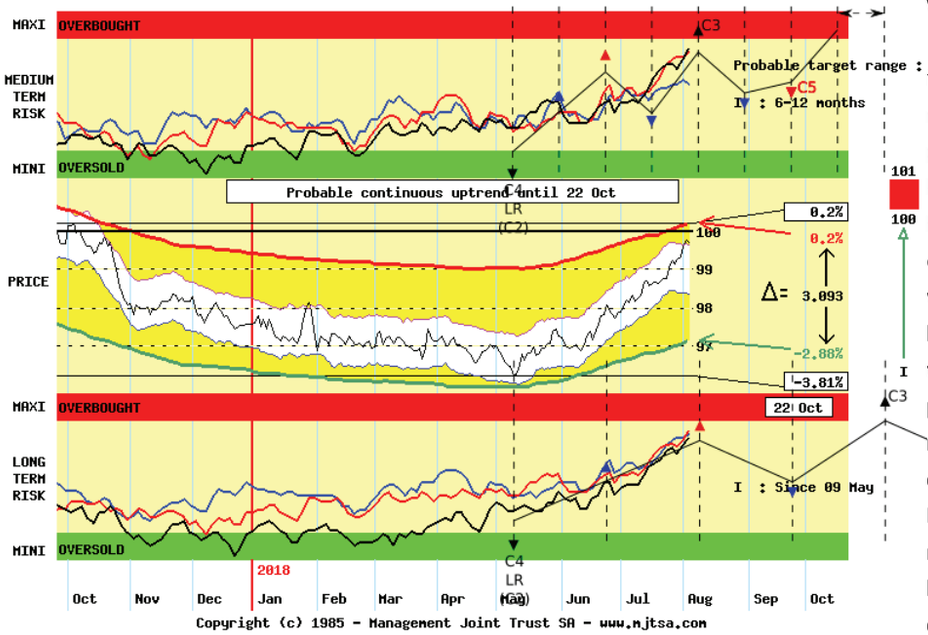
Over the coming pages, we perform similar cross Atlantic simulations to assess the profiles of the various defensive sectors on a stand-alone basis and vs the markets. We first start with Healthcare, which has had a strong run over the last few months and has been one of the market leaders since this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

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



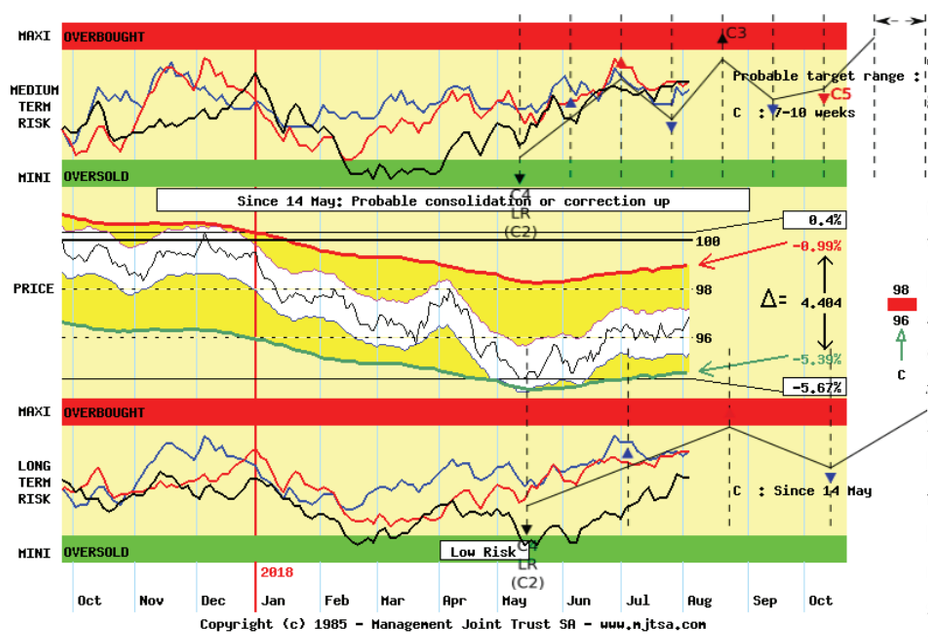
Staples show a similar profile as Healthcare, yet their uptrend since this Spring has been less strong. To simulate this portfolio, we have combined the US Staples sector with the European Food & Beverage and Personal & Household Goods sectors. The portfolio is USD denominated and European positions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

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



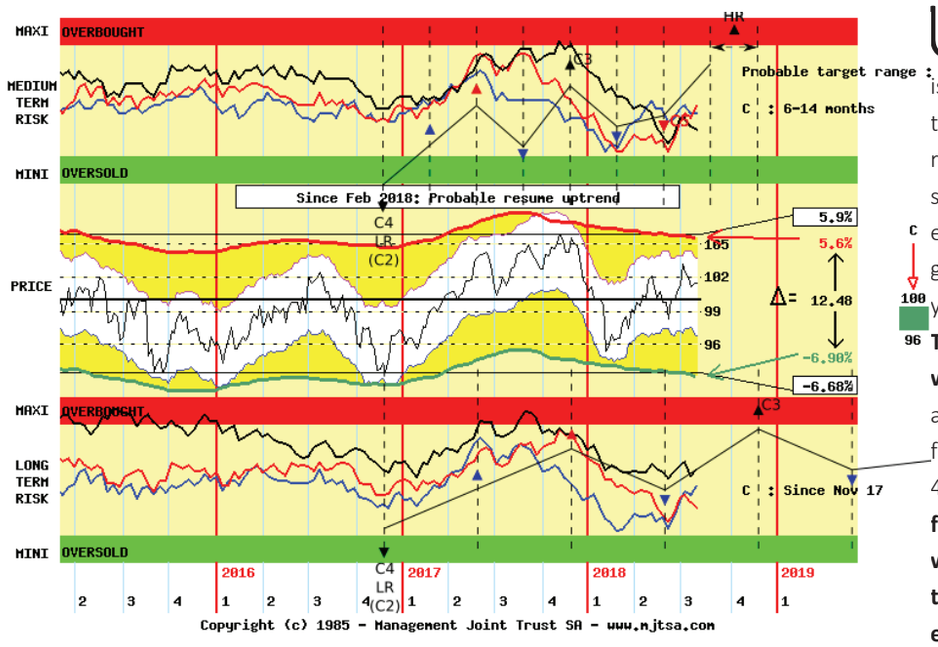
We now turn to the Daily graphs of these 2 defensive sectors and benchmark each element of the portfolio vs its respective market index. This particular graph hence compares Healthcare on both sides of the Atlantic vs the wider market. **Recently, Healthcare's correlation to the market has been quite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

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



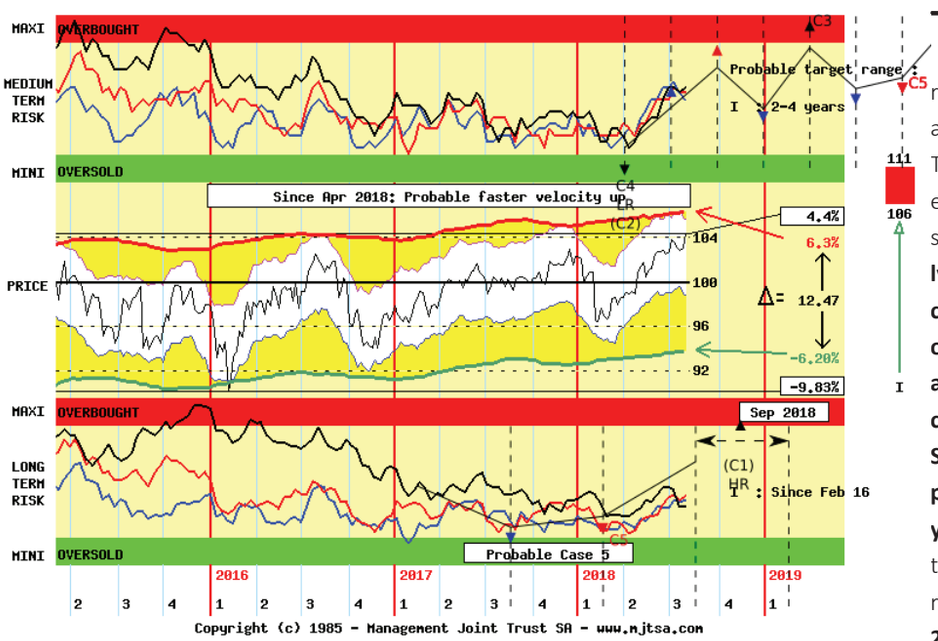
Staples on the other hand are still very much negatively correlated to the markets on a relative basis. On both our oscillator series (lower and upper rectangles), we expect them to outperform between now and the end of August. Following that, they could retrace down again vs the market, probably into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

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



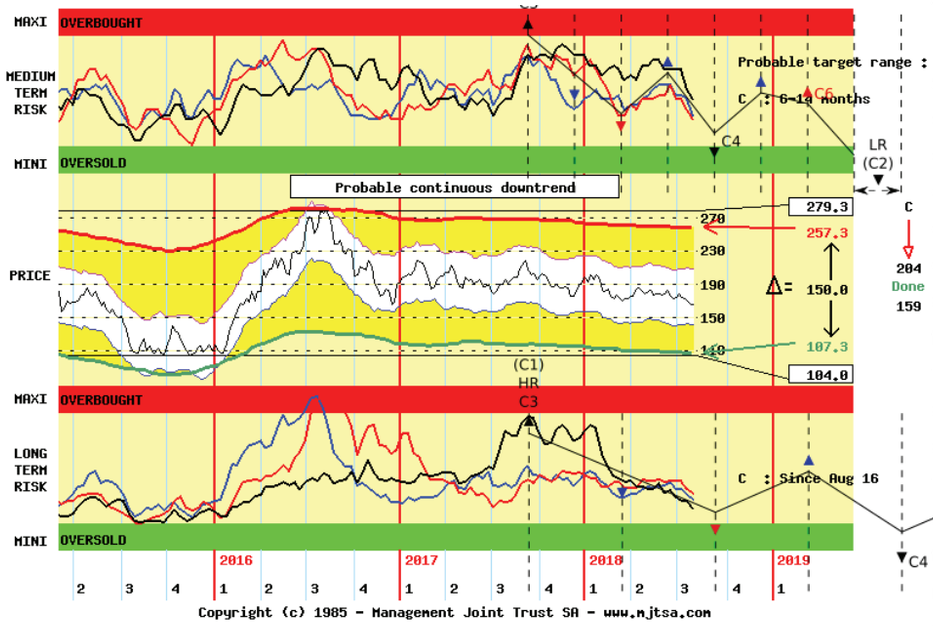
Utilities are also a pure defensive play. The sector is also particularly sensitive to any rise and fall in interest rates. It's a Bond proxy, which since early 2016 has followed equities up, but corrected aggressively each time long term yields have accelerated up. **The flattening environment we expect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

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



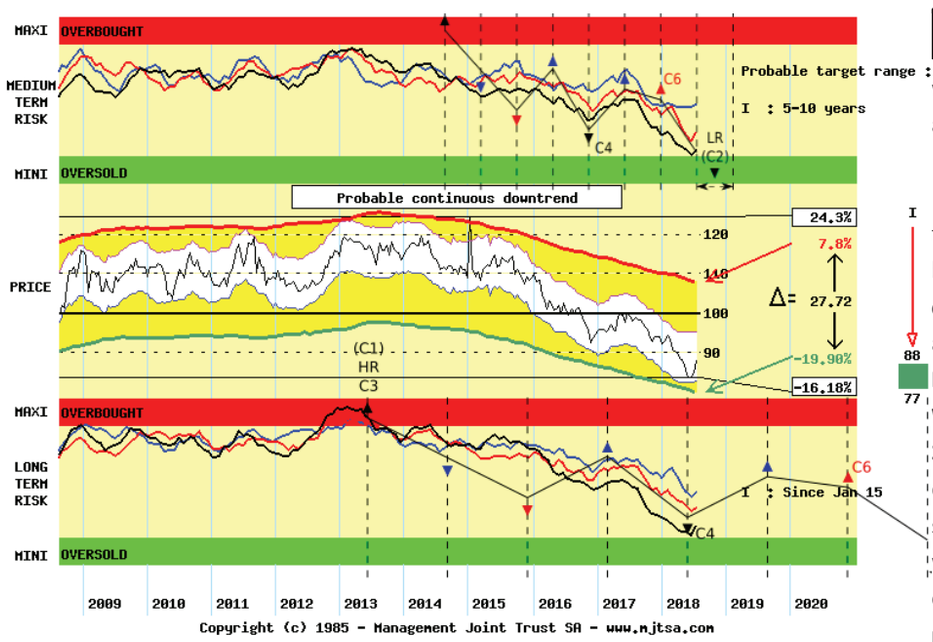
The Real Estate sector is also very sensitive to interest rates and as such shows a similar profile than Utilities. That said, in this late cycle environment, it seems to be stronger. Indeed, **it recently made new highs for this cycle and according to both our oscillator series (lower and upper rectangles)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

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



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

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



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

Concluding remarks

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

23 / What drive equity total returns? (Hint: Earnings Per Share is not one of them; EPS does not even come close)

Earnings Per Share (EPS) in currently front and center in equity price analyses. After all, unexpected EPS data was responsible for the sharp gyrations in the US tech sectors last week. FaceBook (FB) lost circa 20% of its valuation when the company hinted of slowing earnings. The opposite side of the coin is the hyperbolic surge in the equity price of Apple (AAPL), which reported stellar EPS results, pushing up the total market valuation of the company to the trillion-dollar mark. It is so easy to arrive at the conclusion that EPS was THE factor that made all these things happen.

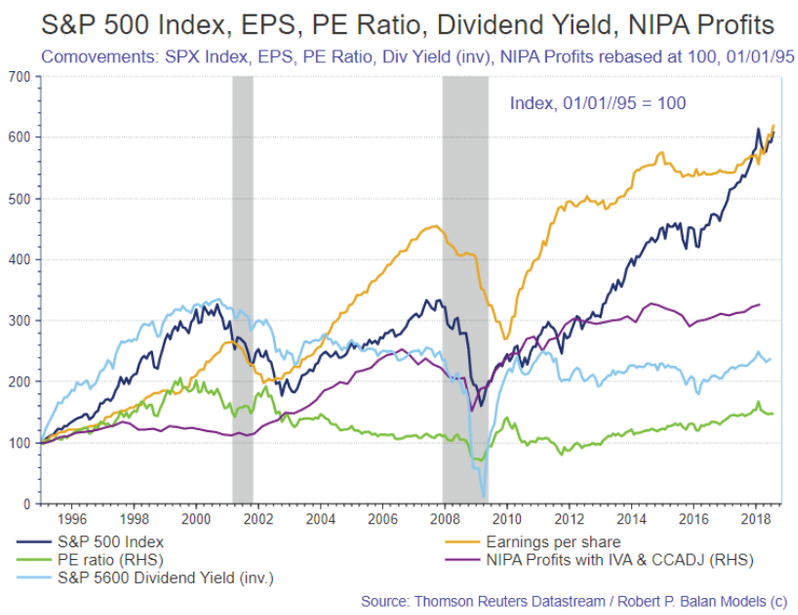
But is a focus on EPS as a prime move mover of aggregate equity returns (indexes) justified? We have done a significant amount of work in the subject, and our conclusion is a flat "NO". At the risk of being derided by EPS stalwarts, we publish this report which offers evidence (at least to us) why EPS is an indicator which lags behind most equity metrics by a virtual mile. Ironically, the saga of EPS starts with another measure of US corporate profits – the NIPA Profits from the BEA.

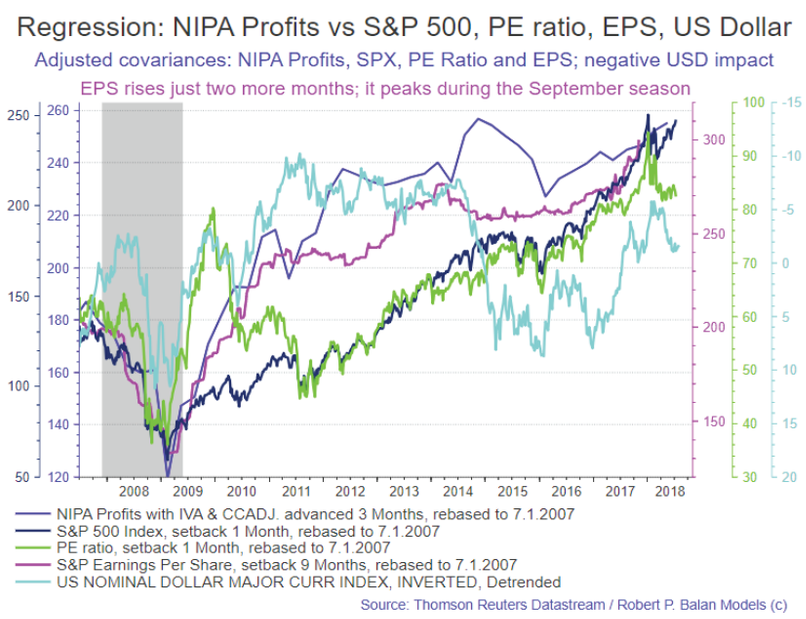
What are NIPA profits?

These are corporate profits from current production, which represent the portion of the total income earned from current production that is accounted for by all U.S. corporations, including those, which are not quoted, some of which are subsidiaries of foreign companies. Profitability provides a summary measure of corporate financial health and thus serves as an essential indicator of economic performance.

NIPA measure of profits is a particularly useful analytical measure of the health of the corporate sector, one which does not show profits attributable to capital gains. **Moreover, the turning points in NIPA Profits generally come ahead of the S&P 500 Index itself, Dividend Yields, the S&P 500 P/E ratio and Earnings Per Share measures – especially the latter** *(see first chart below)*. **It should be the starting point of any exhaustive equity market analysis.**

Here is another view with other elements that drive the valuation of equities, this time including the US Dollar in its inverse. And this time, we have the inflection points adjusted and synchronized *(see 2nd chart below)*.

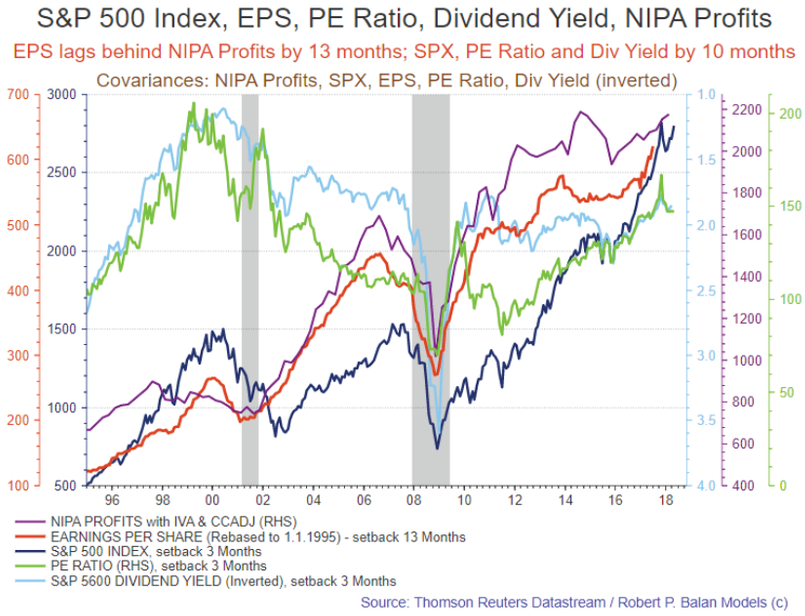




Even allowing for a reporting delay of 1 quarter, NIPA Profits provide good optics as to how the rest of the equity market data will evolve in the near future. We can see that in a multi-factor regression analysis *(see first chart on this page)*.

There are several factors in this regression chart that stand out:

1. The equity price and profits are distinctly correlated, and the relationship is likely concurrent - that is a subject discussed in more detail at the later part of the article.
2. **The evolution of Earnings Per Share (EPS) matches the movements of price and NIPA profits to a reasonably high degree, but the EPS changes severely lag behind changes in both price and NIPA profits (by as long as 12 to 13 months). That does not bestow any predictive value on this variable to any degree**. It is a follower - not a leader. It has the same function as the US oil inventory data – it impacts market sentiment temporarily, but it's evolution lags so far behind the market, it is useless as equity price determinant.
3. EPS will likely rise further over the next two months, but it will not impact the trajectory of equity prices during that period. Rather, a sharp decline in EPS after a September peak will greatly impact equity prices for the rest of the year. It may well define the peak of the S&P 500 this year.
4. The differences in the process of determining the individual profits of S&P 500 companies and the nationwide corporate profits (more details below) would probably explain some of the variations between the S&P 500 EPS and the NIPA Profits.
5. **Nonetheless, knowledge of the temporal sequence of these variables undermines the cult of EPS as a predictor of future equity prices. It is current equity prices (and the concurrent NIPA Profits that are implied) which will determine subsequent EPS, not the other way around.**



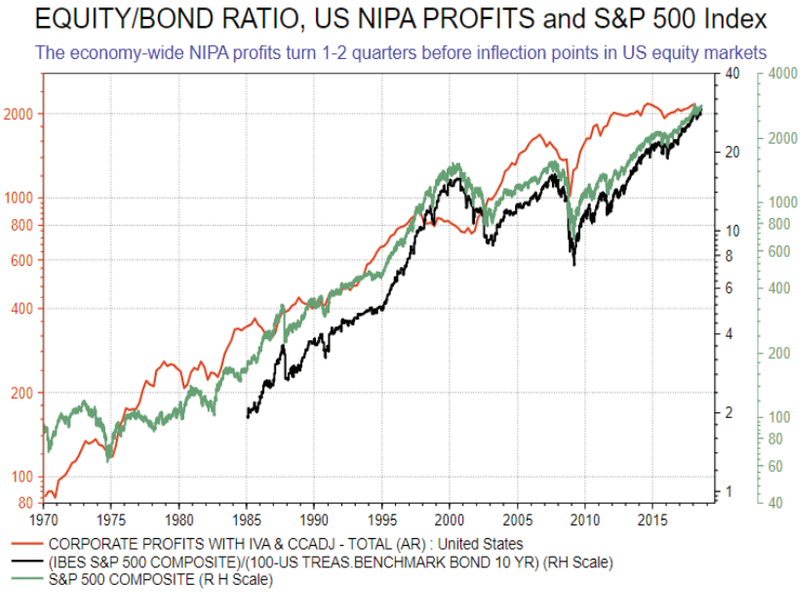
Source: Thomson Reuters Datastream / Robert P. Balan Models (c)

What are NIPA Profits?

Note that NIPA Profits and the profits published by US companies (S&P EPS as proxy) are defined in very different ways, and in recent years, they have increasingly diverged. The divergence is due to the much greater incentives for management to alternately over- and understate the "true" profits, and their much greater ability to do so. Simply put, profits published by companies have become even less "honest" than they used to be. This makes NIPA data much more reliable than those published by companies. One reason is that NIPA profits are part of the Gross Domestic Product when measured in income terms; and necessarily this measure must equal, subject to small statistical discontinuities, to GDP as a measure by expenditure. There is no similar check on the validity of the profits published by companies – despite SEC regulations, it is so easy to "cheat" or prevaricate profitability data. We will highlight the variances of this correlation at the later part of the article.

NIPA profits highly correlated with Equity Bond/Price Ratio and the S&P 500 Index itself

NIPA profits are highly correlated with the Equity Bond/Price Ratio and intuitively indeed, with the S&P 500 Index itself. The basic relationship: profits drive equity prices. Moreover, it can also be shown that NIPA profits, in its nominal form, turn 1-2 quarters before inflection points in US equity markets. *(see graph below)*



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

Therefore, if you know what state profits are in, that should provide indications of where equity prices should be going. It is a simple relationship - except for the fact that NIPA Profits data is reported 1 quarter late.

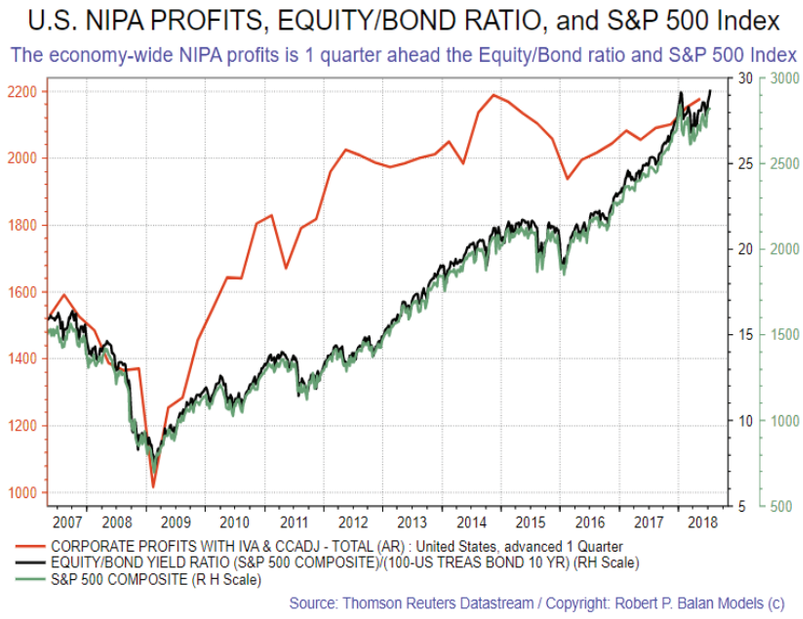
That ceases to be an issue if you adjust for the reporting lag (move the NIPA data 1 quarter ahead), and what you get is the first chart on this page.

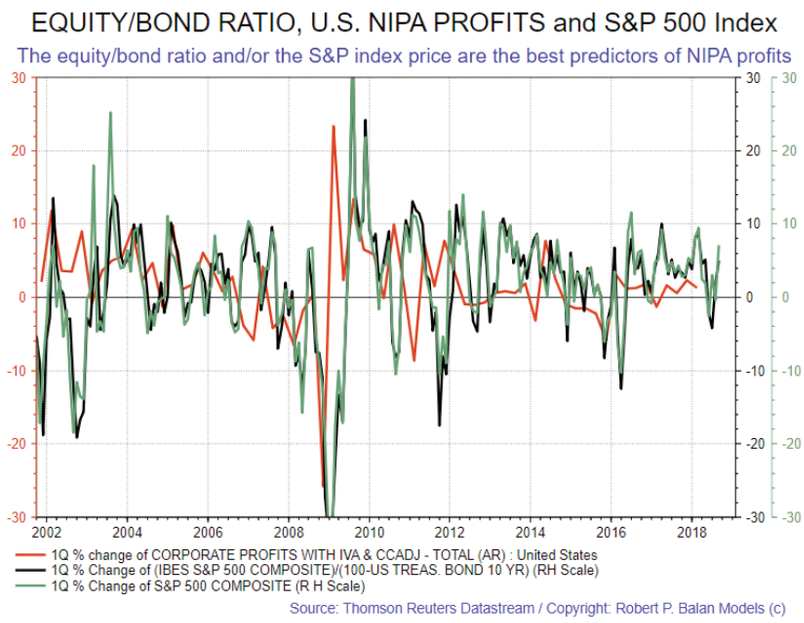
What is the significance of the juxtaposed data?

