THE CAPITAL OBSERVER

APRIL 2019

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

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THE CAPITAL OBSERVER

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

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"The S&P 500 is expected to report a blended rate of actual and estimated earnings decline of 4.2 per cent in the first quarter from a year ago, according to data provider FactSet. If that plays out, it would mark the first year-on-year earnings contraction for the S&P 500 since the second quarter of 2016 and the biggest such decline since the first quarter of the same year, when EPS fell 6.9 per cent. While the debate on scrapping quarterly reporting continues, JPMorgan — whose chief executive Jamie Dimon emphatically argues against quarterly guidance — unofficially kicks off earnings season on Friday."

M Badkar, Financial Times

4/ Executive Summary

12 / **Liquidity indicators show that the S&P500 may probably start its correction this week** - A discussion of the outlook in US stock markets has to start with the outlook in the near-term, and that sets the tone for further discussion of longer-term views of equities and other risk assets. At The Capital Observer, we believe that a temporary peak of the equity markets maybe just days away – the top may even be seen within this week. This phase should be a correction phase of the initial rise since December 2018 and the market should decline until early May, then rallies until July. We are guided by our liquidity models, and in this instance, the liquidity flows from the NY Fed's SOMA transactions, and the US Treasury's Cash Balances at the Federal Reserve. Another class of systemic liquidity, those that come from global central banks' aggregated balance sheets balance and money supply provide a broader view of what to expect in the longer-term. The montage of both supports the theme of a sell-off over the next few weeks, then a rally into June/July.
As a consequence we also expect over the next few weeks that yields and stocks will reach a point where they will revert to the usual covariance of the past decade or so – rising stock market will be accompanied by rising yields.

15 / **Timing and Tactical Insight - Cyclical Correction, until the end of April / early May -** Equity markets now seem well positioned to continue higher into the Summer. US markets may achieve marginal new highs, while European markets could come close to their 2017 ones. In the meantime, however, most equity markets seem to be reaching intermediate tops. These could trigger an intermediate correction, which could last 3 to 6 weeks, into late April, perhaps early May. The S&P500 may retrace back down to the 2'750 – 2'650 range. Relative ratios between the US and Europe, or Emerging Markets, seem to confirm this scenario. Indeed, they have been rather defensive since December (underperforming the S&P500), yet could now be getting ready to bounce. More generally, we believe Defensive and Growth themes should outperform during April, while Cyclical ones should bear the most of the downside consolidation we expect (e.g. Small Caps, Transports, Latin America, or Russia).

23 / **The Fed and bond yields: monetary policy is on hold, but a build-up of systemic liquidity and firmer core CPI will push up yields** - President Donald Trump is calling for a major change in the stance of the Federal Reserve System in order to keep the economy from stalling; Mr. Trump suggested that the Fed cut rates and stop shrinking their balance sheet. But is the Fed monetary policy really restrictive as implied by Mr. Trump and his economic adviser, Mr. Larry Kudlow? The Capital Observer asks these questions, and points out a few issues that say otherwise. The current M2 level compares favourably with the levels seen in normal years when there was no financial or growth crisis. Therefore, in terms of the historical data, this does not represent a banking system that is restricted at all. In fact, we feel that development in sharp money growth may start getting attention from the Fed at some point over the next few months.
There are two things that dominate in the US banking system right now. First, the Federal Reserve continues to conduct monetary policy in a way where they err on the side of too much monetary ease. The Fed doesn't want to "make a mistake."
Second, the US commercial banking system is behaving conservatively. And probably that is what is causing the cautious growth outlook at the present. With this as background, it is easy to understand why the Fed's monetary policy is neither here nor there – they are on a "waiting phase" and so a pause is probably warranted. However, we feel that it is a mistake for the bond market to assume that the Fed will cut rates, or even more extreme, resurrect the Quantitative Easing program and its Large Sale Asset Purchases (LSAP). Therefore, it may also be a mistake to assume that the bond rally will continue and bond yields will continue to fall further. Furthermore, bond yields will also be held hostage to the risk of rising Core PCI over the rest of the year. Core CPI has been tame, but that will likely change very soon.

26 / **Timing and Tactical Insight - Yields could see one last push lower, before reversing up strongly into the Summer -** Yields across the US and European yield curves have lost between 60 and 100 basis points since October. This move, which we had correctly anticipated doesn't seem quite finished yet, and in both regions, we expect a few more weeks of downside retesting, probably into late April, early May. Following that, US yields may then attempt to retest their 2018 highs, probably over the next couple of quarters, while we expect German 10 years Bund yield to correct up between 30 and 40 basis points into midyear, perhaps early Summer. This reacceleration up in US yields, which we believe could start in a few weeks, should then confirm that the flattening of the US yield Curve is over for now. With the FED having shelved its rate hiking ambitions, the US yield Curve should steepen quite rapidly into midyear and the Summer along with long term rates. These developments should favor low duration Value trades such as Financials and Banks, and we would expect them to rebound quite nicely vs the market, probably during May, June and perhaps into Summer.

32 / **Template for a significant oil price recovery into 2020, but before a short-term decline could happen into May** - Oil prices are practically slaved to equities to such a high degree that it is very frustrating to see gasoline and oil prices ignore the sharp decline in gasoline demand and consumption in the past several weeks. The media is focused on the reduced output from OPEC+NOPEC, but as we pointed out at The Capital Observer in past issues, the full impact of changes in production comes after a very long lag. To illustrate this on the global scale, we show a template of how we use changes in global oil production and supply to estimate when the price of oil properly responds to those changes. What matters is (1) the changes in global and US production in actual bbls year-to-year; and similar changes in global supply. (2) Convert the oil price in yearly actual change (in $). Put them together, and you have a good fit. So what we are getting from this template is that the negative impact of the recent surfeit of output (supply) will last until June this year, in a distributed lag process. This will keep prices low until late Q2, after which the oil price takes off as the receding supply/output due to OPEC and NOPEC initiative hits the system fully. In fact, the role of demand and consumption may be even more important; as we are fond of saying at The Capital Observer, no one can manufacture oil demand. What OPEC+NOPEC started by rationalizing the global output two months ago, could push prices up to $90-- But only if the OPEC and NOPEC continues to get their act together. Therefore, the broad strategy is to look for lower levels to initiate some structural portfolio positioning in E&Ps, Refiners, in oil and products by late May time frame.

5/ Executive Summary

35 / **Timing and Tactical Insight - Oil is approaching important resistance levels**- Shorter term, rising concerns on the supply side (e.g. Venezuela, Libya) are supporting the latest Oil rally. Yet, most Energy related markets are now approaching important resistance levels to the upside. We calculate these towards 63 USD/barrel on WTI, 71 USD/barrel on Brent (i.e. close to current levels). From a timing perspective, our oscillator series are also nearing intermediate tops on Oil, the Energy sector, or, on a relative basis, on the Energy sector vs the general market. Hence, we expect that Oil prices may temporarily top out over the next few days and should probably enter a consolidation period to the downside, which could last during 3 to 6 weeks. Following that, we are still very positive on Oil and the Energy sector into the Summer.

41 / **Commodities outperformance over equities: Growth will be supportive but we may have to wait a little longer, as rising yields could push the US Dollar higher** - In the November 2018 Capital Observer issue ("Commodities outperformance over equities"), we published a graph that has held a lot of promise, and therefore has been tracked by us very closely. In the graph, we juxtaposed the rolling correlation between the S&P 500 and the US Dollar TWI, with a 5yr autoregression, which defined and illustrated the highly cyclical performance of commodities as an asset class versus the S&P 500 Index (as proxy for the equities asset class). The promise is the start of a highly cyclical phenomenon with a period of 15 to 18 years, marked by a significant outperformance of commodities over equities. For a new upcycle to take hold, one of more of these events have to happen: (1) commodities could rally while equities decline (or vice-versa); (2) commodities and equities fall together but equities decline at a faster and larger degree relative to commodities, and (3) commodities and equities rise together, but the former outpacing the latter. China has now stepped in with renewed fiscal and monetary stimulus and global central banks universally reversed their tightening bias, prompting a "V-Shaped" equity rally in early 2019. Ironically, this equity rally has been led by emerging market equities, specifically Chinese equities, which were the first equities to turn down in late 2018. Global economic growth readings have turned higher, once again; global economic growth already appears to have bottomed. Commodity prices are confirming the bottom in global growth expectations, similar to what we witnessed in late 2015/early 2016. The picture emerging is that recent fears about a downturn in global growth, led by a downturn in China, have been unfounded, with both the US and China, the two largest economies in the globe, starting to emerge from gloomy outlooks at the start of the year. If we do have a positive outlook for growth in 2019, then there is a chance (a good one) that the outperformance of commodities over equities may finally get rolling and accelerate.

44 / **Timing and Tactical Insight - Commodities could retrace until May, and then enter a new reflationary upturn -** The various Commodity segments are showing different profiles both on an absolute basis and vs the S&P500. Oil is the more pro-cyclical and volatile one, while Gold is the most defensive. Industrial Metals are somewhat in the middle, and very much linked to Chinese demand. Agricultural Commodities have been in a structural downtrend since 2011, yet are starting to look Oversold. When considering them as a whole, by comparing the Reuters CRB price Futures Index vs the S&P500, we would expect one last period of underperformance for Commodities into mid Q2. During this period, Oil and Agricultural Commodities may suffer the most, and should underperform Equities, while Industrial Metals may hold up rather well, and Gold accelerates up to achieve new YTD highs. Then, from mid May, we expect these trades to reverse. Our scenario is then very reflationary into the Summer, with rising Equities, and Bond yields which may attempt to retest last year's highs. This environment should be very beneficial for Oil. Agricultural Commodities may also benefit from their deep value position. On the other hand, China and Industrial Metals may then underperform, while Gold erases most of its uptrend since August last year.

52 / **Splicing the markets - Credit vs Duration. Weighing up the risks and rewards? -** Over the next few months, on a neutral duration basis, we expect further capital gains for High Yield over Investment Grade. This should come on top of the additional yield it generates. On the other hand, the duration trade, which has been very successful over the last 4 to 5 months is probably getting ready to top-out, probably towards late April / early May. Until then, Duration may still have a slight hedge over Credit. Yet, by the end of this month / early next, we would probably favor a subsequent reduction in duration, as well as an increased exposure to the higher yielding segments of the Credit space.

6/ Mapping the markets

L**ast month**, when we published on the 13th of March, we expected equity markets to push higher one more time into late March, and that by early April, Growth, Cyclical themes as well as general market indexes should all reach intermediate tops, probably slightly above 2'850 on the S&P500. Following that, we expected the start of a 3 to 6 weeks correction to the downside, and that the S&P500, for example, may then retest down below 2'700 and possibly into the 2'600s. We are still eyeing this scenario today although the S&P500 did push slightly higher and slightly longer than we had expected. Last month, we also forecast that Gold could correct down again into late March, while the US Dollar remained strong. Gold may have started to reverse up early April, while the Dollar just recently retested towards the top of its year-to-date range. We were still very positive on Treasuries, and expected that by late March / early April, Treasury yields could initiate a last move lower towards mid Q2, probably into the 2.3% – 2.5% range. The move did materialize, yet slightly earlier than we had expected, following the very dovish FED statement in the 3rd week of March.

Going forward, we would confirm our call for a 3 to 6 weeks risk assets correction to the downside, probably until late April, perhaps into early/mid May. Retracement levels we are now considering on the S&P500 are between 2'750 and 2'650. On the EuroStoxx 50, we expect a return into the 3'300- 3'200 range. We believe cyclical themes will probably suffer the most. Growth and Defensive equity profiles may also consolidate, yet to a lesser extent. We would hence favor Technology, Consumer Discretionary and Staples, or Utilities over Industrials, Energy and Financials. Indeed, we expect that interest rates could still retest lower one last time into late April, while yield curves may push slightly more into inversion. At least, we expect yields and yield curves to retest their previous lows. Gold in this defensive environment should attempt a last move higher towards new year-to-date highs, Oil should correct down, while the US Dollar may follow risk assets lower (i.e. the US Dollar has been rather pro-cyclical since the beginning of the year and may hence correct down along with risk assets).

From early / mid May, we believe the 3 to 6 weeks cyclical and risk assets correction we expect could be coming to an end. We then expect an important reversal point to the upside for all Cyclical, Value and Commodity related themes. This new uptrend, which should gradually gather momentum during May and June, may then push higher well into the Summer, perhaps even the Fall. Hence in May, we will probably look to take profit on defensive assets such as Gold and Treasuries, would reduce bond duration as well as exposure to Growth themes such as Technology or Asian Growth, and would reposition into cyclical equities and commodities, High Yielding Credit, or towards Latin America or Russia in Emerging Markets. During the initial stages of this "reflationary" acceleration, we expect global, and especially US Growth, to surprise once again to the upside. Inflationary pressures will eventually follow, yet with a lag. Hence, the US Dollar may also resume higher vs other majors, for the first few months at least.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	US markets could enter a 3 to 6 weeks consolidation to the downside towards the 2'750 - 2'650 range on the S&P500, probably until late April / early May.	From mid Q2, US Equity markets should then resume their strong rally, probably towards midyear and perhaps the Summer.
	Europe EuroStoxx50	European markets could enter a 3 to 6 weeks consolidation to the downside towards the 3'300 - 3'200 range on the SX5E index, probably until late April / early May.	From mid Q2, European Equity markets should resume their strong rally probably towards midyear and perhaps the Summer.
	EMs MSCIEM USD	Emerging Markets could also retrace during April, Asian Growth may pprove quite resilient, while Latam and Russia could suffer more.	From mid Q2, cyclical plays such as Latam and Russia re-accelerate up towards the Summer, while Asia Growth lags.
Treasuries	US10Y Bond prices	US Treasuries yields may continue to retest down into the 2.4 – 2.2% range (US10Y), probably until late April.	From mid Q2, we expect Treasury yields to reverse up strongly. They may retest their 2018 highs at some point during the Summer, perhaps the Fall.
	Germany 10Y Bund prices	German Bund Yields (10Y) could remain under pressure until late April and could dip back slightly further into negative territory.	From mid Q2, we expect Bund yields to initiate a 30 to 40 basis points bounce, possibly into the Summer.

Legend:	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight

Main Equities

World markets
p 15-17, 21, 22

Equity markets are probably reaching an intermediate top. We expect it to trigger between 3 to 6 weeks of consolidation to the downside, probably towards late April, perhaps early/mid May. On the S&P500 Index, our targets to the downside for this correction are between 2'750 and 2'650. We believe that Cyclical trades may suffer the most, and that Growth and Defensives profiles should hold up better.

Main Regional picks
p 15- 17, 21- 22

In this perspective, we believe that Europe and Asian Growth countries have shown a rather defensive profile over the last 6 months. We hence expect them to hold up better during this short cyclical correction we expect. The US may underperform slightly, while Japan could suffer from a strengthening Yen.

Emerging markets
p 18, 19, 20

On Emerging Markets specifically, we continue to favor Asian Growth countries (including China) over Latam and Eastern Europe. They should hold up better during the 3 to 6 weeks cyclical correction we expect. Following that, from May, these trades will probably start to reverse along with cyclicity. We would then favor commodity producers such as Brazil or Russia.

Volatility

Volatility may correct up slightly during April / early May as equity markets correct. VIX may revisit levels in the higher teens.

Government Bonds

US & European Benchmarks
p 26, 27

US Treasury yields saw a strong push lower probably back into late March and entered our I Impulsive targets to the downside in the 2.5 – 2.2% range (US10Y). Yet the move doesn't seem quite over yet and may retest into these targets until late April, early May. Following that, we expect a strong pick up in yields towards the Summer, perhaps the Fall. These may even retest last year's highs. In Europe, the current downtrend on Bund yields could also retest lower over the next few weeks, and then probably bounces 30 to 40 basis points into Summer. It then reverses down at some point during H2 2019, towards 2020.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	The ratio should consolidate along with equities as long bond yields hold up, probably until late April, early May.	From mid Q2, the ratio should resume its uptrend into the Summer, along with equities and yields.
	Europe	The ratio should consolidate along with equities as German Bunds hold up, probably until late April, early May.	From mid Q2, the ratio should resume its uptrend into the Summer, along with equities and yields.
Duration		US and European yield curve spreads may push slightly lower into late April as long bonds retest their late March lows.	From mid Q2, Yield curves should start to steepen quite rapidly towards the Summer, as long term yields follow risk assets up and the FED is "on halt".
Credit		Credit follows a similar path than equities. Corporate spreads could hence bounce again until late April / early May.	From mid Q2, Credit spreads resume their downtrend, probably towards the Summer, perhaps even into the Fall. High Yield should be particurlarly strong.
TIPs/Treasuries		Inflation expectations (TIPs vs Treasuries ratio) should retrace down into late April / early May.	The TIPs vs Treasury ratio gradually reverses up during Q2, and could then start to acclerate up during the Summer.
Oil		Oil corrects down during April, perhaps even into early/mid May, by 5 to 10 USD/barrel.	By mid Q2, Oil initiates a strong rally towards the Summer. It may then retest last year's highs.
Industrial metals		Industrial metals may hold up rather well until mid / late April, before they follow other cyclical assets in their corerction to the downside.	By mid Q2, Industrial metals resume their uptrend into the Summer. However, they may lag other cyclical commodites such as Oil.
Gold		Gold initiates a last push higher towards late April / early May, possibly making new YTD highs in the 1'350 - 1'400 USD/oz range.	From mid Q2, Gold retraces down into the Summer as the risk off sentiment collapses, rates rise and the US Dollar remains rather strong.

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

Equity to Bond Ratios

US & Eurozone Markets
p 26, 27

Equity to Bond ratios should consolidate down with equities until late April, early May. Following that, we expect them to accelerate up during the Summer as Equities resume their uptrend and Bond yields reverse up.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 28, 29

Many portions of the yield curve are now inverted. With the FED "on halt", Treasuries yields are now the yield curve. We expect these to attempt a last retest lower into late April / May, thereby pushing the yield curve slightly more into inverted territory. By May, Treasury yields should start to reverse up. We expect a strong move up on yields into the Summer. The yield curve should then also steepen quite substantially and rapidly.

Credit
p 29

The Credit market has been bouncing back quite strongly since December, following its strong Q4 sell-off. As with other risk assets, it may be reaching an intermediate top and could consolidate down into April. Yet, it probably resumes up strongly thereafter into the Summer. Hence, from May, we would probably favor low duration high yielding credit securities.

Rate Differentials
p 28, 29

Along with US yields, which are more volatile than yields in other regions, the US to the rest of the world spread differential may still retest lower over the next few weeks, probably towards late April / May. Following that, we expect it to widen again into the Summer, along with the reversal up we anticipate for US Treasury yields.

Tips

The TIPs / Treasury inflation breakeven ratio timidly followed risk assets up since early January. We now expect it to retest down along with the intermediate correction we expect on them. Following that, the ratio should gradually start to rise again into the Summer, probably accelerating higher as the year advances. TIPs should follow Treasuries higher into late April/May, and then reverse down into the Summer.

Commodities

Oil
p 35- 39, 47

Similarly, to equities, Oil is currently making an intermediate top. We expect it to correct down by 5 to 10 USD/barrel over the next 3 to 6 weeks. From early/mid May, it then reverses up again, probably towards the Summer, perhaps even the Fall, and it may retest its 2018 highs.

Industrial metals
p 44- 52

Industrial Metals may prove slightly more resilient than other cyclical Commodities during April. These are closely linked to Chinese demand and well correlated to Chinese equity markets, which we also see holding up better (or slightly longer) than other regions during April.They should then correct down with them into May, before resuming up into the summer.

Gold & PMs
p 46, 48, 49

Gold recently finished a corrective move down from its February top, and we now expect it to resume up, potentially to retest these February highs towards late April / early May. Indeed, our targets suggest that it may move back into the 1'350 – 1'400 USD/oz range.

Agriculture
p 45, 51

Agricultural Commodities should continue in their secular downtrend towards May. Yet, on a longer term basis, these are getting quite Oversold, and we would tentatively expect a strong bounce towards late Q2 and the Summer.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	The US Dollar could still attempt to retest up until mid April (below 1.12 on EUR/USD), it then corrects down into early/mid May (towards 1.14-1.16 on EUR/USD).	From mid Q2, the US Dollar should resume its up-trend towards the Summer
	GBP	Cable may attempt to break its 1.30 support during April, yet Brexit remains a strong factor of uncertainty and of asymetric risk (in both directions).	GBP/USD probably remains under pressure until mid/late Q2. It could then bounce with other risk assets unless Brexit comes and spoils the party.
	JPY	USD/JPY probably retraces down towards late April / early May and the 110-108 range.	From mid Q2, USD/JPY resumes its uptrend as risks subside, probably towards the Summer and to-wards 115-116.
	CHF	USD/CHF probably retraces down towards late April / early May and the 0.97- 0.95 range.	From mid Q2, USD/CHF resumes up quite strongly towards midyear and the Summer (towards new YTD highs)
EUR vs	GBP	EUR/GBP probably attempts to bounce back towards the 0.88-0.89 range until late April / early May. Yet, Bexit remains a strong factor of uncertainty.	From mid Q2, EUR/GBP could fall further on risk-ON considerations, yet the Brexit process is still very unpredictable and may surprise negatively for GBP.
	JPY	EUR/JPY probably resumes lower until late April, per-haps even early/mid May (target 123-122).	EUR/JPY should find support towards mid Q2 and then rises towards midyear / the Summer.
	CHF	EUR/CHF probably resumes lower towards late April, perhaps even early/mid May and could retest its recent lows around 1.115.	EUR/CHF should find support towards mid Q2 and then rises towards midyear / the Summer.
GBP vs	JPY	Brexit remains a high uncertainty factor, yet GBP may revisit the 144 - 142 range during April.	GBP/JPY should find support towards mid Q2 and then rises towards midyear / the Summer, yet Brexit remains a strong factor of uncertainty.
	CHF	Brexit remains a high uncertainty factor, yet GBP may revisit the 1.30 - 1.29 range during April.	GBP/CHF should find support towards mid Q2 and then rises towards midyear / the Summer, yet Brexit remains a strong factor of uncertainty.

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

US Dollar

We were constructive on the US Dollar throughout Q1 2019 as we expected it to be rather pro-cyclical. We would now expect it to consolidate down over the next few weeks, along with risk assets, probably until May. Shorter term, the latest move up may retest until mid April.

Euro
p 17

Similarly the latest move down on EUR/USD since mid March could still take another week or so to bottom. Following that EUR/USD probably bounces 3 to 5 figures into late April / May as risk assets consolidate. EUR/JPY and EUR/CHF on the other hand, should follow risk assets lower over the next 3 to 6 weeks, probably towards the 122-123 range on EUR/JPY and potentially back below 1.12 on EUR/CHF.

Yen

Similarly to other risk assets, USD/JPY had rebounded quite nicely since its early January Flash sell-off. Between now and mid April, we expect it to top out again and enter a consolidation period towards early/mid May. We believe it could dip back into the 110 -108 range.

Sterling

The fate of Sterling is still hanging onto the inconclusive Brexit process. Historically, Sterling is rather pro-cyclical against the Dollar. Hence, given the risk asset correction we expect during April (and the concomitant EUR/USD rebound), it should normally bounce less than the Euro, perhaps even decline. Our Daily oscillators are suggesting that GBP/USD could remain under downside pressure until late April / early May. Before any targets can be articulated to the downside, we would first need to break through the 1.30 mark, which has proven to be a very strong support. In the meantime, the asymmetric risk to the upside, which could be linked to a positive conclusion of the Brexit process is still quite high. EUR/GBP probably made an intermediate bottom during March and may continue to rebound into late April / early May, probably towards the 0.88-0.89. Sterling is indeed also more cyclical than the EUR. Hence, this scenario may fit well with the 3 to 6 weeks cyclical correction we expect until late April/May. Here also, a positive conclusion of Brexit would probably lead GBP to strengthen again quite rapidly vs EUR.

Oil & Commodities currencies

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) could remain under pressure vs the USD, probably into May, while vs the EUR, they are also making an intermediate top and they could correct down for several weeks.

Asian currencies

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) on the other hand may resume up vs the both the USD and the EUR, probably into May.

Equities Markets Segmentation

Core Sector Weightings			Next 2 months					3 to 6 months ahead				
US Sectors - S&P500 (general comment)			**Until late April, early May, we will Under-weight Cyclicals and Financials and Over-weight Growth and Defensives**					**From mid Q2, we would reverse these positions to profit from the strong reflationary re-acceleration we expect towards the Summer.**				
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)			**Until late April, early May, we will Underweight Cyclicals and Financials and Overweight Growth and Defensives**					**From mid Q2, we would reverse these positions to profit from the strong reflationary re-acceleration we expect towards the Summer.**				
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 22, 30, 31, 37, 38, 39, 40

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

Our general market scenario calls for a 3 to 6 weeks correction down on risk assets from now until late April, perhaps early/mid May. We believe that during this period Cyclical sectors and Financials should perform the worst, while on a relative basis, Growth and Defensive assets profit from a last retest down in interest rates and a rather risk-off environment.

From mid Q2 (May), we expect the start of a cyclical / reflationary reacceleration. It may be quite strong and last into the Summer, perhaps even the Fall. During this period, we would reverse most of the previous positions, Over weight Cyclicals and Financials and Underweight Growth and Defensives. Indeed, we expect rapidly rising interest rates and a risk-on environment.

Countries allocation

Core Countries Weightings			Next 2 months					3 to 6 months ahead				
All World Country Index Currency hedged (general comment)			**During April, and into early perhaps mid May, we will Underweight cyclical plays such as Canada, France, Germany or Japan, and would Overweight Asian Growth, China and Switzerland.**					**From mid Q2, we will favour the US and Japan on a stronger USD, and also more cyclical France and Germany. We will underweight Switzerland and neutralize China.**				
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 15- 17, 21, 22, 19-20

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

Until late April, early/mid May, during the 3 to 6 weeks cyclical consolidation we expect, China and Asia Growth should hold up rather well. Defensive Switzerland could also outperform on a relative basis. While Europe may be rather neutral as a whole, France and Germany, which are quite cyclical, could underperform. Canada should also suffer from its strong exposure to Commodities, while Japan probably underperform due to a correction up in the Yen.

From mid Q2, given the cyclical reacceleration we expect, we would reverse many of these trades, Overweighting Canada, France, Germany or Japan, as well as the US, which again could be the main motor for the cyclical reacceleration we expect. In Emerging Markets, we would look to neutralize Asia Growth and China, and would favor Commodity producing regions such as Latin America or Eastern Europe.

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	**Until late April, early/mid May, we would favour Growth and Defensive profiles over Cyclicals and Value**					**From mid Q2, we would reverse many of these positions to profit for the cyclical re-acceleration we expect.**				
Themes	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Nasdaq 100 (vs S&P500)										
DJ Industrial (vs S&P500)										
Russell 2000 (vs S&P500)										
Wilshire REITs (vs S&P500)										
US Value (vs US Growth)										
Southern EuroZone (vs Stoxx EZ 600)										
EuroZone Small Cap (vs Stoxx EZ 600)										
Japanese Small Cap (vs N225)										
GDX - Goldmines										
XME - Diversified Mining										

Core factors and Themes

p 21-22

Until late April, perhaps early/mid May, we would favor Growth profiles such as the Nasdaq and Defensive ones such as REITS or Gold mines. Cyclical and Value profiles should underperform during this period as risk assets correct and interest rates retest down. Southern Eurozone is kept at neutral as Italy seems to be much more resilient than Spain or Portugal, while Small caps globally seem to underperform.

From mid Q2, we expect the start of a strong cyclical rally that could last into the Summer. We also believe the US yield curve could reverse up and start to steepen quite aggressively. We would hence favor Value and Cyclical profiles over Growth and Defensive ones.

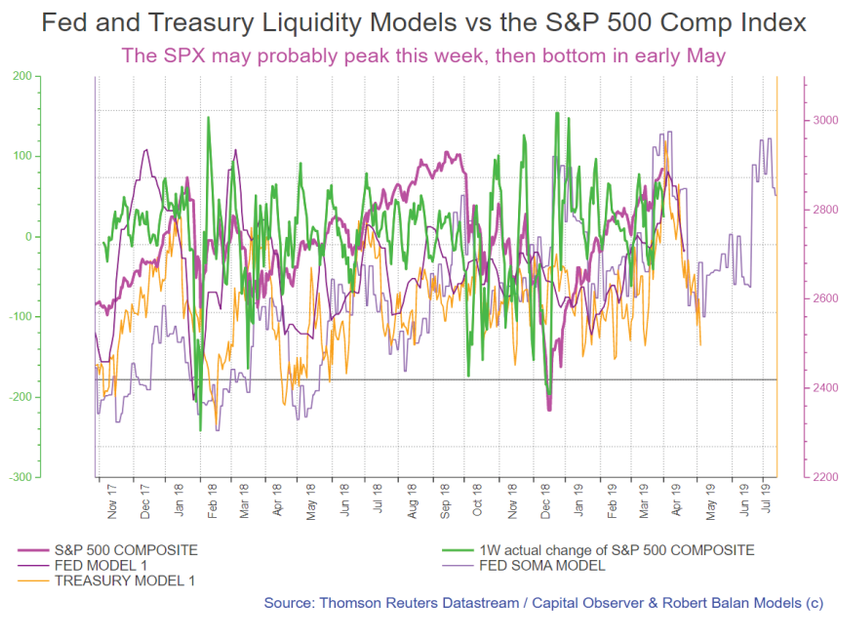
12 / Liquidity indicators show that the S&P500 may peak and start its correction this week, bottom in early May then probably rise till Q3 2019

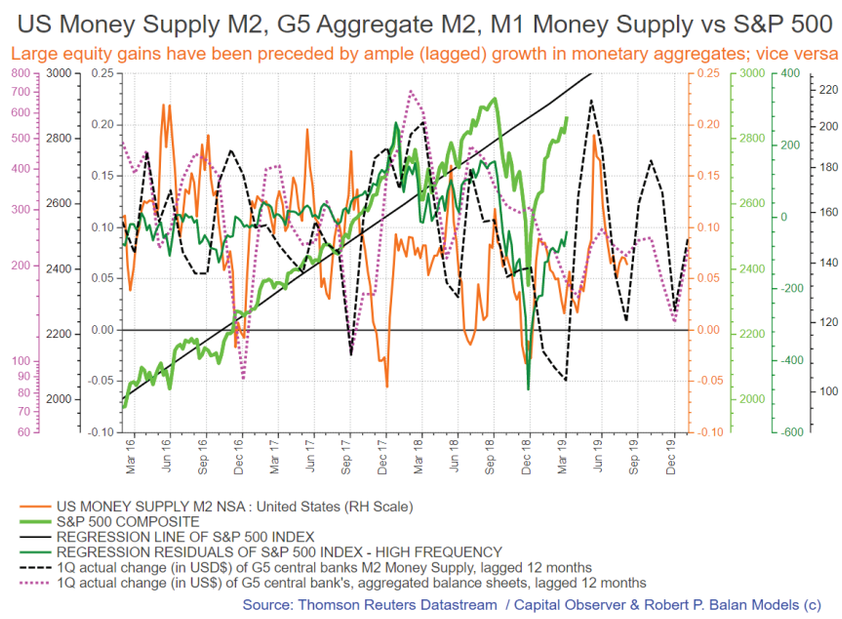
A discussion of the outlook in US stock markets has to start with the outlook in the near-term, and that sets the tone for further discussion of longer-term views of equities and other risk assets. **At The Capital Observer, we believe that the peak of the equity markets maybe just days away – the top may even be seen within this week** (*see 1st graph on this page*). This phase should be a correction phase of the initial rise since December 2018 and the market should decline until early May, then rallies until July.

