THE CAPITAL OBSERVER

OCTOBER 2019

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

DC&C
DIAPASON CURRENCIES & COMMODITIES

THE CAPITAL OBSERVER

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

OCTOBER 15, 2019

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"Our base case is that the Fed, following the two rate cuts in July and September, delivers additional easing over the next several quarters, thus dis-inverting the U.S. Treasury yield curve and reducing recession risks. "

J Fels, Pimco

4/ Executive Summary

12 / **The US Dollar has remained resilient but a short-term weakness of a few weeks due to "safe haven" unwind and liquidity improvement is still in the cards** - The market (and us) were blindsided in August 2019 by the transformation of the US Dollar to a safe haven destination, when yields and equities embarked on their final trip to their seasonal troughs. That continued to push the Dollar higher. At that time, there were cross-currents from day-to-day news flow as the trade discussions between China and the US went nowhere, contributing to the further fall in yields and risk assets. The seasonal changes in US systemic liquidity has been a reliable forecaster of changes in bond yields, and by implication, also of changes in the exchange rate of the US Dollar. We know that to be true, as the 5-year average of the 10yr yield hews very closely to the seasonal patterns of systemic liquidity which varies very little, year-in, year out for the past 10 years at least. The covariance of the US Dollar with the yields and liquidity flows is not as well-defined, but there is a definite rhyme in the relationships. The correlations are lagged, however, tripping unwary analysts. The US Dollar lags behind the major moves of the bond yield, and is now due to fall as consequence of the lagged effect of the previous decline in yields. The DXY may fall for the next 6 to 8 weeks. But we expect yields to rise thereafter towards year-end, and it's likely that the US Dollar will be arising alongside yields during that period, allowing for a short time-lag.

15 / **Timing and Tactical Insight - The US Dollar has entered an intermediate correction** - The US Dollar may have reached an intermediate top vs most currencies. Throughout this year, the US Dollar had indeed continued to grind higher on the back of deteriorating global economic fundamentals and a relative resilience of them in the US (at least on the consumer front). The prospects of some version of QE as well as the cyclical recovery we believe could start materializing over the next few weeks may hence validate this US Dollar correction, which we expect could last 1 to 2 months in first instance, probably into mid/late November, perhaps December. Most Dollar pairs should be affected, yet probably USD/CHF to a lesser extent (USD/JPY on the other hand could even rise). Following that, from late Q4, we expect the US Dollar to resume its uptrend, probably into mid/late Q1, perhaps the Spring. This may indicate some retracement on cyclical assets from late Q4 into early next year.

23/ **Core CPI should continue rising until Q1 2020, at least: actionable ideas in steeper yield curves, and rising cyclical assets**- Our May 2018 premise of further ascent in Core CPI over the subsequent 5 to 6 quarters was essentially substantiated by actual development of the data. Core CPI has risen, pulled back, and is now again rising sharply. That will likely be the case until Q1 2020. The long lag between changes in growth and the variability of inflation, however, presents some peculiar situation, as in when growth is already slowing, and Core Inflation is still rising. That gives rise to one of the least understood economic phenomena-- stagflations. This economic equivalent of a lose-lose situation happens because the lagged response of core inflation does not correspond to the general business cycle. Subsequent, and corresponding, reaction function of the Federal Reserve with its policy rate, the FFR. Here is the timeline: GDP change rates lead changes in Core Inflation by 5 to 6 quarters. Core CPI, in turn, leads changes in the Fed Funds Rate (proxy of Fed policy changes) by 2 quarters. A clarity in the timeline among the three variables of GDP growth, Core CPI and FFR, can help significantly in forming investment strategies. For instance, we now have a way of anticipating the likely Fed policy actions in the near-term, given the current status of GDP and Core CPI. We also note the opportunity that the lagged reaction from govies and corp BBB yield curve provide today. Those yield curves have started to steepen, but there's still a long way to go before the potential created by the Fed policy regime change is fully exploited – the yield curves have not fully steepened yet.

27 / **Timing and Tactical Insight - Now that Inflation Expectations are Oversold, it's time for cyclicity to bounce** - Inflation expectations measured by the Tips to Treasuries ratio are quite Oversold and we would expect them to bottom out and start bouncing during Q4 and perhaps into the Spring. We believe this reversal is important as inflation expectations are quite telling of market sentiment, which we see shifting over the next few months from very defensive to quite pro-cyclical. Other ratios seem to confirm this shift. Indeed, the US Equities to Bonds ratios and the US Equities to Gold ratios are probably also in the process of resuming their long term uptrend and may even extend higher well into 2020. Indeed, we expect equities to rise into next Spring at least while Bonds and Gold retrace some of their year-to date gains. Finally, this pick-up we expect in cyclicity during Q4 should benefit cyclical sectors in the US and Europe. These could see a sharp re-rating vs the market probably into year-end, perhaps until early next year.

35 / **There is very real upside potential to crude oil, and the market is not pricing it in -** It is clear to us that a price baseline at above $50/bbl has been established by the market. Despite fears of an imminent recession (which we at The Capital Observer do not share) prices have become stable above those levels. What this tells us is that there is substantial upside risk to crude oil that the market may not be pricing in. The market is seriously mispricing the OPEC cuts and that in the coming months, the price of crude oil will strongly increase. We also believe that weak demand is currently being trumped by lack of supply, which has led to large drops in stocks this year. Therefore, if we see even a moderate uptick in demand, crude inventories could plummet, and prices could rise significantly. The crude markets remain fundamentally tight and in a positive set up

Crude inventories are currently sitting around the five-year average on the back of an incredible decline in crude stocks this summer. The decline in crude stocks is just a warning of what we believe will be coming to the crude markets sometime soon. Specifically, it could happen that in the coming weeks, we will see the year-to-date draw continue into one of the lowest levels seen in recent years. The reason why we believe that this will occur largely has to do with the supply side of the balance. While demand is still poor, supply is also weak. On the issue of demand, it has been weak this season. As seen in the following five-year range of crude utilization, we have ended the summer driving season with one of the lowest levels of utilization seen in many years.

Nonetheless, underlying fundamentals for crude oil are largely bullish. This bullishness has been felt by an incredible decline in crude stocks earlier this year as well as the forward curve remaining in backwardation. And all of this has been happening with poor demand. There is very real upside risk to crude oil. We do not believe the market is pricing this.

5/ Executive Summary

38 / **Timing and Tactical Insight - Oil should continue to stabilize during October** - Oil and related trades have sold-off quite strongly since April, and are still struggling to stabilize. Yet, our oscillators seem to suggest that following a first bounce from August, Oil, Energy sectors, Energy sectors relative and related geographies are at or close to new cyclical lows. We believe this situation constitutes a base for Oil to start bouncing, probably towards late November / early December in first instance, and potentially towards year-end and early 2020. Obviously, current levels will need to hold over the next couple of weeks to confirm this bullish scenario. On Oil specifically, we believe that prices may retest towards their April highs over the next few months (mid/high 60s on WTI, high 60s/low 70s on Brent).

44 /**Japan's economy is being hobbled by strong Yen, but relief may be on the way as the BoJ strives to steepen the yield curve** - In November 2017, there were hopes then that GDP will notch up a seventh consecutive quarter of growth as exports helped compensate for underwhelming domestic demand. Also, swelling corporate earnings appear likely to have propelled Japan's tax revenue to the highest in 27 years in fiscal 2018 by lifting salaries and shareholder returns. Japan was in a "sweet spot" then. Fast forward to early Q4 2019. Japan has not gotten better – in fact in many respects, the country has gotten worse since we last wrote about their economy. Fiscal policy remains stimulative, but the increase in fiscal liabilities since November 2017, has been minimal, causing the changes rates to fall – a negative development. Government expenditures increase sharply, however, which should underpin GDP growth going forward. Most of the gains that we saw in November 2017 have been decimated by the recently strong yen. The Yen keeps on strengthening, serving as safe haven destination for the world's flight capital. And the globe recently had a long series of geopolitical events that have keep capital seeking safer destinations. Thus, we find a litany of familiar economic and macro data woes, but we also see glimmers of positive news. GDP growth will rise in Q3 2019 relative to Q2. It will be slow take-off, but it looks like Q2 will be the trough for growth, as we said in the July 2019 Capital Observer. Finally, the BoJ is working hard to steepen the curve since last month, scaling back purchases at the long-end of the curve. Also, with stronger macro indications in the US, as measured by the Citi Economic Surprise Index, the US Dollar should start rising, and the Yen continuing to weaken. Domestic equities, especially those of exporters, should rally strongly, if these developments continue.

47 / **Timing and Tactical Insight - Japanese equities continue to bounce, the Yen probably works counter-trend -** Following its rally since mid/late August, and its subsequent retracement during early October, we expect Japanese Equity markets to enter a second leg up, which could last into late November, perhaps early December. Price targets for the Nikkei225 are probably above 23’000, and possibly up to its October 2018 highs above 24’000. Yet, while we are positive on Japanese equity markets, the Yen may work counter-wise and weaken. It could reduce part of the Nikkei’s performance in US Dollar terms, while leading the Japanese market to even underperform vs other equity markets in relative terms. We would hence consider any investment in Japanese equities on a hedged currency basis, probably until early December at least. Japanese Government Bonds are also providing an interesting confirmation as they are probably topping out. They could correct down for the next 3 to 6 months (along with other Government Bonds around the world). This shift out of defensive assets would confirm our risk-ON bias.

53 / **Splicing the markets - The cyclical re-acceleration is probably underway** - Cross-assets, flight to safety probably reached its climax during August and started to unwind with the Momentum Crash early September. Following one more retracement early October, Equity markets, and more generally risk assets, now seem to have built a strong base that could see them accelerate higher into mid/late November, perhaps early December. On the opposite side, Defensive assets such as Bonds or Gold should see a strong sell off during this period, as flight to safety reverses. The rally we expect could almost be labelled “a relief rally”, although starting from very high levels, as overhanging risks dissipate following almost six months of a painful and treacherous consolidation process since April on risk assets.

6/ Mapping the markets

Last month, when we published on the 15th of September, we expected that the September risk assets and cyclical rally could see a short retracement period towards late September / early October and that defensive sectors and defensive assets such as Gold and Treasuries could attempt a last comeback (although probably without new highs). We stated that we would be buyers of this upcoming dip on cyclical themes given that we expected the rotation towards Cyclical assets to gather further steam within the following few months. The late September / early October dip did indeed materialize on risk and cyclical assets, yield retraced down without new lows, defensive sectors retested up vs the market and precious metals bounced timidly. In general, the set-up we had forecast last month unfolded quite precisely, and now, Risk and Cyclical assets are starting to accelerate up again.

Going forward, we expect this current risk asset and cyclical rally to continue, probably towards mid /late November, perhaps even December. We expect yields to rise and the yield curve to steepen, thereby benefiting Value, Cyclical and related Commodity trades which should see a sharp re-rating vs the market and vs defensive sectors in particular. Indeed, following almost 6 months which saw potential geopolitical and economic risks accumulating, while cyclical assets were sold-off, defensive assets were bid up and the general market basically traded sideways, recent newsflow suggest that this rather risk-off environment could be dissipating. The FED is ready to push its “not really QE4 program”, the China-US trade negotiations have apparently reached a possible Phase 1 deal and it appears that PM’s Johnson efforts to broker a last minute Brexit deal could eventually succeed. Over the next 1 to 2 months, we also expect the US Dollar to see an intermediate correction vs most currencies, except for the Yen, as cyclicity and US monetary easing also impact the FX market. As for Precious metals, they should continue their correction down, while Oil gradually stabilizes and starts to resume it uptrend.

From late Q4 into Spring next year, the risk assets rally should continue, although from late Q4, the initial cyclical re-rating we expect could start to reach exhaustion. Cyclical themes could lose the lead to more Growth oriented ones. Generally however, equity markets should continue to trend higher. Our price targets would suggest levels between 3’150s and 3’200s over the next 6 months on the S&P500, between 3’800s - 3’900s the EuroStoxx50. The US Dollar could then make a last rally into new highs as US Growth and Interest rates differentials remain in favor of the US. Oil could also profit from these improved growth perspectives, while Gold continues to retrace into the 1’300s USD/oz and perhaps down to the 1’200s.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	US Equity markets are probably resuming their uptrend towards late November / early December and towards 3'100 / 3'150 on the S&P500.	The uptrend on US Equities may see some consolidation towards year-end / early next year, before resuming higher again into next Spring at least. (3'200?)
	Europe EuroStoxx50	European Equity markets are probably resuming their uptrend towards late November / early December and towards 3'700 / 3'800 on the SX5E.	The uptrend on European Equities may see some consolidation towards year-end / early next year, before resuming higher into next Spring at least. (3'900?)
	EMs MSCIEM USD	Emerging markets are probably resuming their uptrend towards late November / early December with 5 to 10% upside potential.	Emerging markets could continue to bounce into Q1, yet on a relative basis, our graphs suggest that they could underperform again from mid/late Q4.
Treasuries	US10Y Bond prices	US Treasury yields built a base between September and early October and we now expect them to continue to bounce, initially testing their resistance above 2% on US10Y.	US Treasury yields probably continue higher into next Spring potentially towards the mid 2s % on US10Y.
	Germany 10Y Bund prices	German Bund yields should follow US Treasury yields in their rebound. Yet, the bounce should be more subdued.	German Bund yields should continue to bounce into next Spring, but continue to lag behind US ones.

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

Main Equities

World markets
p 29, 47-48, 53

Following the dip we expected late September / early October, we believe that Global Equity markets should resume their uptrend first into mid/late November and perhaps early December, then into Spring next year. Our I Impulsive targets to the upside on the Weekly graphs suggest 5 to 10% of upside potential over the next 6 months

Main Regional picks
p 16, 51

Initially, the first leg up we expect over the next 1 to 2 months should benefit markets which have lagged over the past 12 to 24 months. We would hence favor Europe over the US into November. Following that, we would probably overweight the US once again. Japan also looks like an interesting bet if hedged for a weakening Yen.

Emerging markets
p 17

Emerging Markets could also bounce vs developed ones into November as the US Dollar suffers an intermediate correction. We would probably reduce exposure again towards mid/late November/December.

Volatility
p 30, 52, 54

VIX should drop back to the low teens into November / early December.

Government Bonds

US & European Benchmarks We believe that Treasury and Bund yields have started a 3 to 6 months rebound. US 10Y Treasury yield should rapidly test resistance above 2% and may even continue towards the mid 2s % early next year. Bund yields along with most developed market benchmark bond yields should follow US Treasury yields up, yet with less upside potential.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	US Equity to Bond ratios have probably started to reverse up. They should climb into late November / early December in first instance.	Early next year could see some consolidation on the ratio, yet the uptrend probably continues thereafter well into the Spring.
	Europe	European Equity to Bond ratios have probably started to reverse up. They should climb into late November / early December in first instance.	Early next year could see some consolidation on the ratio, yet the uptrend probably continues thereafter well into the Spring.
Duration		We expect yield curve spreads to widen across the curve into late November, early December. Duration trades will suffer a correction	While yields may continue to push higher, the US10Y - US3Y curve may start flattening again from early next year as the FED turns less acomodative.
Credit		Credit spreads are back in a downtrend, which continues towards December in first instance.	Credit spreads could continue lower towards Spring next year.
TIPs/Treasuries		Inflation expectations (TIPs / Treasuries ratio) could start reversing up during Q4, probably until late November / December in first instance.	Following some consolidation early next year, the TIPs vs Treasury ratio then probably continues to bounce into Spring 2020.
Oil		Oil should continue to stabilize and gradually start to bounce from mid/late October into December, WTI may reach back to the high 60s, Brent to the low 70s USD/barrel.	Following some consolidation early next year, Oil could then continue its uptrend well into 2020 and test its 2018 highs.
Industrial metals		Industrial metals are probably reversing up and could continue higher towards December, Copper could bounce back above 6'000 USD/ton at least.	Following some consolidation early next year, Industrial metals probably continue higher into Spring 2020.
Gold		Gold has probably started to reverse down and may correct down to below 1'400 USD/oz or perhaps even to below 1'300 into December.	Gold probably remains under pressure into the Spring.

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

Equity to Bond Ratios

US & Eurozone Market
p 27, 28

Equity to Bonds ratio in the US and Europe should resume their uptrend, first into November/December as Yields bounce and Equities resume their uptrend, then into next Spring, perhaps even H2 2020.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 32

US Yield curve spreads should widen across the curve into November, perhaps December. Long duration trades should suffer during this period. Thereafter, the US10Y-US3Y spread may retrace into Q1 as the FED's policy may become less accommodative, while the US3Y-US3M, which is more cyclical, could continue to bounce into the Spring. Generally, Duration probably remains under pressure into the Spring.

Credit We expect Credit markets to continue their recovery from the lows made late last year, probably into early /Spring next year. Spreads should hence continue to drop even as yields rebound.

Rate Differentials The US rate differentials vs the rest of the world should start to reverse up. The rebound may be quite substantial and last into Spring next year. These widening spreads should support the US Dollar from mid/late November into mid/late Q1, probably as long as Inflation Expectations don't accelerate up.

Tips
p 27, 31

The TIPs / Treasury inflation breakeven ratio may have started to bounce and we would expect inflation expectations to follow other cyclical metrics higher into year-end and perhaps Spring next year.

Commodities

Oil
p 38, 39

Oil should continue to stabilize and gradually start to rise again during October. We believe it may reach back to the mid/high 60s USD/barrel on WTI and the high 60s / low 70s on Brent, between now and December. Further upside potential is then foreseeable into Spring / Summer next year and perhaps towards oil's 2018 highs.

Industrial metals While Industrial metals on average have been back in a weak uptrend since June, Copper has lagged and recently made new lows for the year early September. We believe the whole space is now in the process of reversing up, initially towards mid/late November, perhaps December. Copper could reach back above the 6'000 USD/ton mark by then, perhaps even towards 6'500 USD/ton over the next 6 months.

Gold & PMs
p 28, 30, 54

Following its 30% rise from August last year, Gold probably just made an important intermediate top. The next 3 to 6 months may see it retrace most of its recent progression. Indeed, it will probably retrace to below 1'400 USD/oz at least, and potentially even to below 1'300 USD/oz. Silver and Platinum should also be quite weak, while Palladium may hold up much better and perhaps even rise.

Agriculture
p 31

Agriculture Commodities may benefit in the short term from an ease in the US-China Trade tensions as well as from the correction to the downside we expect on the US Dollar into November. We however expect them to retrace down again towards year-end and early 2020.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	EUR/USD has started to bounce and could reach into its C Corrective targets range to the upside (1.11 - 1.12) over the next couple of months. Above these, the next level of targets are towards 1.14 - 1.15.	From mid/late Q4, EUR/USD then probably resumes lower again, into early next year and may make new lows for this cycle (possibly back below 1.10). It then reverses up again towards Spring / midyear 2020.
	GBP	The current bounce on GBP/USD may continue towards mid November, perhaps early December. The move should meet strong resistance around 1.28. The next level of upside targets are in the low/mid 1.30s.	GBP/USD may then retrace down towards year-end and early 2020. We cannot exclude that it could make new lows. Developments on the Brexit front will be key drivers. Cable then reverses up again towards Spring / midyear 2020.
	JPY	USD/JPY has probably started to correct up, probably towards mid November, perhaps early December and the upper end of its C Corrective targets to the upside around 110. Above these, the next level of targets is towards 114 - 115.	USD/JPY then retraces down towards year-end and early 2020, but may resume higher again from mid/late Q1 into the Spring / midyear 2020.
	CHF	USD/CHF is rather neutral over the next couple of months. Indeed, Swiss Franc and the US Dollar are both defensive currencies, yet less defensive than the Yen.	USD/CHF probably also retraces down towards year-end and early 2020, and may then also follow USD/JPY higher during the Spring.
EUR vs	GBP	EUR/GBP has recently broken down on positive Brexit developments. It could now continue lower towards mid November, perhaps early December, and the mid/low 0.80s.	EUR/GBP could bounce from year-end into Q1, perhaps back into the high 0.80s.
	JPY	EUR/JPY could bounce towards its resistance at 122 towards mid November, perhaps early December. Above these levels, the next level of targets are in the the mid/high 120s.	From late Q4 and into early/mid Q1, EUR/JPY may retrace down towards 120, before it potentially reverses up again into Spring / midyear 2020.
	CHF	EUR/CHF could bounce towards its resistance at 1.12 towards mid November, perhaps early December. Above these levels, the next level of targets are in the 1.14-1.15s.	From late Q4 and into early/mid Q1, EUR/CHF may retrace down towards 1.10, before it potentially reverses up again into Spring / midyear 2020.
GBP vs	JPY	GBP/JPY continues to bounce towards mid November, perhaps early December and towards the low/mid 140s.	From late Q4 and into early/mid Q1, GBP/JPY may retrace down towards the 135-140 range, before it potentially reverses up again into Spring / midyear 2020.
	CHF	GBP/CHF continues to bounce towards mid November, perhaps early December and towards the high 1.20s.	From late Q4 and into early/mid Q1, GBP/CHF may retrace down towards the mid/low 1.20s, before it potentially reverses up again into Spring / midyear 2020.

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

US Dollar
p 15, 16, 18, 22

The US Dollar has probably entered an intermediate correction, which could see it retrace 2 to 3 figures over the next 1 to 2 months. It then rises again into mid Q1 and probably makes new highs. From late Q1 / Spring next year, it may weaken again if Commodities continue to accelerate up and rising inflation expectations start counter-balancing the US to the RoW's positive interest rates differential.

Euro
p 15,17,18

EUR/USD probably bounces into mid/late November, perhaps early December and its corrective target range between 1.11 and 1.12. If it manages to break above these levels, the next target range is around 1.14 – 1.15. Following that, we believe EUR/USD then resumes lower into early next year, potentially back below 1.10, and eventually down to 1.05. EUR/JPY and EUR/CHF should also bounce over the next 2 months, respectively towards 122 and 1.12. Here also, if EUR/JPY and EUR/CHF manage to break above these resistances, the next level of targets are in the mid/high 120s on EUR/JPY and towards 1.14-1.15 on EUR/CHF. Following that, the Euro also retraces down vs Yen and Swiss Franc, probably from late Q4 into Q1 and towards current levels.

Yen
p 49, 50

The Yen is more defensive than the US Dollar. It hence corrects down vs it over the next couple of months. USD/JPY may hence move back towards its resistance around 1.10, and if it manages to break above this level, could even rise in the 114 – 115 range.

Sterling
p 21

Sterling continues to be very sensitive to any news around the Brexit process. It is currently bouncing on the promises of a last hour deal between PM Johnson and the European Union. We expect Cable to meet strong resistance around 1.28. If these levels are taken out, it may even rise back into the low/mid 1.30s. Concomitantly, GBP may also rise vs EUR, JPY and CHF during this period. According to our graphs, GBP then retraces back down vs most currencies between late Q4 and Q1 next year.

Oil & Commodities currencies
p 19, 43

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) may have entered an intermediate bounce vs the US Dollar and the Euro. It may be quite strong and last into mid/late November, perhaps early December. Following that, Commodity currencies should retrace back down to current levels, probably between late Q4 and mid Q1.

Asian currencies
p 20

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) could continue to bounce vs the USD into November and perhaps into early December. It then retests down into early/mid Q1 next year. The portfolio may be quite neutral vs the Euro which should also be bouncing vs the US Dollar over the next couple of months.

Equities Markets Segmentation

Core Sector Weightings			Next 2 months					3 to 6 months ahead				
US Sectors - S&P500 (general comment)			**We would Overweight Cyclical sectors vs Defensive ones into mid/late November, perhaps into December.**					**From December, we would neutralize Cyclical and Defensive sectors and Overweight Growth.**				
Sectors	Proxy ETF symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Technology	XLK	21%										
Healthcare	XLV	15%										
Financials	XLF	14%										
Discretionary	XLY	10%										
Communication	XLC	10%										
Industrials	XLI	10%										
Staples	XLP	7%										
Energy	XLE	6%										

			Next 2 months					3 to 6 months ahead				
European Sectors - Europe Stoxx 600 (general comment)			We would Overweight Cyclical sectors vs Defensive ones into mid/late November, perhaps into December.					From December, we would neutralize Cyclical and Defensive sectors and Overweight Growth.				
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 33-34, 40-42

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

We believe early October just delivered a Buy the Dips opportunity on cyclical sectors. We expect them to outperform into mid/late November, perhaps December. Their re-rating vs the market may be quite strong, especially vs defensive sectors.

From late Q4, we believe cyclical sectors may give up their market leadership to more Growth oriented sectors. The general market may also see some consolidation into early/mid Q1. We would hence neutralize cyclical and defensive sectors from late Q4 into Q1 and favor Growth ones. Note: the European Industrial sector has shown a rather Growth oriented profile over the last couple of years.

Countries allocation

Core Countries Weightings			Next 2 months					3 to 6 months ahead				
All World Country Index Currency hedged (general comment)			We would Overweight pro-cyclical regions into mid/late November, perhaps December.					From late Q4, we will Overweight the US again, and underweight China as the cyclical bounce retraces into early Q1.				
Countries	Index symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
US	S&P 500	52%										
Canada	TSX	3%										
Europe	SXXP	21%										
-UK	FTSE	6%										
-France	CAC40	3%										
-Germany	DAX	3%										
-Switzerland	SMI	3%										
Japan	N225	8%										
China	MSCICN	3%										

Main Country Allocation
p 43

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

Over the couple of months, probably into mid/late November, perhaps into early December, we expect Europe to perform well vs the All Country World Index, this despite a slightly stronger EUR/USD. We would probably favor France and Germany and underweight defensive Switzerland. We would also underweight the UK as a rapidly rising Pound may hurt its performance in local currency terms. Otherwise, we also like Japan, but would hedge it to protect against some weakness in the Yen. We are neutral on China and would probably underweight the US while the US Dollar corrects down.

From late Q4, we would probably neutralize these exposure as the cyclical rally and the US Dollar correction eventually die out, would Overweight the US again and Underweight China.

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

Core factors and Themes

Core Factor/Themes Weightings	**Next 2 months**					**3 to 6 months ahead**				
General Comment	**We would Overweight Cyclical and Value themes into mid/late November, perhaps December.**					**From late Q4, we would gradually neutralize the positive Cyclical and negative Defensive exposures and favour Growth themes.**				
Themes	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Nasdaq 100 (vs S&P500)										
DJ Industrial (vs S&P500)										
Russell 2000 (vs S&P500)										
Wilshire REITs (vs S&P500)										
US Value (vs US Growth)										
Southern EuroZone (vs Stoxx EZ 600)										
EuroZone Small Cap (vs Stoxx EZ 600)										
Japanese Small Cap (vs N225)										
GDX - Goldmines										
XME - Diversified Mining										

Core factors and Themes
p32

Into mid/late November, perhaps early December, we would Overweight all cyclical and value themes such as the Dow Jones Industrials, the Russell 2000, US Value or Diversified Mining. We would underweight US Defensive themes such as REITs or Goldmines, or Japanese Small caps which usually underperform vs their large exporting peers once the Yen starts weakening.

From late Q4, we expect the cyclical / value rally to loose steam. Although for now we do not foresee a strong correction down for risk assets, we would probably neutralize most cyclical Overweightings as well as defensive Underweightings and potentially consider Growth profiles as an alternative.

12 / The US Dollar has remained resilient but a short-term weakness of a few weeks due to "safe haven" unwind and liquidity improvement is still in the cards

The last time The Capital Observer discussed the US Dollar (in the August 2019 issue) we said this:

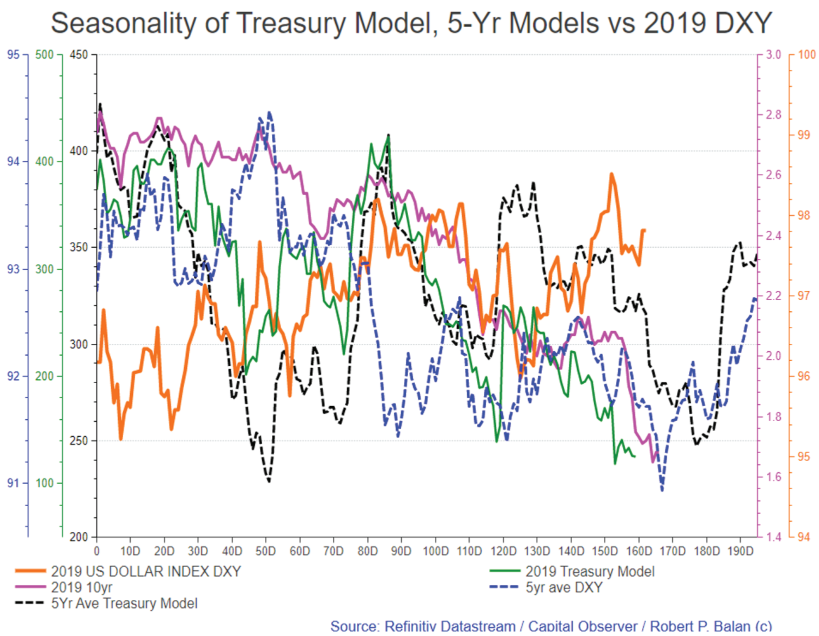
The US Dollar (and the DXY proxy) are due for a significant repricing lower over the next few weeks . . . The expected residual weakness in the US Dollar is expected in a matter of weeks, not months. The sharp dive in bond yield is about to end . . . any further declines in both yields and stocks are also measured in matter of few weeks (see the chart below) . . . therefore, any US Dollar weakness should cease a few days after the 10yr yield starts rising. A new upcycle in yields and the US Dollar is also supported by the threat of the US Core CPI to rise during the rest of the year.

In the August Capital Observer, we illustrated our expectations for the greenback along-side our expectations for the 10yr yield via the Treasury yield models (*see first two charts on this page*).

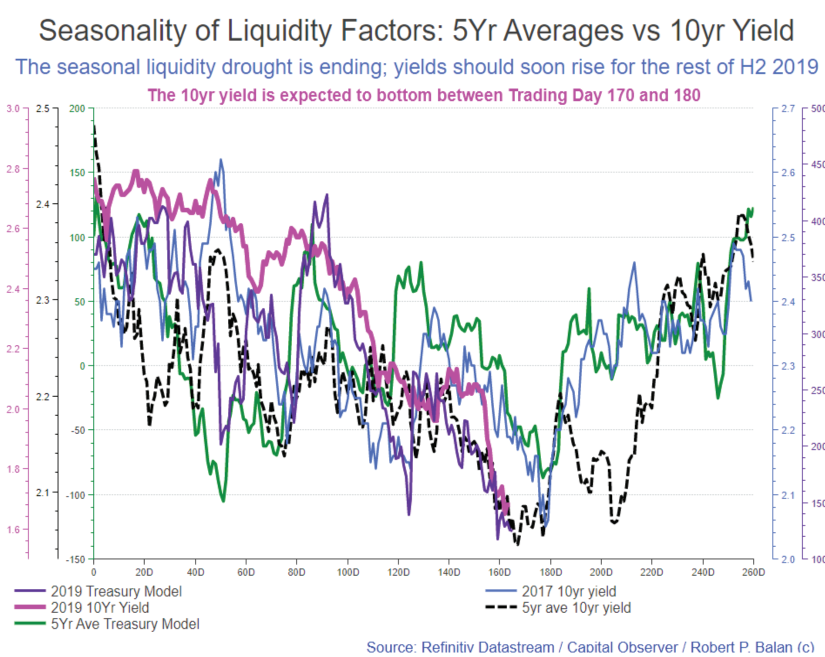
Alas, since we wrote those words, the 10yr yield and equities indeed continued to fall, but the US Dollar (the DXY as proxy) kept on rising, contrary to expectations. It only weakened for a few days (not the few weeks we were hoping for). The sharp dive in bond yield and equities did eventually end, as the systemic liquidity drought pervading the financial markets at that time disappeared when US Treasury's paper issuance come into full swing following the resolution of the debt ceiling cap (*see 1st graph on the next page*). That offered no solace, as the DXY ratcheted even higher.

The market (and us) were blindsided in August 2019 by the transformation of the US Dollar to a safe haven destination, when yields and equities embarked on their final trip to their seasonal troughs. That continued to push the Dollar higher.

Original chart in the August 2019 Capital Observer



Original chart in the August 2019 Capital Observer

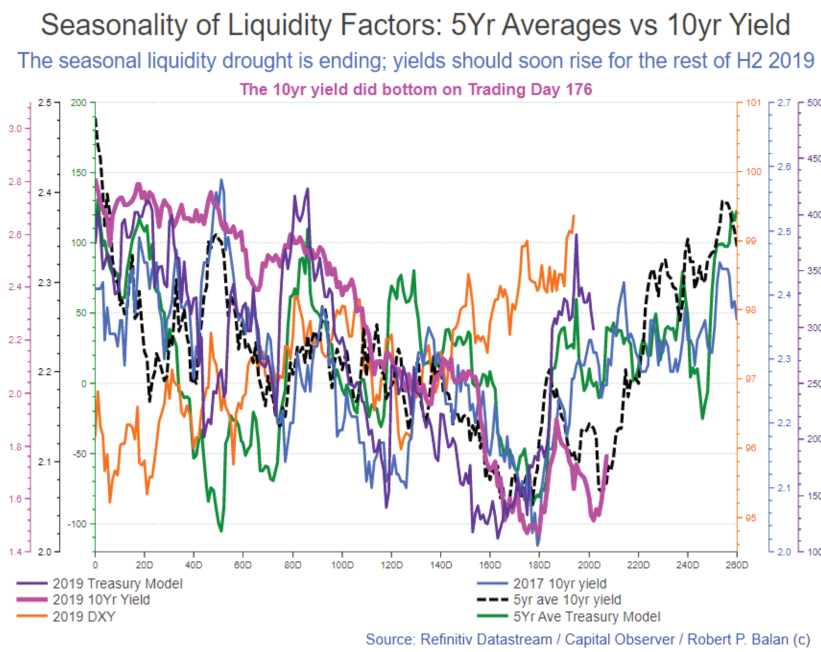


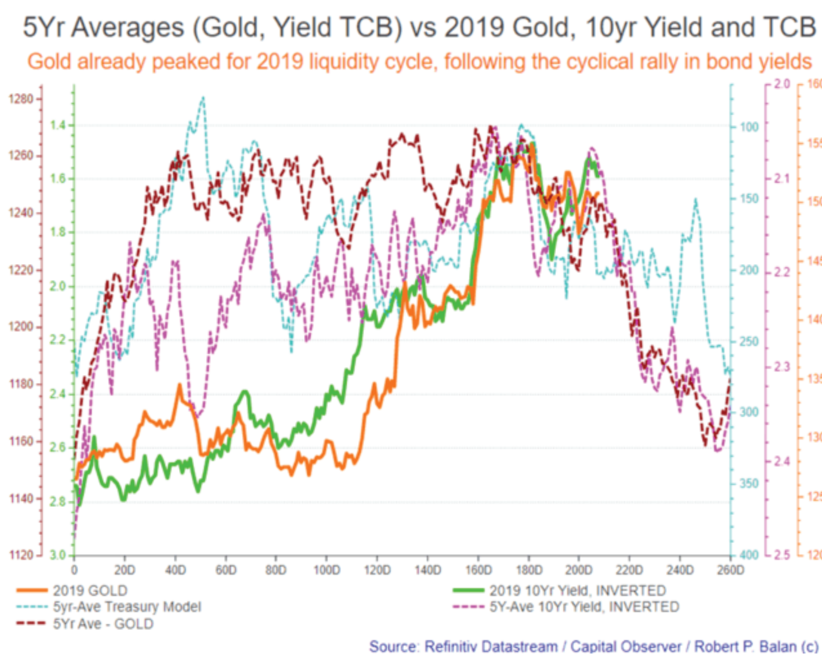
At that time, there were cross-currents from day-to-day news flow as the trade discussions between China and the US went nowhere, contributing to the further fall in yields and risk assets. That also sparked a rally in safe haven assets; in addition to the decline in yields (and rise in the price of bonds), gold prices also rose, alongside the rally in the US Dollar. But the news flow eventually improved, which was propitious as bond yields started to stabilize as the liquidity drought ended as well, which had a marked effect on the market. Bond yields rose sharply higher in early September, which many observers have called the "Repricing Massacre"; see that in the graph on the next page (pink line).