This simple data tweak means that the equity/bond ratio or the S&P 500 price has become the predictor of the NIPA profit itself. How? If profits drive equity prices, it is easy to make the short leap of faith that equity prices have been rising because the NIPA profits have been rising as well (and vice versa), although we would not know that until a full quarter later, when the NIPA data is published.

How can we prove this to be true?

A simple graphical analysis will prove or disprove this thesis. If the S&P Index price is indeed a real-time manifestation of the much-delayed NIPA profits, then change rates in the real-time S&P should also eventually be seen in the changes in rates in the much-delayed NIPA profits. And we see that to be generally true in the second graph on this page:





If NIPA Profits lag behind real-time equity data, of what use is it?

NIPA Profits, by construction, lag behind real-time equity data and the equity/bond ratio, but it is very useful in one respect - it leads the Fed's Equity Risk Premium (the Fed Model) and a like-for-like S&P 500 Risk Premium (which compares the risk of investing in equities against corporate bonds - the real conundrum for most investors). Equity Risk Premium (*(ERP) properly defined, is the expected return on stocks in excess of the risk-free rate. The ERP serves as a metric of how desirable it is in buying equities against holding bonds. In the Fed model, ERP is calculated as the equity earning yield less the 10yr Treasury long bond yield. In our like-for-like ERP, it is the S&P 500 earnings yield less the corporate BAA bonds. The Fed model is a universal metric of the attractiveness of equities versus bonds, while our S&P ERP limits the comparison to the S&P 500 universe, between SPX equity prices and S&P corporate bonds.

We can show that changes in NIPA Profits provide as long as a 7-quarter lead over changes in the Fed's ERP model and the S&P ERP. See that in the first chart on the next page. The immediate implication from this study: in the near-term bonds (govies and corporates) may become more attractive than equities.

Finally, where do NIPA profits come from?

Put differently, what is the primary factor that influences whether corporates, nationwide, turn in profits or not? As always, it boils down to funding - Corporate Net Cash Flow leads changes in NIPA Profits by 2 to 3 quarters.

Net Cash Flow is equal to undistributed corporate profits with IVA and CCAdj plus consumption of corporate fixed capital less capital transfers paid (net). It is a profits-related measure of internal funds available

for investment (BEA definition). IVA is inventory valuation adjustment factors, and (CCAdj) is the capital consumption adjustment.

Net Cash Flow also leads major changes in US GDP growth by the same period. And this is one of our arguments why a focus on NIPA Profits as a predictor of subsequent economic growth or asset price is important, but is not the be-all in a comprehensive analysis. **We put it this way: Cash Flow is the dog, NIPA Profits the spine, and equity prices or other micro-economic data (like payrolls) the tail of the dog. To complete the simile, Cash Flow is the dog that moves the spine (NIPA Profits) which wags the tail (equity prices)** *(see 2nd chart on this page).*

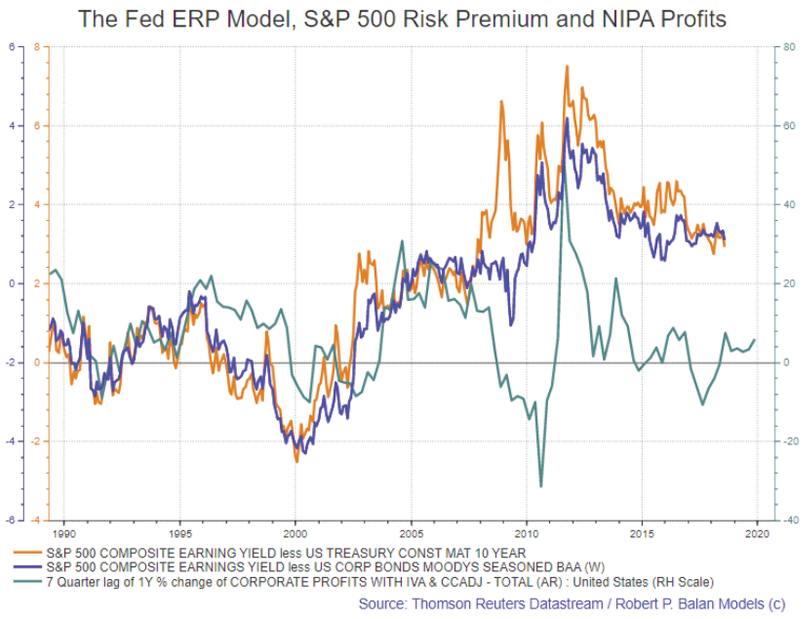
Squaring the circle:

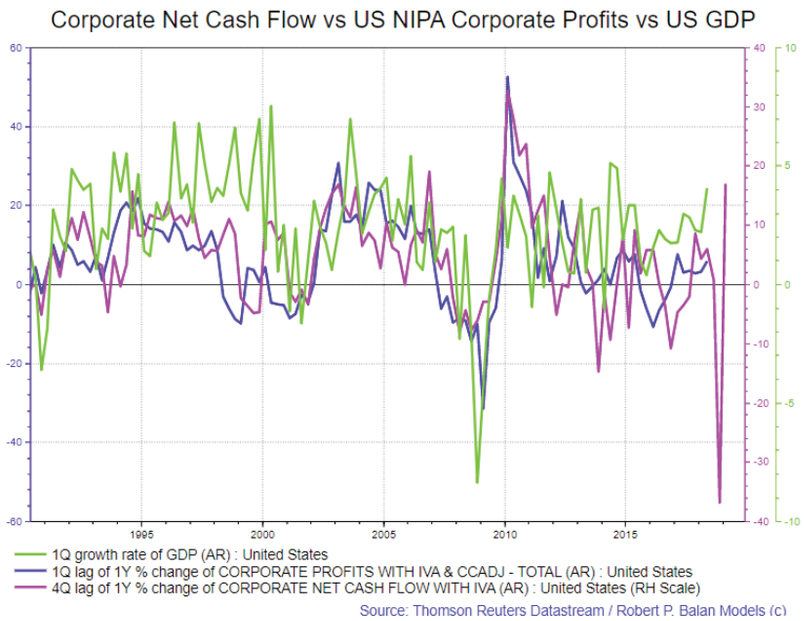
If Corporate Net Cash Flow can provide leads as to the future development of NIPA Profits several quarters ahead, then it follows that Cash Flow should provide clues as to the future trajectory of the S&P 500 broad market - and it does. Cash Flow tells you what to expect of the broad market as far as 3 quarters ahead. *(See 3rd chart on this page)*

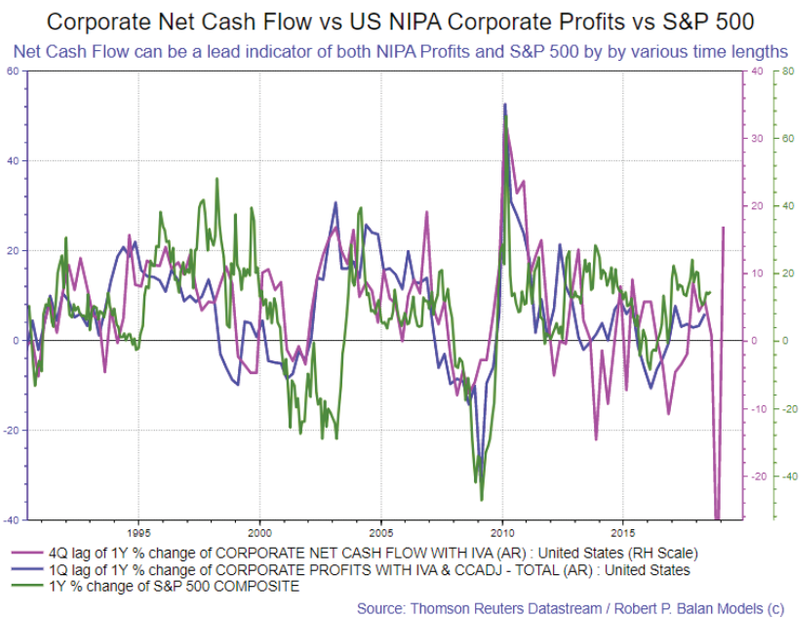
What the chart above implies is that it takes 2 quarters for the impact of funding to percolate into the business profit dynamics, and the profits then work concurrently into the equity price evolution. Subsequently, all of these come to a head when NIPA profits data are released, with a 1-quarter delay from real-time equity prices. Earnings Per Share (EPS) will make its impact a full year after changes in the Corporate Net Cash Flow has set the entire sequence into motion.

Conclusion:

If we escalate the inquiry philosophically, we should also ask: where do Corporate Net Cash Flows come from? We have been working on this issue for some time, and we have arrived at some preliminary conclusions. Corporate Cash Flow is





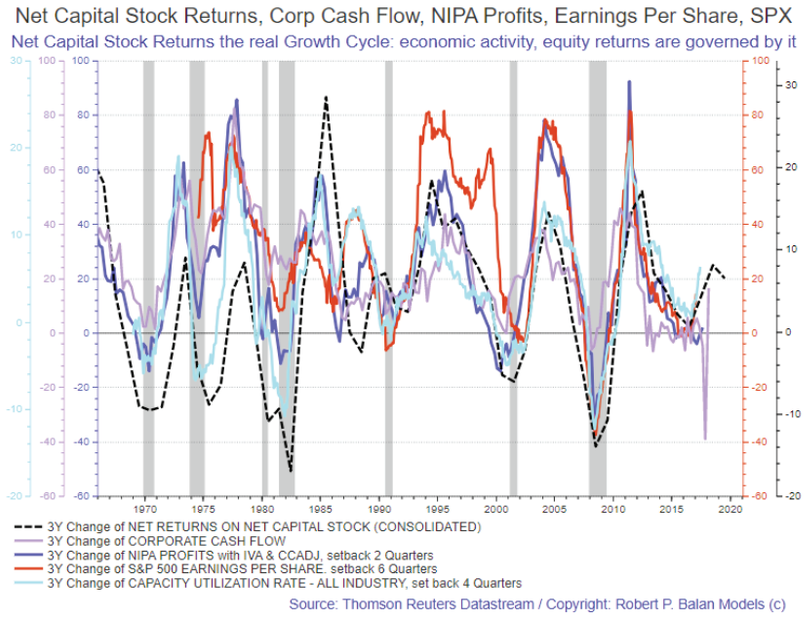


likely derived from Net Capital Stock Net Returns *(see chart on this page)*.

Net capital stock is described by the OECD as the sum of the written-down values of all the fixed assets still in use is described as the net capital stock; it can also be described as the difference between gross capital stock and consumption of fixed capital. Its impact on economic activity, and therefore on equity return measures, is pervasive.

Net Capital Stock Net Returns, for us is the real Growth Cycle. We have seen enough indications that it is the corporate equivalent, and a robust rival, of the bond market's yield curves insofar as capability to predict growth and asset price trends are concerned. We have seen enough evidence that the properties which allow corporate cash flows and NIPA profits to predict equity price trends come from the evolution of Net Capital Stock Net Returns.

The direct links between Net Capital Stock Net Returns and equity prices is a worthwhile study. But that is another article in a subsequent issue of the Capital Observer.

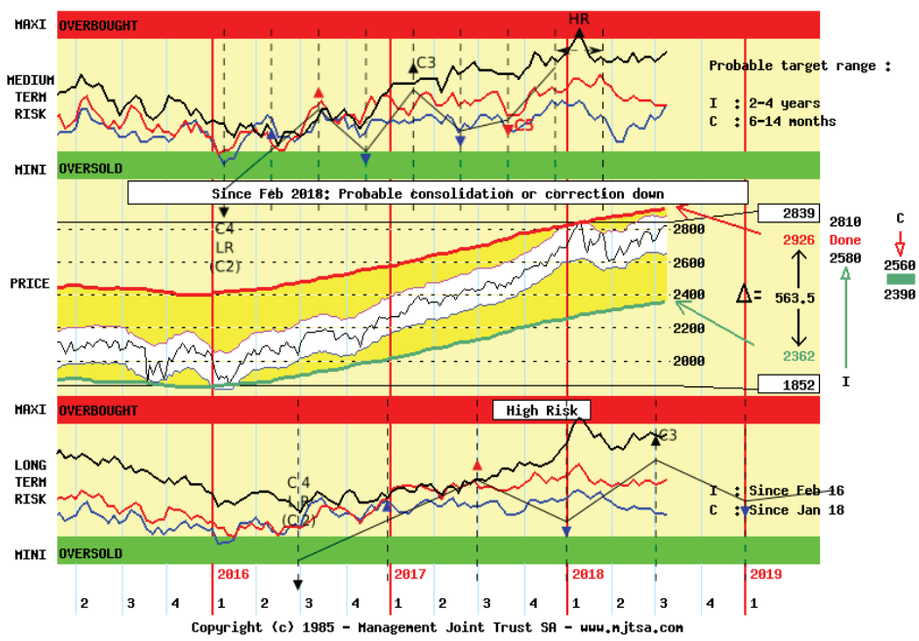


28 / MJT - TIMING AND TACTICAL INSIGHT

Rather than a shift towards Value, we believe that the recent weakness in the Nasdaq is a Defensive warning

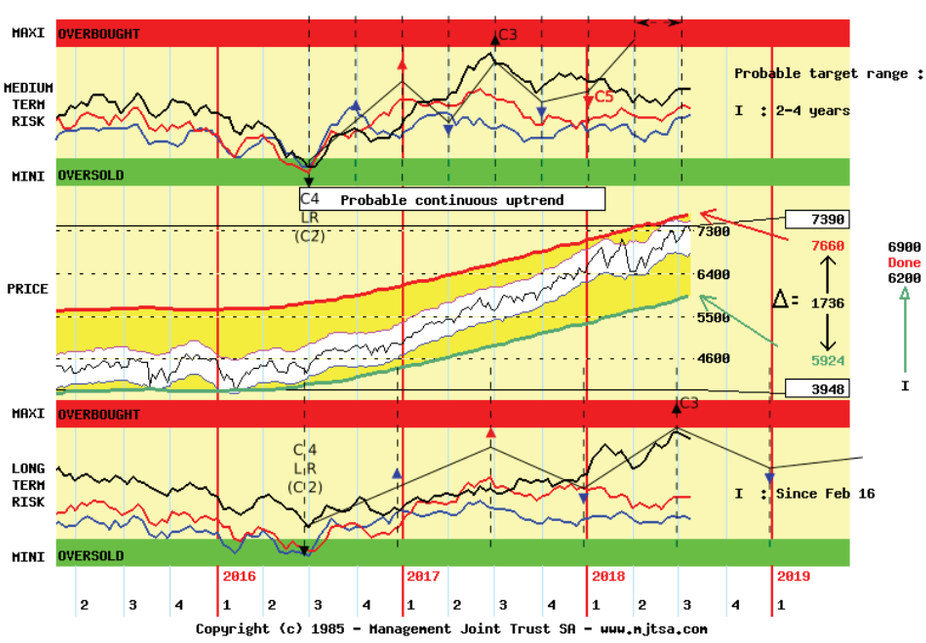
During the second half of July, many cyclical assets such as Emerging markets or cyclical sectors (e.g. Industrials and Energy) did manage to rebound vs the S&P500. On the one hand, this rebound can be explained by a slight steepening bounce in the US yield curve. On the other, two prominent Big Growth stocks, Facebook and Netflix, did deceive on earnings. The Nasdaq 100 started to correct and many voices in the market came out to forecast a major shift from Growth to Value. We believe this call is premature as we expect the yield curve to continue to flatten into late Q4 (a strong tailwind for Growth vs Value). The fact that some of the FAANGs stocks are starting to deceive and correct, in our view, rather signals the beginning of a Defensive shift in the market, rather than a rotation towards Value. Below, we go over the main US and international equity markets to confirm this view.

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



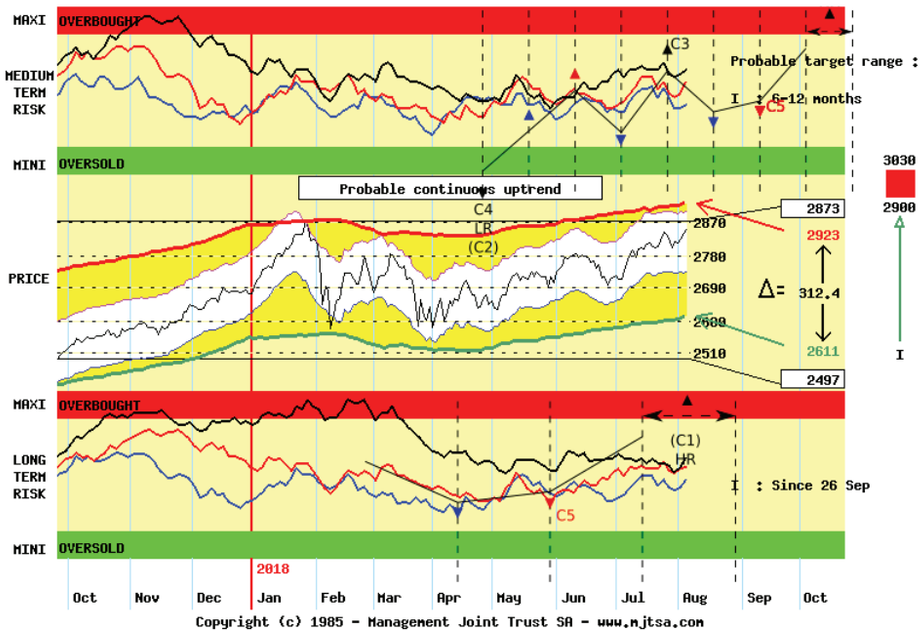
Following the uptrend sequence it completed in January on our medium term oscillators (upper rectangle), the S&P500 Index has been in a "High Risk" position as confirmed by our automatic messaging. Just recently, a second uptrend sequence, which we show on our long term oscillators (lower rectangle), may have been completed. We believe that it marks **a retest of the January highs and that it probably confirms an important inflection point to the downside for the S&P500. At this stage, risk/reward is also quite disadvantageous**. Our I Impulsive targets to the upside (right-hand scale) have been achieved for the second time this year (and are now labelled as "Done"), while our C Corrective targets to the downside point to **initial support in the 2'560 (February/March lows) - 2'390 (January 2017 highs) range, 10 to 15% below current levels.**

Nasdaq 100 Index
Weekly graph or the perspective over the next 2 to 4 quarters



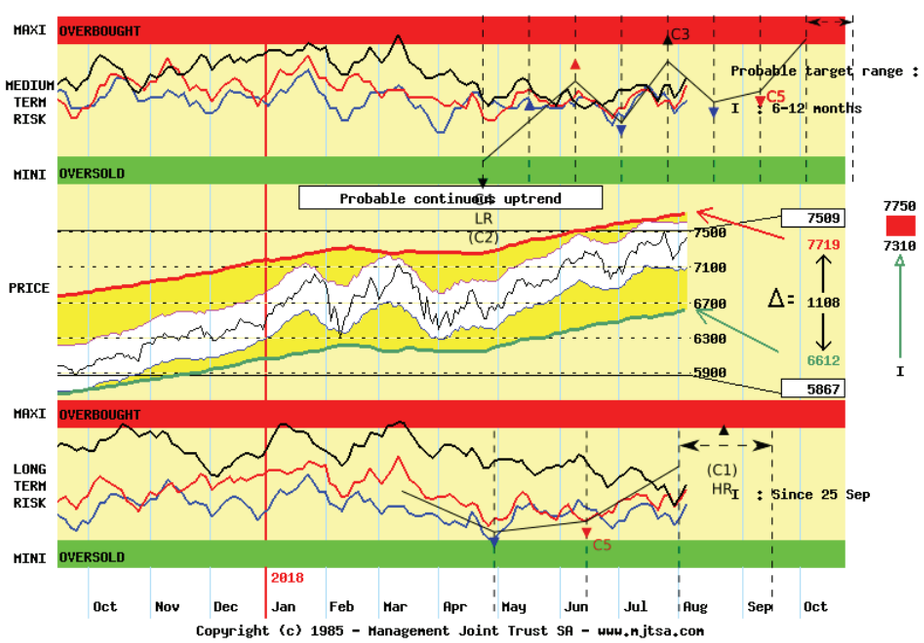
The graph on the Nasdaq 100 seems even clearer. Both oscillators series (lower and upper rectangles) just completed their uptrend sequences on the new highs, which were just made in July. Our I Impulsive targets to the upside have also been achieved (right-hand scale). **Hence, the timing looks right to call an important top, while the upside potential is exhausted (i.e. the risk/reward is extended anyways).**

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



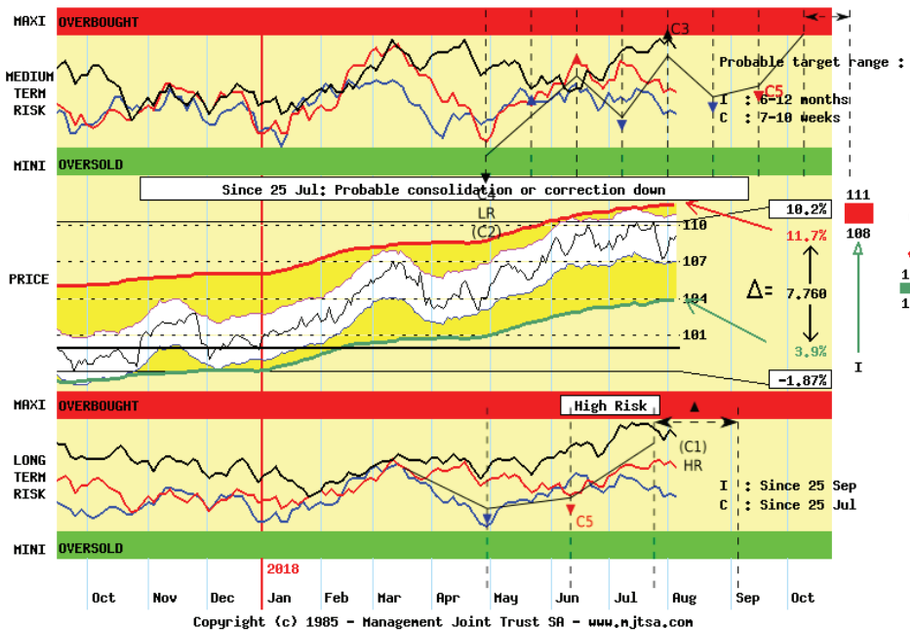
On the Daily graph, our long term oscillators (lower rectangle) are back in a "High Risk" position, while our medium term oscillators are approaching a potential top (upper rectangle). We expect it to materialize over the next week or so, and initiate a correction to the downside that could last until late August / early September in first instance (upper rectangle). On the target front, there is still some upside potential left (right-hand scale), and theoretically the S&P500 could still reach new highs. Yet, we believe that the time window to do so is closing and that anyways, the downside risk is at least as high as the upside potential (we calculate 2-7% upside potential, vs 6 to 9% initial downside risk). **In general, this Daily graph situation is rather toppish, but not that stretched. Yet, given our weekly (previous page) and bi-monthly graphs (page 15 of this issue), which are now quite extended, we would confirm that we are now in take profit mode on the S&P500**. Last month we had already anticipated that this could be the case between late July, early August.

Nasdaq 100 Index
Daily graph or the perspective over the next 2 to 3 months



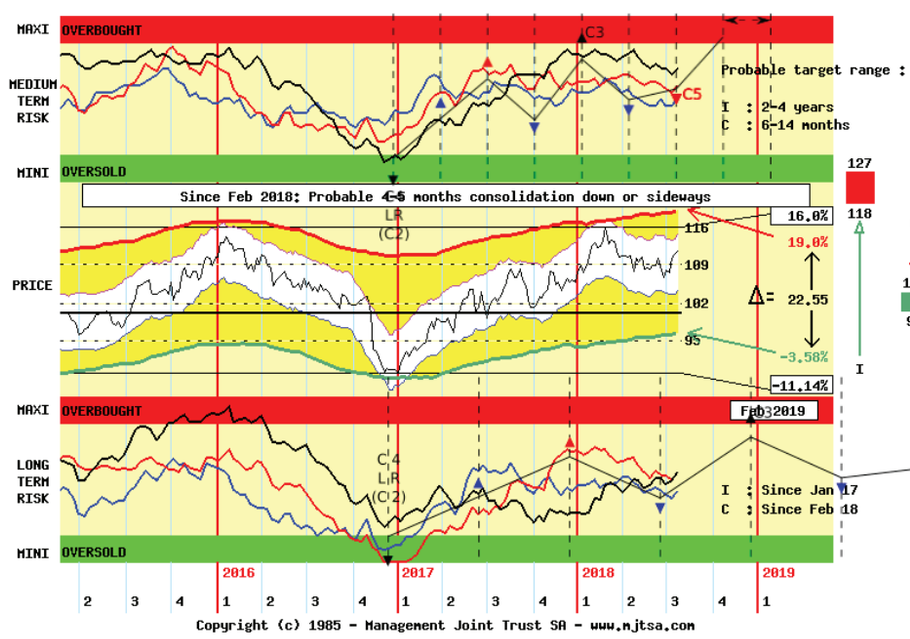
This situation is similar, yet more extended on the Nasdaq 100. Our long term oscillators (lower rectangle) have reached a "High Risk" position, while the top we were expecting on our medium term oscillators (upper rectangle) has probably already been done. Our I impulsive targets to the upside (right-hand scale) have pretty much been achieved late July, while the C Corrective targets to the downside we initially calculate are around the 6'950 – 6'620 range. **The risk/reward is hence disadvantageous. Our view is that the initial correction may have already started late July and that it could extend into late August / early September** (medium term oscillators; upper rectangle). Following that, the Nasdaq 100 may attempt to retest up towards late September / October, yet we have no guarantee that it will manage to match or even exceed its recent highs. Hence, we also believe that it is now take profit time on the Nasdaq 100.

