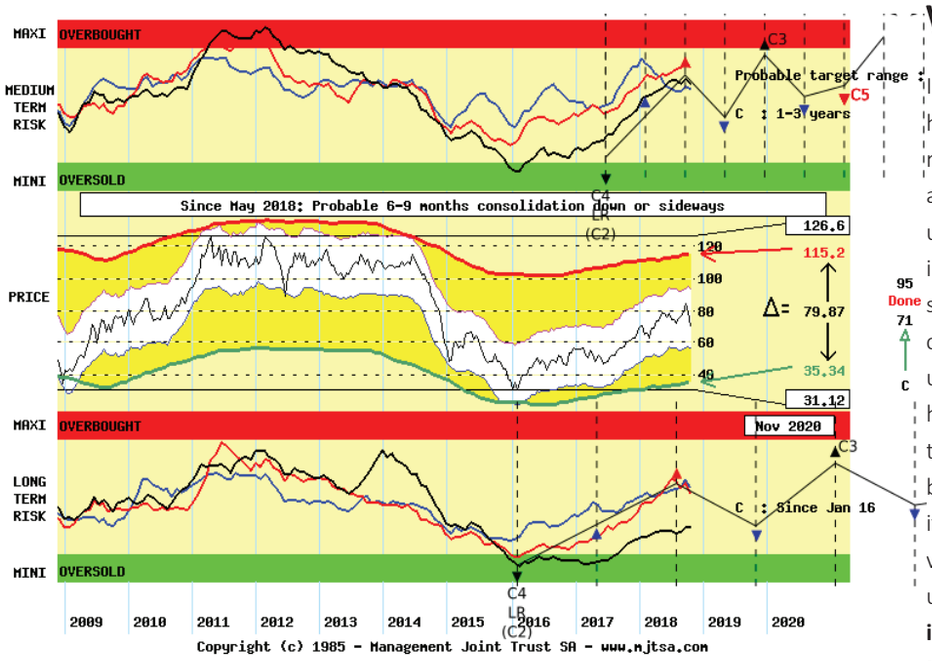
37 / MJT - TIMING AND TACTICAL INSIGHT

Expect one last retest down on Commodities, probably towards mid/late Q1 2019

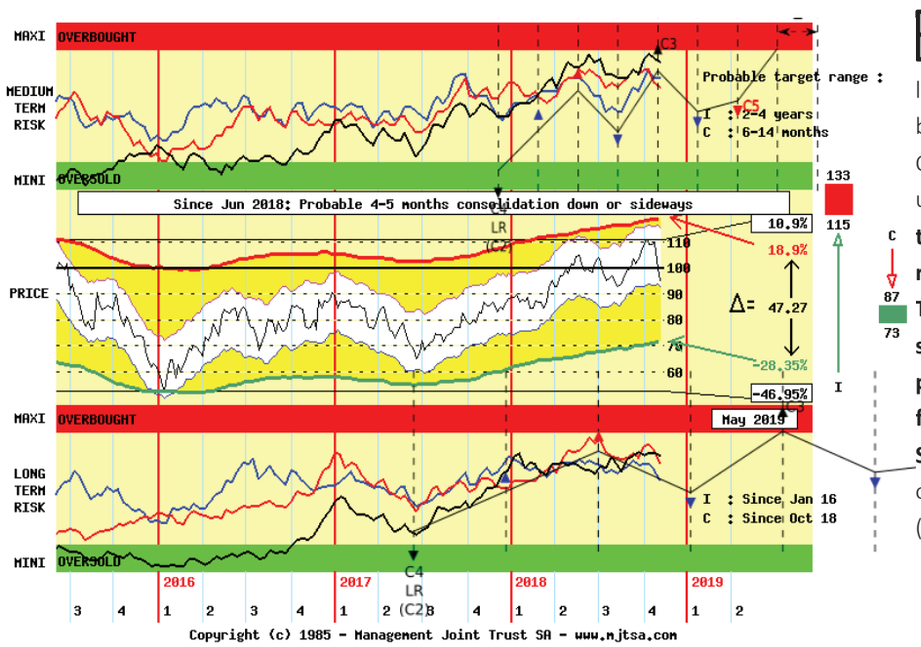
It has been a difficult year for Commodities, except for Oil which managed to extend its 2016-2017 uptrend until early October. Now that Oil has also started to correct down, one may wonder if the Commodity space is resynching to the downside, and how long and deep the current correction could continue. In this article, we review the various Commodity profiles (Energy, Industrial Metals, Gold and Agricultural Commodities), both on a standalone basis and vs Equities.

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



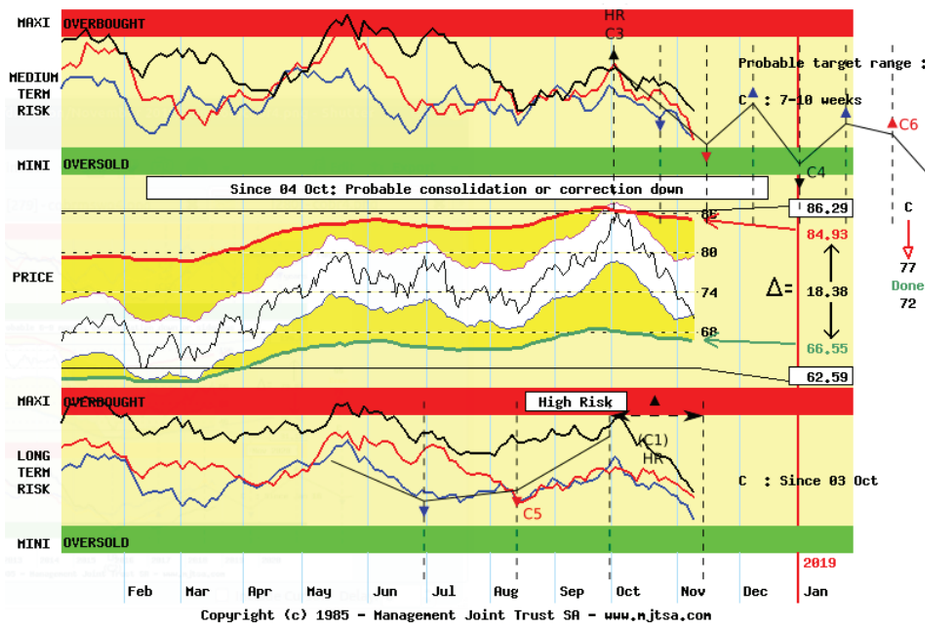
We start this commodity review with the long term graph of Oil. Indeed, Oil is a late cycle performer and has been emblematic of the reflationary re-acceleration that started 2.5 years ago. On both oscillator series (lower and upper rectangles), it recently reached important intermediate tops. These should imply between 3 to 5 quarters of correction to the downside. The move up since 2016 has been impressive. It has fulfilled our C Corrective targets to the upside between 71 and 95 USD/barrel (right hand scale). Yet for now, it has failed to break above these levels to confirm a long term impulsive uptrend. **Hence for now, we are still in the early stages of a potential long term uptrend, and during these early stages, retracements can be quite drastic. We would hence tread with extreme caution on oil over the next 3 to 6 months at least.**