We said in August that the bottom in the 10yr yield will probably occur between Trading Day 170 and 180. It did – the actual low point of the yield's down cycle was Trading Day 176 (*see 1st graph on this page*). **The seasonal changes in US systemic liquidity has been a reliable forecaster of changes in bond yields, and by implication, also of changes in the exchange rate of the US Dollar. We know that to be true, as the 5-year average of the 10yr yield hews very closely to the seasonal patterns of systemic liquidity which varies very little, year-in, year out for the past 10 years at least**. The covariance of the US Dollar with the yields and liquidity flows is not as well-defined, but there is a definite rhyme in the relationships. The correlations are lagged, however, tripping unwary analysts.

Not long after the yields made bottom and rose, the US Dollar turned higher alongside the sharp repricing higher of the 10yr yield which precipitated the Repricing Massacre (pink line in the 1st graph on this page). But bond yields have wilted since the initial surge and have weakened, and is now recovering. If the message from the yield models are correct, the rally in yields may extend up to the end of the year (black, dashed line in the fisrt chart on this page). **The US Dollar lags behind the major moves of the bond yield, and is now due to fall as consequence of the lagged effect of the previous decline in yields. The DXY may fall during the next 4 to 5 weeks. But we expect yields to rise thereafter towards year-end. And it's likely that the US Dollar will be arising alongside yields during that period, allowing for a short time lag. That lagged effect can clearly be seen, as illustrated in the fisrt graph on this page.**

Indeed, a DXY peak is upon us, and price developments late last week tells us the models' forecast is likely correct. The US Dollar (DXY) has been falling hard since September 30, and during this period, yields have been paradoxically rising. Gold prices have been falling as well, providing a rare spectacle of Gold and the US Dollar falling together.



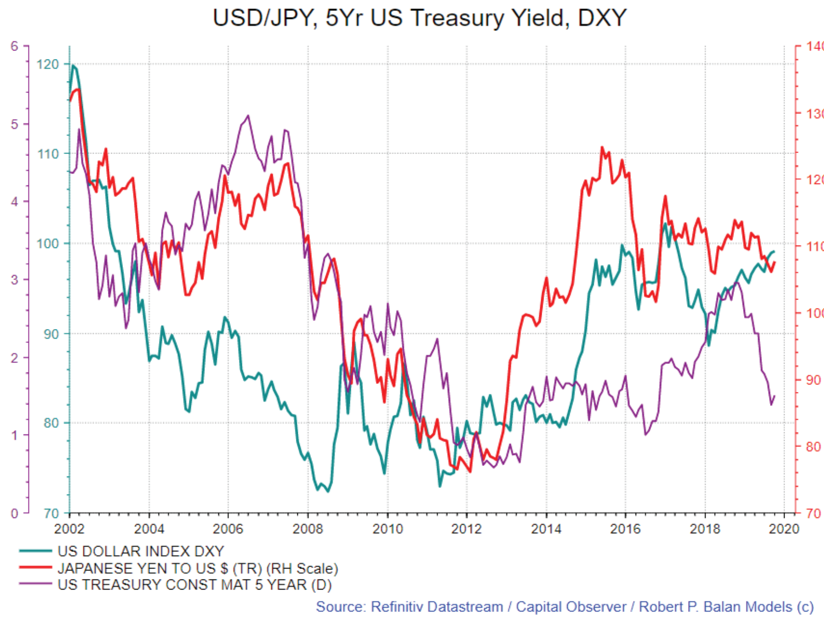


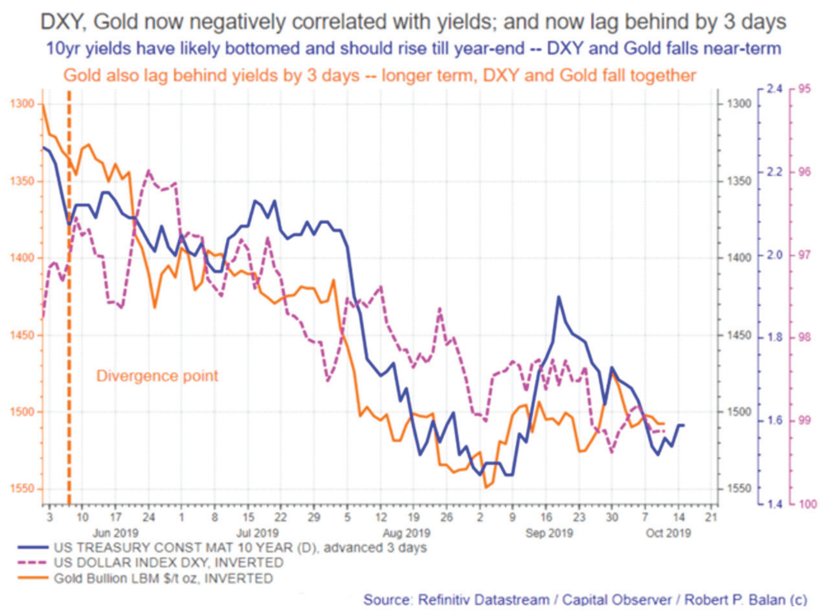
As market fear dissipate, we will see the bottoming theme (in yields and risk assets) play out across a number of assets, including that of gold, a safe haven instrument. The point is that if yields will rise (alongside equities), Gold (as a safe haven destination) should fall, given the mechanistic relationship of the yellow metal to the inverse of yields *(see graph 2nd graph above)*. **The irony is that the same devolution process will also weaken the US Dollar.**

Since June, the DXY and yields have been on negative covariance. The DXY firms when the yields fall, and vice versa. We concluded that the DXY has been rallying in the wake of falling yields, as a safe haven asset. But if yields rise, as we expect, then the safe haven trades will unwind, and DXY will fall.

We should make a distinction between the DXY and USD/JPY. If yields rise, USD/JPY will rise (even as DXY falls) because JPY will weaken sharply on safe haven outflows. USD/JPY has been historically trading as a close proxy of the 5Yr Treasury Bond, although the relationship has suffered lately (see 1st graph on the next page).

DXY and Gold have now become negatively correlated with yields; and both lag behind changes in yields by 3 days on short-term price changes *(see 2nd graph on the next page)*. The linchpin in the argument posits that 10yr yields have likely bottomed and should rise till year-end. **Therefore, DXY and Gold have to fall together in the near-term, at least when yields continue to ratchet higher.**



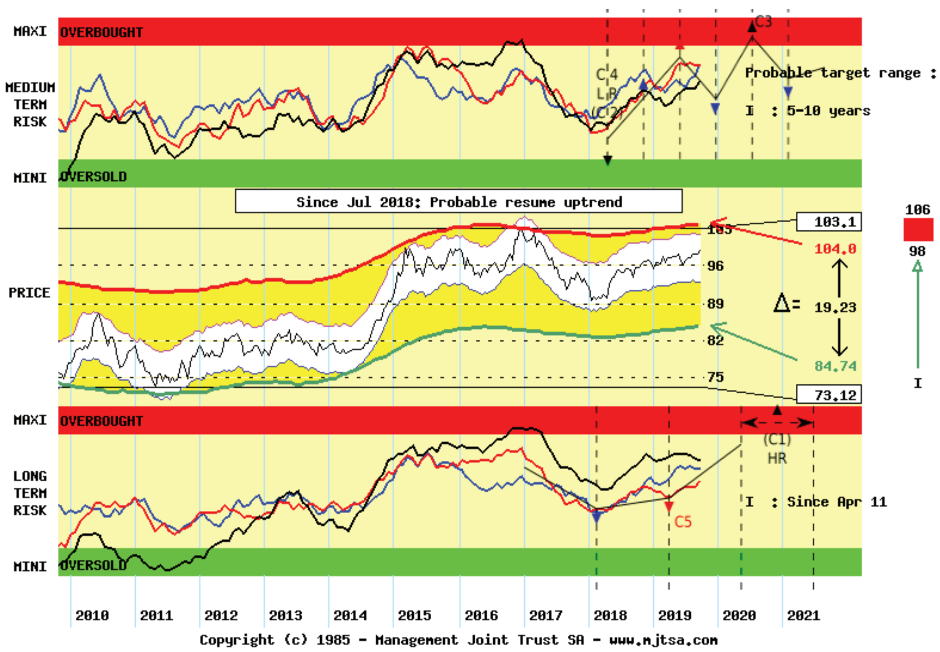


15 / MJT - TIMING AND TACTICAL INSIGHT

The US Dollar has entered an intermediate correction

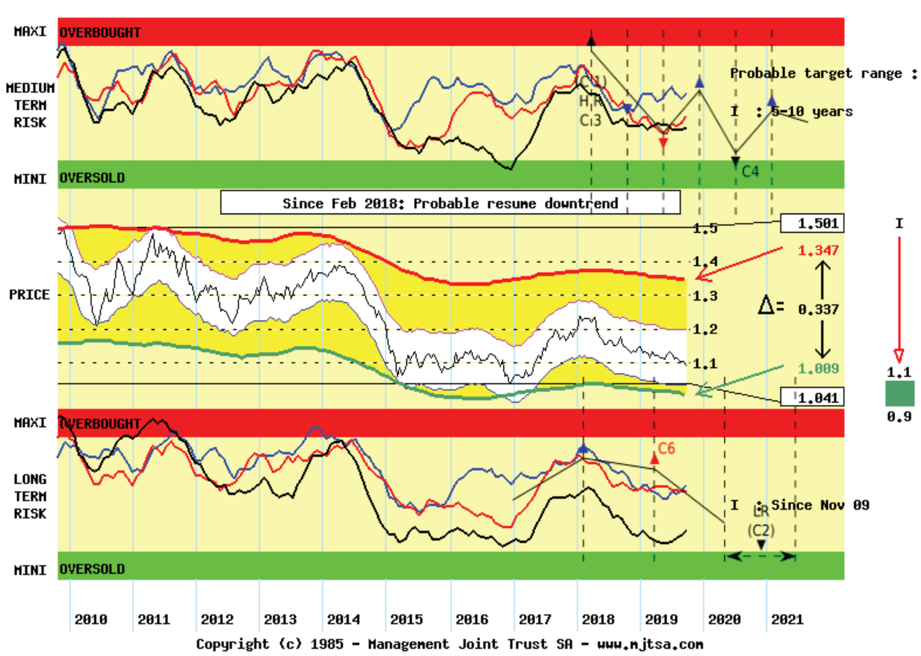
Despite the sell-off in US yields over the last 12 months and the concomitant sharp tightening of the interest rate differential between the US and the rest of world, the US Dollar has continued to grind higher. This strength may be due to its rather defensive profile in an environment where geopolitical and economic risks have sprawled. More specifically, it may also be attributable to the sharp sell-off in US Inflation Expectations since Spring 2018. Looking into Q4, considering the pseudo QE4 that may be coming our way, and the early cyclical re-acceleration we expect, the Dollar is due for an intermediate correction at least.

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



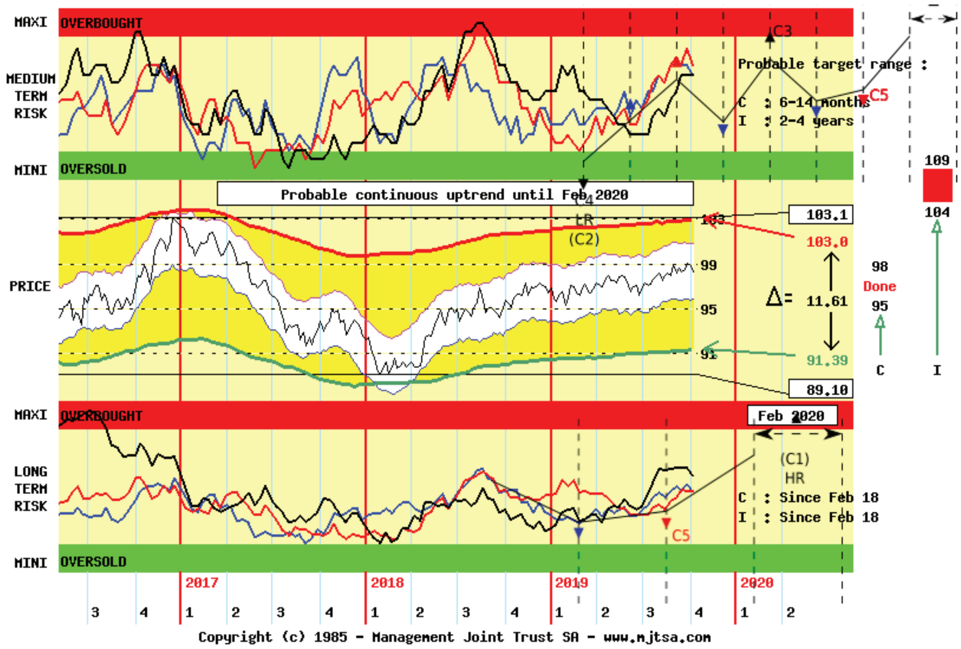
On this long term graph of the Dollar Index, our long term oscillators (lower rectangle) are still heading up, probably into Spring, perhaps late next year. For now, the uptrend still shows some upside potential according to our I Impulsive targets to the upside (right-hand scale), potentially towards its 2016 highs over the next few quarters. In the meantime, however, **our medium term oscillators (upper rectangle) may have reached an intermediate top, which suggests some consolidation to the downside during Q4.**

EUR/USD
Bi-monthly graph or the perspective over the next 1 to 2 years



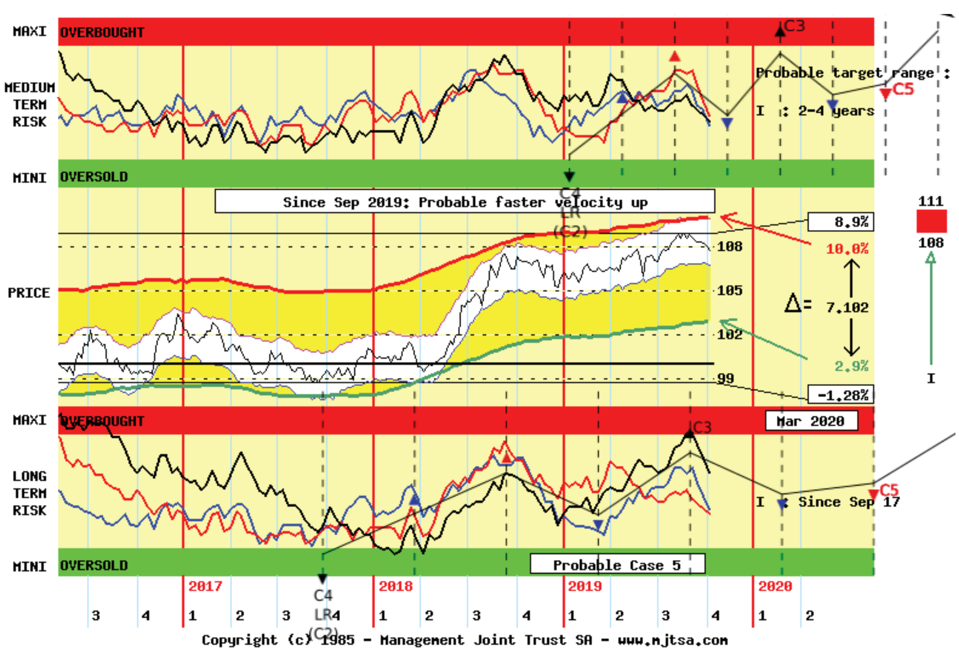
EUR/USD is showing a similar pattern in reverse. Indeed, our long term oscillators (lower rectangle) are still following a downtrend sequence, which may lead the pair lower into Spring, perhaps late next year. Our I Impulsive targets to the downside are also pointing to further weakness over the next few quarters, probably towards the pair's 2016 lows. Here also, however, **our medium term oscillators (upper rectangle) are suggesting that an intermediate low may be due, which could trigger a bounce during Q4.**

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



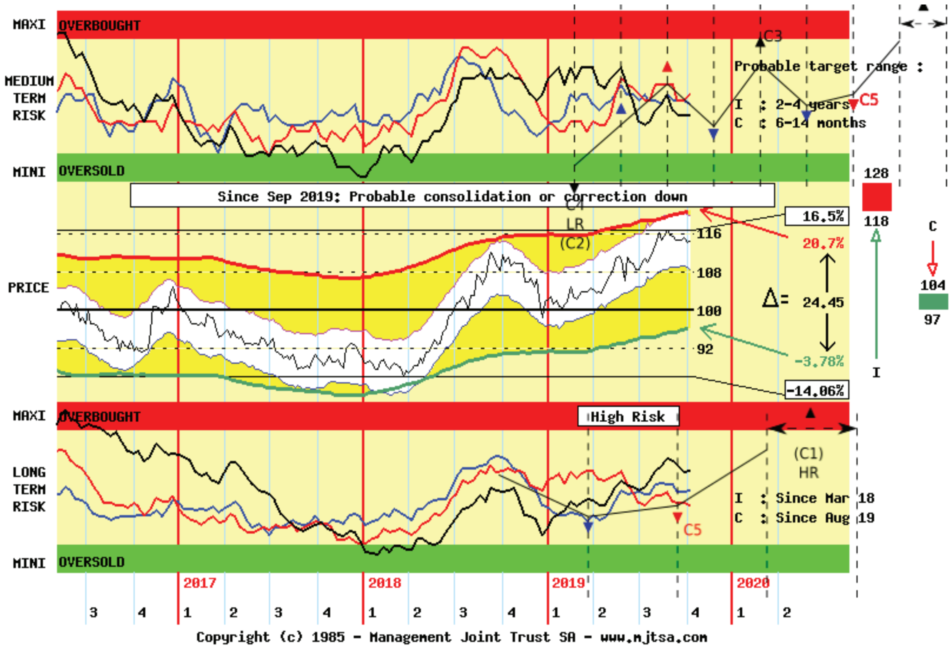
On Our Weekly graph, the Dollar Index is for now still uptrending. It recently made it back above our C Corrective targets to the upside (right-hand scale), and could be eyeing our I Impulsive ones in the 104 – 109 range into next year. This is what our long term oscillators (lower rectangle) would confirm, with a possible uptrend which lingers on until early next year ("February"), perhaps even into Spring next year. As with the bi-monthly graph, **an intermediate correction to the downside is also due on our medium term oscillators (upper rectangle), probably into mid, perhaps late Q4.**

S&P500 Index vs the All Country World Index
Weekly graph or the perspective over the next 2 to 4 quarters



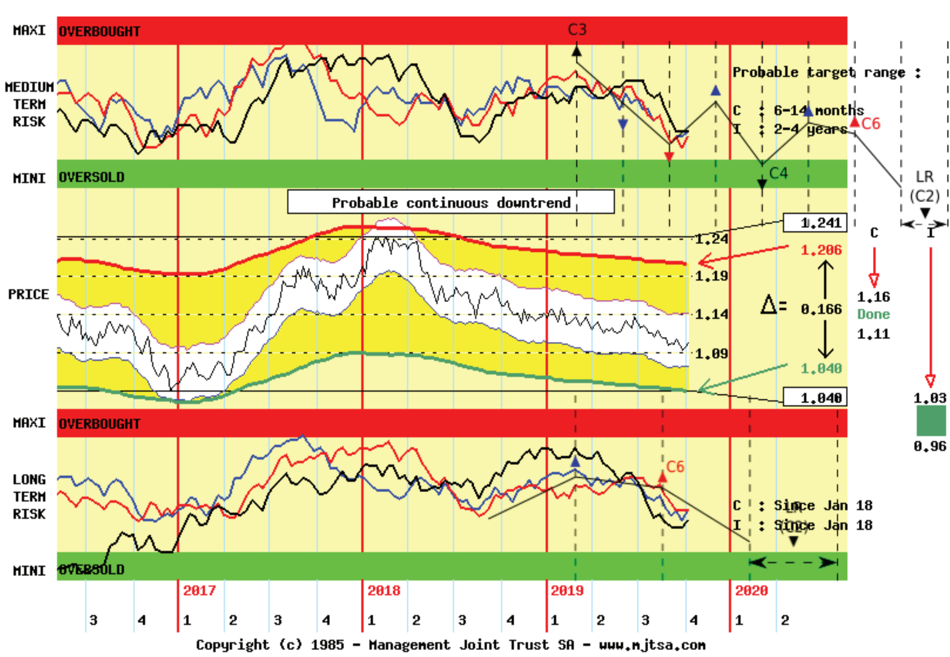
Over the last couple of years, US Equity markets outperformance has followed the US Dollar higher. Part of it is due to the negative translation effect of foreign equities into US Dollars (rising USD), the rest to the persistent outperformance of US equities in local currency terms. Indeed, despite the global slowdown over the last 12 to 18 months, the US has pretty much maintained, or even increased, its growth differential with other economies, which have also been slowing. Going forward, our long term oscillators (lower rectangle) suggest that an important intermediate top may have recently been made. It could trigger between 6 to 12 months of consolidation to the downside (of US underperformance). For now, however, similarly to what we expect on the US Dollar, our medium term oscillators (upper rectangle) do point to a further upside extension into Q1 next year. Hence similarly to the Dollar Index, **we expect US outperformance to stall in Q4, yet to re-accelerate once more into mid Q1 next year. Following that, a more substantial correction to the downside may start to take place.**

S&P500 Index vs the MSCI Emerging Markets Index
Weekly graph or the perspective over the next 2 to 4 quarters



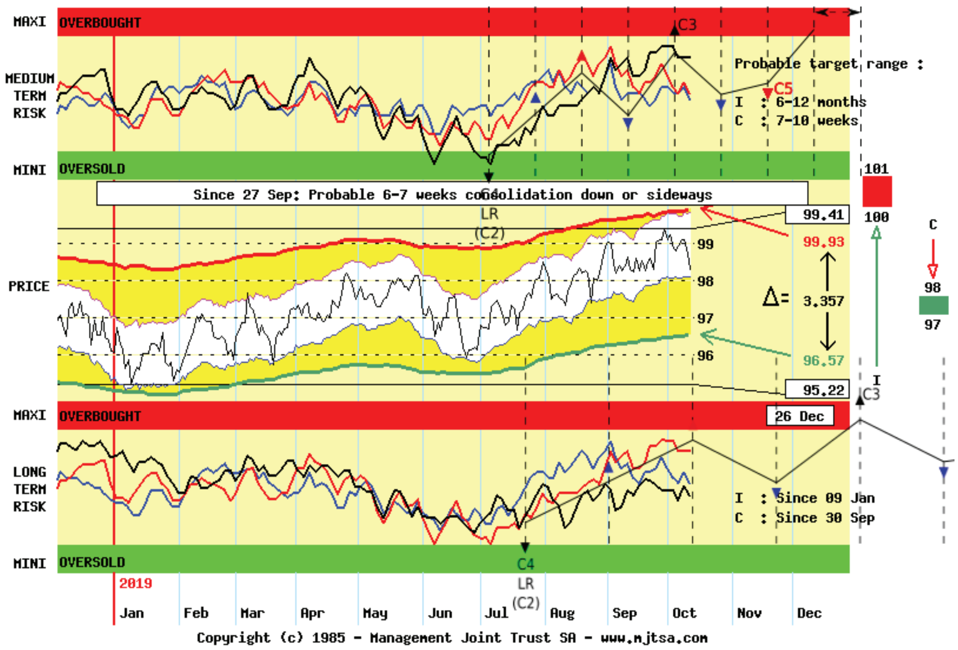
Similarly, vs the MSCI Emerging Markets Index, the S&P500 Index has been outperforming quite strongly over the last 2 years. On a our medium oscillators (upper rectangle), the ratio may have reached an intermediate top. **We expect a couple of months of correction to the downside into mid/late Q4. Thereafter, however, according to the sequences we show on both oscillator series (lower and upper rectangles), we expect the US to outperform Emerging Markets one last time into mid/late Q1, perhaps Spring next year.** The upside potential (another 5 to 10% according to our I Impulsive targets to the upside – right-hand scale) is interesting although not compelling.

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



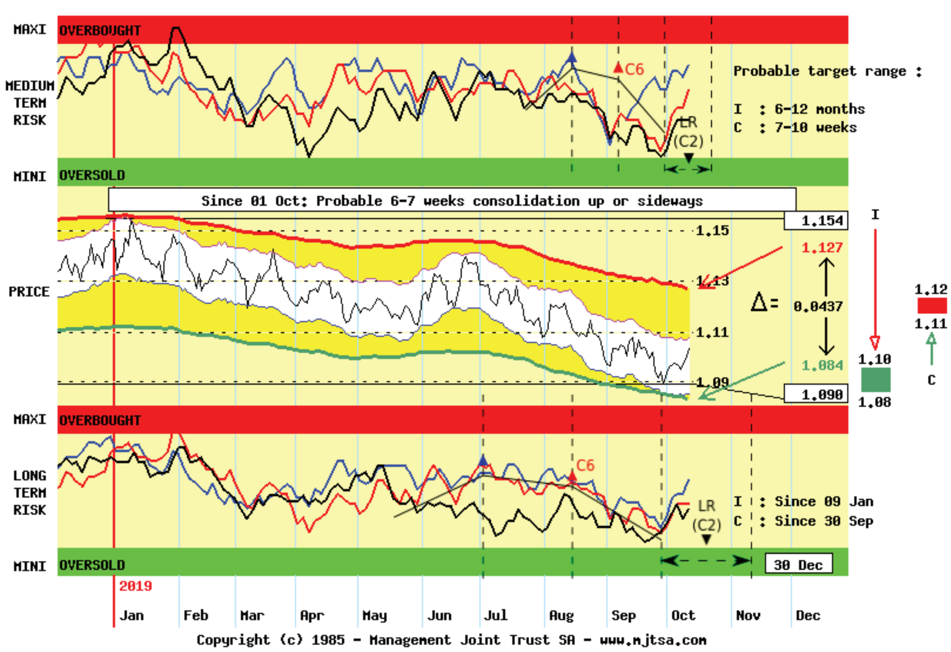
Moving to the Weekly graph of EUR/USD, the intermediate correction on the Dollar we expect (a bounce a EUR/USD) is also visible on our medium term oscillators (upper rectangle). It could last into mid, perhaps late Q4. Following that, EUR/USD could resume its downtrend into mid/late Q1, perhaps Spring next year as shown on our long term oscillators (lower rectangle). This potential last EUR/USD sell-off could lead us towards the late 2016 lows, perhaps even below them according to our I Impulsive targets to the downside (right-hand scale).

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



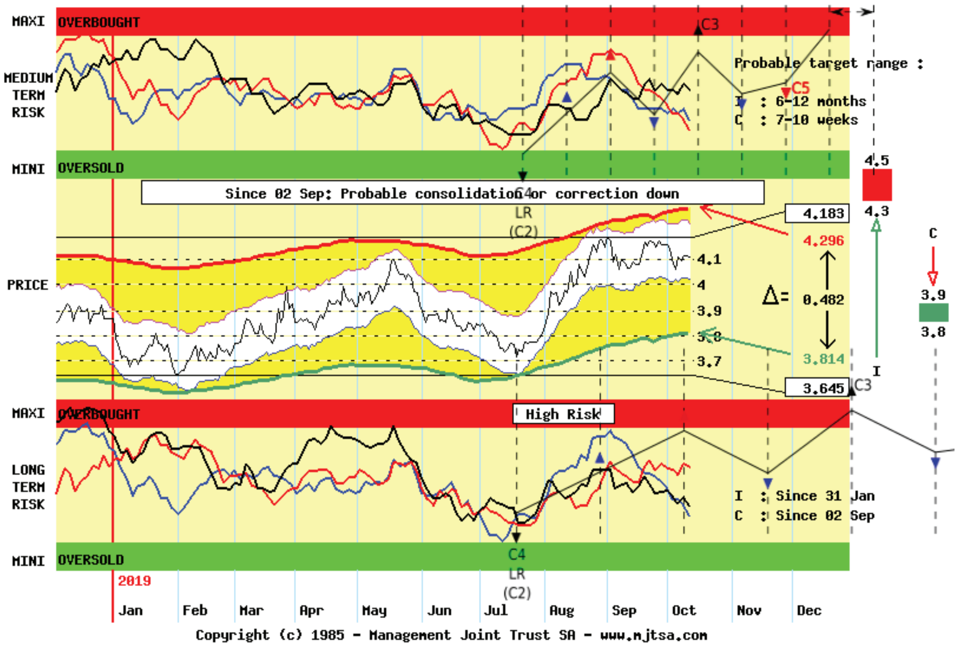
Shorter term, the US Dollar has been grinding higher throughout the year. On both our oscillators series (lower and upper rectangles), it recently reached an intermediate top. **Hence, during the second half of October and into November, we expect a downside correction on the US Dollar. Following that, the Dollar Index probably resumes higher towards year-end and into Q1. The corrective target range we can calculate to the downside is between 2 and 3 figures** or circa 0.5 to 0.8 times our historical volatility measure "Delta" (here at 3.357 figures – middle rectangle, right-hand side).

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



Inversely, EUR/USD is looking quite Oversold on both oscillator series (lower and upper rectangles), which have probably both reached potential Low Risk situations (i.e. a situation marking the end of a sell-off). Furthermore, our I Impulsive targets to the downside (right-hand scale) were pretty much been fulfilled late September in the 1.10 – 1.08 range (right-hand scale). In such situations, **a bounce may last 1 to 2 months, or probably into November, perhaps early December and travel towards our C Corrective targets to the upside (right-hand side) in the 1.11 – 1.12 range.** For now, and as long as we stay below the resistance of the upper-end of these targets (circa 1.12), the long term downtrend of EUR/USD is probably still in place.

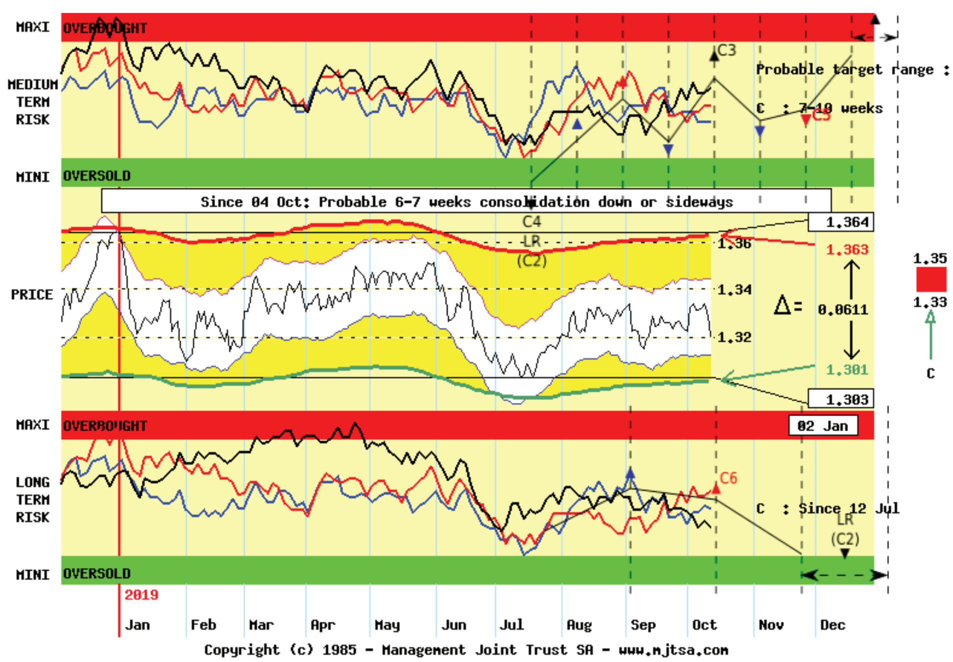
USD/BRL
Daily graph or the perspective over the next 2 to 3 months



Corrective targets to the downside (right-hand scale).