Nasdaq 100 Index / S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



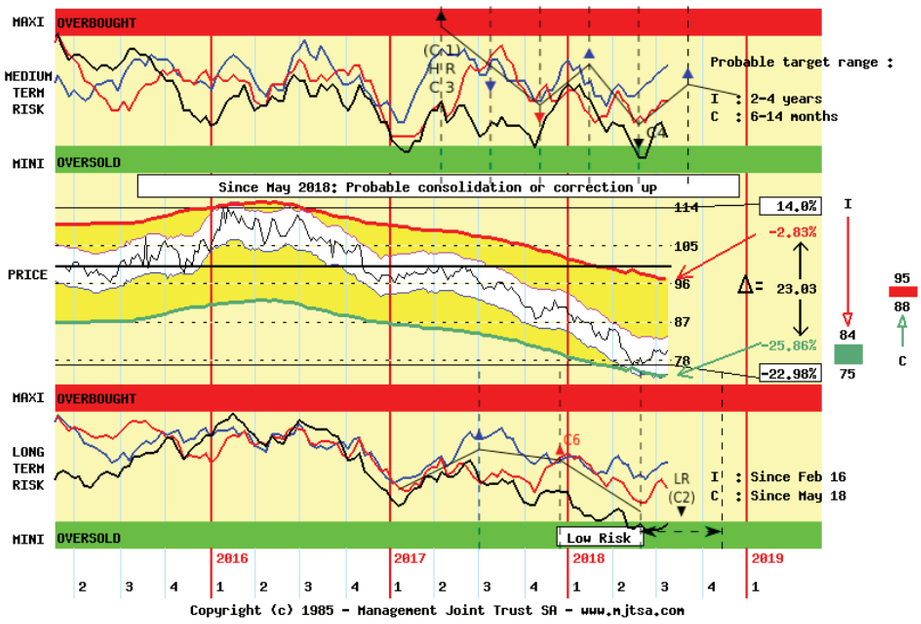
We now compare the Nasdaq 100 vs the S&P500. The ratio also looks extended. As with the S&P500 or the Nasdaq 100 standalone, it also entered a High Risk position on our long term oscillators (lower rectangle). It probably also made an important top late July on our medium term oscillators (upper rectangle), and could also initially correct down towards late August / early September. Risk/Reward is also extended (right-hand scale), i.e. our I impulsive targets to the upside (right-hand scale) have been achieved, while our C Corrective targets to the downside are pointing towards 3 to 5 % underperformance for the Nasdaq 100 vs the S&P500 over the coming weeks. **These projections are very similar to the ones we expressed above on the S&P500 or the Nasdaq 100, yet we believe that these similarities are simply due to the higher beta profile of the Nasdaq 100 vs the S&P500, rather than a shift from Growth to Value.**

S&P500 Growth / Russel 2000 Value
Weekly graph or the perspective over the next 2 to 4 quarters



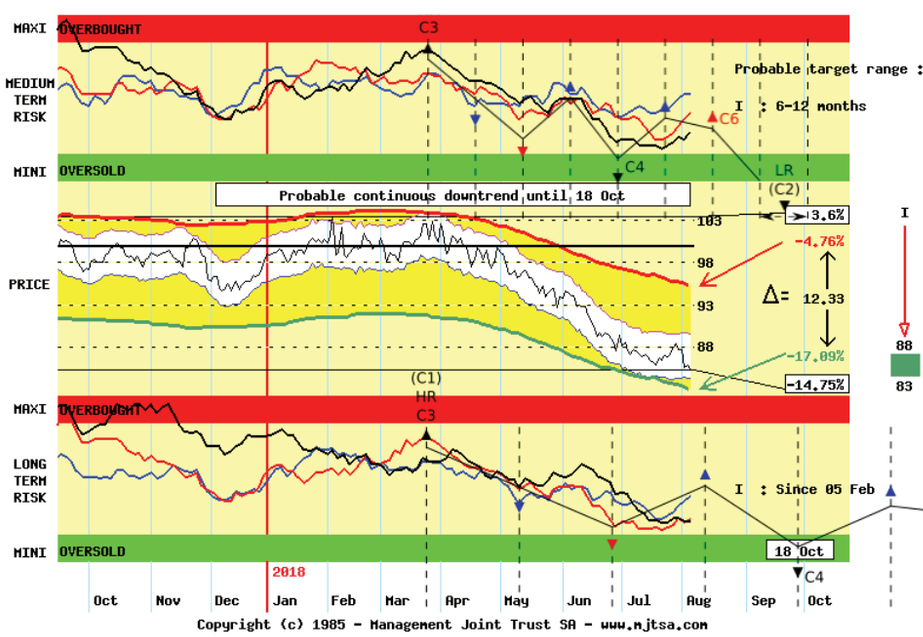
Further down in this issue, as part of our US yield curve analysis (page 52), we compare the Value to Growth relationship within the S&P500 and conclude that Growth will probably continue to outperform Value at least into Q4 this year. In this graph, we push this comparison to an extreme, by comparing Big Growth (the S&P500 growth constituents) vs Small Value (the Russell 2000 value constituents). **The resulting ratio is rather defensive, or at the least quite counter-cyclical**. On both oscillators series (lower and upper rectangles), **it is still clearly in an uptrend, possibly until late Q4 and perhaps even into 2019**. Our I impulsive targets to the upside (right-hand scale) are pointing to **compelling upside potential for Big Growth vs Small Value during this period.**

US Consumer Staples / S&P500
Weekly graph or the perspective over the next 2 to 4 quarters



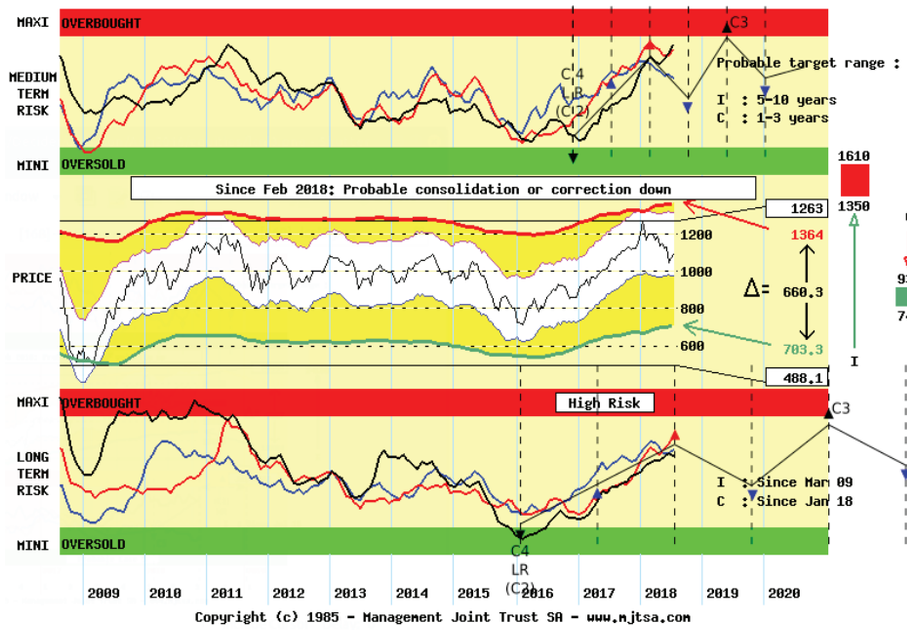
We now move further into the defensive spectrum and compare the US Staples sector vs the S&P500 Index. Both oscillators series (lower and upper rectangles) have probably reached "Low Risk" situation and we are anticipating that **US Staples outperform the market, probably during the next 6 to 12 months.** Their underperformance risk is pretty much exhausted, i.e. our I Impulsive targets to the downside (right-hand scale) have been achieved, and our C Corrective targets to the upside are suggesting that **even in the case of a temporary rebound, Staples may outperform the S&P500 by 10 to 20% over the next few quarters. This ratio certainly calls for a much more defensive environment for risk assets into late 2018 and 2019** (also see its bi-monthly graph on page 16 of this edition).

MSCI Emerging Markets / S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



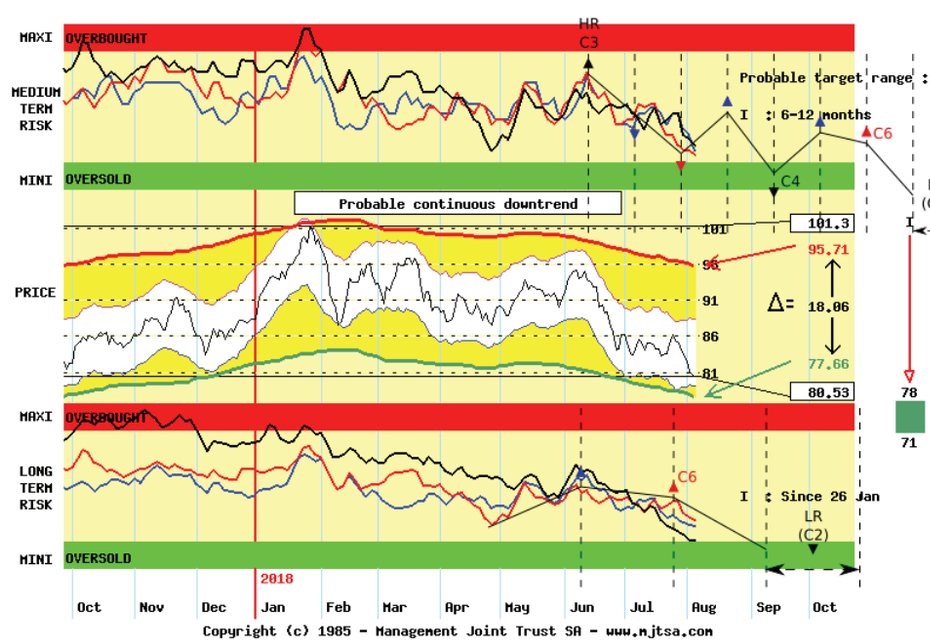
We now turn to emerging markets which have seen most of the suffering since the US Dollar started to rise, first vs the Euro in May, and then vs the Yuan since June. In a way, this has been quite a reversal of fate for Emerging markets, which were quite resilient vs developed markets during the February and March equity markets sell-off. According to both our oscillators series (lower and upper rectangles), **Emerging markets should continue to underperform the S&P500, probably until mid/late September and perhaps even early October. Their I Impulsive potential to the downside, is however rather exhausted and we would hence consider that most of their underperformance vs the S&P500 is behind us for now. That said, Emerging markets still appear to be under pressure which is usually defensive.**

MSCI Emerging Markets
Bi-monthly graph or the perspective over the next 1 to 2 years



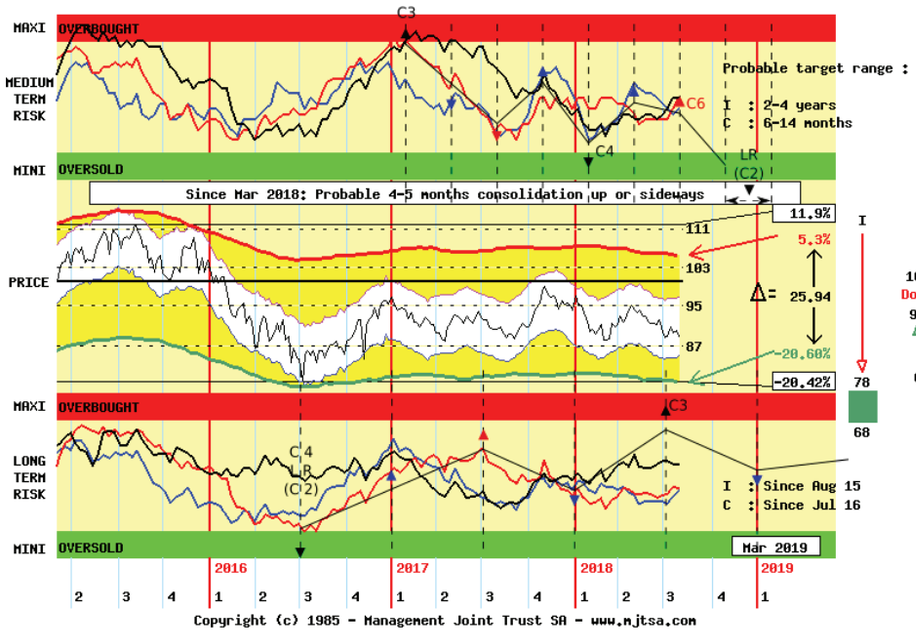
Long term, some chartists may be arguing that the move up since early 2016 on emerging markets, doesn't seem finished yet, and that a last leg up is probably missing. This scenario would correspond to the one we show on our medium oscillators (upper rectangle), which together with our I Impulsive targets to the upside (right-hand side) would confirm that there is quite a bit of potential left. That said, for now it has failed to materialize, and we believe that the current downside correction since January is probably the start of a more substantial reversal. This prudent view on Emerging Markets is confirmed by the sequence we show on our long term oscillators (lower rectangle), as well as our automatic messaging, which are both confirming a High Risk situation. Our view is hence that **Emerging markets have probably already topped out and started to correct down for this cycle.**

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



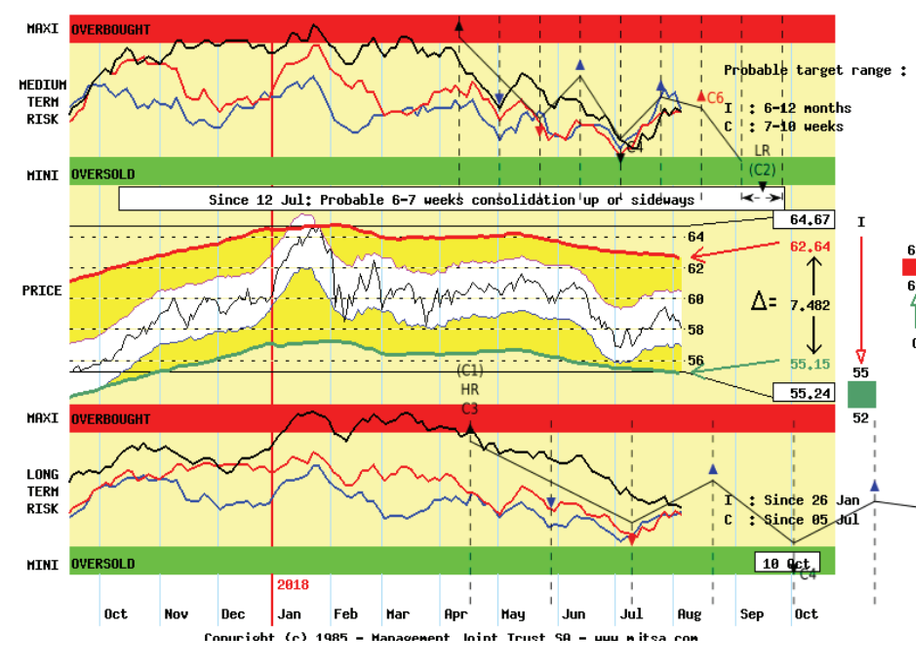
The MSCI China is by far the largest constituent of the Emerging Markets index, and over the next few months at least, it still seems to be headed lower. Our long term oscillators (lower rectangle) are probably **still downtrending, probably towards late September / October, while our I Impulsive targets to the downside suggest 5 to 10% of additional downside potential** (right-hand scale). Our medium term oscillators (upper rectangle) do point to a slight bounce over the next couple of weeks, yet the trend then resumes lower into early/mid September at least.

Nikkei 225 Index / S&P500 Index (hedged currency ratio)
Weekly graph or the perspective over the next 2 to 4 quarters



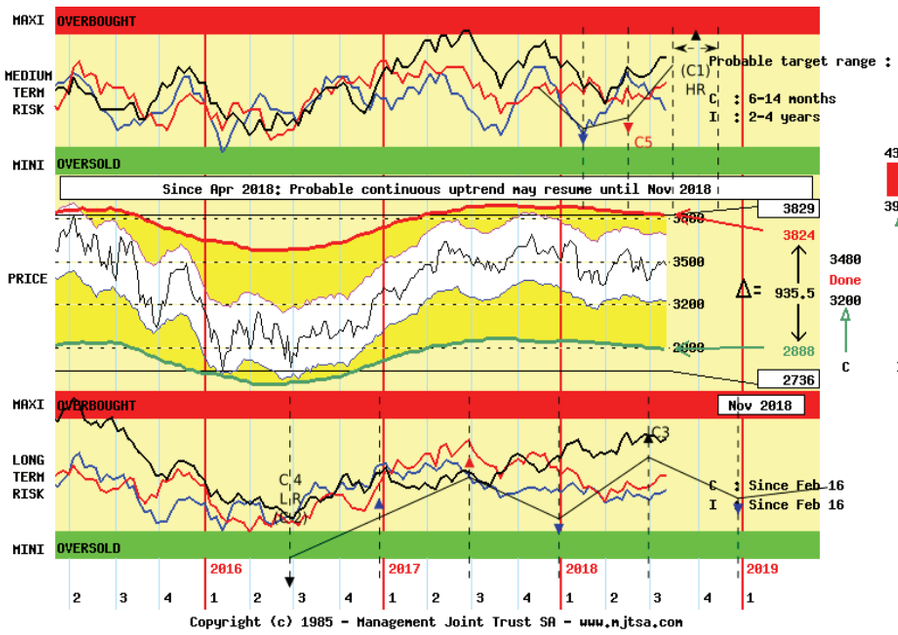
When comparing the Nikkei 225 Index to the S&P500 Index, the projections we show on both oscillator series (lower and upper rectangle), now seem to be in favour of the US index. This probably implies that the Yen could soon strengthen as it usually does in a risk-off environment. In such cases, the Japanese markets suffers vs the rest of the world on a hedged currency basis. **Going forward, the downside risk for the Nikkei vs the S&P500 is quite compelling, between 10 and 25% if the compensating effect of the falling USD/JPY is excluded** (I Impulsive targets to the downside; right-hand scale). Hence, whatever you invest into in Japan over the next couple of quarters, **we would recommend not to hedge the USD/JPY exposure, as it may compensate for some of the shortfall in Japanese stock performance.**

EWJ - iShares MSCI Japan Index Fund (denominated in USD)
Daily graph or the perspective over the next 2 to 3 months



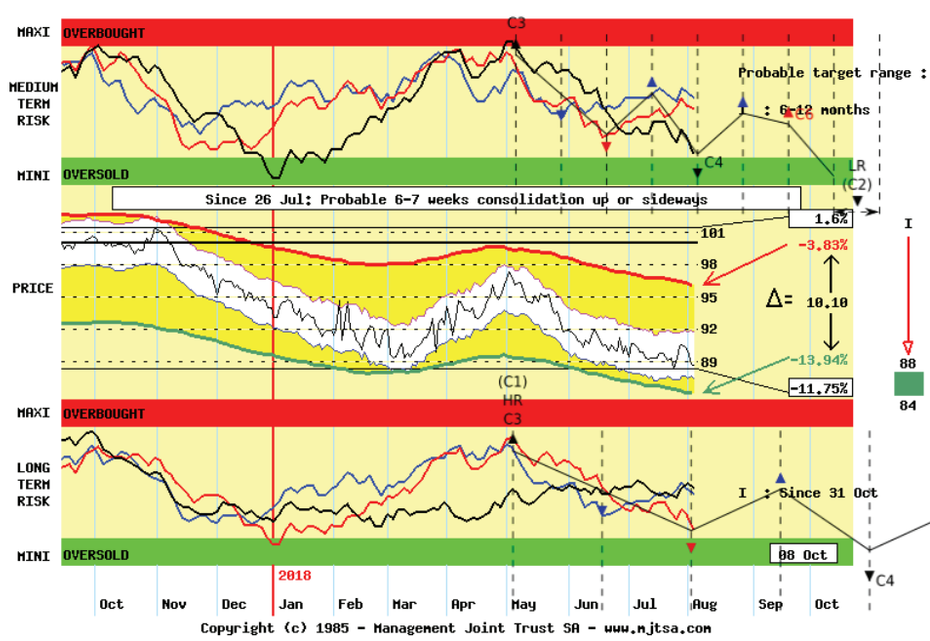
We will hence consider the Japanese market in US Dollar terms, using the EWJ ETF as a proxy. Both oscillators series (lower and upper rectangles) would suggest **further weakness going forward, probably from early/mid August into early, perhaps late September**. Our I Impulsive targets to the downside (right-hand scale) are pointing towards the 55 – 52 USD range, or circa 5 to 10% lower that today. This is relatively benign and probably confirms that **not hedging the Yen exposure could offer some welcome compensation for declining Japanese markets** (i.e. it's now probably too late in the cycle to hedge your JPY currency exposure when you invest in Japan).

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



The EuroStoxx 50 has widely deceived since Spring last year. This is mainly because of the strong Euro exchange rate. The fact that the index hasn't managed to break out to new highs in 2018, as the Euro started to weaken again, is in our view a sign of weakness. Indeed, on both our oscillator series (lower and upper rectangles), **the EuroStoxx 50 may have already reached important tops (lower rectangle), or at best, could be reaching them soon (upper rectangle). As with other indexes, we may expect a first sell-off into late August / September, then a bounce towards October, and then further weakness towards year-end. The downside risk over the next couple of quarters is between 10 and 20%** as shown by our C Corrective targets to the downside (right-hand scale). Yet, if their support was to break (a break below their lower end, i.e. below 2'940), the next level of targets is quite scary in the 2'600 – 2'200 range.

EuroStoxx 600 / S&P500 Index (currency hedged ratio)
Daily graph or the perspective over the next 2 to 3 months



We now look at the EuroStoxx 600 vs the S&P500 on a hedged currency basis. The ratio did bounce during March and April as the US Dollar started to rise, yet sold off again, along with EUR/USD as the Italian political crisis started to hit. Since late May, it has been falling again, as EUR/USD has stabilized. Hence, our view is currently that the EuroStoxx 600 can only outperform the S&P500 when EUR/USD declines, and that this will only be the case, if the negative newsflow does not come from Europe. Hence, **a global equity sell-off where the US Dollar acts as a Flight to Quality recipient, may lead to some temporary outperformance for the EuroStoxx 600 vs S&P500. This is what both our oscillator series (lower and upper rectangles) may be suggesting between now and late August, perhaps early September.**

Concluding remarks

We believe that while US markets are on the verge of topping out, other markets such as Emerging markets, Europe or Japan are getting ready to resume lower again. The fact that the ratio of the Nasdaq 100 vs the S&P500 Index is also topping out, is probably a consequence of the higher beta of the Nasdaq 100 vs the S&P500 rather than the beginning of a wider shift out of Growth and into Value. Indeed, when comparing both, our models do suggest that Growth continues to outperform Value probably into mid Q4 and even perhaps into early 2019. Hence, we expect equity markets to start a first leg down from now into late August / early September, then bounce into October, perhaps even until early November, before they start to sell-off again towards year-end and then Spring next year.

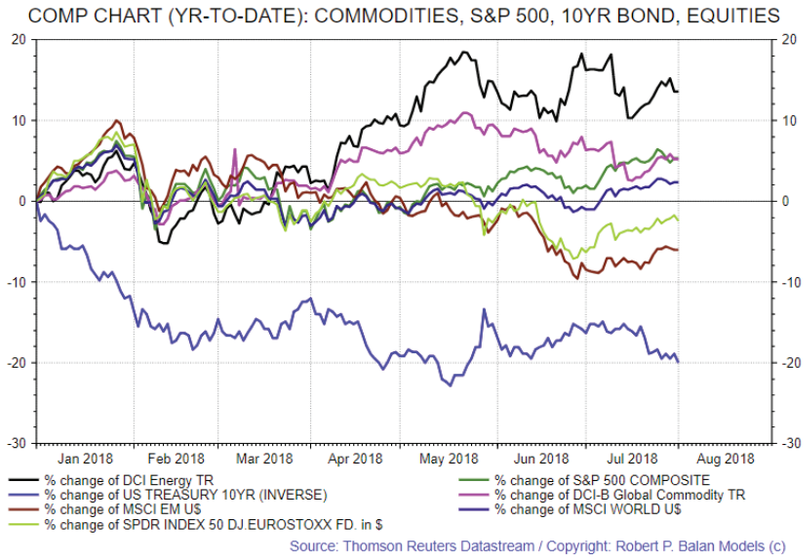
35 / The US Dollar, trade spats, China: it may not end well short-term for commodities, but there should be a firm relief at some point in September 2018

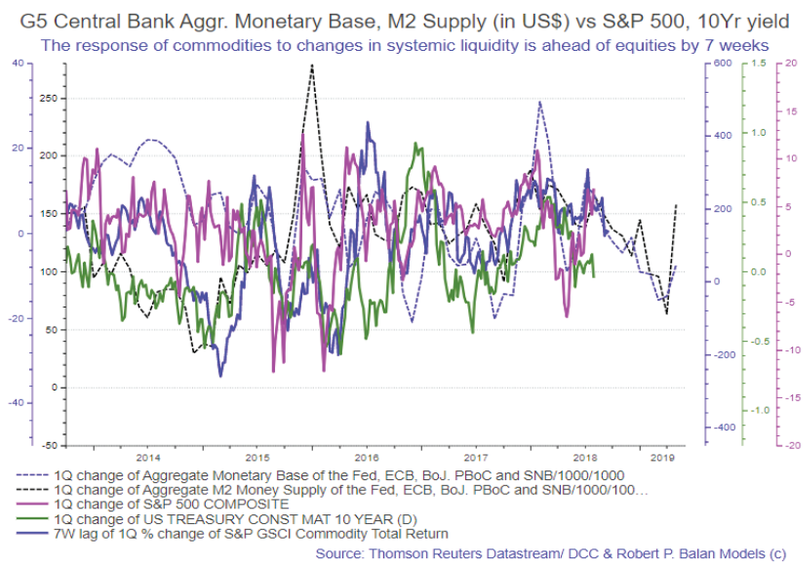
Markets reflect, and in fact anticipate, foreign and domestic political and economic events. Commodities are global assets, and are sensitive to geopolitical and economic developments. That makes them the barometer of global growth and activity trends and therefore tend to be the most volatile sector of the markets. Nonetheless, commodities in general, and the energy sub-sector in particular, have been the best performers among a wide range of asset classes this year on ytd basis *(see 1st graph on this page)*.

