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

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Diapason Currencies & Commodities

MJT

DIAPASON CURRENCIES AND COMMODITIES MACRO ANALYSIS

A Monthly Macro and Asset Review

Featuring MJT's Timing Methodology

CONTENTS

04/ Executive Summary

06/ Mapping the markets

12 / The Cycle Is Transitioning Towards The Last Stage - Asset Outlook For H1 2018

18 /Timing and Tactical Insight

Since September, Inflation and Growth expectations have finally been pulling long term rates up, how long is this trend sustainable?

Heading into 2018, it is important to remember some time-tested principles for successful long-term investing: cash isn't always king, diversification is essential, harness the power of compounding and don't let volatility derail you.

J.P Morgan Market Insights, January 2018

Europe's financial industry is distracted by the introduction of 7,000 pages of penalising regulatory restriction, the only certain aspect of whose consequences is that they will be unintended by its authors. It is not entirely coincidental that the equity year has begun with a profit warning from one of the region's beleaguered investment banks. It is extraordinary that in the year in which the euro zone economies finally emerged from a decade-long stagnation the volumes traded of the area's largest stocks fell to the lowest level since 2001

Christopher Potts, Head of Economics, Kepler Cheuvreux

24 / The US Dollar will be boosted by capital inflows in 2018 and should rise again – that could push the economy, markets over the tipping point

27 /Timing and Tactical Insight

The US Dollar could bounce in Q1, re-test down in Q2 and then accelerate up in H2 2018

32 / Medium-term prospects for Gold, Silver and Gold Miner Equities : Q1 should not be supportive for the precious metal sector

35 / Timing and Tactical Insight

Commodities have re-synched in December, yet should diverge again in Q1

43 / These hurdles should not stop investors from engaging the equity markets this year

45 /Timing and Tactical Insight

Equity markets have now entered the latest stages of their uptrend, they should top out between March and mid year

53 / Splicing the markets - Avoid negative USD correlations until March

4/ Executive Summary

12 / **The Cycle Is Transitioning Towards The Last Stage - Asset Outlook For H1 2018 -** Despite strong global equity performance in 2017 and markets, which are expecting cyclical reflation, it seems that many investors are still wedded to the idea of New Normal playbook: they have settled into expectations for 'more-of-the-same' which has been low, non-inflationary-driven growth. Investors have also become wary of the elongated business cycle, and more conservative in their longer term outlook as last year progressed. Indeed, the market performance in most part of 2017 was typical of the asset performance and the state of investor sentiment just ahead of a last reflation stage, which we believe started to unfold late last Summer and could continue over the next 6 to 9 months. Gradually, the wariness seen last year should disappear as many investors who stayed away will re-embrace the cyclical side of markets, re-enter the USD and push yields higher during H1 2018. But this phase should mark the latest stage in the uptrend cycle, as the blow-off turns into the initial stage of a important downward correction. Once it happens, a more defensive positioning in equities, currencies, credit and commodities will be warranted, and fixed income will become the sole safe haven along with gold and maybe the agricultural sector.

18 / **Timing and Tactical Insight - Since September, Inflation and Growth expectations have finally been pulling long term rates up, how long is this trend sustainable?** - Equity to Bond ratios are still rising. From what we can assess today, until late Q1 for the US, and late Q2 for Europe. Both timing points correspond to potentially two tops on the US 10 year benchmark bond yield. For Q1, we are still very positive on the reflation trade: we would expect an environment of rising yields (towards 2.8% on the US 10Y), rising equity and probably a stronger US Dollar. Our perspective for Q2 are still split between two scenarios, one where markets start to distribute, US equities and yields first correct down, then re-retest up towards mid year, yet will not necessarily make new highs, the other, where the reflation trade follows through relatively unscathed into Q2, and ends with a late cycle Commodity blow-off, with US 10Y yield reaching above 3%. Perhaps, a mix of both.