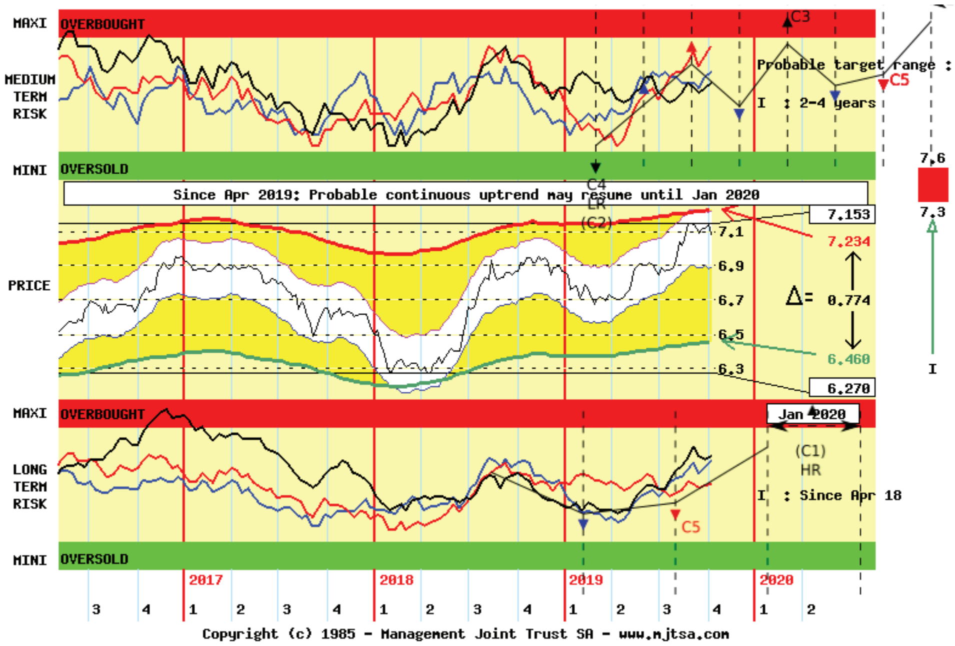
Other Dollar pairs around the world are showing similar dynamics. Indeed, USD/BRL could also be approaching an intermediate top. It has reached a High Risk situation on our long term oscillators (lower rectangle), while our medium term ones (upper rectangle) are suggesting a **mid October intermediate top. A month to a month and a half of consolidation to the downside may follow, probably into mid/late November, perhaps even early December. Downside risk to the USD/BRL is towards the 3.9 – 3.8 range** according to our C

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



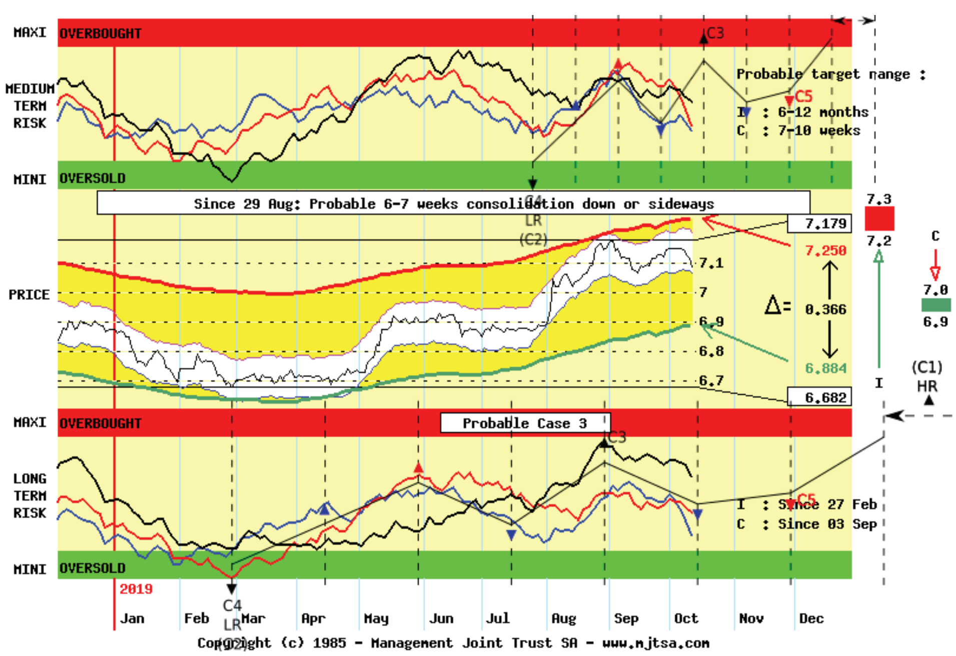
Vs the Canadian Dollar, the US Dollar does appear even weaker. Indeed, following its June/July sell-off, it is still below its C Corrective targets to the upside (right-hand scale). Both oscillator series (lower and lower rectangles) suggest that **USD/CAD may have just topped out, and that it could now resume lower into November, perhaps even December**. Following that, it may also bounce back into early 2020.

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



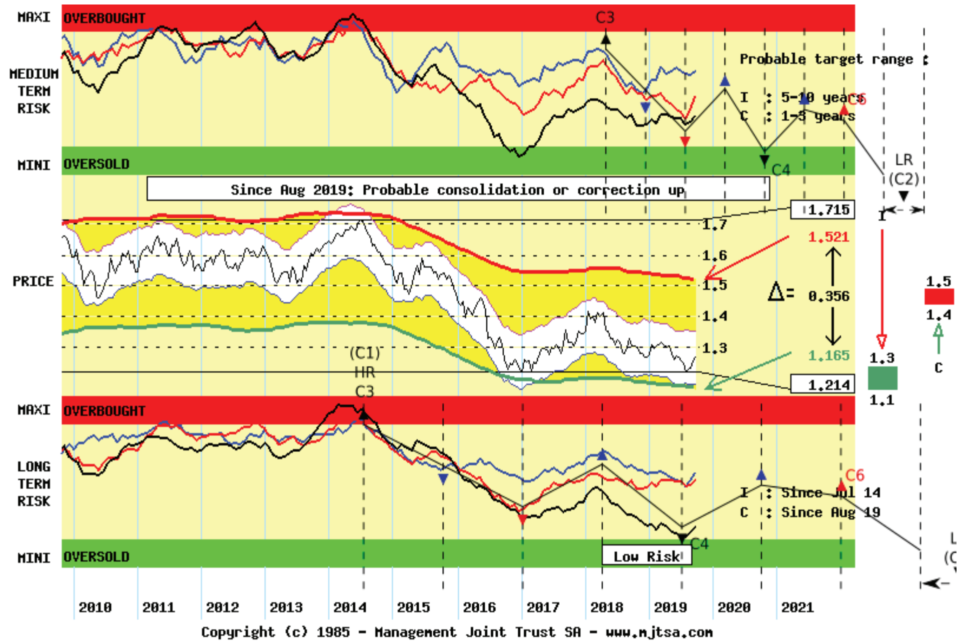
We now consider USD/CNY, which has made headlines this year as a sideshow of the US- China Trade War. Similarly to the Dollar Index, our medium term oscillators (upper rectangle) do suggest that **an intermediate top is near. It could lead to a correction to the downside over the next couple of months. Yet, for now, the uptrend since early 2018 is still strong, and both our oscillator series (lower and upper rectangles) continue to point to a further leg up from mid/late Q4 into mid/late Q1, perhaps Spring next year.** Our I Impulsive targets to the upside (right-hand scale) indicate some additional upside potential towards the 7.3 -7.6 range. Hence, if USD/CNY is taken as a proxy, a comprehensive (/final) trade deal between the US and China may take a couple more quarters to be finalized.

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



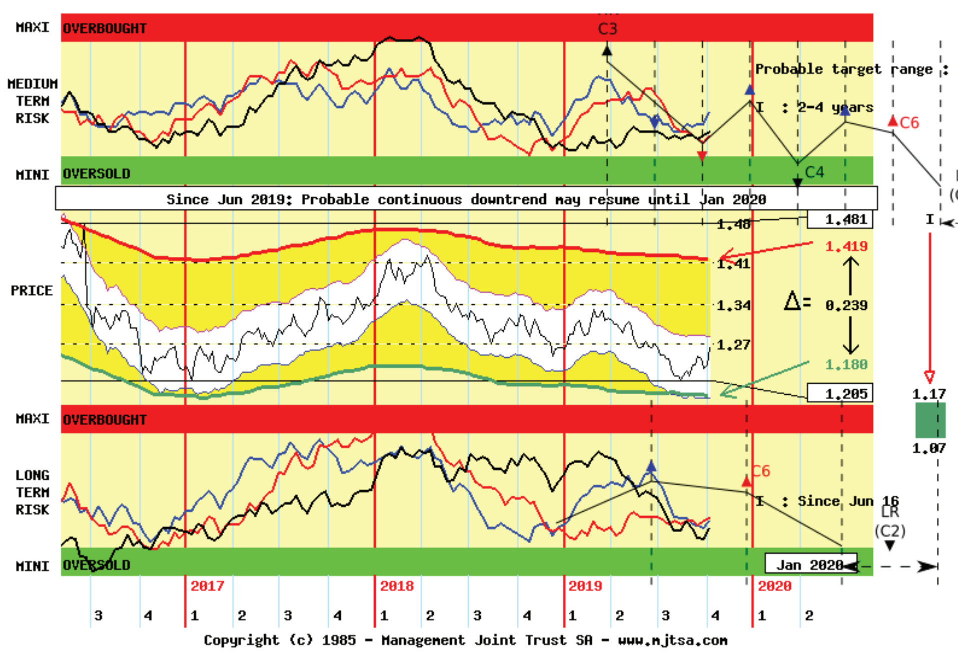
Shorter term, USD/CNY probably entered an intermediate / high level consolidation early September on long term oscillators (lower rectangle). Both oscillator series (lower and upper rectangles) now suggest **further consolidation to the downside into mid/late November, perhaps early December. Our C Corrective targets to the downside are in the 7.0 – 6.9 range (right-hand scale)**. Following that, from December, we expect USD/CNY to rise again into Q1 in line with our Weekly graph above.

GBP/USD
Bi-monthly graph or the perspective over the next 1 to 2 years



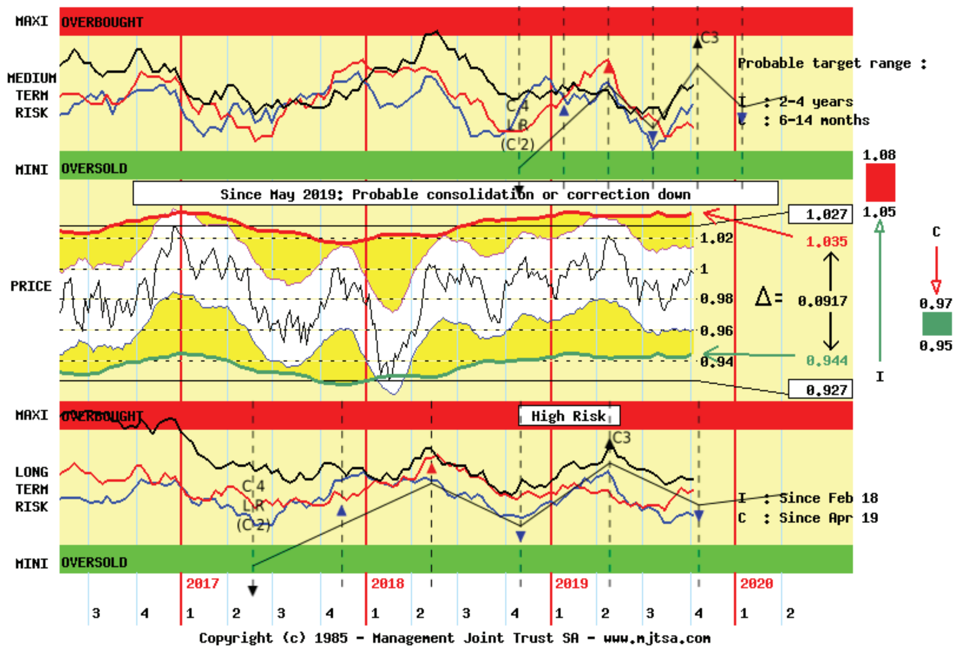
Throughout this article, we have considered the upcoming US Dollar correction as an intermediate one with a last US Dollar leg up probably due into Q1, perhaps Spring next year. Looking at the long term graph **on GBP/USD, however, we must note that our long term oscillators (lower rectangle) are quite oversold and have reached our I Impulsive targets to the downside (right-hand scale). This doesn't mean that we can exclude further downside risk (the lower end of these targets is still pointing towards 1.10), but that long term, the risk/reward for GBP/USD to the downside is getting stretched. Similarly to other US Dollar pair, our medium term oscillators (upper rectangle) do suggest a rebound during Q4 and then a possible downside retest into early next year.** It may hence be slightly early to anticipate a final resolution of the messy Brexit process, although some relief may materialize over the next few months.

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



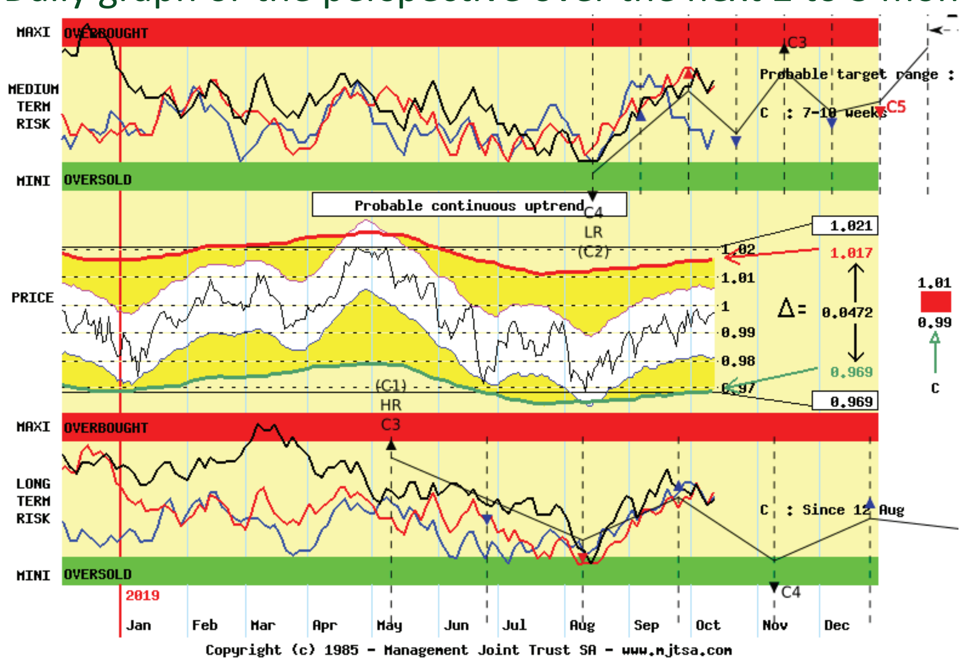
On the Weekly graph, our medium term oscillators (upper rectangle) would also suggest **that GBP/USD continues to bounce into mid/late Q4**. Following that, both oscillators series (lower and upper rectangles) suggest that a **further leg down could materialize into early next year.** The downside risk for now is still quite compelling as our I Impulsive targets to the downside (right-hand scale) are still pointing towards the 1.17 – 1.07 range. Given both graphs above, we would probably reduce long term short positions, but engage in tactical shorts following strong rebounds in order to profit from eventual setbacks in the Brexit process.

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



Finally, we look at USD/CHF, one of the more pro-cyclical Dollar pairs (Swiss Franc being quite defensive). We will also consider USD/JPY in another article of this issue of The Capital Observer, the one on Japan. For now, the uptrend since 2018 is still in place and we would still expect a possible recovery for USD/CHF into Q1, perhaps Spring next year (although with low conviction for now as to how far and how long it could rise). Our Impulsive targets to the upside (right-hand scale) are still quite aggressive though. **In the meantime, however, as with other US Dollar pairs, we expect USD/CHF to correct down during Q4, possibly towards our C Corrective targets to the downside in the 0.97 – 0.95 range.**

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



On the Daily graph, USD/CHF is also stuck between two conflicting forces, its inherent defensiveness and the correction in the USD which may have started. Graphically, USD/CHF has staged a nice rebound since August (rather risk-ON). Yet, for now, the bounce is still corrective having stopped within the range (0.99 – 1.01) of our C Corrective targets to the upside (right-hand scale). Our long term oscillators (lower rectangle) suggest a rather strong retracement into November, while our medium term ones (upper rectangles) are still uptrending with potential intermediate corrections to the downside in between. Hence, **if our scenario of a cyclical recovery between mid October and late November is correct, we would probably expect USD/CHF to retrace slightly, but to a lesser extent than most other USD pairs.**

Concluding remarks

The US Dollar may have reached an intermediate top vs most currencies. Throughout this year, the US Dollar had indeed continued to grind higher on the back of deteriorating global economic fundamentals and a relative resilience of them in the US (at least on the consumer front). The prospects of some version of QE as well as the cyclical recovery we believe could start materializing over the next few weeks may hence validate this US Dollar correction, which we expect could last 1 to 2 months in first instance, probably into mid/late November, perhaps December. Most Dollar pairs should be affected, yet probably USD/CHF to a lesser extent (USD/JPY on the other hand could even rise). Following that, from late Q4, we expect the US Dollar to resume its uptrend, probably into mid/late Q1, perhaps the Spring. This may indicate some retracement on cyclical assets from late Q4 into early next year.

23 / Core CPI should continue rising until Q1 2020, at least: actionable ideas in steeper yield curves, and rising cyclical assets

The last time The Capital Observer discussed Core Inflation was at the May 2018 issue *("What's Up With Core Inflation? Core CPI Will Rise Over The Next 5 To 6 Quarters: Actionable Ideas")*. In that issue we said:

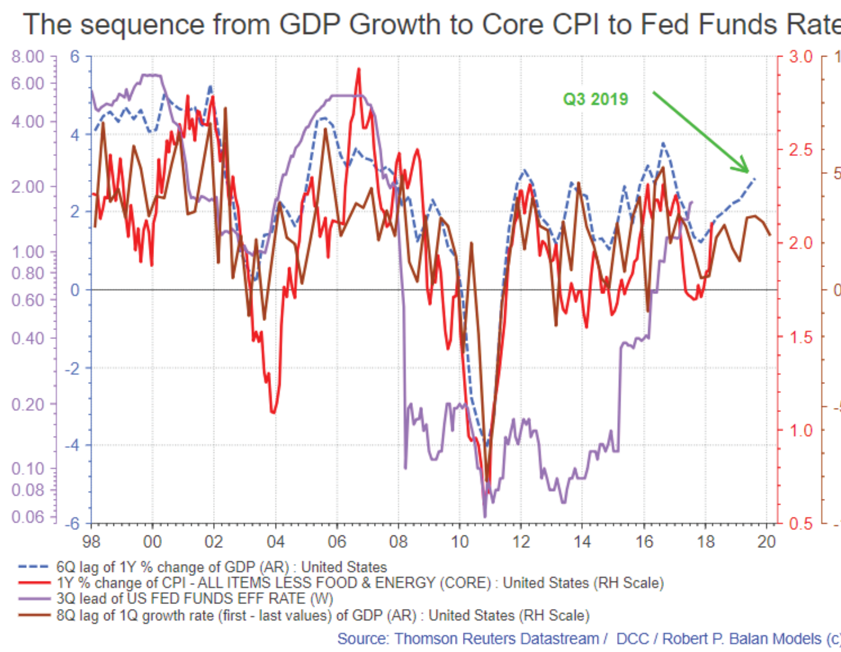
Core Inflation is back in the limelight. Sharp gains over the past several months refocused market's attention to this very lagged variable which, if you properly think about it, does not deserve the attention of the market, much less the Federal Reserve. Why? Because Core CPI (or Core PCE, for that matter) is nothing but a "residue" of GDP growth, in the same way that the exhaust smoke of a car is a residue of the internal combustion that is powering the car. . . The higher the GDP growth, the higher the resultant core inflation. Simply put, inflation is a function of GDP growth.

Today, 6 quarters after we penned that narrative, the same chart shown then looks like this (*see 2nd graph on this page*). This explanation of the procedure in May 2018 still holds true today:

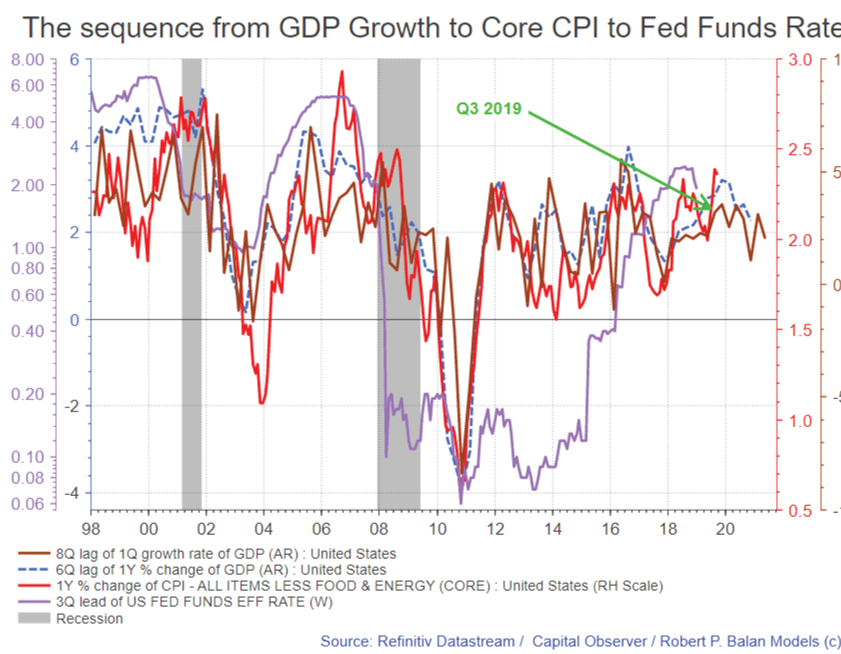
There is a unique link between the change rate of core inflation and GDP change rate in the US, as can be obtained since 1950 (the earliest data available to me). Properly defined, core inflation is a linear and lagged function of GDP growth change rate -- therefore GDP growth rate is a valid predictor of core inflation. As we are interested in using GDP growth as a predictor of inflation, we use GDP growth rates (both year-on-year, and quarter-on-quarter) in order to match the dimensions of core inflation (also, y-o-y and q-o-q). The GDP change rates lead Core CPI variability by 6 quarters.

That thesis has been validated previously by our work published over the past five years. It is gratifying that this simple lagged covariance is still calling the major turns in Core CPI, without the need for elaborate

We illustrated that historical covariance with the chart below



This is how Core CPI looks today



modelling. The fit is so good, and the process is so simple, *that "we treated the links between GDP and core inflation as "mechanical," so that any change in the defining parameters of GDP is always fully transmitted into a strictly proportional change in core inflation."*

Our May 2018 premise of further ascent in Core CPI over the subsequent 5 to 6 quarters was essentially substantiated by actual development of the data. Core CPI has risen, pulled back, and is now again rising sharply. That will likely be the case until Q1 2020. **That's no big feat of analysis – we just followed the trajectory of US GDP, which was advanced 6 quarters, as we have been doing at The Capital Observer for the past five years.**

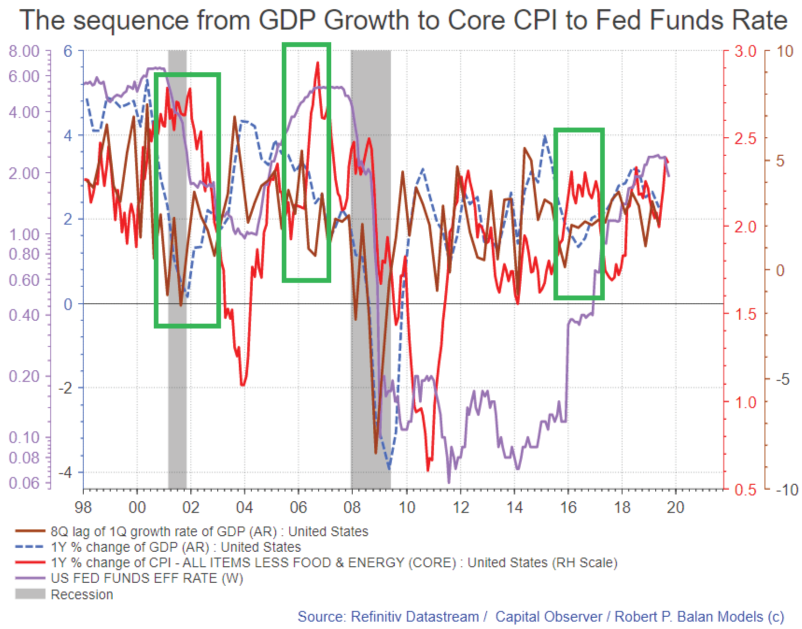
The long lag between changes in growth and the variability of inflation, however, presents some peculiar situation, as in when growth is already slowing, and Core Inflation is still rising. That gives rise to one of the least understood economic phenomena -- **stagflations**. This economic equivalent of a lose-lose situation happens because the lagged response of core inflation does not correspond to the general business cycle. If, for instance, we move the lags between GDP growth and Core CPI, using the same data template as shown in the previous charts, we will get the 1st graph on this page.

We had stagflation in 2001 to 2003, in late 2005 to late 2006, and late 2016 to late 2017 (*see 1st graph on this page*). If we add the Fed's policy reaction function into the mix (the Fed Funds Rate, FFR), the situation even becomes messier. Here is an unmodified 50-year chart of these three variables plotted on concurrent basis (*see 2nd chart on this page*).

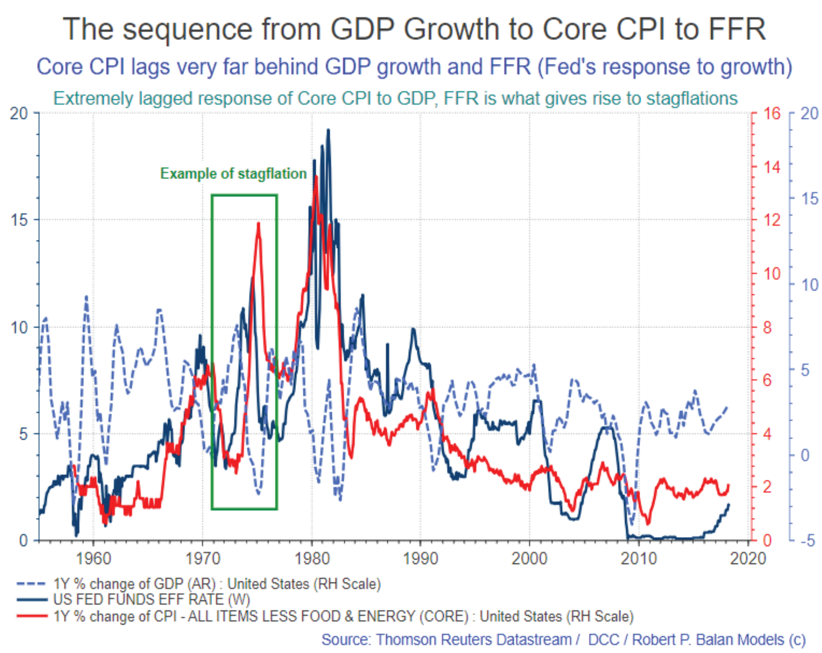
There is a distinct cadence in the relationship between GDP growth, core inflation and the subsequent, and corresponding, reaction function of the Federal Reserve with its policy rate, the FFR. Here is the timeline: GDP change rates lead changes in Core Inflation by 5 to 6 quarters. Core CPI, in turn, leads changes in the Fed Funds Rate (proxy of Fed policy changes) by 2 quarters.

It seems anomalous that the Fed reaction function is so late relative to the other variables in the trilogy. But that is a fact that does not change. However, it explains why the Fed's policy changes sometimes do not make sense to some analysts and pundits. We are sure that the Fed is aware that their policy response to changes in growth and core inflation dynamics lags behind, therefore any policy promulgated is not proactive but palliative.

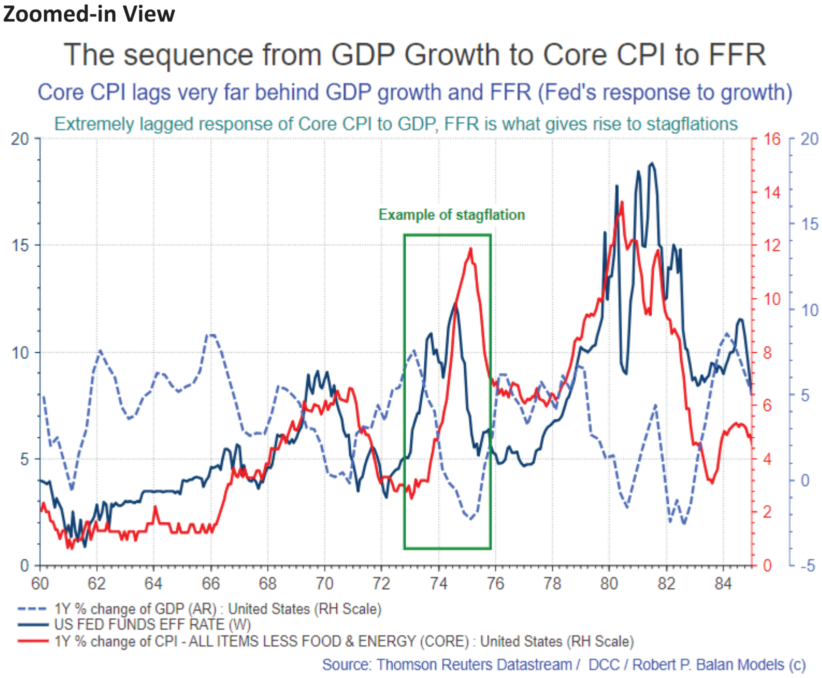
We heard of Fed Chair Jerome Powell of talking about boosting financial conditions as the economy is in a mid-cycle pause. **Whether those perceptions are true or not,**



Fed policies, GDP growth and Core Inflation rate in the past 50 years



Zoomed-in View



it underlines the fact that the Fed has accepted the fact that they are behind the curve. And they only hope to accentuate the positive aspect, and ameliorate the negative development.

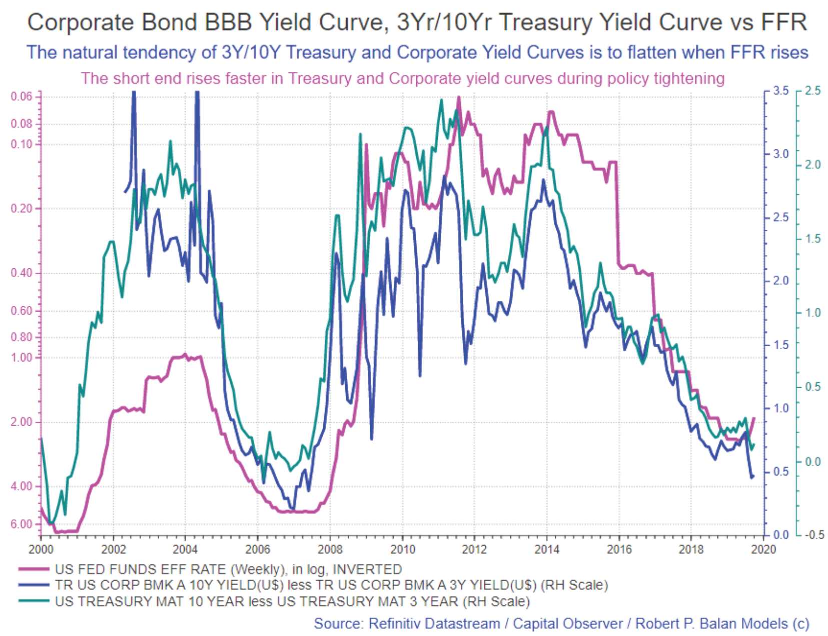
A clarity in the timeline among the three variables of GDP growth, Core CPI and FFR, can help significantly in forming investment strategies. For instance, using our analysis template of Core CPI as a lagged derivative of GDP, and FFR as likewise a lagged derivative of Core CPI (or Core PCE, it does not matter), we have a way of anticipating the likely Fed policy actions in the near-term, given the current status of GDP and Core CPI. That knowledge become immediately useful, as we also know that it is the Fed policy actions which drive the yield curves. Simply put, when the Fed raises the FFR policy rate, yield curves flatten. That holds true going the other way – when the Fed cuts rates, yield curves steepen. (*see 1st chart on this page*)

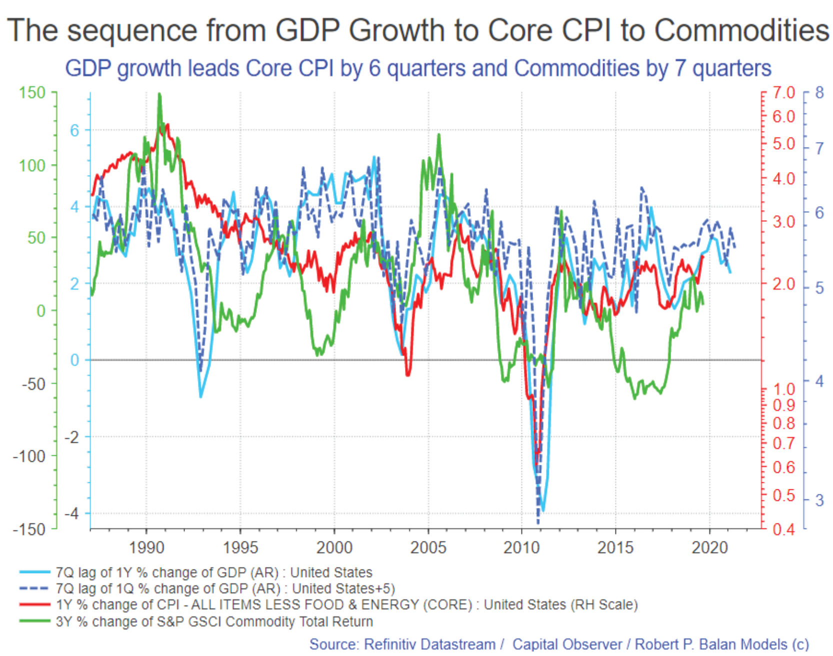
It is also significant to note that the consequent steepening of yield curve after the Fed begins to cut rates, lag behind the Fed's policy action, sometimes by as long as several months. This allows plenty of time to take action on the impending market changes brought about by the Fed change of policy regime.