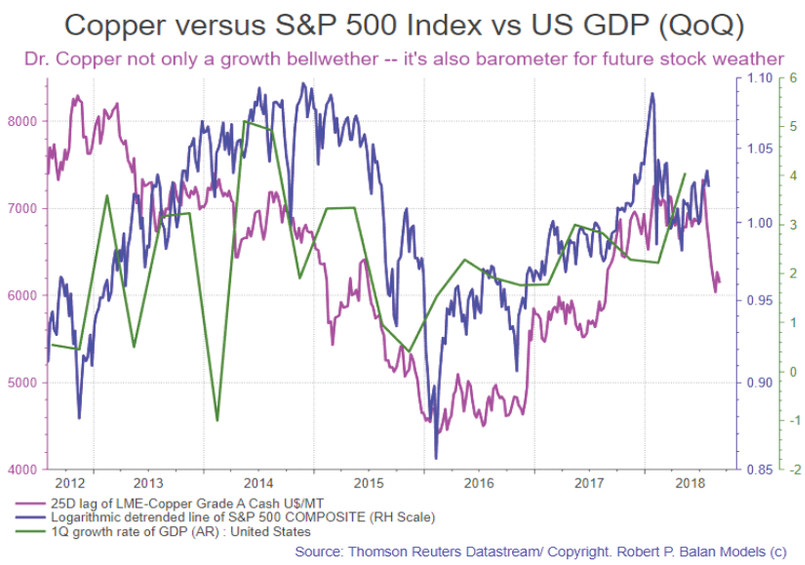
The US stock market was roiled late July by unfavourable earning expectation issues that cropped up in the technology sector, an event that has been flagged by our systemic liquidity models well ahead of time (see "No, it is not different this time", this issue of the Capital Observer). Those same models have also been indicating the same troubling message for commodities, which are, in fact, even more sensitive to the changes in flows of real money balances *(see 2nd graph on this page)* relative to equities.

Early storm signal warning from commodities

For some time now, commodities have been signalling a brewing storm that could create some wild volatility across all asset classes in the coming weeks and months. For us, we can see that we are already headed for a storm of price variance over the next few months, before we enter into calmer weather by Q2 next year, thanks to the lead indications from commodities response to receding liquidity flows *(see 3rd graph on this page)*. Dr. Copper is once again living up to its billing as the metal with a Ph.D degree – its response to receding systemic liquidity is 5 to 7 weeks ahead of a similar response from equities. Not only is Dr. Copper a bellwether of US GDP growth in this regard – it also a barometer of incoming (adverse) weather for common stocks.







The trade spats cloud the future for commodities further

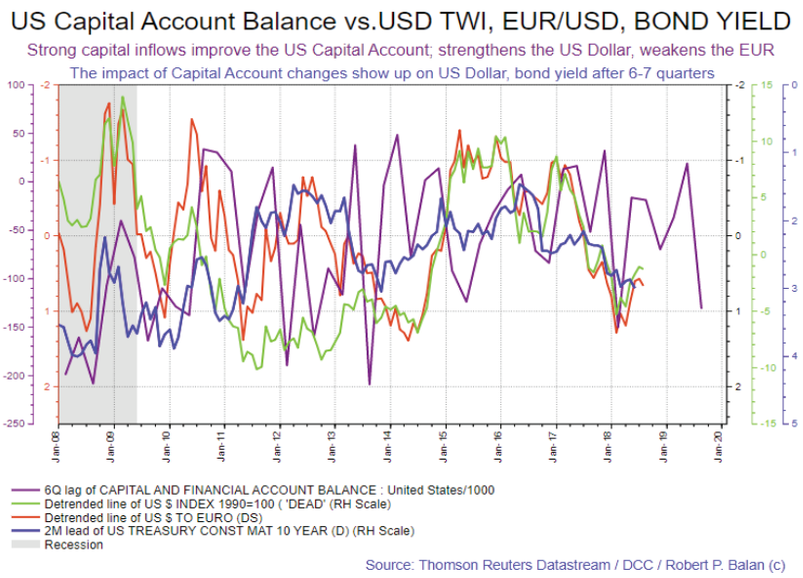
There are a lot of reasons to expect stormier weather up ahead. President Trump is still facing scrutiny over his meeting with Russian leader Vladimir Putin on July 16. The Donald, unlike most of his predecessors, responds to any controversy by creating more. In the aftermath of his meeting with President Putin, President Trump turned his attention back to a continuation of his battle through the media with the Special Prosecutor and intelligence services in the U.S. over charges of Russian collusion in the 2016 election. And the probe over alleged collusion of Trump's aides with Russia during the 2016 presidential election is reaching a critical trial phase.

At the same time, negotiations with the Chinese over trade are not bringing about Mr. Trump's desired outcome, so the administration upped the ante by threatening to increase tariffs to cover the entire amount of the trade imbalance. That covers around $500 billion in Chinese goods being exported to the United States. China pledged to meet additional tariffs with a proportionate response. Since there is not a half-trillion dollars' worth of U.S. goods flowing into China, it is possible that the response will come in the form of other measures. There will be plenty of collateral damage to the US and global (EM) economy.

The Federal Reserve on Trump's firing lane

Recently, President Trump also took aim at another one of his appointees, Fed Chairman Jerome Powell. The Fed embarked on a steady course of tightening credit in the US starting in late 2015. The Fed added another 25 basis points to the policy rate last month, and has on August 1 confirmed their stated tightening schedule of at least two more rate hikes in 2018. The Fed also expects for more rates hikes in 2019 – likely the final straw that will break the camel's back which leads to a recession in 2020.

The President complained that rising interest rates diminish all of the initiatives to bolster the economy that has been put in place by the administration, including tax reform and fewer regulations on businesses. Moreover, the widening interest rate gap between the dollar and euro-currencies has been exacerbated by the Fed's tight stance, which is causing the value of the dollar to rise against other currencies. This diminishes the competitiveness of the US, which will be a continuing irritant to Mr. Trump – the US Dollar will likely be stronger over the rest of the year, excepting a brief correction in August or September. **The primary culprit is the continuing inflow of domestic and foreign capital into the US, as tallied by the US Capital Account – the flows of which will support the US Dollar until Q2 next year** *(see 1st graph below)*:



As we go into the middle of the sweltering hot summer season of 2018, a time when markets are typically quiet, the news cycle is increasingly focused on the US-China trade spat, and the fundamental strength of the U.S. dollar. The market promises to be everything but quiet. The primary victim of all that ensuing volatility would be resource materials, and the EM markets would receive extensive collateral damage.

From trade spat to trade war

The U.S. administration will, sooner or later, come to terms with trading partners around the world, including China. Trump has already come to some favourable terms with the European Union, and currently administration officials are talking with Mexico to restart the bogged down NAFTA talks. But there is a risk of miscalculation, especially in the case with the Chinese, who do not want to lose face by capitulating to Mr. Trump. This may lead towards a prolonged trade war if neither side decides that a compromise provides the optimal solution to the current conflict.

After a brief period of panic due to the trade spats, the US stock market rallied over recent weeks as equities have focused on improving earnings as a result of corporate tax reform adopted at the end of last year. **However, the earnings season is fast coming to an end, and once again as if on cue, Mr. Trump reopens the situation with China with a threat to ratchet up to 25% additional duties on $200 bln of Chinese exports to the US. It is likely that trade spat will once again take center stage, and that could weigh on the prices of many stocks. A trade war will cause global business activity to decline which will likely stoke fears of a worldwide recession. And commodities would be hammered hard.** As the chances

of a trade war rise, expect volatility in the stock market and in commodities to increase, perhaps dramatically over coming weeks and months.

The China-commodities connection

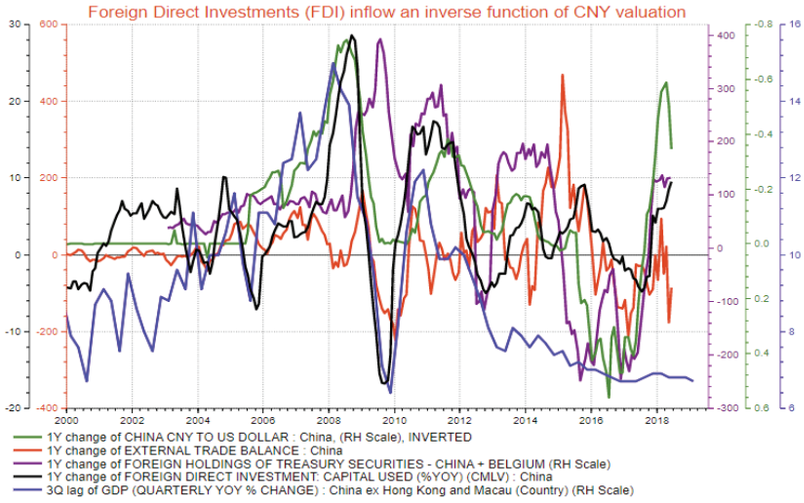
What is more alarming for the outlook of commodities is the prognosis for economic growth in China. **The Chinese government has starved the domestic economy of needed fiscal expenditures by letting fiscal expenditures dwindle over the past three years** *(see two first graphs on this page)*. **Result: growth has been declining for the past four quarters, although the fall has not yet reached critical dimensions, based on current prices**. However, based on official, seasonally adjusted data, the GDP medium term outlook remains dismal *(see 1st graph on this page)*.

It's is not hard to fathom why. Government expenditures in China have virtually collapsed since January 2016. **And like everywhere else, if the government does not spend, economic activity slows down in proportionate degree. And the government tightening in China had been severe**. The heady rise of the central government expenditures from January 2015 to January 2016 has been essentially erased over the past two years *(see 2nd & 3rd graphs on this page, blue line)*.

Even more significantly, Total Social Financing expenditures (orange line) have been falling hard. The TSF illustrates the link between fiscal spending and growth in China. This is key element in this illustration: the impact of fiscal and budgetary expenditures is being transmitted to the real economy via the Total Social Financing (TSF) expenditures. This leading indicator has already peaked, has declined sharply, and has been falling hard. **These have been the consequence of the (TSF) slowdown: (1) As a consequence, China's Leading Economic Indicator (LEI) will also decline soon, as soon as the next few months, (2) the fall in M1 Money Supply dropped precipitously from January, this year, and no bottom in sight, so far, while the (TSF) kept on falling.**

USD/CNY Currency, Trade Surplus, FDI, Treasuries bought by China

Foreign Direct Investments (FDI) inflow an inverse function of CNY valuation

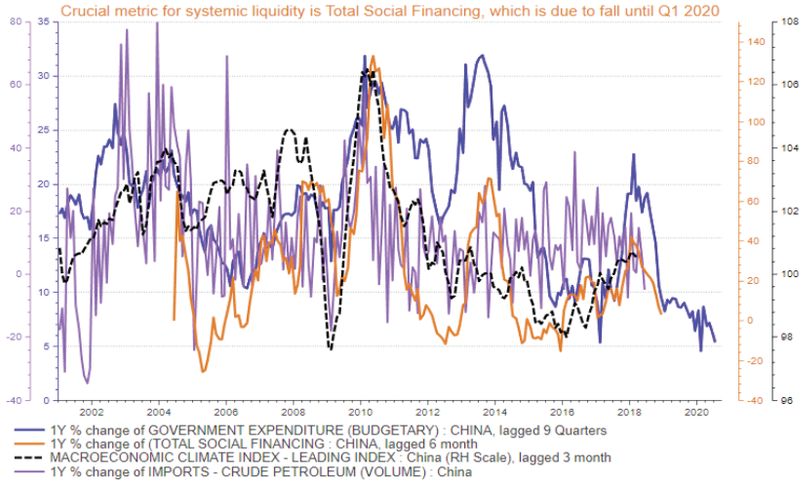


Source: Thomson Reuters Datastream / Robert P. Balan Models (c)

China Gov't Expend., Total Social Financing, China oil imports (volume)

There will be growth in China until Q1 2018, but then looks to go downhill until Q1 2020

Crucial metric for systemic liquidity is Total Social Financing, which is due to fall until Q1 2020

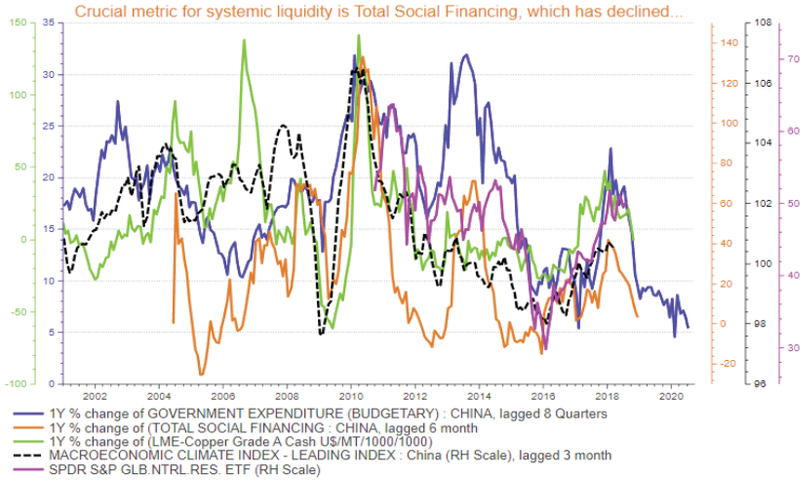


Source: Thomson Reuters Datastream / Copyright: Robert P. Balan Models (c)

China Gov't Expend., LEI, Total Social Financing, Copper price

Base metal prices have lpeaked, as China enters slower growth period. commodity producers at risk

Crucial metric for systemic liquidity is Total Social Financing, which has declined...



Source: Thomson Reuters Datastream / Copyright: Robert P. Balan Models (c)

TSF is a very reliable indicator of future economic activity in China and is therefore an excellent tool in forecasting the future direction of commodity prices. As the previous chart shows, oil import going into China follow the lead and direction of the TSF.

In the immediate chart above, fiscal expenditures are reliable guide to the prices of copper and the stock of the S&P mining sector.

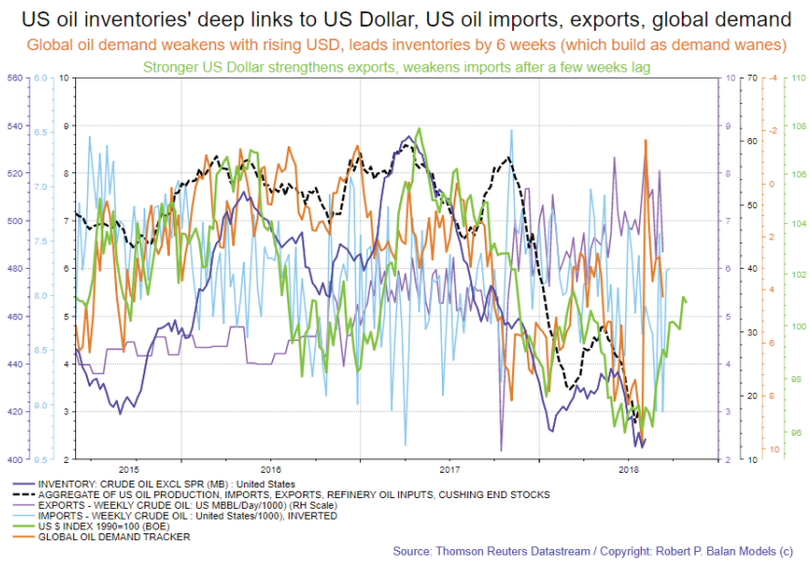
Crude oil is in trouble, as global demand wanes

It is especially a trouble-some outlook for Crude oil. Not only are China imports going to slow significantly; global production will certainly increase during the course of H2 2018. Russia just announced that it will open the oil spigots, something that it has already done surreptitiously over the past three months. Saudi Arabia is now less constrained, using significant US growth as excuse to unshackle its oil well caps. And the *coup de grace*: global demand has started to wane, and so US oil inventories will start building rapidly soon. Our US oil inventory model is showing that we have likely seen the last inventory draws for the year. We should see rapid US oil inventories builds from here on *(see chart on this page)*:

A combination of falling systemic liquidity flows, a rising dollar, higher interest rates, and fears of recessionary pressures caused by the trade issues, and diminishing demand (for crude oil) have created a potent bearish cocktail for many global commodities prices. Since the energy sector comprises from 45% to 55 % of many commodity indices, a severe beating for oil prices from here will bring down commodity funds across the financial universe.

Reasons to be optimistic

But we still view that there is a chance of positive outcome for the trade tensions. While the current trade issues have no easy answers, a solution to the conflict between the U.S. and China is in the best interest of both countries. President Xi is a pragmatist, and he is aware that handing a small victory to President Trump going into the mid-term elections via a compromise would yield the optimal result for both leaders. There is a small window of opportunity to settle matters before the mid-term elections in the US. A solution could arrive sometime in September via a Trump-Xi summit on the economy. That is the closest the Trump administrations, known for its brinkmanship, will let the situation fester.



China has promised to unleash fiscal policy initiatives soon. The Xi government is ramming through a currency devaluation. We have no doubt that the outlook in China will stabilize, although growth slowdown has already been baked in the cake. **But it is now obvious that Chinese authorities have recognized the extent of the damage their forced deleveraging of corporate balance sheets have inflicted on the economy. That is half the battle won.**

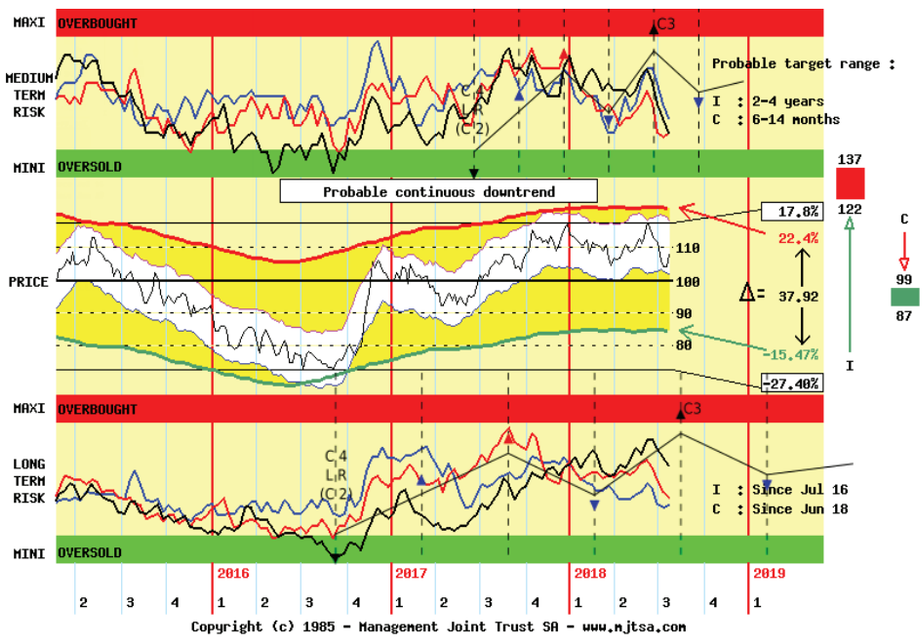
The biggest relief rallies will likely come in the commodities markets that took the brunt of selling over recent weeks. A rally in equities will not be far behind. Nonetheless, the outlook for commodity sector leader Crude Oil will be undercut by unfettered production at a time when demand is slowing. Where the leader goes, the minions will follow.

39 / MJT - TIMING AND TACTICAL INSIGHT

The current sell-off in commodities may find some support towards September, yet overall, commodities probably remain under pressure into H1 next year at least.

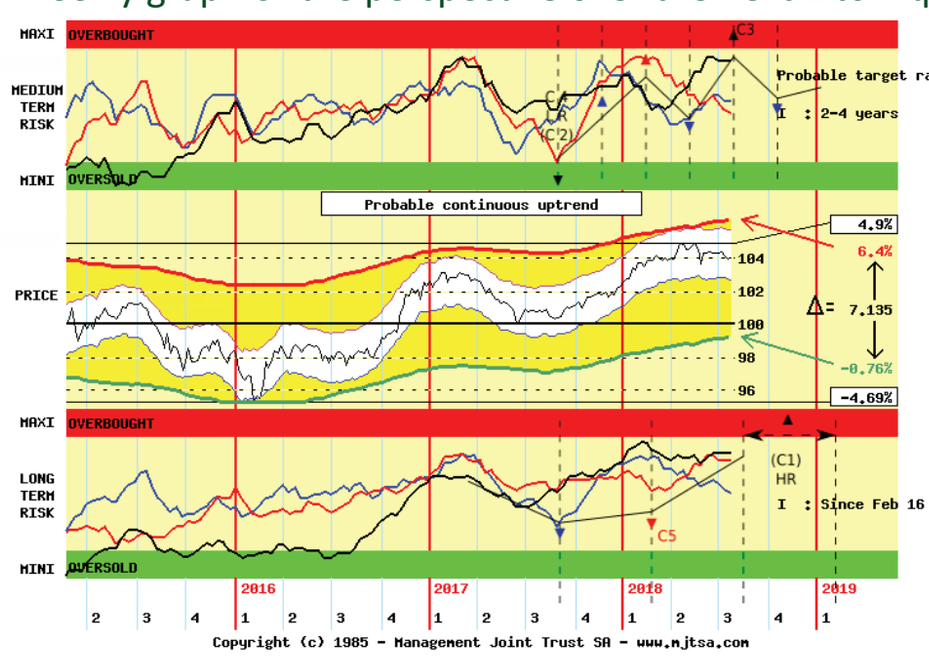
Commodities have accompanied the reflation trade up since 2016. Indeed, the oil rebalancing story helped kick start reflation in 2016, and more generally, since then, commodities have followed its fluctuation (e.g. H1 2017 retracement / H2 2017 re-acceleration). Currently, our cross asset scenario is turning quite defensive. We expect the global economy to start decelerating soon and believe that this deceleration is probably not factored into risk assets prices yet. On average, Commodities are in the high beta corner of the risk assets space and should particularly suffer if the deceleration we anticipate, actually materializes.

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



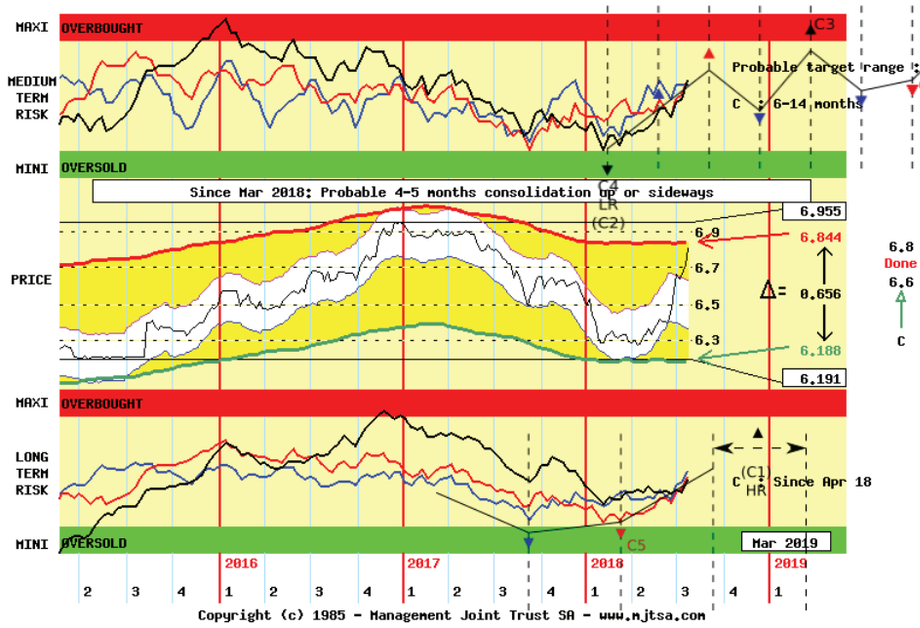
The Copper to Gold ratio has been an important commodity proxy for the reflation trade. Indeed, it benchmarks a pro-cyclical commodity such as Copper against a more Defensive one such as Gold. As shown on our long term oscillator series (lower rectangle), we did expect it to top out towards mid Summer, yet now believe, **that it may have started down earlier, and that an important correction period to the downside is probably already under way**. Our "C" Corrective Price targets to the downside (right-hand scale) suggest **that the ratio could fall between 10 to 20% over the next few quarters**, while our "I" Impulsive targets to the upside (10 to 20% higher) now seem less likely. At best, the risk/reward is neutral. On the market timing front, our medium term oscillators (upper rectangle) would suggest a bounce between September and October, while our long term oscillators (lower rectangle) imply further downside pressure towards late Q4 and early 2019.