Brent Oil (USD/barrel) vs the MSCI World Index
Weekly graph or the perspective over the next 2 to 4 quarters



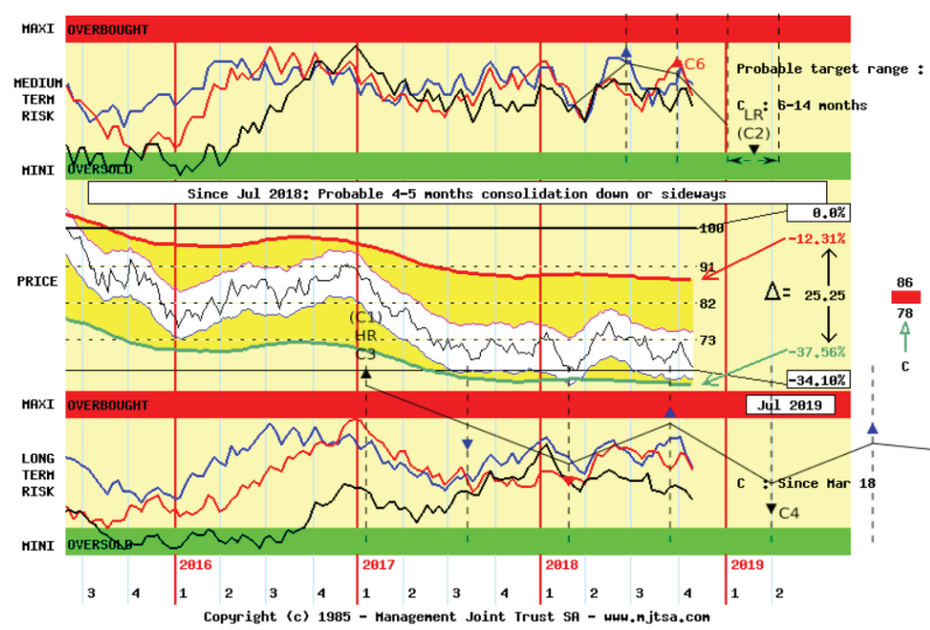
Both Oil and global Equities have been in strong uptrends since early 2016. When comparing both, Oil has been stronger given its higher volatility. On both our oscillator series (lower and upper rectangles), **the ratio of Oil vs the All Country World Index recently reached an important intermediate top. The current correction to the downside could last until early next year and possibly into the Spring. Oil could still fall between another 10 to 20% vs the S&P500 during this period** according to our C Corrective targets to the downside (right-hand scale).

Brent Oil
Daily graph or the perspective over the next 2 to 3 months



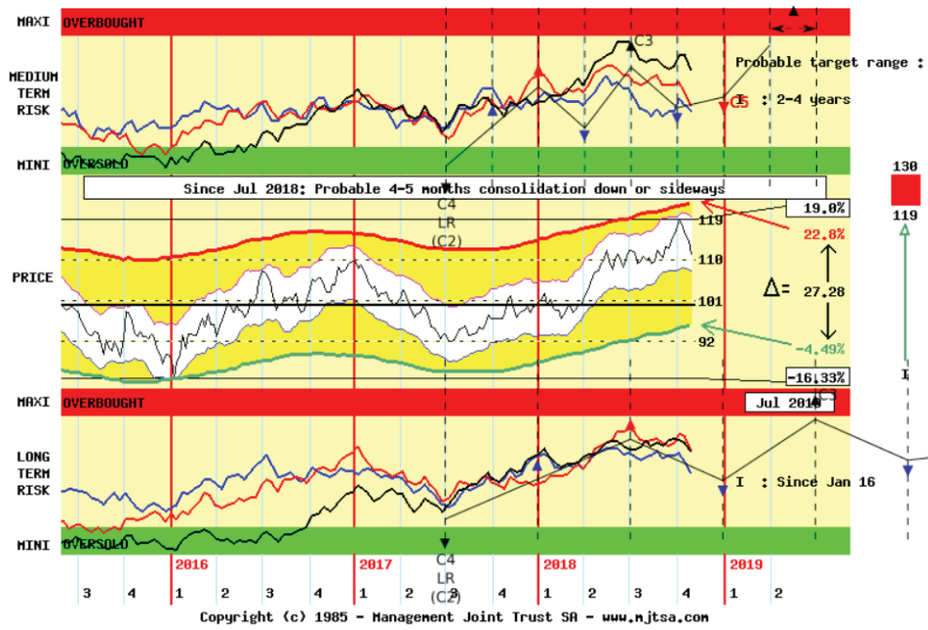
Shorter term, **Oil reached a High Risk situation early October** on both oscillators series (lower and upper rectangles). Such situations usually trigger at least 2 to 3 months of correction to the downside. The sequence we show on our medium term oscillators (upper rectangle) would suggest **a first intermediate low towards mid November and a slight bounce. Following that, Oil could resume lower first towards year-end and then possibly into late Q1**. On the target front, Oil just made it below the support of our C Corrective targets to the downside (right-hand scale). The next level of targets, **our I Impulsive targets to the downside would calculate in the 62 – 55 USD/barrel (right-hand scale). This is another 10 to 20% below current levels**. We would hence suggest to limit investments in the Oil space between late November and early next year.