We are guided by our liquidity models, and in this instance, the liquidity flows from the NY Fed's SOMA transactions, and the US Treasury's Cash Balances at the Federal Reserve. Our work has shown that those flows have a tremendous impact on the high-frequency turns of the major stock indices. The impact of the liquidity flows is seen in, and corresponds with, the change rate of the S&P 500 (weekly or monthly).

Another class of systemic liquidity, those that come from global central banks' aggregated balance sheets balance and money supply provide a broader view of what to expect in the longer-term (*see 2nd graph on this page*).

The 2nd graph on this page combines the aggregated balance sheet of the five central banks that still holds Quantitative Easing balance sheets: Federal Reserve Bank, European Central Bank, the People's Bank of China, Bank of Japan, and Swiss National Bank. As a control variable, we also included the aggregated M2 Money Supply of the five central banks. **The montage supports the theme of a sell-off over the next few weeks, then a rally into June/July, then a general weakness again in September.**





Given this outlook, some of us were wondering whether equities and bond yields will maintain their divergent trends. That tendency to keep the trend diverging is also shown by our bond yield models, which are suggesting that yields should start to turn around.

What makes the graph above interesting is that M2 Money Supply flows which have been declining for almost a quarter, are now showing strong take off in the past six weeks. M2 money supply trends are not seasonal and tend to maintain moves once started, so we believe that M2 will be instrumental in supplying systemic liquidity which will tend to raise yields and push up asset prices. *(see 1st graph on the next page)*

We also get the kind of support from the G5 central banks' aggregated balance sheets and M2 money supply for our theme that yields will likely be rising for most of H2 2019. US bond yields respond very well to the imperatives of those monetary flows (*see 2nd graph on this page*).

It has the same implications as equities: rising rates into June, and a decline yields until September. The models suggest a possible wide-range in the movement of yields, but that does not always happen. But the actual movement in yields should have some commensurate degree of similarity to the models.

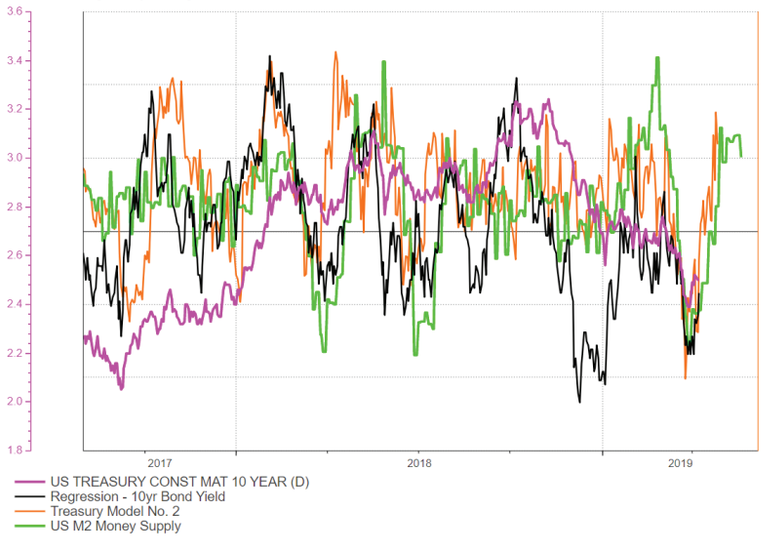
Nonetheless, over the next few weeks, yields and stocks will reach a point where they will revert to the usual covariance of the past decade or so – rising stock market will be accompanied by rising yields. if we take a guess it could be after three or four weeks, when an equity market correction being flagged by our models, has ran its course. **Stocks would rise and rally and yields would rise alongside.**

Finally, analysts have been fretting about the results expected to be reported by the corporate world this earnings season, that there is the possibility of an earnings recession. Analysts estimate S&P 500 profits in the first quarter contracted 4.2% from a year earlier, according to FactSet. They expect that will be followed by no growth in the second quarter. That puts the broad index at risk of entering its first earnings recession—marked by at least two or more consecutive quarters of declining earnings—since 2016.

Well, we can tell you now that there will be disappointment during this earning season. Here is a broad picture of the leading indicators of EPS. (*see 3rd graph on this page*)

The chain of events triggered by sharp dislocation of corporate net cash flows (lagged 5 Quarters in the graph) is culminating in a roll-over of

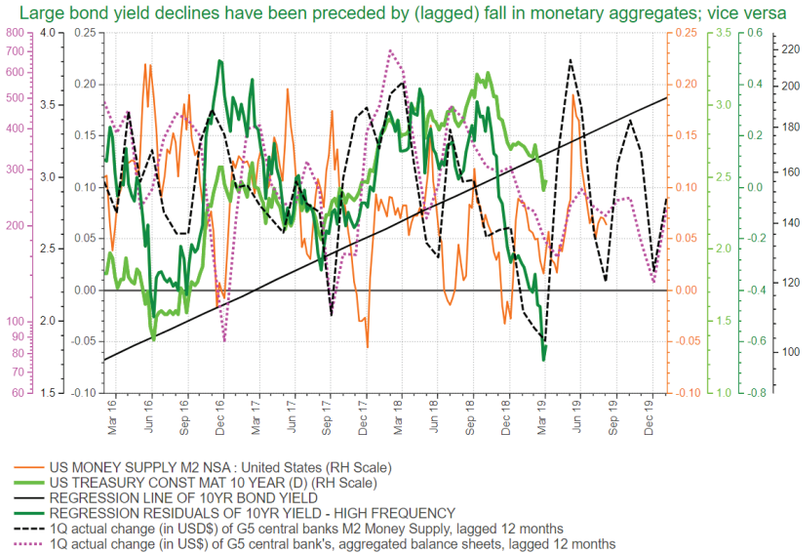
Treasury Liquidity Models, M2, Bank Reserves, Comm'l Banks' loans, leases



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

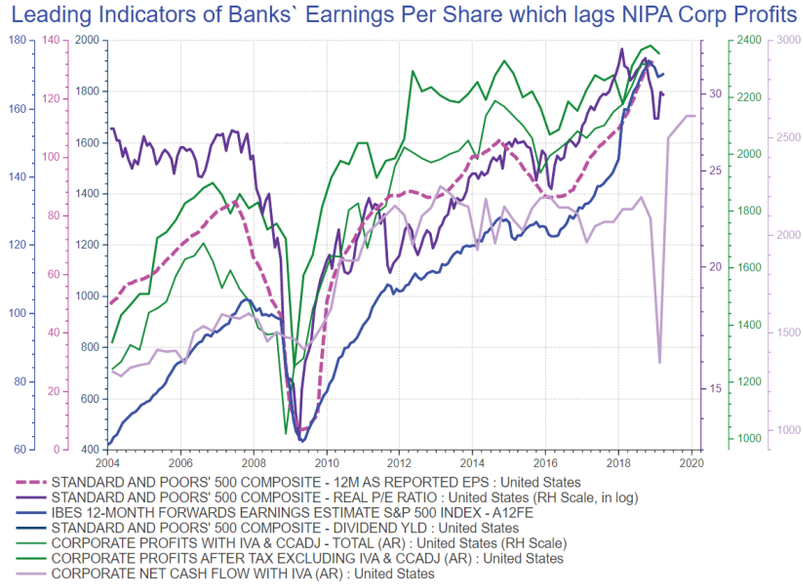
US Money Supply M2, G5 Aggregate M2, M1 Money Supply vs 10yr Yield

Large bond yield declines have been preceded by (lagged) fall in monetary aggregates; vice versa



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

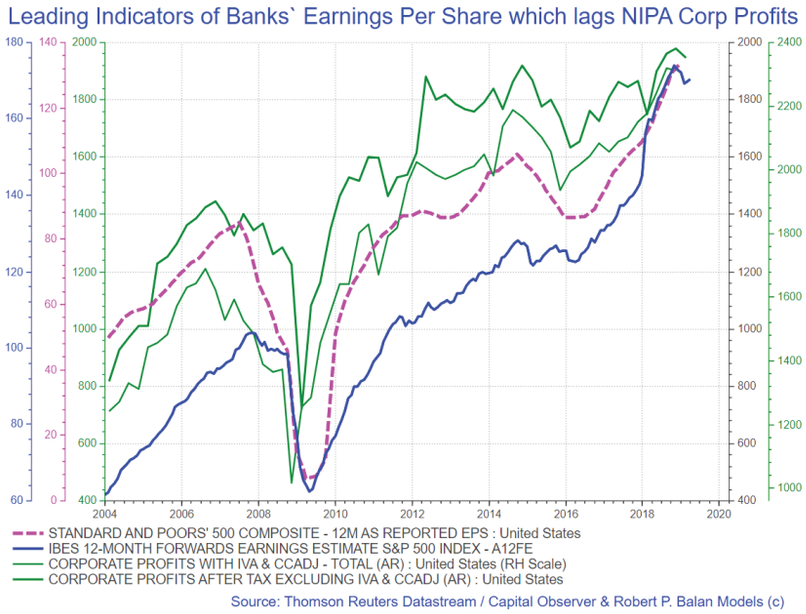
Leading Indicators of Banks` Earnings Per Share which lags NIPA Corp Profits



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

EPS over the next few quarters – that is already baked in the cake. To show that clearly, here is a less cluttered chart (*see graph on this page*).

Liquidity droughts function like gravity – there is a relentless pull, and all it takes is a trigger to set off a price dislocation in asset prices. One of the triggers which we expect to manifest at this time is market disappointment during the coming earnings session.

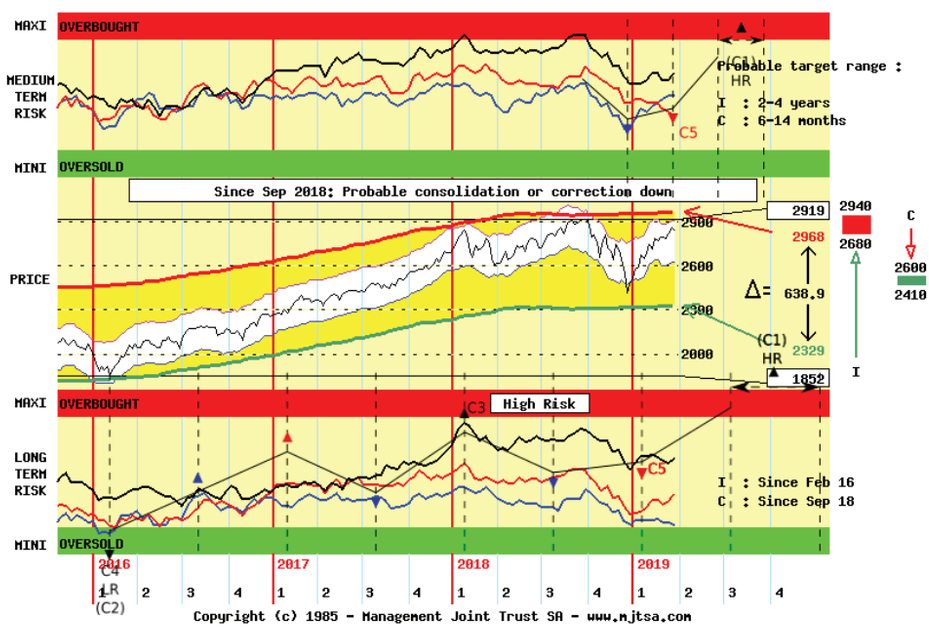


15 / MJT - TIMING AND TACTICAL INSIGHT

Cyclical Correction, until the end of April / early May

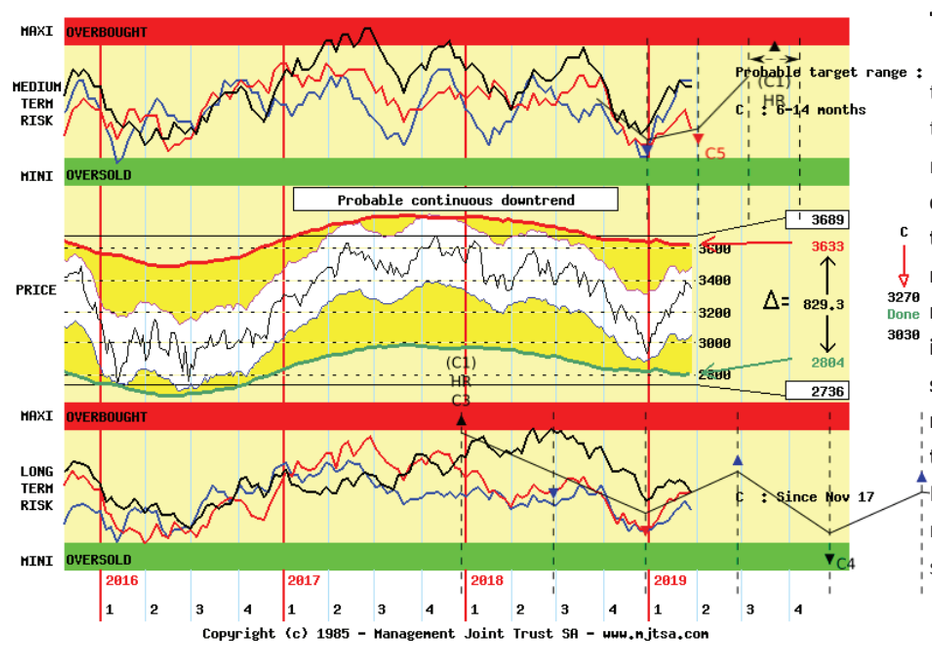
The market rebound since December has been very linear. Yet, behind the scene, several sector and theme rotations have taken place. While Cyclicals (Transport, Industrials, Energy, Diversified Miners or Small caps) and Financials were very strong in January and early February, Growth themes then outperformed along with the sell-off in yields. Defensive sectors, on the other hand, lagged during most of Q1. We expect these rotations to continue during April. Our general view is that the market may be ripe for a correction and that Cyclicals may suffer the most. This article provides an overview of this scenario. Other articles in this issue of The Capital Observer will review Oil and Energy, Yields and Financials and Commodities in more detail.

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



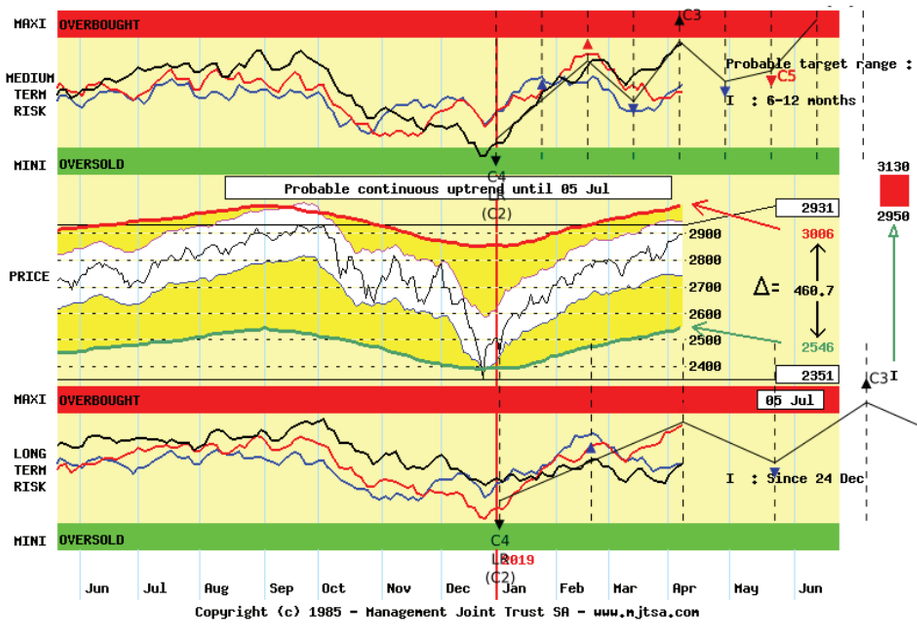
The Q4 sell-off on equity markets pretty much held our C Corrective targets to the downside (right-hand scale). Hence theoretically, the uptrend since 2016 is still in place. Both our oscillator series (lower and upper rectangles) are also constructive, probably into the Summer, perhaps the Fall. Yet, the whole price action since early 2018 is looking more and more like a high level distribution. Indeed, our larger yellow envelope has flattened (middle rectangle), while our thinner white one is showing several exaggeration points to the upside (contacts points to the upside against the larger yellow envelope). Such patterns are often found during rounding tops, where following several upside retests, the trend finally turns lower. Hence, **we do expect one last push higher over the next couple of quarters, potentially towards marginal new highs as indicated by our I impulsive targets to the upside (right-hand scale). Yet, by year-end, a new period of downside correction could materialize, probably towards 2020, and it could easily retest last year's lows.**

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



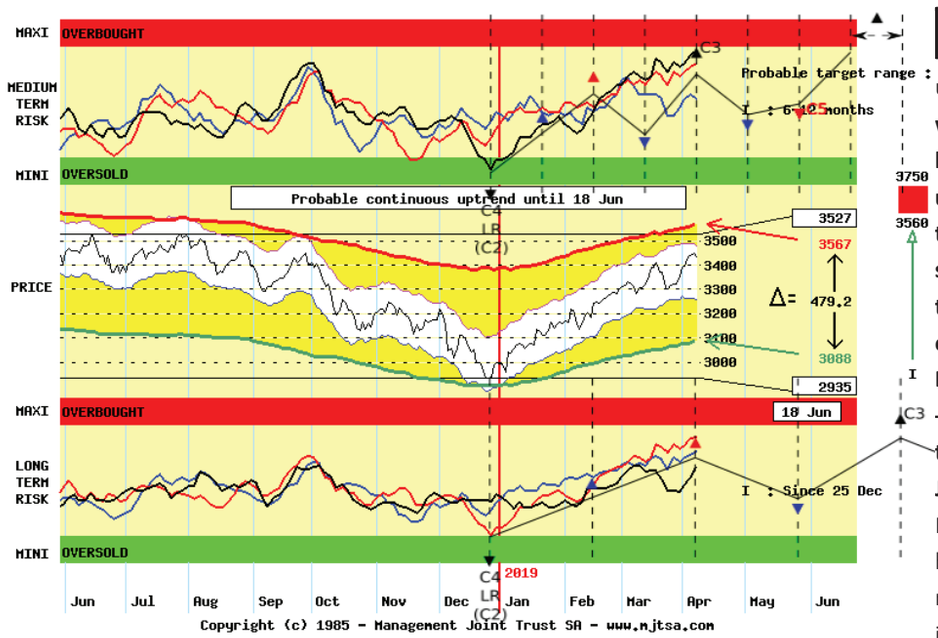
The EuroStoxx 50 has also seen an impressive bounce since December. Both oscillator series (lower and upper rectangles) seem to indicate that it could continue to rise into midyear, perhaps the Summer. For now, **the downtrend since 2017 is still in place, and the current rebound must still be considered as counter-trend. Hence, while the EuroStoxx 50 may attempt to make new highs, it will probably struggle to do so. At least, it should continue to rise for another several months. Then, during the Summer, it could top out again and start to reverse down.** By late 2019 / 2020, it may retest our C Corrective targets to the downside (right-hand scale), perhaps even more.

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



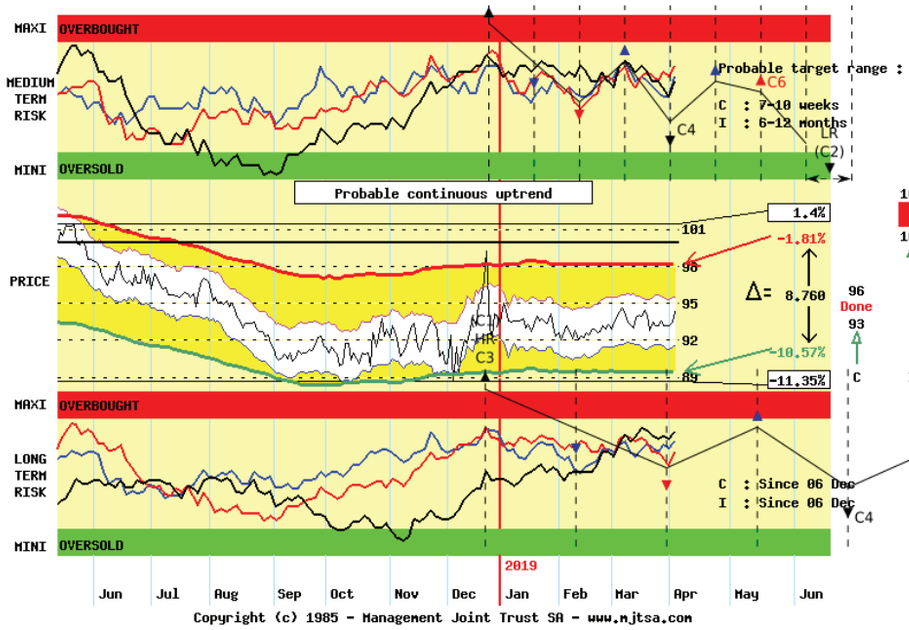
The Daily graph of the S&P500 is now in a strong uptrend. On both our oscillator series (lower and upper rectangle), we expect it to continue higher into June / July, at least. Our I Impulsive targets to the upside (right-hand scale) are pointing to new all time highs between 2'950 (marginal new highs) and 3'130 (200 points, or circa 7% above last year's highs). We still believe that such a move would constitute a further upside retest, before another correction to the downside materializes towards year-end. **In the meantime, however, both oscillators series are approaching an intermediate top. It could trigger a 3 to 6 weeks consolidation to the downside between now and late April, perhaps early/mid May. Our general view remains that it could move down towards the 2'750 – 2'650 range**. The depth of the correction will probably depend on how broad it actually is. Indeed, in this issue of The Capital Observer, our general scenario is that Cyclicals could suffer a further sell-off vs the market. The resilience of Growth and Defensive trades will hence determine how well the market actually holds up.

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



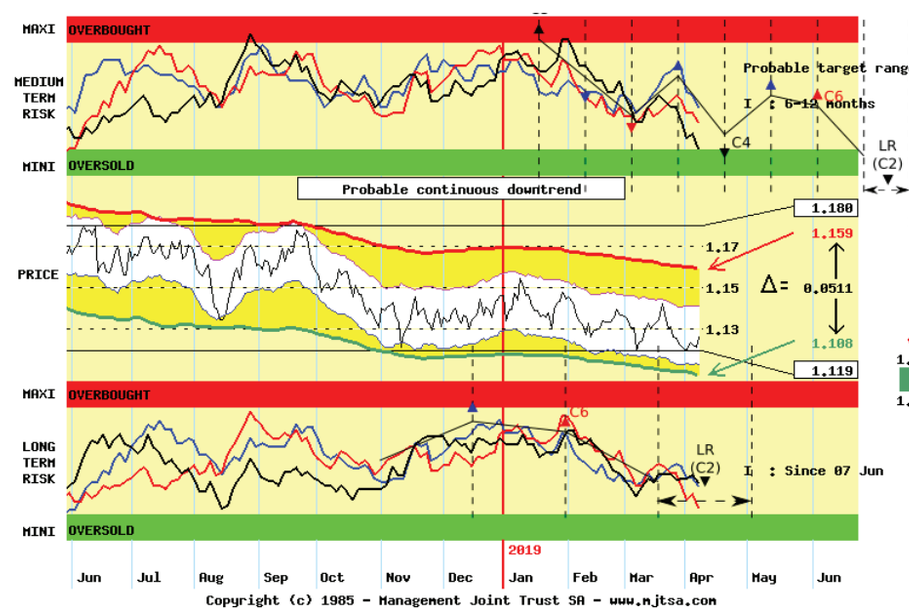
It's hard to be too pessimistic when considering such a strong linear uptrend. Yet, **over the next few weeks, the sequences we show on both oscillator series (lower and upper rectangles) are also pointing to some consolidation to the downside. We expect it to start soon, and to continue into late April, perhaps early May. During this period, the EuroStoxx 50 could revisit the 3'300 – 3'200 range. From early/mid May, the trend then resumes higher into June, perhaps July** and towards our I Impulsive targets to the upside (right-hand scale) into the 3'550 – 3'740 range. Again, it may come close to its 2017 highs, and may even surpass them, although the downtrend on our Weekly graph rather precludes new highs.

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



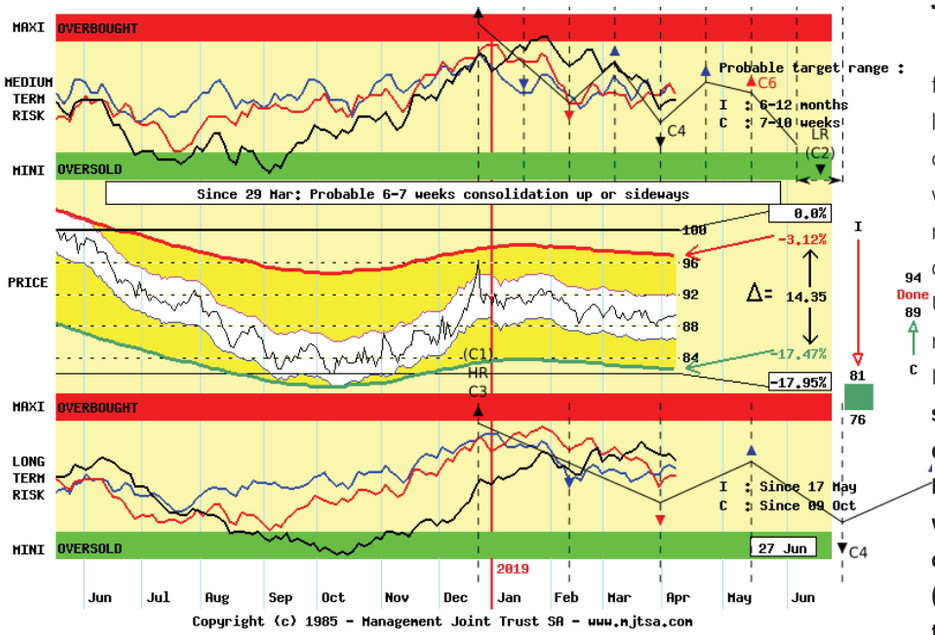
In the graphs above, both US and European markets look strong towards midyear. In the meantime, both could also suffer an intermediate correction during April. **Interestingly, over the last 6 months, Europe seems rather Defensive vs the US**. We believe this is mostly a matter of fund flows as investors repatriate funds towards their domestic markets when the US equity markets weaken, and reallocate to them when these rise. Both oscillator series (lower and upper rectangles) are suggesting that following 3 months of underperformance (especially from late December to mid February), **Europe may have reached an intermediate low vs the US. We hence expect Europe to outperform the US until late April, perhaps early May. We believe this is indicative of some sort of equity market consolidation.**

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



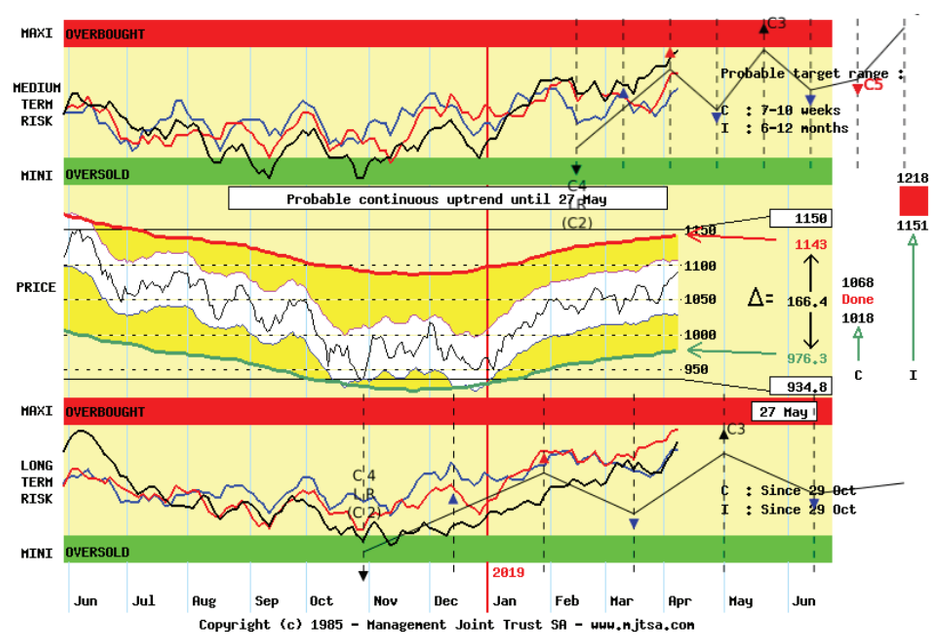
If the relative performance of Europe vs the US is currently a question of fund flows, the EUR/USD exchange rate may also be. Indeed, **it is interesting to note, that during the Q4 market correction, EUR/USD did act rather defensive, a least during November and December**. Following that, during the recent rally, EUR/USD has been gradually pushing lower. On both oscillator series (lower and upper rectangles), we expect EUR/USD to make a new intermediate low between now and mid April. It could then bounce into early, perhaps late May. Over the next week or so, **we cannot exclude a last sell-off towards our I Impulsive targets to the downside (1.11 – 1.09 range; right-hand scale)**. Yet, our main view is that a weak EUR/USD rebound from mid April to early May could match a more defensive environment, and that European markets could then rise with EUR/USD as funds repatriate to Europe.