24 / **The US Dollar will be boosted by capital inflows in 2018 and should rise again - that could push the economy, markets over the tipping point -** The dollar has weakened for most of 2017, and did so in several waves. However, the response by investors to the incentives partly created by the combination of monetary and fiscal policy will soon determine the near-term course of the US Dollar and its counterparts. The US just announced significant tax cuts even as the economy showed signs of accelerating. The reduced corporate tax should encouraged capital repatriation and new inflows of foreign capital. The US has morphed from having the highest tax regime in the G5 to the lowest . This could be a game-changer for Foreign Direct Investments (FDIs) which play a large part in a currency's long term valuation. This will have significant impact on the course of US bond yields and the US Dollar during 2018 and perhaps beyond.
But the combination of rising US Dollar and rising inflation, which we both expect to see not so long from here, will lead to tighter financial conditions later in the year. If the Fed follows through with its self-imposed regimen of three policy rate increases of 25 basis points for 2018, it may just push the financial markets and the economy over the tipping point. The US dollar is the most important asset class to watch in 2018.

27/ **Timing and Tactical Insight - The US Dollar could bounce in Q1, re-test down in Q2 and then accelerate up in H2 2018** - Over the last few weeks, the Dollar has sold off against most currencies as well as against most USD denominated assets. We believe it is now Oversold, and that, over the next few weeks, it could initiate a bounce, which could last into March and travel 3 to 5 figures vs other Major currencies. Following that, the Dollar could retrace back down during Q2, before it accelerate up again from mid 2018 towards 2019. On the sidelines, Commodity currencies, should be particularly strong vs the Majors, between late Q1 and mid year, probably a sign of a late cycle Commodity blow-off.

32 / **Medium-term prospects for Gold, Silver and Gold Miner Equities : Q1 should not be supportive for the precious metal sector -** Precious metals rallied 13.4% higher in 2017 (DCI Precious Metal index), thereby posting its second consecutive annual gain-- precious metals gained 11.50 % in 2016. It was also the best yearly performance for gold since 2010. The US Dollar and precious metals (as well as a host of other cyclical assets) have also been very responsive to the changes in liquidity funding measures being provided by the Federal Reserve and the US Treasury. Although the impact of liquidity on asset prices is short-lived (from 3 to 6 months), the distributed, lagged effect could sometimes be profound, and could be a determinant of the high-frequency changes in precious metals and some cyclical assets. Our liquidity funding models (derived from Fed and Treasury provided financing flows) suggest that precious metals (especially Silver and Gold) are still getting some support on the very short term, then this should be followed by a likely decline in the price of those assets until the first half of April.

35 / **Timing and Tactical Insight - Commodities have re-synched in December, yet should diverge again in Q1 -** As the Dollar sold off again in December, Copper, Gold and Oil have all been on the rise. Yet, the Dollar bounce we expect over the next couple of months should bring some differentiation within the Commodity space. Indeed, during Q1, Oil should continue to perform, while Copper consolidates at high levels and Gold sells off. From Q2, Copper should take the lead while Oil continues to perform and Gold stabilizes. Finally, from mid year, we would be buyers of Gold, while selling Oil and Copper. On the equity side, we would favour Energy (and especially its deep value segments) in Q1, Diversified Metals & Mining in Q2 and Gold mines for the rest of 2018.

The Capital Observer editors team, London / Geneva, January 10th 2018
to view previous issues, please visit our website at: http://www.thecapitalobserver.com

5/ Executive Summary

43 / **These hurdles should not stop investors from engaging the equity markets this year -** Forecasting «macro regimes» is difficult enough but predicting how the equity asset class and styles would behave in that regime is even more difficult. With the business cycle transitioning into its late stage, the task is set to become more difficult in 2018. The Federal Reserve has overseen the reduction in its securities portfolio without undue disturbances. The other buzz words which investor cite for their wariness of the market is the flattening and eventual inversion of the yield curve. The flattening of the yield curve toward inversion has not only had a consistent long-term track record of predicting the onset of economic recessions, it has also done well in providing a leading signal of an impending bull market peak and subsequent bear market decline. While the premise is generally true, the devil is in the details. These macro hurdles are not insurmountable, and these factors should not stop investors from participating in a blow-off last stage of the business cycle later in the first part of the year.