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



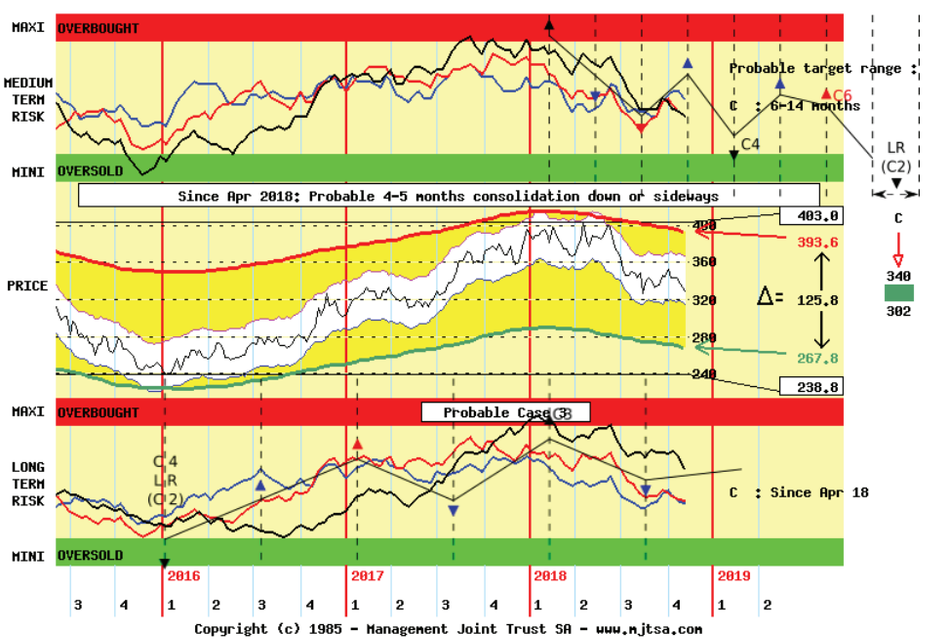
Despite the strong rise in Oil prices since early 2016, the US Energy sector has consistently underperformed the S&P500 Index. This poor relative performance is most likely attributed to the Value characteristic of the sector in an environment where the US Yield curve was mostly flattening. Going forward, both our oscillators series (lower and upper rectangles) are suggesting that the current downtrend may continue towards Q1 next year, probably towards late Q1**. Following that, the sector may start to bounce vs the market during the Spring and could outperform by circa 20 to 30% towards late Summer 2019 according to our C Corrective targets to the upside (right-hand scale).**

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



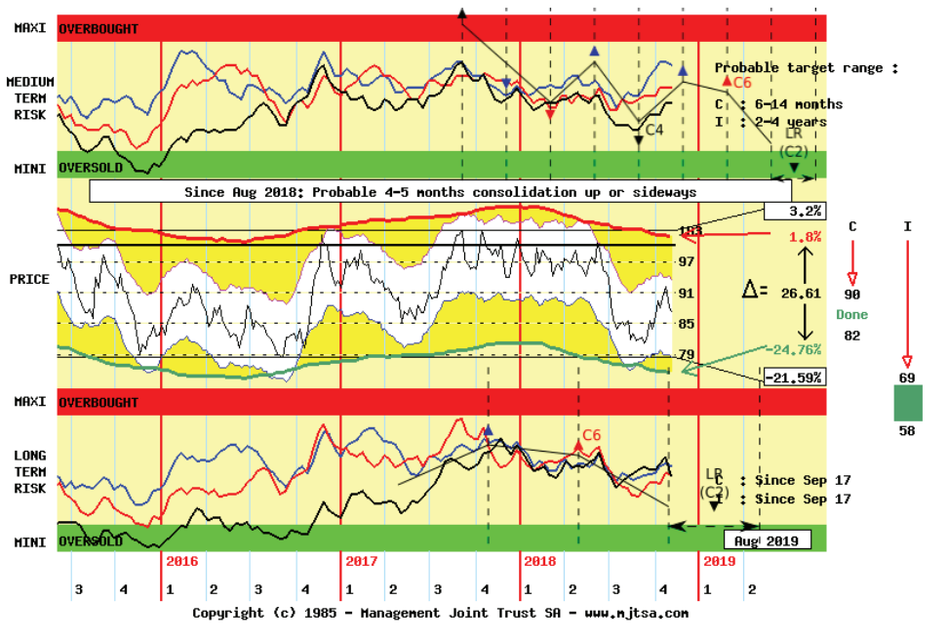
In Europe, the sector has shown a much stronger performance vs the EuroStoxx600 index during the 2016-2017 reflation period. Yet, recently, in early October, it also made an important intermediate top. Both our oscillator series (lower and upper rectangles) are suggesting **that the current correction could last until year-end at least. Following that, from Q1 and into midyear 2019, our I Impulsive targets to the upside (right-hand scale) are suggesting that the sector could outperform the Europe Stoxx 600 by 10 to 20%.**