We note the opportunity that the lagged reaction from goviesand corp BBB yield curve provide today. Those yield curves have started to steepen, but there's still a long way to go before the potential created by the Fed policy regime change is fully exploited. **The yield curves have not fully steepened yet.**

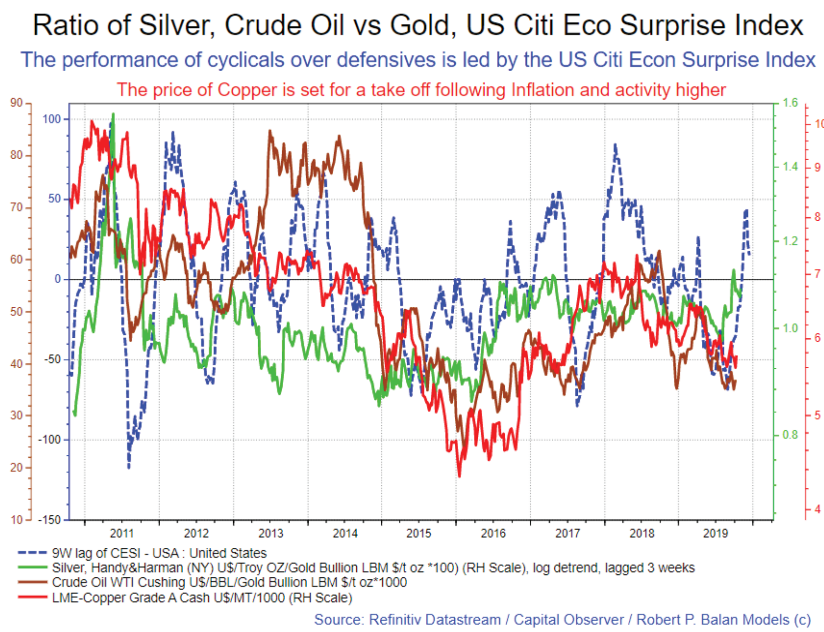
Other actionable ideas:

Based on the template of Core CPI as a lagged derivative of GDP growth, we have confidence that core inflation will rising into at least the year-end, and probably even into late-Q1 2020 as well. Therefore, rising Core CPI into Q1 2020 provides support for a thesis that commodities can perform well into early next year. This supports our other thesis that some sectors in the commodities universe will start outperforming defensive sectors in equities soon. We illustrate the dynamics of the improving general outlook for commodities, as core inflation takes hold. *(see 2nd graph above)*





The ongoing outperformance of cyclicals, such as commodities, and ratios of cyclicals over defensives overpurely defensive sectors has also been boosted by the upward shift of activity and macro data in the US and G-10 countries, as tracked by the Citi Economic Surprise Indexes (*see graph on this page*). In fact the CESI US is indicating exactly the performance profile being indicated by the Core CPI template over the near-term.

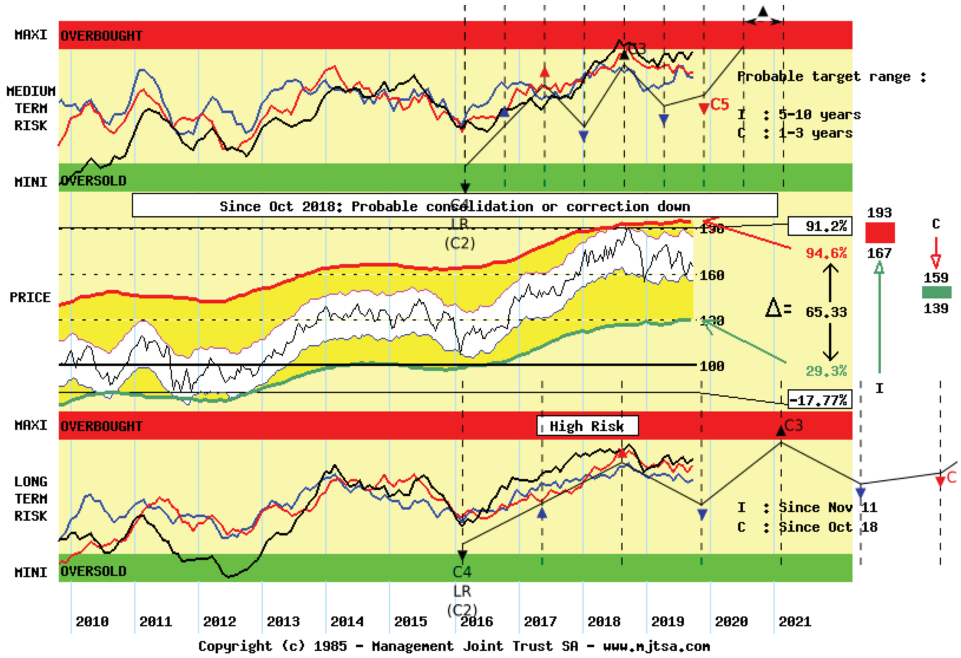


27 / MJT - TIMING AND TACTICAL INSIGHT

Now that Inflation Expectations are Oversold, it's time for cyclicity to bounce

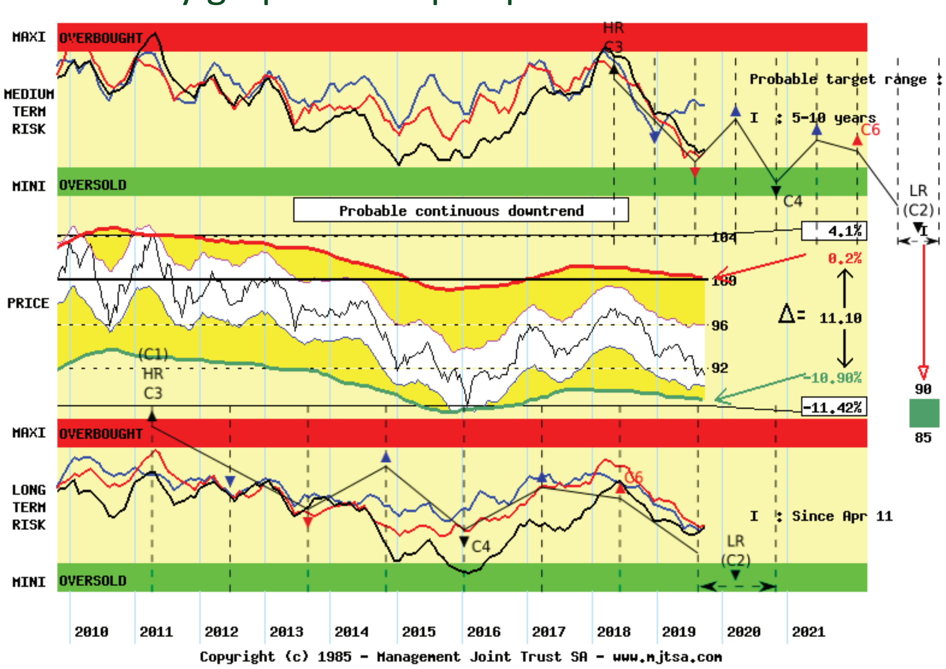
Year-to-date, Equity markets have climbed a wall of worry. Indeed, despite a large overhang of geo-political and economic risks, US equity markets, in particular, are still close to their all-time highs. Looking behind the scenes however, into the different sectors, themes or geographical profiles, but also cross-assets, financial market do reveal a much more defensive picture. Defensive assets have been bid up sustainably all year, while cyclicity has suffered. Inflation expectations are a great sentiment proxy for this shift away for cyclical assets into defensive ones. These are now very Oversold. A bounce in cyclicity is due and may have just started.

S&P500 Index vs the US 30Y Treasury Bond Futures (Dec)
Bi-monthly graph or the perspective over the next 1 to 2 years



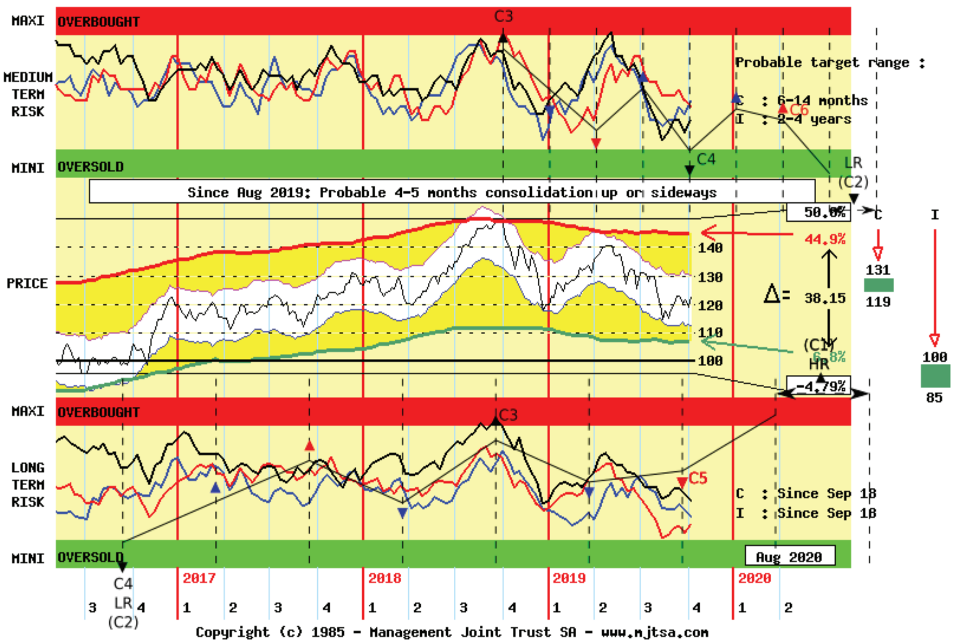
The US Bond to Equity ratio is a decent proxy for the slowdown of the US economy and the market's positioning towards it. On this long term graph of the S&P500 vs the US 30Y Treasury Bonds Future, we can clearly spot the correction down from last October. At the time both our oscillator series (lower and upper rectangles) had reached important intermediate tops. **We now believe that we are approaching support on these oscillator series and that equities could start outperforming bonds soon, probably between now and year-end, and towards mid/late next year**. According to our I Impulsive targets to the upside (right-hand scale), the ratio may reach back towards its 2018 highs, or potentially 15 to 20% higher than today. This would imply quite a strong rally on equities, or an equally strong sell-off in the bonds, or perhaps both.

US Tips vs Treasuries
Bi-monthly graph or the perspective over the next 1 to 2 years



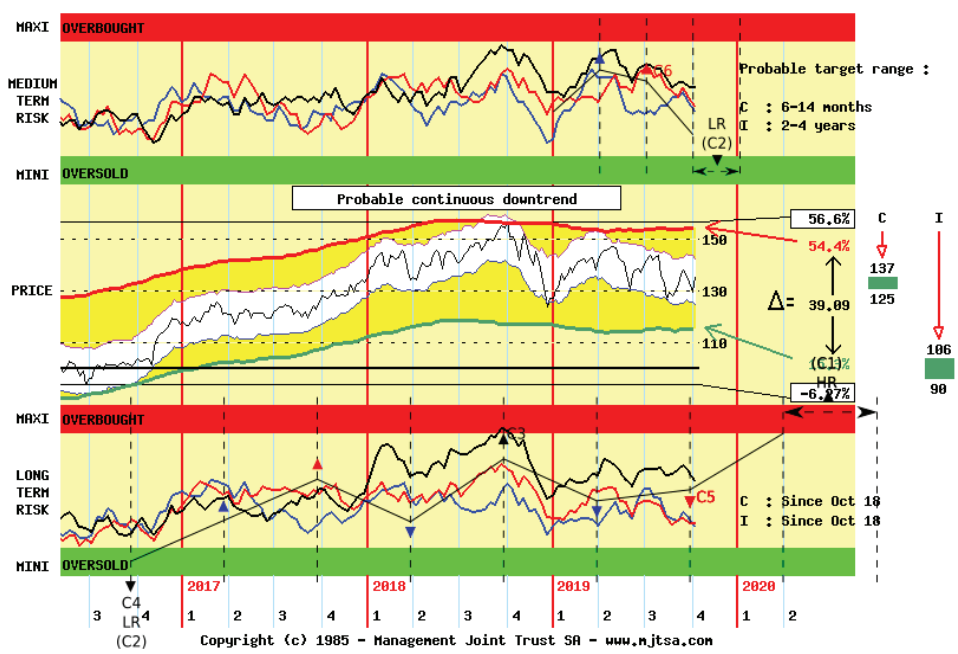
Similarly, inflation expectations which are represented here by the break-even ratio of US Tips vs Treasuries of similar duration (TIP vs IEF ETFs) have corrected down sharply since last year. The top in 2018 came slightly earlier that the Equity to Bond ratio one as the economy started to slow down (US Equity and Bond markets respectively levitated/sold-off slightly longer until late Q3 as the US lingered on higher due to its decoupling story vs the rest of the world). Our medium term oscillators (upper rectangle) now suggest that following 15 months of selling off, the TIP/Treasuries ratio may soon reach an intermediate low. The bounce that follows could last into Spring next year. Longer term, our long term oscillators (lower rectangle) may still suggest more downside pressure into late 2020. **These prospects are less aggressive that what we project on the US Equity to Bond ratio above, but they do leave ample room for a cyclical bounce that could develop into next Spring.**

S&P500 Index vs Gold Spot (USD/oz)
Weekly graph or the perspective over the next 2 to 4 quarters



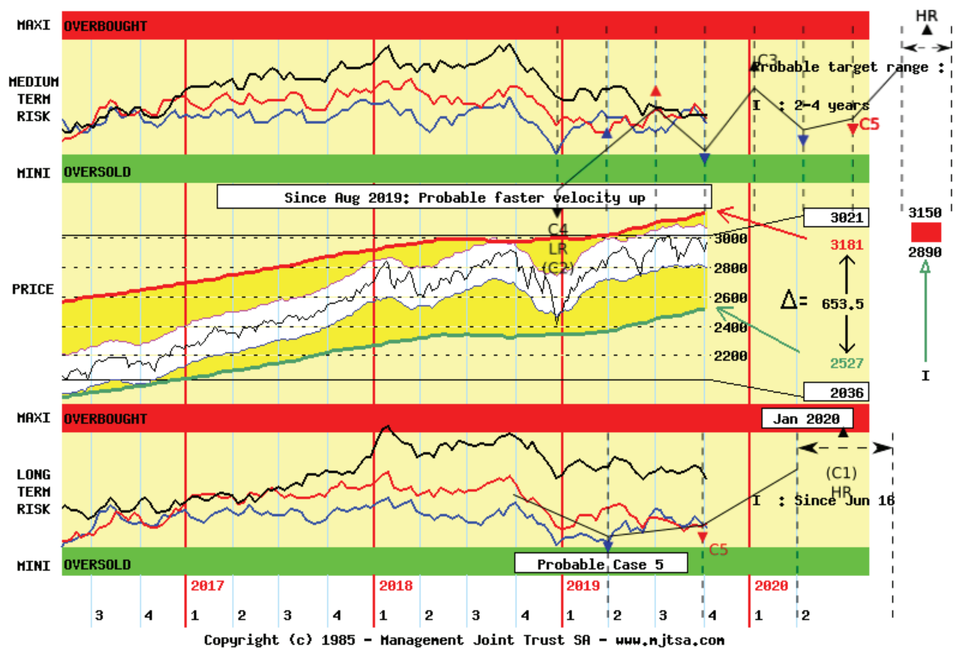
Another ratio, we monitor to capture risk-ON / risk-OFF rotations, and hence cyclicity, is the one comparing the S&P500 Index to Gold. On this Weekly graph we can see how it has corrected down quite sharply since October last year, initially as equity markets sold-off in Q4 2018, then as Gold started to accelerate up from this Spring. Both oscillator series (lower and upper rectangles) now suggest that **the ratio could bounce into year-end. It may even resume its uptrend into mid/late next year** on our long term oscilllators (lower rectangle) . Indeed, while the support of our C Corrective targets to the downside was recently broken in August, this break was only marginal, and we would probably consider that the uptrend since 2016 is still in place. Hence, this uptrend should now resume, potentially over several quarters and it could even make new highs.

S&P500 Index vs the US 30Y Treasury Bond Futures (Dec)
Weekly graph or the perspective over the next 2 to 4 quarters



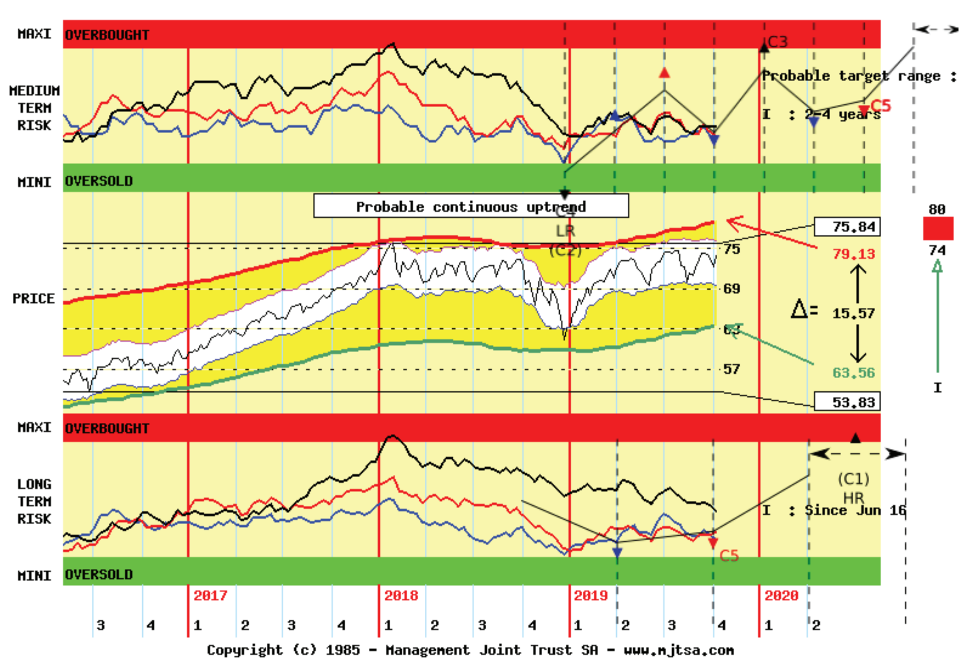
Similarly, we look at the Weekly graph of the S&P500 Index vs US30Y Treasury Bond Futures. Here also the support of our C Corrective targets to the downside was broken, in December, yet also only marginally. More recently the ratio has been able to hold above this support, which is a sign of strength. Although less clear than on the S&P500 Index to Gold ratio, the configuration appears to be reaching support points on both oscillator series (lower and upper rectangles). **We expect this equity to bond ratio to bounce towards year-end at least, and potentially to continue to rise into mid/late 2020. This is in line with what we expect on our bi-monthly graph above.**

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



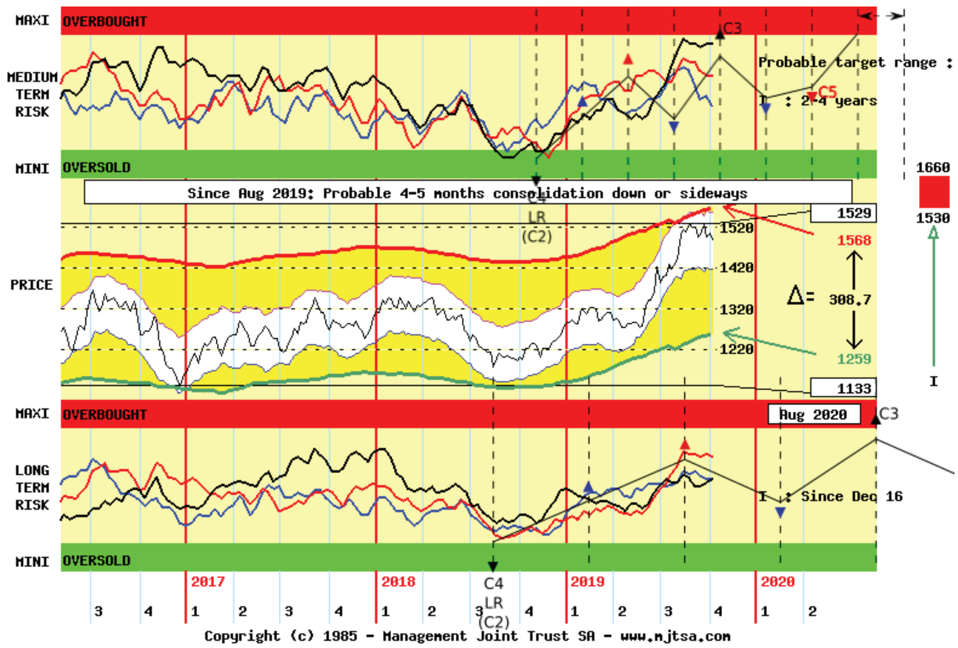
Switching to the S&P500 Index on a standalone basis, we can note that it is still holding up very close to its all time highs made in July this year. On both oscillator series (lower and upper rectangles), we believe **it has probably started to resume its uptrend, towards year-end in first instance, and then potentially towards mid/late next year. Our I Impulsive targets to the upside (right-hand scale) suggest that price targets towards 3'100, perhaps even 3'200 are very possible.**

All Country World Index
Weekly graph or the perspective over the next 2 to 4 quarters



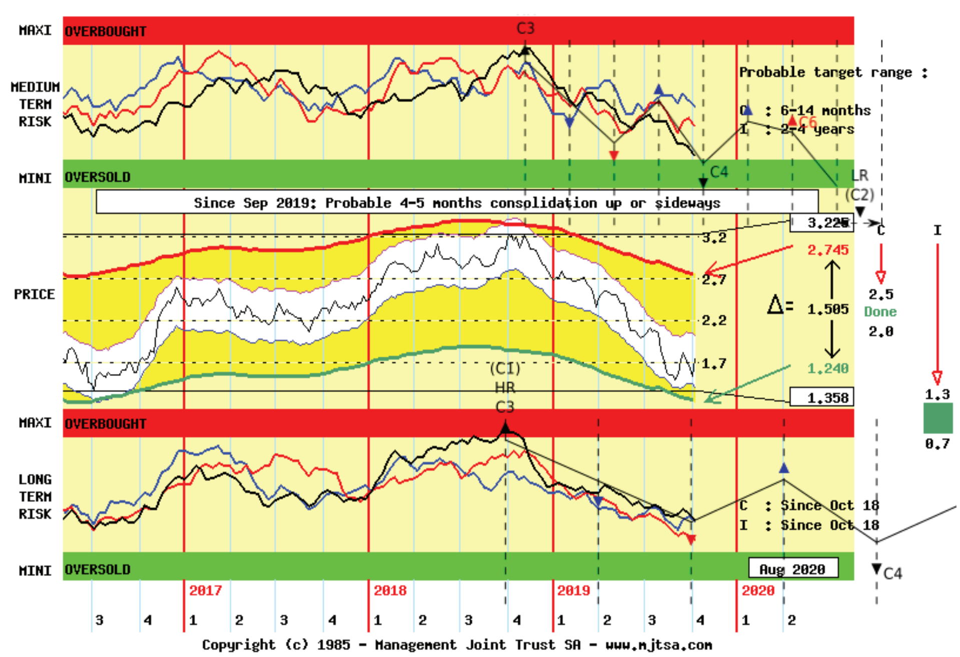
The All Country World Index had been weaker than the S&P500 Index in 2018. It has since performed a remarkable recovery and is now also very close to its 2018 all time highs. While our medium term oscillators (upper rectangle) would suggest **a new leg up into year-end, our long term ones (lower rectangle) indicate that this move may last well into 2020. Our I Impulsive targets to the upside (right-hand scale) indicate 5 to 10% of further upside potential into next year.**

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



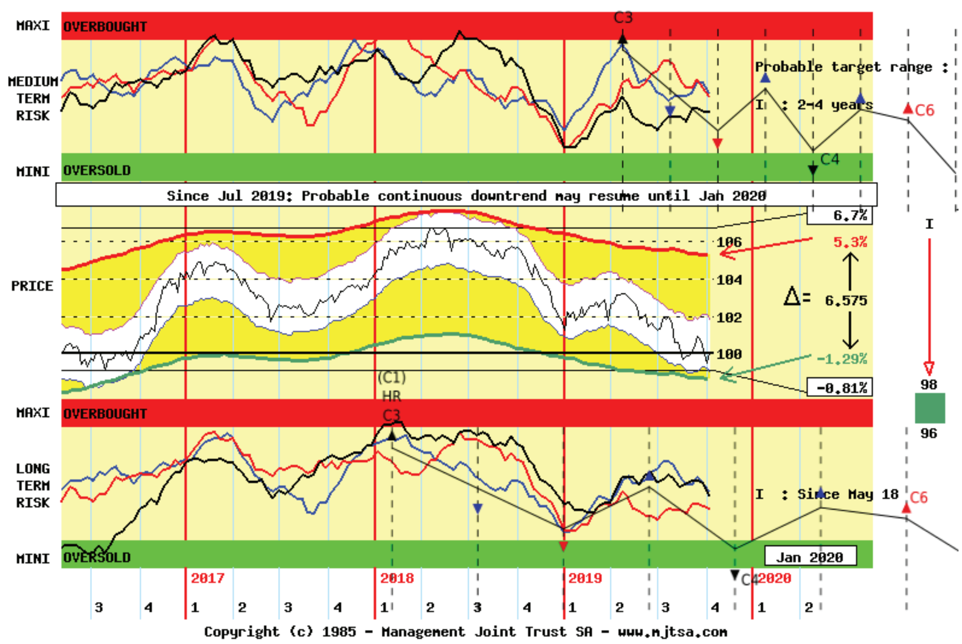
In last month's issue of the The Capital Observer, we expected Gold to top out towards late Q3 / early Q4. We now believe that the top is probably behind us. Our long term oscillators (lower rectangle) do confirm this reversal. On our medium term ones (upper rectangle), there is still some leeway for a slight extension into late October, yet we believe that it is now probably unlikely. We would rather expect **3 to 6 months of consolidation to the downside, probably into Q1, perhaps towards next Spring. The C Corrective targets to the downside we can calculate suggest retracement targets in the 1'375 – 1'280 USD/oz range** (0.5 to 0.8 time our historical volatility measure "Delta, here at 308.7 – middle rectangle, right-hand side – subtracted from the graph's highest point at 1'529) or back towards the resistance zone which capped prices during the 2016-2018 period. As for our I Impulsive targets to the upside (right-hand scale), they may still be achieved over the next 12 to 18 months, following the retracement period we now expect.

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



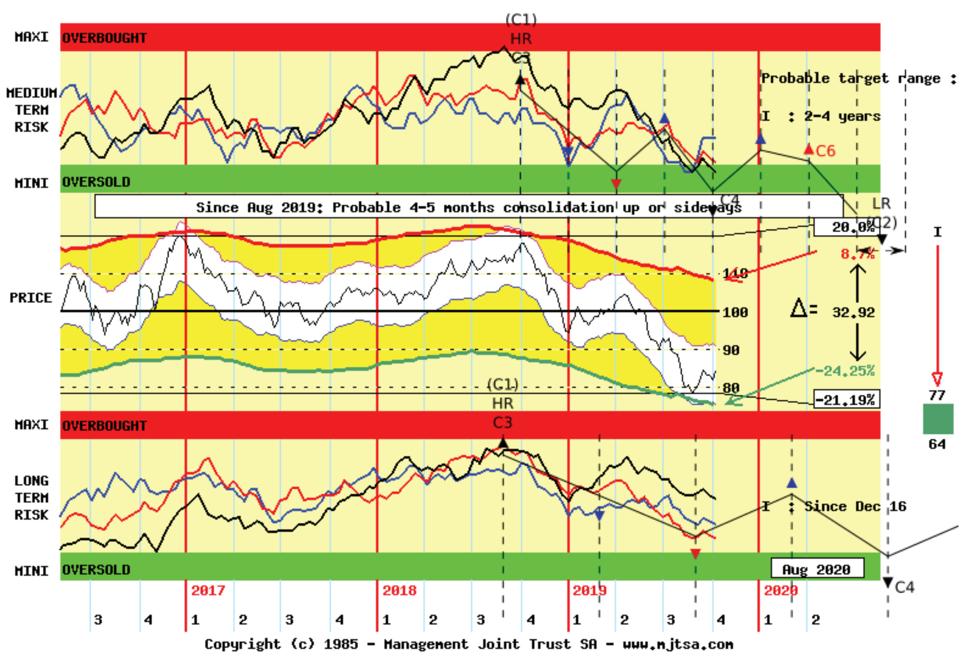
Similarly to Gold, US 10Y Treasury yields have probably reached an intermediate low on our long term oscillators (lower rectangle). The sequence on our medium term ones (upper rectangle) may still justify some downside retesting into late October, but we believe that these will probably not achieve new lows. Indeed, **we now expect 3 to 6 months of rebound on US Treasury yields, probably into early, perhaps Spring next year. The rebound could travel back between 75 and 100 basis points (0.5 to 0.8 times our historical volatility measure "Delta") or potentially back into the mid 2s %**. Our I Impulsive targets to the downside (right-hand scale) may still be achieved over the next 12 to 18 months, yet probably following the rebound we now expect.

US Tips vs Treasuries
Weekly graph or the perspective over the next 2 to 4 quarters



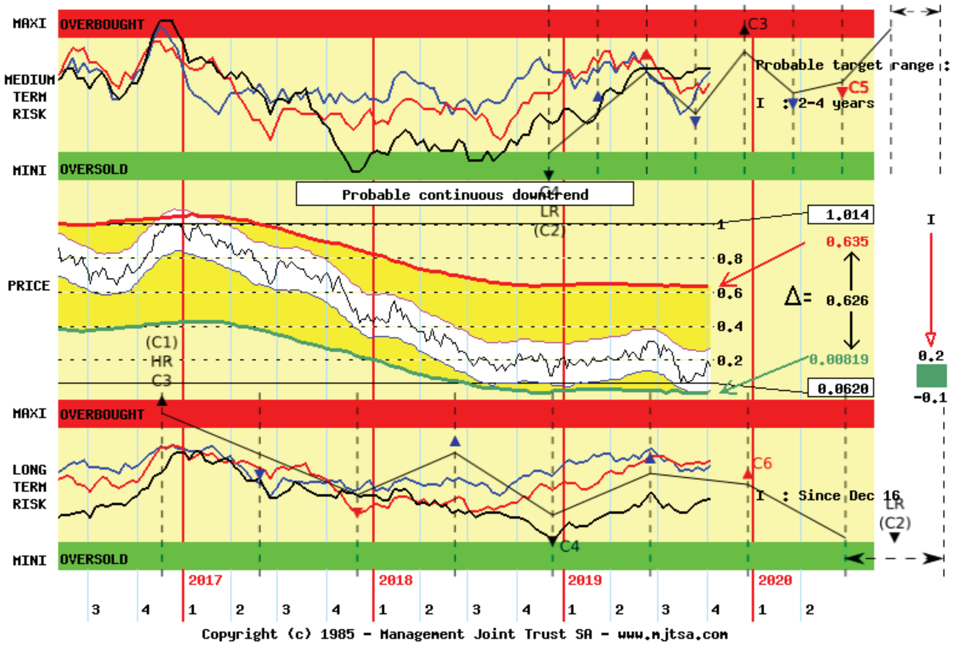
Over the last 18 months, falling inflation expectations (represented by the Tips to Treasuries ratio) have tracked the slowdown in the US economy. Both oscillator series (lower and upper rectangles) now suggest that **the ratio should find support during Q4 and start to bounce**. As with other risk and cyclical assets, we expect this rebound to last 3 to 6 months. Probably into Q1 and perhaps next Spring.