45 / **Timing and Tactical Insight - Equity markets have now entered the latest stages of their uptrend, they should top out between March and mid year -** Equity markets are entering the late stages of their 9 years Bull market. We expect them to top out in 2018, sometime between late Q1 and mid year. The correction that follows could be quite compelling and could last into mid / late 2019. In the meantime, during Q1, we would favor European and Japanese equity markets, which should outperform on the back of the US Dollar rebound we expect. Q2 may see a last extension up, which could be fuelled by a typical late cycle Commodity and Emerging markets boom.

53 / **Splicing the markets - Avoid negative USD correlations until March -** On the back of the US Dollar rebound we expect over the next couple months, we would hence avoid Defensive assets and Commodity related geographies. We would also favour large International Companies in Europe and Japan and smaller domestic companies in the US. Coming March, we may decide to reverse this market positioning, especially if our global markets scenario then favours a late stage Commodity blow-off in Q2, rather than a dull Distribution phase.

The Capital Observer editors team, London / Geneva, January 10th 2018
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6/ Mapping the markets

General comment

As we enter 2018, we believe that the business cycle is maturing and that the secular Equity Bull market since 2009 is reaching the last stages of its ascension. Reflation trades, which have been on the rise since early 2016 (commodities, interest rates, credit, emerging markets) are also approaching an important inflexion point. Indeed, and as we have been forecasting throughout 2017, we expect an important top to materialize on all risk assets between late Q1 and the middle of this year. The following correction could be substantial, and may probably last towards mid/late 2019.

Yet, in the meantime, we would warn on turning too negative too early. Indeed, we expect more positive surprises during Q1 2018, and even envisage the possibility of a potential late stage Commodity, Emerging markets and Growth assets blow-off (positive acceleration towards a final top) in Q2. A more conservative scenario would be that Equity markets top-out late Q1, and then distribute throughout the Spring, before they start moving lower in H2 2018. As often, the resultant will probably be a mixed outcome, with some risk assets making a last spike, while others gradually start to roll over.

That said, whatever the scenario we expect for Q2 and then for H2 2018, we are still very positive on the potential outcome for Q1. Especially, we see strong potential for European and Japanese equity markets, a trend that should be reinforced by the initial US Dollar bounce we expect until March (which may then be retraced if the blow off scenario materializes in Q2). These stronger Dollar dynamics in Q1 should be led by rising US long term yields, and possibly a steepening rebound in the yield curve. The macro factors to justify this move are abundant, ranging from the US tax plan, to the related repatriation of foreign earnings, or to a possible increase in near term US inflation perspectives. On the other hand , this mix, i.e. a rising Dollar, rising yields and steepening rebound in the yield curve, should be negative for Treasuries and Gold as well as all related Defensive assets. Other Commodities are more cyclical and should be more immune, Industrial Metals should consolidate at high levels, while Oil may even carry on up slightly higher. Finally on the sector front, we would favor value and industrial profiles, such as the Banks, Industrials and Energy.