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



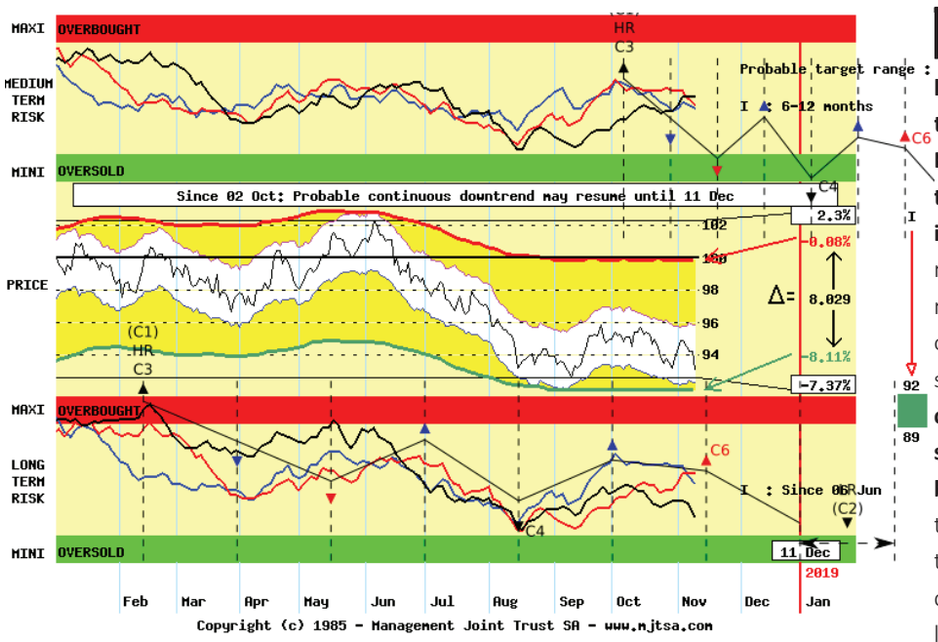
Since the Spring, Industrial metals have also been correcting down. Indeed, these are very much related to China, which for example accounts for circa 70% of the global demand for Copper. Hence, as China decelerates, industrial metals prices are correcting. **For now, we expect them to continue lower** (the sequence we show on our medium term oscillators; upper rectangle), **first into mid Q1 2019, and then following a Spring bounce, probably once again during H2 2019**. On the target front (right-hand scale), **we are currently working through the support of our C Corrective targets to the downside between 340 and 302 (right-hand scale). If these break over the next couple of months, much lower targets could then be envisaged probably towards the 2016 lows by the end of 2019.**

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



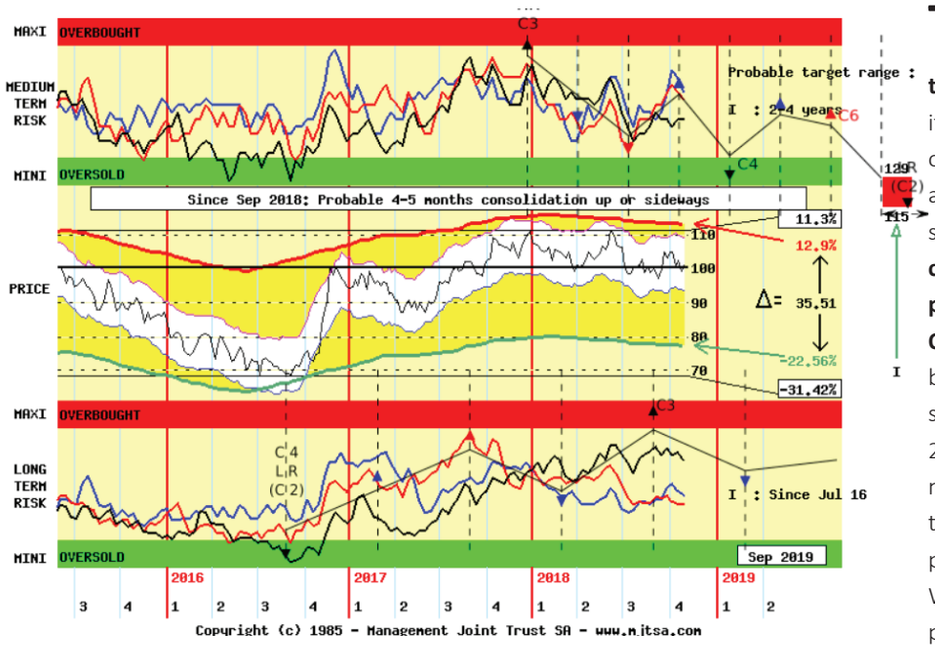
We now compare Copper vs the All Country World Index. For now, the ratio is still in a downtrend, despite its strong bounce over the last couple of months. **We expect it to resume lower soon, probably towards late Q1, early Q2 at least** on both our oscillator series (lower and upper rectangles). This Summer, the support of our C Corrective targets to the downside, did break although briefly (right-hand scale). This has opened the door to **much lower targets (I impulsive targets to the downside) some 20 to 30% lower than today. Given this risk, we would avoid any exposure to industrial metals, until this Spring at least.**

Equal Weighted Portfolio of US Mining and European Natural Resources vs their respective Market Indexes
Daily graph or the perspective over the next 2 to 3 months