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



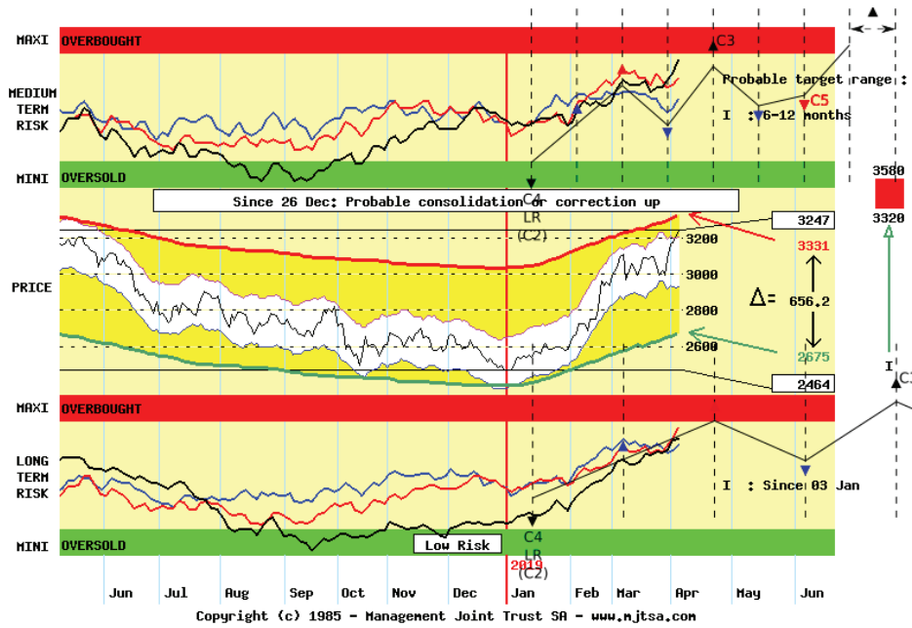
The ratio of Emerging Markets vs the US further highlights these flows. Indeed, in Spring and Summer last year, the US was on the right side of the growth differential (US growth was accelerating, while, in other regions, growth was slowing). Yet, during the 4th Quarter last year, the US re-coupled to the downside. Other markets then started to outperform. In fact, in today's world, **cyclicity is still very much driven by the ups and downs of the US economy. Emerging Markets then offer an alternative when US growth slows, or cyclicity corrects down. Both oscillator series (lower and upper rectangles) suggest that such a period may lie ahead, probably from now into late April, possibly early May. We hence expect Emerging Markets to outperform again over the next few weeks as the environment briefly turns more defensive.**

MSCI Emerging Markets Index
Daily graph or the perspective over the next 2 to 3 months



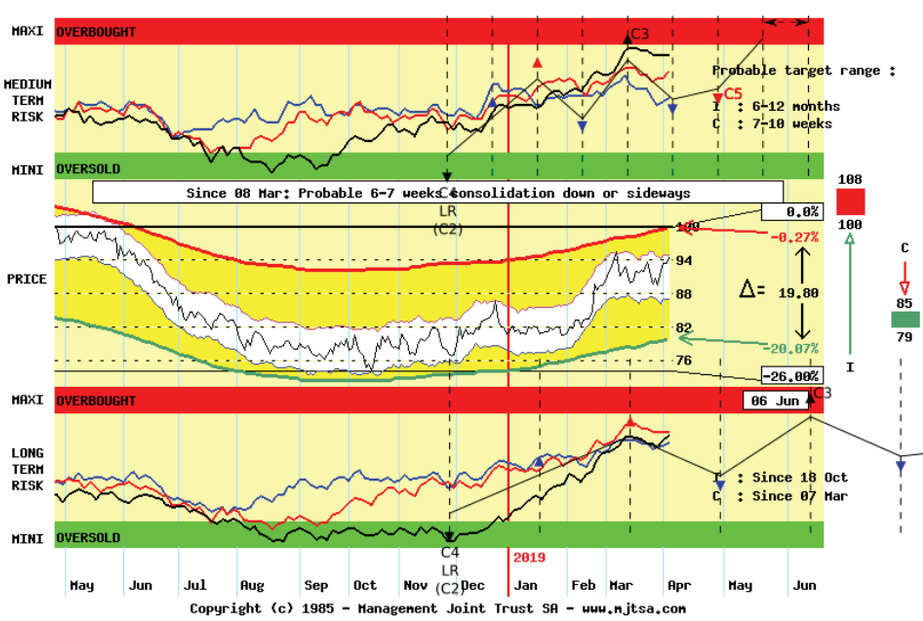
On an absolute basis, as with other markets, the **MSCI Emerging Markets Index, may also see a slight consolidation during April as shown on our medium term oscillators (right-hand scale). On our long term oscillators (lower rectangle), however, the current uptrend may continue higher, rather unscathed, until late April/ May**. This apparent resilience over the next 2 to 3 months may be the result of some rotation within Emerging Markets. As we show below, we first expect China to hold up rather well during April. Then, from May, Commodity producing regions such as Latin America and Russia should pick up the lead and accelerate higher. **Over the next 2 to 3 months, the upside potential for the wider Emerging Markets Index is still quite compelling. Our I Impulsive targets to the upside (right-hand scale) point to the 1'150 – 1'217 range, or 6 to 13% above current levels.**

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



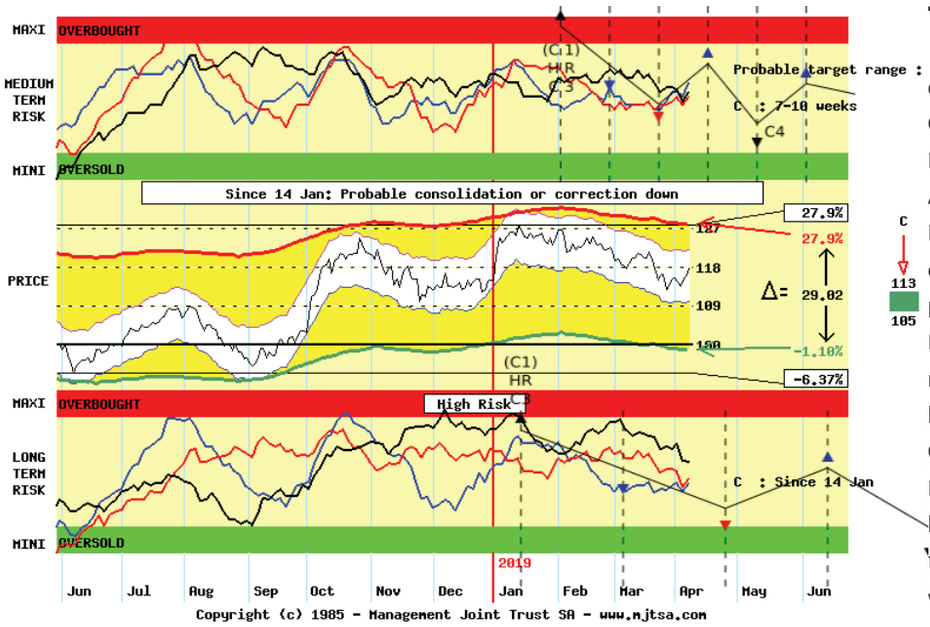
The recent Chinese break-out has been impressive. On both our oscillator series, we expect it to continue into mid/late April in first instance. We would then expect some consolidation into late April, early May, before China resumes higher into mid year. Our I Impulsive targets to the upside (right-hand scale) suggest further upside towards the 3'320 – 3'580 range (up to 10% higher than today). **We hence expect China's uptrend to remain rather resilient over the next few weeks, while other equity markets may enter a consolidation period.**

Shanghai Composite Index vs the All Country World Index (in USD terms)
Daily graph or the perspective over the next 2 to 3 months



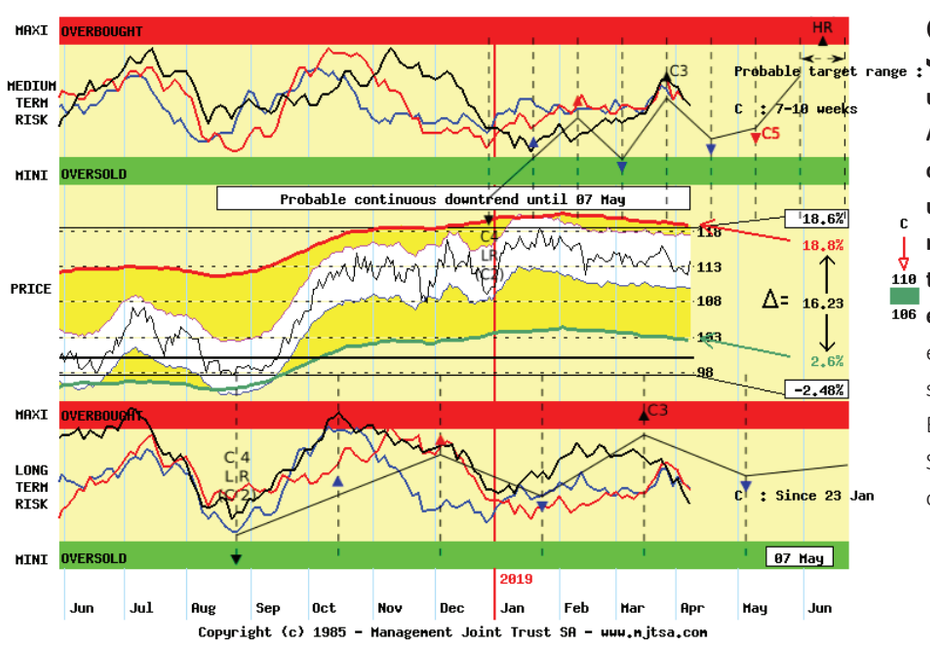
Following its break-out in February, China did lag other equity markets during March. Our medium term oscillators (upper rectangle) now suggest that it has probably started to accelerate up again vs the All Country World Index. Both oscillator series are showing that **this outperformance may last until May, perhaps even early June. Our I Impulsive targets to the upside (right-hand scale) point to a further 7 to 15% of outperformance until then.**

MSCI Latin America vs MSCI Emerging Asia
Daily graph or the perspective over the next 2 to 3 months



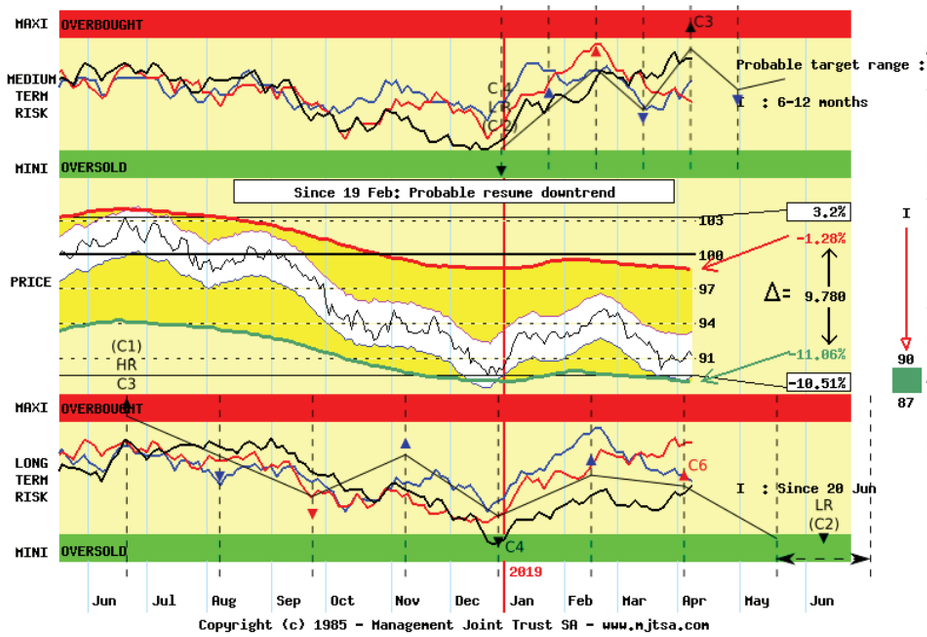
The title of this article suggests that we expect a cyclical correction during April. Comparing other Emerging Markets regions to Emerging Asia highlights this scenario. Indeed, while Emerging Asia is often considered a "Growth" play, Latin America and Eastern Europe (mainly Russia) are more cyclical as they are very linked to the performance of Commodities, and Oil especially. For this relative comparison, we have decided to exclude China from Emerging Asia as it appears very strong, and constitutes a large part of the Emerging Asia index, thereby skewing the analysis. Instead, we compare the MSCI Latin America Index to an cap. weighted portfolio of Emerging Asia's other 3 large constituents, South Korea, Taiwan and India. The graph shows that **Latin America has been underperforming Emerging Asia since mid January. On both oscillator series, we expect this underperformance to continue over the coming weeks, probably until late April, perhaps early May. In our view, this highlights that cyclical themes could remain weak during April.**

MSCI Eastern Europe vs Emerging Asia ex China (S. Korea, Taiwan, India)
Daily graph or the perspective over the next 2 to 3 months



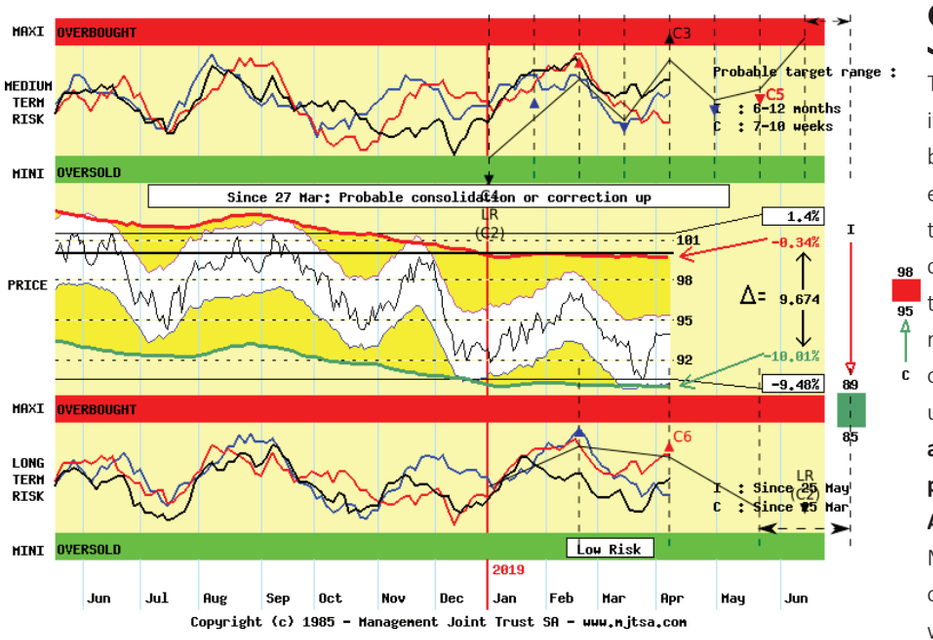
Similarly, since mid January, Eastern Europe has also been underperforming our Emerging Asia portfolio ex China. On both oscillator series (lower and upper rectangles), we expect the ratio to remain under pressure towards late April, perhaps early May. Following that, from early/mid May, Eastern Europe should resume its uptrend vs Emerging Asia, probably into the Summer. Russia especially should outperform, along with Oil.

Russell 2000 Index vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



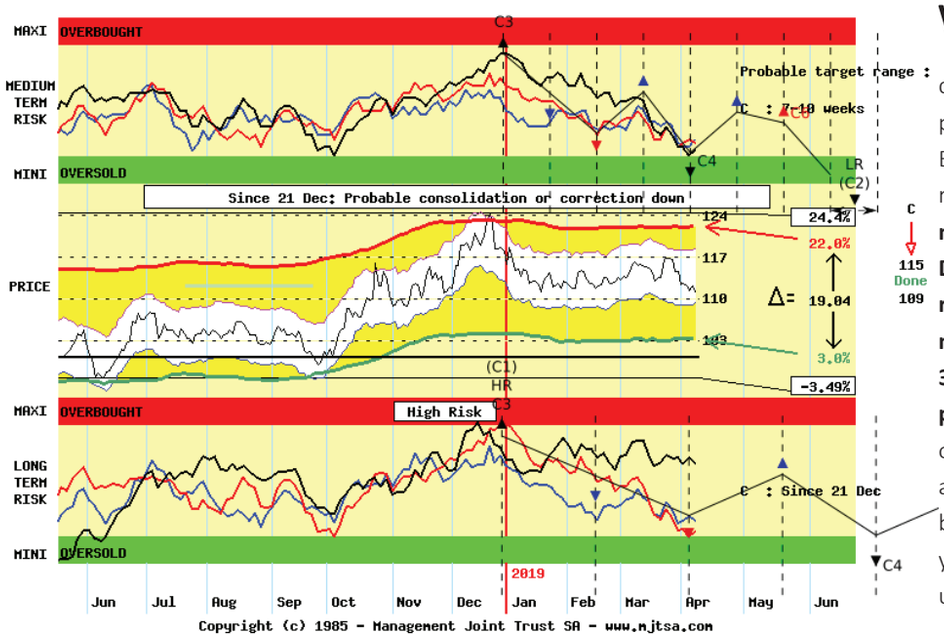
As another cyclical play, we also consider the Russell 2000 Small Cap index vs the S&P500. It had led the rebound from late December into late February. Since then, it has been retracing. Both our oscillator series (lower and upper rectangles) are now suggesting that **the ratio should resume lower again into late April, perhaps May**. Our I impulsive targets to the downside (right-hand scale) point to some remaining downside potential.

IYT - iShares Dow Jones Transportation Average ETF vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



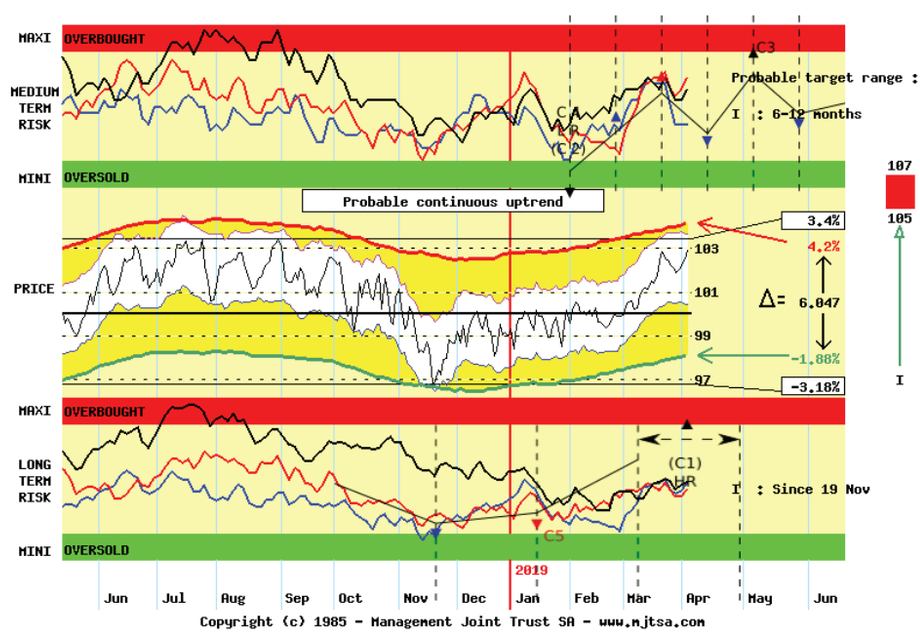
Similarly, we look at another cyclical ratio, the one of Transports vs the S&P500. Recently it has stabilized and may be building a base (our larger yellow envelope has flattened and our thinner white one is showing contact/exaggeration points to the downside against it; middle rectangle). Yet, according to both our oscillators series (lower and upper rectangles), **the ratio could also see one last push lower, probably from now into late April, perhaps May**. Then, from May, Transports should start to outperform the market, probably with a strong move into the Summer.

S&P US Utilities sector vs S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



We now switch to the US Utilities sector, probably one of the most defensive equity profiles (i.e. a bond proxy) and compare it to the S&P500. Both oscillators series (lower and upper rectangles) suggest that **following 3 months of underperformance since December, US Utilities might be getting ready to rebound vs the S&P500. The move up vs the market could last between 3 to 6 weeks, probably into late April, perhaps into early May**. This corroborates our general defensive view into late April, and probably also indicates that there could be one last move lower left on long term yields (before they bottom out and reverse up towards the Summer).

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



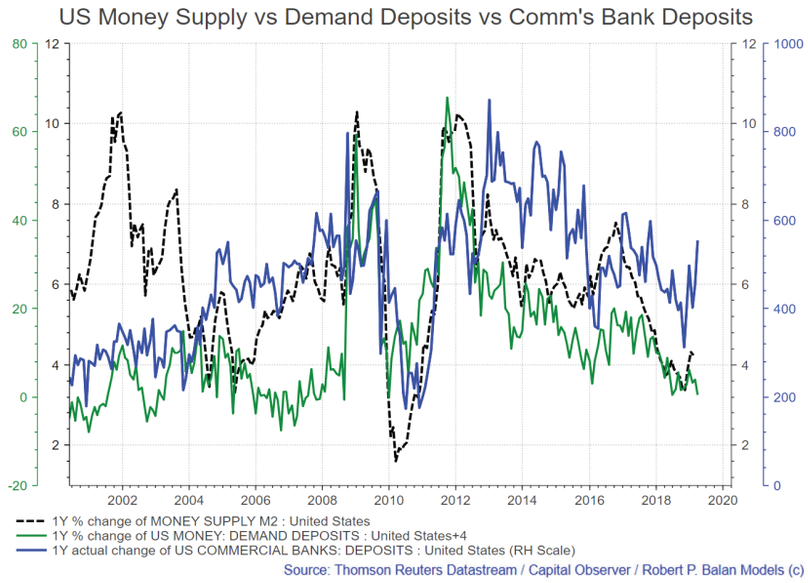
As Cyclicals underperform and Defensive rebound vs the market, **Growth stock may continue to outperform slightly during April**. Both our oscillator series (lower and upper rectangles) would confirm this view, **probably into late April, early May. The upside potential for the Nasdaq 100 vs the market is still quite compelling, between 2 to 4% according** to our I Impulsive targets to the upside (right-hand scale). Our view is that Growth trades should continue to profit from the fact that interest rates should continue to retest to the downside, probably into the end of the month. Hence, again, while Growth and Defensive sectors outperform, cyclicals could suffer during April.

Concluding remarks

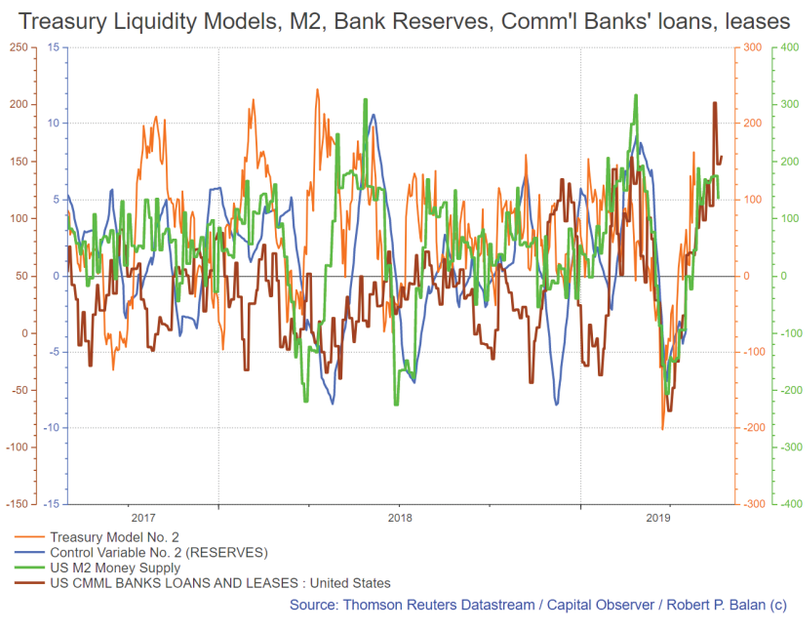
Equity markets now seem well positioned to continue higher into the Summer. US markets may achieve marginal new highs, while European markets could come close to their 2017 ones. In the meantime, however, most equity markets seem to be reaching intermediate tops. These could trigger an intermediate correction, which could last 3 to 6 weeks, into late April, perhaps early May. The S&P500 may retrace back down to the 2'750 – 2'650 range. Relative ratios between the US and Europe, or Emerging Markets, seem to confirm this scenario. Indeed, they have been rather defensive since December (underperforming the S&P500), yet could now be getting ready to bounce. More generally, we believe Defensive and Growth themes should outperform during April, while Cyclical ones should bear the most of the downside consolidation we expect (e.g. Small Caps, Transports, Latin America, or Russia).

23 / The Fed and bond yields: monetary policy is on hold, but a build-up of systemic liquidity will push up yields

President Donald Trump is calling for a major change in the stance of the Federal Reserve System in order to keep the economy from stalling; Mr. Trump suggested that the Fed cut rates and stop shrinking their balance sheet. **But is the Fed monetary policy really restrictive as implied by Mr. Trump and his economic adviser, Mr. Larry Kudlow? The Capital Observer asks these questions, and points out a few issues that say otherwise.**



If one looks at the growth of the money stock, the broader M2 Money Supply, we see that year over year for the four weeks ending March 26, 2019, was 4.2 percent. For comparison, the December 2017 to December 2018 growth rate of the M2 measure was 4.5 percent, which was down slightly from the 4.9 percent rate of growth from December 2016 to 2017. All these figures however were substantially below the 10.42% growth in money supply in January 2009, when the recovery from the Great Financial Crisis started. *(see 1st graph on this page)*



However, the current M2 level compares favourably with the levels seen in normal years when there was no financial or growth crisis. Therefore, in terms of the historical data, this does not represent a banking system that is restricted at all. There is no indication that the US banking system is feeling any kind of restraint from monetary policy. **In fact, we feel that development in sharp money growth may start getting attention from the Fed at some point over the next few months.**

We single out the M2 money Supply because it is the most visible evidence of the money creation activity of the banking industry. In the 2nd graph on this page, we juxtapose the loan assets of the US commercial banking sector with the M2 money supply. The significance of the good fit is due to the fact that loans creates deposits which in turn creates new money. **Loans, and therefore eventually the M2 supply, have been rising briskly which would have a consequence on the bond yields at the long end in a short while.**

Looking at another measure of commercial bank liquidity, the Reserve Balances with Federal Reserve Banks, a proxy of "excess reserves" in the banking system, **we see that commercial banks have over $1.6 trillion in excess reserves (see graph below). This figure has been reduced from $2.2 trillion on September 27, 2017, just before the Fed began to shrink its securities portfolio, but well below the $2.999 trillion held by the commercial banking system in 2014 during the recovery from the Great Financial Crisis of 2007-2008**. As a foot note, the US commercial banking system kept "excess reserves" of less than $10.0 billion for most of the 2000s.

There are two things that dominate in the US banking system right now. First, the Federal Reserve continues to conduct monetary policy in a way where they err on the side of too much monetary ease. The Fed doesn't want to "make a mistake."

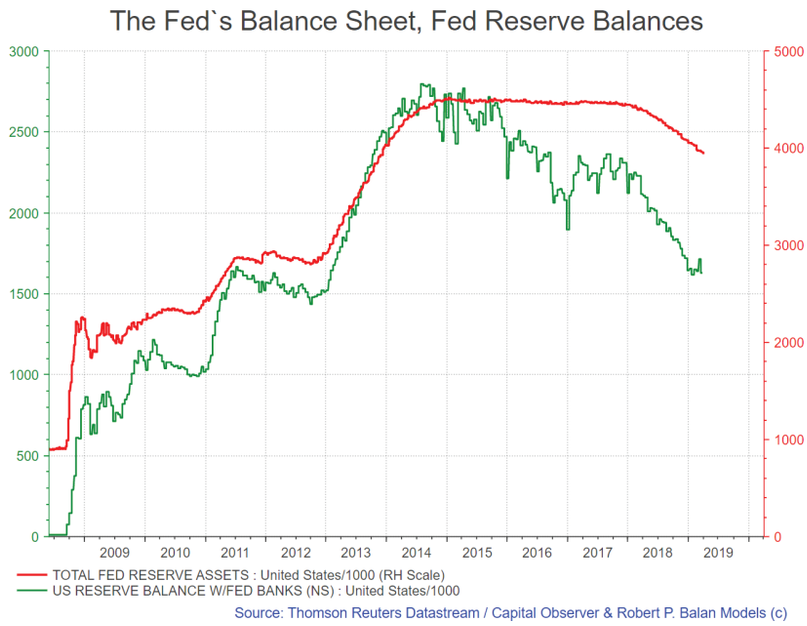
Second, the US commercial banking system is behaving conservatively. And probably that is what is causing the cautious growth outlook at the present. They do not want to upset the cart by "ticking off" the regulators, or

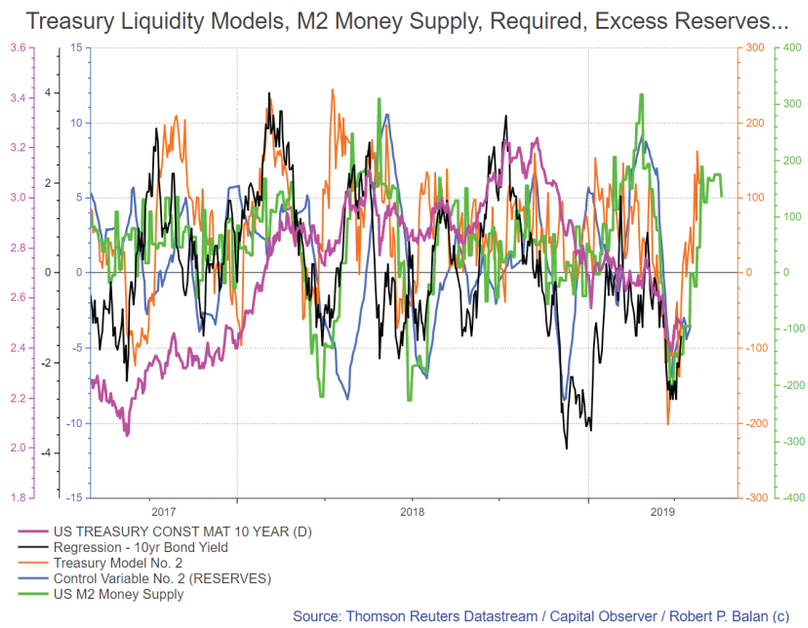
by being too aggressive on the lending side, despite a significant uptick in loan growth over the past few weeks.

Mr. Trump has also attacked the Fed's reduction of their balance sheet. The Federal Reserve has been shrinking its portfolio of securities since September 27, 2017. Between that date and the end of the most recent banking week, the securities portfolio, including the premiums and discounts recorded on the Fed's balance sheet, has declined by $518 billion (*see 1st graph on this page*). This is a little less than the Fed originally scheduled, but close enough to fulfil their promise.

Also, Reserve Balances with Federal Reserve Banks, the proxy for commercial bank "excess reserves", declined by a little more than this, approximately $550 billion. The $550 billion drop represents a 25 percent decline in commercial bank excess reserves as shown on the Fed's balance sheet. That reduction pace has been prudent in whatever metrics you measure it against.

By September, the U.S. central bank said its current practice of allowing up to $50 billion of Treasuries and mortgage-backed securities (MBS) to roll off its balance sheet each month will come to an end if the economy evolves "about as expected."





With this as background, it is easy to understand why the Fed's monetary policy is neither here nor there – they are on a "waiting phase" and so a pause is probably warranted. However, we feel that it is a mistake for the bond market to assume that the Fed will cut rates, or even more extreme, resurrect the Quantitative Easing program and its Large Sale Asset Purchases (LSAP). <u>Therefore, it may also be a mistake to assume that the bond rally will continue and bond yields will continue to fall further.</u>

Here is why:

Bond yields are always, and everywhere a systemic liquidity phenomenon. Put differently, bond yield changes are creation of liquidity inflows and outflows (*see 2nd graph above*). As example, we show a model of liquidity flows from the Fed's SOMA in juxtaposition with the monthly change rate of the M2 Money Supply. The models tell us that bond yields are about to bottom in this cycle and should expect a sharp rise in the 10yr yields (and other long bond yields) going into the next few months. The culprits will likely be strong positive flows from M2 supply (given the sharp loan growth in the past several weeks), and the decision of the Fed to cease reduction of its balance sheet (which also means that henceforth, the monthly change rates of the bank reserves at the Fed will change to positive). **Rising liquidity flows translate into rising bond yields. That is, these are some of liquidity flow sources, among others, which would act in concert to push up yields very soon.**

Bond yields will also be held hostage to the risk of rising Core PCI over the rest of the year. Core CPI has been tame, but that will likely change very soon. Wage growth and a host of job remuneration data have been rising sharply for the past several quarters, but it takes from 9 months to a year before these strong, positively skewed data are reflected fully on Core CPI (*see 1st graph on this page*).

There is also the fact that Core CPI has been baked into the GDP cake 6 to 8 quarters ago. GDP growth (annual) has risen from 1.26% during Q2 2016 to 2.97% during Q4 2018. Core CPI is about to step up several notches higher until early 2020, regardless of whether GDP will grow or not in the interim. (*see 2nd graph on this page*)

Summary:

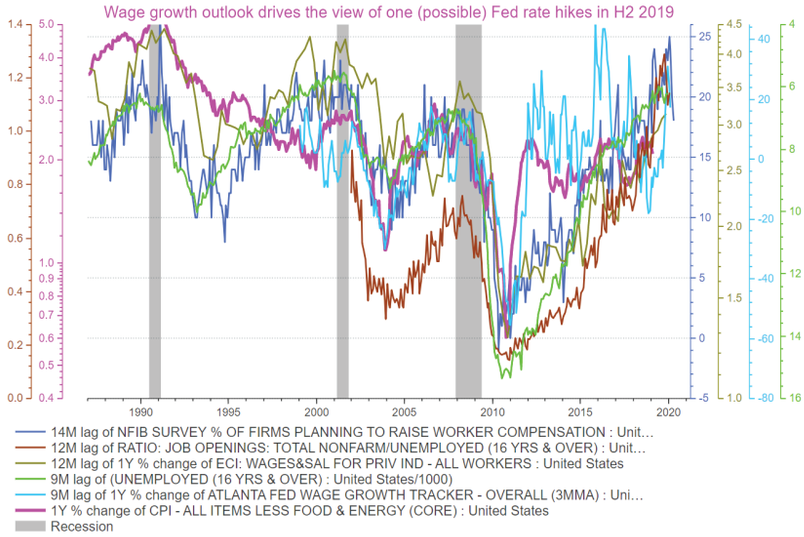
There is no evidence that Federal Reserve policies are in any way restricting the growth of the US economy or possibly setting the stage for a recession. And from the summary of their action, they are not probably preparing for a recession, either. The economy is not growing that rapidly, but the Fed is not the reason for this and there is really little or nothing it can do to speed up growth. **Certainly, the economy is not in extremis which warrants cutting rates or putting in place QE programs which would do Large Scale Asset Purchases (LSAPs)**.