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



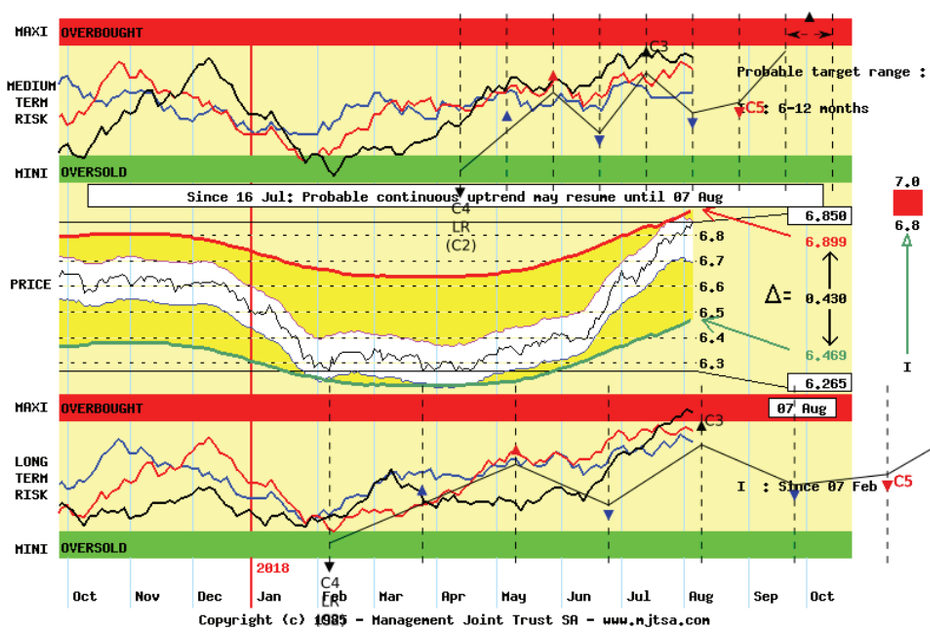
Rising inflation expectations have also accompanied the reflation trade higher since 2016. In this graph, we consider their market proxy by comparing the price of TIPs with the price of Treasuries of similar duration. When the ratio rises, investors are buying more Inflation Protected Government Bonds vs Treasuries. It implies that they probably believe that the inflation expectations currently priced into Treasuries are not high enough (and vis-versa, when the ratio declines). According to both our oscillator series (lower and upper rectangles), **the ratio should be approaching an important intermediate top, probably between now and the Fall**. On the target front, our I Impulsive targets to the upside (right-hand scale) may suggest 1-3% of additional upside potential. Yet, this is smaller than the C Corrective targets to the downside we can calculate, somewhere between 4 and 5% **(negative risk/reward over the next few quarters).**

Yuan Renminbi per U.S. Dollar (USD/CNY)
Weekly graph or the perspective over the next 2 to 4 quarters



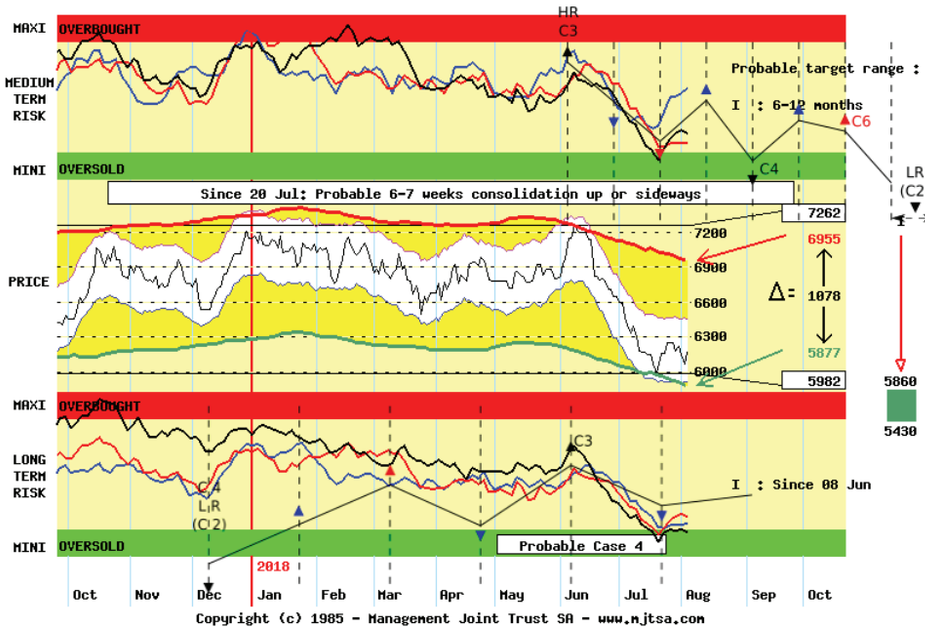
As we had projected in May, the People's Bank of China did let the Yuan weaken quite substantially over the last couple of months. At the time, we expected it to do so to counter a deceleration in its economy as the effects of the 2015 and 2016 increase in Total social Financing were starting to run off. We expected it to use the Trade War as an excuse to do so. Considering both our oscillators series (lower and upper rectangles), we believe this strong USD/CNY move will not be reversed. It may pause slightly between late Q3 and Q4, but in general, we expect the Yuan to remain under pressure vs the US Dollar into next year (upper rectangle). **While, a devaluation of the Yuan may be beneficial for the Chinese economy in the future, for now, the market is focusing on the causes of this devaluation rather than its potential impact. Indeed, despite a slight bounce during July, Chinese equity markets are still very much under pressure, along with Commodities, and we believe both should continue lower into September. They may then bounce towards October and perhaps November before their negative trends resume further, probably as USD/CNY rises again until Spring next year at least.**

Yuan Renminbi per U.S. Dollar (USD/CNY)
Daily graph or the perspective over the next 2 to 3 months



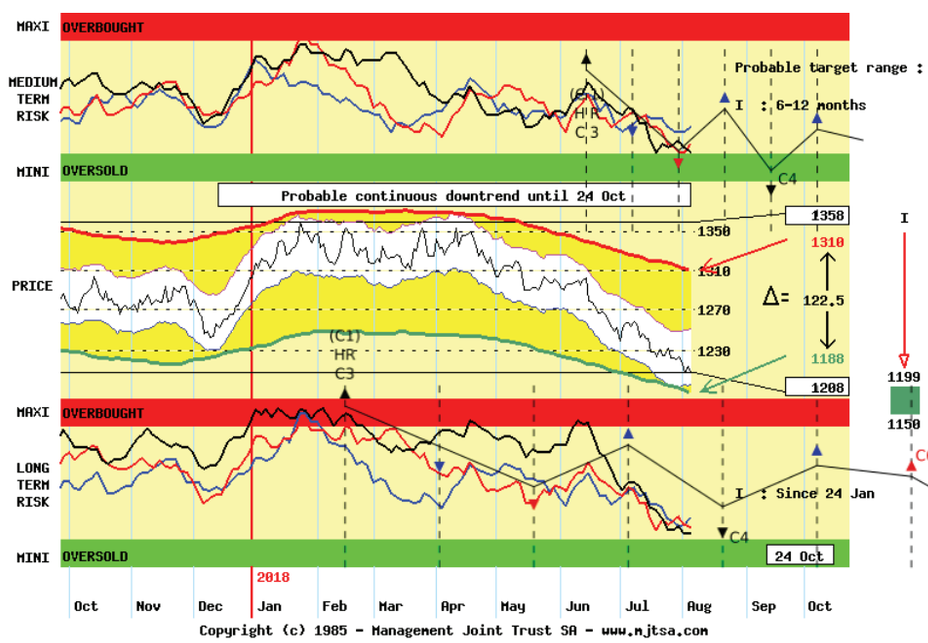
Shorter term, the USD/CNY exchange rate has reached the lower end of our I Impulsive targets to the upside (6.8; right-hans scale). As such, it has probably achieved more than 80% of its upside potential for now (i.e. in this initial leg up) and any further increase will probably reach exhaustion around the 7.0 mark (the upper end of our I Impulsive targets to the upside). On the timing front, our long term oscillators (lower rectangle) would suggest that a top is neigh, yet the model we show on our medium oscillators (upper rectangle) seems to be a better fit for the price pattern. **We would hence expect USD/CNY to continue slightly higher, probably into mid/late September.**

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



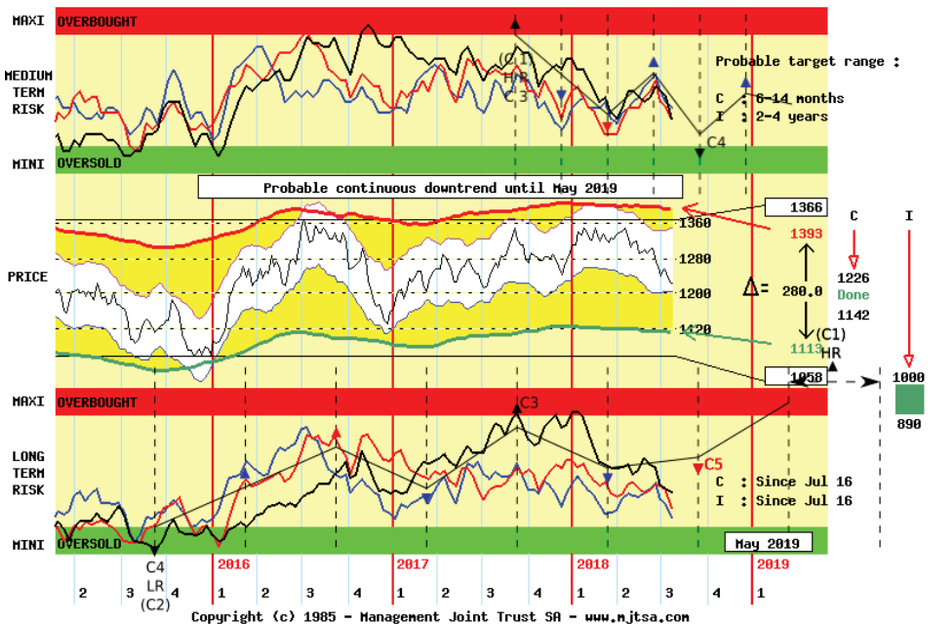
Interestingly, as the PBoC let its currency devaluate, most Commodity prices did not compensate, but rather followed the Yuan lower (rising USD/CNY). This highlights China's current dominance on the demand side of the commodities and especially the industrial metals markets. Hence, we believe that going forward, Copper should continue to follow the Yuan lower. While both our oscillator series (lower and upper rectangles) made an intermediate low in July. We now expect **Copper to resume lower again during August, probably into early / mid September** (upper rectangle). This timing would pretty much fit our timing for a top on USD/CNY (towards mid/late September). On the target front (right-hand scale), our I Impulsive targets to the downside are suggesting that **Copper could lose another 7 to 13% over the next month or so.**

Gold Spot (USD/oz)
Daily graph or the perspective over the next 2 to 3 months



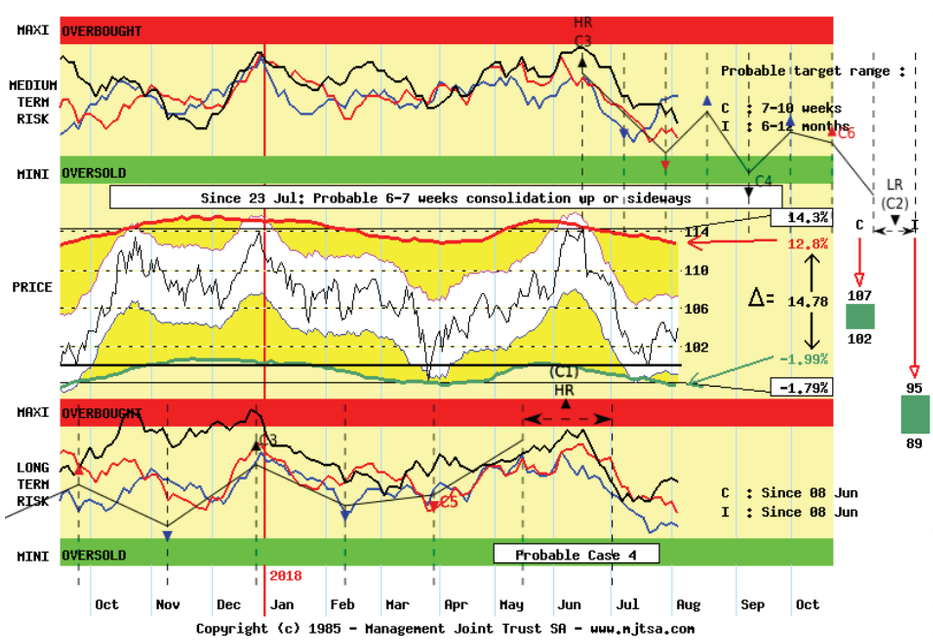
Gold has also been suffering lately, and its recent sell-off also matches the recent sell-off in the Yuan (rising USD/CNY). While our long term oscillators (lower rectangle) are suggesting that the move could continue lower into late August, our medium term oscillators (upper rectangle) would imply that **it continues down into early/mid September (similar to Copper). We will hence remain prudent until then**. Furthermore, our I Impulsive targets to the downside (right-hand scale) are suggesting **further downside potential towards the 1'199 – 1'150 range until then.**

Gold Spot (USD/oz)
Weekly graph or the perspective over the next 2 to 4 quarters



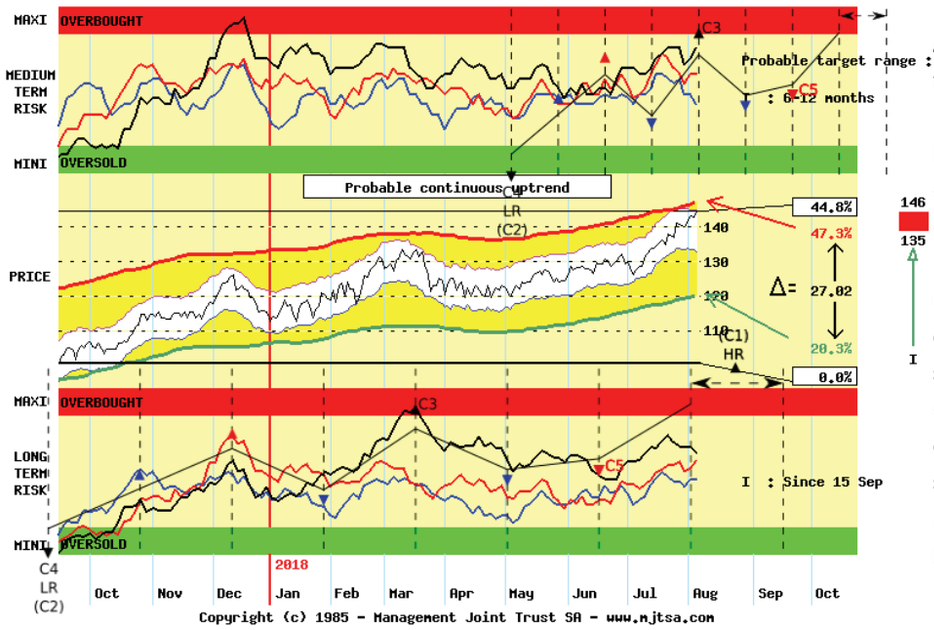
Long term, on both oscillator series (lower and upper rectangles), we are also expecting a low point on Gold towards late Q3. The bounce that follows may lead Gold back up towards year-end (upper rectangle) and then possibly higher well into next year (lower rectangle). Our **upside targets** (not shown here anymore given the recent sell-off) **are still above 1'500 USD/oz towards mid/late 2019. In the meantime, however, Gold will first need to hold above the support of its C Corrective targets to the downside, or above circa 1'142** (right-hand scale). Indeed, if these 1'150-40 levels break, the I Impulsive potential to the downside could be below 1'000 USD/oz.

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



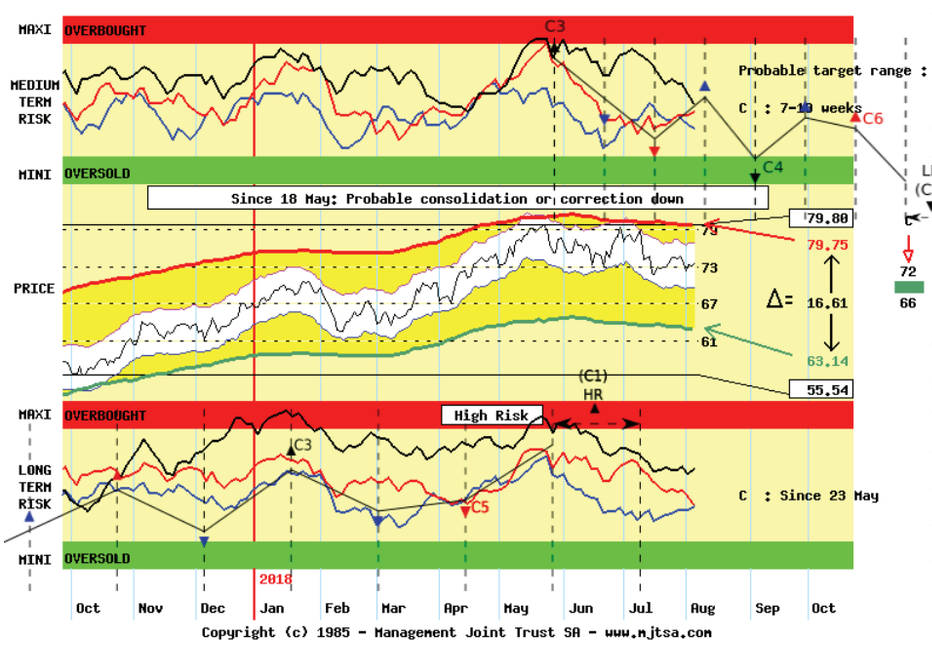
We now move back to the Copper to Gold ratio mentioned above and now consider its Daily graph. According to the model we show on our long term oscillators (lower rectangle), the ratio did indeed make an important "High Risk" top in June. Such configurations could easily justify a sell-off that could last 2 to 3 months. We hence believe that **the mid July low is probably only an intermediate one, and that the ratio will probably resume lower during August towards early/mid September** (as shown on our medium term oscillators; right-hand scale). On the targets front, the support of our C Corrective targets to the downside (right-hand scale) has been broken, and **the ratio could continue to Fall towards our I Impulsive targets to the downside, 10 to 15% lower than today.**

S&P 500 / HUI - Gold Bugs Index (NYSE Arca)
Daily graph or the perspective over the next 2 to 3 months



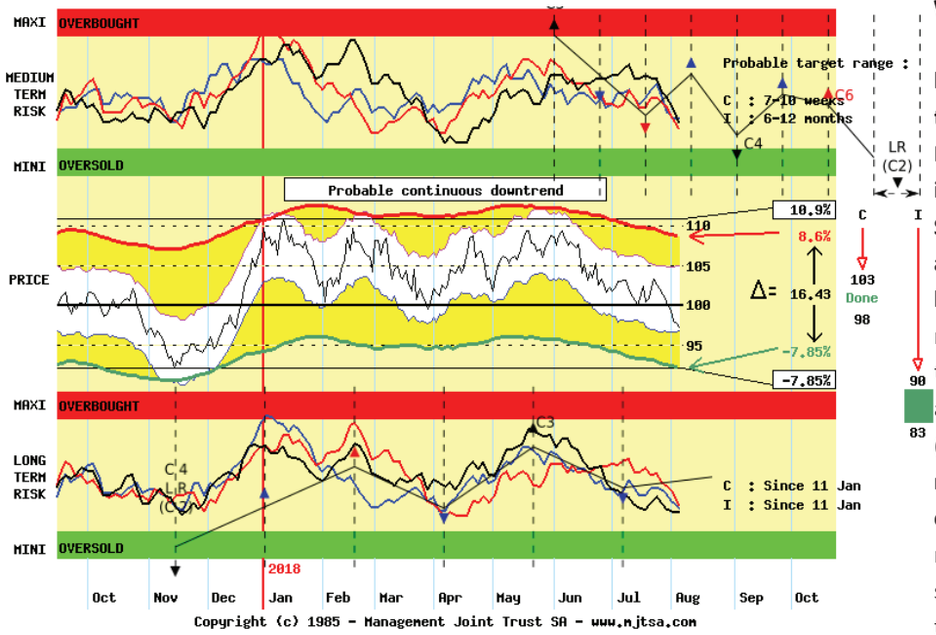
Another ratio, which we believe is quite interesting at the moment, is the comparison between the S&P500 and the HUI Gold Bug Index. While sell-offs in the market don't always correspond the sell-offs in the ratio (as in early February), **usually, sell-offs in the ratio do coincide with equity markets sell-off**. According to both our oscillator series **such an event could be happening quite soon.** Our long term oscillators are in a "High Risk" position (lower rectangle), while our medium term oscillators (upper rectangle), would suggest some consolidation into late August, at least. At the same time, our I Impulsive targets to the upside are exhausted and labelled "Done" (right-hand scale). **A sell-off in the S&P500/HUI would probably confirm a wider sell-off in the risk asset space. Industrial metals and Copper are very pro-cyclical and would be first in line to experience further drops in prices.**

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



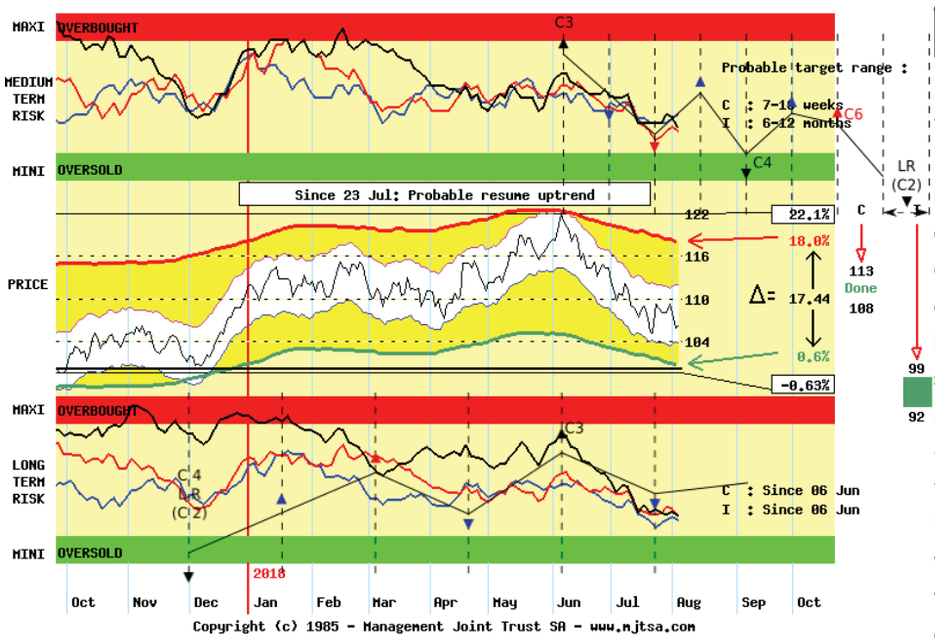
We now turn to Oil (Brent), which up to **now has resisted better than Copper and Industrial Metals**. Yet, it also reached a High Risk position on our long term oscillators during May/June (lower rectangle), and **we now expect it to move lower, probably from early August into early September** (upper rectangle). This corroborates our views in the last 2 editions of The Capital Observer, where we expected Oil to reach an important top at some time between midyear and mid Summer. The consolidation period we expect could last between 3 and 5 quarters (or well into 2019). On the target front, our I Impulsive targets to the upside (right-hand scale) have pretty much been achieved, while our C Corrective targets to the downside would suggest **initial support around 66 USD/barrel**. Below these, I Impulsive targets to the downside would calculate between 50 and 60 USD/barrel.

XME - SPDR S&P Metals & Mining ETF / S&P 500
Daily graph or the perspective over the next 2 to 3 months



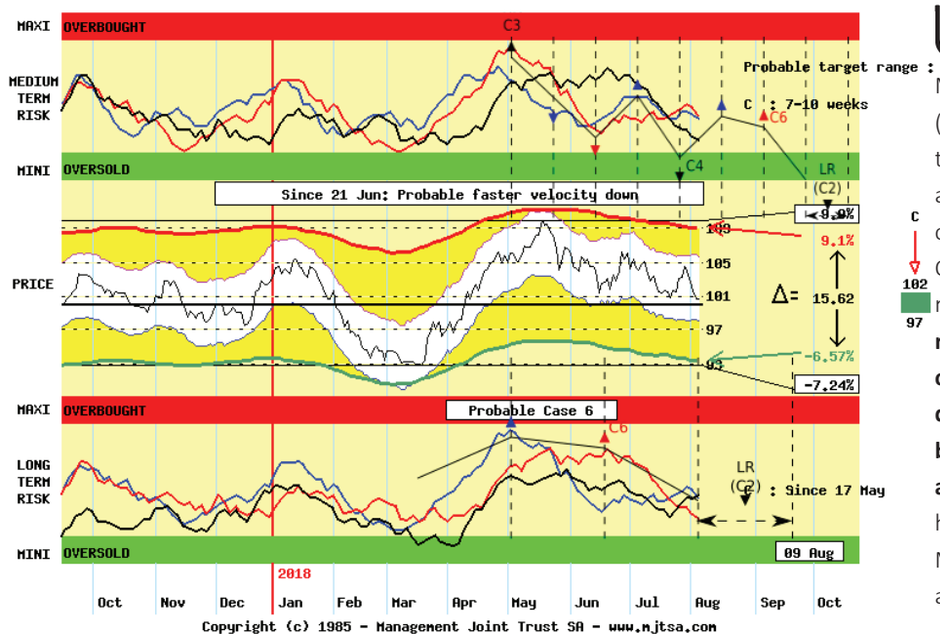
We now compare the various commodity related sectors vs their respective markets, in the US and in Europe. US Metals & Mining is very pro-cyclical and vs the S&P500, it probably reached an important top between late May and early June (lower rectangle). It has now started to correct lower, and following a weak bounce since mid July (upper rectangle), **should soon resume lower, probably until early September at least**. The ratio has recently broken the support of our C Corrective targets to the downside (right-hand scale). This opens the door to further underperformance, possibly 7 to 15% below current levels. **The risk/reward for US Metals & Mining vs the market is hence quite negative over the next few months.**

European Basic Resources Sector (STOXX) / Dow Jones STOXX Europe 600
Daily graph or the perspective over the next 2 to 3 months



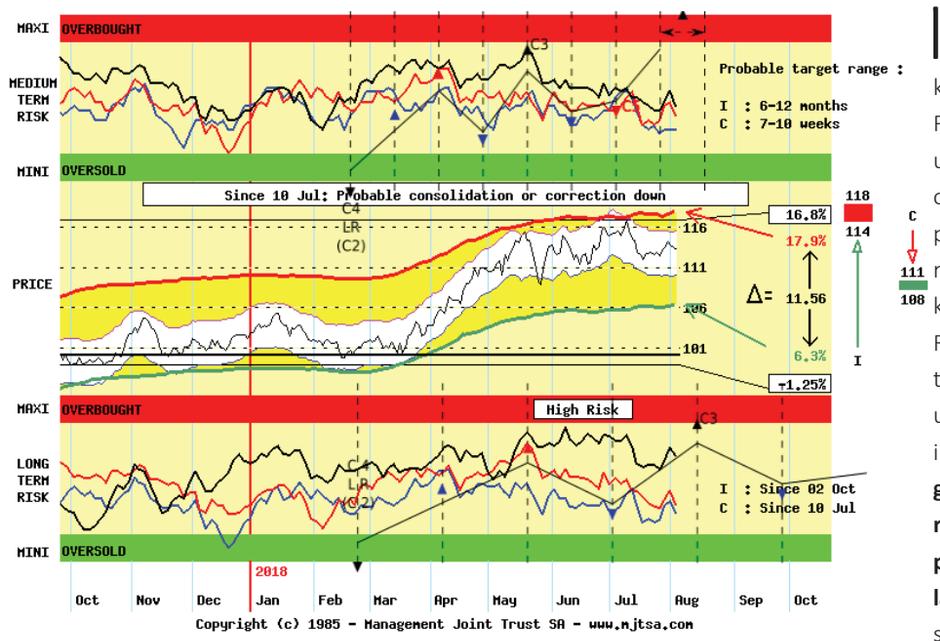
European Basic Resources also topped out vs the market in early June (lower rectangle), and it has since been underperforming. **It has also broken below the support of our C Corrective targets to the downside** (right-hand scale), **opening the door to our much lower I Impulsive target down, some 7 to 15% below current levels.** Our medium term oscillators (upper rectangle), would suggest that the current bounce dies out soon and then **the sector resumes lower vs the market, probably until early September.**

XLE - Energy Select Sector SPDR Fund / S&P 500 Index
Daily graph or the perspective over the next 2 to 3 months



US Energy has resisted slightly better vs the market since May. Yet, our long term oscillators (lower rectangle) would suggest that we are now in a downtrend, and that this downtrend could continue well into September. Our medium oscillators (upper rectangle) would **imply that the recent bounce has probably died out, and that US Energy now underperforms vs the market probably until mid/late September at least**. On the target front (right-hand scale), the move lower since May, is for now still labelled only as a correction.