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	The S&P500 may carry on beyond 2'800 towards early March, or 2 to 4% above current levels	The S&P500 starts to distribute and could top out netween late Q1 and late Q2. Above 2'800, the upside potential is exhausted on all frequencies
	Europe EuroStoxx50	Strong performance potential towards 3'900 until early March or more than 10% potential	During Q2, the EuroStoxx 50 may carry on another 5 to 10% to above 4'000 and possibly even 4'400
	EMs MSCIEM USD	Global Emerging Markets top out in January and could retrace some of their recent gains until late February / March	From late Q1 and into Q2, Global Emerging markets accelerate up one last time to circa 5% above current highs
Treasuries	US10Y Bond prices	US Treasuries continue to correct until late February / March, US10Y Yield make marginal new highs between 2.6 and 2.8%	US Treasuries bottom out during Q2 as US10Y yields top out in the high 2s %. Strong performance expected in H2 2018 for very High Quality Bonds
	Germany 10Y Bund prices	Bunds consolidate down between 2 and 4% towards late February / March (towards 159-156 range)	Although a sell-off cannot be exlcuded during Q2 2018 (towards circa 151), this Dip should be bought as the Bund should perform strongly during H2 2018

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

Main Equities

World markets
p 45, 46, 48
We are still positive on global equity markets, first into early March. Then, following and possible intermediate correction (during late March and April), still positive potentially until mid year.

Main Regional picks
p 45, 46, 47, 48
On a relative basis, Europe seems oversold and Japan could still deliver strong potential. We would favour these over US markets in Q1. The Dollar rebound, which we expect over the next couple of months, should also help these markets outperform in their local currencies (perhaps as much as plus 5% until March for European markets vs the US).

Emerging markets
p 49, 50
The USD rebound we expect during Q1 should weigh on Dollar denominated Emerging Markets Indexes. A correction to the downside on Commodities currencies could also have a negative impact. Emerging Markets could consolidate slightly or at best underperform rising global equity markets.

Volatility
p 52
Following several spikes to the upside on the VIX during November and December, the downtrend should resume, potentially towards March as Equity markets continue to rise.

Government Bonds

US & European Benchmarks
p 20
US 10 year yields should make new highs for this cycle in Q1, possibly reaching towards 2.8%, while German 10Y Bund prices may correct some 2 to 4 % until March.

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	Equities carry on, Treasuries continue to consolidate, 5-10% outperformance potential for equities	Equities start to distribute, Treasuries stabilize, the ratio gradually reverses and should then favour Treasuries over Equities in H2 2018
	Europe	Strong outperformance (10-15%) by European Equities while Bunds consolidate	European equities may carry on vs the Bund into May/June.
Duration		Yield Curve spreads in the US and Europe bottom out and bounce 20 to 30 bps towards March	The steepening bounce gradually dies out during Q2, yield curves then flatten again until end 2018.
Credit		High Yield, Corporate, EM and Sovereign Credit Spreads attempt a last move down with marginal new lows towards late February/March	Credit Spreads bottom out between late Q1 and mid Q2, and start to move up towards end 2018/2019
TIPs/Treasuries		TIPs re-accelerate up vs Treasuries until end February/March as investors seek inflation protection	TIPs start to top-out and gradually reverse vs Treasuries, from mid year, inflation expectations worldwide start to fall
Oil		Oil extends up slightly further towards 65 USD/barrel on WTI and 71 USD/barrel on Brent	A last push higher during Q2 2018 cannot be excluded. From mid year, Oil should start to reverse down
Industrial metals		Industrial Metals may consolidate at high levels until early/mid February. Retracements should be bought	Industrials Metals extend up from mid Q1 to mid year. Copper reaches above 8'000 USD/ton on the LME
Gold		Gold retraces back down into late February/ March, retesting below 1'250 USD/oz and possibly even droping below 1'200	From late Q1, Gold gradually starts to move up again. It may reach 1'500 USD/oz by year-end. Accumulate!

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

Equity to Bond Ratios

US Markets
p 18

The S&P500 may carry on another 2 to 4 % to the upside until March, while US 10Y Treasuries may correct down between 2 to 3 %. we expect between 5 to 10 % outperfomance for US Equity vs US Treasuries until March.

Eurozone Markets
p 19

Strong performance by European and Eurozone Equity markets, while the Bund corrects, could deliver more than 10 % outperformance for European equities vs the Bund until March.