In fact, what we fear is the reverse situation – the Fed may reconsider their decision to stay paused if/when Core CPI starts rising in earnest during the entirety of Q2 2019. They will likely tighten monetary policy, and bond yields will rise again. In fact, we believe that we are seeing the low point of the yield cycle, and that yields will be rising smartly over the next few months. The Fed and bond yields: monetary policy is on hold, but a build-up of systemic liquidity will push up yields

US NFIB growth and wage survey vs ECI raising wages and Core CPI

The strong wage outlook provides a case for rising Core CPI until Q1 2020

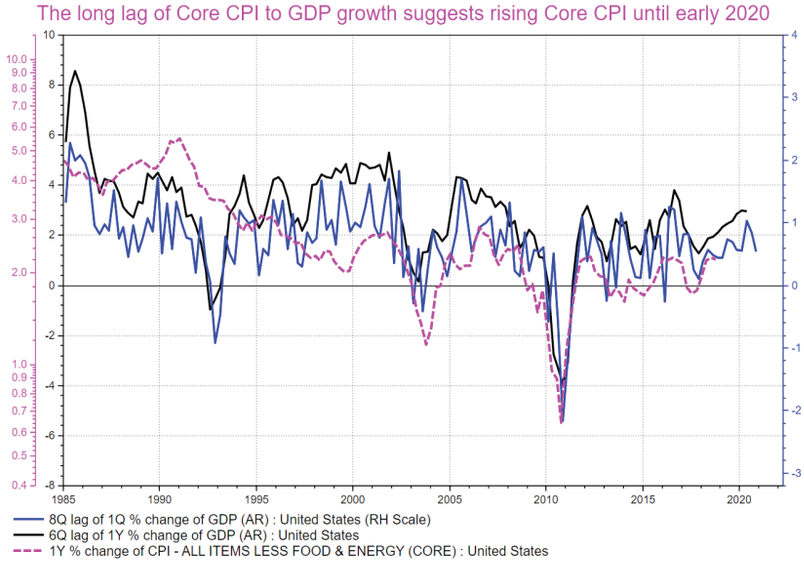
Wage growth outlook drives the view of one (possible) Fed rate hikes in H2 2019



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

US GDP (yoy and qoq) vs Core CPI

The long lag of Core CPI to GDP growth suggests rising Core CPI until early 2020



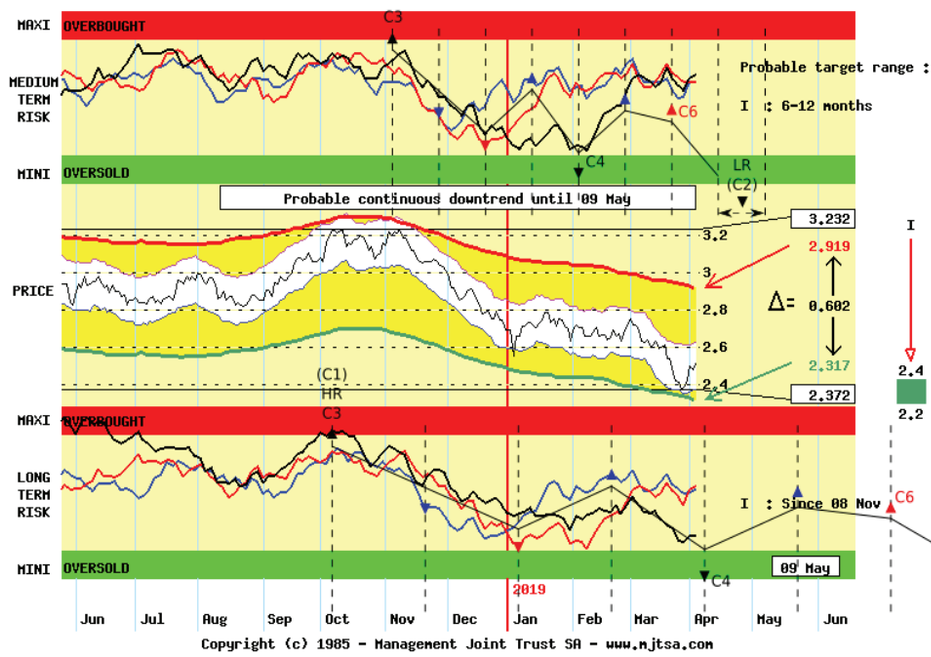
Source: Thomson Reuters Datastream / Capital Observer / Robert P. Balan Models (c)

26 / MJT - TIMING AND TACTICAL INSIGHT

Yields could see one last push lower, before reversing up strongly into the Summer

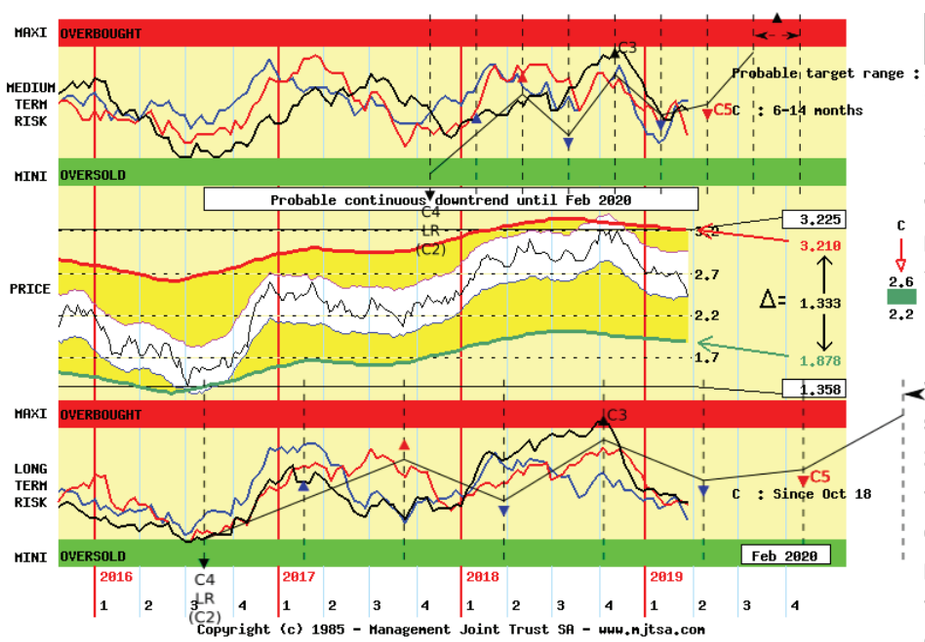
Last October we forecast a 60 to 100 basis points correction on US10 and 3Y yields. Our projections, which were then very much out of consensus, did materialize, first thanks to strong Flight to Safety flows during the Q4 risk assets correction, then as a consequence of the ultra dovish reversal in the FED's rhetoric. March saw another acceleration lower on yields, and although our targets to the downside have now been reached, we would still expect one last push lower over the next few weeks. In this article we review the current situation in order to assess when the current Treasury rally may finally top out and start reversing down.

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



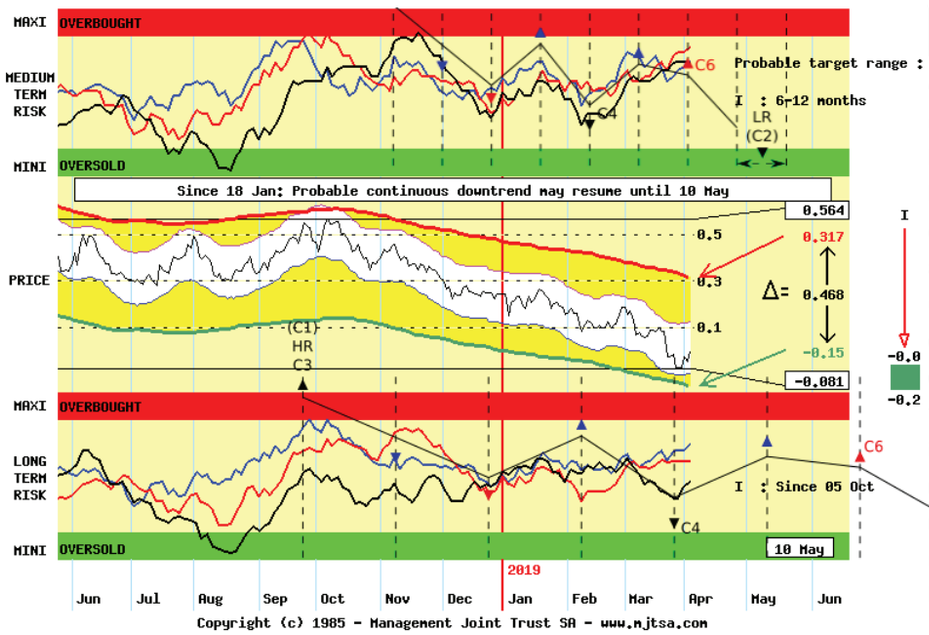
The downtrend on UY 10Y yields is well under way, yet our I Impulsive targets to the downside (right-hand scale) still point **to the possibility of a last retest down in the 2-4-2.2% range.** Indeed. While our long term oscillators (lower rectangle) may be signaling that a low point is near, our medium ones (upper rectangle) still suggest one last push lower into late April, early May. We believe that this second scenario may be correct as it matches our anticipation of some risk asset consolidation during April, as mentioned in other articles in this issue of The Capital Observer.

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



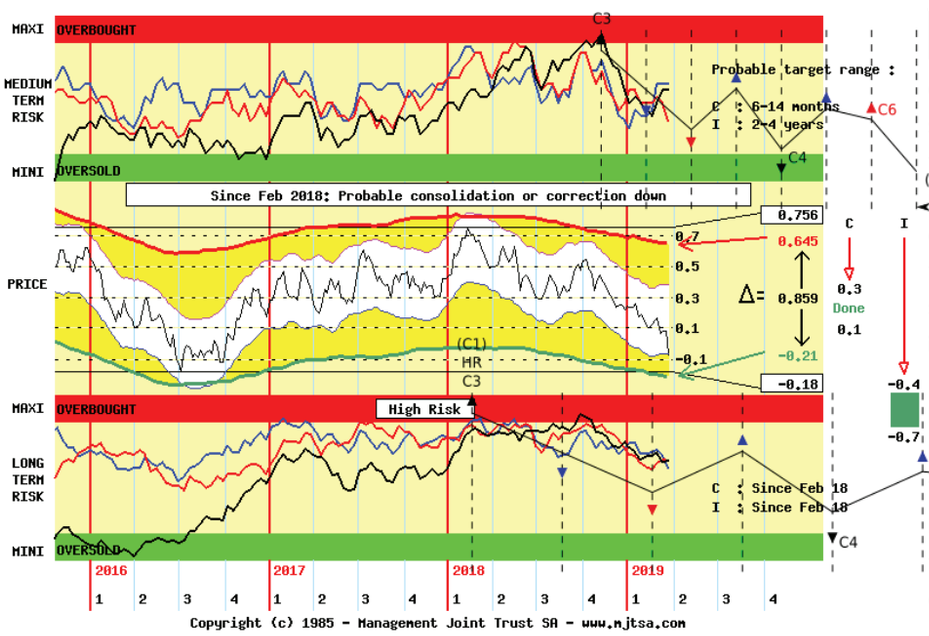
Longer term, the sequences we show on both oscillator series (lower and upper rectangles) also suggest that **the sell-off since October may not be quite finished yet. Indeed, both point to support points towards early/mid Q2**. On the targets front, the C Corrective potential to the downside (right-hand scale) is also not quite fulfilled yet. These may justify **further downside towards the lower end of the 2.6 - 2.2% range. Following that, from mid Q2 (May probably), we expect US yields to resume their previous uptrend, probably into the Summer. The move may be quite strong and for now, we still believe that it could retest last year's highs, above 3%.** Hence, over the next few weeks, we would seize the opportunity of a last push lower on yields to reduce duration risk.

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



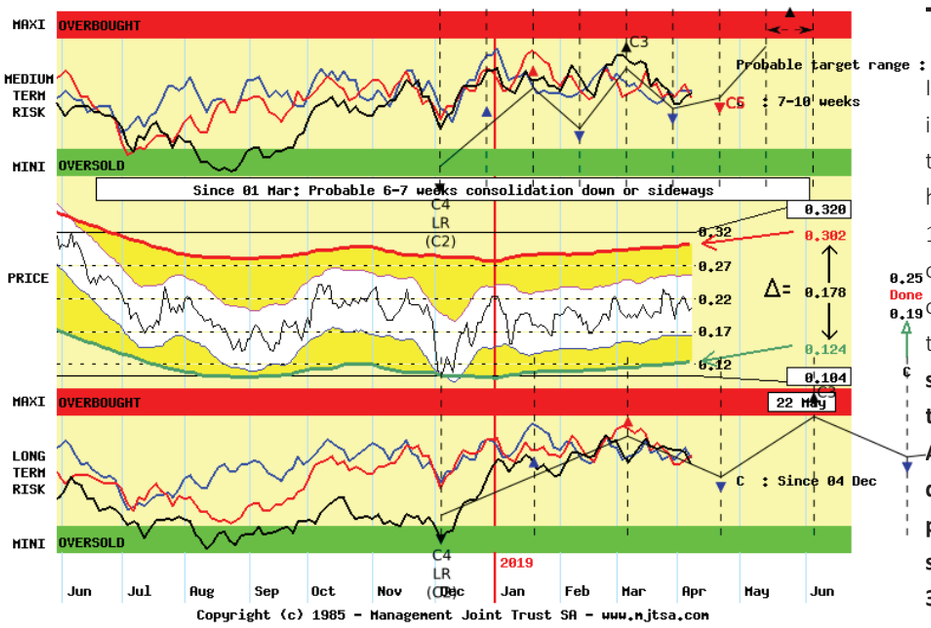
In Europe, 10Y German Bund yields have also followed a strong downtrend since last October. Similarly to US 10Y yields, they may have reached a first intermediate low late March on our long term oscillators (lower rectangle). Yet, here also, our medium term oscillators (upper rectangle) would suggest **one last push lower into late April, early May**. Our I Impulsive targets to the downside (right-hand scale) indicate a possible move **back into negative territory into the 0 to minus 0.2% range**. This again would match a potential risk asset consolidation during the rest of April.

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



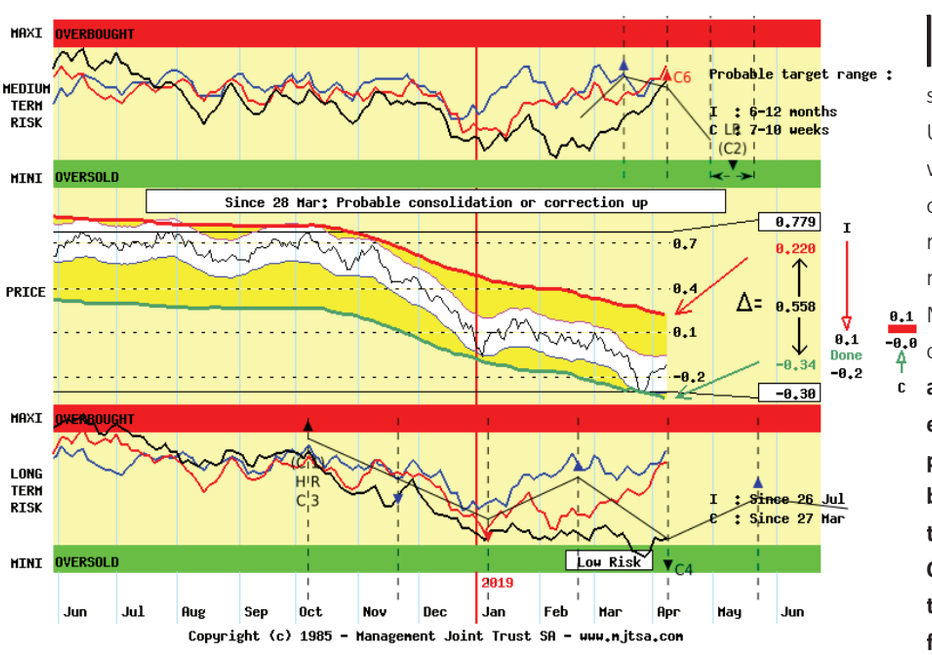
Longer term on the Weekly graph, German 10Y Bond yields could also take a bit more time to stabilize. Indeed, while our long term oscillators (lower rectangle) may have suggested some support during mid/late Q1, our medium term oscillators (upper rectangle) still point to **one last move lower into mid Q2 (late April / May)**. Following that, we would expect a bounce in German 10Y yields, probably from May into the Summer. The move down since early 2018 is now impulsive and according to our I Impulsive targets to the downside (right-hand scale) could end up much lower over the next 12 to 18 months (minus 0.4 – 0.7% range). Hence, any bounce will probably remain countertrend. In terms of targets, **we expect 30 and 40 basis points of upside rebound potential between mid Q2 and the Summer.**

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



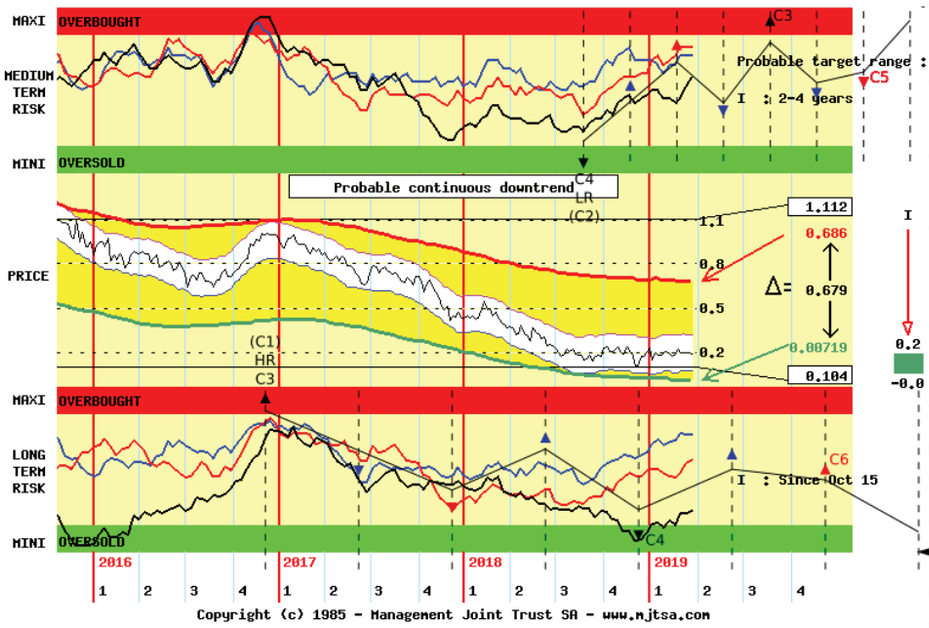
The yield curve may be already pointing to higher yields ahead. Indeed, despite the strong sell off in long term yields during March, the middle part of the yield curve hasn't moved much. In fact, the 10Y-3Y spread has remained flat over the last 3 months. On both our oscillators (lower and upper rectangles), **the spread may still move sideways, or even flatten a bit over the next few weeks. Yet, from late April, we believe it will start to rise quite dynamically, and this middle portion of the yield curve will then start to steepen. Once, the US10Y-3Y spread makes it above 0.25%, our next levels of targets (I Impulsive targets to the upside) would calculate in the 0.34 – 0.41 % range, or back to levels not seen since early Q2 2018. This may happen between late April and midyear**. It is interesting to note that the long end of the US yield curve (US30Y-10Y) has now been steepening for about 9 months. This analysis suggests, that the middle portion of the US yield curve should soon start to follow. With the FED having shelved its rate hike program, we believe it's only a matter of time until the short end (3Y-3M), and hence the whole US yield curve, then starts to steepen quite aggressively.

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



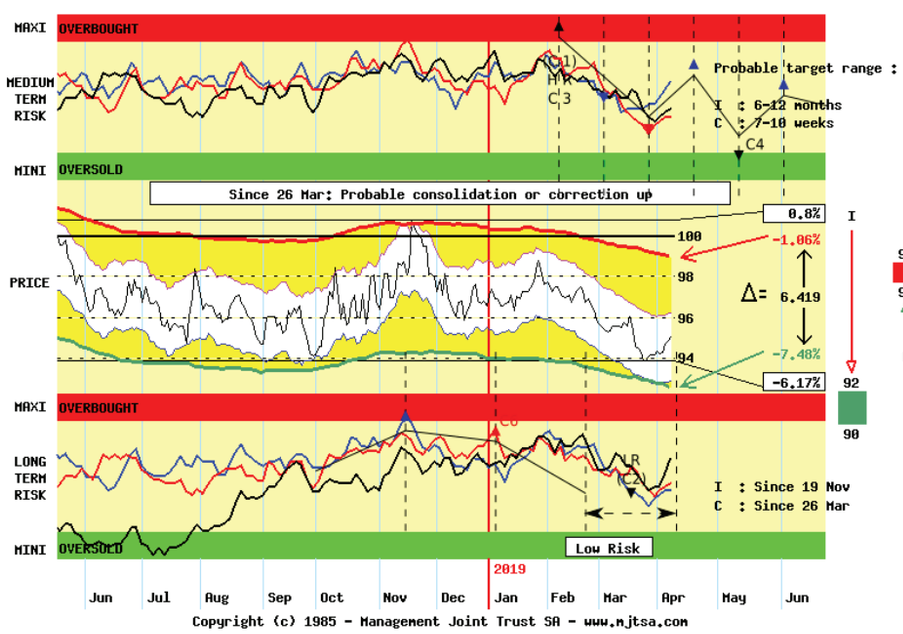
Indeed, the shorter end of the yield curve (US3Y-US3M) is very Oversold. With the FED on pause, the US3Y yields are now the show. As with US10Y yields analyzed above, our long term oscillators (lower rectangle) suggest that the spread may have bottomed already in late March. Yet, our medium term oscillators (upper rectangle) point **to a last move down into late April / early May. Hence, by then, we expect the whole US yield curve to be either moving up already, or for the shorter end to be extremely Oversold, thereby laying ground to the steepening scenario we expect from mid Q2 into the summer.**

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



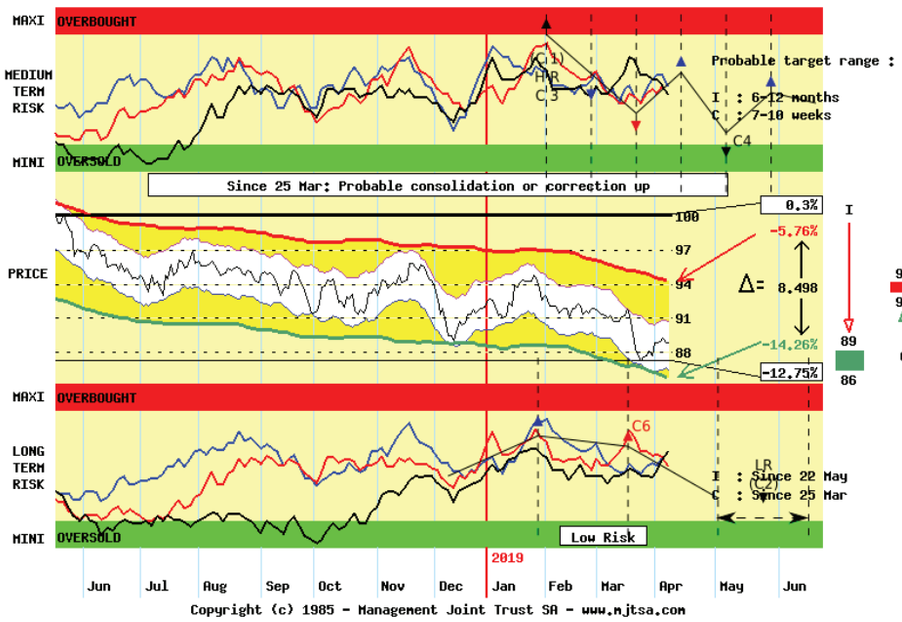
We now consider the Weekly graph of the middle portion of the US yield curve (US10Y-3Y spread). Here also, our long term oscillators (lower rectangle) may have bottomed already, during Q4. Our medium term oscillators (upper rectangle) may have even started an uptrend, although the sequence may still consolidate slightly during early Q2. **Following that, both oscillator series suggest that the yields curve starts to steepen again towards midyear and the Summer**. The C Corrective targets to the upside we can calculate for this move are between 0.44% and 0.65%, i.e. our historical volatility measure "Delta" (here at 0.679 – middle rectangle, right-hand side) multiplied by our 0.5 to 0.8 corrective factors, added to 0.104%, the low point of the graph. These are levels not seen since late 2017 – early 2018. **This move could be as strong as the steepening rally which materialized during H2 2016.**

IVE - iShares S&P 500 Value ETF / IVW - iShares S&P 500 Growth ETF
Daily graph or the perspective over the next 2 to 3 months



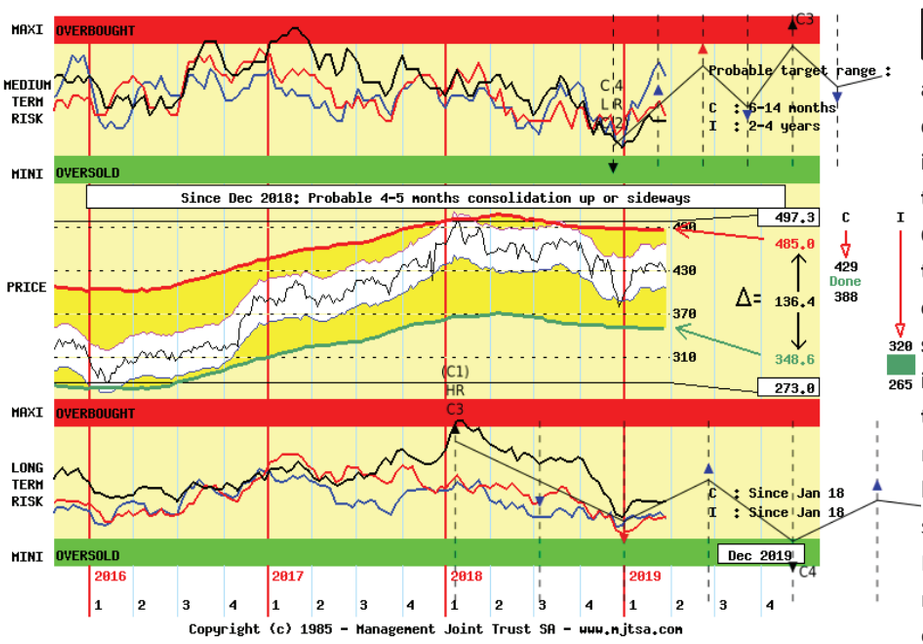
Historically, the US Value to Growth ratio is very much linked to the shape of the US yield curve. We believe it could also be bottoming out over the next month or so. Our long term oscillators (lower rectangle) are now in a "Low Risk" position, while our medium terms oscillators (upper rectangle) may justify a last push lower into late April, early May, but not much more (as with US10Y yields and the shorter end of the yield curve, i.e. US3Y-US3M). Following that, **we expect Value trades to reverse up, probably from May into midyear and the Summer. Again, this situation reminds us of H2 2016, when Value trades really took off during a 3 to 4 months period.**

S&P US Financials sector vs the S&P500 Index
Daily graph or the perspective over the next 2-3 months



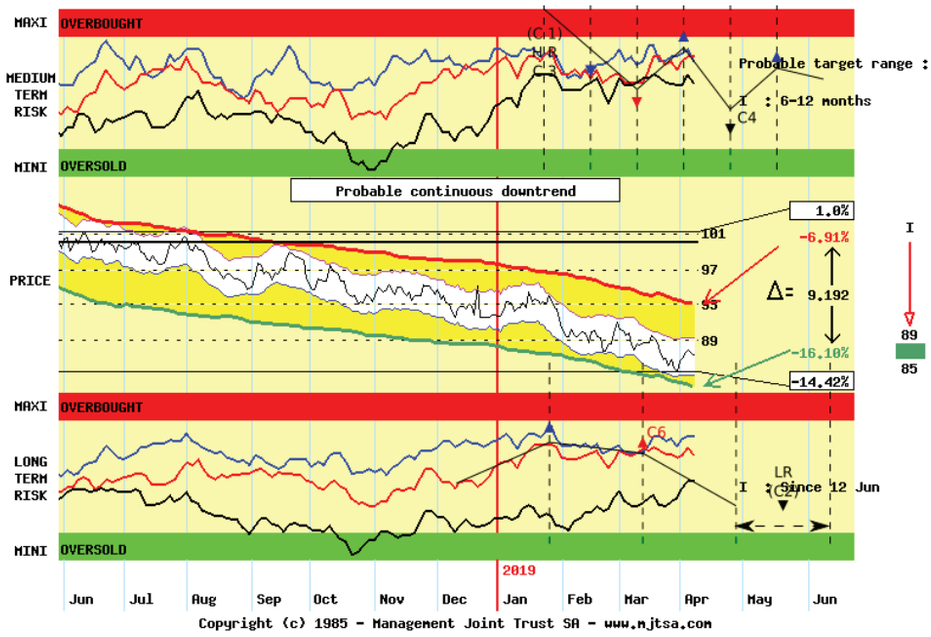
The US Financials sector is a typical Value driven sector. Here also, vs the S&P500, both oscillator series (lower and upper rectangles) are pointing to one last period of underperformance between now and late April, early May. Our I Impulsive targets to the downside (right-hand scale) are suggesting **3 to 4% of further underperformance over the next few weeks. Following that, US Financials should then start to outperform, probably from early May into midyear and the Summer**. Our C Corrective targets to the upside suggest at least 5 to 10% of outperformance potential during this period. Hence, towards late April, we will be looking to pick up US Financials for a strong relative play.

S&P US Financials sector
Weekly graph or the perspective over the next 2 to 4 quarters



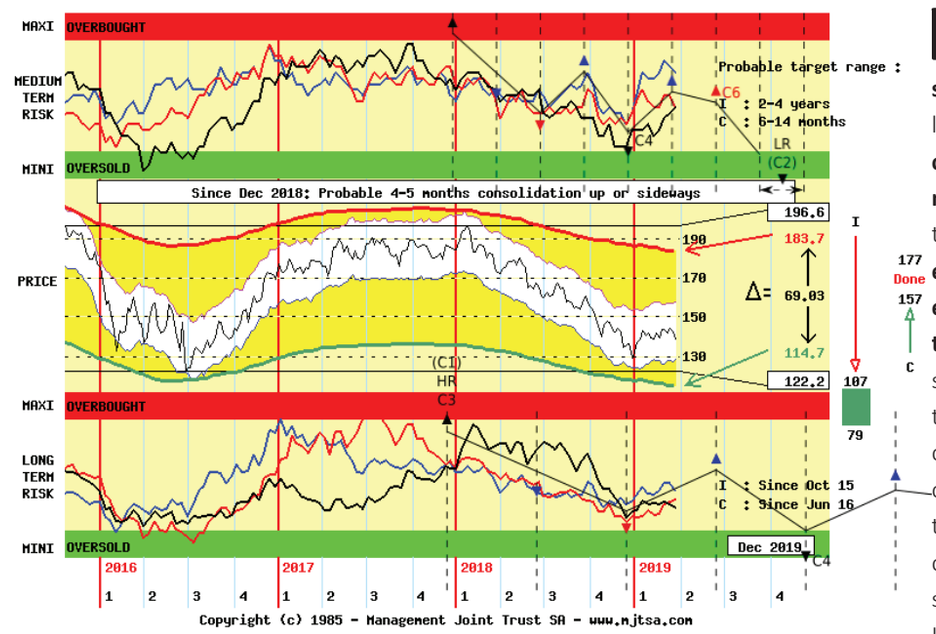
Longer term, on this Weekly graph, US Financials could see a slight dip during early Q2. Indeed, prices are still under the influence of the intermediate top that was probably made late Q1 on our medium term oscillators (upper rectangle). Yet, this corrective period may be quite short, and hence, by late April, it will probably be time already to start buying the Dips. The next move higher will probably last towards late Q2 / midyear as shown by both oscillator series. For now, we would consider the rebound since December as a counter-trend move and would hence favour the scenario we show on our long term oscillators (lower rectangle), i.e. rebound / retest into midyear and then further weakness during H2 2019.