European Energy sector (STOXX) / Dow Jones STOXX Europe 600
Daily graph or the perspective over the next 2 to 3 months



Interestingly, European Energy has been stronger vs the market than the US Energy sector. For now, it is still holding on to an uptrend. Yet, according to both our oscillator series (lower and upper rectangles), the sector should reach an important top vs the market over the next couple of weeks. Risk/Reward is also stretched given that our I impulsive targets to the upside have already been reached in early July. Hence, **from mid August at the latest, we expect European Energy to start to underperform, probably towards mid/late September** and towards the support of our C Corrective targets to the downside some 3 to 7% below current levels.

Concluding remarks

The reflationary trend since 2016 in the commodity space probably reached exhaustion this Spring, and we believe it has now started to reverse. Many of these trades, and Industrial metals in particular, had been strongly correlated since 2016 with stronger Chinese growth momentum. That said, this trend may also be reversing as the effects of strong fiscal stimulus in 2015 and 2016 are gradually fading, and the reality of the current US vs China trade war settles in. The current Yuan devaluation is symptomatic of this deterioration, yet it is really its underlying causes that are concerning. These are leading Chinese Equities and Industrial Metals to sell-off. Following an intermediate low in mid July and a weak bounce since then, we expect Industrial Commodity trends (Oil, Copper, Industrial Metals and related sectors) to weaken again probably from early/mid August, until early and perhaps even mid/late September. Following that, we would expect a late September, October bounce, before these Industrial Commodities resume lower from November into next year. Gold on the other hand may bottom during September and start accelerating up as markets gradually enter a more risk-off environment from early/ mid Q4 into next year.

46 / Why does the US yield curve continue to flatten? Taking the cue from Global Quantitative Tightening, and the collapsing US bond term premium

In the June issue of the Capital Observer, we wrote an article devoted to the yield curve: *("The yield curve universe is changing – shifting inflation expectations is prime mover for those changes"). We noted that pre-QE, "the tendency for the yield curve was to steepen during bond (price) rallies and to flatten during (price) selloffs. Put simply, there was a NEGATIVE correlation between the 10yr yield and the slope of the 2y/10y yield curve. Described another way, when the 10yr yield starts falling, it won't be long before the yield curve steepens (see 1st chart on this page)."*

We also explained how the current conundrum associated with the yield curve started:

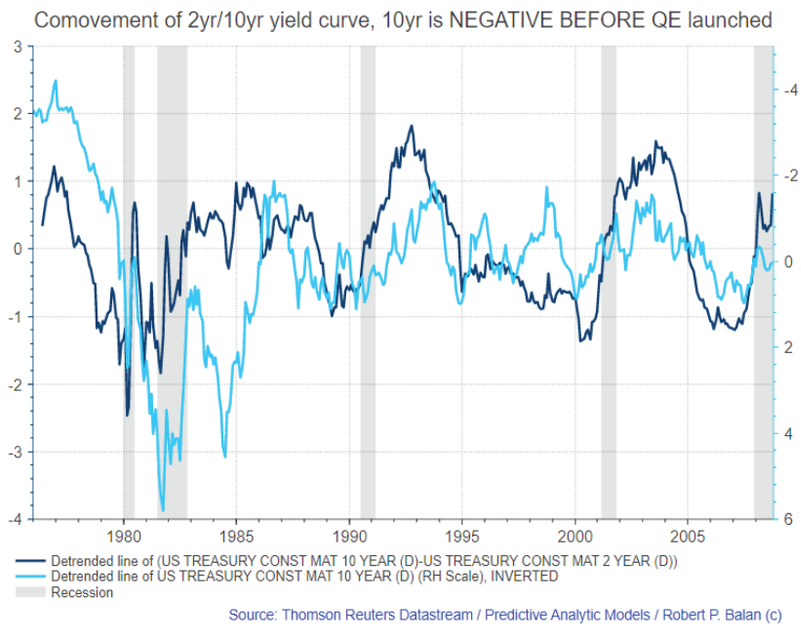
"Quantitative Easing (QE) started in November 25, 2008, (and) the massive infusion of systemic liquidity and new monetary policy tools unleashed by the Federal Reserve sent the yield curve and bond yield comovements into a different direction. The relationship had turned POSITIVE."

"Since November 2008, the curve has tended to flatten during bond price rallies (falling yields) and steepen during price selloffs (rising yields) - it was the complete opposite of what was seen pre-QE. True to the new form, when bond yields started to rise sharply after bottoming in July 2016, the yield curve dutifully steepened (see 2nd chart on this page)."

Then we noted that since September 2017, the yield curve and the 10yr yield are diverging again *(see 2nd graph on this page)***. The changes in comovements or covariances are symptoms of profound changes taking place in the US and global yield curves.**

We suggested that all these changes may have roots in the changing reaction function of investors to the central bank supplied systemic liquidity, as the changes taking place in the US yield curve are also taking place at a global macro setting. We said that "we are talking about really grand scale – as in the aggregate QE proceeds of the five largest, stimulus-addicted central banks of the world – the Fed, the European Central Bank,

Original graph in June Capital Observer



Original graph in June Capital Observer

the Bank of Japan, the People's Bank of China, and the Swiss National Bank *(see 1st graph on this page)".* The aggregated central bank balance sheets ballooned due to massive Large-Scale Asset Purchases (LSAPs) undertaken by the central banks in their effort to check the downward spiral of economic activity and consequent decline of risk asset prices.

Those transactions were essentially just plain asset swaps - the Fed took in short-dated securities from the banks (many with no market price at that time), and gave them back Treasury Notes averaging 5yr-7yr duration. That converted the banks' illiquid holdings into bank reserves. Arguably, the effect of those huge bank reserves, transmitted via the portfolio balance channel and the signalling channel, did push up house and equity prices, and also lowered the path of short-term rates and reduced longer-term yields.

The relationship between QE and yield curves was negative – more QE resulted in lower bond yields, lower term premium, and higher equity prices (*see 1st graph on this page*).

However, something strange happened in June 2014. That month, the covariance between the change in the global balance sheet and the US yield curve turned positive (*see 1st graph on this page, blue demarcation line*).

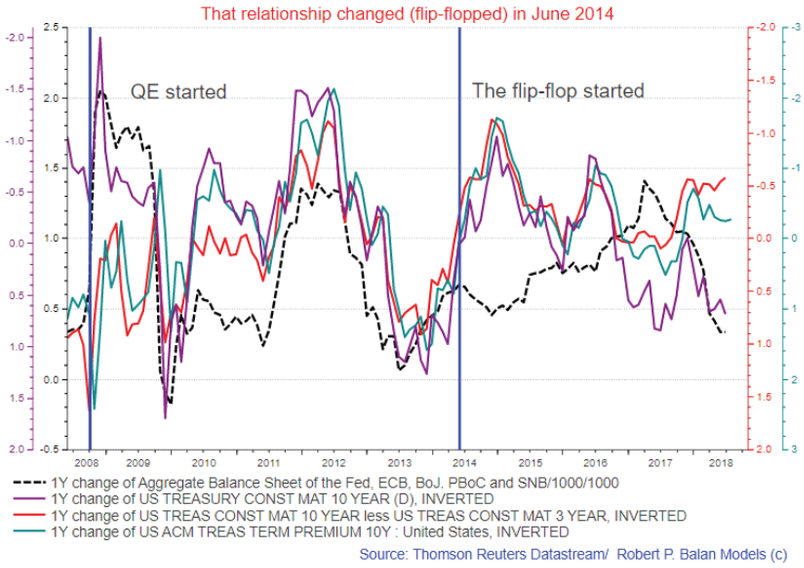
We illustrated this change in the 2nd graph provided on this page. **It is plain to see that after June 2014, the relationship between the US bond term premium and the flows (change over time) in the global balance sheet have turned positive. Its therefore no surprise that the US yield curves have flattened massively as the global balance sheet flows receded and as the US term premium shrunk, and even become negative** *(see 2nd chart on this page).*

We have always pointed out that the US yield curve has always flattened whenever the Fed started to tighten monetary policy – an observation that was not mainstream when we started discussion this phenomenon in the issues of the Capital Observer last year. That line of thinking has now become mainstream, but it is like the act of raising the policy rate itself is causing the yield curve flattening *(see last graph above).* Indeed, there is a very reliable covariance between the changes in the Fed policy rate, the 3yr/10yr yield curve and the bond term premium *(see last graph above)*:

G5 (US,EU,JPN,CHI,CHF) balance sheet, M0 (in US$) vs Bond Yields, Yield Curve

From Nov. 2008, bond yields have been negatively correlated with the change rate of bank reserves

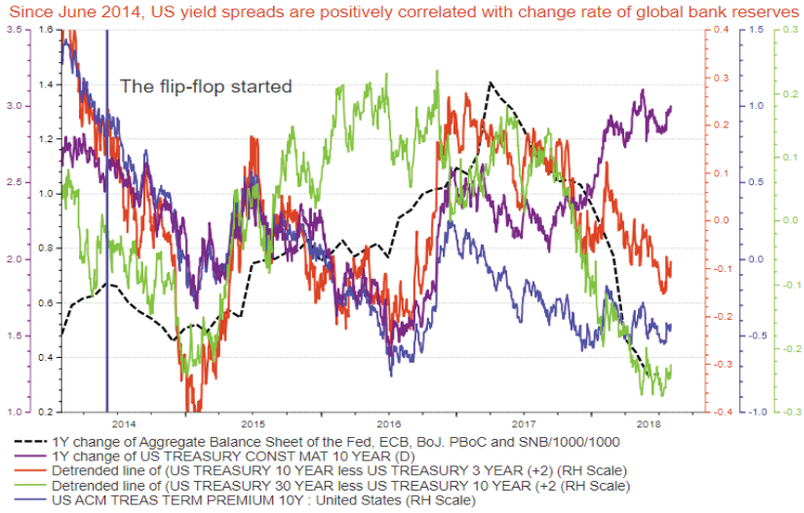
That relationship changed (flip-flopped) in June 2014



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

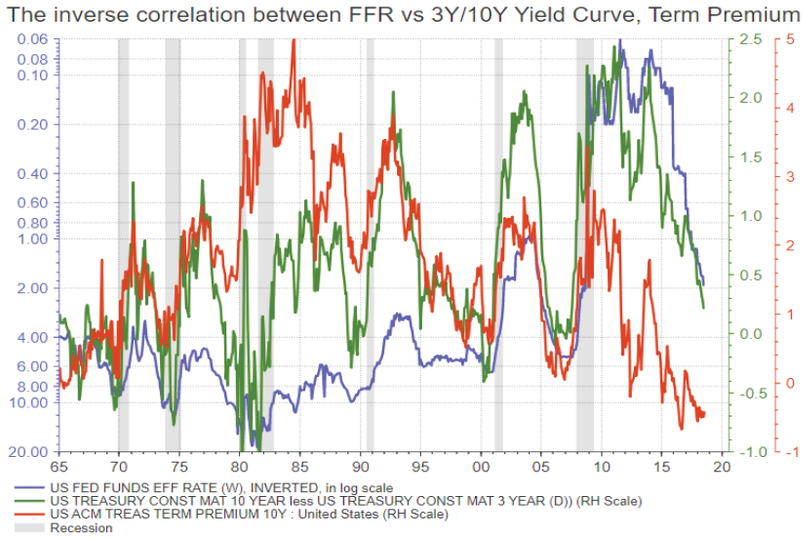
G5 (US,EU,JPN,CHI,CHF) balance sheet, M0 vs Term Premium, Yield Curve

Since June 2014, US yield spreads are positively correlated with change rate of global bank reserves



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

The inverse correlation between FFR vs 3Y/10Y Yield Curve, Term Premium



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

It is plain for all to see that the bond term premium is also falling in lock-step with the flattening of the yield curve, as the Fed policy rates are tightened. Since the term premium comprises compensation for interest rate and inflation risks, it is a significant part of a bond rate. Rising term premium increases the bond rate, and vice versa.

This is what is causing US yield curves to flatten: term premia have been declining since 2009 (when the Great Financial Crisis officially ended), and correspondingly, yield curves have flattened.

So, we can now summarize the function of the rising Fed Funds Rate in flattening the curve: rising policy rates diminish inflationary risks over the longer term. That impacts the long bond yield profoundly as the bond term premium correspondingly falls. The long bond will therefore tend to fall (or at least not rise significantly), even as the short rate is being pushed higher by upside pressure from rising Fed policy rates. Ergo, the yield spread narrows, and the yield curve flattens.

Conclusion:

We have seen two primary movers of the flattening of the US yield curve: (1) Global Quantitative Tightening (or declining flows from the global central banks' aggregate balance sheets, QT), and (2) the continued policy tightening modality of the US Federal Reserve. We have seen how any one of those factors can make the yield spreads narrow, which makes the yields curves consequently flatten.

The Fed is acting out its normal reaction function to rising growth and full employment (when job openings are more numerous than the number of unemployed, which is the case today). Since after World War II, that has consistently produced an inversion of the US yield curve, followed by an actual recession (two sequential negative quarterly growth) 6 to 7 quarters later. As we have pointed numerous times in previous issues of the Capital Observer, it is NOT the yield curve INVERSION that does the damage – it is the PROCESS to an inversion which kills growth and asset prices. The inversion is the symptom – analogous to a cancer which has become distinct enough to be detected by imaging techniques. But the harm has been done even before the cancer is detectable – the patient is already dying. "This time will not be different" – the Fed will overtighten (they always have done so) and we will get a recession sometime in H1 2019 (on this metric alone).

It gets worse. Global central banks are also doing QT, which by itself is also capable of inverting the US yield curve and those of other lesser economies. And global QT will accelerate during Q4 when the ECB starts to pare its balance sheet. The Bank of Japan is already making noises about lightening up, although you have to take that with a bagful of salt, as that desire is more of a wish than actual policy. Therefore, global yield curves will flatten further, and would invert, sooner or later.

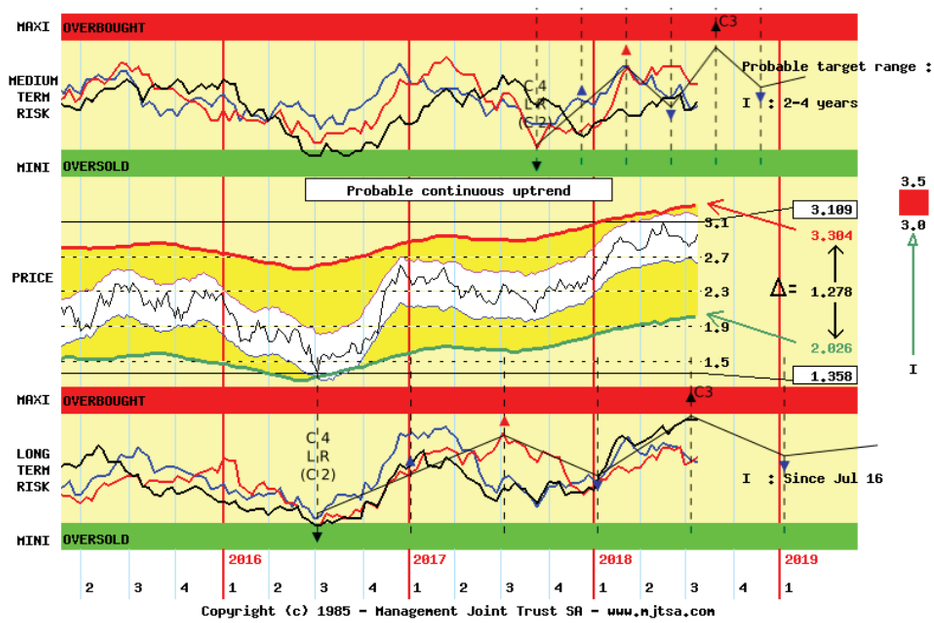
It's a double whammy folks. So, a bunch of clichés come to mind. "Batten the hatches"; "plug the dikes (with your fingers)"; and eventually, "away all boats". Mixed metaphors; but there one thing that is singularly clear: after the Fed and the other central bankers are done with their thing, only those that have been forewarned, and have managed to keep their powder intact and dry, will be around to pick up the pieces. On the cheap. Stick with us, and we will try to guide you through this looming coming deterioration – we will do the cheap-picking together.

49 / MJT - TIMING AND TACTICAL INSIGHT

More Flattening to come on the US yield curve, possibly inversion by year-end

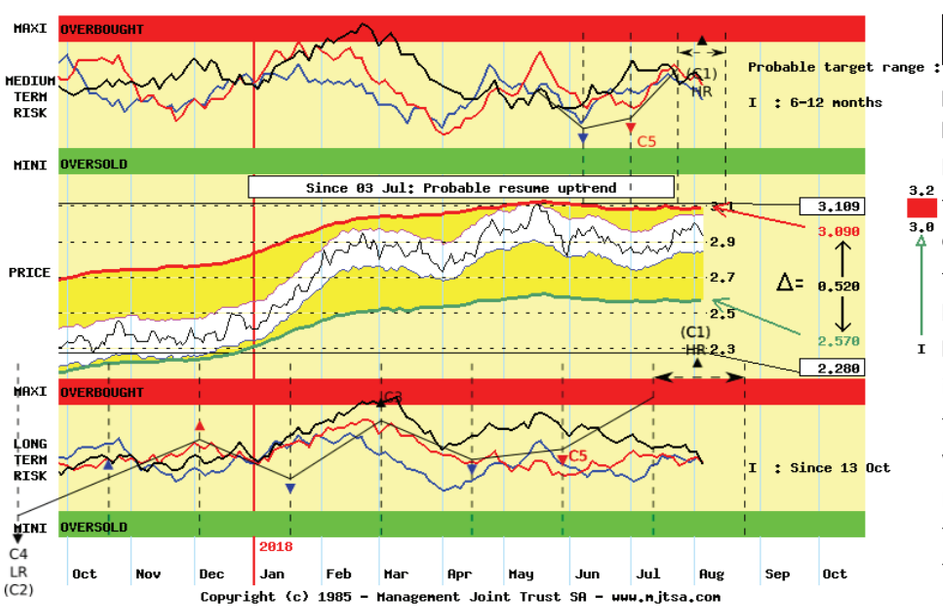
Over the last few weeks, concerns about a steepening yield curve have arisen as it was rumoured that the BOJ was planning to engineer a slight shift up on the long end of its curve. More generally, there was some debate about the general attractiveness of the US Treasury market in light of the strong issuance schedule ahead and the possible reduction in holdings from foreign strategic buyers (such as Russia which recently sold all its US Treasury holdings). In the end, expectations about the BOJ meeting were somewhat deceived, while concerns on the demand side for US debt issuance are probably overblown, for now at least. Given the economic deceleration we expect ahead and the FED's commitment to continue to normalize, we anticipate further Bear Flattening for the US Yield Curve over the next few months.

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



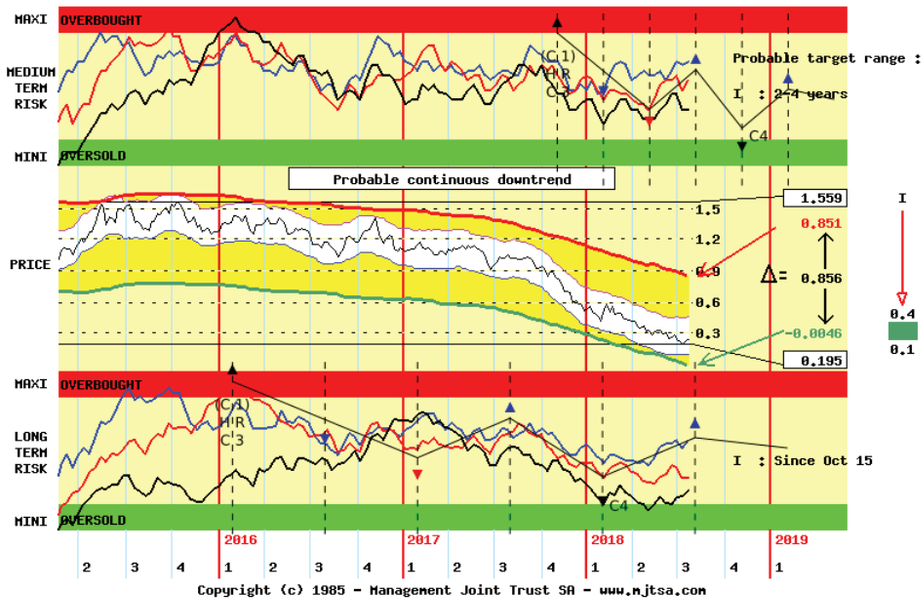
From their lows in mid 2016, rising US long term Treasury yields have accompanied the reflation trade up. That said, on both our oscillator series (lower and upper rectangles), we now believe **that an important intermediate top is approaching**. Indeed, even if our I Impulsive targets to the upside (right-hand scale) still suggest that US10Y yields could rise into the mid 3s%, the time left to achieve such a move is limited: until mid Q3 on our medium term oscillators (upper rectangle), while, on our long term oscillators (lower rectangle), the top could already be behind us. **The retracement move we expect on US10Y Treasury yields into next year is between 60 and 100 basis points. Hence, over the next few weeks, we would start accumulating US Treasuries.**

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



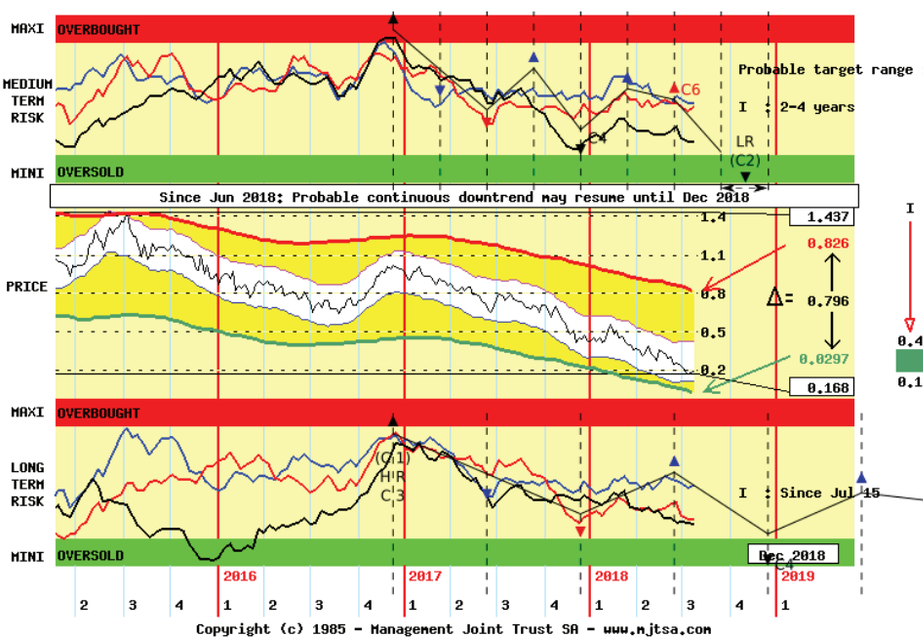
Both our oscillator series (lower and upper rectangles) are **approaching "High Risk" situations between now and mid August**. We hence expect the current upside retest on US10Y Treasury yields to die out over the next week or so. Going forward, we would typically expect between **2 and 3 months of consolidation to the downside at least** in such situations, if not more if the previous uptrend eventually reverses down. Initially, we would expect that US10Y yields go down and test the support of our C Corrective targets to the downside (towards 2.7%; right-hand scale), probably towards late August. If these were to break, **the next levels of downside targets we can calculate is between 2.4% and 2.2%**. These pretty much match our projections above on the Weekly graph.