Fixed Income Dynamics

Duration
p 21

Yield Curves are oversold, they could make a steepening bounce in the US during Q1 and resume their steepening in Europe. The move happens mostly on the long end and could add 20 to 30 bps to yield curve spreads in both regions (10Y- 3Y).

Credit
p 23

In the rising long term interest rates environment we expect during Q1 2018, Corporate debt should be less sensitive than Treasuries, and should continue to outperform. High Yield should also make a comeback, yet its uptrend and relative performance vs Investment Grade may be already rolling over for this cycle. At the moment, we believe High Yield is probably the weakest link in the reflation trade.

Rate Differentials
p 22

Rate differentials in favour of the US (vs Europe, Japan or the UK) continue to climb on all tenures, until March at least.

Tips
p 22

TIPs should follow Gold and the whole fixed income space lower until March at least, considering the rising interest rates environment we expect. That said, inflation expectations are rising and the inflation break-even ratios (TIPs vs Treasuries) should continue higher until March at least.

Commodities

Oil
p 41, 42

Oil is approaching the targets we have been projecting for Q1 2018 since early 2016 (70$/barrel on Brent). Our daily graphs could suggest that its uptrend may carry on towards February/March and possibly add some marginal additional performance. Following some consolidation in late Q1, early Q2, a blow-off (strong acceleration before a major top) cannot be excluded in Q2 towards mid year.

Industrial metals
p 35, 36, 42

Following their strong rally in H2 2017, and more recently in December, they could consolidate at high levels until late February/March. Following that, we expect them to resume up towards mid year and potentially accelerate in a typical late cycle Commodity blow-off.

Gold & PMs
p 38, 39, 40, 53

In the rising interest rates, rising USD environment we expect over the next 2 months, we expect Gold and Precious Metals to sell-off once more (for Gold possibly back to below 1'250 USD/oz or even below 1'200 USD/oz until March). We will then be positive for Gold for the rest of the year, which could possibly reach 1'500 USD/oz by year-end.

Agriculture

Agricultural Commodities as a whole are still lingering lower, possibly until mid year.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	EUR/USD tops out again during January (1.21-1.22max). EUR/USD then moves back below 1.16	From late Q1 and during Q2, EUR/USD may attempt to retest its highs. It then weakens substantially during H2 2018
	GBP	GBP is more pro-cyclical than the Euro. It may correct a bit (1.33 - 1.31 range), but pretty much holds ground vs the Dollar in Q1	From late Q1 into Q2, GBP/USD moves up once more (high 1.30s). It then weakens substantially during H2 2018
	JPY	USD/JPY moves up towards end February / early March with prices targets towards 117 - 120	USD/JPY could extend into late Q2 and challenge previous 2015 highs above 125, even 130
	CHF	USD/CHF moves up towards late February / March. It may challenge its 2017 highs towards 1.015	The move up on USD/CHF could extend into late Q2 and challenge previous 2015 highs above 1.03
EUR vs	GBP	EUR/GBP weakens until late February / March: GBP is more pro-cyclical than EUR and cyclical assets should outperform in Q1 2018	From late Q1 and during Q2, asset rotation shifts to Growth and then Defensive assets, which should benefit EUR/GBP
	JPY	During Q1 EUR/JPY should continue up towards 140	Following some consolidation in late Q1 / early Q2, EUR/JPY extends towards 150 by mid year.
	CHF	EUR/CHF may consolidate at high levels until mid/late February.	From late February, EUR/CHF re-accelerates up into mid/late Q2, when it could top out in the mid 1.20s
GBP vs	JPY	During Q1 GBP/JPY extends up another 5% towards 159/160	GBP/JPY continues up during late Q1 / Q2, possibly towards 165/166.
	CHF	During Q1 GBP/CHF extends up another 3 to 5% towards 1.35 - 1.39	GBP/CHF continues up during late Q1 / Q2 and extends above 1.40

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

US Dollar
p 27, 30

The Dollar should bounce in Q1 2018, probably between now and early March. It could add between 3 to 5 figures against the Majors. Then in Q2, it should retrace some of these gains and could even make new lows. From H2 2018, however, as risk assets start to correct, the Dollar should reaccelerate back up possibly into 2019.