Reuters Commodity CRB Future Price Index vs Gold Spot (USD/oz)
Weekly graph or the perspective over the next 2 to 4 quarters



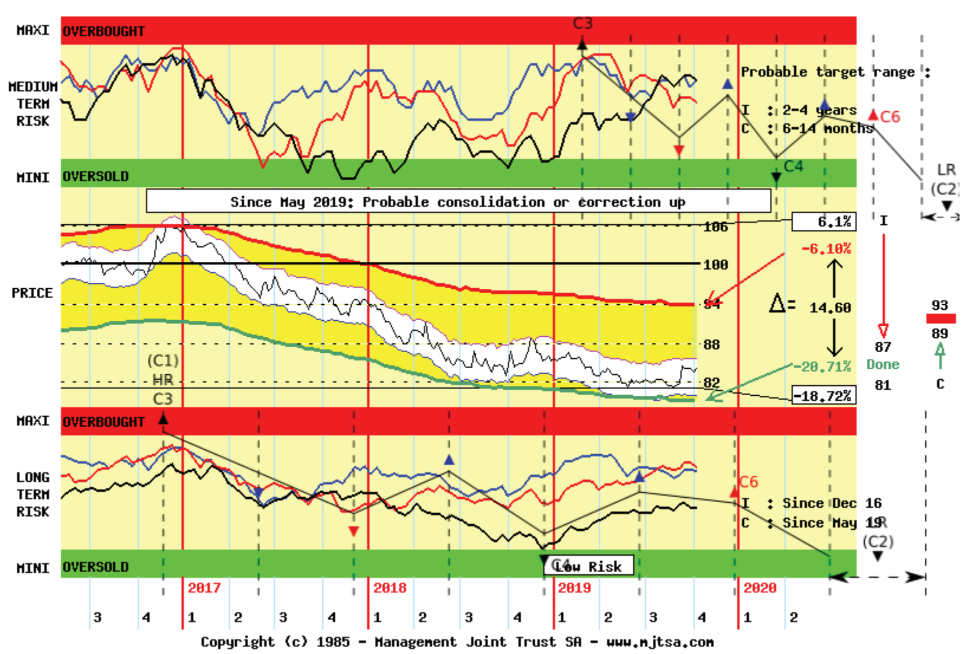
Talking about inflation, we now look at the ratio of the general Commodity CRB Futures Index vs Gold. The CRB Index is composed of circa 40% Energy and 35% of Agriculture. It is hence more diversified than other commodity indexes. On both oscillator series (lower and upper rectangles), the **CRB Index has reached an important low vs Gold and we expect it to correct up for 3 to 6 months, probably into Q1 and perhaps Spring next year. This would be quite reflationary and would correspond to pick up in cyclicity we expect.**

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



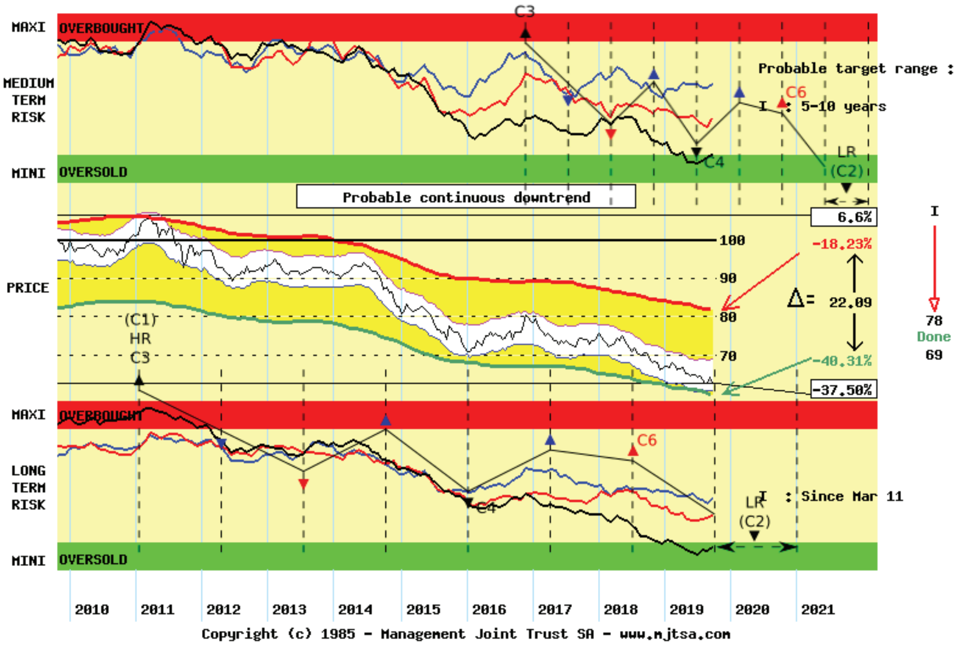
We now look at the middle portion of the US yield curve (US10Y-US3Y) which we believe is the most reactive to anticipations around US central bank policy. When the market considers the FED to be too hawkish (2017-2018), the spreads flattens. On the contrary, when the FED appears to be too dovish, the spread steepens. With the prospects of the upcoming "not QE4" program, and considering the cyclical pick-up we expect from here, **we believe the US10Y-US3Y could see a bounce during Q4 at least as shown on both oscillator series** (lower and upper rectangles). Following that, it may flatten again in early 2020 as the FED eventually turns neutral again. **Such bounces in the US10Y-US3Y are often accompanied by strong re-ratings of all cyclical and value profiles.**

US Value vs Growth
Weekly graph or the perspective over the next 2 to 4 quarters



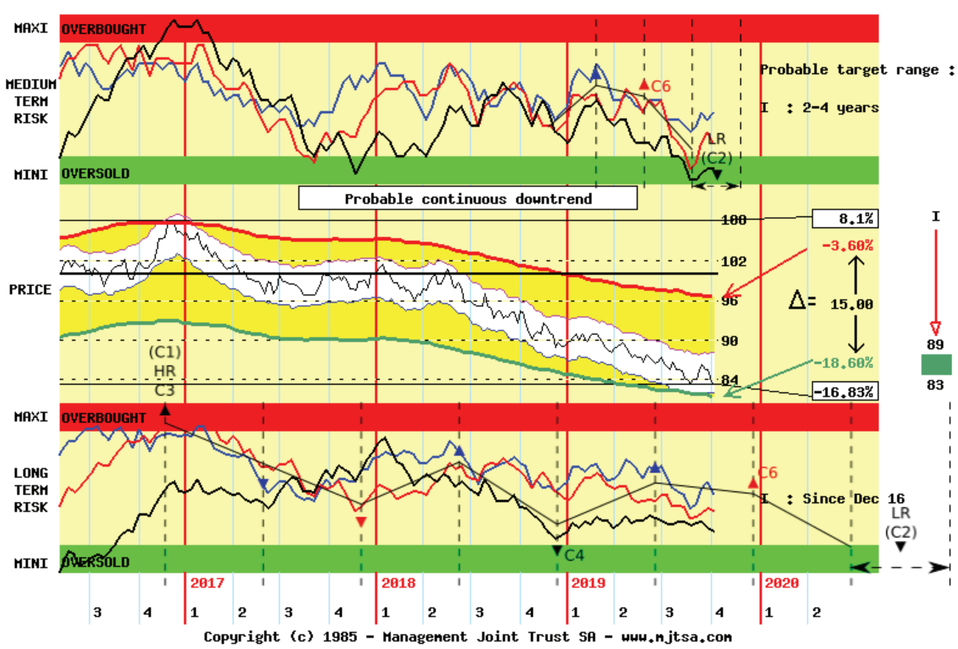
Indeed, the Value to Growth relationship was heavily Oversold this Summer and may have since started to bounce. According to both our oscillator series (lower and upper rectangles), this rebound may continue into late Q4, perhaps year-end. Following that, value themes may underperform again as they give up the lead to more growth oriented profiles. This does not necessarily mean that they will drop, but just that they may start to lag again as the equity market rally becomes more mature and probably continues higher into Spring next year.

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



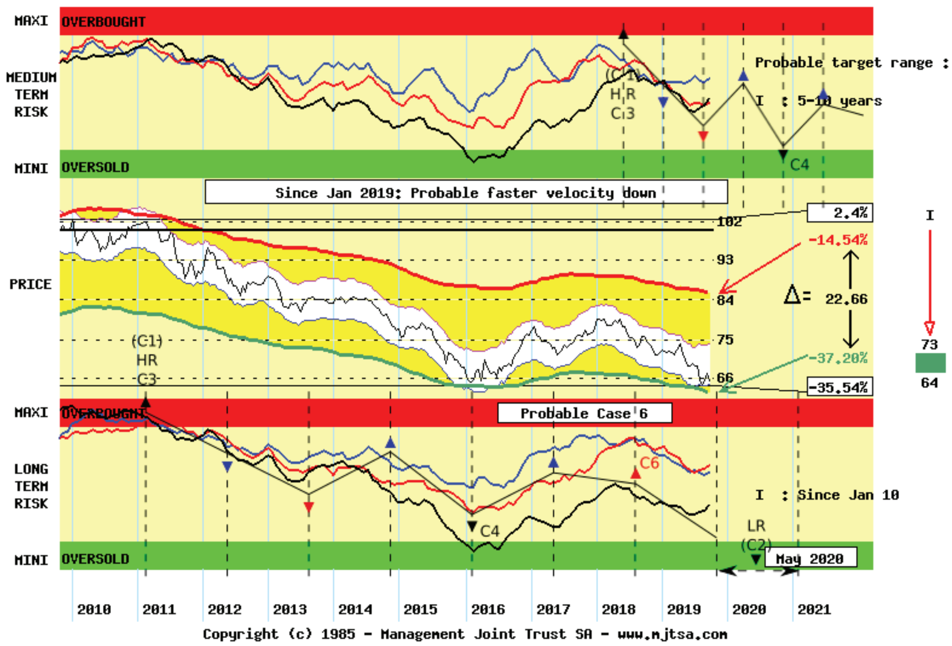
We now consider cyclical sectors vs their reference indexes. First in the US with this long term graph of US Cyclical sectors (an equal weighted portfolio comprising the Industrials, Materials, Energy and Financials sectors) vs the S&P500 Index. **The ratio is Oversold on both oscillator series and the downtrend seems rather exhausted in term of potential** as the ratio has made it below our I Impulsive targets to the downside (right-hand scale). On our medium term oscillators (upper rectangle), **we expect an initial bounce to materialize into early next year**. Following that, our long term oscillators (lower rectangle) would suggest a Low Risk situation that extends into late next year. This may imply that Cyclical sectors could be building a base over the next 15 months, perhaps indicating the beginning of a secular reversal in favor of cyclical sectors.

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



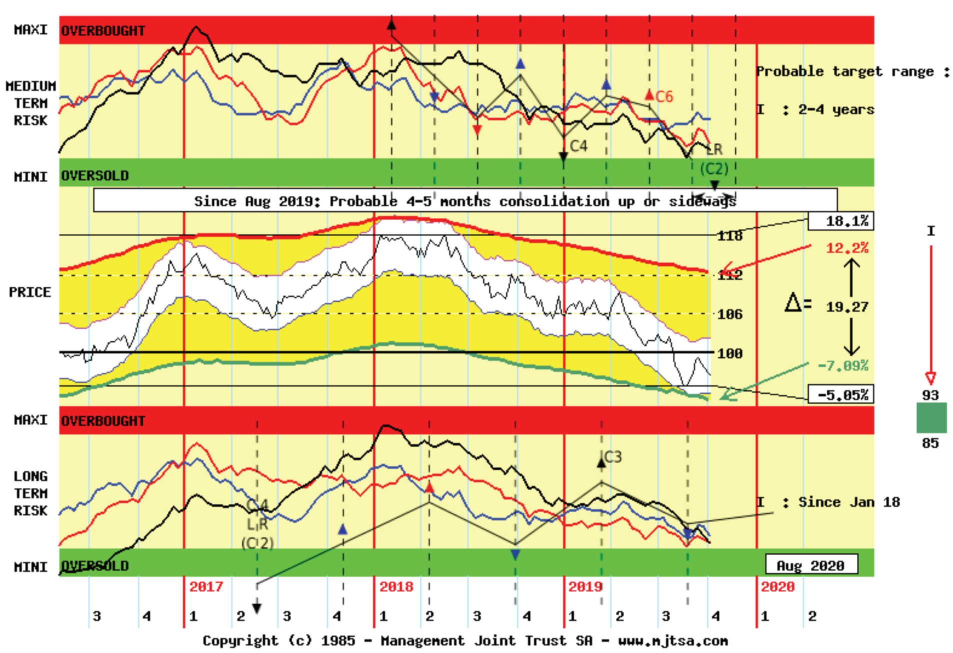
On the Weekly graph of these cyclical sectors vs the S&P500 Index, our medium term oscillators (upper rectangle) are very Oversold, and a 3 to 6 months bounce can probably be expected. Our long term oscillators (lower rectangle) show a similar picture than the US10Y-US3Y yield spread above. They indicate a period into year end when cyclical profiles could bounce. Following that, this move could be retraced, at least partially, during H1 2020. Nevertheless, **the next three months probably offer a very interesting re-rating opportunity for US Cyclical sectors vs the market**. Indeed, the downtrend is exhausted in terms of targets (our I Impulsive targets to the downside have been fulfilled) and the relative rebound potential we can calculate could amount to circa 10% over the next quarter or so (0.5 to 0.8 times our historical volatility measure "Delta", here at 14.79% - middle rectangle, right-hand side).

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



The long term downtrend of Cyclical sectors in Europe (an equal weighted portfoliocomprising the Banks, Autos, Natural Resources, Chemicals and Energy sectors) **vs the Europe Stoxx 600 is also quite exhausted in terms of price targets** (our I Impulsive targets to the downside have been fulfilled; right-hand scale) **and as in the US, our medium term oscillators (upper rectangle) do suggest a bounce of the ratio into early next year**. On our long term oscillators (lower rectangle), we are slightly more negative than in the US. Indeed, the ratio is less Oversold than the US one, and could suggest that following the bounce we expect into early next year, it could retest down into the second half of 2020, and will probably make new lows.

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

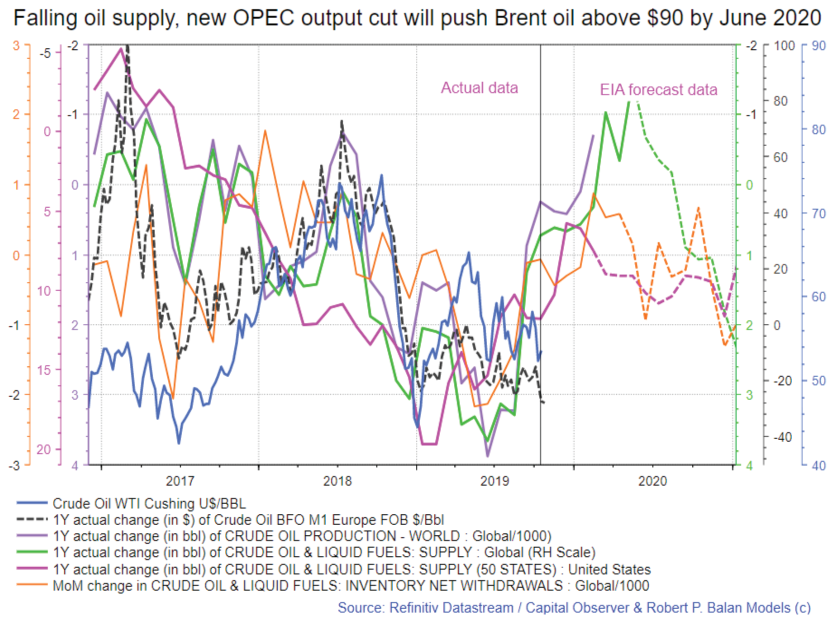


The Weekly graph of the ratio between European Cyclical sectors and the Europe Stoxx 600 is also less Oversold than in the US both in terms of our oscillator series and in terms of targets. Nevertheless, **we still expect it to bounce on both oscillator series (lower and upper rectangles), probably during the next 3 to 4 months (i.e. into early 2020).** Following that, cyclical sectors may lag again during 2020 as suggested by our bi-monthly graph above. Yet in the meantime, **the re-rating potential for Cyclical sectors vs the market is probably quite interesting, perhaps circa 10%** or 0.,5 to 0.8 times our historical volatility measure "Delta" (middle rectangle, right-hand side).

Concluding remarks:

Inflation expectations measured by the Tips to Treasuries ratio are quite Oversold and we would expect them to bottom out and start bouncing during Q4 and perhaps into the Spring. We believe this reversal is important as inflation expectations are quite telling of market sentiment, which we see shifting over the next few months from very defensive to quite pro-cyclical. Other ratios seem to confirm this shift. Indeed, the US Equities to Bonds ratios and the US Equities to Gold ratios are probably also in the process of resuming their long term uptrend and may even extend higher well into 2020. Indeed, we expect equities to rise into next Spring at least while Bonds and Gold retrace some of their year-to date gains. Finally, this pick-up we expect in cyclicity during Q4 should benefit cyclical sectors in the US and Europe. These could see a sharp re-rating vs the market probably into year-end, perhaps until early next year.

35 / There is very real upside potential to crude oil, and the market is not pricing it in



The last time Capital Observer discussed crude oil prices was in the August 2019 issue, and after a long discussion of various factors that were impacting the oil market at that time, we concluded:

Our thesis from April 2019 remains valid: oil prices will bottom very soon (if they have not already done so), and we still expect Brent oil to rise to at least $90.00/bbl during Q2 2020.

In earlier editions of Capital Observer, we expected that the oil price was going to fall to circa $50.00/bbl by late May-early June before oil prices stabilize. Indeed, that is what happened. By August nominal lows were seen, and then prices went sideways. Then there was significant volatility caused by the attack on the Aramco facilities in Saudi Arabia. But prices settled back after the Saudi repairs will be done quickly, and there will only be minor disruptions in oil supplies from the Kingdom.

Therefore, it is time again to compare what oil prices have been doing relative to our price models. Here is an updated chart of the oil price models that we have been tracking: (*see 1st chart on this page*)

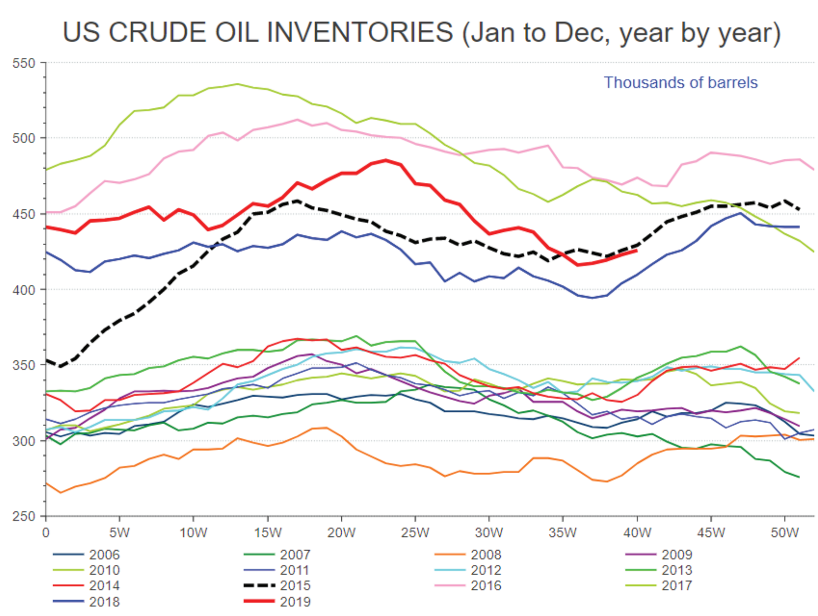
It is clear to us that a price baseline at above $50/bbl has been established by the market. Despite fears of an imminent recession (which we at Capital Observer do not share) prices have become stable above those levels. What this tells us is that there is substantial upside risk to crude oil that the market may not be pricing in.

The market is seriously mispricing the OPEC cuts and that in the coming months, the price of crude oil will strongly increase. We also believe that weak demand is currently being trumped by lack of supply, which has led to large drops in stocks this year. Therefore, if we see even a moderate uptick in demand, crude inventories could plummet, and prices could rise significantly. The crude markets remain fundamentally tight and bullish. We develop those themes in this oil article.

We start with the global supply and demand. We, at the Capital Observer, have been hammering on the primacy of the variance between global oil demand and oil supply as the prime mover for global oil prices in the longer run. We have not seen any other model yet that surpasses the efficacy of the simple equation having the changes in the delta of supply versus demand as proxy for the changes in global oil price.

The way to comprehensively study the balance is to start with an examination of the five-year range of inventories. As you can see in the chart below, crude inventories are currently sitting around the five-year average on the back of an incredible decline in crude stocks this summer. (see chart below)

The decline in crude stocks is just a warning of what we believe will be coming to the crude markets sometime soon. Specifically, it could happen that in the coming weeks, we will see the year-to-date draw continue into one of the lowest levels seen in recent years. (*see 1st chart on the next page*)



The reason why we believe that this will occur largely has to do with the supply side of the balance. While demand is still poor, supply is also weak. This interesting situation leaves the market seriously vulnerable to upside risk on either a supply disruption or even a moderate uptick in demand.

On the issue of demand, it has been weak this season. As seen in the following five-year range of crude utilization, we have ended the summer driving season with one of the lowest levels of utilization seen in many years. (*see 2nd chart on this page*)

The reason for this weakness in utilization has to do primarily with the gasoline markets. We simply have too much gasoline in stocks and refineries are running at lower levels to keep from oversupplying the market (*see 3rd chart on this page*).

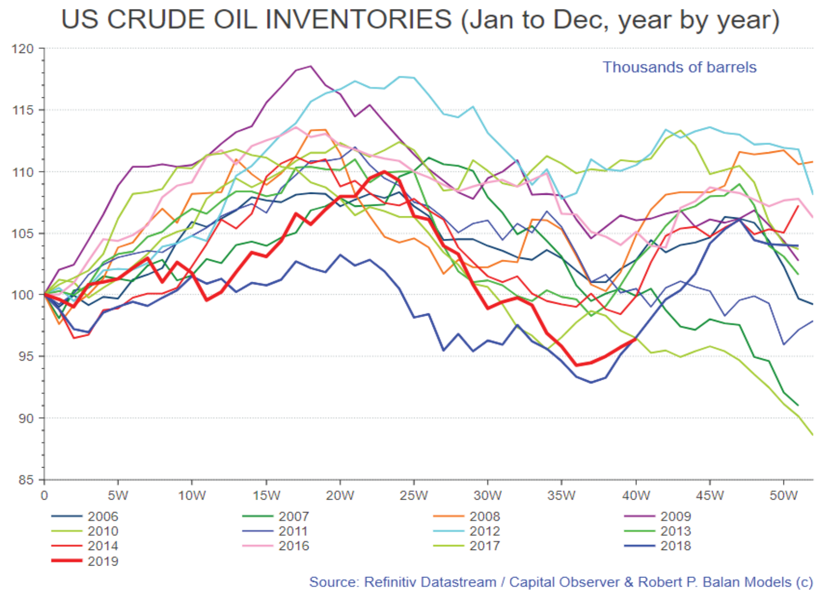
The underlying reason why we have such high stocks has to do with the fact that the economy has slowed. With a weaker economy, there is less business and personal driving, which results in fewer barrels of gasoline being consumed. As long as the economy remains weak, driving demand will remain weak and gasoline stocks will generally be elevated. Long-term factors (like the PES refinery explosion) can sap the market of supply, but it can take lengthy periods of time for the effects to be felt.

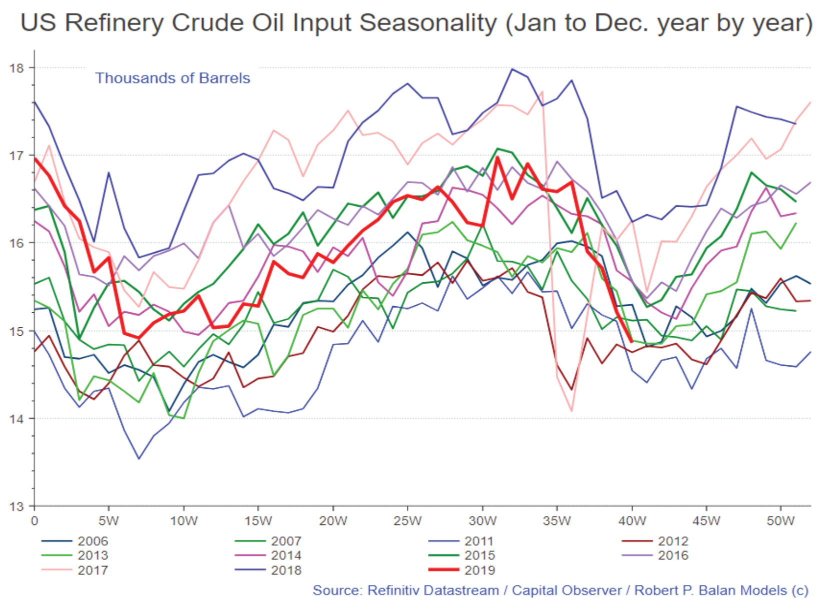
The other side of the demand equation has to do with exports. Exports have remained strong and we believe that they will remain strong going forward. If exports take off like they did last year, then we have an entirely new dynamics in the supply side (*see 1st chart on the next page*)

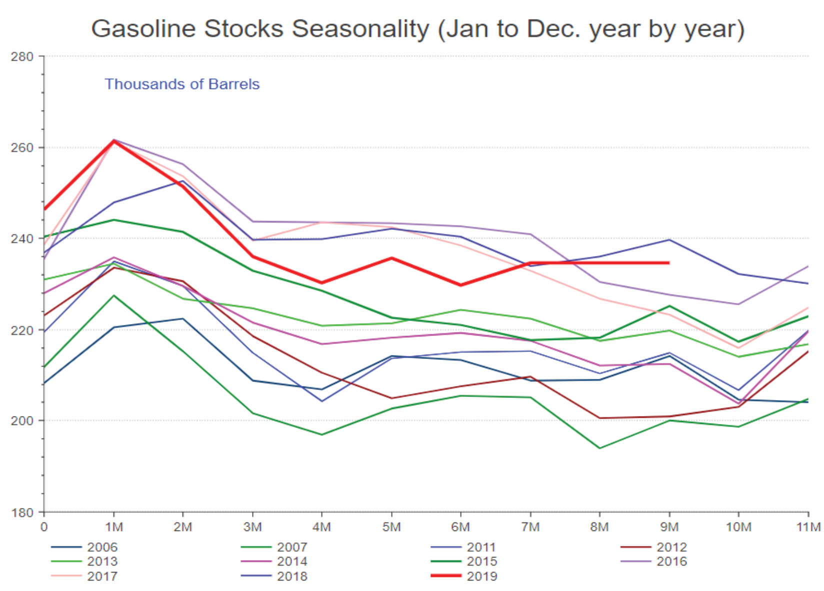
The reason why we believe that exports will remain strong is due to the fact that we have seen elevated and growing exports, even with the Brent-WTI spread contracting by around $6 per barrel over the last few months.

The basic export economics require a large enough spread to move barrels from the United States, and the market has demonstrated a willingness and ability to keep the barrels flowing even with volatility in key market spreads.

The supply side is currently driving much of the volatility in the crude balance. From a production standpoint, barrels continue to come from the ground at a growing rate. (*see 2nd chart on the next page*)







There is some concern that oil production growth is slowing, but our base case assumption is that growth will continue at the same rate it has been. In other words, we believe that growth will continue into the future for at least the next few years. And despite this growth in production, the supply side is the weakest side of the balance.

The reason why supply is so weak has to do entirely with OPEC. Put simply, OPEC is dictating the long-term trends of crude oil stocks in the United States. To arrest the price decline of late 2018, OPEC initiated production cuts. These cuts were extended in the middle of this year through March of 2020.

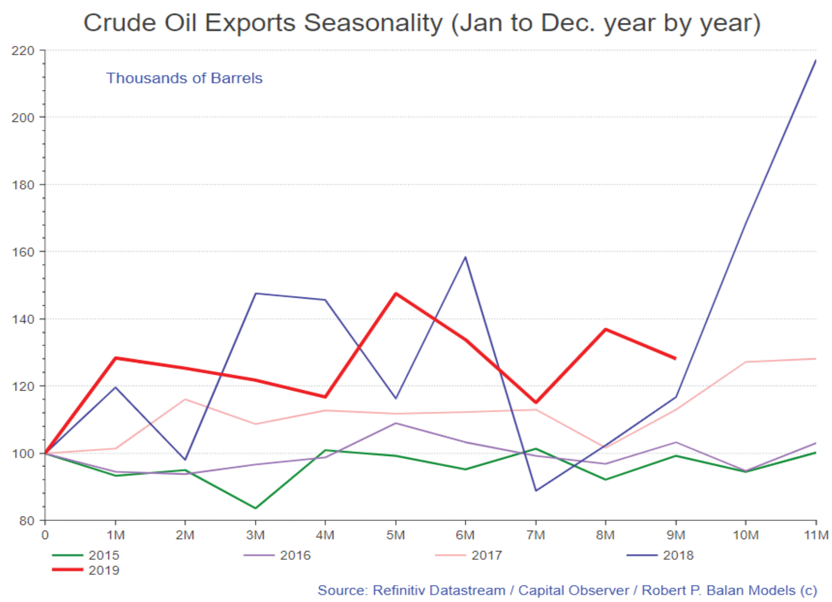
The impacts of these cuts can be pretty clearly seen in the five-year range of imports which shows most weeks coming in below the bottom of the five-year range.

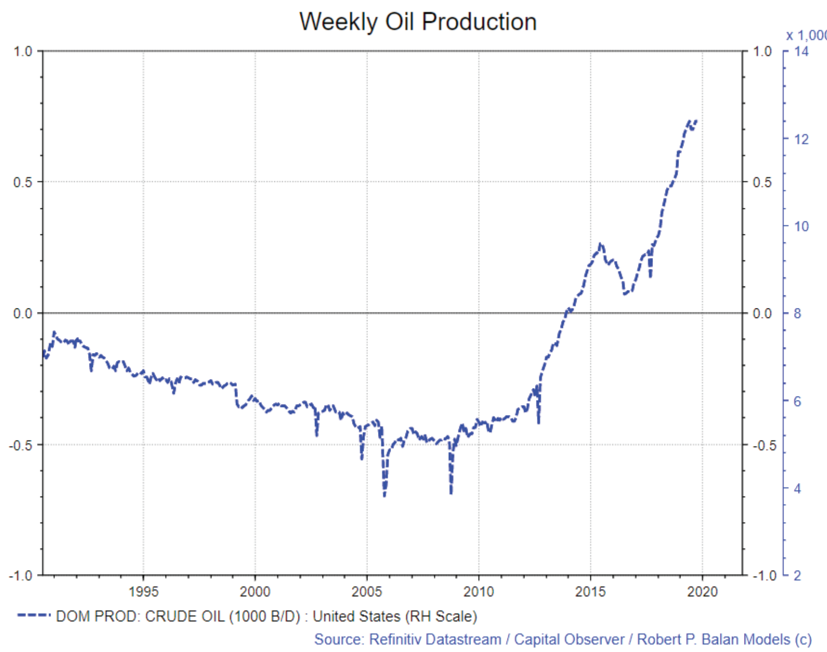
The fact that OPEC is the driving force here can be clearly seen through a breakout of imports by origin country. This incredibly low level of OPEC barrels flowing to the United States has resulted in the smallest amount of imports seen to the United States in decades. Canadian imports have attempted to step in and fill the gap. But the overall story remains: OPEC has curtailed production, and the world supply and demand balances are feeling the impact.

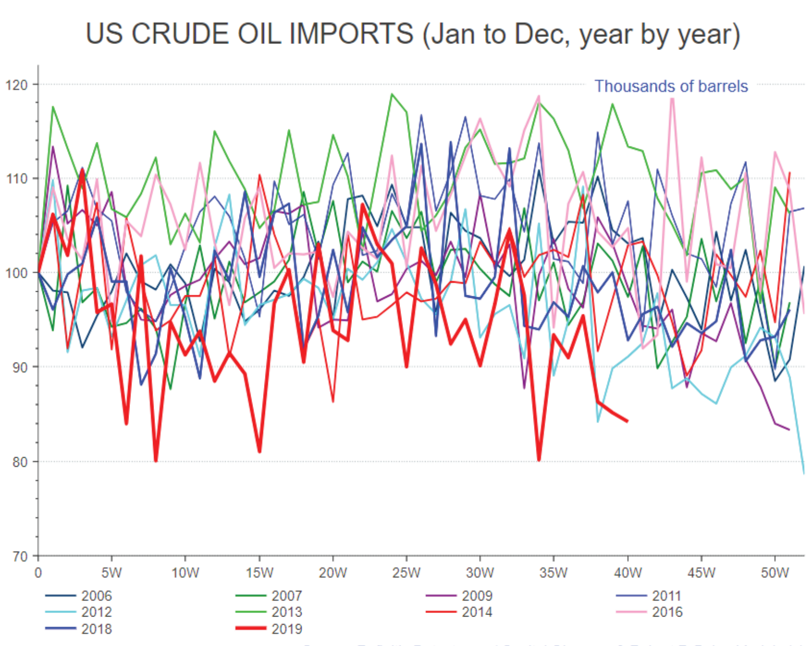
If you look at the above summary, you'll notice that the underlying fundamentals for crude oil are largely bullish. This bullishness has been felt by an incredible decline in crude stocks earlier this year as well as the forward curve remaining in backwardation. And all of this has been happening with poor demand.

Imagine an even slight uptick in the economy. If we see a few months of positive growth in refining demand and crude runs even come back to the five-year average, crude stocks would rapidly decline and the price per barrel would surge due to the ongoing OPEC cuts sapping the market.

There is very real upside risk to crude oil. We do not believe the market is pricing this in. We do not believe the market is seeing the fact that the large drawdown in stocks which happened in May through August (one of the largest drops ever seen) occurred simply due to slightly above-average refining runs. If we see an uptick in refining demand due to a brightening economy, crude stocks are poised to collapse rapidly and the price per barrel to rise. The risk is to the upside, and traders should consider going long crude oil now.



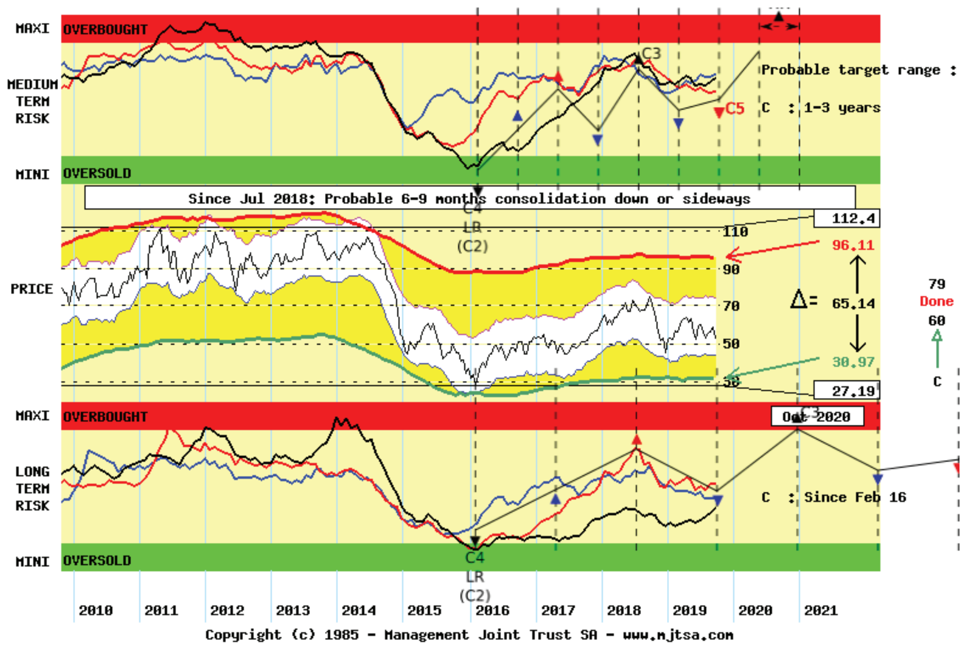




Oil should continue to stabilize during October

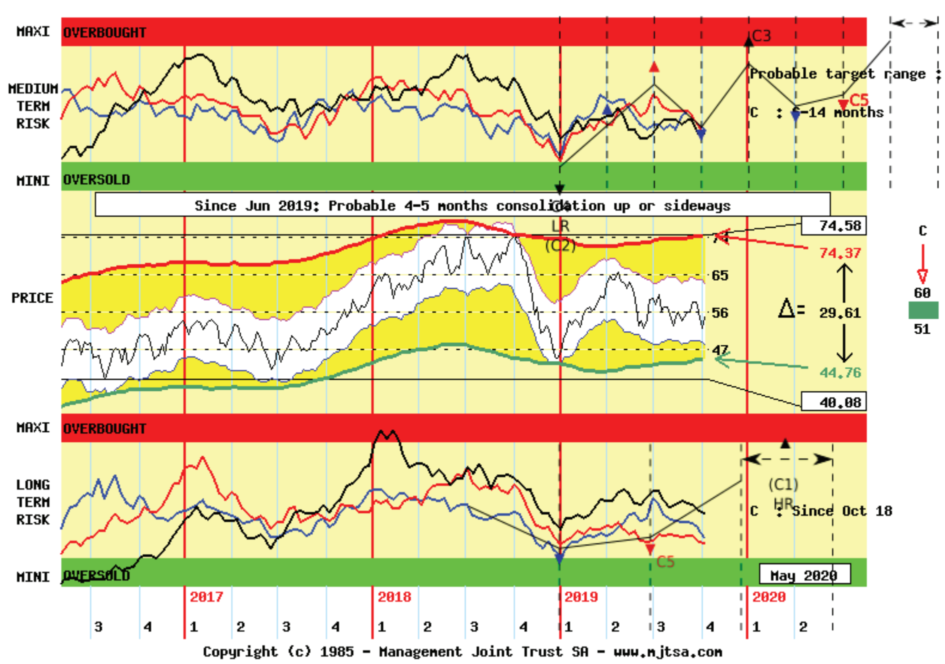
Following the Houthi / Iranian attack on Saudi oil facilities last month, Oil spiked and then retraced. It has since filled the gap to the downside and is now continuing to slide. It is currently below its June and August lows on Brent and slightly above them on WTI. For now, the configurations on our graphs are still quite menacing in term of trend. Yet, several elements do indicate that Oil could continue to stabilize during October.