US 30 years Benchmark Bond Yield - US 5 years Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



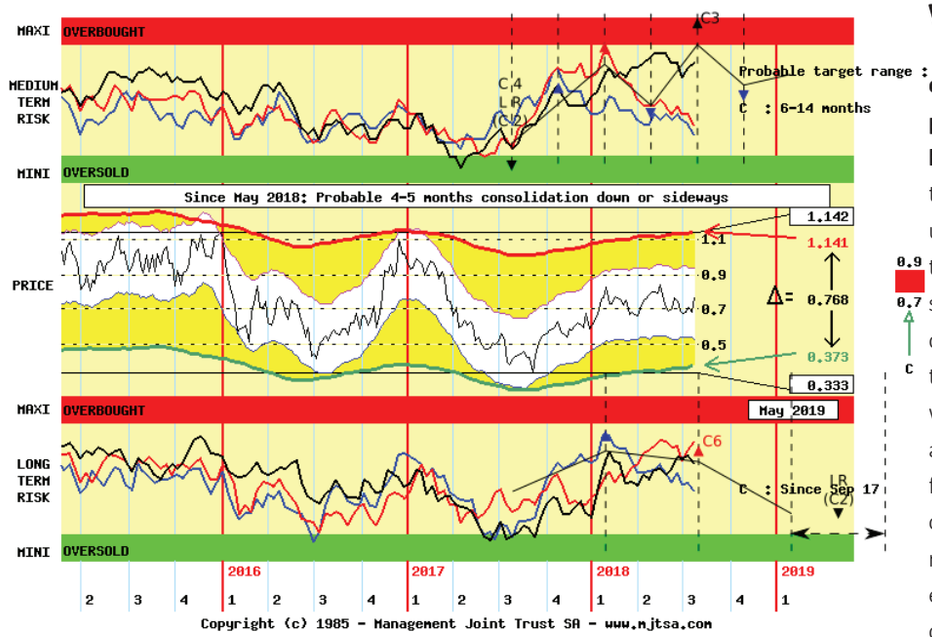
We now switch to the US Yield Curve and first to its longer end with the 30Y – 5Y spread. For now, it is still in a downtrend, yet is getting quite close to exhaustion. Our I Impulsive targets to the downside (right-hand scale) have almost been fully achieved (although another 10-20 bps of tightening is theoretically still possible), and our long term oscillators (lower rectangle) are already well oversold. On our medium oscillators (upper rectangle), we may expect one last leg down, possibly towards mid Q4. **The 30Y-5Y spread is close to inversion and may dip into negative territory towards year-end.**

US 10 years Benchmark Bond Yield - US 3 years Benchmark Bond Yield
Weekly graph or the perpsective over the 2 to 4 quarters



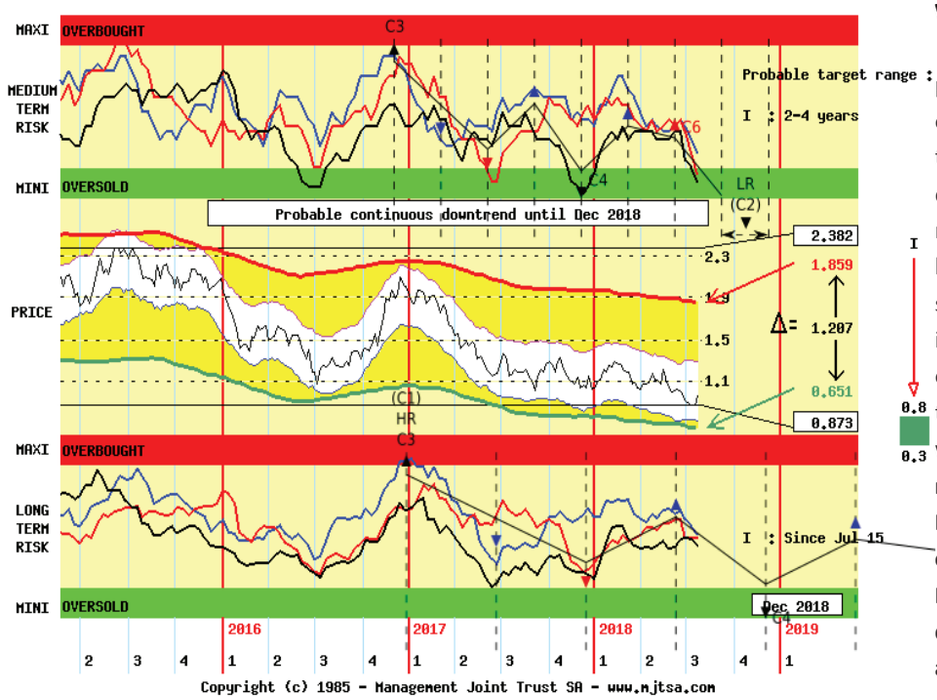
The 10Y – 3Y spread shows similar exhaustion, yet the timing of the next inflection point seems clearer. Indeed, on both our oscillators series (lower and upper rectangles), we would expect an important intermediate low towards December this year (as confirmed by our Automatic Messaging). **Here too, we can probably expect 10 to 20 additional basis points of flattening before the curve actually inverts towards year-end.**

US 3 years Benchmark Bond Yield - US 3 Months benchmark Bond Yield Weekly graph or the perspective over the next 2 to 4 quarters



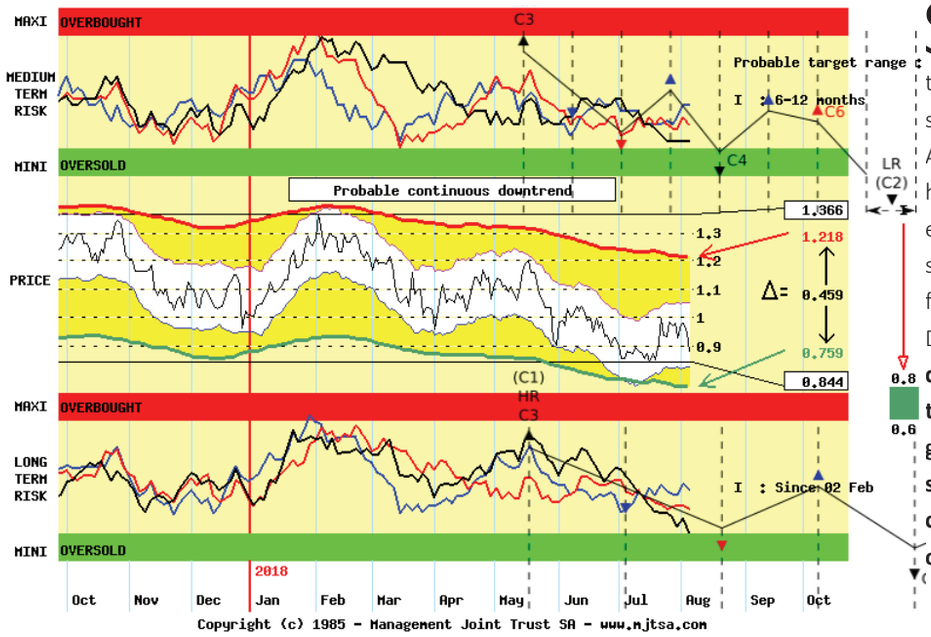
We now turn to the shorter end of the yield curve where we probably expect the most flattening to happen. Indeed, 2 to 5 years treasury yields have been bid up quite aggressively during the last 12 months given the strong US debt issuance schedule. On the other hand, negative short positions across the whole Treasury spectrum are at all time highs (Bear Steepening fears). We believe that these conditions may create an interesting set-up for the shorter end 3Y-3M US yield spread to correct down. Indeed, on both oscillators series (lower and upper rectangles), we have reached an intermediate top. Given that the move up since Q3 2018 is still in its early stages, and hence fragile (it hasn't yet broken above our C Corrective targets to the upside; right-hand scale), **the retracement to the downside may be quite substantial over the next couple of quarters.**

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



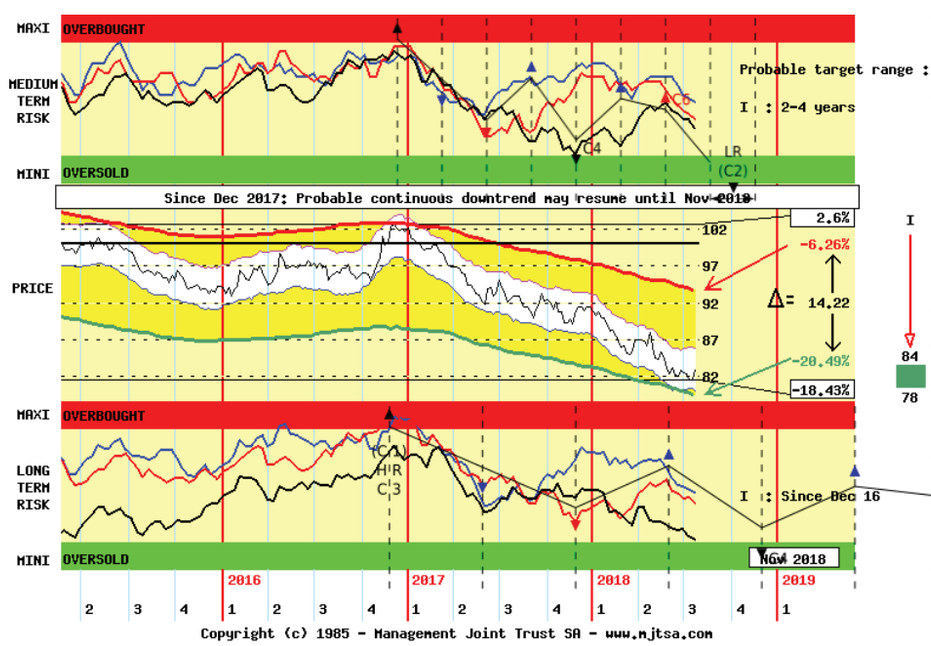
We turn to the 10Y – 3M spread which encompasses both the projections on the long and short end of the US yield curve. On our medium term oscillators (upper rectangle), the spread already looks oversold. That said, it should manage to extend lower into the Fall. On our long term oscillators (lower rectangle), the situation seems clearer, with **a continuation of the current downtrend, possibly until December (as mentioned by our Automatic Messaging). I Impulsive targets to the downside (right-hand scale) are pointing towards the 0.8% - 0.3% range. Achieving the lower end of these targets would imply that the shorter term spread (3Y-3M) could drop as much as 50 to 60 basis points (probably retesting its 2017 lows), given that the longer term end is already quite exhausted (perhaps 10 to 20 basis points of flattening potential left to the max)**. This probably implies a significant unwind of the current net short position on US Treasuries and an important cross asset shift towards safer assets. Following that, the spread could start to widen again as we move into H1 2019, possibly as the US FED tightening spree reaches its own exhaustion and anticipations for higher short term interest rates start to recede.

US 10 years Benchmark Bond Yield - US 3 Months benchmark Bond Yield
Daily graph of the perspective over the next 2 to 3 months



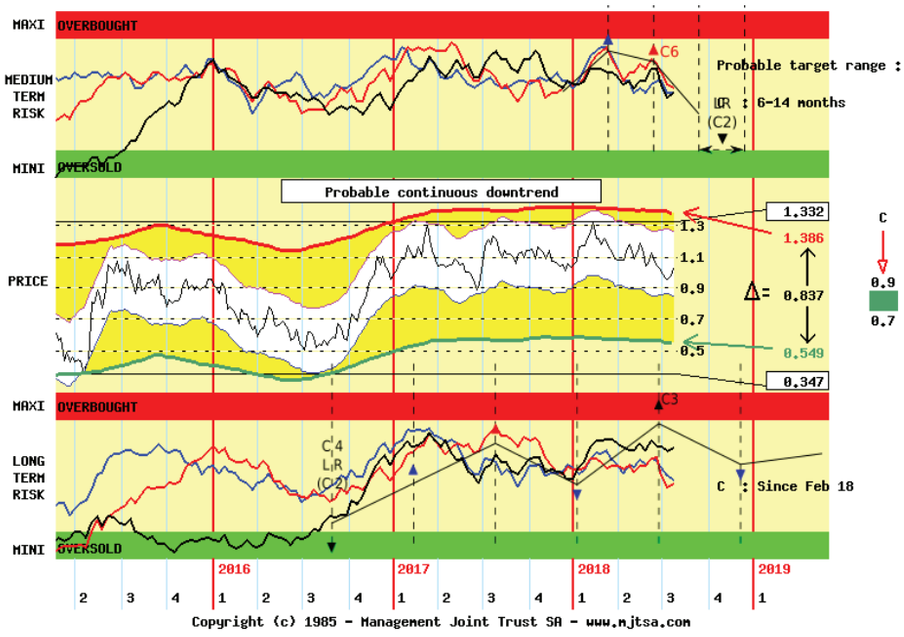
Shorter term, we expect the 10Y-3M spread to resume lower towards late August on both oscillator series (lower and upper rectangles). A slight steepening bounce may happen again towards late August / early September, but in general, the spread continues to tighten, possibly from late September into November/ December. **Over the few weeks, the drop could tighten the spread by 20 to 40 basis points (I Impulsive targets to the downside; right-hand side), which would probably be concomitant with the possible sell-off we expect on risk assets.**

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



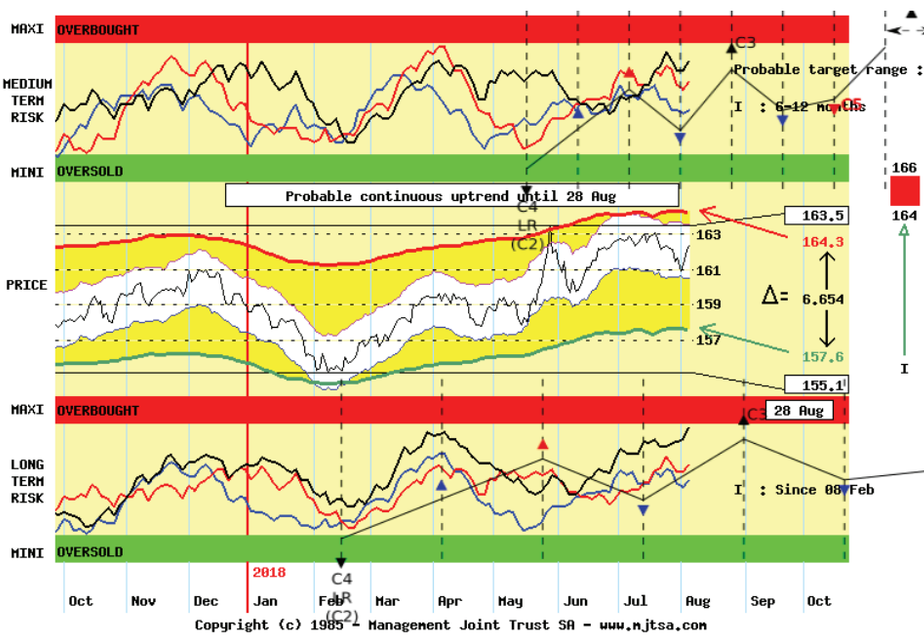
The ratio of Value vs Growth stocks within the S&P500 confirms our yield curve flattening anticipations towards year-end. Indeed, both our oscillators series (lower and upper rectangles) would suggest that **Value probably continues to underperform Growth well into Q4 this year. That said, we don't expect this shift to be as strong and as long as what happened in 2017, given that the downside potential of Value vs Growth is slowly reaching exhaustion**, i.e. 5 to 6% additional downside according to our I Impulsive targets down (right-hand scale).

Germany 10 years Benchmark Bond Yield - Germany 2 years Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



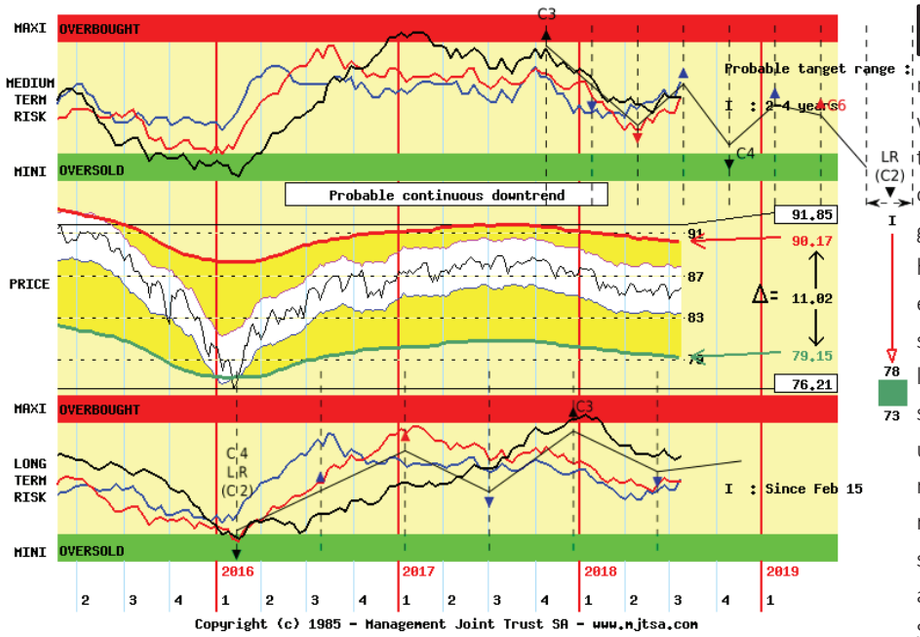
In Europe, we expect the yield curve spread, which is mainly driven by its long end, to continue to tighten, probably towards mid/late Q4 in first instance. Both our oscillator series (lower and upper rectangle) seem to confirm this trend. Downside targets over the next 3 to 4 months should reach the support of our C Corrective targets to the downside (right-hand scale) or towards 0.7%, 30 to 40 basis points below current levels. **This is quite a defensive projection and our view is that the ECB has probably missed its window of opportunity to normalize its monetary policy, for this cycle at least.**

Bund Futures
Daily graph or the perspective over the next 2 to 3 months



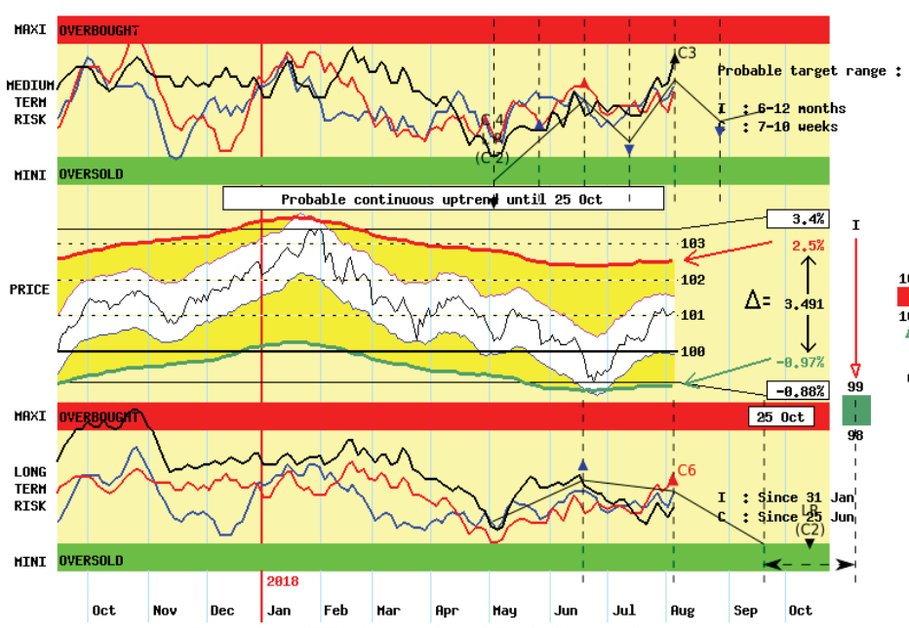
Shorter term, the Bund has moved up quite substantially since February and actually made new year to date highs in May, which it then retested in July. Both our oscillators series (lower and upper rectangles) would suggest that **the current leg up, probably extends into late August at least.** The upside potential from our I Impulsive targets to the upside (right-hand scale) is still quite compelling, **some 2 to 3 % above current levels.** Following that, the Bund probably retraces a bit during September and perhaps early October, and then moves up again into year-end. **These projections would confirm our rather risk-off anticipations until year-end with a slight pause during September and October.**

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



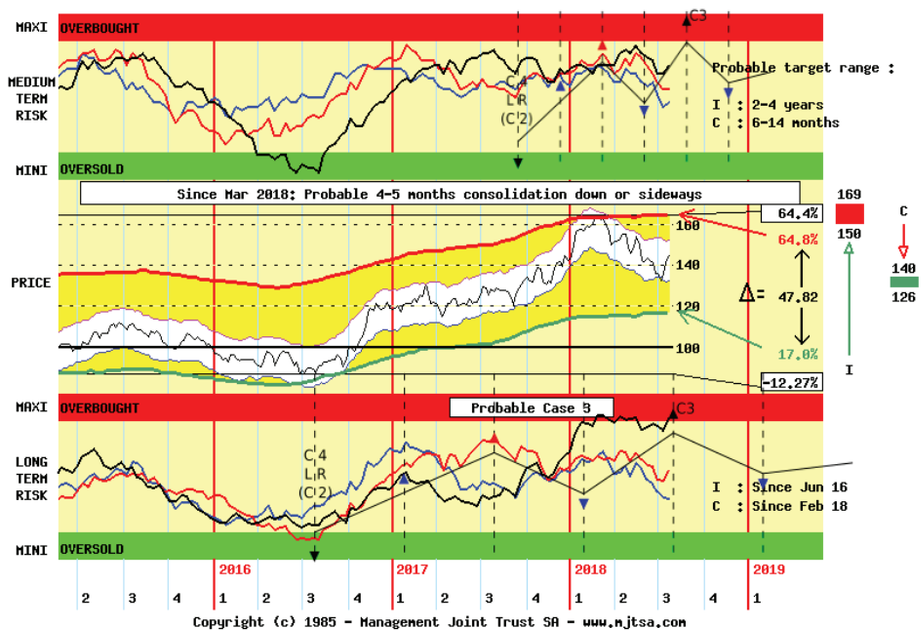
Back to the US, we now consider the High Yield segment, where we expect further weakness into year-end. Indeed, the segment was one of the first ones to move when reflation got started in early 2016. It was heavily weighted towards Energy and when the Oil market started to show signs of rebalancing, its bounce was quite swift. From the Summer of 2016 until the Summer of 2017, it managed to compensate for rapidly rising yields, given that Credit spreads were falling as quickly as Treasury yields were rising. Since Q4 2017, this hasn't been the case anymore and US High Yield has begun to reverse lower. On both our oscillator series (lower and upper rectangles), **we expect High Yield to continue to weaken, probably into mid Q4 at least. Given that we believe that Treasury yields could start to retrace down, it implies that Credit spreads could then start to widen even more. For now, US High Yield prices are still holding up, yet our I Impulsive targets to the downside (right-hand scale) highlight the risk of a more substantial correction to the downside.**

LQD - iShares iBoxx $ Investment Grade Corporate Bond ETF / IEF - iShares 7-10 Year Treasury Bond ETF
Daily graph or the perspective over the next 2 to 3 months



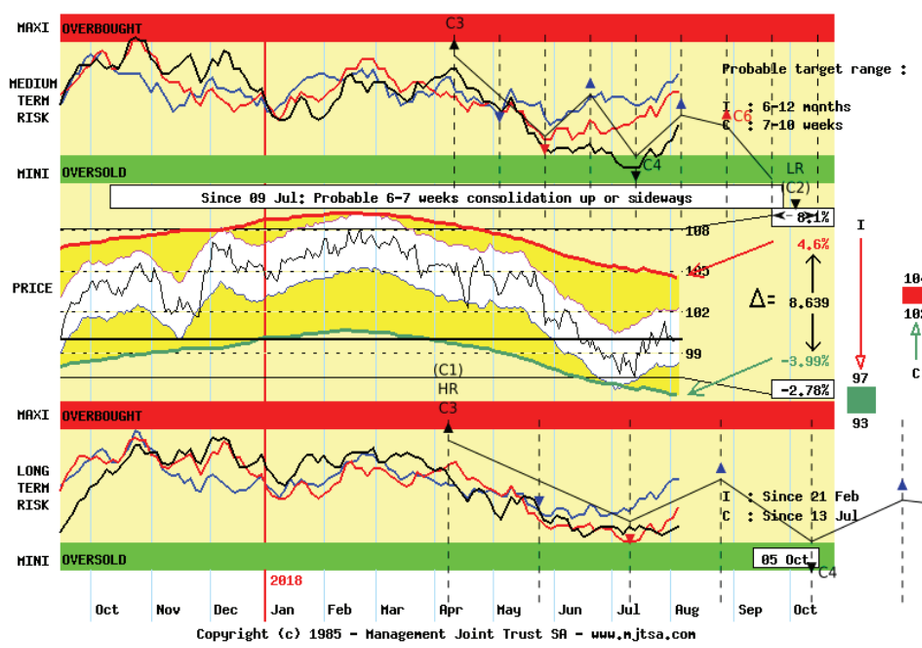
Looking at the price of Corporate Bonds vs Treasuries (i.e. similar to looking at inverted credit spreads), we believe that an important top was made in late January and that the downtrend since then is still in place. Our I Impulsive targets to the downside (right-hand scale) would suggest 2 to 4% of additional underperformance for Corporate bonds vs Treasuries (credit spreads should resume their widening). According to both our oscillator series (lower and upper rectangles), we believe that **the bounce in the ratio since late June (retracement in credit spreads) is probably coming to an end and we expect it to resume lower probably towards late August and perhaps even mid September. This projection would match our view that a tougher environment for risk assets will probably materialize over the next few weeks.**

XLF - Financial Sector SPDR Fund / RWR - SPDR DJ Wilshire REIT ETF
Weekly graph or the perspective over the next 2 to 4 quarters



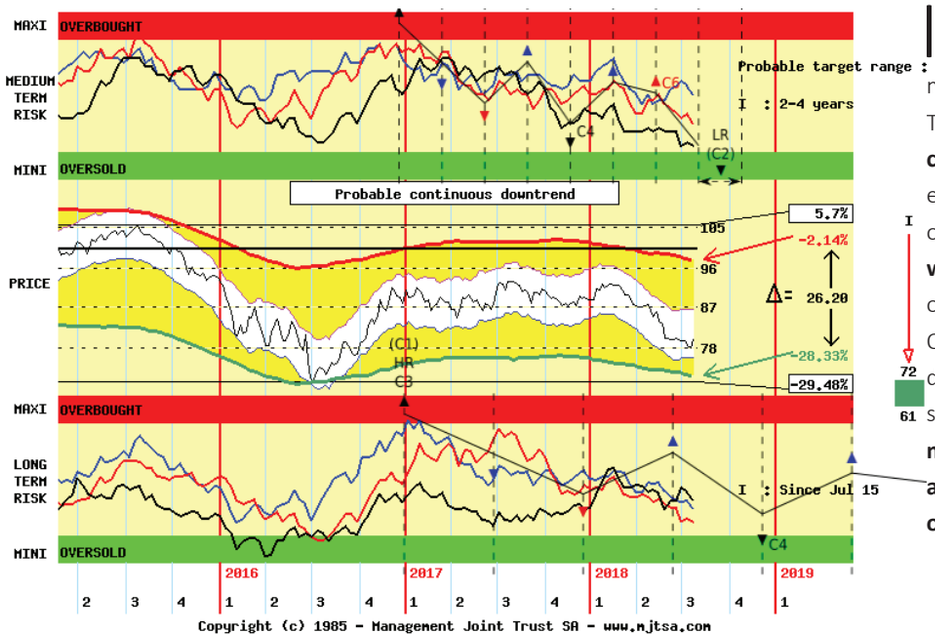
Looking into the sectors, which are most closely related to long term yields and the yield curve, we first compare the US Financials sector with US REITs. Both show dynamics, which are quite opposite. Indeed, **as the relative strength of Financials usually correlates quite well with risk assets, the yield curve and inverted credit spreads, the relative strength of REITs is closely related to the performance of Treasuries and Defensive sectors.** The graph suggests that the breakdown since mid Q1 is quite serious and in our view probably concludes the reflation trade in place since early/mid 2016. Both our oscillator series (lower and upper rectangles), which are reaching potential new reversal points to the downside, would suggest **that the current short term rebound is probably a weak upside retest before a greater fall.** In late January our I Impulsive targets to the upside had been reached (right-hand scale), which probably concluded the uptrend. Looking into year-end and early next year, we expect that the support of our C Corrective targets to the downside will be tested (more than 10% below current levels on this ratio). This again is quite Defensive in terms of cross sector allocation.