Europe Stoxx Banks sectors vs the Europe Stoxx 600 Index
Daily graph or the perspective over the next 2 to 3 months



In Europe, following months of underperformance, Banks are now heavily Oversold on a relative basis. Yet, here also, both oscillator series (lower and upper rectangles) do point to **one last period of underperformance into late April / early May**. On the target front (right-hand scale) the move seems quite exhausted, having reached below of I Impulsive targets to the downside. **In general, we expect that by late April, European banks may represent an interesting Value opportunity, and that these may bounce vs the market towards midyear.**

Europe Stoxx Banks sector
Weekly graph or the perspective over the next 2 to 4 quarters



Longer term, on an absolute basis, European Banks have seen a weak rebound since December. On our medium term oscillators (lower rectangle), **they are currently correcting back down, following an intermediate top made late Q1** on our medium term oscillators (upper rectangle). **We then expect them, probably from late April / early May, to make another attempt to the upside, probably towards midyear** as shown on both oscillator series. Following that, European Banks should resume their downtrend during H2 2019, probably towards the Fall and year-end. Over the next 12 to 18 months, our I impulsive targets to the downside (right-hand scale). are still quite scary, some 30 to 40% below current levels. Hence, it may be interesting to play a short European Bank rebound during mid/late Q2, but we would then warn not to overstay.

Concluding remarks

Yields across the US and European yield curves have lost between 60 and 100 basis points since October. This move, which we had correctly anticipated doesn't seem quite finished yet, and in both regions, we expect a few more weeks of downside retesting, probably into late April, early May. Following that, US yields may then attempt to retest their 2018 highs, probably over the next couple of quarters, while we expect German 10 years Bund yield to correct up between 30 and 40 basis points into midyear, perhaps early Summer. This reacceleration up in US yields, which we believe could start in a few weeks, should then confirm that the flattening of the US yield Curve is over for now. With the FED having shelved its rate hiking ambitions, the US yield Curve should steepen quite rapidly into midyear and the Summer along with long term rates. These developments should favor low duration Value trades such as Financials and Banks, and we would expect them to rebound quite nicely vs the market, probably during May, June and perhaps into Summer.

32 / Template for a significant oil price recovery into 2020, but before a short-term decline could happen into May

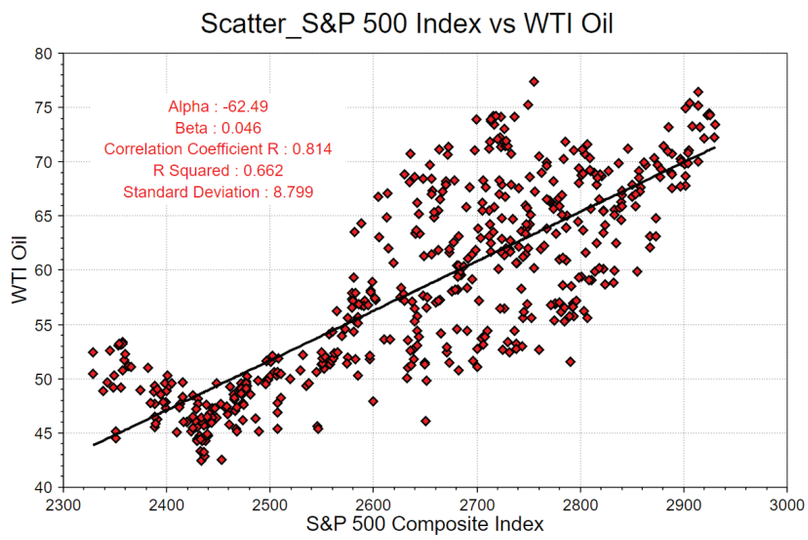
Oil prices are practically slaved to equities to such a high degree that it is very frustrating to see gasoline and oil prices ignore the sharp decline in gasoline demand and consumption in the past several weeks. (*see 1 st graph on this page*)

Oil prices also briefly came off the boil after an unexpectedly large build in US oil inventories reported Wednesday, last week. But with the equities rising again thereafter, oil prices broke through to new highs for the year.

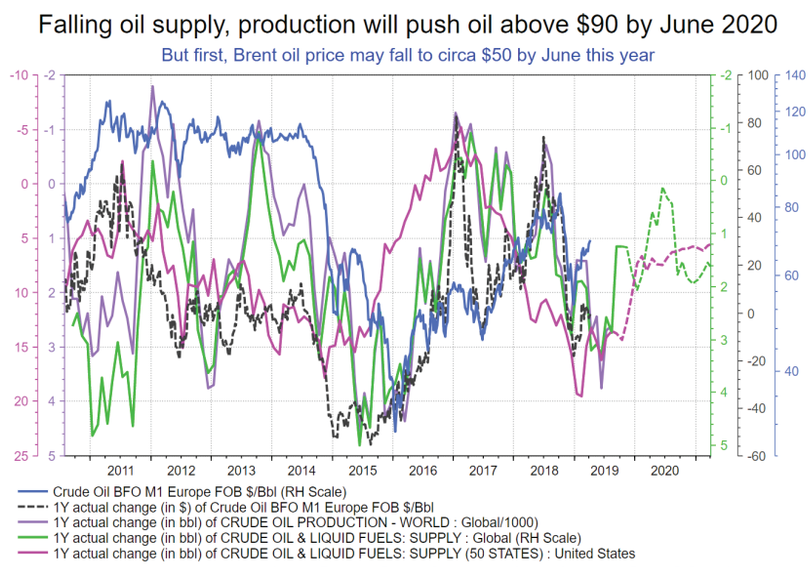
The media is focused on the reduced output from OPEC+NOPEC, but as we pointed out at The Capital Observer in past issues, the full impact of changes in production comes after a very long lag. There is no application of the Efficient Market Hypothesis (EMH) in the process that goes from production to consumption on oil.

To illustrate this on the global scale, we show a template of how we use changes in global oil production and supply to estimate when the price of oil properly responds to those changes (*see 2nd graph on this page*). This is the start of the modeling process, which is visualizing the time variance between the fundamental data (output), conversion to supply/inventories, and finally the impact of that process on the price of oil.

What matters in this graph: (1) the changes in global and US production in actual bbls year-to-year; and similar changes in global supply. The supply data is a good proxy for output, which data is notoriously published late on a global basis, (2) Convert the oil price in yearly actual change (in $). Put them together, and you have a good fit. Juxtapose the nominal oil price, which barely corresponds to the data converted into change rates.



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



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

So what we are getting from this template is that the negative impact of the recent surfeit of output (supply) will last until June this year, in a distributed lag process. This will keep prices low until late Q2, after which the oil price takes off as the receding supply/output due to OPEC and NOPEC initiative hits the system fully.

There are other steps in the modeling prices before we get a target price, but the graphical representation does provide very good optics into the role of oil production in the oil price discovery process.

Of course, production is not the only factor which determines the price of oil. **In fact, the role of demand and consumption may be even more important; as we are fond of saying at The Capital Observer, no one can manufacture oil demand**. Therefore, we also need to pay attention to this vector, which we juxtaposed on the production and supply elements of the earlier production chart. The distributed lagged effect of oil demand suggest that demand is strong in May, but falls sharply thereafter, which is supporting prices at this time. Solid lines are actual data. Dashed lines are EIA forecasts. (*see 1 st graph on the next page*)

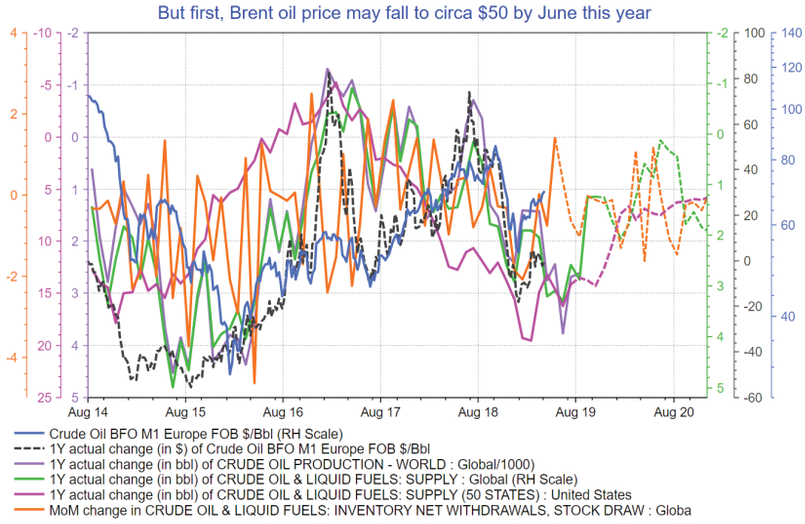
What OPEC+NOPEC started by rationalizing the global output two months ago, could push prices up to $90 -- But only if the OPEC and NOPEC continues to get their act together. NOPEC consist of 10 additional oil-producing nations, the largest three being Russia, Mexico and Kazakhstan. When people speak of NOPEC, they focus on Russia. Saudi Arabia and Russia are therefore the de facto brain trust of the current program which guides the production output of OPEC and NOPEC super cartel.

In December 2018, the new super-cartel announced a 1.2 million barrel per day (bpd) production cut effective January 2019, running through June 2019. That cut was to be reassessed four months later last April. According to news reports, at a meeting of the cartel in Baku, Azerbaijan, on March 18, the scheduled April meeting was cancelled, which means a decision on whether to extend or discontinue the cut will be delayed until just before they are set to expire, in two months' time.

These developments have to be assessed against a backdrop of reports on March 17, that had Saudi officials saying OPEC's job in rebalancing the oil market was far from done. The Saudis also made mention of the harsh sanctions the United States placed on Iran and Venezuela, and despite these supply disturbances, OPEC+ NOPEC may need to expand output cuts into the second half of 2019. The very next day Khalid Al-Falih, the Saudi energy minister, agreed to cancel the April meeting. Russia, apparently, wanted to have more time to see how the current cut are working, or going to work. Russia's desire to wait to see how the diminished oil output works is sound because it normally takes 4 to 6 months before the impact of output changes impact oil prices (*see 2nd graph on this page*). This aggregated approach also shows the potential for sharp increase in oil prices until the first half of 2020.

Falling oil supply, production will push oil above $90 by June 2020

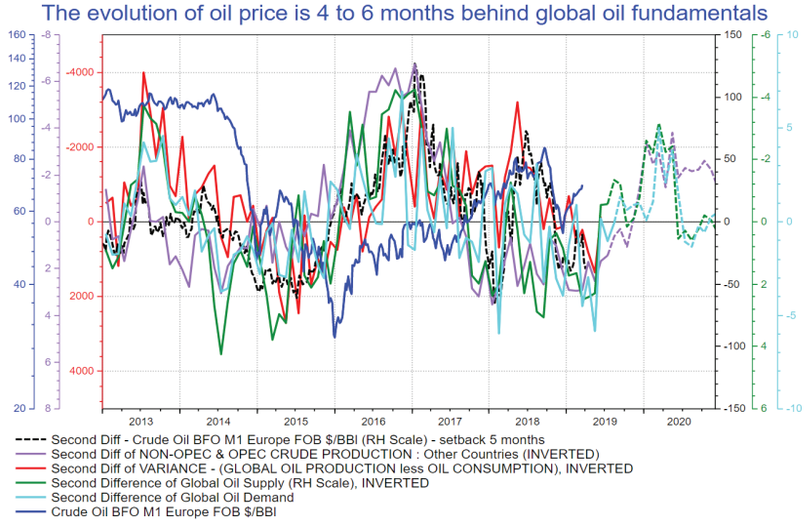
But first, Brent oil price may fall to circa $50 by June this year



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

Variance bet. Global Production less Global Consumption vs Global Supply

The evolution of oil price is 4 to 6 months behind global oil fundamentals



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

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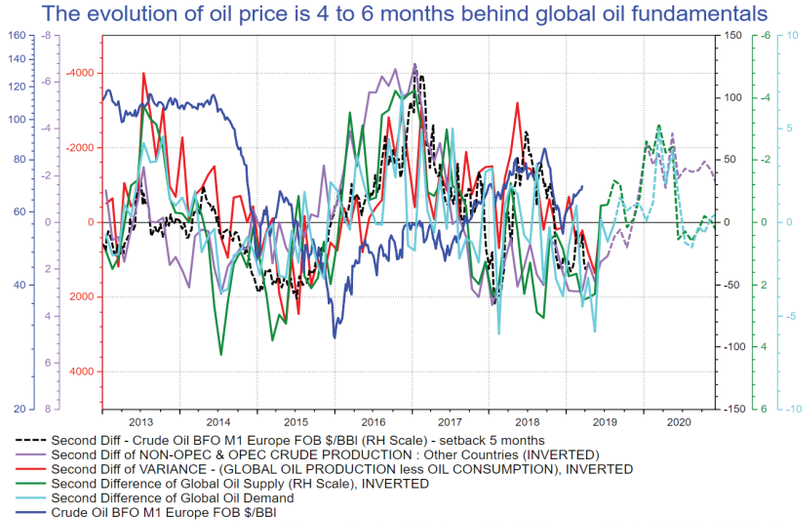


Source: Thomson Reuters Datastream / Capital Observer & Robert P. Balan Models (c)

The postponement of the April meeting created a buzz, as there seem to be cracks developing in the super-cartel's strategy to keep output low to push prices higher. OPEC has been shown to be able to influence prices higher, but they can't do it alone – they need the Russians and NOPEC. The Saudis seem to realize this (*See last graph above*). In allowing more time to assess the effects of the current cuts, OPEC officials commented that the

"fundamentals are unlikely to materially change in the next few months" but also noted that are "critical uncertainties" in the market.

Those "critical uncertainties" likely refer to the surging production from the shale sector in the US.

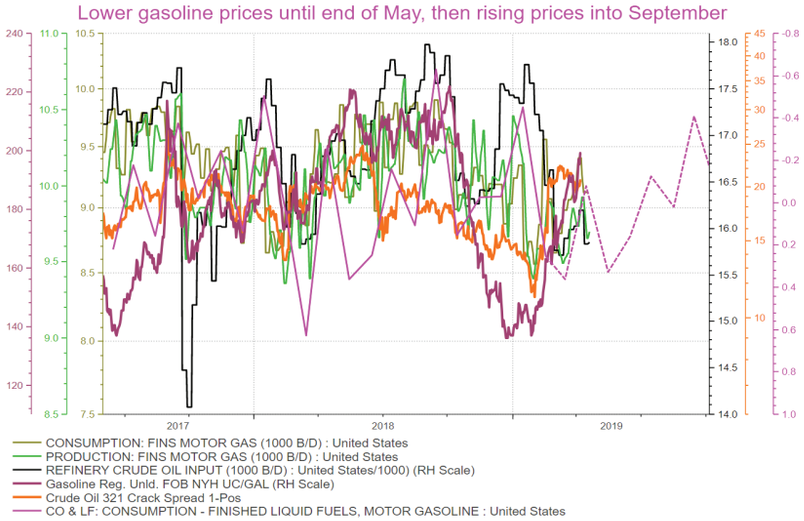
The IA reported that U.S. production fell in January by 90,000 bpd after hitting new record high in 2018. This suggests that the shale industry has not yet recovered, in terms of capital expenditures, from the price collapse of late 2018.

The desire of Russia to take a wait-and-see approach makes some sense, given that prices have not risen as fast or as much as OPEC+ NOPEC would hope; moreover, the U.S. isn't getting in the way at the moment with increased production. The tame rise in oil prices, so far, was due to expectations of slower oil demand. Global economic data has taken a turn lower, led by falling global yields, so the cartels are cutting supply but global demand is falling with it. That means they are selling much less oil at only marginally higher prices. Russia sees it as an opportunity loss, if they continue to cut, even with merely marginal benefits from tame oil prices.

The Saudi said that they will continue to cut deeper than required under the deal through to the end of April, and that has prevented another fall in prices when the April meeting was cancelled. While continued cooperation within NOPEC is all but guaranteed, there is some tension, disagreement and cracks in the foundation of the super-cartel. It seems like at this point, we won't know if those cracks have been mended until the late June meeting of super-cartel. That itself should introduce volatility, which will be exacerbated by demand from the summer driving season which is right around the corner. With the production cuts due to expire June 30, and increased demand at the same time, we may have a volatility spike as we approach that June meeting.

Crack Spread 321: the lead impact of gas consumption, production

Lower gasoline prices until end of May, then rising prices into September



Source: Thomson Reuters Datastream / Capital Observer & Robert P. Balan (c)

Our templates for rising prices into 2020 also suggest that oil prices may go lower into June before taking off on a sustained rise. The templates are however, too broad and too coarse, that is why we need intermediate, high-frequency models to project possible short-term nuances in the pricing of oil. That is why we use gasoline and product demand and consumption data, in conjunction with the crack spread. (*see graph above*)

Therefore, the broad strategy is to look for lower levels to initiate some structural portfolio positioning in E&Ps, Refiners, in oil and products by late May time frame, expecting to hold those investment up to later in the year (in principle, at least).

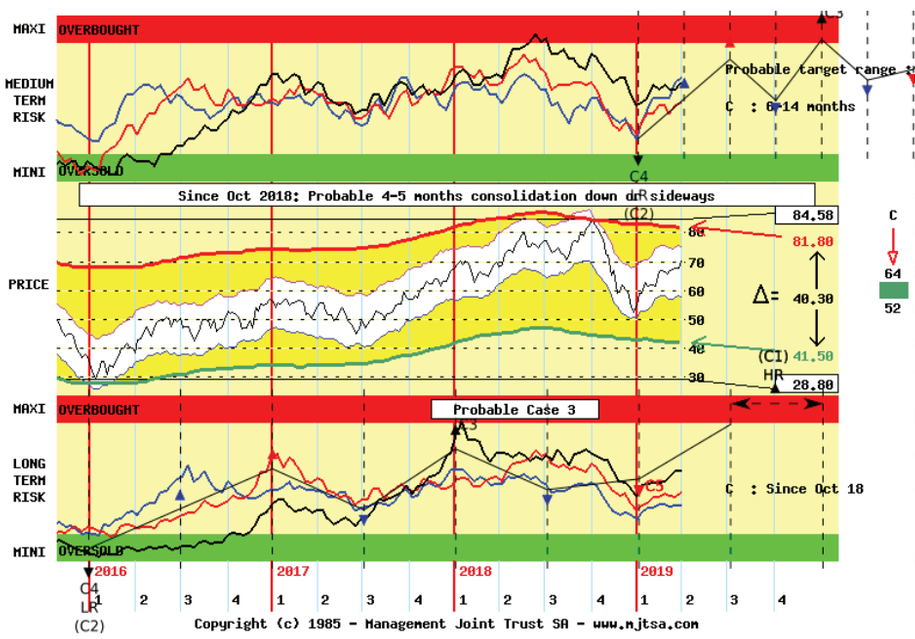
The consumption trends in oil and fuel oils, plus the likelihood that the agreement to reduce output (the case strengthened by a fall in oil prices in late May, if it happens) are good harbingers of higher prices into 2020.

35 / MJT - TIMING AND TACTICAL INSIGHT

Oil is approaching important resistance levels

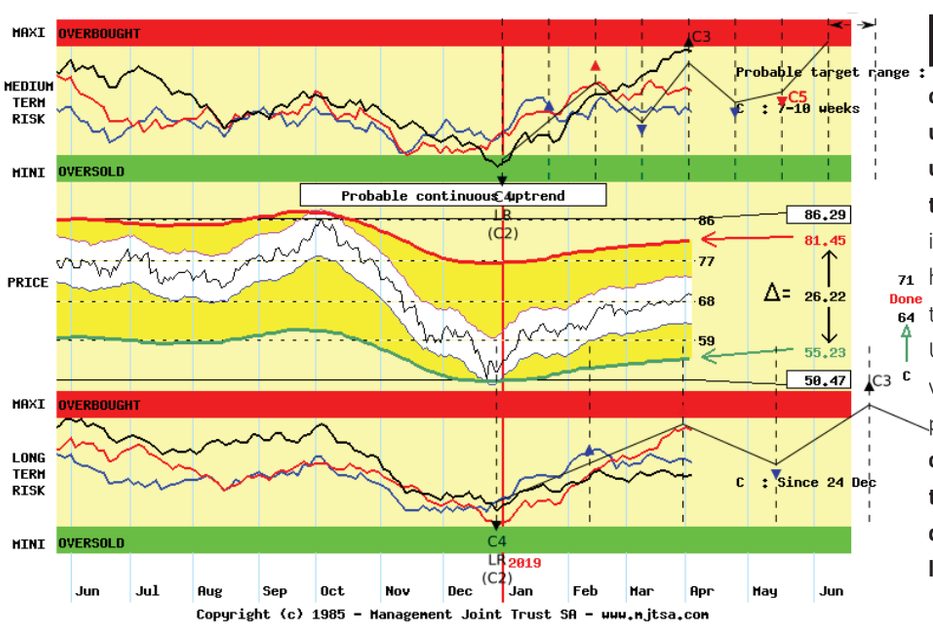
Oil has recovered by almost 20 U$/barrel since late December. On WTI prices, this equates to a 61% retracement of the October to December sell-off (56% on Brent). Historically, we can also note that current prices levels did offer strong resistance on Brent in January 2018, putting an end to the 6 months rally, which started in June 2017. Again, on Brent, the same levels also served as support in August last year and put an end to almost 3 months of downside correction since May. Resistance turns into Support, and then to Resistance again. This is pretty much where we stand today. Yet strong job numbers last week, further deterioration in the Venezuelan political chaos, and the prospects of a new civil war in Libya do seem to be adding further fuel to the current rally. Our technical view, however, seems to be calling for prudence over the next few weeks.

Brent Oil, Spot (USD/barrel)
Weekly graphs or the perspective over the next 2 to 4 quarters



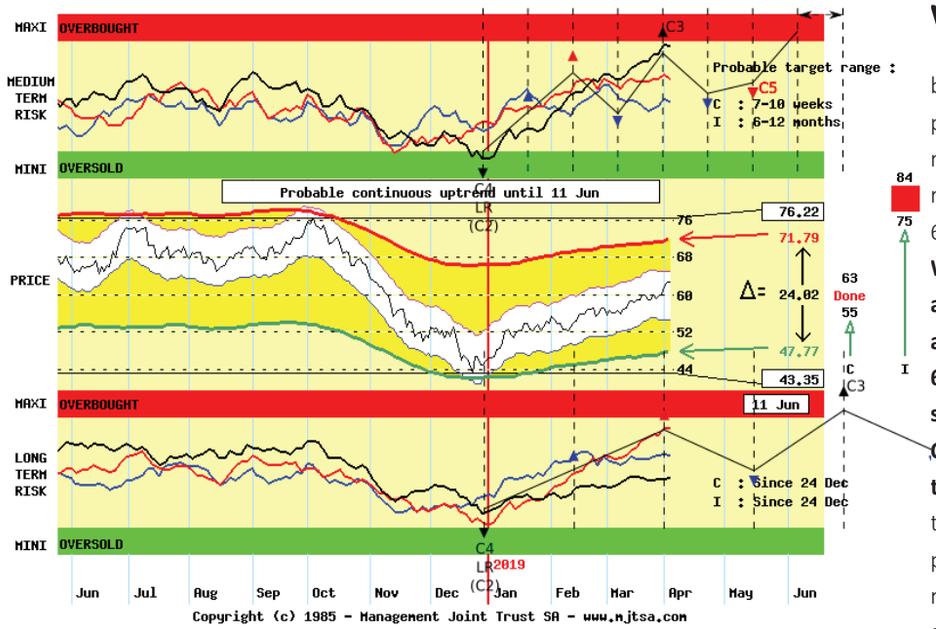
On both oscillator series (lower and upper rectangles), **Oil seems well positioned into the Summer**. The downside correction did find support near the lower end of our C Corrective to the downside (right-hand scale) late December, and theoretically the uptrend since 2016 is still in place. We see no reason for now why **Oil could not continue higher over the next couple of quarters to retest its 2018 highs. Shorter term, however, the rebound since December is reaching its first intermediate tops as shown on our medium term oscillators (upper rectangle). We would hence expect some consolidation over the next month or so.**

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



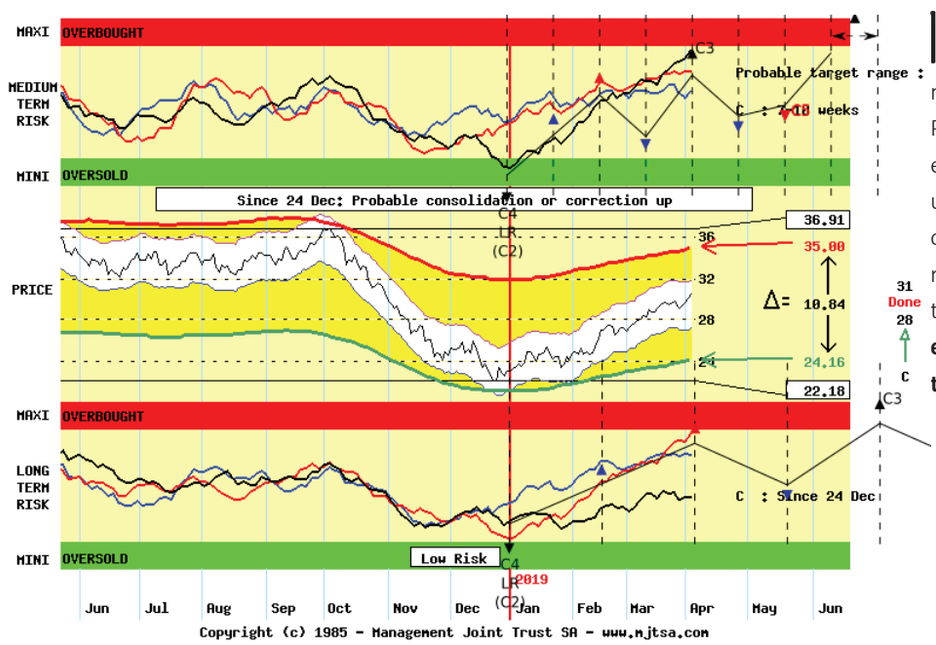
Indeed, **the rebound since December is approaching an intermediate top on both our oscillator series (lower and upper rectangles). Such configurations usually trigger 3 to 6 weeks of correction to the downside**. Furthermore, Brent is now approaching the resistance of the higher end of our C Corrective targets to the upside (right-hand scale) in the 70-71 USD/barrel, and these levels have also served as strong support and resistance in the past. **We would hence call for prudence on Oil over the next few weeks despite the strong newsflow, which is currently developing about possible supply risks linked to Venezuela and Lybia.**

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



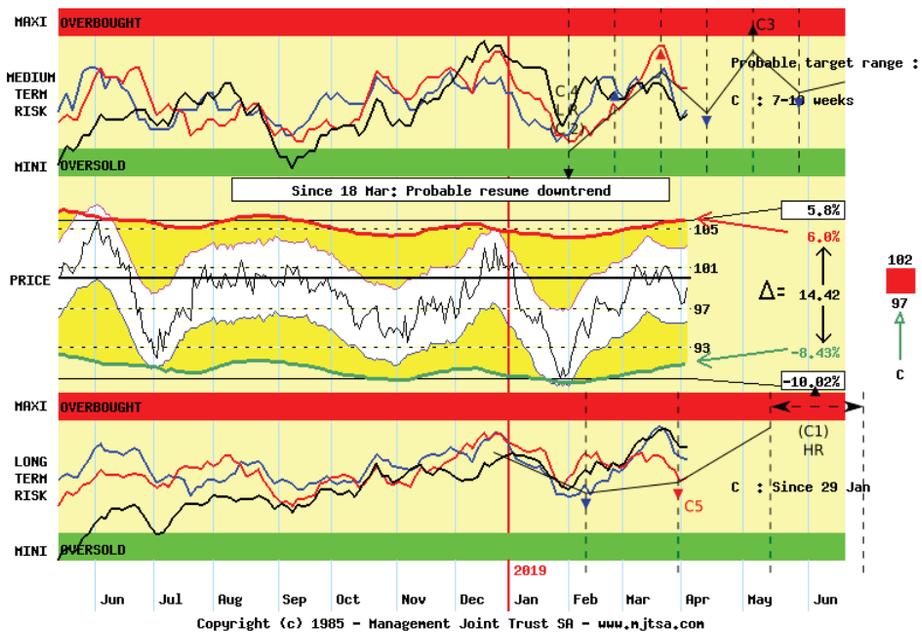
WTI Oil is also approaching potential intermediate tops on both oscillators series (lower and upper rectangles). Here also, prices have reached the upper end of our C Corrective targets to the upside around 63 USD/barrel (right-hand scale). **We hence expect strong resistance around these levels and possibly, as on Brent, the beginning of a 3 to 6 weeks consolidation to the downside. Following that from late May, Oil should resume its uptrend into the Summer.** Our I Impulsive targets to the upside are already pointing to a potential rise into the 75-85 USD/Barrel towards the Summer, i.e. slightly above last year's highs.