WTI Light Crude Oil (USD/barrel)
Bi-monthly graph or the perspective over the next 1 to 2 years



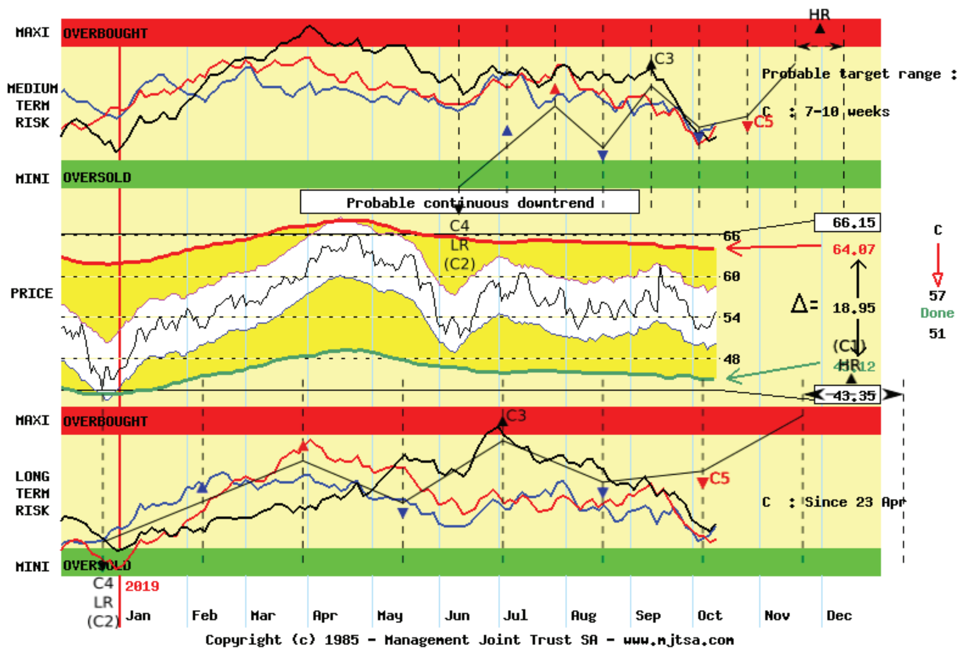
The long term graph of WTI Oil has been correcting down since mid last year. On both our oscillator series (lower and upper rectangles), we would expect it to reach support over the next few months. The uptrend that follows could last well into 2020. Some doubts do subsist however about the strength and speed of this recovery. Indeed, while the uptrend between 2016 and 2018 was strong, it remained corrective compared to the 2013 – 2015 sell-off, as it never made it back above the resistance of our C Corrective targets to the upside (above 79 USD/barrel on WTI, right-hand scale). Hence, for now, we will continue to consider the whole move since 2016 as being counter-trend. Such an environment can be quite treacherous and we would probably seek further confirmations on our shorter term frequencies to gradually reenter the Oil trade.

WTI Light Crude Oil (USD/barrel)
Weekly graph or the perspective over the next 2 to 4 quarters



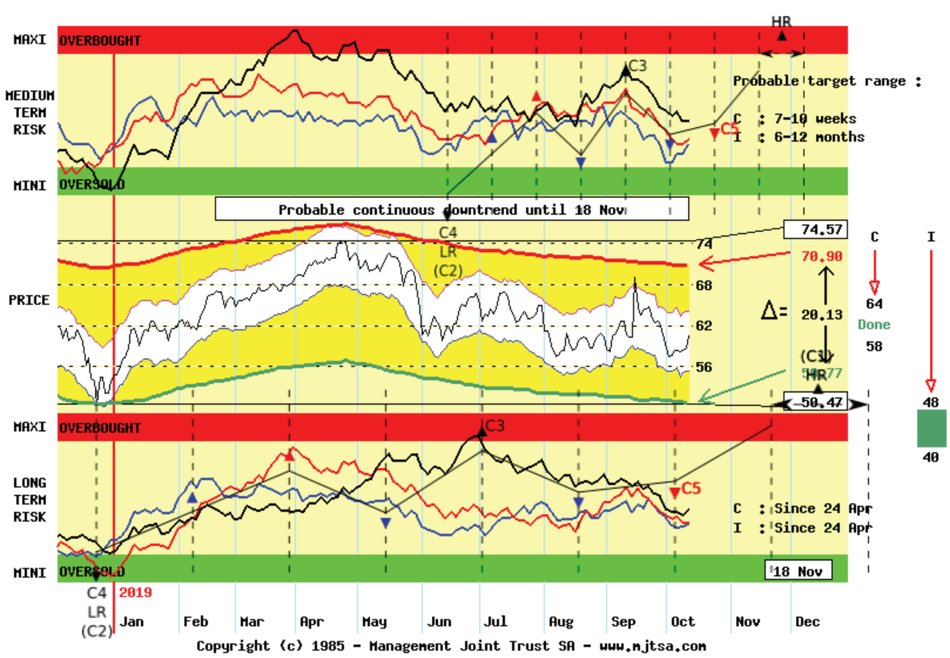
On the Weekly graph, following the sell off into last December, WTI Oil has been attempting to create a higher low during Summer (as shown on our long term oscillators, lower rectangle). For now, it has been struggling to do so, although it hasn't broken down either. Indeed, the support of the lower end of our C Corrective targets to the downside has held (above 51 USD/barrel, right-hand scale). **On our medium term oscillators (upper rectangle), a very weak uptrend sequence may be under way. It may find a new support during October to move higher until year-end.**

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



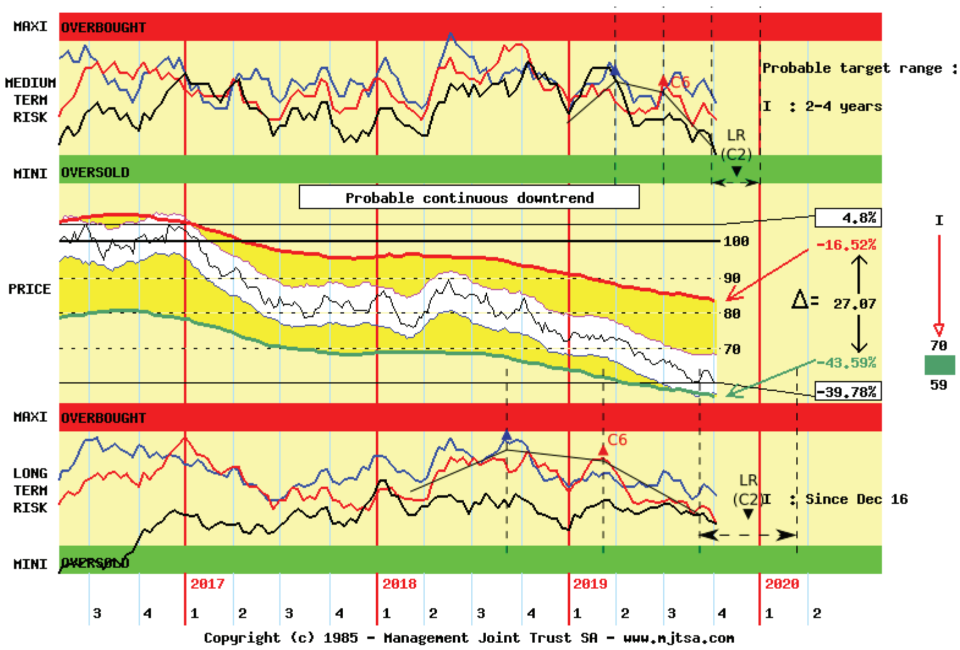
On the Daily graph of WTI Oil, the lows that we show on both oscillator series (lower and upper rectangles) are not really “Buy the Dips opportunities” as the trend is heading down rather than up. Yet, these lows do represent cyclical bottoms according to our models. Some reassurance can also be found from the fact that, for now, we have held above the support of the lower end of our C Corrective targets to the downside (above 51 USD/barrel, right-hand scale). **The current situation may seem like an uncomfortable buying opportunity and further confirmation during October may be warranted (a higher low as shown on our medium term oscillators for example; upper rectangle). Yet, purely from a cyclical perspective, the low point for the year is probably behind us.**

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



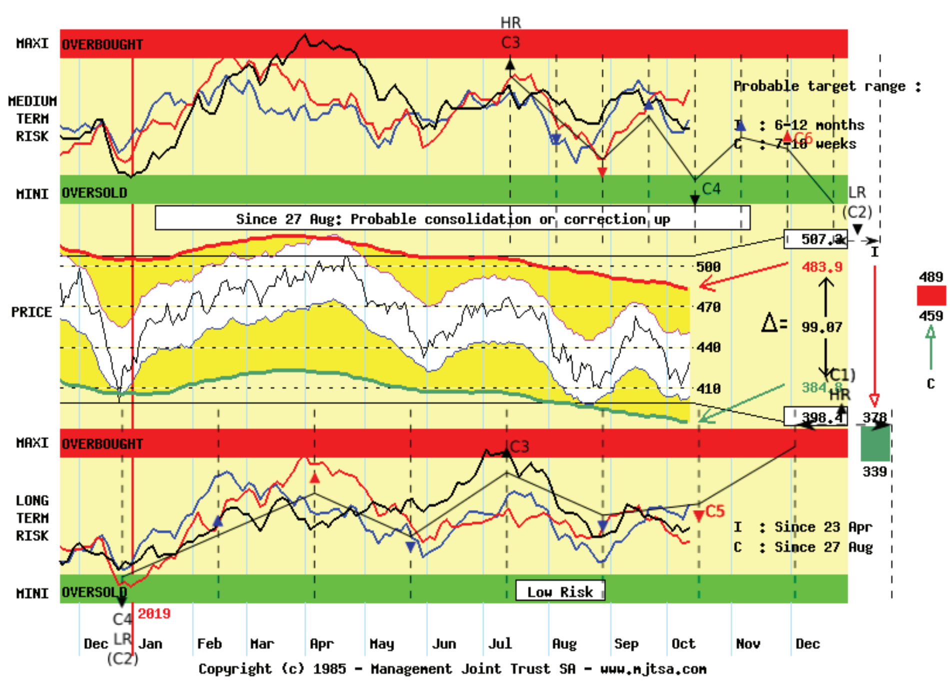
On the daily graph of Brent Oil, the situation is more uncomfortable as it has broken through its June lows as well as the lower end of our C Corrective targets to the downside (below 58 USD/barrel, right-hand scale). Hence, **the risk of a stronger downtrend towards our I Impulsive targets to the down side cannot be excluded** (48 – 40 range over the next 3 to 6 months, right-hand scale). **Nevertheless, here also, our oscillator series are showing a brighter picture with both oscillator series (lower and upper rectangles) pretty much at cyclical lows**. Waiting for a higher low late October as shown on our medium term oscillators (upper rectangles) may provide further confirmation, but ideally, the reversal could start happening sooner.

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



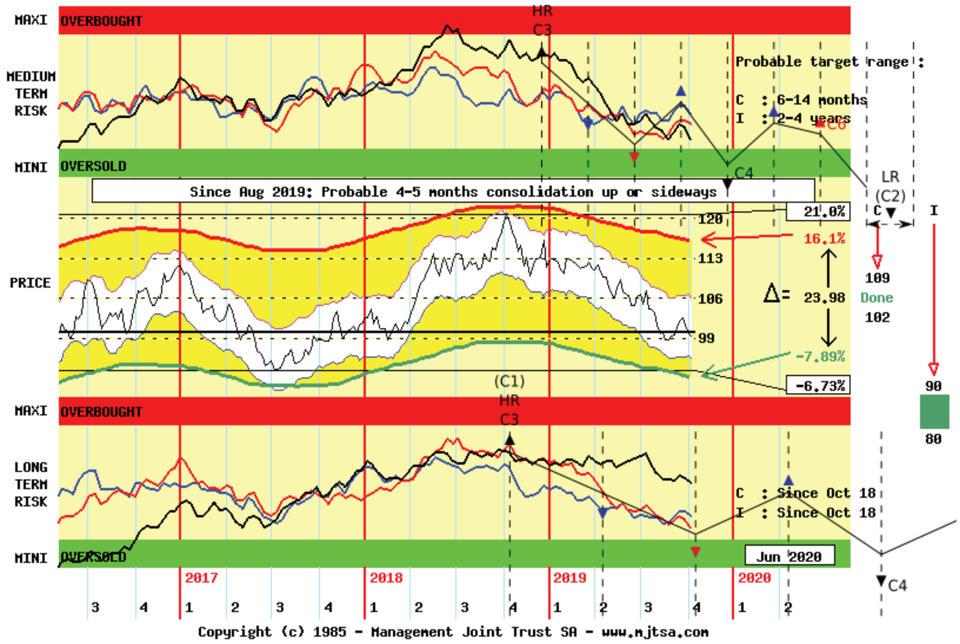
The US Energy sector is very much a Value sector and hence, on a relative basis, it usually underperforms when the yield curve is flattening. Oil prices, obviously, is the second factor effecting its relative strength. Both factors are currently quite Oversold and hence this relative ratio also is. Indeed, **both our oscillator series (lower and upper rectangles) are now close to "Low Risk" positions. We hence expect a bounce of the Energy sector vs the S&P500 Index, probably into year-end in first instance**. On the targets front (right-hand scale), our I Impulsive targets to the downside are pretty much exhausted, while our C Corrective targets to the upside are suggesting a 15 to 25% rebound over the next 6 to 12 months on a relative basis. **The Energy sector may hence prove quite interesting into year-end as it may be starting to reverse up vs the market.**

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



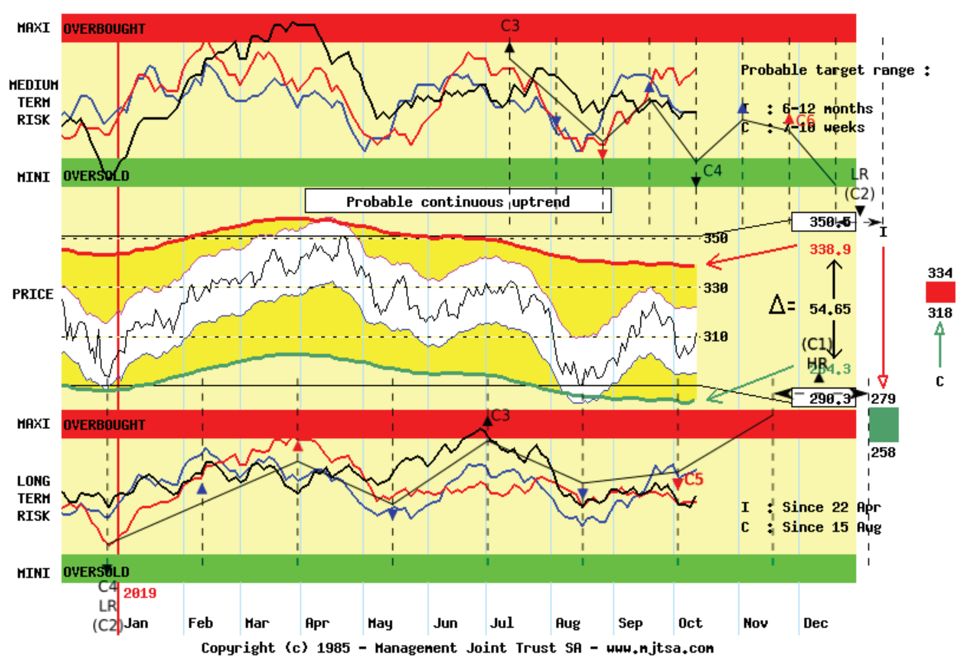
On a Daily basis and standalone basis, the US Energy sector has been following Oil prices year-to-date. **For now, the sector is still in a downtrend** and prices even made it below our C Corrective targets to the downside, thereby opening the door to potentially much lower targets over the next few months (right-hand scale). **Yet, as with Oil prices themselves, both our oscillator series (lower and upper rectangles) are suggesting that a cyclical low may be near. To the least, it should justify a bounce between mid October and late November.**

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



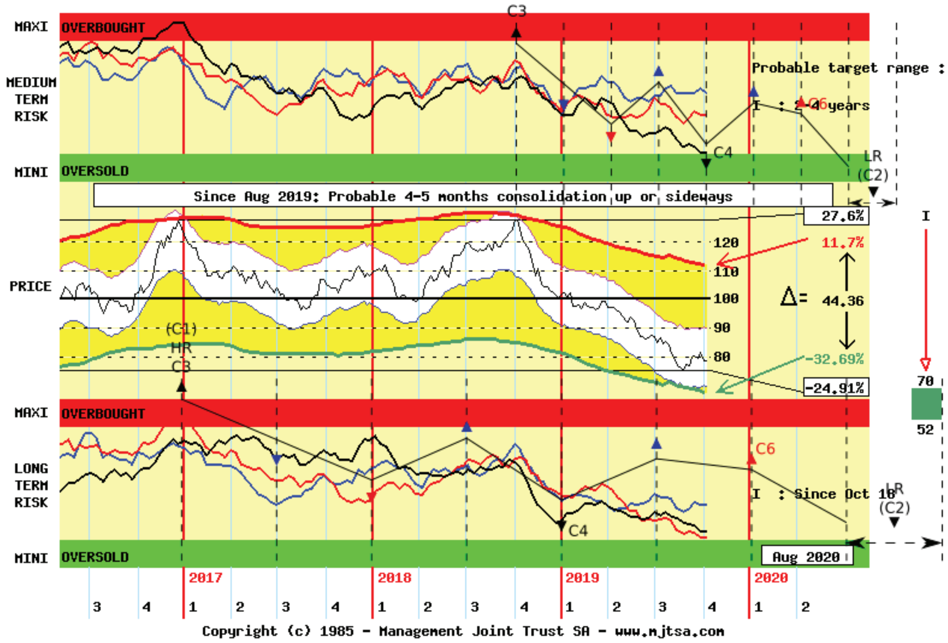
In Europe, considering the ratio of Energy vs the market, the current support point is less clear. While it is probably close on our long term oscillators (lower rectangle), our medium term ones would suggest further retests to the downside until mid/late Q4. Furthermore, the ratio has recently broken below the support of our C Corrective targets to the downside and is now showing further downside risk towards our I Impulsive ones (right-hand scale). **Hence, in Europe, although some support is expected on our long term oscillators, the general risk/reward situation on a relative basis is still quite uncertain, for now.**

European Energy sector
Daily graph or the perspective over the next 2 to 3 months



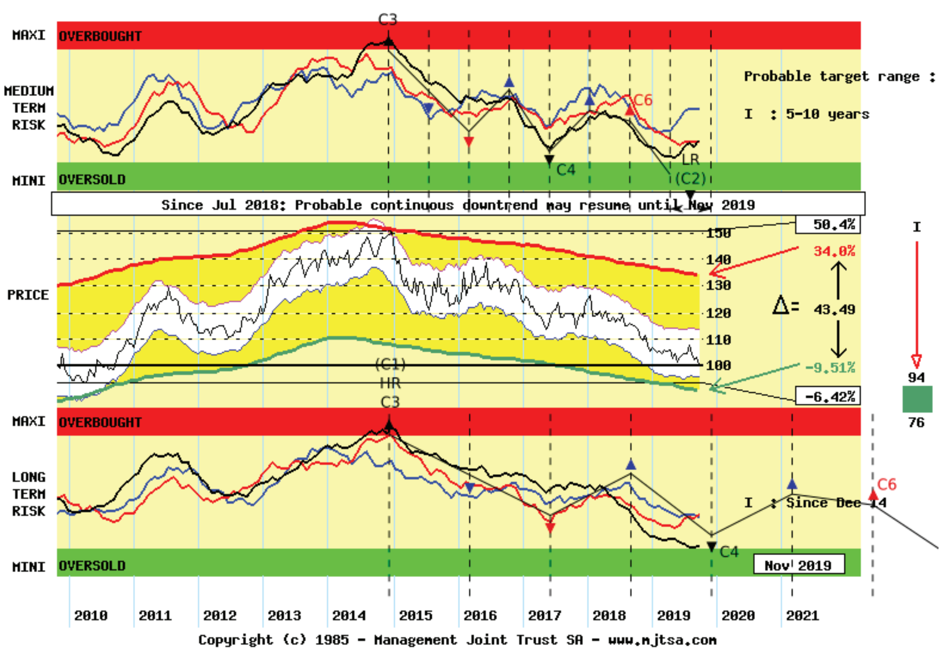
The Daily graph of European Energy on a standalone basis is showing that following a first move up from August and some retracement into late September / early October, the sector may have reached a higher cyclical low on both oscillator series, and could now re-accelerate towards year-end on our long term oscillators (lower rectangle), towards November on our medium term ones (upper rectangle). Obviously, the current low points will have to hold to justify this bullish scenario, especially given that this trend is still heading down with compelling I Impulsive downside potential (right-hand scale). On the positive side, European Energy could rally into our C Corrective targets to the upside between 318 and 334. If it does break above these, it could even reach new year-to-date highs. **In general, this is a neutral risk/reward situation with strong potential/risk on both sides, yet from a cyclical perspective, the timing looks right.**

Global Energy vs Global Clean Energy
Weekly graph or the perspective over the next 2 to 4 quarters



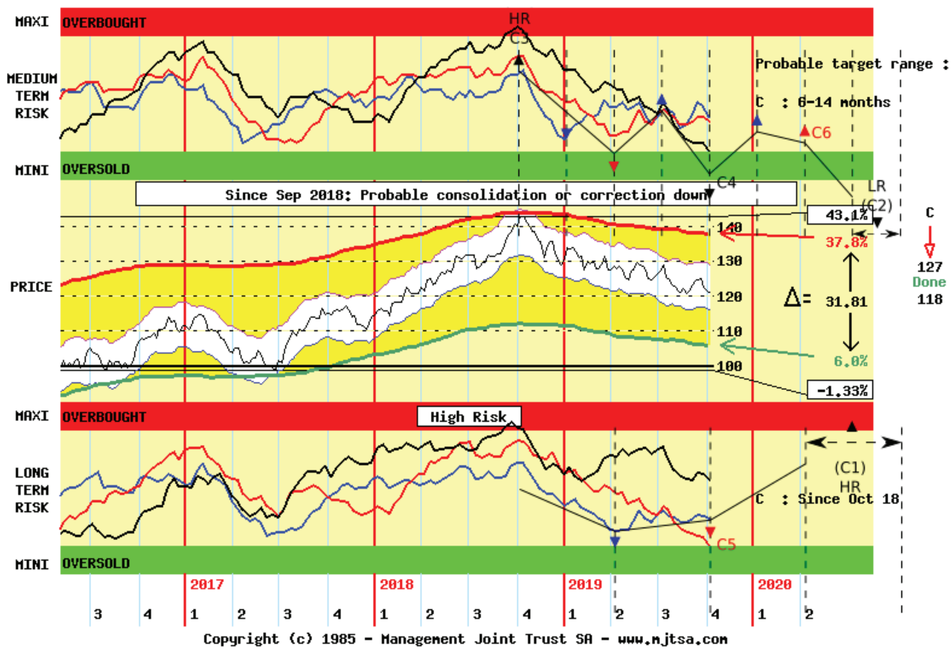
Another ratio, which may confirm our timing for a bounce in Energy and a rally in Oil is the one comparing Global Energy vs Global Clean (Alternative) Energy. Indeed, while Energy is rather a value sector, Clean Energy has very much traded as a growth/momentum sector year to date. **On our medium term oscillator series (upper rectangle), the ratio is now very Oversold and could bounce into year-end, perhaps into late Q1**. On our long term ones, the sequence we show is for now still downtrending, but does leave a time window for a recovery into year-end. On the targets front (right-hand scale), there is still some underperformance risk left over the next 12 to 18 months. Hence, without calling for a broad reversal of trend, the ratio does however justify a 3, perhaps a 6 months bounce of the Energy space.

US Energy Sector vs European Energy sector (currency hedged)
Bi-monthly graph or the perspective over the next 1 to 2 years



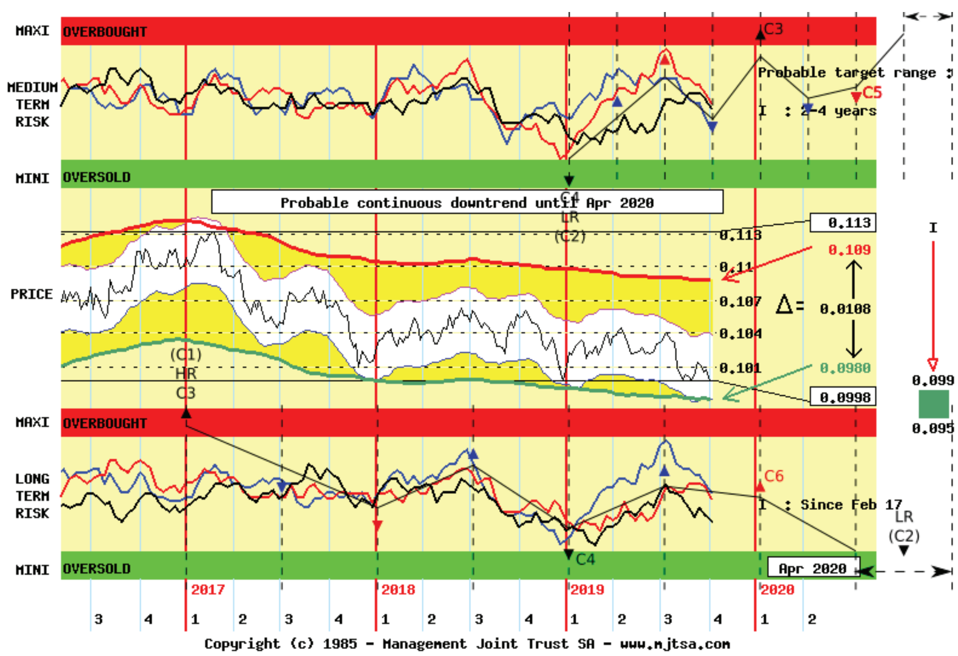
Comparing the US vs the European Energy sectors (on a hedged currency basis) is also quite interesting as the US Energy sector has been much more value driven and underperforming than the European one. We believe this is due to the fact that the US Energy space includes many geared up Oil Explorers and Producers, companies, while the European Energy sector is weighted towards larger, more international, more stable, more integrated ones. On this long term graph of the ratio, it appears that US Energy is now Oversold vs European Energy on both our oscillator series (lower and upper rectangles). **A counter-trend bounce which may even last into late next year could start materializing soon.**

Norway Oslo Obx Index vs Europe Stoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



Finally, we review some geographical plays linked to Oil, and specifically Norway for which Energy is the dominant exporting industry. The ratio of the Norwegian OBX Equity index vs the Europe Stoxx 600 has been consolidating down for 12 months, and seems to be close to an important intermediate low on both oscillator series (lower and upper rectangles). Furthermore, the support of our C Corrective targets to the downside has held (right-hand scale), which provides a comfortable base to resume higher. **We now expect 3 to 6 months of Norwegian outperformance vs Europe.**

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



On the currency front, the Norwegian Krone is also quite Oversold vs the Euro. According to both our oscillators series (lower and upper rectangles), it may now bounce for 3 to 4 months into year-end and perhaps January. The C Corrective targets we can calculate are towards 0.105, perhaps even 0.108, or 0.5 to 0.8 times our historical volatility "Delta" (middle rectangle; right-hand side) added to the graph's low point. The Norwegian Krone also has a carry of almost 2% vs the Euro.

Concluding remarks:

Oil and related trades have sold-off quite strongly since April, and are still struggling to stabilize. Yet, our oscillators seem to suggest that following a first bounce from August, Oil, Energy sectors, Energy sectors relative and related geographies are at or close to new cyclical lows. We believe this situation constitutes a base for Oil to start bouncing, probably towards late November / early December in first instance, and potentially towards year-end and early 2020. Obviously, current levels will need to hold over the next couple of weeks to confirm this bullish scenario. On Oil specifically, we believe that prices may retest towards their April highs over the next few months (mid/high 60s on WTI, high 60s/low 70s on Brent).

44 / Japan's economy is being hobbled by strong Yen, but relief may be on the way as the BoJ strives to steepen the yield curve

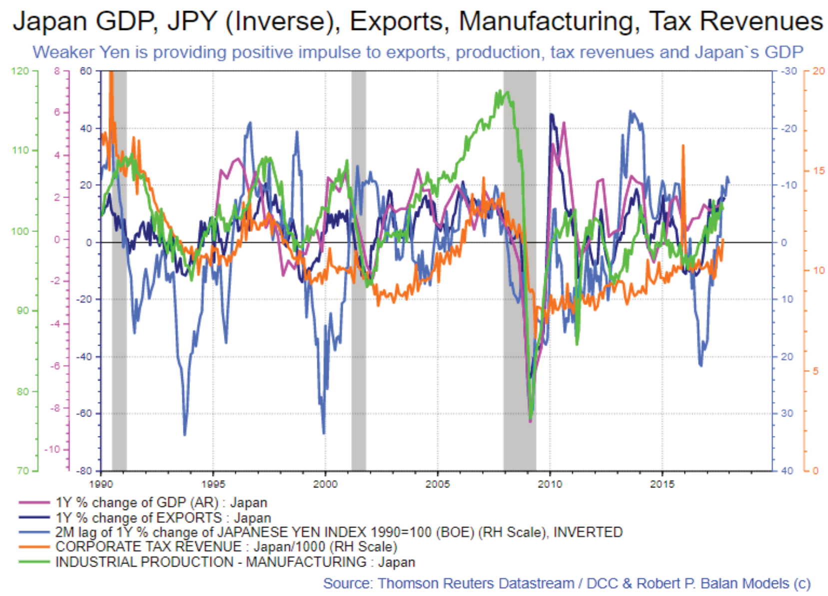
The last time The Capital Observer wrote about Japan was on November 2017, we suggested that "Abenomics" which had led Japan's economy to six quarters of growth may offer the best prospect for the country. We said then:

The best prospects for Japan's economic recovery seem to be a continuation of "Abenomics," which has led the economy to expand for six straight quarters. Unemployment has gone below 3%, the lowest rate in 23 years. The Nikkei-Markit "flash" Japan manufacturing purchasing managers' index rose to 53.8, from 52.8 in October, as manufacturing conditions picked up at the sharpest rate since March 2014. The "flash" manufacturing output index rose to 54.2, the strongest rate of expansion for since March 2014 (FT). And Japan's manufacturing sector may have grown at its fastest pace in more than three years in November, according to a preliminary reading.