Euro
p 28, 29, 30

The EUR may attempt to make new highs over the next week or so, yet, following that, it is more likely to correct down into March, possibly back towards the 1.16 – 1.13 range. During this period it could also correct down vs GBP, consolidate at high levels vs CHF, and continue to progress vs JPY. Following that, during Q2, it should re-test to the upside again vs the Dollar and the Pound, and accelerate up vs JPY and CHF. Longer term, we believe that the uptrend on EUR/USD since late 2016 is only a correction, that its upside potential is in the low 1.20s, and that its should die out during H1 2018. Thereafter, it resumes down quite aggressively during H2 2018, vs USD, JPY and CHF, while it remains strong vs GBP, which could be particularly vulnerable in a market downturn.

Yen
p 28

The Yen remains the ultimate defensive currency. During the late stages of the risk asset rally (expected until mid year), the Yen should weaken substantially, possibly towards 130 vs USD, and 150 vs EUR. It could then bottom out between mid year and the Summer, and recoup all of its losses, and perhaps more, until mid/end 2019.

Sterling
p 29

Sterling is pro-cyclical and still re-rating following the Brexit shock election. It should hence correct only moderately vs USD in Q1 (back to the 1.33 – 1.31 range). Following that, between late Q1 and early Q2, it could make new highs in the high 1.30s. Once risk assets top out, it should then weaken substantially vs most currencies into 2019. Indeed, we expect GBP to be particularly vulnerable in the important market downturn we are forecasting.

Oil & Commodities currencies
p 31

Commodity currencies (proxied by our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB and ZAR) have seen a strong rally vs the US Dollar since December. This performance should be retraced until early March as the Dollar rebounds. Following that, Commodity currencies should accelerate up again until mid year (a scenario that would confirm a possible Commodity blow-off in Q2). From mid year, they should then roll-over and underperform aggressively into 2019. The articulations we anticipate are similar vs EUR, yet with slightly less volatility.

Asian currencies

Our Asian Growth equal weighted portfolio (INR, KRW, THB and TWD) could consolidate slightly against USD until March. It then seems to resume up towards the Summer. This could be the case against all the Majors. From late Summer, at the latest from the Fall, they could start to correct down vs USD and JPY. They may however continue to outperform European currencies as their profile seems more defensive than them.

Equities Markets Segmentation

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

US Sectors - S&P500			From mid January, we expect pro-cyclical and Value sectors to outperform towards late February / early March					Equities may retrace a bit during late Q1 / early Q2, mid/late Q2 could see Growth and Commodity themes extend up				
Sectors	ETF symbol	Benchmark-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Technology	XLK	26%										
Financials	XLF	15%										
HealthCare	XLV	14%										
Discretionary	XLY	12%										
Industrials	XLI	10%										
Staples	XLP	8%										
Energy	XLE	6%										

European Sectors - Europe Stoxx 600			From mid January, a strong move up for European markets should benefit all pro-cyclical and high beta sectors, while Defensive sectors underpeform					Following some consolidation late Q1, in Europe, cyclicals seem to maintain momentum into late Q2				
Sectors	Index symbol	Benchmark-weight	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 51, 52

Overall, our sector allocation for the next couple of months (until March) is skewed towards short duration equities (yield curve steepening rebound), value driven ones (in search of remaining price potential), Dollar sensitive ones (avoiding sectors inversely correlated to a Dollar rebound) and higher beta ones (light on Defensive profiles).