UGA - United States Gasoline ETF
Daily graphs or the perspective over the next 2 to 3 months



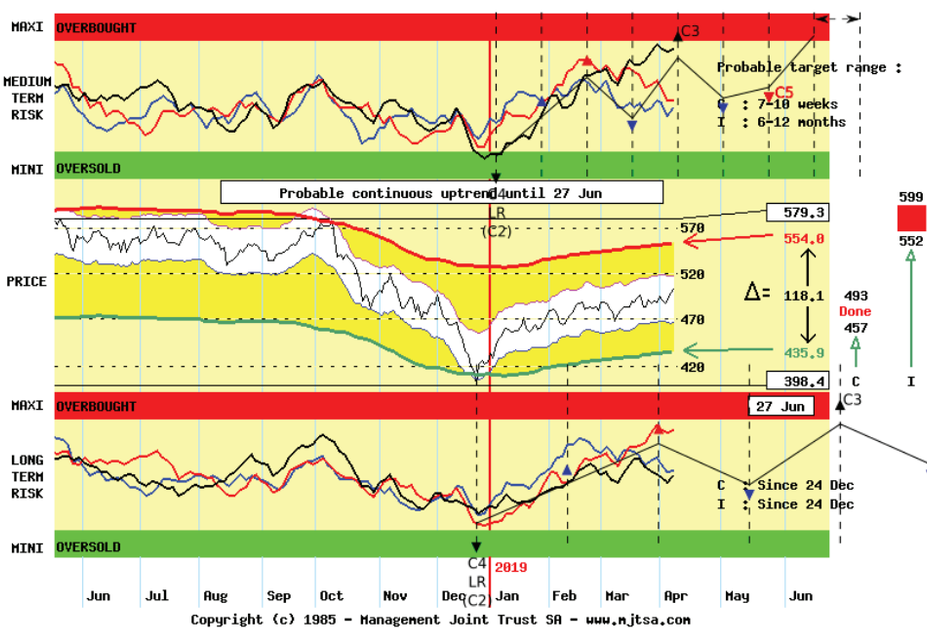
In is interesting to note, that further downstream, in the US Gasoline market, the situation is quite similar. Prices have risen back to the higher end of our C Corrective targets to the upside (right-hand scale), while both our oscillator series (lower and upper rectangles) are also approaching an intermediate top. **Here also, we would expect 3 to 6 weeks of consolidation to the downside.**

UGA – United States Gasoline ETF vs Light Crude Oil, Spot (USD/Barrel)
Daily graph or the perspective over the next 2 to 3 months



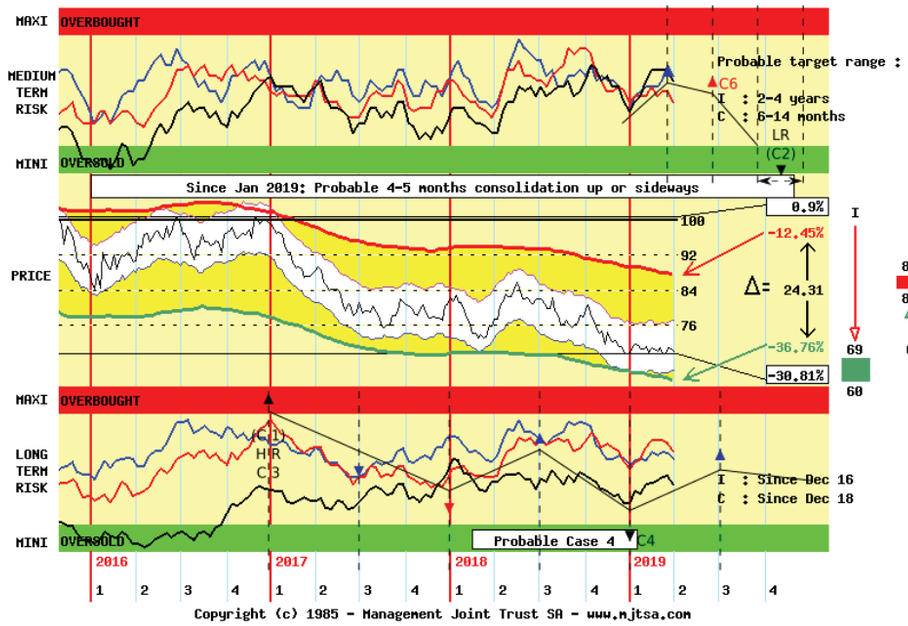
We now consider the Crack Spread, or more precisely the ratio between Gasoline and WTI prices. Recent history teaches us that when Oil prices rapidly move up, the spread usually falls. Similarly, when Oil prices fall and progress less rapidly, the spread usually rises. **As a rule of thumb, we will consider that when the spread rises, Oil prices usually don't accelerate up, but are rather slightly ascending, flat or descending. In this respect, over the coming weeks, both our oscillator series would suggest further progress to the upside in the spread, probably into May. This corroborates our view that we are probably approaching an intermediate top on oil prices.**

S&P US Energy sector
Daily graph or the perspective over the next 2 to 3 months



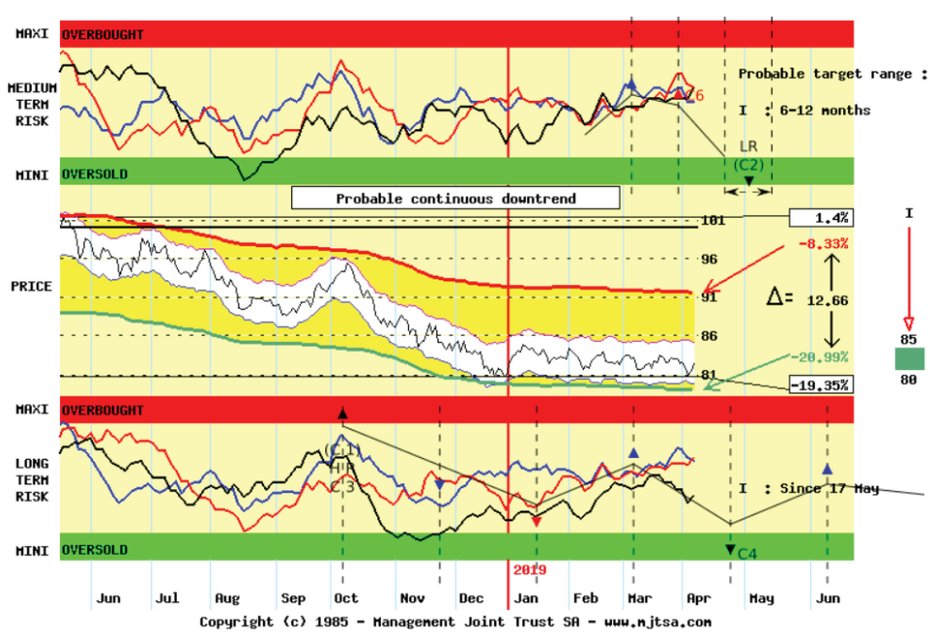
Moving to the US Energy sector, we can identify a similar scenario. **As with most risk assets, it has also rebounded since December. As with Oil, it is currently testing the upper end of our C Corrective targets to the upside (right-hand scale). Here also, both our oscillator series (lower and rectangles) are suggesting that an intermediate top is probably near, and that the sector could start to correct , probably for 3 to 6 weeks**. Following that, from May, it rises again into the Summer, with circa 20% of additional upside potential (our I Impulsive targets to the upside; right-hand scale).

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



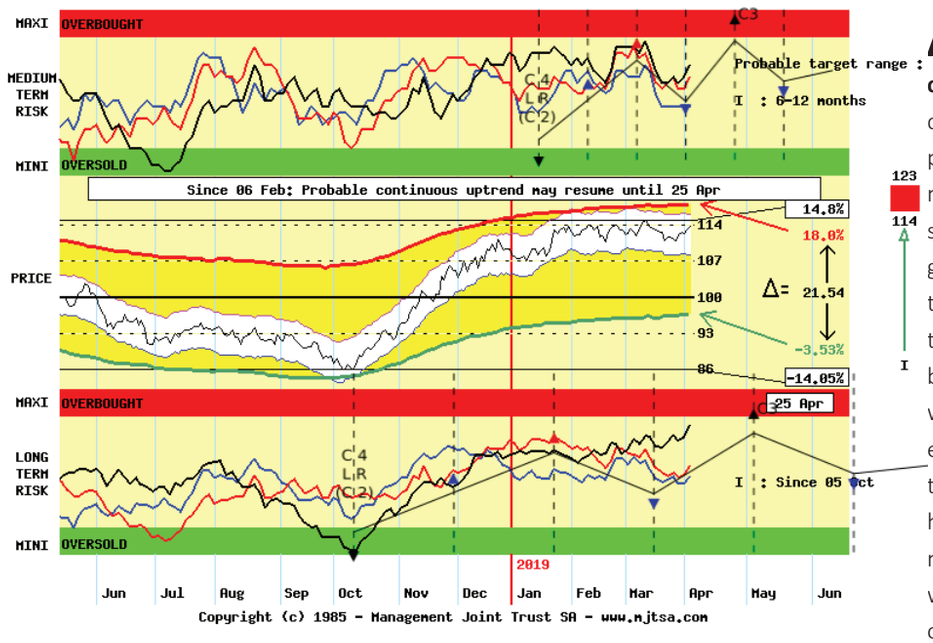
Longer term, on a relative basis, the US Energy sector, is quite Oversold. Last December, it reached an intermediate low on our long term oscillators (lower rectangle). **For now, however, the rebound has failed to gather any momentum on a relative basis. Worse, our medium term oscillators (upper rectangle) suggest that it could soon suffer a new period of underperformance**, before it attempts to bounce again towards late Q2. Our cross asset scenario which, by then, forecasts a steepening yield curve and rising Oil prices, may suggest a more successful outcome for this second rebound attempt. Yet, in the meantime, the US Energy sector probably underperforms again, for a few more weeks at least.

S&P US Energy sector vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



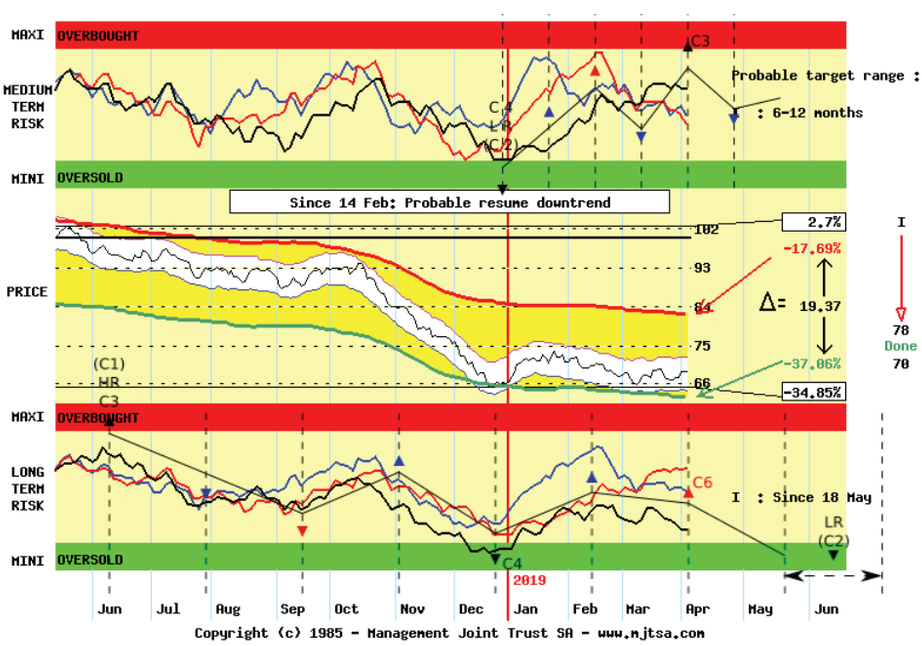
Shorter term, on a Daily basis, the ratio is quite Oversold in terms of price targets. Indeed, our I impulsive targets to the downside have been pretty much achieved (right-hand scale). Nevertheless, both our oscillators series (lower and upper rectangles) still suggest one last push lower into late April / early May. Hence, **although quite Oversold and with little downside risk remaining, the US Energy sector may still underperform the wider market for another few weeks.**

ICLN - iShares S&P Global Clean Energy Index Fund / IXC - iShares Global Energy ETF
Daily graph or the perspective over the next 2 to 3 months



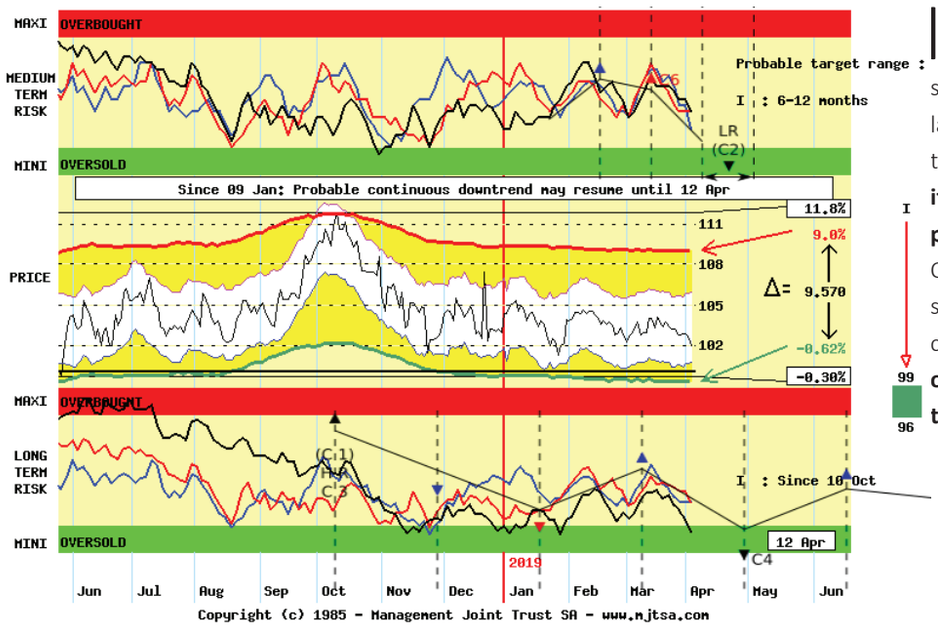
Alternative Energy is often considered the Defensive segment of the wider Energy sector. Indeed, during the strong Q4 sell-off, it outperformed the sector by a wide margin (25-30%). Since the rebound started late December, it has held its ground. One must also note that Alternative Energy is very much linked to China (many of its constituents are based in China or produce in China), which has widely outperformed other equity markets lately. That said, over the last few years, the ratio's profile has been quite consistent, with alternative Energy outperforming Energy when Oil corrects, and vis-versa. Both our oscillator series (lower and upper rectangles) are currently suggesting **that the ratio may push higher over the next few weeks, probably towards late April, early May. This provides further evidence that a correction of the Energy sector, and more generally of Oil related trades is probably imminent.**

OSX - PHLX Oil Service Sector / S&P US Energy sector
Daily graph or the perspective over the next 2 to 3 months



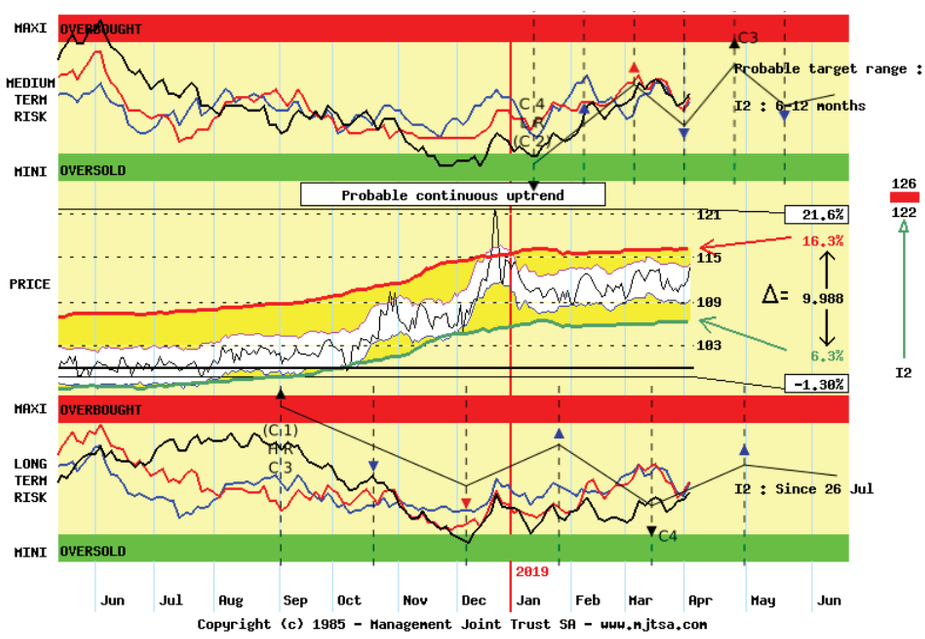
We now consider Oil Services, the deep value segment of the Energy sector. Over the last few years, its ratio vs the wider Energy sector has risen on rare occasions, usually during risk asset rallies, accompanied by stronger Oil prices as well as rising yields (or to some extent when the yield curve has attempted to steepen). As mentioned throughout this issue of The Capital Observer, we may expect such an environment from May into the Summer. In the meantime, however, on both oscillator series (lower and upper rectangles), **the ratio is expected to move lower once again, probably into the end of April, and perhaps even into mid/late May. On the target front, the downside potential, however, is pretty much exhausted, as Oil services are now below their I impulsive targets to the downside vs the wider US Energy sector** (right-hand scale)**.**

Europe Stoxx Energy sector vs the Europe Stoxx 600 Index
Daily graph or the perspective over the next 2 to 3 months



In Europe, the Energy sector has performed sideways vs the markets since November, yet both our oscillator series (lower and upper rectangles) may now be suggesting **that it could start to underperform again, probably towards the end of April**. Our I Impulsive targets to the downside (right-hand scale) are still quite compelling with **an additional 3 to 6 % of potential underperformance over the next few weeks.**

Europe Stoxx Energy sector vs the S&P US Energy sector (currency hedged ratio)
Daily graph or the perspective over the next 2 to 3 months



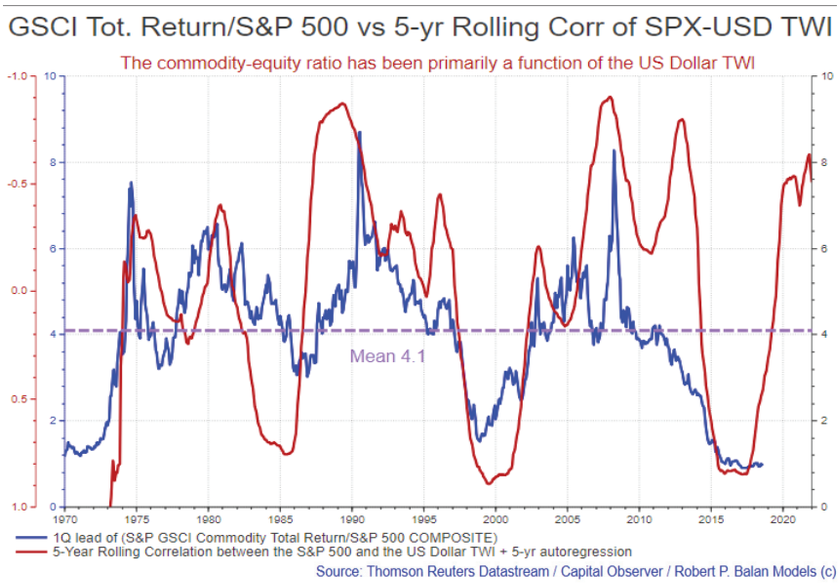
Finally, we conclude this section on Oil and Energy, with a comparison of the European Energy sector vs the US one on a hedged currency basis (like to like comparison of both indexes, no currency translation effect). **Historically, the European sector usually outperforms when Oil prices are weaker**. Indeed, European Energy companies on average are less pro-cyclical than their US peers. European companies are usually larger, more international, more integrated players whereas their American peers are more domestic and more focused, with many companies active in Production & Exploration. Hence, when the ratio rises, Oil prices are usually stable or declining. Both our oscillator series (lower and upper rectangles) suggest that **this could be the case over the next few weeks, probably into late April in first instance. This analysis corroborates our call through out this article for some consolidation on Oil and the Energy sector, probably towards late April, early May.**

Concluding remarks

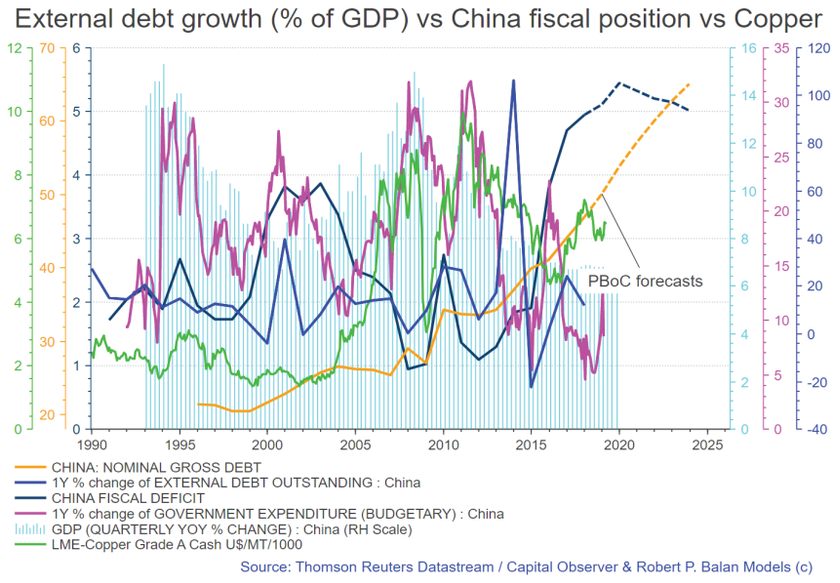
Shorter term, rising concerns on the supply side (e.g. Venezuela, Libya) are supporting the latest Oil rally. Yet, most Energy related markets are now approaching important resistance levels to the upside. We calculate these towards 63 USD/barrel on WTI, 71 USD/barrel on Brent (i.e. close to current levels). From a timing perspective, our oscillator series are also nearing intermediate tops on Oil, the Energy sector, or, on a relative basis, on the Energy sector vs the general market. Hence, we expect that Oil prices may temporarily top out over the next few days and should probably enter a consolidation period to the downside, which could last during 3 to 6 weeks. Following that, we are still very positive on Oil and the Energy sector into the Summer.

41 / Commodities outperformance over equities: we may have to wait a little longer, as rising yields could push the US Dollar higher

In the November 2018 Capital Observer issue ("*Commodities outperformance over equities*"), we published a graph that has held a lot of promise, and therefore has been tracked by us very closely. In the 1st graph of this page, we juxtaposed the rolling correlation between the S&P 500 and the US Dollar TWI, with a 5yr autoregression, which defined and illustrated the highly cyclical performance of commodities as an asset class versus the S&P 500 Index (as proxy for the equities asset class)



The promise is the start of a highly cyclical phenomenon with a period of 15 to 18 years, marked by a significant outperformance of commodities over equities. For a new upcycle to take hold, one of more of these events have to happen: (1) commodities could rally while equities decline (or vice-versa); (2) commodities and equities fall together but equities decline at a faster and larger degree relative to commodities, and (3) commodities and equities rise together, but the former outpacing the latter.



Even then in November, we believed that for a commodities outperformance to happen, we believed that the more likely case will be (3), where commodities and equities will continue to rally, but with commodities outperforming equities. For factor (3) to become valid, where commodities outperform equities in a general upturn in risk assets, there has to be a certain set of macro conditions present, primarily presence of economic growth and/or the rise of core inflation. We said then that those conditions should happen in 2019 to early 2020, at least. It did not happen in Q1 2019, as the seasonal weakness of Q4 2018 GDP cascaded over to Q1 2019, primarily due to fears that China's economic slide will worsen further.

However, China stepped in with renewed fiscal and monetary stimulus and global central banks universally reversed their tightening bias, prompting a "V-Shaped" equity rally in early 2019. Ironically, this equity rally has been led by emerging market equities, specifically Chinese equities, which were the first equities to turn down in late 2018. China's previously mentioned fiscal and monetary stimulus, initiated in the fourth quarter of 2018 and accelerated in the first quarter of 2019, appears to be working its way into the local economy (*see 2nd graph above*). **Global economic growth readings have turned higher, once again; global economic growth already appears to have bottomed.**

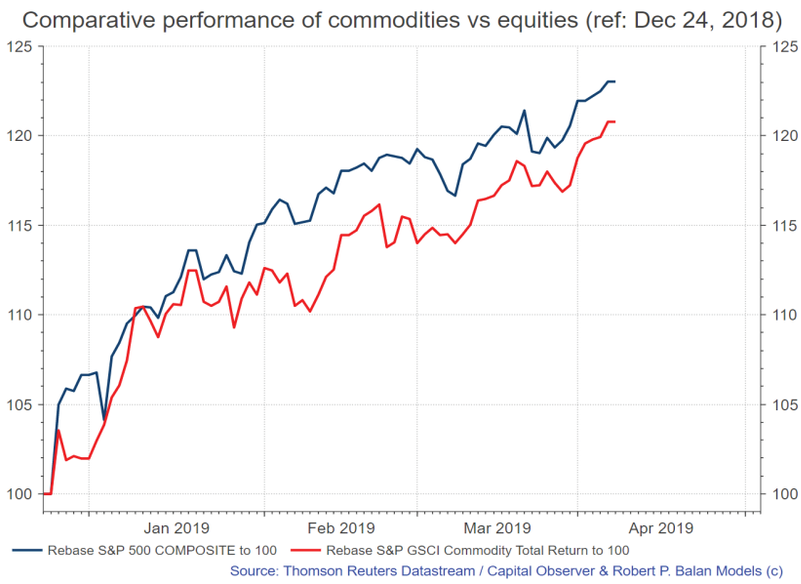
We cannot stress enough how crucial is the Chinese growth outlook to commodities. Chinese appetite for commodities had slackened somewhat from 5 to 7 years ago, but Chinese demand and consumption of raw materials is still the largest in the world. Despite lower growth rates, China has kept consumption of commodities still at high levels because the size of its economy has grown in the interim. The percentages may have shrunk but the nominal volume of commodities consumption is still phenomenal.

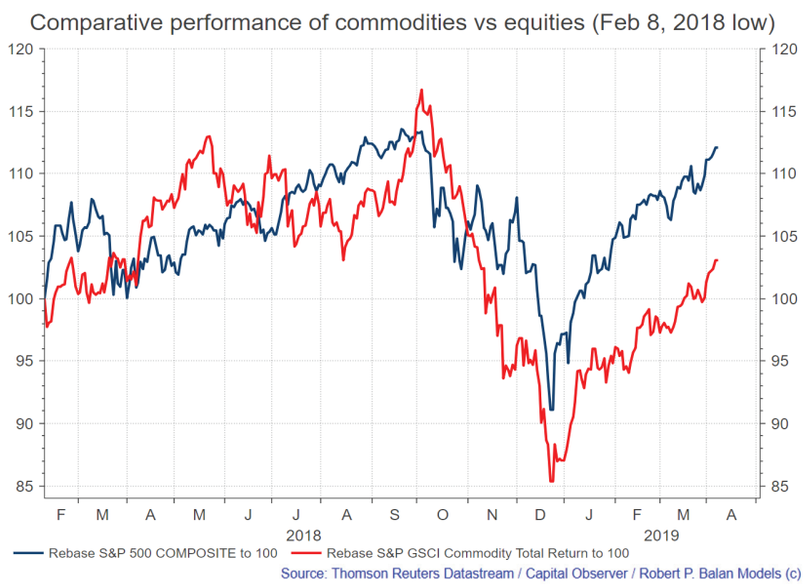
Commodity prices, led by oil prices, which as measured by $WTIC, are up roughly 37% in 2019 (the United States Oil Fund (USO) is higher by 34% in 2019), **are confirming the bottom in global growth expectations, similar to what we witnessed in late 2015/early 2016**. Commodities had a chance to catch up with equities early in the year but with the Fed signalling a pause in monetary policy tightening, equities took flight again and widened the gap vis-à-vis commodities (*see 1st graph on this page*).

The US is also pulling its own weight, with the GDPNow model estimate for real GDP growth in the first quarter of 2019 is 2.1 percent on April 2, unchanged from April 1. The outlook has improved tremendously from few weeks back when the GDPNowcast was hovering below 1.5% growth. Economists said that solid service sector performance helped offset a deteriorating trend in manufacturing to leave the PMI surveys indicative of robust economic growth in March. **For the first quarter as a whole, the surveys are consistent with the economy growing at an annualized rate of approximately 2.5%, painting a relatively rosy picture compared to official data, which so far suggest GDP could come in slightly weaker.**

The recent US jobs report also revealed a solid payroll path, with a 196k March gain after 14k in upward revisions that trimmed the February weather-hit. Other weather distortions were also unwound, with hours-worked bounces in the goods sector overall and construction in particular, alongside a workweek bounce-back to 34.5 from a weather-depressed 34.4 and a down-tick in the y/y hourly earnings gain to 3.2% from the weather-boosted 3.4% cycle-high.

The picture emerging is that recent fears about a downturn in global growth, led by a downturn in China, have been unfounded, with both the US and China, the two largest economies in the globe, starting to emerge from gloomy outlooks at the start of the year. If we do have a positive outlook for growth in 2019, then there is a chance (a good one) that the outperformance of commodities over equities may finally get rolling. But will commodities really close the performance gap with equities which become wider since the Fed signalled a pause? (see 2nd graph above).

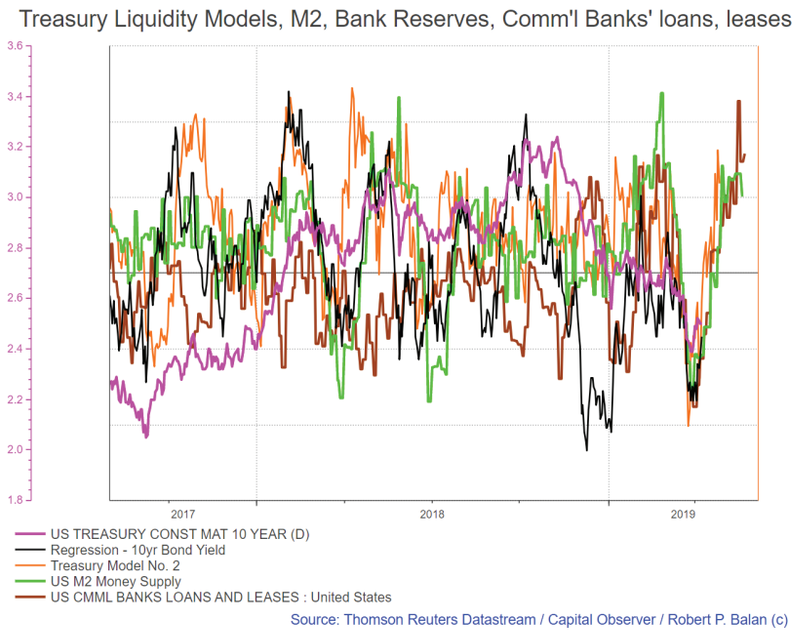




In the final analysis, it may depend on how the US Dollar will fare over the rest of the year. And that is basically saying, how interest rates are going to perform during the rest of 2019. The inverse correlation between the US Dollar and commodity prices is well-known and of course we also understand that higher yields will rebound to a stronger US Dollar after a short time lag.

If US bond yields will indeed be the final arbiter on the commodity-equity comparative performance, due to its impact on the US Dollar, there might be a brief period when the US dollar could temporarily weaken as a result of an equity market correction which is long overdue. However, we also believe that we are seeing the cycle low for bond yields. Bond yields should rise soon as systemic liquidity is set to increase sharply. M2 Money Supply is rising as a pick up in bank lending threatens to

increase deposits, which are money as we know it (*see 1st graph on this page*). That should push rates higher, and temporarily weaken the US Dollar due to the Quantity Theory of Money. But eventually sustained rise in rates should strengthen the US Dollar, and so the start of a commodity outperformance may have to wait a little longer.