XLF - Financial Sector SPDR Fund / S&P 500 Index
Daily graph or the perspective over the next 2 to 3 months



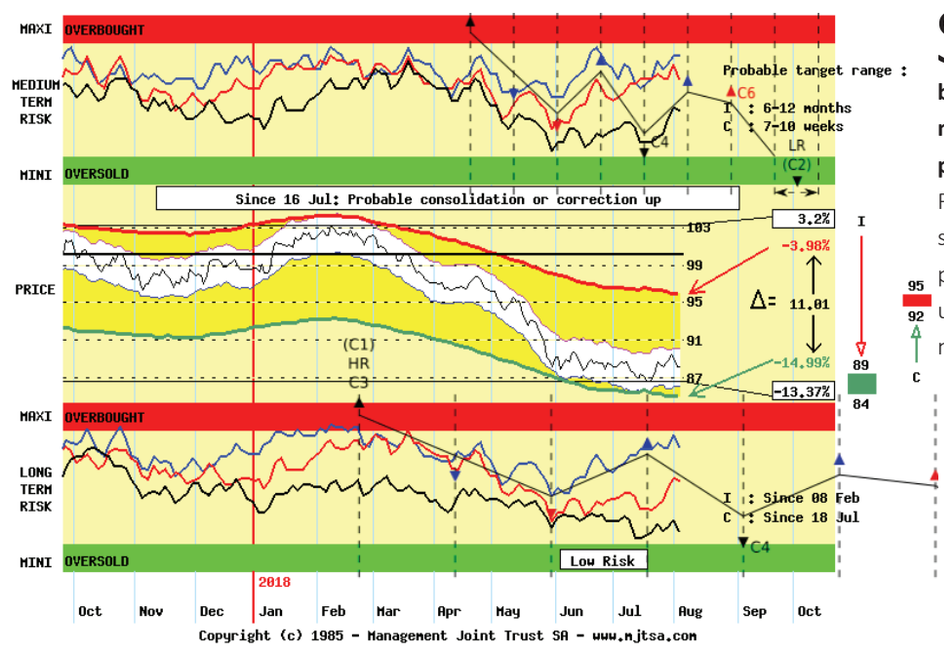
We now look at US Financials vs the S&P500 index. The sector has underperformed the market since February and according to both our oscillators series (lower and upper rectangles) should continue to do so, probably into late September, perhaps even early October. Shorter term, we expect **the current bounce to die out soon and gradually start to roll-over. We hence expect little relief for the Financial sector vs the market over the next few months** and according to our I Impulsive targets to the downside, the underperformance potential is between 3 and 7%.

European BANK Sector / Dow Jones STOXX Europe 600
Weekly graph or the perspective over the next 2 to 4 quarters



In Europe, the Banking sector has also been underperforming the market since Q1 2018. This **underperformance should continue** probably into late Q3, early Q4 on our medium term oscillators (upper rectangle) and **well into Q4** on our long term oscillators (lower rectangle). Our I Impulsive targets to the downside (right-hand scale) also suggest **further underperformance, potentially between 10 and 25% over the next couple of quarters.**

European BANK Sector / Dow Jones STOXX Europe 600
Daily graph or the perspective over the next 2 to 3 months



Shorter term, we expect that **European Banks are probably resuming lower vs the market, potentially until early, perhaps even late September**. For now, there is limited downside potential left in this move, probably between 4 and 5% underperformance over the next few weeks.

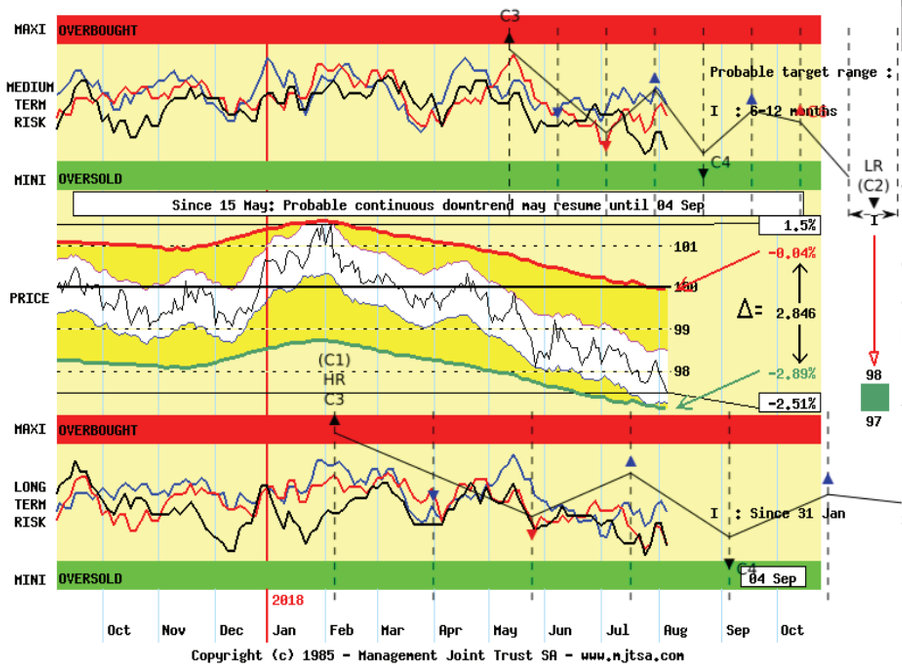
Concluding remarks

While the last few weeks have seen quite a few comments about Bearish steepening, we believe that the next few months should see more Bearish Flattening and even Inversion on some spreads. Indeed, for now, the FED remains committed to normalize its monetary policy (potentially 4 more rates hikes and more QT), while medium to long term treasury yields should gradually start to retrace. We believe that the flattening could be particularly strong on the shorter end of the curve as 2 to 3 years Treasury yields have been bid up quite strongly since mid last year, probably because of the large amount of new debt issuance on that segment. More generally, net short positions against Treasuries across the whole yield curve are currently at record highs, which makes them vulnerable to a rapid short squeeze. In Europe, we also expect long term rates to continue lower, probably until Q4 at least. Not surprisingly, Financial sectors on both sides of the Atlantic are expected to continue to underperform, probably well into Q4.

57 / Splicing the markets – Is the US Dollar risk-on or risk-off?

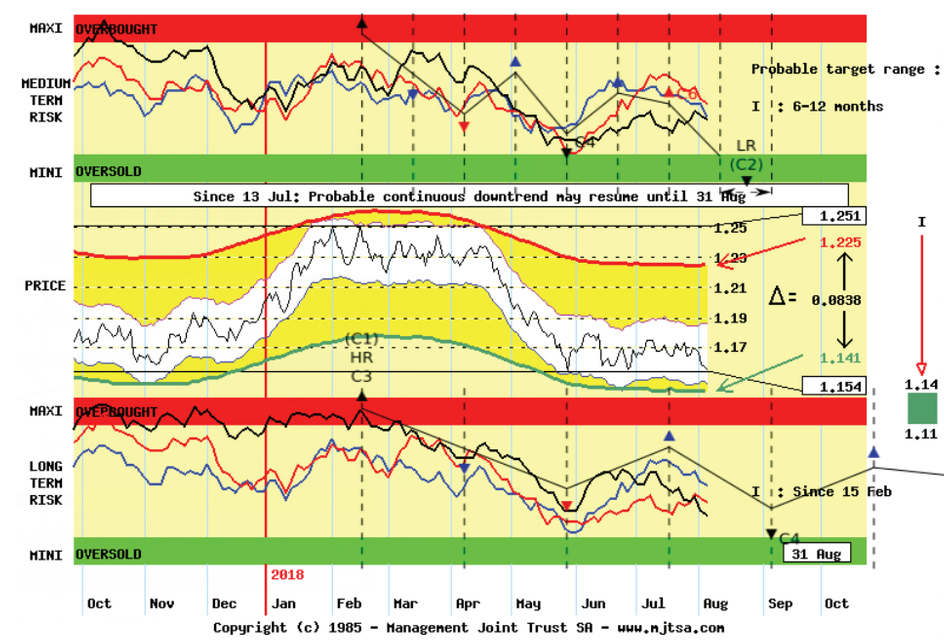
The above question is difficult to answer as the US Dollar and US market have been acting as a Growth trades since the Spring. Indeed, while the hard data is Europe is decelerating and the Trade War has rocked havoc in China, the US still appears as an island of stability and equity flows have pilled into the US and especially its Big Growth technology stocks. That said, at some point, we believe the US will reach its own deceleration problematics, this may be the case during the Defensive shift we expect between now and the Fall.

TIP - iShares TIPS Bond ETF / iShares Government Germany 5.5-10.5yr UCITS ETF
Daily graph or the perspective over the next 2 to 3 months



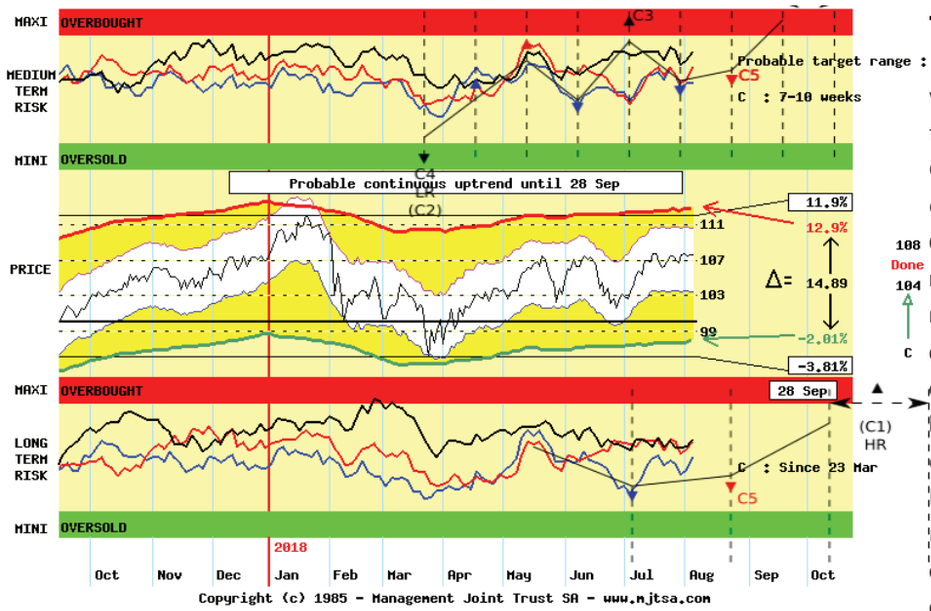
In previous issues of The Capital Observer, we attempted to single out the different drivers of the EUR/USD relationship. **Our conclusion led us to believe that the pair is currently reacting to two main factors, inflation expectations in the US and the interest differential between the US, and Europe. We've hence come up with this ratio, which take both into account, i.e. US TIPs vs German Goverment Bond on a hedged currency basis**. The ratio rises when inflation expectations in the US rise faster than the deceleration perspectives in Europe. On both oscillators series (lower and upper rectangles), we believe **that the ratio should reach an intermediate low between mid/late August and early September.** On a price target the downtrend since February is also reaching exhaustion as it has reached our I Impulsive targets to the downside (right-hand). **Hence, during this Fall, we would probably expect a counter-move on the ratio (inflation expectations in the US may be slowing? Or is it Europe that is feeling slightly better?).**

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



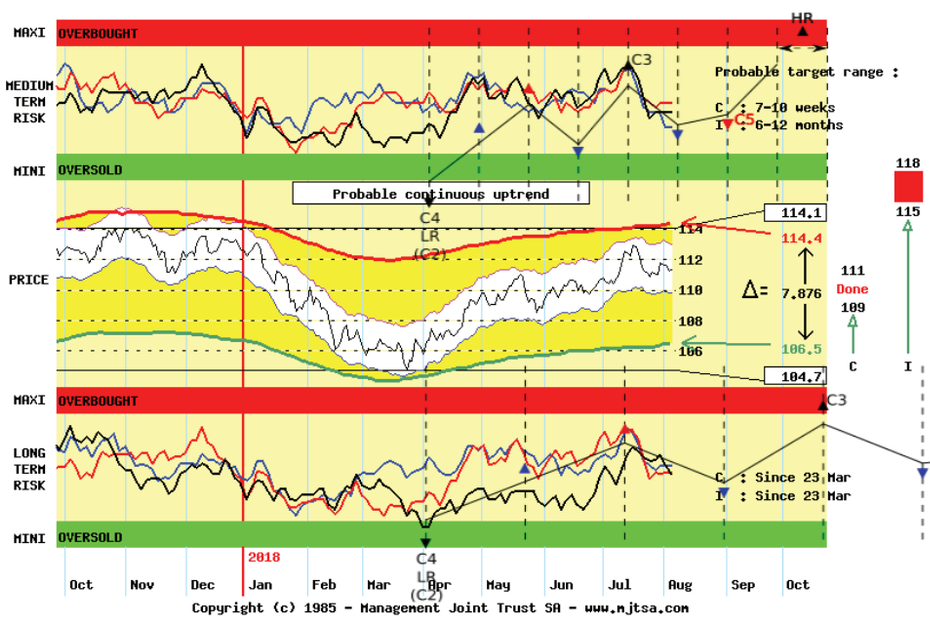
As you can notice, EUR/USD does indeed seem to follow the dynamics above, yet its moves are less gradual (long consolidation periods followed by rapid directional moves). That said, the scenario we map our on both our oscillator series is similar to the one above. We would expect that **the current downtrend finds a intermediate low, probably towards mid/late August, perhaps early September. The bounce that follows could last well into October**. On the price target front, EUR/USD may have some catching up to do vs the ratio as its I Impulsive targets to the downside have not yet been reached (right-hand scale). Indeed, **EUR/USD could reach the 1.14 – 1.11 zone during a final sell-off. Following that, the C Corrective targets to the upside we can calculate imply that EUR/USD moves back up towards the 1.17 – 1.19 range, probably towards late October** (or 0.5 to 0.8 times our historical volatility measure "Delta", here at 0.0838 added to the middle of the current downside target range, i.e. 1.125).

MSCI All Country World Index / Japanese Gov. Bonds (Sep)
Daily graph or the perspective over the next 2 to 3 months



Trying to understand the dynamics behind USD/JPY, we are attempting to use the following ratio: the MSCI All Country World Index vs JGBs, denominated in Yen. **The All Country World Index is the main volatility driver in this ratio, yet the JGBs and the Yen do have a negative influence, especially in periods of market turbulence**. From, what we can read from both our oscillator series (lower and upper rectangles), **we are currently expecting a slight period of consolidation on the ratio, probably into late August, before it moves up again towards late September and perhaps October.**

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



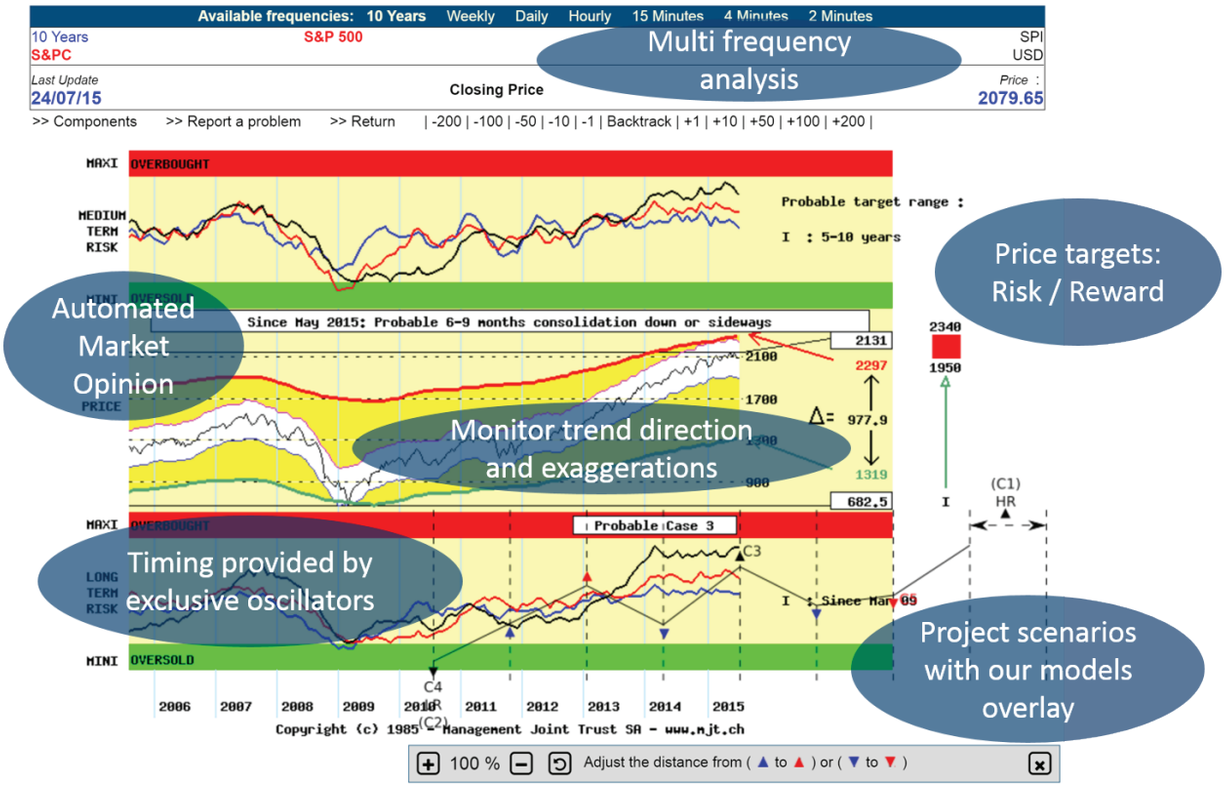
Similarly to the ratio above, USD/JPY has been moving up since late March. This is pretty standard as the pair usually follows risk assets up and down. According to both our oscillator series (lower and upper rectangles), **USD/JPY just made an intermediate top mid July, and is still is a period of consolidation, probably until late August. Following that, we expect it to move up gain, probably into late October. Depending on the sell-off we get during the rest of August our I Impulsive targets to the upside (right-hand scale), above 1.15 may or may not be difficult to achieve during September and October.**

Concluding remarks

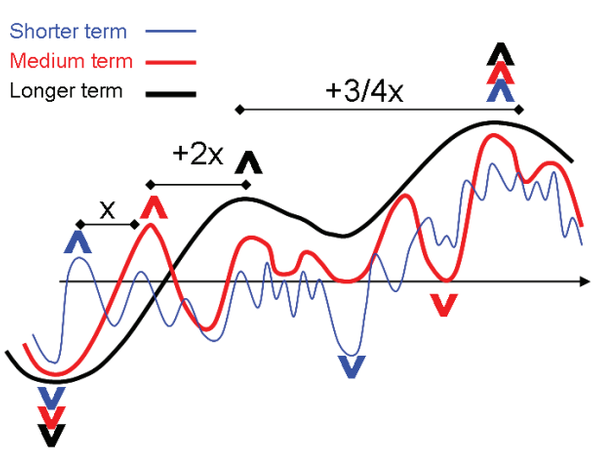
Currently, the US Dollar is moving up vs both the Euro and the Yen. We believe that during the next few months, this relationship may change. Indeed, the Yen should first strengthen and then weaken again vs the US Dollar (risk-off, then risk-on), while the EUR/USD continues to weaken until late August before it rebounds into October (defensive/growth extension). These dynamics, if true, should trigger a rally in EUR/JPY from end August, and according to our tables, this cross usually correlates quite well with a flattening yield curve and a tightening of the US to Europe interest differential. During such periods, Defensive and Growth profiles usually also outperform. Not surprisingly, these are the basic tenants of our scenario from September into October. It remains to be seen however if we are correct in calling a worthwhile risk asset correction until the end of August, and then, following that, how strong the September/October recovery/extension actually turns out to be.

59/ 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)



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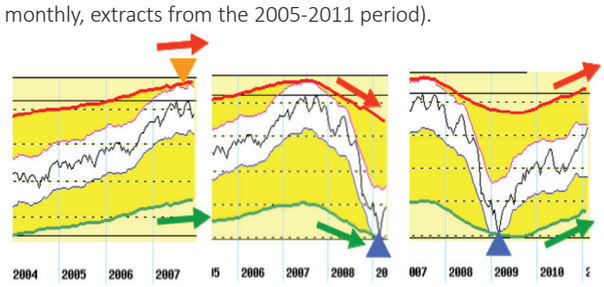
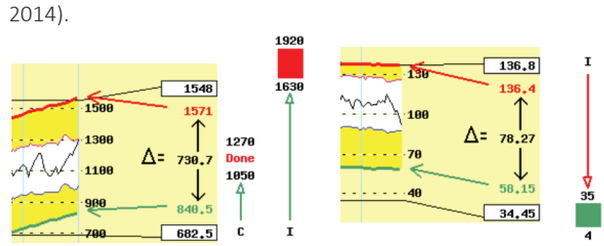
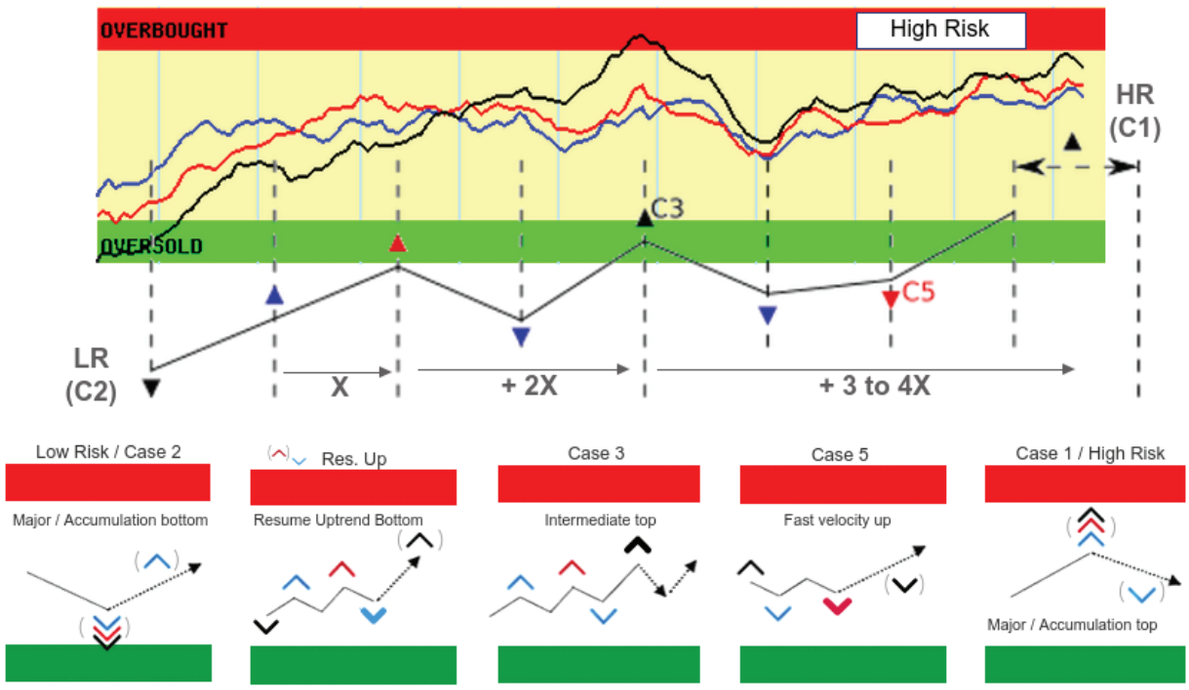
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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



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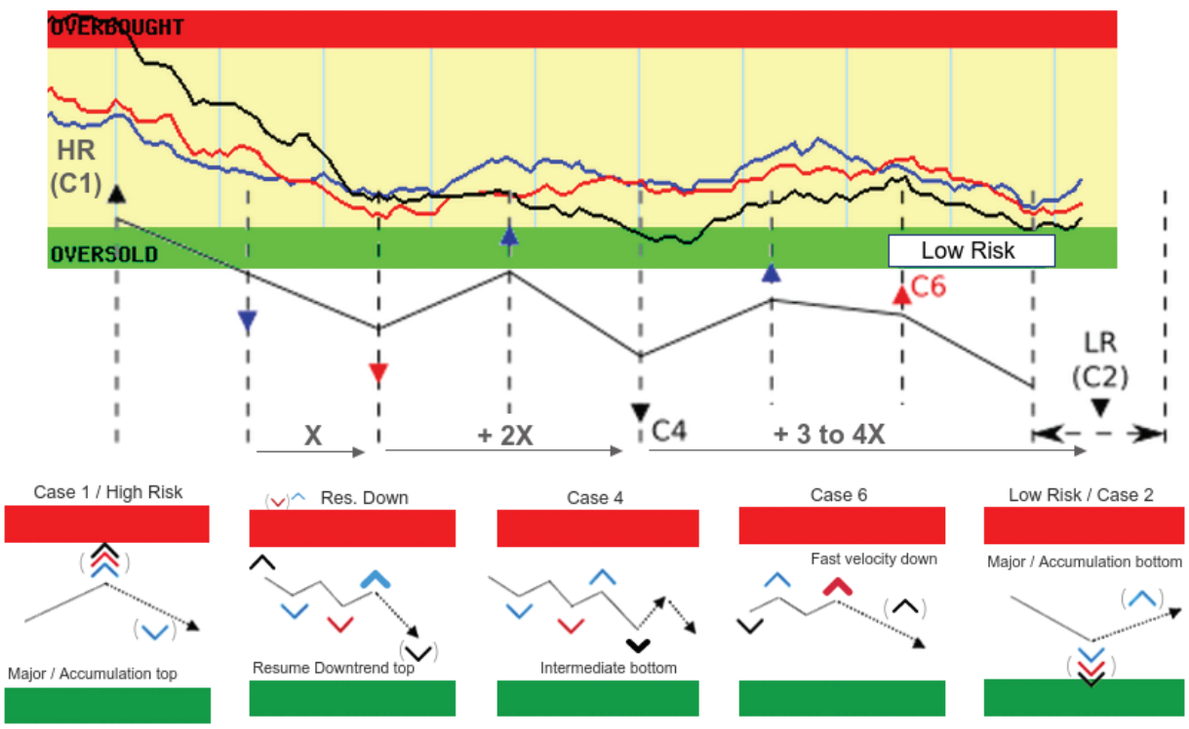
(left to right) from an oscillator black bottom (usually a Low Risk or a Case 2), the oscillators and prices will start moving up. An uptrend is confirmed once a red top can be made above a blue one. The correction down that follows delivers a buying opportunity ("Resume Uptrend") followed by an intermediate 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



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(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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