Looking forward towards Q2, we remain pro-cyclical for now, yet are split between a Global Equity distribution scenario and a more aggressive one where Commodities and Emerging markets, and possibly Growth profiles, could blow-off. We will aim to confirm one or the other of these scenarios over the next few months.

Satellite sectors and Segments

p 42

Deep value, in the Energy sector for example, looks quite promising in terms of profile and potential upside (oil services, natural gas).

Core Countries Weightings **Next 2 months** **3 to 6 months ahead**

All World Country Index Currency hedged			**European Markets are heavily Oversold vs World markets when hedged for currency risk. A US Dollar rebound in Q1 should benefit EuroZone markets from mid January**					**Following some consolidation late Q1 / early Q2, World markets reposition for a last rally into mid year. Growth and Commodity markets could then outperform**				
Sectors	Index symbol	Benchmark-weight	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

p51, 53

With the Dollar rebound we expect during Q1, we are clearly overweighting Europe and Japan, and within Europe, Core EuroZone countries such as Germany or France. Our view, indeed, is that EUR crosses could also correct some during Q1, which could result in slight UK and Swiss underperfomance vs Europe. Inversely, we would also underweight the US where we see less potential over the next few months. Canada is at risk given the correction we expect until Match on precious metals. China has had a great run in H2 2017 and its uptrend seems exhausted for now.

Going forward and looking into Q2, we will wait to confirm either a Global Market distribution or a potential Commodity blow-off scenario until mid year, but have tentatively penciled Canada and China as potential outperformance candidates.

Satellite Country allocations

Similarly to Canada, we would probably reduce risk on most commodity driven geographies, the ones focused on precious metals especially.

Note: these country and regional allocations are considered hedged for currency risk, i.e. performances are anticipated in local currency.

Core Factor/Themes Weightings **Next 2 months** **3 to 6 months ahead**

	Pro-cyclical, short duration and US Dollar friendly assets could outperform, while Defensive assets could lag or correct down					**Distribution starts in Global equity markets. Some cyclical assets may carry on into Q2, yet Growth assets are shifting to Market Neutral**				
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 37,39, 54

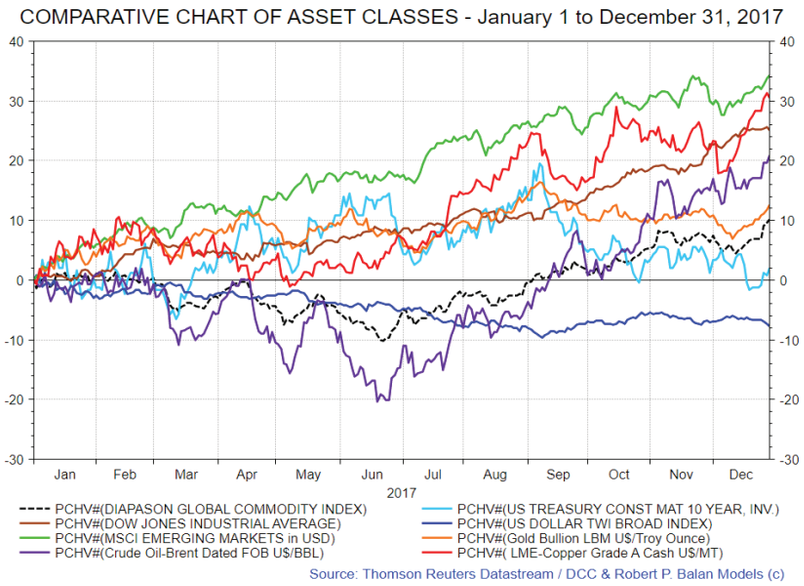
Over the next 2 months, we are underweighting Growth (Nasdaq100) and Defensive (REITs) themes, as well as Goldmines and Small Cap. profiles outside of the US. US Small Caps. and Value are overweight given our rebound scenario on the USD.