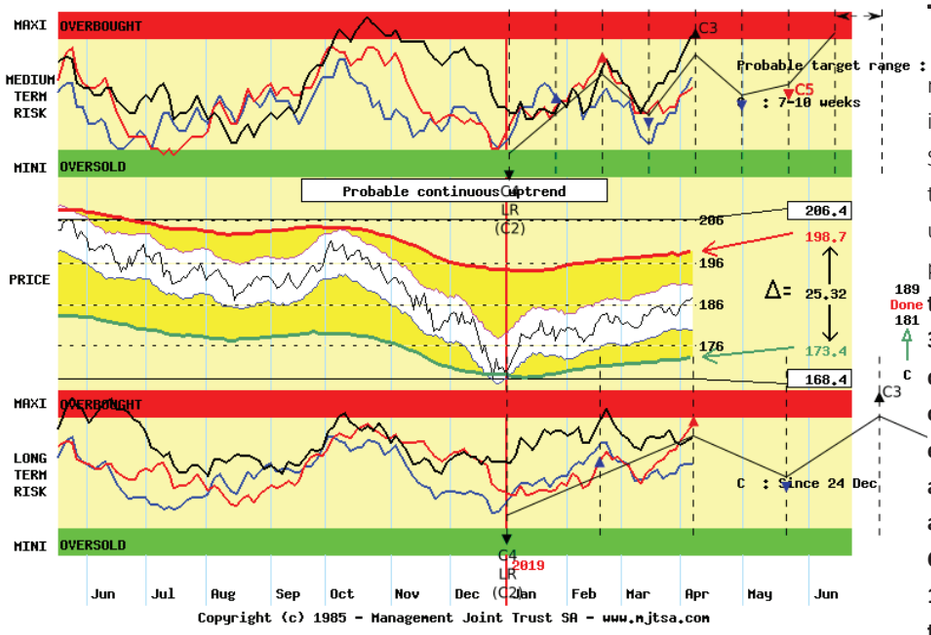


44 / MJT - TIMING AND TACTICAL INSIGHT

Commodities could retrace until May, and then enter a new reflationary upturn

Last November, we expected Commodities to retest lower one last time vs Equities, probably into mid/late Q1, before outperforming towards the Summer. While this projection was correct on the well diversified Reuters CRB Future Price Index vs the S&P500, the differentiation between the different Commodity segments has been quite strong. Going forward, we still expect Commodities to outperform other asset classes over the next couple of quarters, yet this trend may take a big more time to set in. In this article, we review our timing perspectives for most Commodity segments, on a standalone basis, vs the S&P500 and among each other.

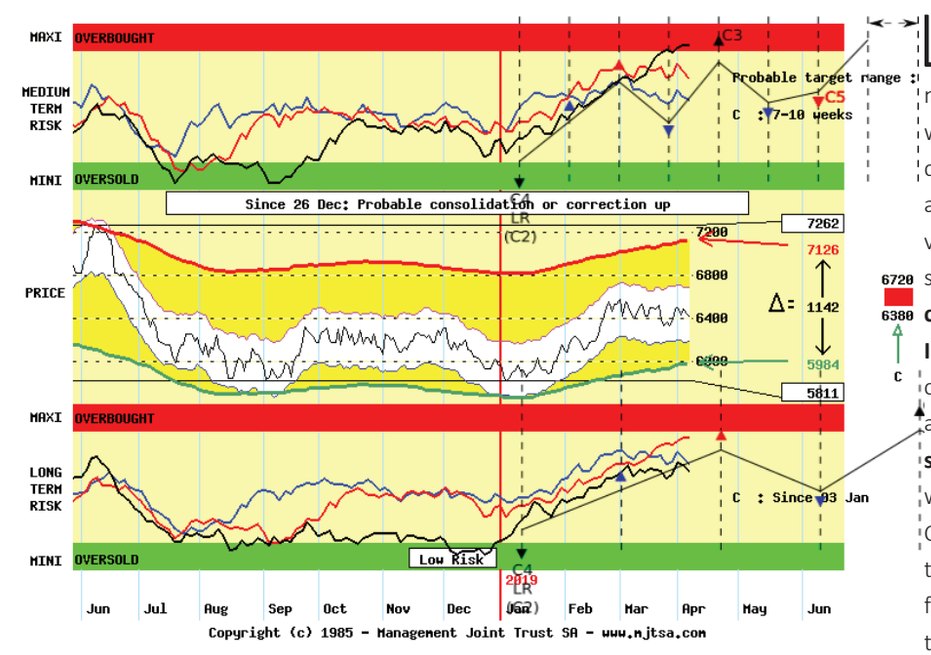
Reuters CRB Future Price Index
Daily graph or the perspective over the next 2 to 3 months



The Reuters CRB Future price Index is the more diversified of the large Commodity Index. It includes 33% Energy, which is far less than other Commodity Indexes. Since late December, and mostly thanks to this Energy exposure, it has been correcting up. Both our oscillator series (lower and upper rectangles) are **now approaching an intermediate top. It should trigger between 3 and 6 weeks of consolidation to the downside. This scenario is similar to the one we see on other risk assets, such as equities. On the target front, the index is also reaching important resistance levels, as it is approaching the upper of our C Corrective targets to the upside around 189 (right-hand scale). Again, this implies that a consolidation period may lie ahead**.

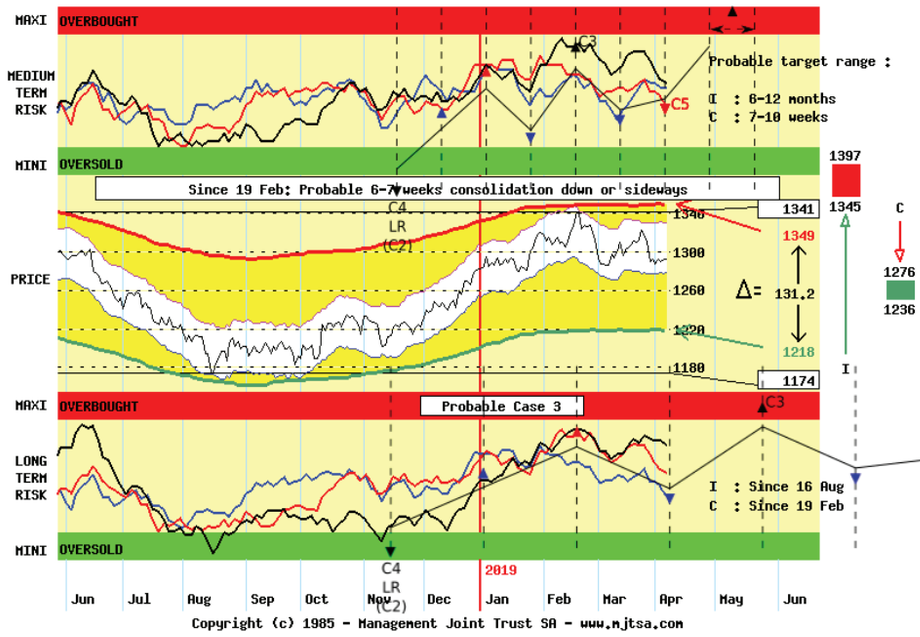
Following that, from early May, we expect the index to resume its uptrend, probably above these corrective targets and towards midyear and the Summer.

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



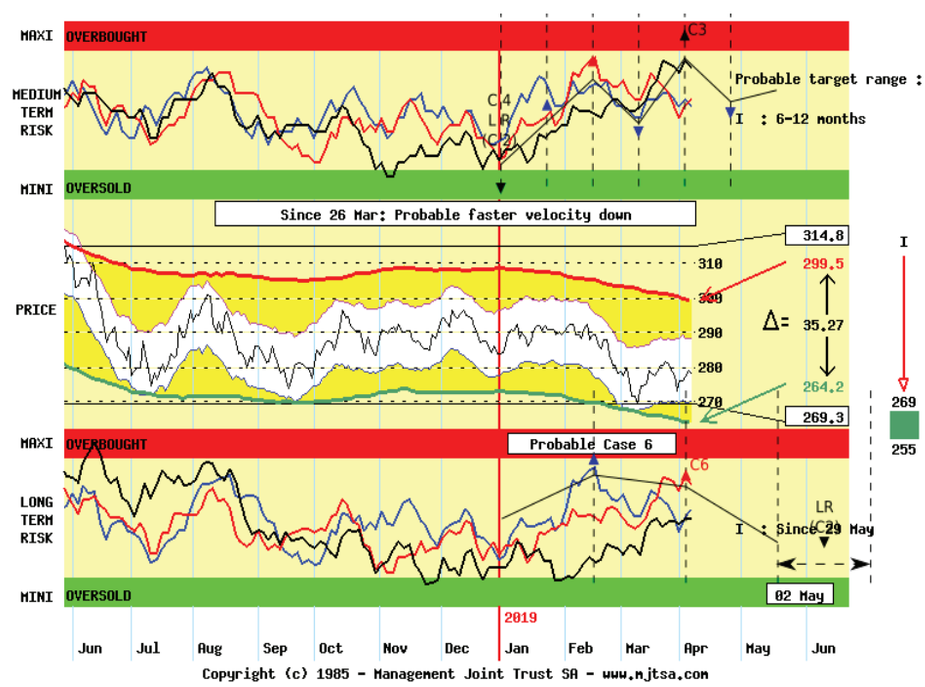
Looking into the different Commodity segments, we first start with Industrial metals, and more specifically with Copper, which is the larger constituent of their index (Oil was already reviewed in another article in this issue of The Capital Observer, which is dedicated to it). As we can see from this graph, **Copper bottomed a couple of weeks after the CRB Reuters Index, in early January,** while both our oscillator series (lower and upper rectangles) are implying that **it could also top out slightly later, towards mid/late April**. This would be consistent with our scenario on China, which we believe could hold up better than other equity markets over the next few weeks. Indeed, China represents by far the largest demand driver for Copper and more generally Industrial metals. From a target perspective, Copper may push slightly higher until it reaches the resistance of the upper end of our C Corrective targets to the upside around 6'720 USD/ton on the LME (right-hand scale). This is circa 5% above current levels. **Going forward, following some consolidation to the downside between mid/late April and early/mid May, Copper should resume its uptrend with other Commodities towards midyear, and perhaps the Summer.**

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



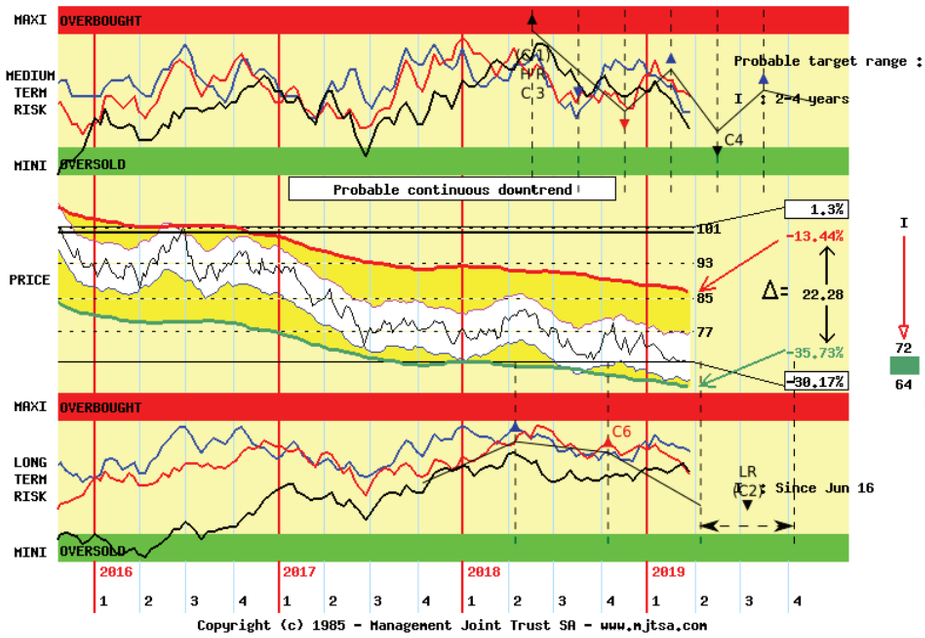
Gold shows a very different dynamic from Oil or Copper. It is a defensive Commodity and since September / October last year has benefited from both the Q4 risk asset correction and from the concomitant retracement in interest rates (Gold renders no yields and hence usually rises when rates are declining). On both oscillator series (lower and upper rectangles), Gold made an intermediate top mid/late February, and following 6 weeks of consolidation to the downside is now probably ripe to resume its uptrend. We hence expect **a last push up on Gold, probably towards late April / mid May, and into, or slightly above, its February highs (1'345 – 1'397 range; I Impulsive targets to the upside; right-hand scale).**

Goldman Sachs Agriculture Index
Daily graph or the perspective over the next 2 to 3 quarters



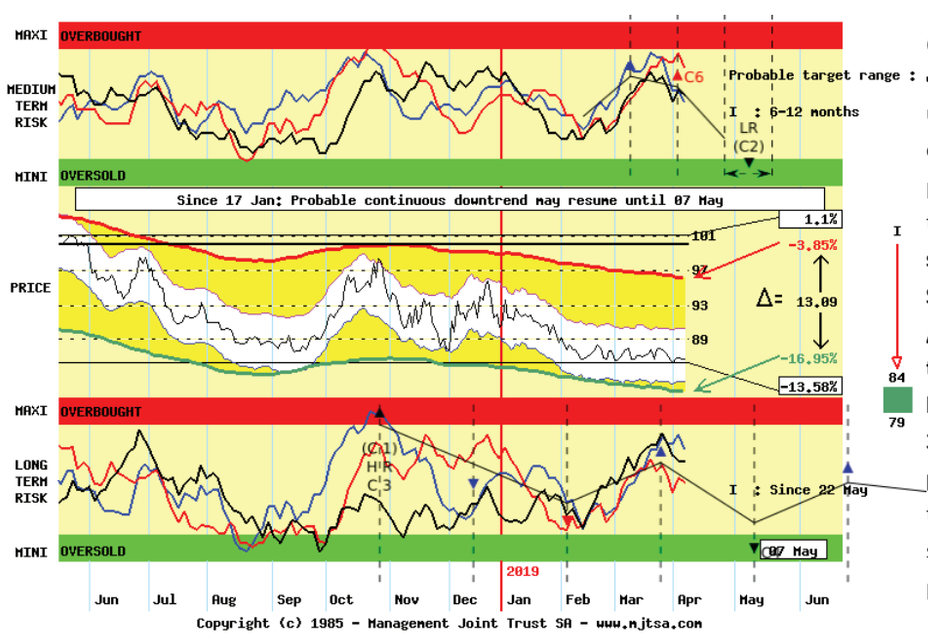
Agricultural Commodities have been the weakest link of the Commodity sector. According to both our oscillator series (lower and upper rectangles), **we expect them to remain weak until late April, and probably towards mid/late May**. Following that, we expect them to bottom-out, and reverse up into the Summer. In the meantime, our I impulsive to the downside (right-hand scale) are suggesting **more downside risk over the next few weeks, probably between 4 and 10% on this broad index.**

Reuters CRB Future Price Index vs the S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



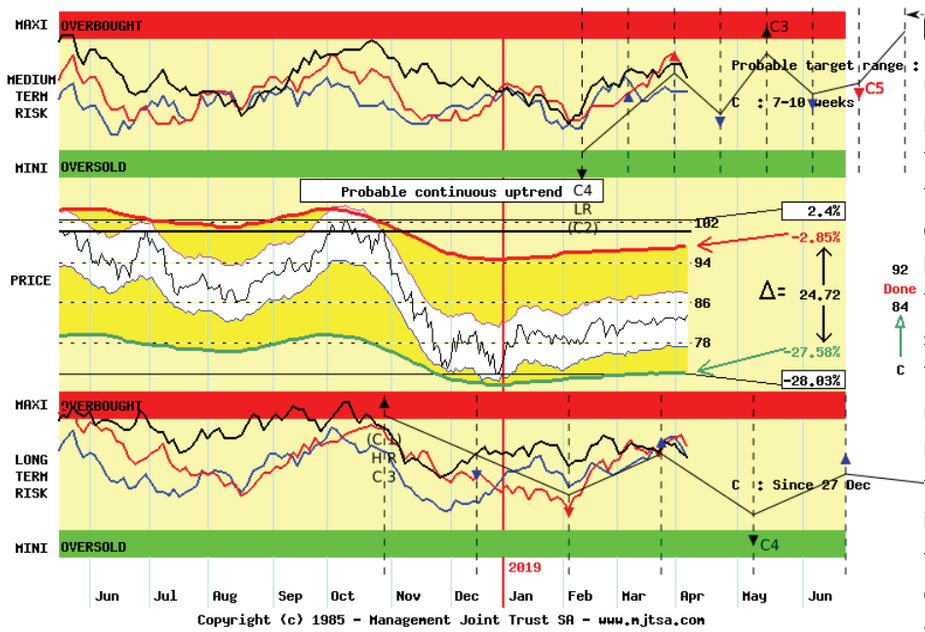
We now compare the CRB Reuters Commodity Index to the S&P500. Given its diversity of profiles, and despite Oil strong performance, the index has indeed underperformed the S&P500 since we last reviewed the ratio in November. According to both our oscillator series (lower and upper rectangles), **the downtrend is still underway, probably until mid Q2**. On the target front, the ratio is nearing exhaustion, although according to our I Impulsive targets to the downside (right-hand scale), **another 10% of underperformance is still possible before a bottom is reached. We would hence hold it out a bit longer, until May, before we consider Overweighting Commodities as an asset class.**

Reuters CRB Future Price Index vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



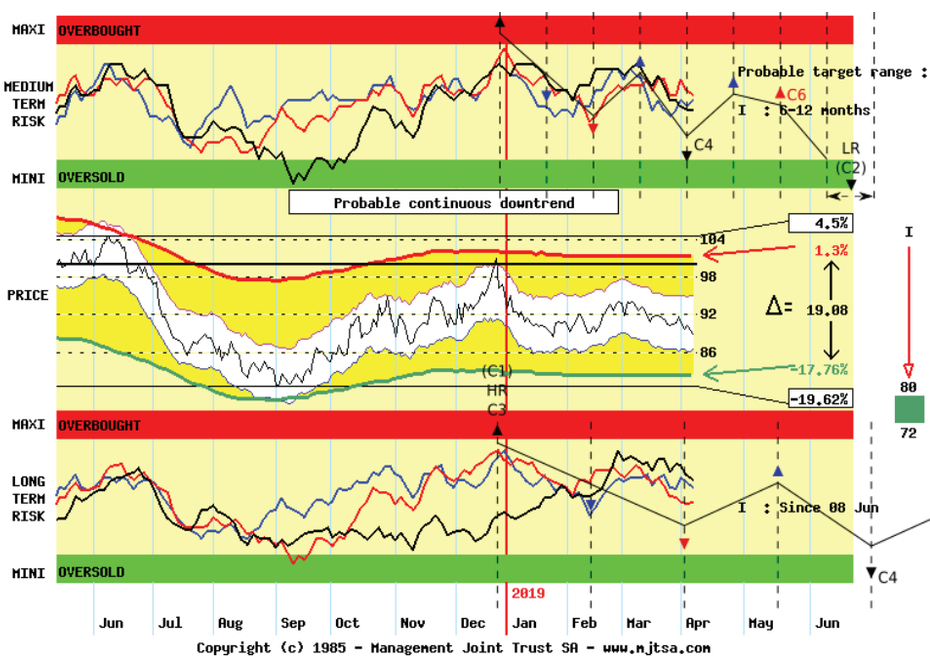
Shorter term, on the Daily graph, the ratio may give us a bit more precision. Both oscillator series (lower and upper rectangles) are suggesting that **Commodities may resume lower once more vs the S&P500 index into late April / early May. Our I Impulsive targets tot he downside (right-hand scale) point to between 3 to 10% of further downside potential until then**. Thereafter, we expect Commodities to start reversing up vs Equities, probably towards the Summer.

Brent Oil (USD/barrel) vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



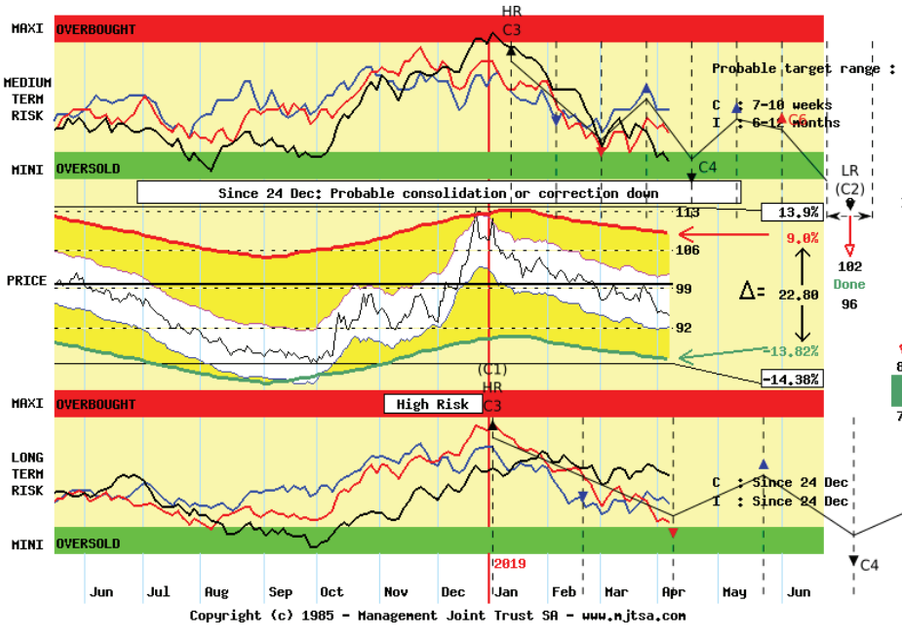
Oil is more volatile than Equities, and since both bottomed in December, Oil has outperformed the S&P500. Our long term oscillator series suggest than the ratio's rebound was probably counter-trend, and that a new leg lower is expected into early May. This may suggest quite a deep setback for Oil vs the S&P500. The sequence we show on our medium term oscillators (upper rectangle) is more constructive. In fact, it considers that Oil is already in an uptrend vs the S&P500, and that following a short 2 to 3 weeks of underperformance, Oil could start to outperform again from late April into mid May and then midyear. For now, we will keep both options open, yet **we do expect between 3 to 6 weeks of Oil underperformance vs the S&P500, i.e. until late April at least.**

Copper Spot (USD/ton, LME) vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



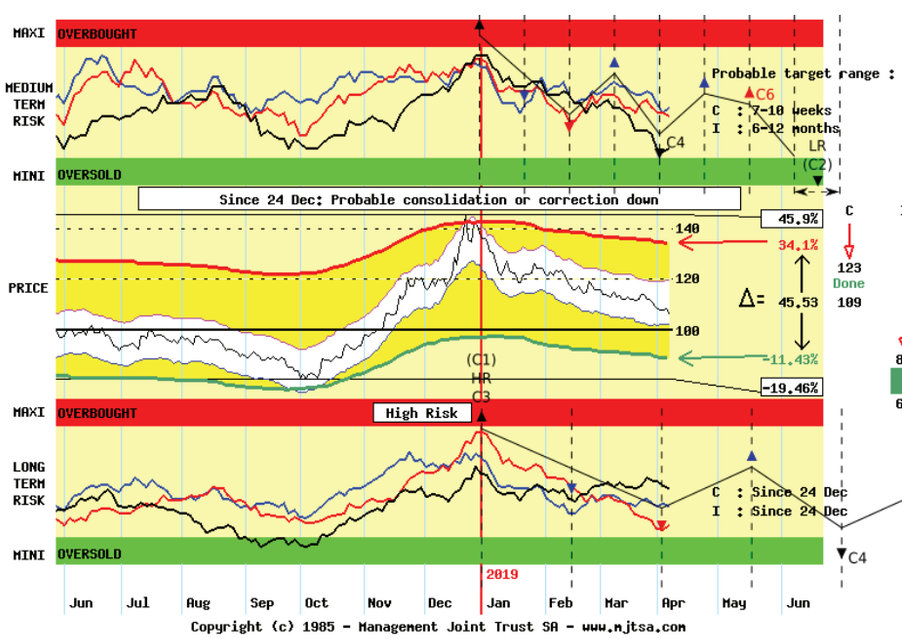
Copper has been more defensive than the S&P500 since last Fall. It started to outperform in Q4, as US markets re-coupled to the downside and the rest of the world held up better. Since December however, Copper has been underperforming the S&P500 again. According to both our oscillator series (lower and upper rectangles), **we expect Copper to soon make an intermediate low vs the S&P500. It may then bounce during 3 to 6 weeks on a relative basis. Following that, it probably resumes lower towards midyear, perhaps the Summer with relative price targets some 10 to 20% below current levels**. This is quite compelling, and may suggest either than China looses its current equity market lead, or that the Dollar, following some consolidation during April / early May, could then start to re-accelerate up quite strongly into the Summer, perhaps a bit of both.

Gold Spot (USD/oz) vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



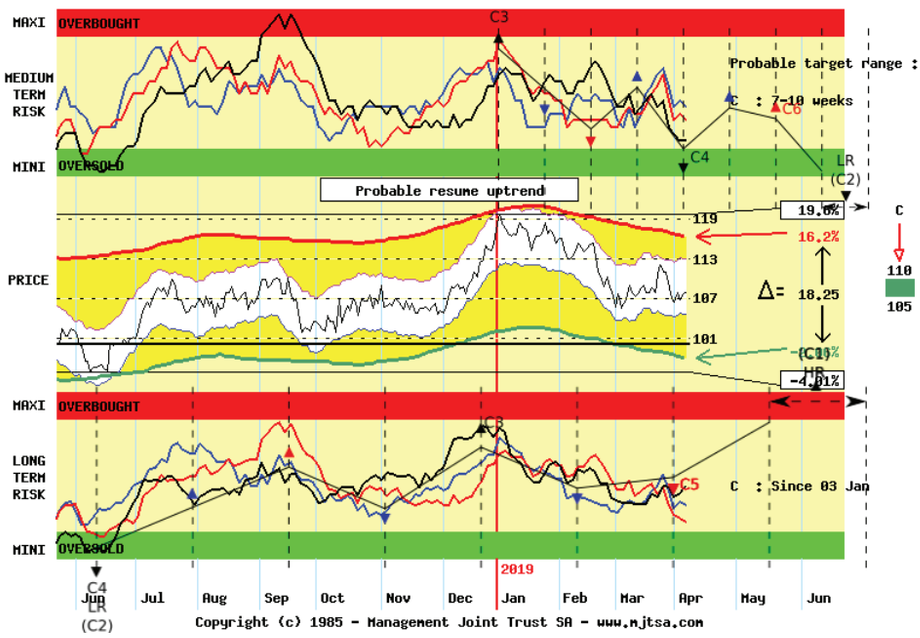
Gold is a defensive asset, and despite its decent performance since December, it has been linearly underperforming the S&P500. Both are oscillator series (lower and upper rectangles) are now suggesting that **Gold could find support vs the S&P500 between now and mid April, and that it could then bounce towards late April / even mid May**. Following that, it resumes lower again, from mid/late May into the Summer, as risk assets resume their uptrend and interest rates could start to reverse up. This may also be beneficial for the US Dollar and hence, **from late Q2 into the Summer, we expect a more difficult environment for Gold**.

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



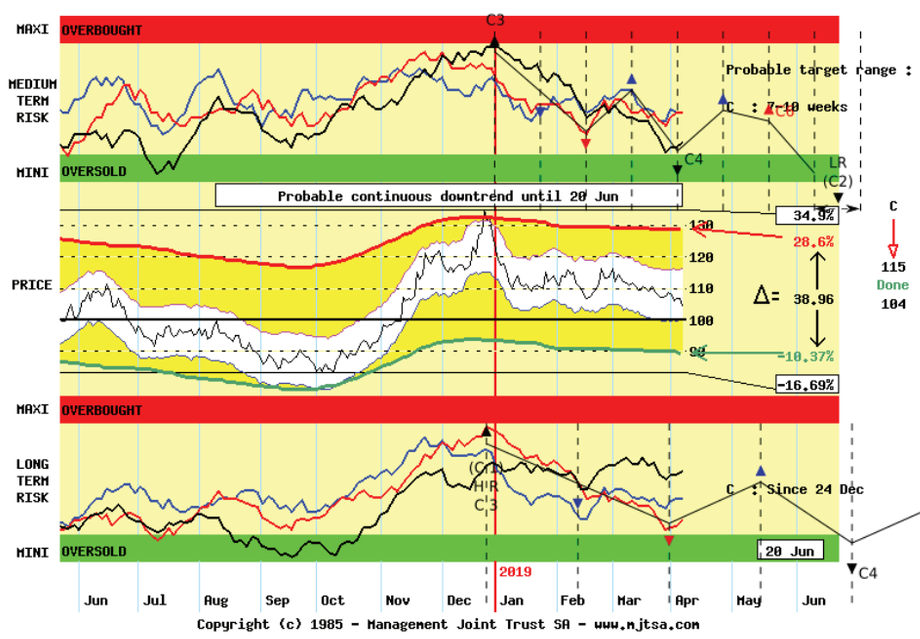
Comparing Gold to Oil ends up to comparing the most defensive, to probably to most cyclical Commodity. Both trends, linearly up from early October to December, and then linearly down from late December, highlight the ratios cyclical sensitivity. On both oscillator series (upper and lower rectangles), the ratio is nearing an intermediate low. **We would hence expect Gold to start to stabilize soon vs Oil, and initiate a rebound on a relative basis, probably into late April, perhaps early/mid May. This in our view provides further confirmation for the more general cyclical correction we expect over the next few weeks.** Following that, from mid early/mid May, we expect Gold to start underperforming Oil again, probably quite substantially into the Summer.

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



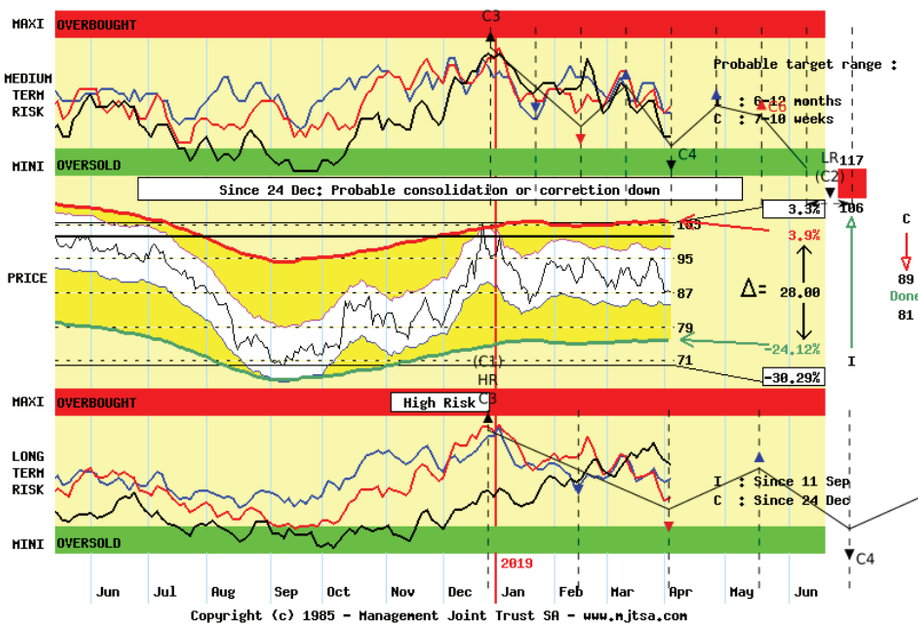
Gold to Copper is another classic ratio, often considered the best dis-inflation / reflation gauge (and vice-versa). From last June, the model on our long term oscillators (lower rectangle) has followed a perfect sequence up and down. We believe it should find support soon within our C Corrective targets to the downside (right-hand scale), and then start moving up again, probably towards mid/late May. Our medium term oscillators (upper rectangle) show a slightly more reflationary scenario, where **Gold rebounds vs Copper between now and late April / mid May,** and then resumes lower into June. **Anyhow, both sequences seem to confirm, the cyclical correction we expect during April.**

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



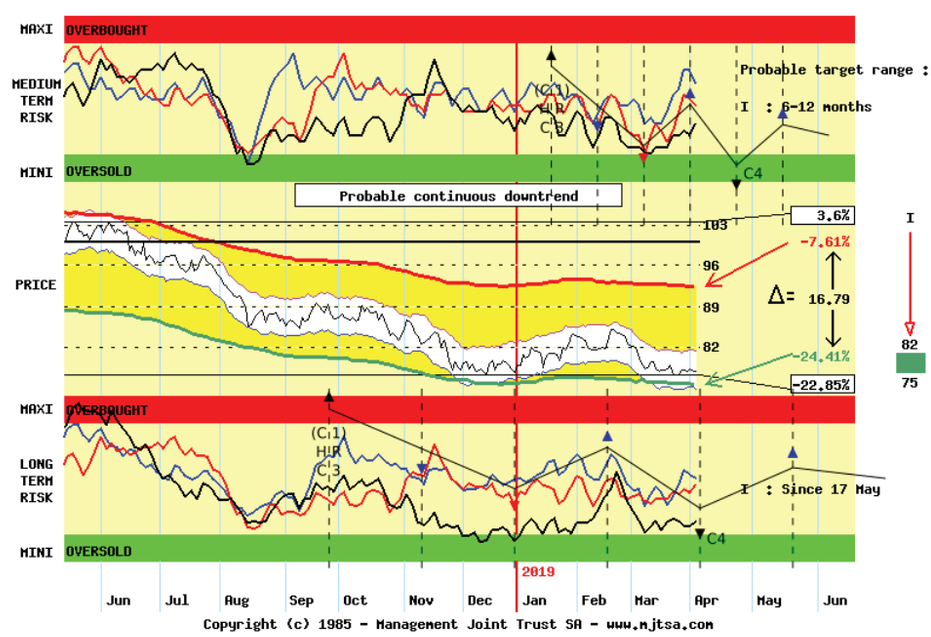
Finally, we compare Copper to Oil. The ratio again highlights the strong cyclical nature of Oil vs other Commodities. According to both our oscillator series (lower and upper rectangles), **Copper is currently approaching an intermediate bottom vs Oil and could soon start to bounce. We hence expect it to outperform between 3 to 6 weeks, and into late April, perhaps mid May**. Following that, Copper then underperforms again vs Oil into the Summer.