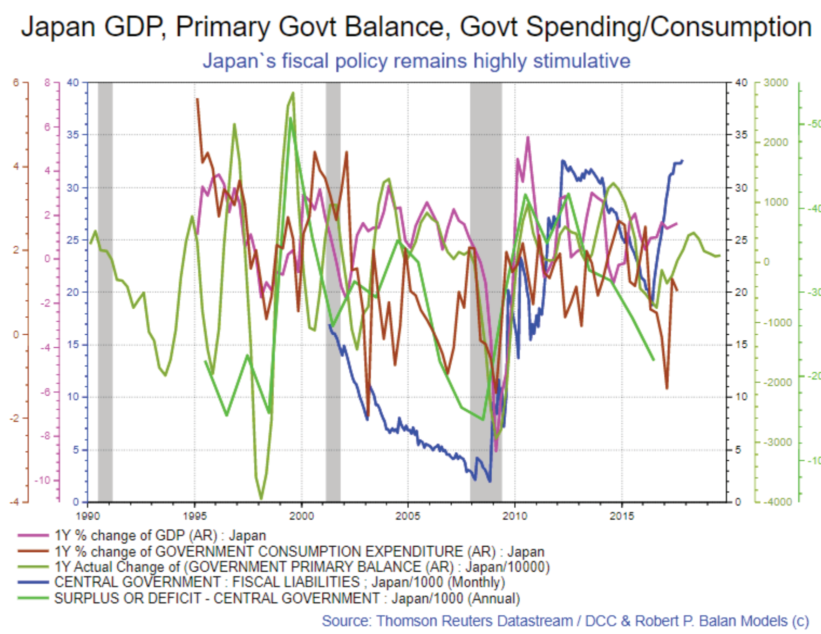
There were hopes then that GDP will notch up a seventh consecutive quarter of growth as exports helped compensate for underwhelming domestic demand. Also, swelling corporate earnings appear likely to have propelled Japan's tax revenue to the highest in 27 years in fiscal 2018 by lifting salaries and shareholder returns. This is the illustration of Japan's "sweet spot" then. (*see 1st graph on this page*)

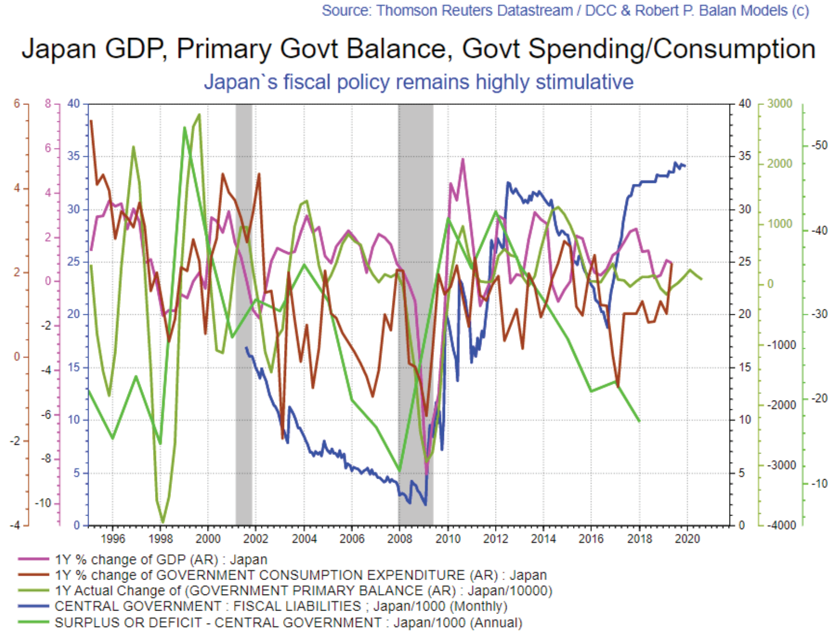
The Abenomics policy was also pretty aggressive at that time, and that needed the government's fiscal policy to remains stimulative -- defense spending has significantly increased, helping offset the effects of a scheduled sales tax increase the following year. **Abenomics was basically calling for super-charged government spending**. We illustrated Japan's fiscal situation with the *2nd graph on this page*:

Original chart in the November 2017 Capital Observer



Original chart in the November 2017 Capital Observer





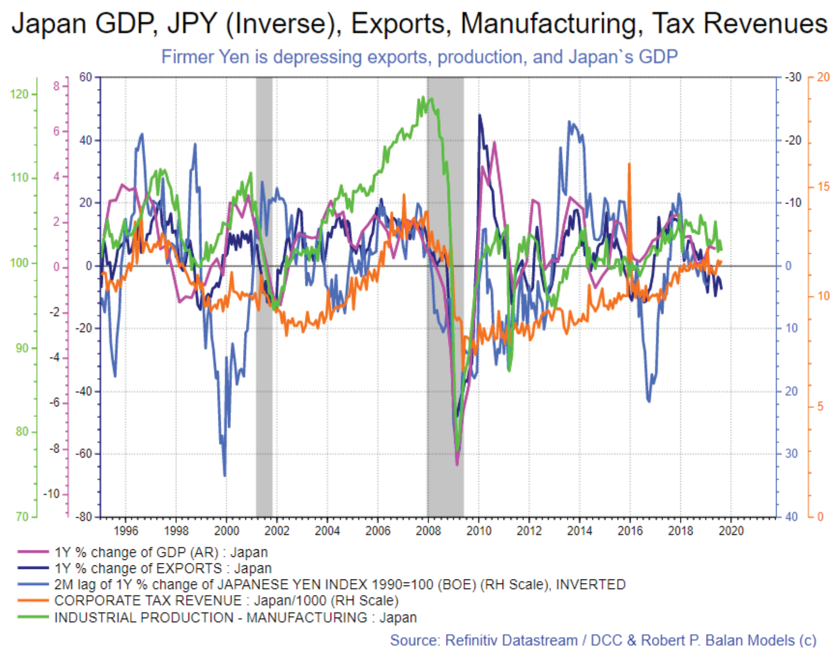
Fast forward to early Q4 2019. Japan has not gotten better – in fact in many respects, the country has gotten worse since we last wrote about their economy. Fiscal policy remains stimulative, but the increase in fiscal liabilities since November 2017, has been minimal, causing the changes rates to fall – a negative development. Government expenditures increase sharply, however, which should underpin GDP growth going forward. This is how the fiscal situation looks today: *See 3rd graph on previous page*

But in the final analysis, what is keeping Japan in the doldrums is the counter-intuitively strong domestic currency. The Yen keeps on strengthening, serving as safe haven destination for the world's flight capital. And the globe recently had a long series of geopolitical events that have keep capital seeking safer destinations. All the gains that we saw in November 2017 have been decimated by the recently strong yen. We see that in this current update of the previous chart: *See 1st graph on this page*

Thus, we find a litany of familiar economic and macro data woes . . .

PPI deflation deepened to -1.1% in September, from -0.9% in August, in line with the consensus. But Japan's PPI deflation likely just troughed. Petroleum and coal accounted for around half of the decline. Utilities inflation accounted for the other half of the September decline in the headline. But deflation from commodities and chemicals should now diminish, with September marking the trough in PPI deflation. Utilities inflation should also rise, reflecting oil price rises earlier this year. Looking for a new uptrend in PPI inflation.

The services PMI fell to 52.8 in September, after the spike to 53.3 in August; a correction was due. The rise in output slowed, though the orders subindices both gathered some pace. The future output subindex, however, showed a loss of momentum.



In a global context, however, the PMI report overall is uncharacteristically strong. Japanese activity has benefitted from a series of temporary boosts this year, and that the underlying story is weaker. But for now, the services report signals a modest uptick in quarterly GDP growth in Q3. Weakness in manufacturing is set to infect services thereafter.

. . . but we see glimmers of positive news

Monetary base growth ticked up to 3.0% y/y in September, from 2.8% in August. October monetary base growth uptick attributable to shifts on the liabilities side; tapering continues. Large withdrawal of government deposits appears to have flowed into reserves, benefitting monetary base. The story on the asset side of the balance sheet continues, with JGB holdings falling m/m, albeit at a slower pace than in September last year. The Monetary Base looks set to grow again.

Japan's all-industry activity index rebounded by 0.2% m/m, after last month's downwardly revised 0.7% fall, in line with the consensus. Net revisions were +0.1pp. The industrial production and tertiary indices, which together make up 94% of the index, were unchanged today. The headline increase was driven by the 1.3% bounce-back in the tertiary index.

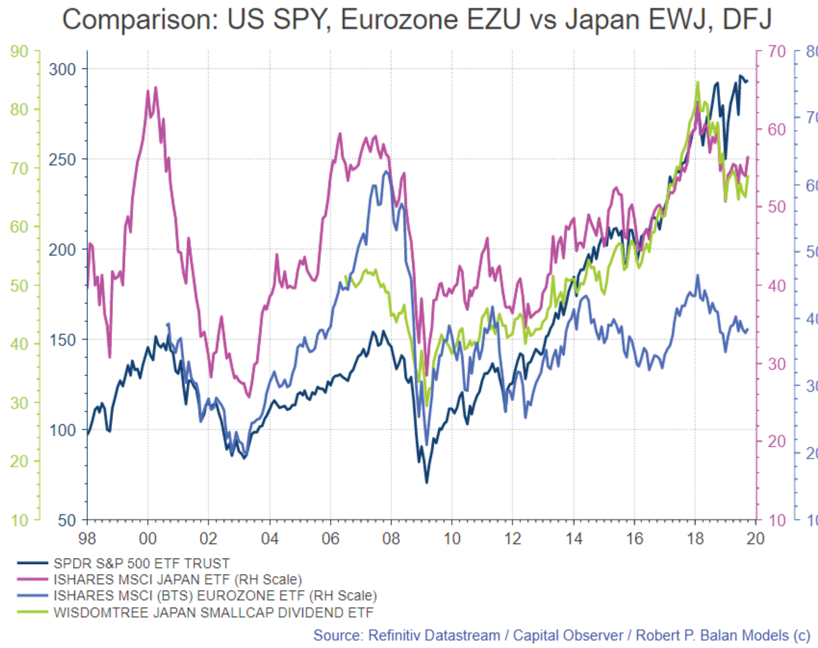
GDP growth will rise in Q3 2019 relative to Q2. It will be slow take-off, but it looks like Q2 will be the trough for growth, as we said in the July 2019 Cap Obs.

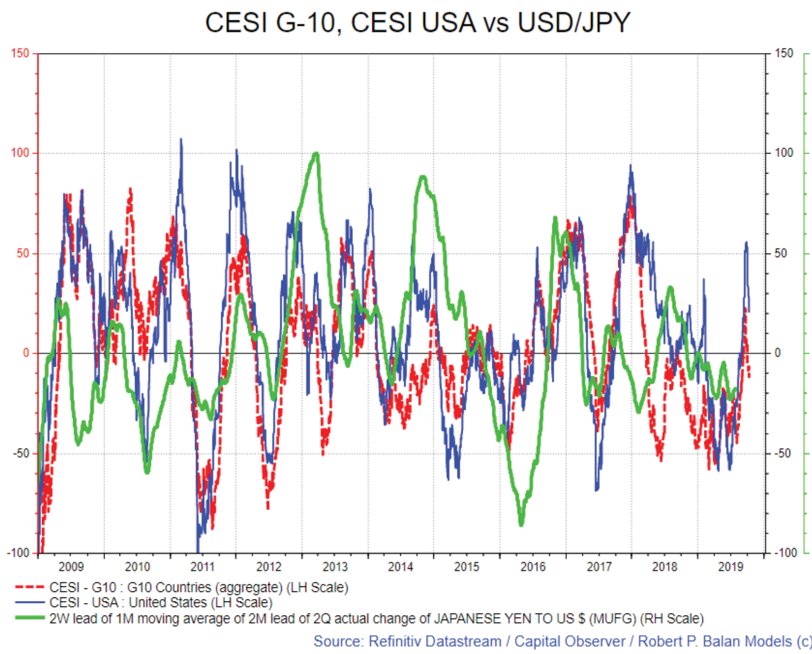
Finally, the BoJ is working hard to steepen the curve since last month, scaling back purchases at the long-end of the curve. Markets expect some kind of reverse Operation Twist. The Bank may not make the policy official at its meeting this month, but the operation will continue for some time. The Bank also seems likely to cut the policy balance rate by 10bp, but to fully offset this with more favourable tiering, to mitigate the cost to the banking system. (*see 1st graph on the next page*)

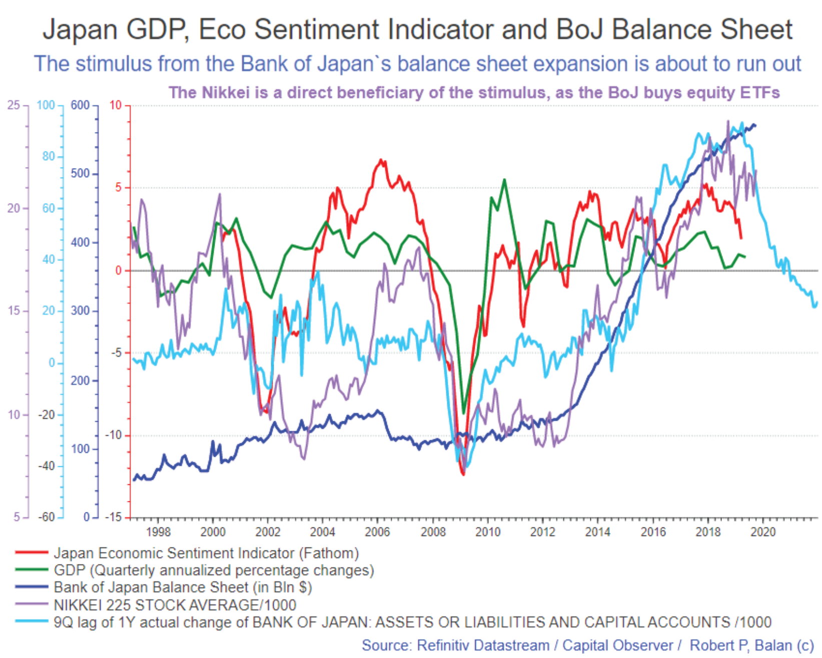
Japanese stocks have participated in the global bull market for equities, and have posted their longest winning streak since 1988, until late 2018. The largest Japan equity ETF on the US market, the iShares MSCI Japan ETF, EWJ, which covers about 85% of the investible universe of securities traded in Japan, has pulled back since late 2018 due to the strength of the Yen, which was hammering the country's export sector. It is still performing much better than similar European equities, but has not kept pace with the U.S. equivalents.

The culprit has been the very strong Yen. But with stronger macro indications in the US, as measured by the Citi Economic Surprise Index, the US Dollar should start rising, and the Yen continuing to weaken (*see 2nd graph on this page*). Domestic equities, especially those of exporters, should rally strongly, if these developments continue.

Finally, Japan seems to be taking steps in limiting the Bank of Japan balance sheet, which is in contrast to what the US Federal Reserve and the EU European Central Bank are projecting to do in the near-future. Most of the GDP growth and economic activity that happened since 2009 can be directly attributed to the massive increase in the BoJ's balance sheet since the advent of the global recovery in 2009. With the annual change rate falling for the past two years, it bodes ill portents for Japan. Japan cannot afford to tighten policy by reducing the BoJ balance sheet, just yet. Otherwise, the central bank may later have to restart it QE programs, just like what the Fed and ECB are doing now. (*see 3rd graph on this page*)





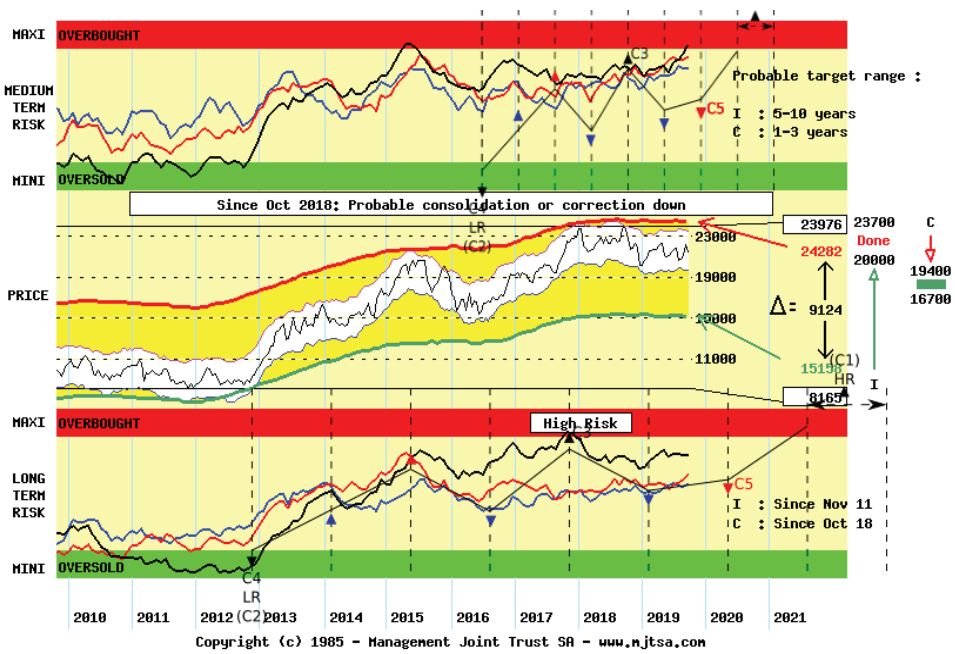


47 / MJT - TIMING AND TACTICAL INSIGHT

Japanese equities continue to bounce, the Yen probably works counter-trend

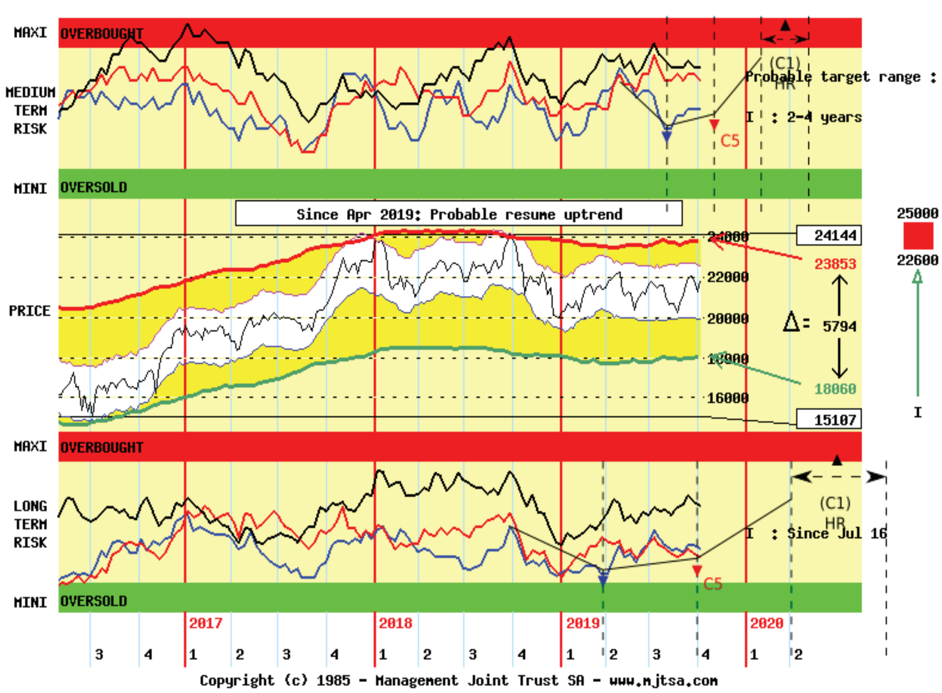
Over the next few weeks, we expect the current cyclical bounce to continue. In this article, we look into the Japanese Equity markets which since August have already rallied quite dynamically. We will consider them in light of Yen exposure, as it often works counter-trend to the equity exposure when reported in US Dollars.

Nikkei 225 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



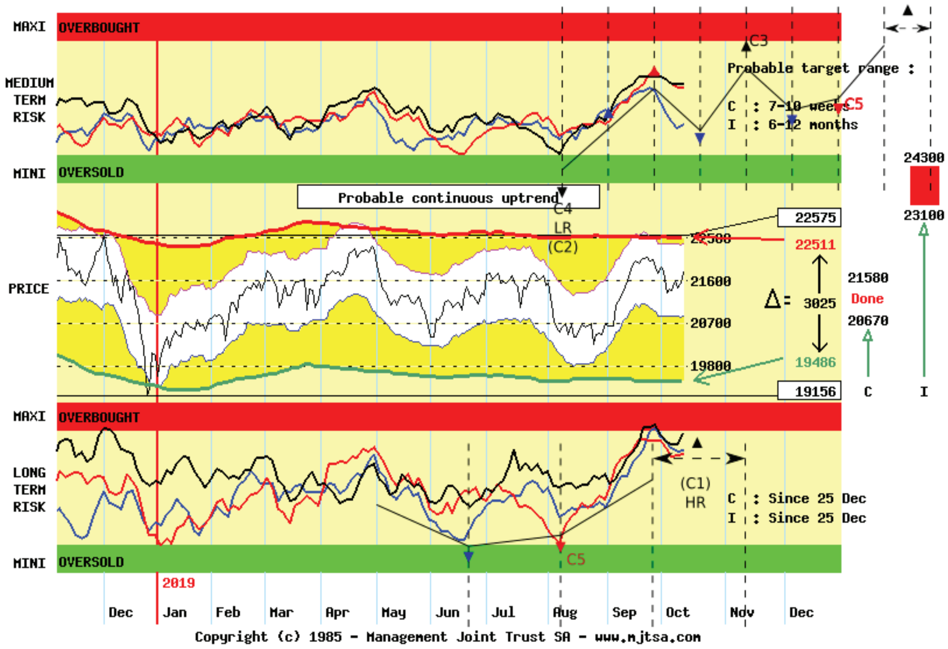
The Nikkei 225 Index (in Yen) has corrected down along with other equity markets since early 2018. On both oscillator series (lower and upper rectangles), resume uptrend indications are starting to arise. On our long term oscillators (lower rectangle), such confirmations may wait until early next year, while on our medium term ones (upper rectangle), these may materialize over the next few months. **Overall, if this long term graph is considered, Japanese equity markets may extend higher into H2 2020, perhaps even 2021. Risk / reward is stretched though as our I Impulsive targets to the upside have been reached (right-hand scale).**

Nikkei 225 Index
Weekly graph or the perspective over the net 2 to 4 quarters



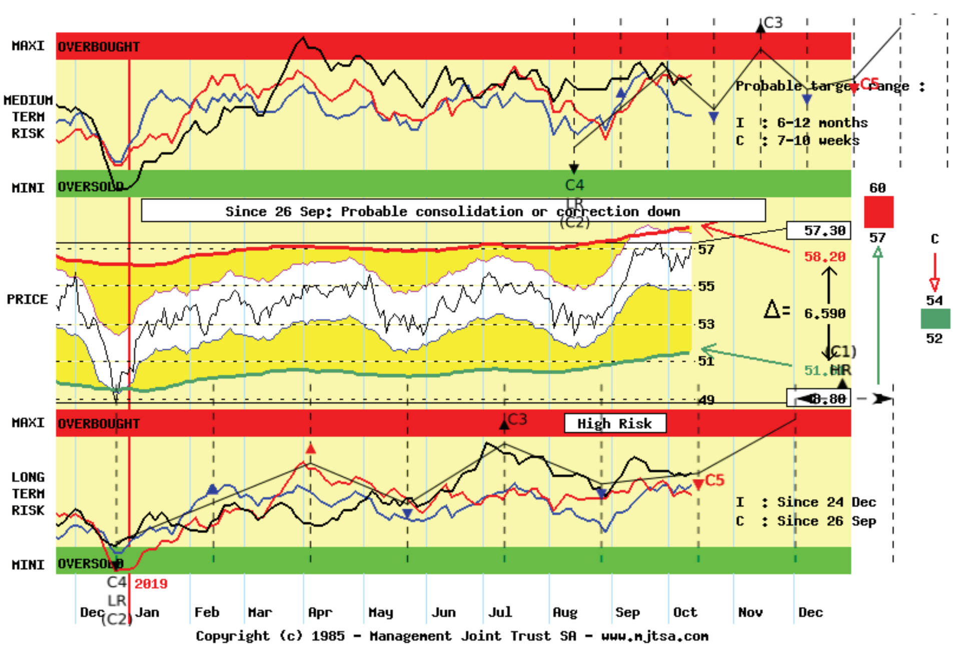
The price action on the Weekly graph of the Nikkei 225 Index has been very choppy this year. Yet, the sequence we show on long term oscillators (lower rectangle) would suggest that **the recent rally could extend into Spring next year**. On our medium term oscillators (upper rectangle), the model shows a support point during October and a further move up into late Q1, perhaps the Spring. For now, the C Corrective targets to the downside we can calculate are between 21’250 and 19’500 (0.5 to 0.8 times our historical volatility measure “Delta” - middle rectangle, right-hand side – subtracted from the highs of the graph at 24’144). This means that, for now, prices are still in the area of a standard correction to the downside, which implies that the uptrend since 2016 is underway. Our I Impulsive targets to the upside (right-hand scale) are also pointing point to the possibility to reach new highs over the next 6 to 12 months. **We would hence remain constructive for now on the Nikkei 225, probably into Spring next year.**

Nikkei 225 Index
Daily graph or the perspective over the next 2 to 3 months



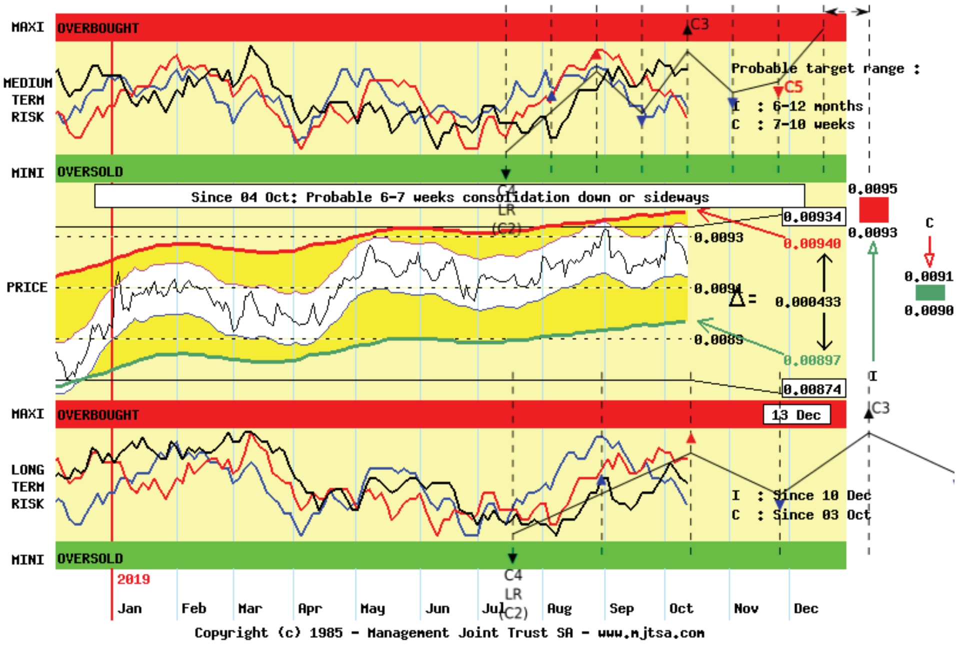
On the Daily graph of the Nikkei 225 Index, the recent rally is clear to see. On our long term oscillators (lower rectangle), it may have reached a High Risk situation and may now retrace. Yet, our medium term oscillators (upper rectangle) are more positive. They probably started **a new sequence up in August, which, following the recent retracement may soon continue higher into November at least, and then perhaps into early next year**. It is also positive that during the recent rally, prices did make it back above the resistance of our C Corrective targets to the upside (i.e. above 21'580; right-hand scale). Such strength opens the door to our next level of targets, our I Impulsive targets to the upside, in the 23'100 to 24'300 range over the next few months (right-hand scale)

Japanese Equity Market in US Dollars
Daily graph or the perspective over the next 2 to 3 months



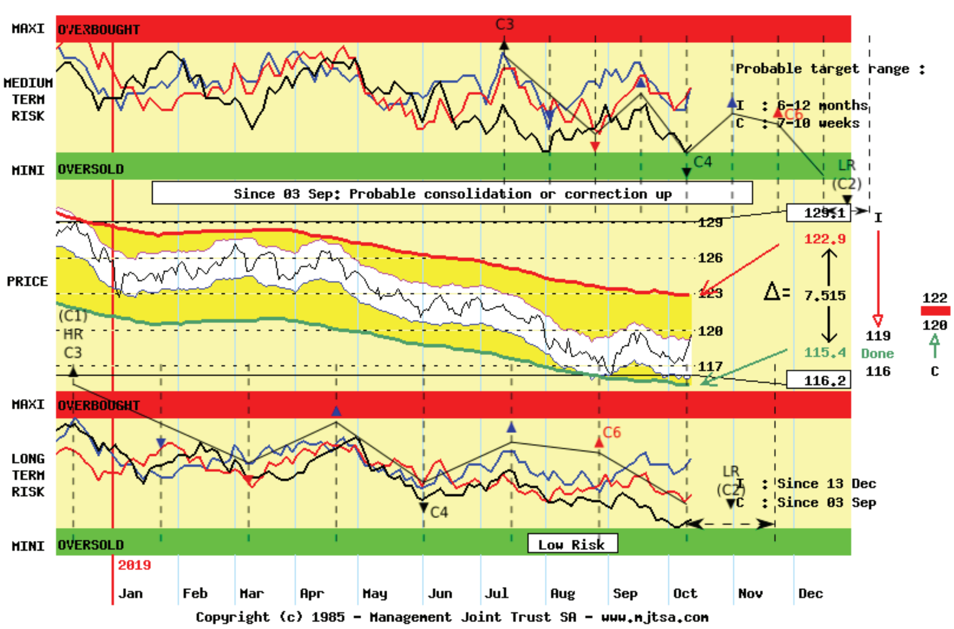
When measured in US Dollars (EWJ ETF), Japanese equities have been less volatile. Indeed, the Nikkei and the Yen often work counter-trend (rising equities, declining Yen). Nevertheless, a nice rally has also materialized since mid August on this ETF. **Similarly to the Nikkei 225 graph above, we expect this uptrend to continue**. Our I Impulsive targets suggest more upside potential over the next few months (right-hand scale). To the downside, the current uptrend is safeguarded as long as the level of 52, which has served as support since February, continues to hold (i.e. the lower-end of our C Corrective targets to the downside). **Generally, we believe that this Japanese Equity ETF in US Dollars is positively oriented, yet shows less potential than the Nikkei 225 in local currency. Indeed, the Yen may weaken as Japanese Equity markets continue to rise.**

Yen vs Swiss Franc (JPY/CHF)
Daily graph or the perspective over the next 2 to 3 months



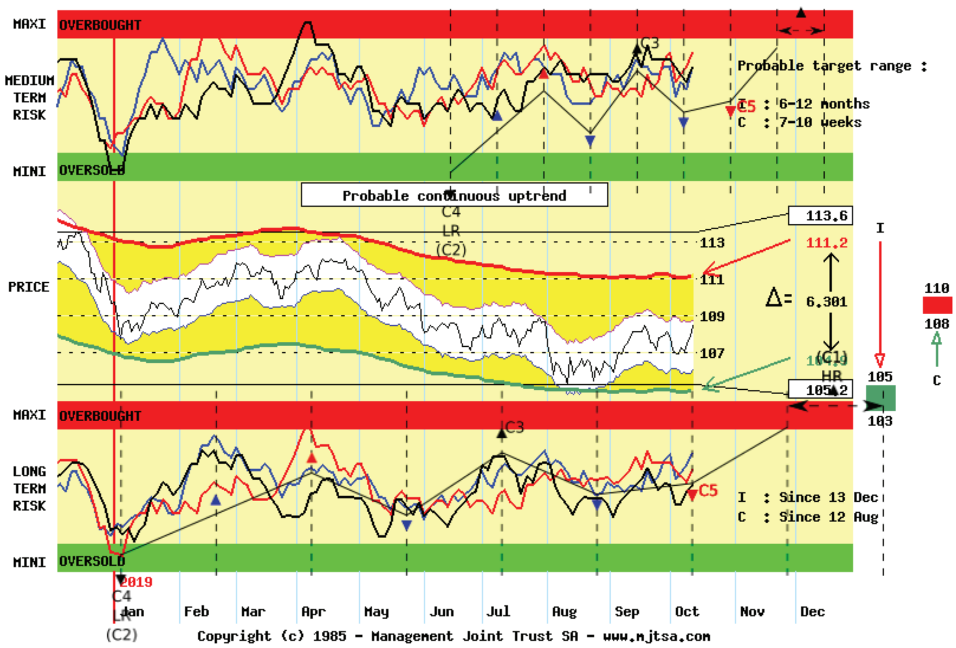
We hence turn to the Yen and first to some interesting crosses. In this graph, we compare the Yen to Swiss Franc, another rather defensive currency, but less defensive than the Yen. Since March, the graph is quite similar to the Dollar index, which seems to confirm that the Yen is more risk-off than Swiss Franc. Similarly to the Dollar Index again, on both oscillator series (lower and upper rectangles), **we believe that an intermediate top is currently being made on the pair and that a one to two months consolidation to the downside should follow, probably into mid/late November, perhaps early December. This weakness is probably risk-ON rather than risk-OFF.** As with the Dollar, the Yen may hence correct down vs most currencies during this period. Following that, it may resume higher again into next year.