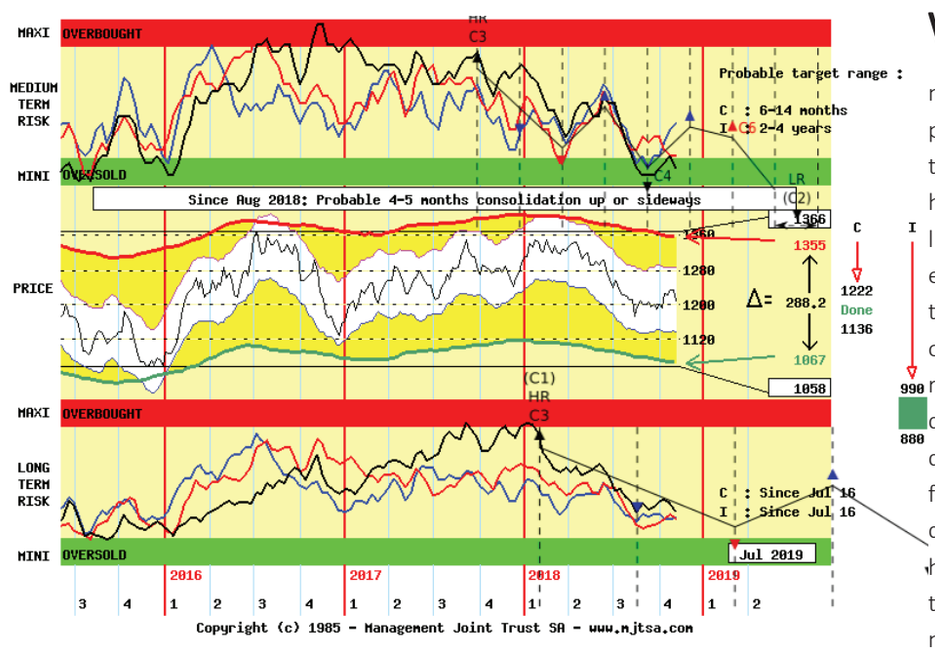
In this graph, we have computed an **equal-weighted balanced portfolio of the US Metals & Mining sector and the European Basic Resources sector vs their respective market indexes**. Both sectors are very much exposed to the industrial metals space. Our long term oscillators (lower rectangle) are suggesting that **the portfolio could resume its downtrend soon, probably towards February next year.** Our medium term oscillators (upper rectangle) could make an intermediate bounce between mid and late November and then move lower again towards January and then possibly towards late Q1. Our I Impulsive targets to the downside (right-hand scale) show another 5% of underperformance for these sectors vs the market. On its Weekly graph (not shown here), the underperformance is more compelling, possibly towards 10 % into Q1 2019. **We would hence avoid any exposure to these sectors until then.**

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



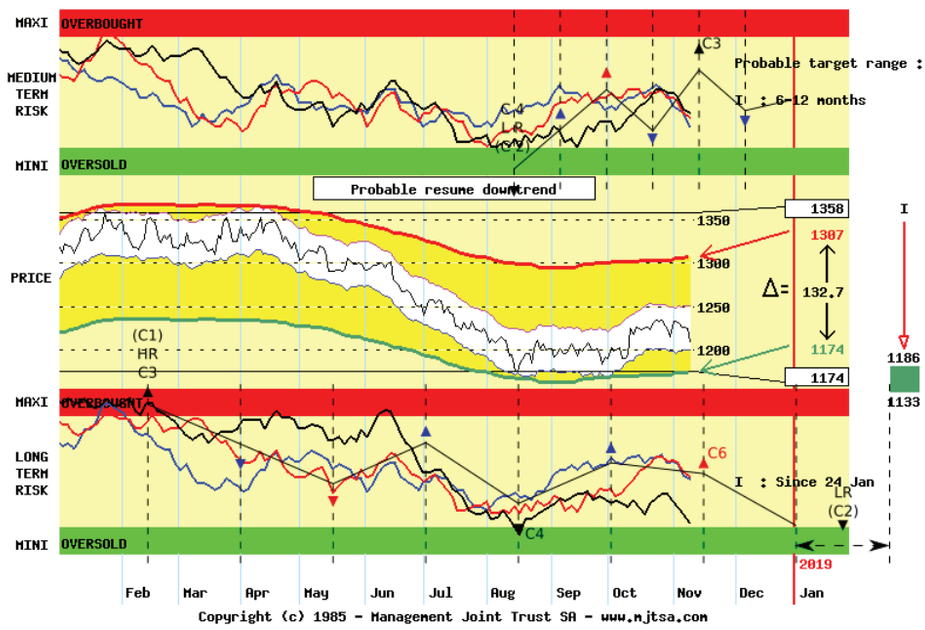
This ratio is emblematic of the 2016-2017 reflation trade. Yet, since June this year, it has been rolling over. Both our oscillator series (lower and upper rectangles) are now suggesting **that the current correction to the downside probably continues until mid Q1 at least**. Following a Spring bounce next year, it could resume lower again during H2 2019 (upper rectangle). For now, our I Impulsive targets to the upside (right-hand) are still pointing to new highs in 2019. We doubt this can actually happen. Rather, **we prefer to focus on our C Corrective targets to the downside, which would currently calculate in the 93.5 – 83.0 range** (0.5 to 0.8 times our historical volatility measure "Delta" – here at 35.51%; middle rectangle, right-hand side – subtracted form the graph's highest point at 111.3%), **or circa 7 to 17% lower than today**. **Hence, over the next few months at least, we expect the ratio to continue its recent correction. Copper and Industrial metals should underperform the more defensive Gold and Precious Metals during this period.**