HUI - Gold Bugs Index vs the S&P 500 Index
Daily graph or the perspective over the next 2 to 3 months



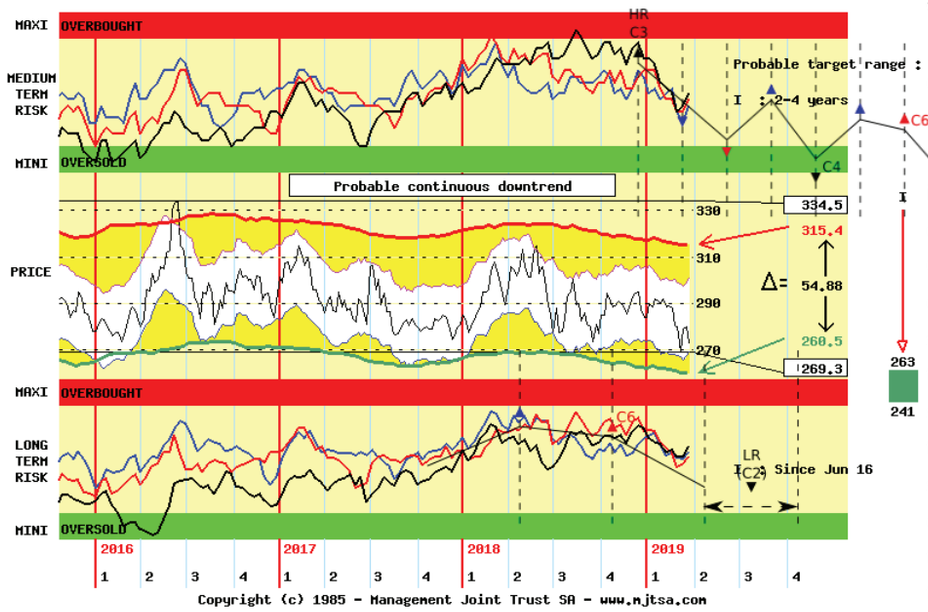
Looking to related equity sector, we now compare the HUI Gold Bug Index (Goldmines) to the S&P500. These again have been underperforming the S&P500 since December, yet, are now also reaching intermediate lows on both oscillators series (lower and upper rectangles). **We hence expect Goldmines to start outperforming the market soon, probably into late April, perhaps early/mid May. This again would confirm the more defensive bias we expect over the next 3 to 6 weeks**. Following that, Goldmines should start underperforming the S&P500 again into the Summer (in line with the cyclical re-acceleration we then expect).

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



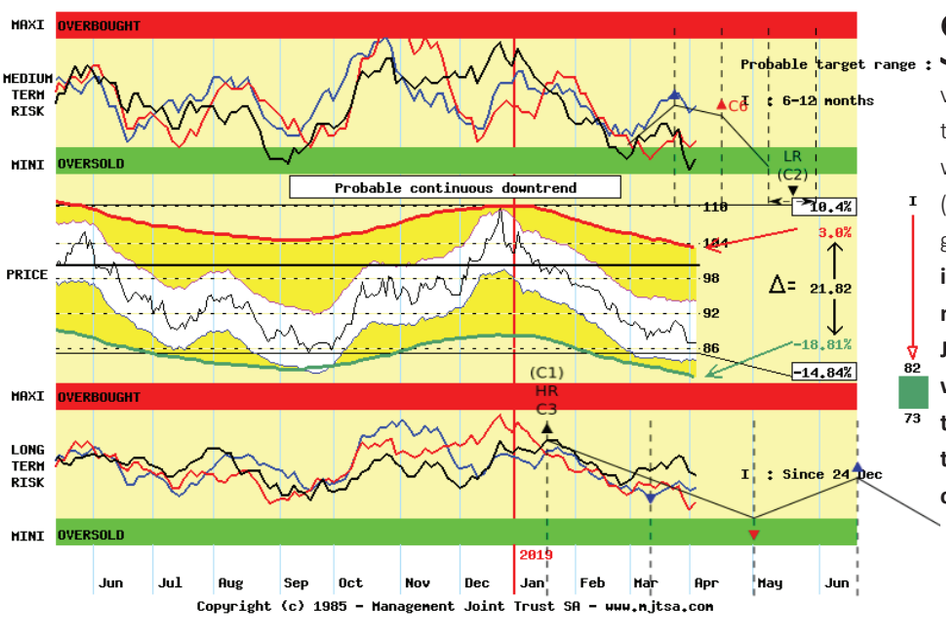
Similarly, we consider the XME diversified Mining ETF vs the S&P500 Index. Diversified Mining is much more cyclical than Goldmines, and may constitute an interesting bet for the 2nd half of Q2, once the Cyclical and Value trades start reacceleration up vs the market. Their profile, is quite similar to the Energy sector, which we also see outperforming from may into the Summer (pages 37-38). On this ratio, our long term oscillators (lower rectangle) are already quite Oversold and could soon start forming a base. Furthermore, our I Impulsive targets to the downside (right-hand scale) have pretty much been fulfilled. **We would wait for a last retest lower during April on our medium term oscillators (upper rectangle) before considering diversified mining vs the S&P500. This timing matches the cyclical correction we expect over the next few weeks as well as the last retest down we anticipate on interest rates.**

Goldman Sachs Agriculture Index
Weekly graph or the perspective over the next 2 to 4 quarters



We conclude this section on Commodities with Agricultural Commodities, which have suffered a sustained downtrend since early 2011. This Goldman Sachs Agricultural Index includes all sub-segments of the Agricultural space (Grains, Softs, Lumber, Coton, LiveStock). On our long term oscillators (lower rectangle), the index should enter a "Low Risk Zone" during the 2nd Quarter. Risks are still quite substantial as our I impulsive targets to the downside (right-hand scale) suggest between 5 and 15% of further downside. On a more positive note, the sequence we show on our medium term oscillators (upper rectangle) is pointing towards a possible low towards mid/late Q2 (probably May). This is pretty much what our daily graph also suggests on page 45 of this document. **We cannot exclude further downside retests later on this year, but we believe that a May bottom on Agricultural Commodities may represent a long awaited opportunity to enter this segment, and given our reflationist scenario into the Summer, may be worth considering.**

Goldman Sachs Agriculture Index vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



Shorter term, comparing the same Goldman Sachs Agricultural Index vs the S&P500 does deliver a similar timing point. Indeed, the sequences we show on both our oscillator series (lower and upper rectangles) are suggesting that **following a retest down into May, Agricultural Commodities may then start to outperform into June and towards midyear. For now, we would avoid stepping into them too quickly as our I impulsive targets to the downside still point to 5 to 10% of additional underperformance risk.**

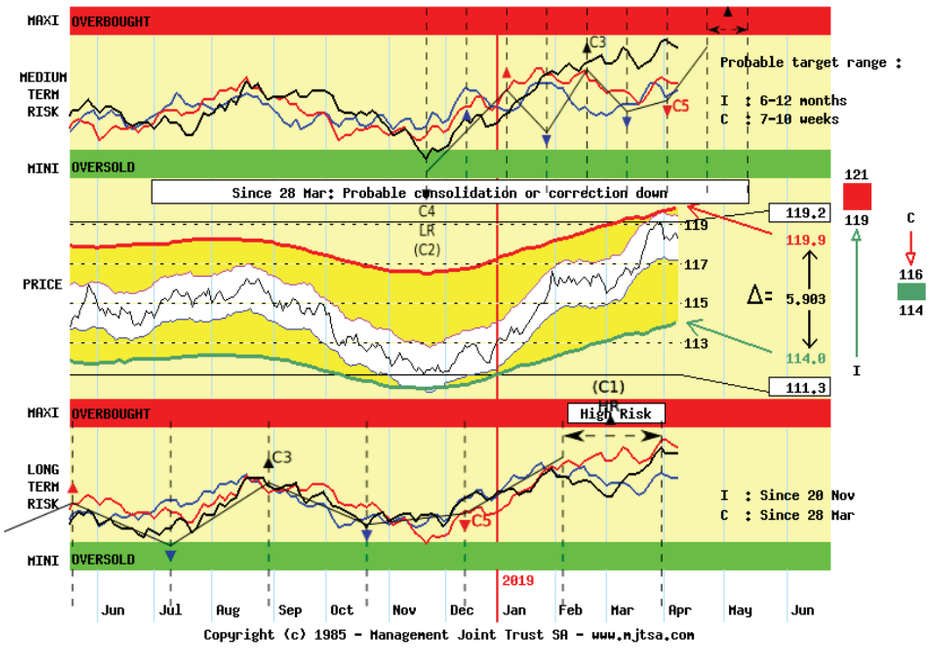
Concluding remarks

The various Commodity segments are showing different profiles both on an absolute basis and vs the S&P500. Oil is the more pro-cyclical and volatile one, while Gold is the most defensive. Industrial Metals are somewhat in the middle, and very much linked to Chinese demand. Agricultural Commodities have been in a structural downtrend since 2011, yet are starting to look Oversold. When considering them as a whole, by comparing the Reuters CRB price Futures Index vs the S&P500, we would expect one last period of underperformance for Commodities into mid Q2. During this period, Oil and Agricultural Commodities may suffer the most, and should underperform Equities, while Industrial Metals may hold up rather well, and Gold accelerates up to achieve new YTD highs. Then, from mid May, we expect these trades to reverse. Our scenario is then very reflationary into the Summer, with rising Equities, and Bond yields which may attempt to retest last year's highs. This environment should be very beneficial for Oil. Agricultural Commodities may also benefit from their deep value position. On the other hand, China and Industrial Metals may then underperform, while Gold erases most of its uptrend since August last year.

52 / Splicing the markets – Credit vs Duration. Weighing up the risks and rewards?

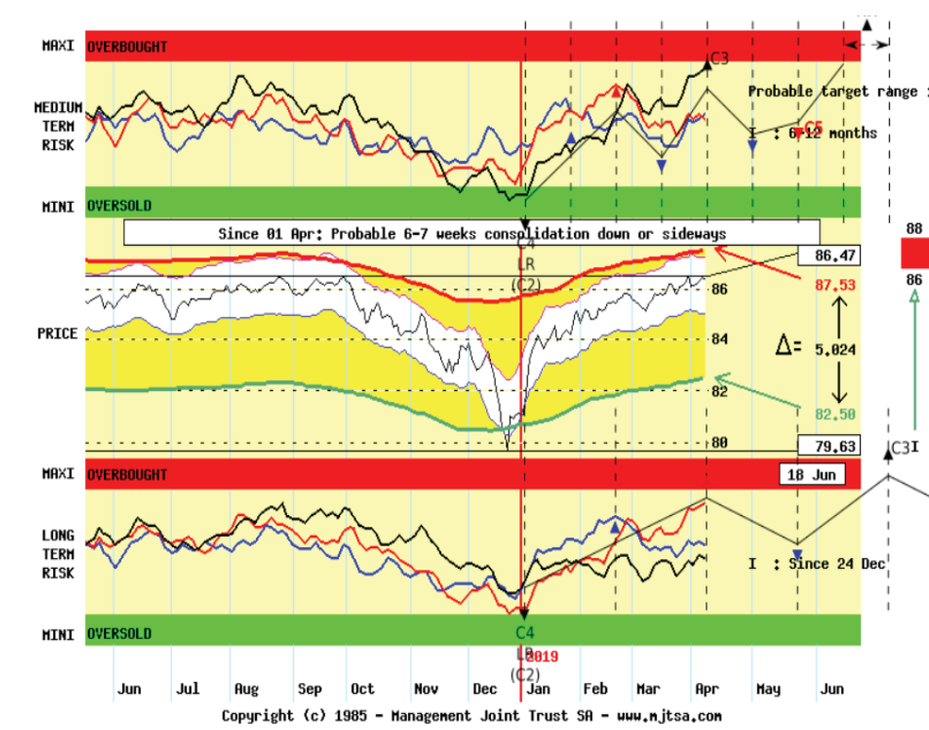
Late Last year, the Duration play did marvels as a hedge vs declining equities. Again, since the beginning of the year, and despite the strong risk asset rebound, it has continued to deliver stable and less correlated performance. That said, the 60 to 100 basis points retracement on US yields we had anticipated last October may slowly be coming to an end. Indeed, from May, we expect yields to start reversing up, potentially retesting last year's highs towards late Summer / the Fall. In this article, we consider the risk/reward for both US Investment Grade and US High Yield considering that Duration risk may be getting stretched, while Credit may still have several quarters to perform.

LQD - iShares Investment Grade Corporate Bond ETF
Daily graph or the perspective over the next 2 to 3 months



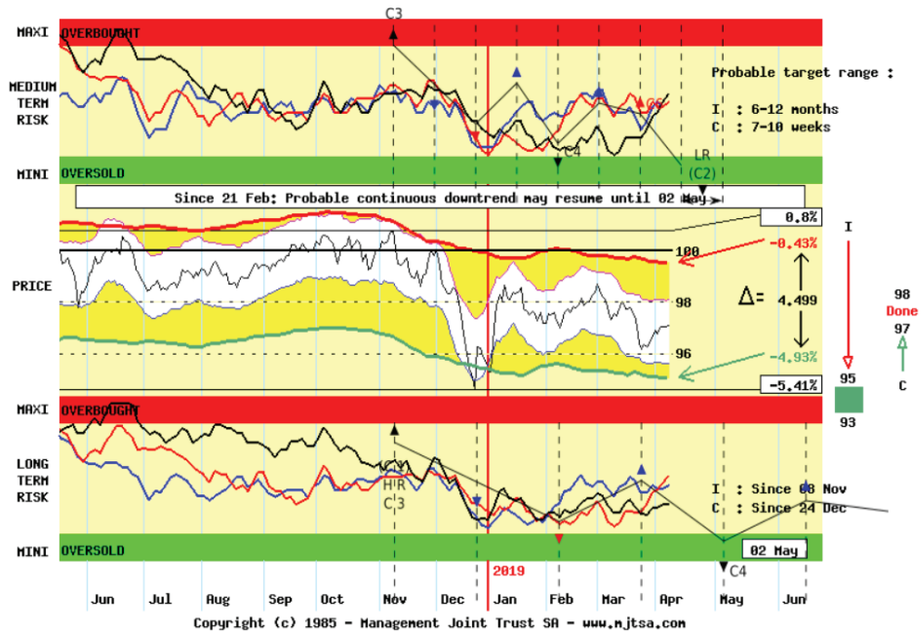
The current uptrend for this long duration Corporate ETF (8.3Y duration) may not be quite finished yet. Our I Impulsive targets to the upside (right-hand scale) still suggest 1 to 3 % of potential upside, while our medium term oscillators (upper rectangle) point to a prospective top late April / early May. That said, **the trend has already traveled a long way since last November, and our long term oscillators (lower rectangle) have now reached a "High Risk zone". The risk/reward is hence stretched and by May, we fear that the current uptrend may start to reverse.** Our C Corrective targets to the downside (right-hand side) indicate an initial 3 to 5% risk, once it starts to reverse.

HYG - iShares High Yield Corp. Bond ETF
Daily graph or the perspective over the next 2 to 3 months



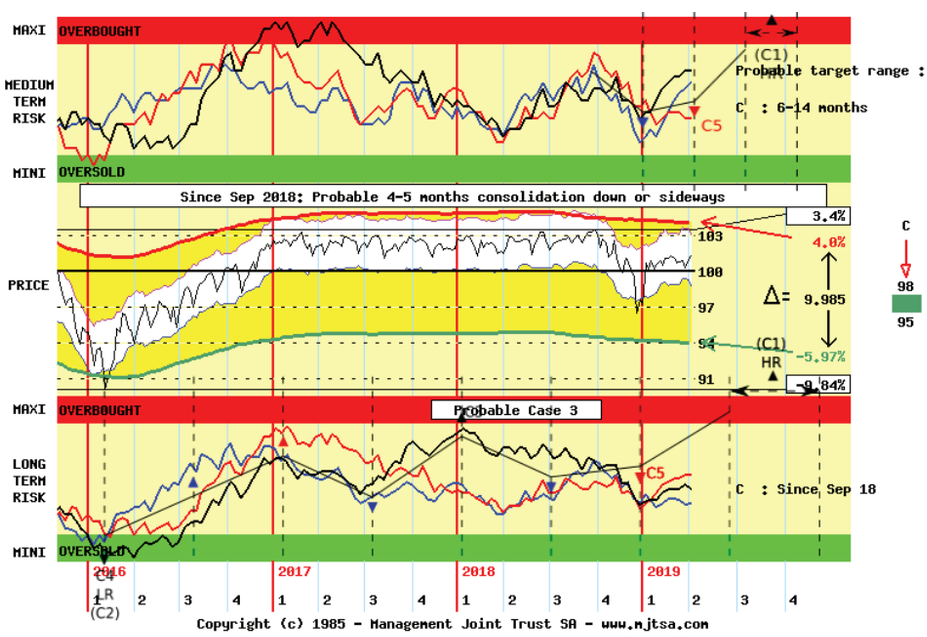
This High Yield ETF is of rather short duration (3.77Y). During Q4, it dipped almost 8% while Investment Grade Bonds of similar duration were either flat or slightly ascending. Hence, the Q4 sell-off can be fully attributed to widening credit spreads. These have since narrowed again along with the bounce in risk assets. Both our oscillator series (lower and upper rectangles) suggest that it may currently be **reaching an intermediate top and that it could correct during 3 to 6 weeks to the downside. By early/mid May, however, we then expect HYG to resume its uptrend into the Summer, with capital gain targets possibly 2 to 3% higher than today. Our view is that the current risk of a short intermediate correction is probably outweighed by the high yield cushion this instrument bears (YTM 6.31%).**

HYG - iShares High Yield Corp. Bond ETF vs LQD - iShares Inv. Grade Corp. Bond ETF
Daily graph or the perspective over the next 2 to 3 months



Yet, comparing both (i.e. different duration, different credit rating), Investment Grade may still have slight edge in the near term, although in terms of yields, High Yield offers almost twice as much as Investment Grade (YTM 6.31% vs 3.89% for these ETFs). Indeed, both our oscillator series suggest (lower and upper rectangles), that **the ratio's current downtrend is probably not quite over yet, and may extend into late April / early May. The remaining relative risk to the downside is between 2 and 4% according to our I Impulsive target down (right-hand scale). We would hence probably wait until the end of this month to consider a switch.**

High Yield vs an Investment Grade portfolio of similar duration
Weekly graph or the perspective over the 2 to 4 quarters



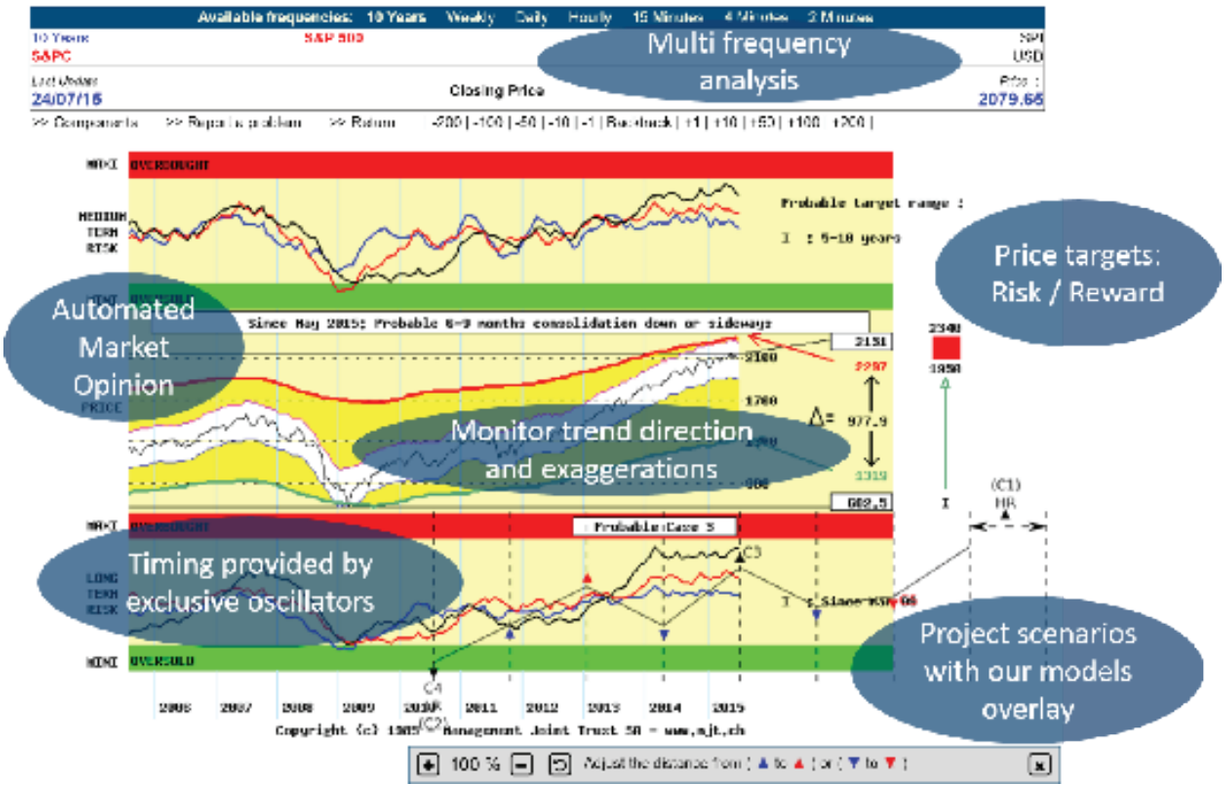
For this graph, we compare the HYG High Yield ETF (3.77Y duration, YTM 6.31%) with a portfolio composed of 28% of the VCIT Vanguard Intermediate-Term Corporate Bond ETF (6.31Y duration, YTM 3.82%) and 72% of the VCSH Vanguard Short-Term Corporate Bond ETF (2.79Y duration, YTM 3.16%). The resultant comparison is neutral in terms of duration, while High Yield offers an additional carry of circa 3%. As we can see from this graph, the ratio follows periods of rapid sell-offs during strong risk assets corrections, followed by rapid recoveries (H2 2015 – 2016, Q4 2018 – Q1 2019). Between these, High Yields performs on par and generates additional yield. Both our oscillator series (lower and upper rectangles) suggest that **the recovery since December last year may not be over yet, and that it could extend higher into the Summer. Hence, from late this month / early May (as mentioned in our previous graph), we would probably consider an increase in High Yield exposure.**

Concluding remarks:

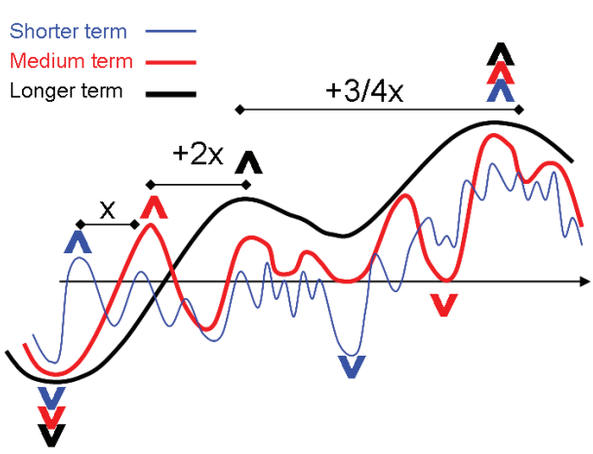
Over the next few months, on a neutral duration basis, we expect further capital gains for High Yield over Investment Grade. This should come on top of the additional yield it generates. On the other hand, the duration trade, which has been very successful over the last 4 to 5 months is probably getting ready to top-out, probably towards late April / early May. Until then, Duration may still have a slight hedge over Credit. Yet, by the end of this month / early next, we would probably favor a subsequent reduction in duration, as well as an increased exposure to the higher yielding segments of the Credit space.

54/ METHODOLOGY

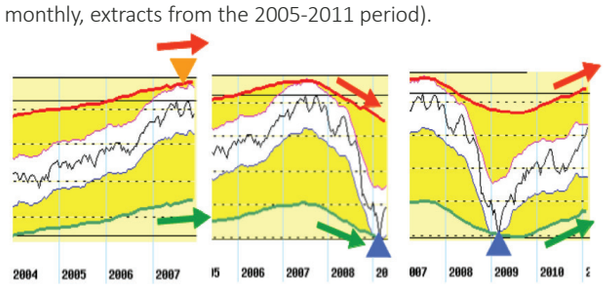
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



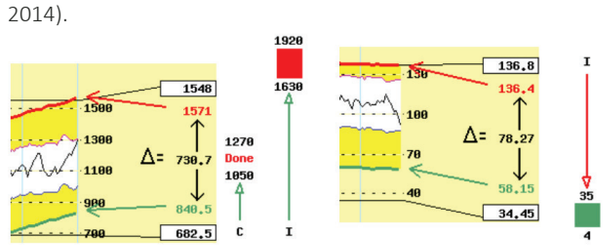
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)



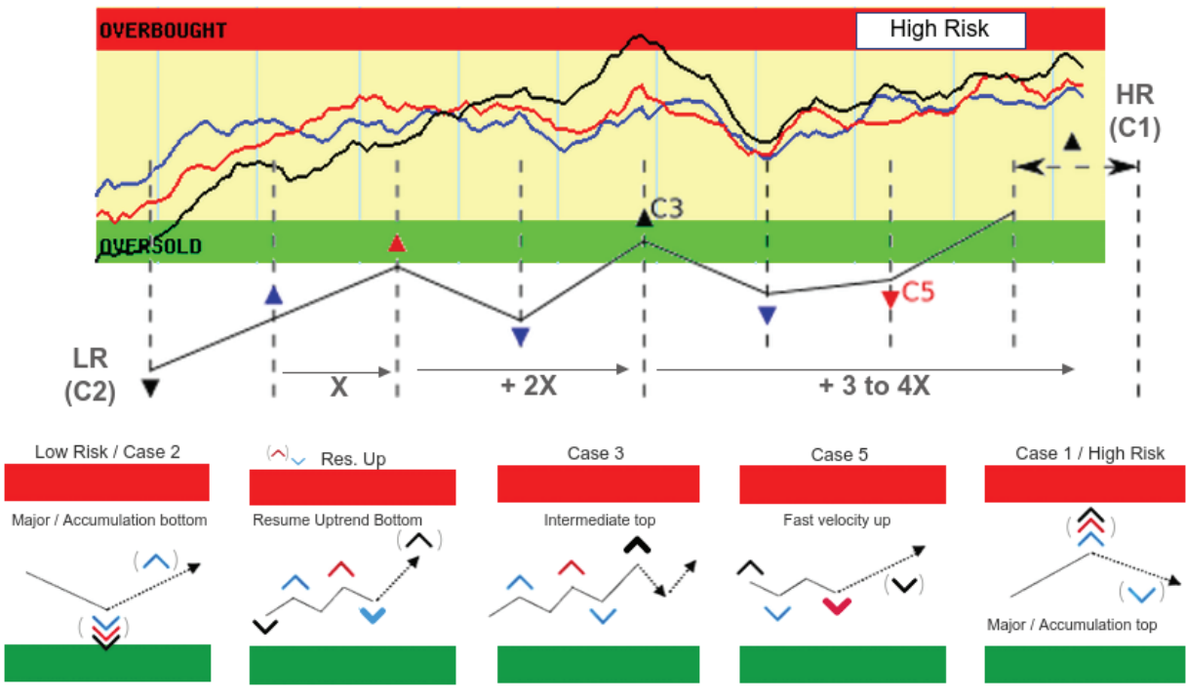
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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).

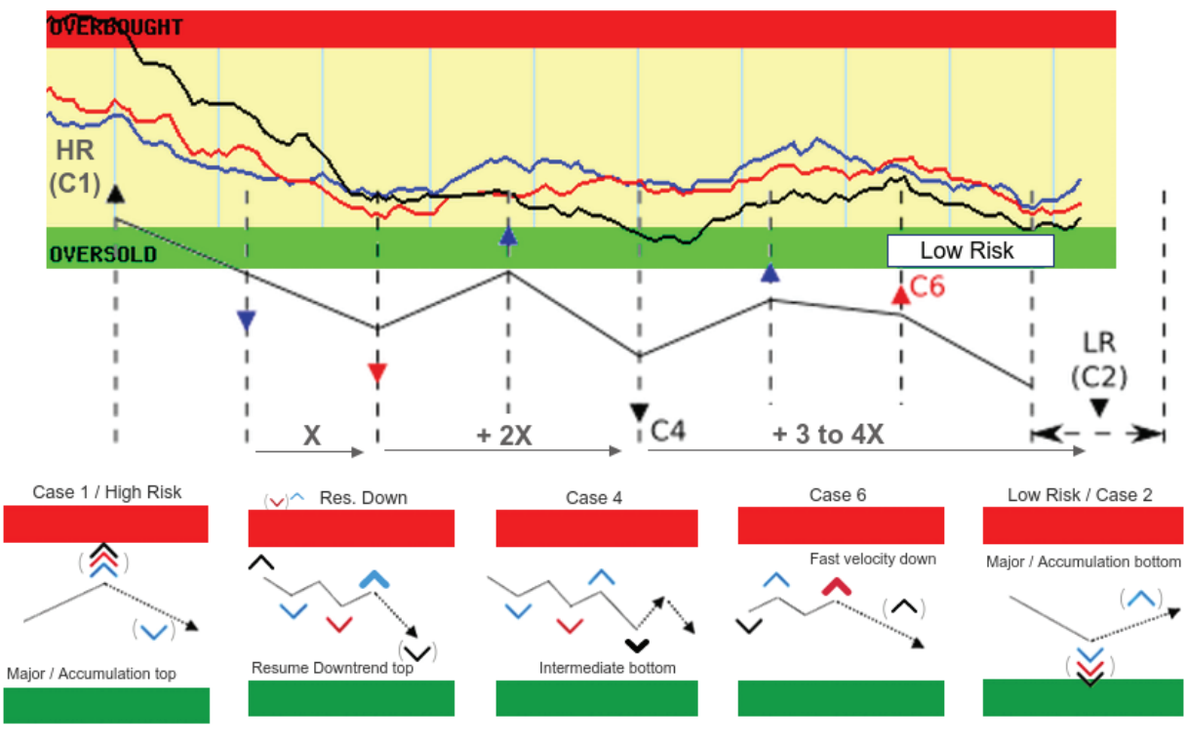


Ideal Uptrend Model



(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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