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



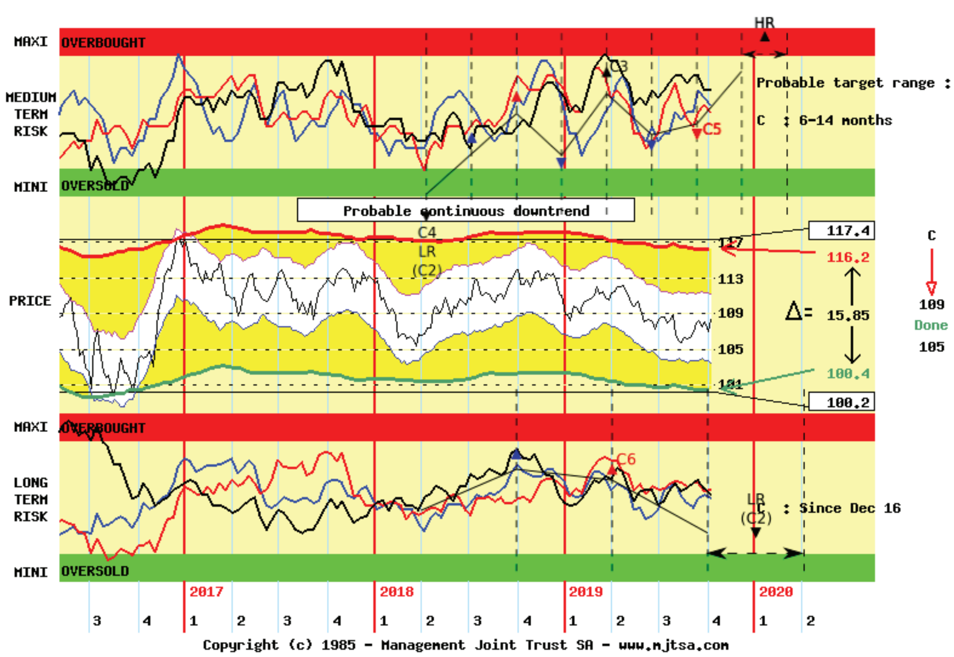
We now compare, the Euro vs the Yen. The pair, which is traditionally pro-cyclical, is quite Oversold. Our long term oscillators (lower rectangle) have probably reached a "Low Risk"position, while our medium term ones (upper rectangle) are suggesting that a new support point has just been confirmed. Here also, **we would expect one or two months of consolidation, to the upside, probably into mid/late November perhaps early December**. On the target front, our I Impulsive targets to the downside have now been reached (the downtrend seems exhausted), while the corrective potential for a bounce points to the 120 – 122 range (right-hand scale). **This rebound we expect on EUR/JPY would confirm our cyclical bias into November, perhaps early December.**

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



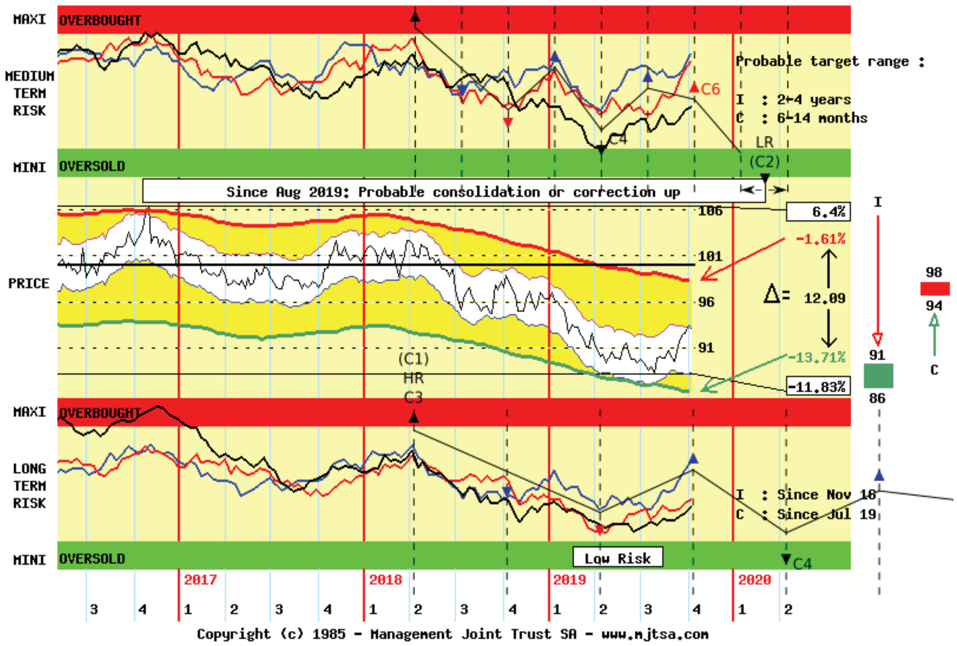
We now circle in on USD/JPY, which actually compares two rather defensive currencies. Similarly to EUR/JPY (or JPY/CHF is reverse), the downtrend since late last year is starting to look exhausted. The pair already started to bounce in August, our I Impulsive targets to the downside (right-hand scale) had been reached, while both our oscillator series (lower and upper rectangles) seem to confirm that new support points are approaching. **We hence expect that this nascent uptrend continues, probably into mid/late November, perhaps early December in first instance. Our C Corrective targets to the upside suggest that USD/JPY could reach back towards 1.10 by then.Our more general scenario on the US Dollar is that it could correct down vs most currency pairs during late October and November. The Yen, the ultimate defensive currency, could be even weaker.**

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



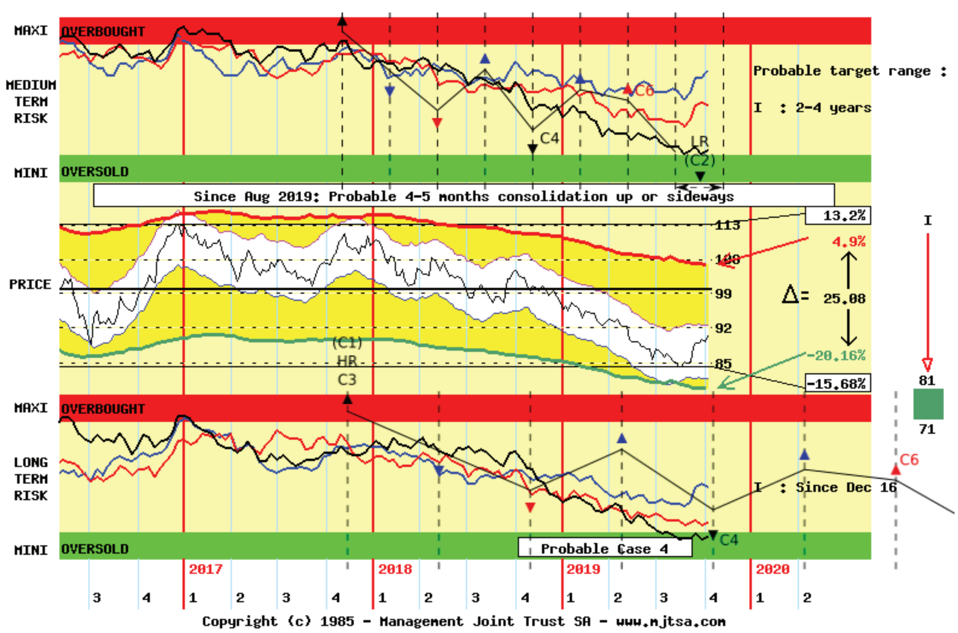
The weekly graph of USD/JPY has been stuck in a sideways consolidation range since 2017. For now, it is still holding above the support of the lower end of our C Corrective targets to the downside around 105 (right-hand scale). **The cyclicity we capture with our medium term oscillators (upper rectangle) could be suggesting that USD/JPY has reached support once again and that it could bounce into late Q4**, perhaps into Q1 next year. Further downside retests are however still possible until late Q1 as shown by the sequence on our long term oscillator series (lower rectangle). Hence, the rebound we expect between now and December could still be retraced down once more early next year.

Japanese Equity Market in USD vs All Country World Index
Weekly graph or the perspective over the next 2 to 4 quarters



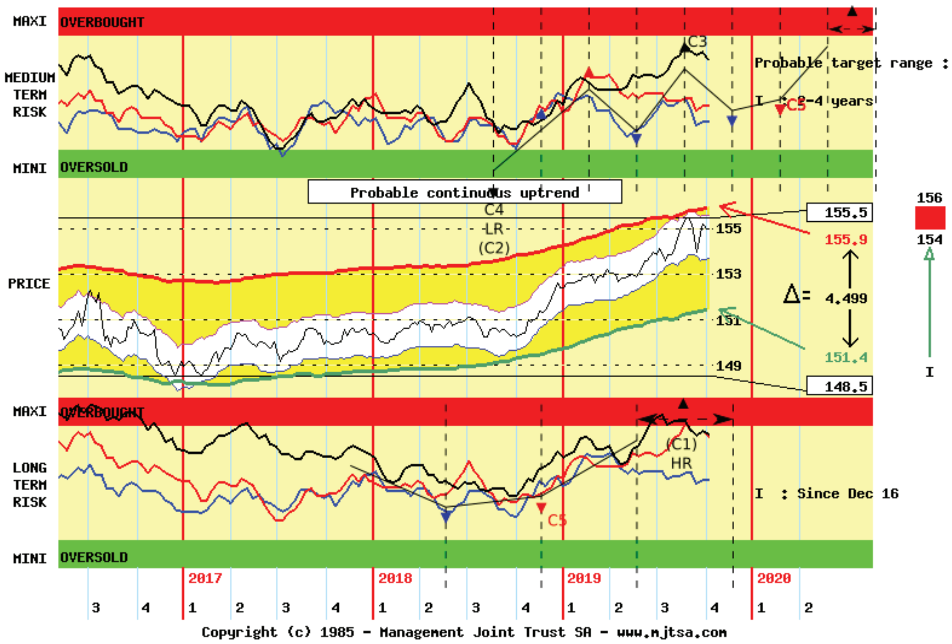
We now consider the Japanese Equity market vs the All Country World Index, first in USD denominated terms (EWJ ETF vs ACWI ETF). Over the last 3 years, the ratio has usually underperformed when the Yen has sold-off vs the US Dollar (Q4 2016, Q2 2018, Q1 2019). On the contrary, when the Yen was strong (usually during risk-OFF periods), the ratio tended to hold up or even outperform. Since this Spring, the Yen has been strengthening vs the US Dollar again resulting in the ratios outperformance. **Going forwards, over the next 3 to 6 months, both our oscillator series (lower and upper rectangles) suggest that the ratio could retrace down. This probably implies that a rising USD/JPY may counterbalance much of the rise in the Japanese market, on a relative basis at least.**

Japanese Markets hedged for USD/JPY risk vs All Country World Index
Weekly graph or the perspective over the next 2 to 4 quarters



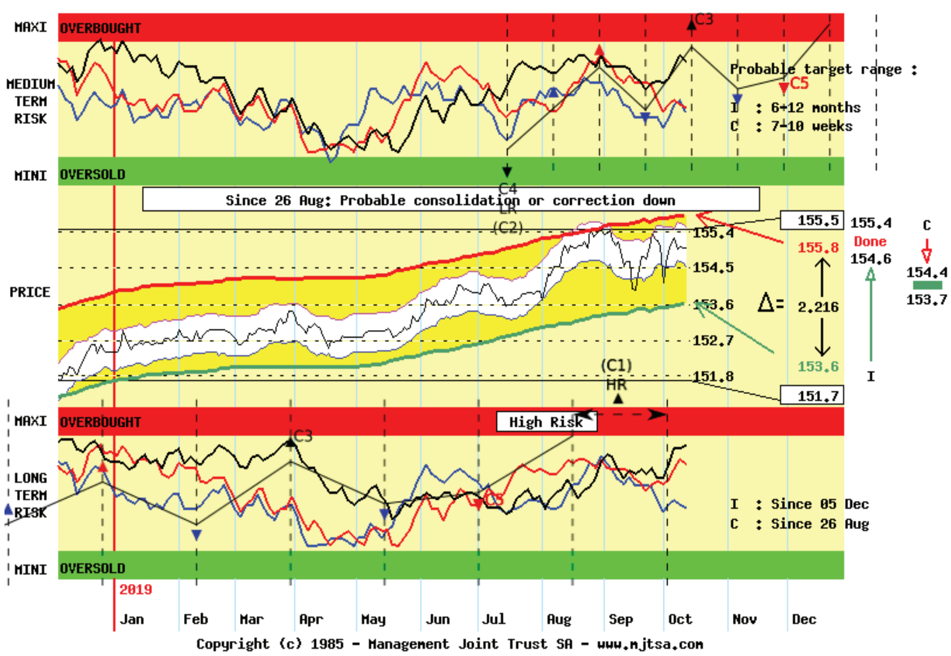
A similar ratio comparing the Japanese Equity market vs the All Country World Index, but hedging the Japanese market for its Yen exposure (DXJ hedged ETF vs ACWI ETF) shows a different profile. It usually rises with USD/JPY and equity markets (e.g. H2 2016, Q4 2017) or at least remains flat (Q2 and Q3 2018). It then falls when the Yen is strong (Q1 2017, Q1 2018, Q4 2018 or year-to date). On both our oscillator series (lower and upper rectangles), **the ratio is now quite Oversold and could be reaching an important intermediate bottom. We expect it to bounce over the next few months, possibly even until Spring next year. We would hence favor investing in Japan on a hedged currency basis.**

Japanese Goverment Bond Futures (Dec.)
Weekly graph or the perspective over the next 2 to 4 quarters



Finally, our review of Japan would not be complete without looking at its bond market. As with other Government Bond Indexes, the uptrend on the Japanese Government Bond Futures is now very stretched. It has fulfilled our I Impulsive targets to the upside (right-hand scale) and may have reached a High Risk position on our long term oscillators (lower rectangle). **We now expect 3 to 6 months of consolidation to the downside as shown on our medium term oscillators** (upper rectangle)**. A correction in JGBs usually implies quite a risk-ON environment.**

Japanese Government Bond Futures (Dec.)
Daily graph or the perspective over the next 2 to 3 months



Similarly to the Daily graphs of other Government Bond Indices as well as the ones of other defensive assets such as Gold, the Yen, USD/JPY (inv.), EUR/JPY (inv.) or JPY/CHF, JGBs have probably reached a "High Risk" position on our long term oscillators (lower rectangle) in early September, while our medium term oscillator (upper rectangle) are pointing to another inflection point to the downside over the next few days. We hence expect JGBs to correct down into late October and November in first instance. This again usually reveals a risk-ON environment.

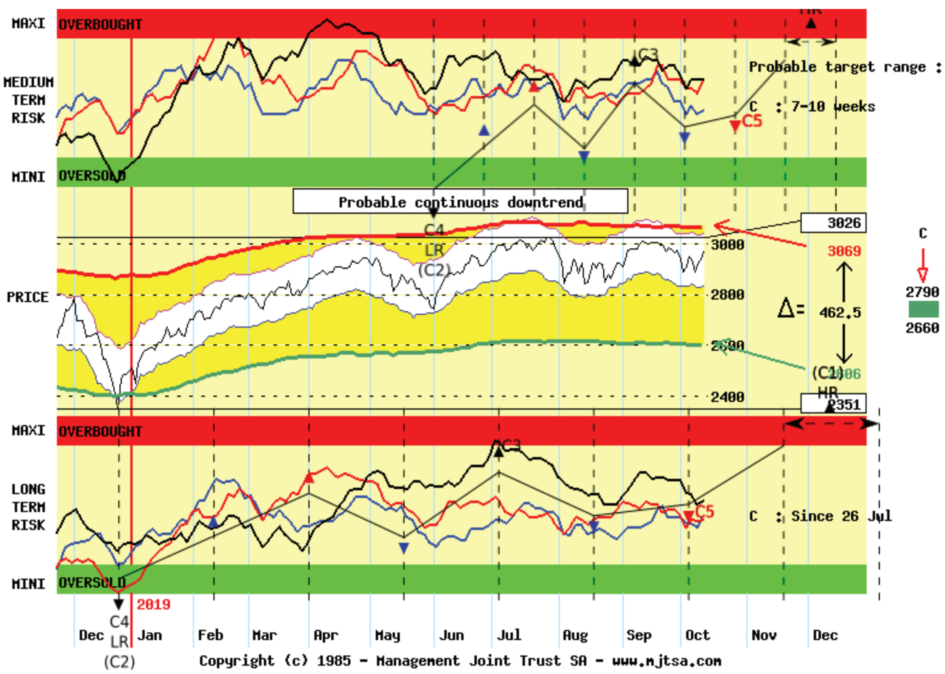
Concluding remarks :

Following its rally since mid/late August, and its subsequent retracement during early October, we expect Japanese Equity markets to enter a second leg up, which could last into late November, perhaps early December. Price targets for the Nikkei225 are probably above 23'000, and possibly up to its October 2018 highs above 24'000. Yet, while we are positive on Japanese equity markets, the Yen may work counter-wise and weaken. It could reduce part of the Nikkei's performance in US Dollar terms, while leading the Japanese market to even underperform vs other equity markets in relative terms. We would hence consider any investment in Japanese equities on a hedged currency basis, probably until early December at least. Japanese Government Bonds are also providing an interesting confirmation as they are probably topping out. They could correct down for the next 3 to 6 months (along with other Government Bonds around the world). This shift out of defensive assets would confirm our risk-ON bias.

53 / Splicing the markets – The cyclical re-acceleration is probably underway

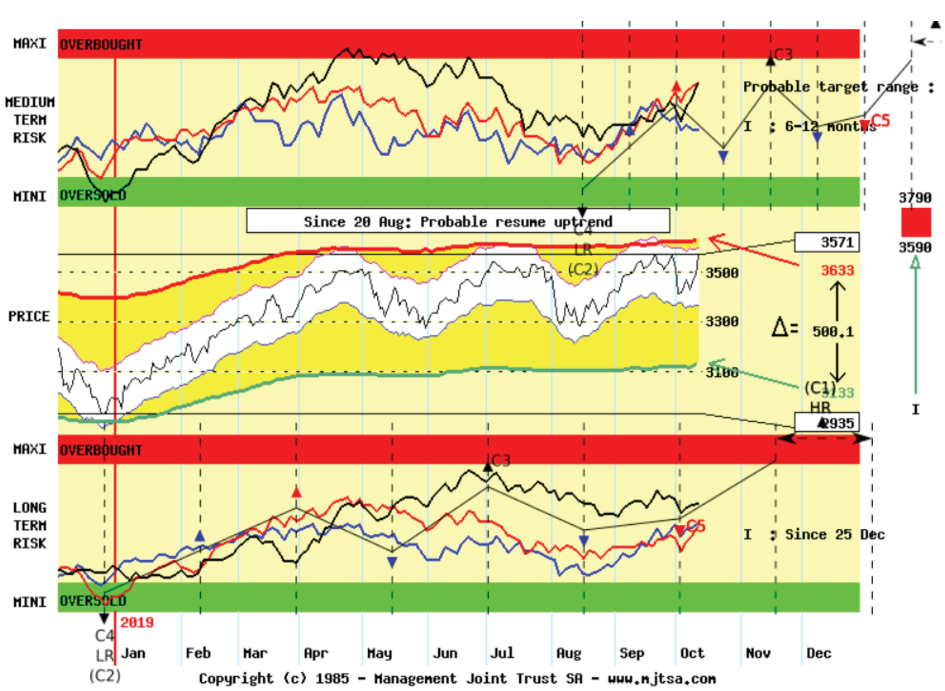
The last few days have seen the promise of some important overhanging risks potentially dissipating. Indeed, the US and China seem to have come to an initial agreement with the promise of a substantial "Phase One" deal on the table, while the Brexit negotiations have apparently seen unusual positive developments. Concomitantly, the FED is moving forward with its "not QE4" purchase program on the shorter end of the curve. These developments only serve to reinforce our conviction that a strong cyclical rally may lie ahead as the US economy should start to show some initial signs of recovery. We hereby highlight the Daily graphs of the main asset allocation drivers to support this view.

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



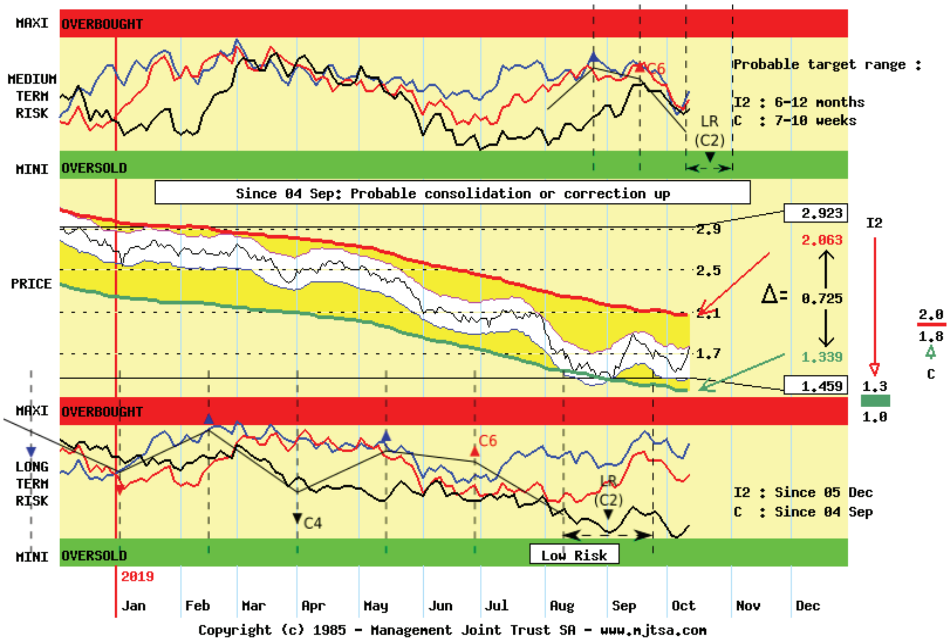
The S&P500 Index is now back just below its all time highs and while our C Corrective targets to the downside still look quite menacing (right-hand scale), the I Impulsive potential to the upside we can calculate is equally promising towards 3'150 (1.7 time our historical volatility measure "Delta", here at 462.5 – middle rectangle, right-hand side – added to the 2'351 December lows). **Both our oscillator series (lower and upper rectangles) also paint quite a supporting picture as both have just made cyclical lows while prices have started to react to the upside. We hence expect this rally to continue, probably towards mid/late November, perhaps December in first instance.**

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



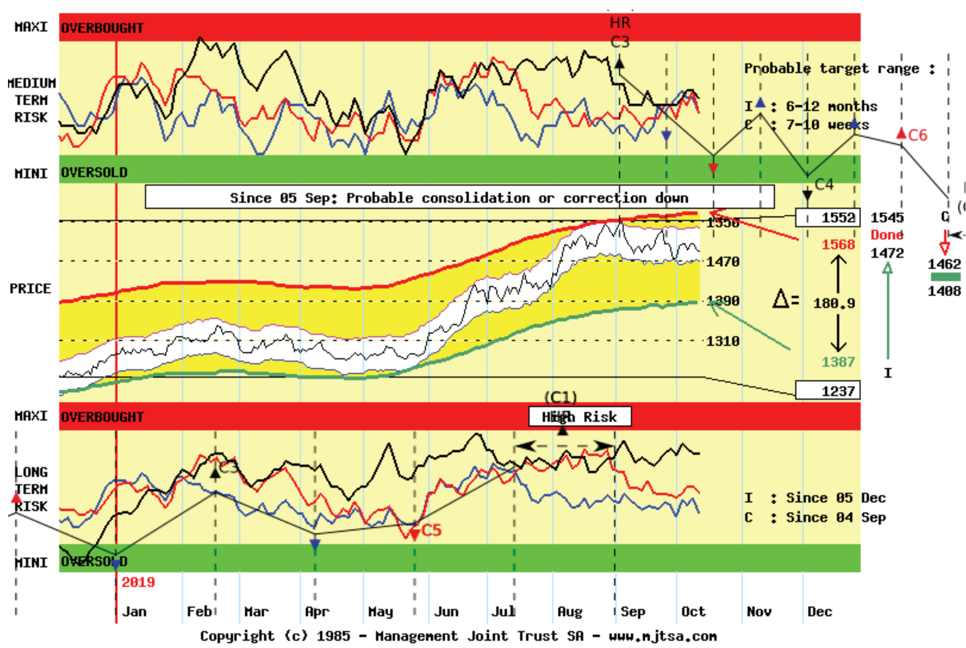
The Euro Stoxx 50 has been even stronger over the last few days as it reacted to the positive Brexit developments. It is now a whisker below its all-time highs while **our I Impulsive targets to the upside do suggest further potential above 3'600 and possibly up to 3'800 over the next few months**. This would imply new post 2009 all-time highs. **Our long term oscillators (lower rectangle) are resuming their uptrend and are on the verge of breaking-out following a sideways consolidation which lasted almost 6 months. The resulting rally could indeed be quite strong**. On our medium oscillators (upper rectangle), we are now in a new uptrend sequence which may extend into mid/late November, perhaps even early next year.

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



On the Defensive side, US10Y Treasury yields also seem ready to start a strong rebound. Following their climax sell-off in August, their early September rebound, and their deep retest into early October, we believe they have built a strong base. While our long term oscillators (lower rectangle) were in a "Low Risk" position in early September and yields were very Oversold in terms of price targets, having almost reached our extended I2 Impulsive 2 targets to the downside (right-hand scale), our medium oscillators may have just confirmed this base with their own "Low Risk" situation, following the recent downside retest. **Such Daily "Low Risk" situations usually trigger 2 to 3 months of consolidation to the upside, at least, and given recent volatility we would expect our C Corrective targets to the upside between 1.8 and 2.0% to be rapidly tested. Above these, the next level of targets we can calculate are between 2.4 and 2.7%** (1.3 to 1.7 times our historical volatility measure "Delta", here at 0.725% – middle rectangle, right-hand side – added to the graphs low point, 1.459%).

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



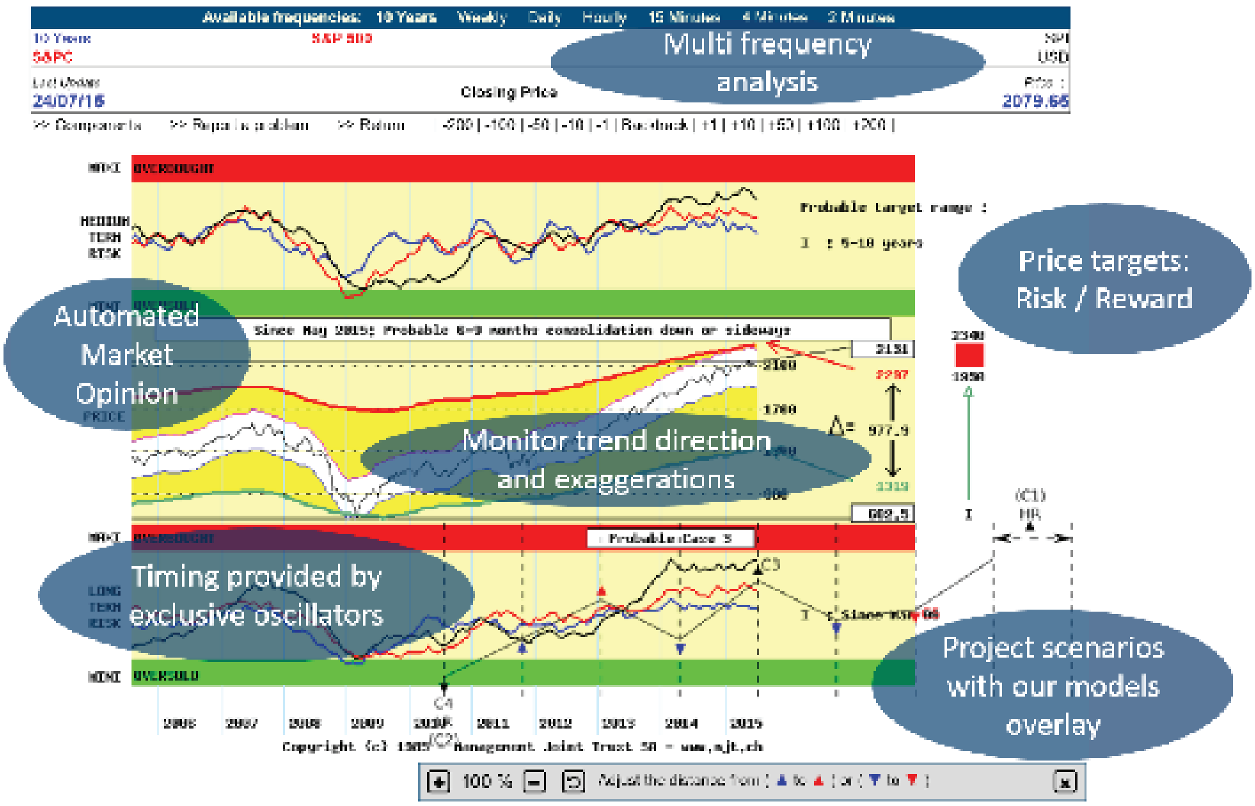
Inversely to US yields above, Gold confirmed a "High Risk" situation in early September. By then it had also fulfilled our I Impulsive targets to the upside (right-hand scale). **We now believe that Gold is gradually positioning itself in a downtrend sequence that could lead it lower into early December. Initial targets are in the low 1'400s or the support of our C Corrective targets to the downside (right-hand scale). Below these, the I Impulsive targets we can calculate are in the 1'316 – 1'243 USD/oz range** (or 1.3 to 1.7 times our historical volatility measure "Delta, here at 181 – middle rectangle, right-hand side – subtracted from the graph's high point at 1'552).

Concluding remarks:

Cross-assets, flight to safety probably reached its climax during August and started to unwind with the Momentum Crash early September. Following one more retracement early October, Equity markets, and more generally risk assets, now seem to have built a strong base that could see them accelerate higher into mid/late November, perhaps early December. On the opposite side, Defensive assets such as Bonds or Gold should see a strong sell off during this period, as flight to safety reverses. The rally we expect could almost be labelled "a relief rally", although starting from very high levels, as overhanging risks dissipate following almost six months of a painful and treacherous consolidation process since April on risk assets.

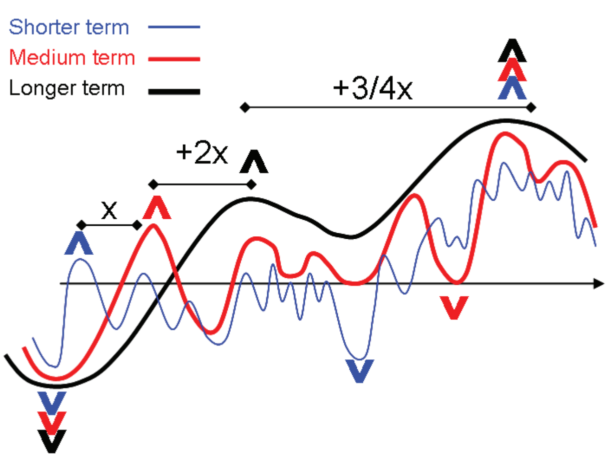
55/ METHODOLOGY

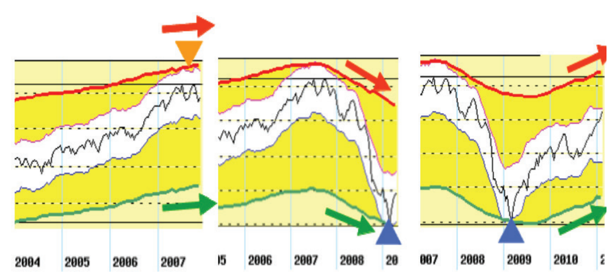
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



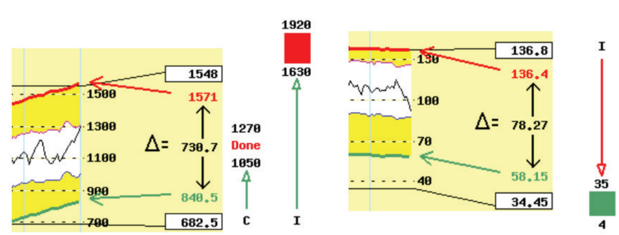
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)

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

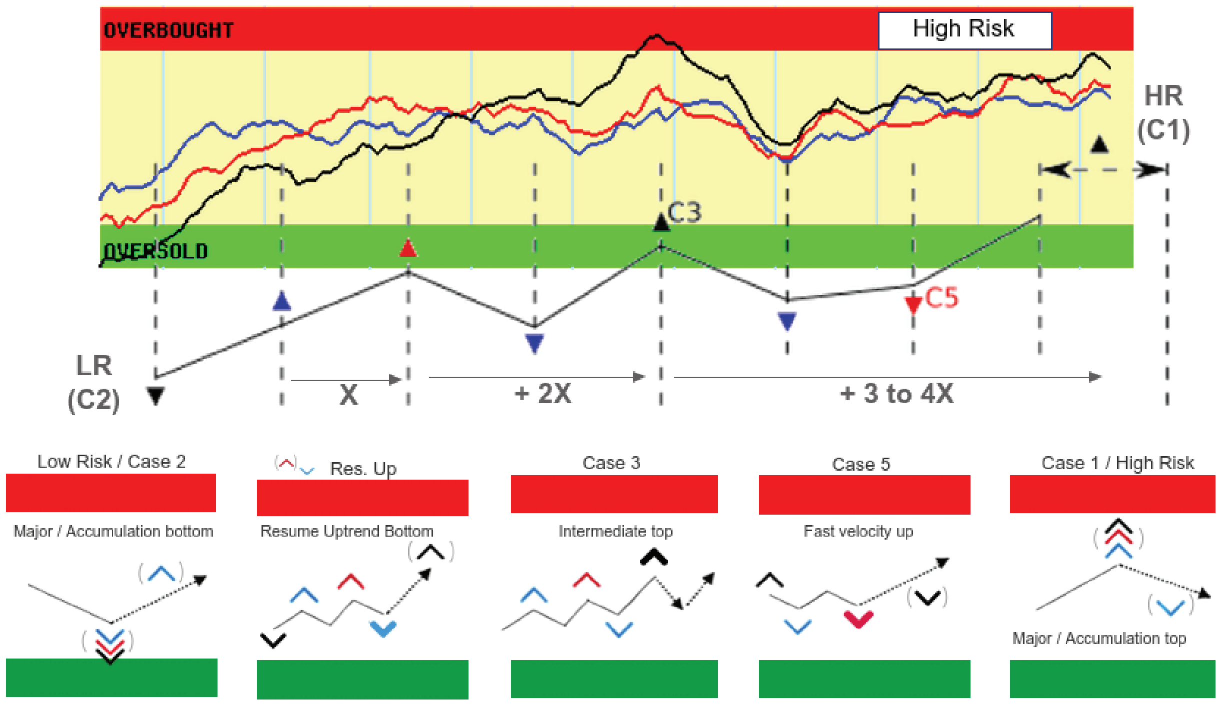




Price targets: based off historical volatility, they can highlight price potential or risk and, once achieved, define take profit or stop loss areas (e.g. below S&P500 in early 2011, Brent in October 2014).

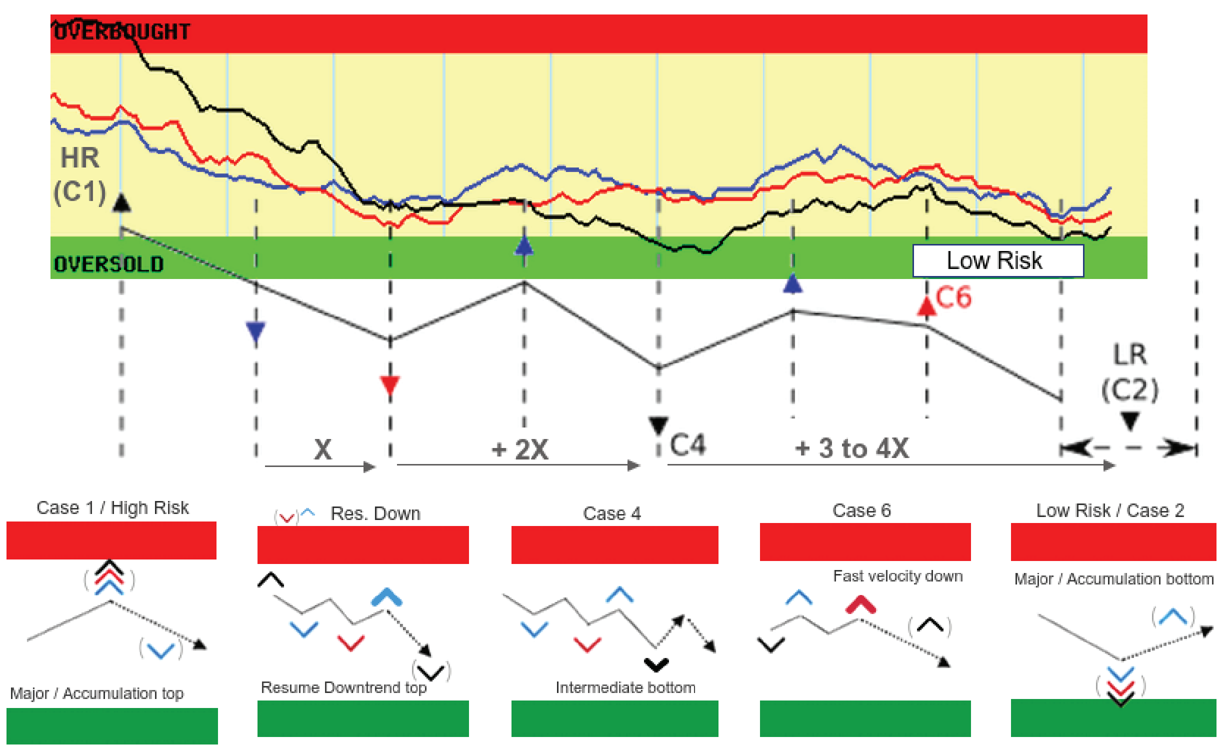


Ideal Uptrend Model



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

Ideal Downtrend Model



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

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THE CAPITAL OBSERVER

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