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



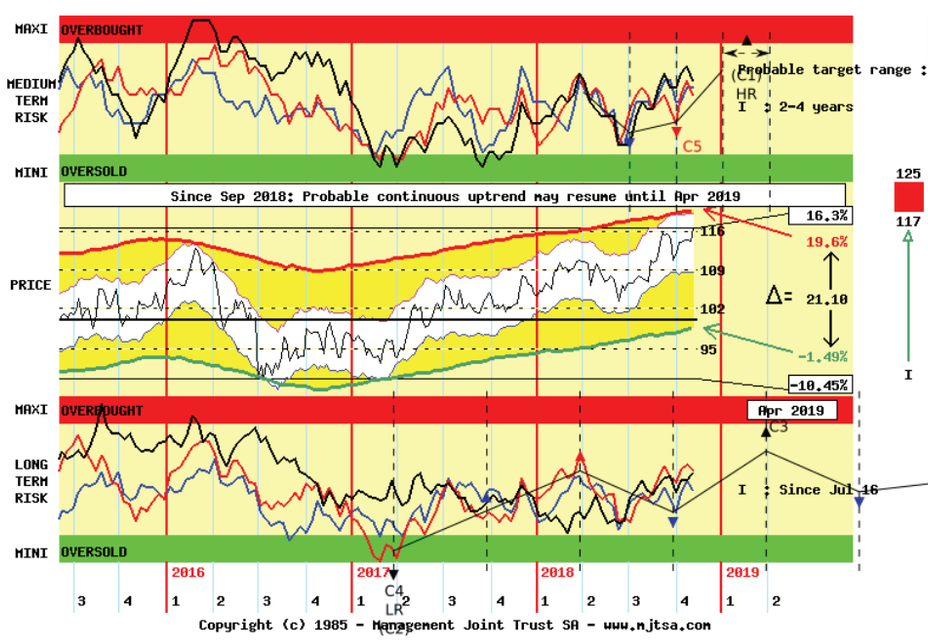
We now turn to Gold on a standalone basis. Our medium term oscillators (upper rectangle) reached an intermediate low mid August and have since seen a weak consolidation to the upside. We now expect them to resume lower towards Q2/mid next year. On our long term oscillators (lower rectangle) we show a slightly different sequence. It is also down-trending, yet basically follows USD/CNY in reverse. Indeed, both the Yuan and Gold have been very correlated vs the US Dollar since the beginning of the year. This second sequence suggests an earlier **low, probably towards mid/late Q1**, which is more in line with the projections on other Commodities in this article. On the target front (right-hand scale), Gold has held for now above the support of the lower end of our C Corrective targets to the downside, above 1'136 (right-hand scale). This is rather reassuring. We would be more worried if at some point over the next few months, it did break through this level as this could imply further downside below the 1'000 mark (a liquidation). **Our preferred scenario for now, is that Gold probably retests below 1'150 over the next few months, but ultimately holds and then gradually resumes up during the rest of 2019. We would however, consider any break below 1'130 as a strong warning signal of further downside risk.**

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



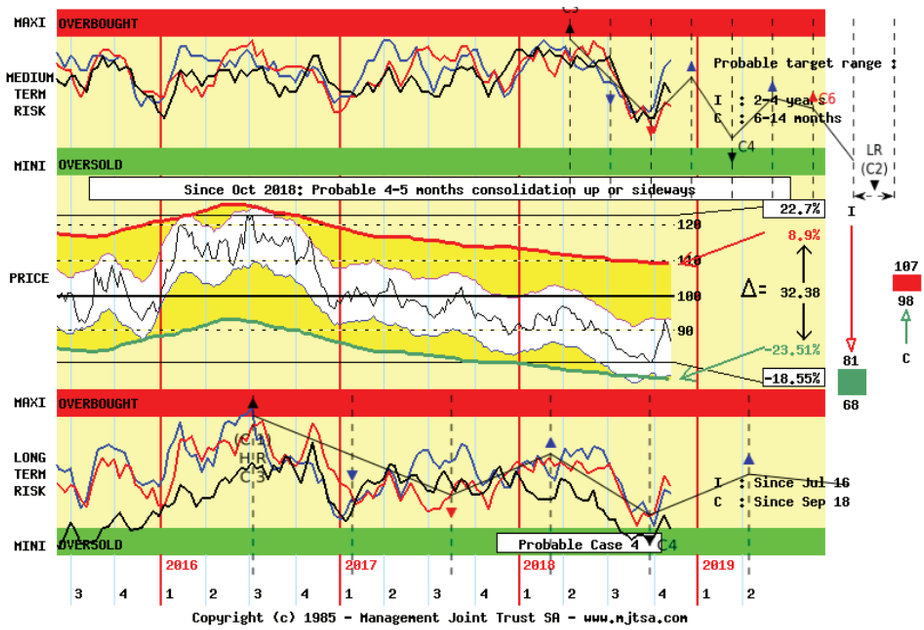
On the Daily graph. Gold is acting very much as EUR/USD. It made a low mid August and has since seen a weak consolidation up. Both our oscillator series (lower and upper rectangles) are now suggesting **that it could resume lower between now and late November, probably towards February. This is in line with our projections on the US Dollar, which highlights the fact the Dollar is still probably the dominant factor affecting Gold prices for now** (rather than its defensive bias). This was also the case during the May to August downtrend period this year (less so during the October sell-off). This usually coincides with negative newsflow in Emerging Markets, rather than in the US. Throughout this issue of The Capital, this is the scenario we are projecting. On the target front, our I Impulsive targets to the downside are suggesting that **Gold could reach back down towards the 1'150s, probably testing its support (mentioned above on the Weekly graph) around 1'130.**

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



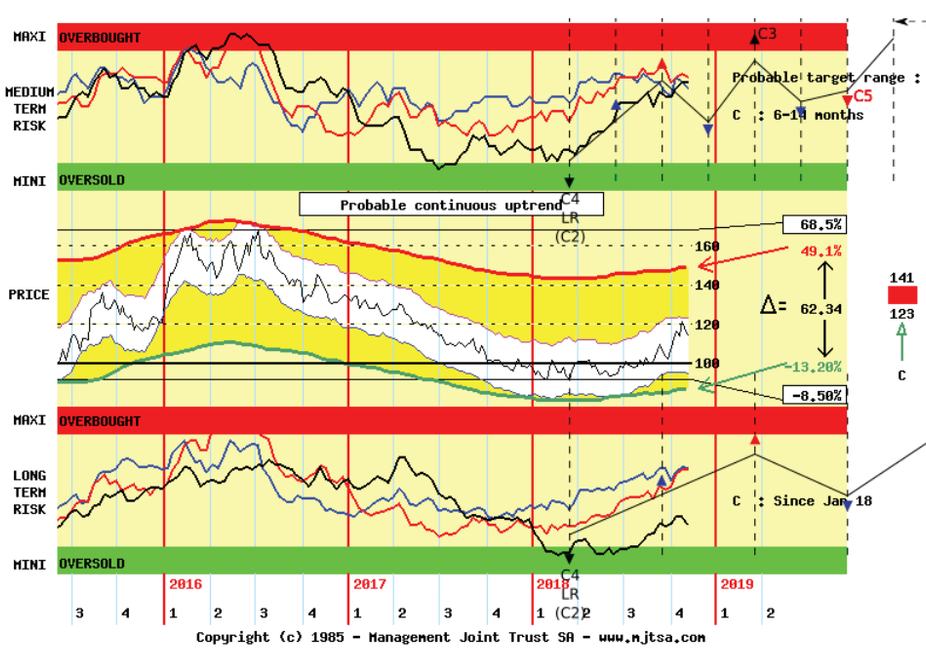
Looking at Gold in EUR doesn't really brighten the picture. As we have argued in previous issues of The Capital Observer, Gold is much more volatile than currencies. Hence, when Gold falls against the US Dollar, it also falls vs other currencies, although slightly less. Our long term oscillators (lower rectangle) may have reached an intermediate low towards late Summer, yet our medium term oscillators (upper rectangle) suggest **a continuation of the downtrend probably into mid/late Q1 next year**. On the target front (right-hand scale), Gold in EUR did break through our C Corrective targets to the downside in September (right-hand scale). Hence, **we cannot exclude that it could reach down into our I Impulsive targets to the downside in the 946 – 857 range. This is more negative than what we are projecting on Gold in US Dollars, but at least it reminds us to remain prudent of Gold until mid/late Q1 at least.**

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



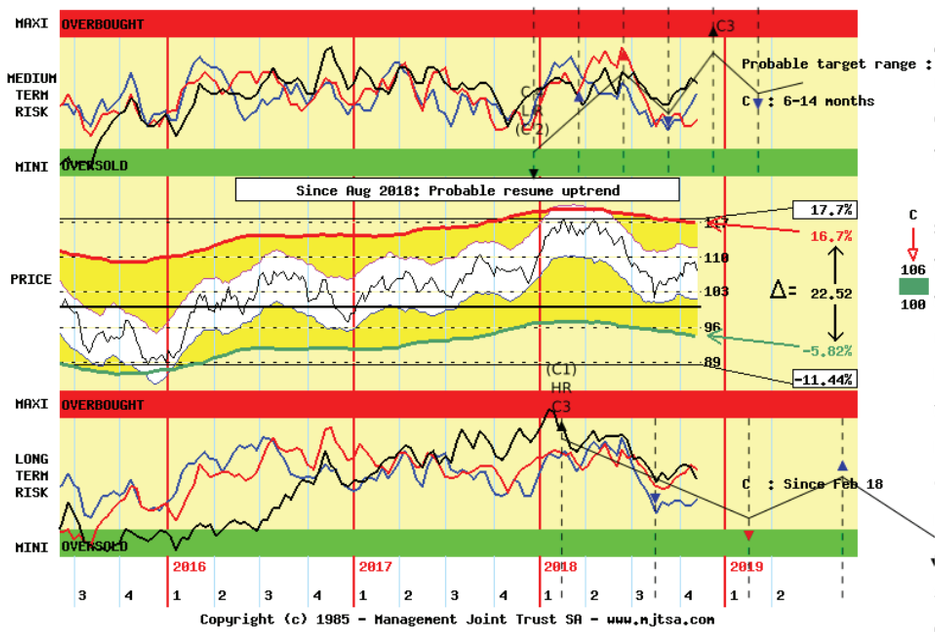
As we have done with other Commodities above, we now compare Gold to the All Country World (equity) Index. On our long term oscillators (lower rectangle), it may have reached an important intermediate low in late September (just prior to the equity market sell-off). Yet, on our medium term oscillators (upper rectangle), **we would still expect one last downside retest into mid/late Q1**. Hence, although Gold is quite Oversold vs Equities, the US Dollar should remain its dominant negative factor, and Gold may underperform equities one last time over the next few months as it already did during the Q1-Q2 Emerging markets sell-off earlier this year. On the target front (right-hand scale), our I Impulsive targets to the downside are still quite compelling. They suggest **that Gold could fall a further 10 to 20% vs Global Equities until mid/late Q1. Following that, it probably rebounds up quite nicely towards mid next year.**

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



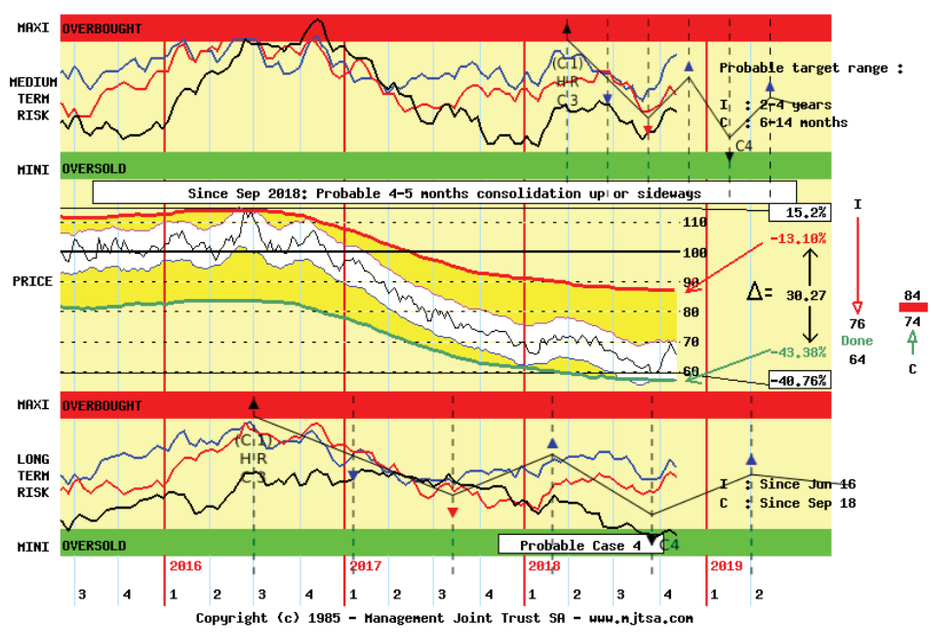
Given the links we make above between Gold, the US Dollar, the Yuan and Emerging markets, it is interesting to compare Gold vs the MSCI China equity index. The resulting profile is quite different to the one of Gold vs Global Equities and it highlights the important risk we expect for Chinese equities over the next few months. Indeed, **since early 2018, Gold has started to trend up vs the MSCI China index and should probably continue to do so towards late Q1 next year** in first instance according to both our oscillator series (lower and upper rectangles). Hence, **Gold may represent an interesting Flight to Safety alternative for Chinese investors if, as we expect, the MSCI China starts to sell-off again.**

Gold Spot (USD/oz) vs 7-10 Year Treasury Bonds
Weekly graph or the perspective over the next 2 to 4 quarters



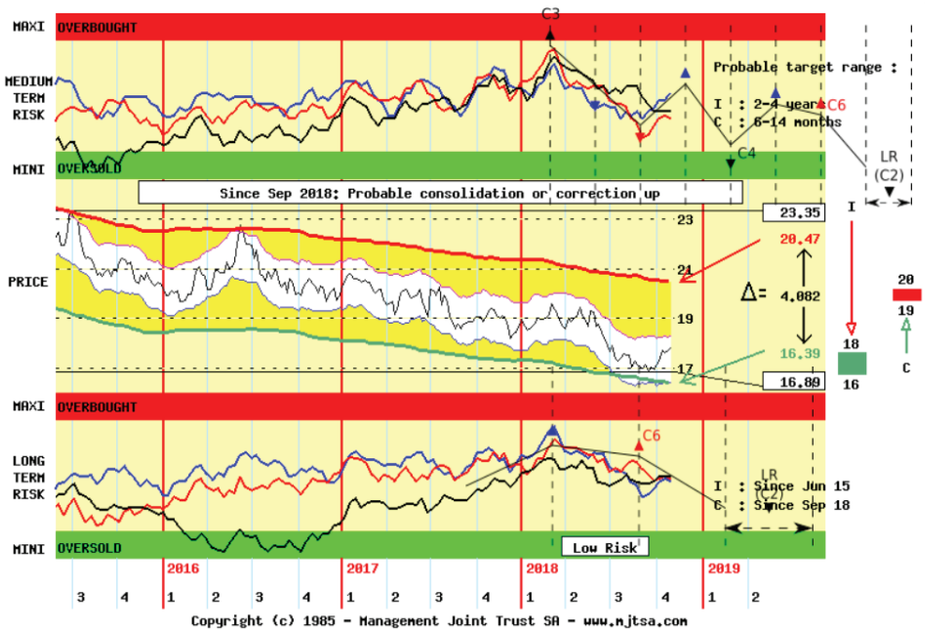
Another comparison, which we believe confirms our negative prospects for Gold over the next few months, is the Gold to US Treasuries ratio. Interestingly, its profile is quite similar to many of the reflation trades, which we have monitored throughout this document. Indeed, Gold outperformed US Treasuries throughout the 2016-2017 reflationary period, and since the beginning of this year, it has started to retrace. While, our long term oscillators (lower rectangle) are suggesting that **the ratio could continue lower towards mid Q1 in first instance**, our medium term oscillators (upper rectangle) are pointing that this move could start over the next few weeks. Given the above, we would consider Gold as a reflationary asset vs US Treasuries, i.e. **Gold for now is more pro-cyclical than Treasuries, and in the current strong US Dollar environment, Treasuries are more defensive than Gold.**

Cap Weighted Portfolio of Agricultural Commodities vs the MSCI World Index
Weekly graph or the perspective over the next 2 to 4 quarters



One last Commodity segment we are considering is this article is Agriculture Commodities. The portfolio we show contains various grains and softs, each equal weighted according to the Reuters Commodity Futures Price Index. Agricultural Commodities are usually more defensive than other Commodities and hence their profile vs the All Country World (equity) Index is closer to Gold than to cyclical Commodities such as Oil or Industrial Metals. **As with Gold vs Equities, our long term oscillators (lower rectangle) probably made an important low late September, yet our medium term oscillators (upper rectangle) are still suggesting a last downside retest, probably into mid Q1 next year.** On the target front (right-hand scale), the downtrend since 2016 seems exhausted. Hence, although we suggest to wait another 2 to 3 months, **Agricultural Commodities may provide an interesting diversifying trade to equities, probably from mid/late Q1 into mid 2019 in first instance.**

PowerShares DB Agriculture Fund
Weekly graph or the perspective over the next 2 to 4 quarters



We finally look at the Powershare Agriculture Fund as a proxy for the path of Agricultural Commodities on an absolute basis Its profile confirms our relative timing vs Equities outlined in the graph above. Indeed, our long term oscillators (lower rectangle) have reached an important intermediate low this Summer ("Low Risk" as mentioned on the graph), and our I Impulsive targets to the downside (right-hand scale) have been achieved (i.e. the downtrend since 2016 is exhausted). Yet, **both our oscillator series (lower and upper rectangles) still suggest one last retest lower, probably into mid/late Q1 next year. Following that, we hence expect that Agricultural Commodities could present an interesting value opportunity, probably from Spring to Summer next year.**

Concluding remarks

While Oil recently topped out in early October, other Commodities (Industrial Metals, Gold, Softs and Grains) have been suffering since the Spring, mainly from USD strength and a deceleration in China. We believe these factors should continue to influence the wider Commodity space probably towards mid/late Q1 next year. Oil should correct down until then, Industrial Metals should continue their correction, and Gold and Agricultural Commodities should retest down once more. Although, we do expect Equities to also resume lower during this period, Commodities are more volatile, and should hence continue to underperform Equities over the next few months. From mid/late Q1, however, Commodities may represent a strong investment case both on an absolute basis and vs equities, probably until Summer next year at least.