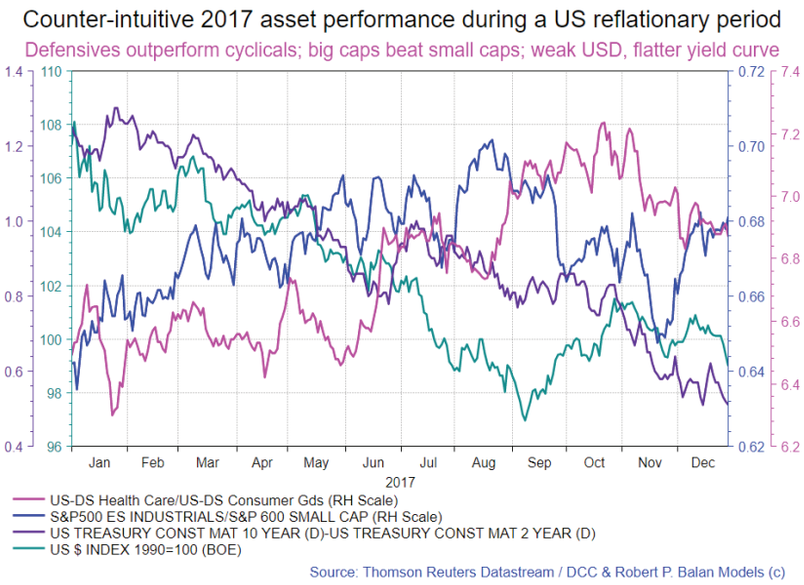
Additional Satellite Theme

Within Southern Europe, which is neutral on our table, we would favour Italy, which shows a strong profile as we approach the elections in March.

12 / The Cycle Is Transitioning Towards The Last Stage - Asset Outlook For H1 2018

Despite strong global equity performance in 2017 and markets expecting cyclical reflation, it seems that many investors are still wedded to the idea of New Normal playbook: they have settled into expectations for 'more-of-the-same' which has been low, non-inflationary-driven growth. This was despite signs of cyclical reflation emerging worldwide throughout the year as we have documented at The Capital Observer as early as mid-2016. **Investors have also become wary of the elongated business cycle**, and have become more conservative in their longer term outlook as the year progressed. Many media commentators wrote that this was the most hated equity market rally in history. Obviously, that wariness had great significance to the "quality" of market gains last year, especially during H2 2017 *(see first graph on this page).*





Some of the consequences of the wary investor mind-set were counter-intuitive: in 2017, one would not have expected equity defensives to outperform equity cyclicals, large caps outperform small caps, a weaker U.S. dollar and a flattening U.S. yield curve in the face of cyclical reflation (see 2nd graph on this page). However, that is what we saw, and we have seen this before in previous business cycles. **The market performance in 2017 was typical asset performance and state of investor sentiment just ahead of a last reflation stage - we expect this final stage which started late summer to unfold over the next 6 to 9 months**. And at the last stage of the cycle, the pessimism seen last year will disappear (as is wont to during the last, blow-off stage of a business cycle). **The wariness seen last year should disappear as many investors who stayed away will re-embrace the markets.**

The shift to the last stage of the cycle should usher in other changes:

- A consequence of this change is that beneficiaries of late cycle reflation stage (over the next 6-9 months since last autumn) would include «value» style of investing and hard assets such as commodities. Value stocks tend to be comprised of more cyclical and financial companies that are driven by revenue growth versus growth stocks which tend to rely more on their profitability characteristics (i.e. expense controls) to support rise in their valuations.
- Implicit sector rotation at this stage may also provide a support for the US Dollar (although the US unit would likely benefit from one-off effects of the new US corporate tax laws, rather than from structural macro reasons).
- According to estimates by the OECD, real (inflation-adjusted) GDP for the US economy is expected to grow 2.2% in 2017 versus 1.5% in 2006, with further acceleration anticipated in 2018 to 2.5%.
- Both Europe and Japan which are now showing signs of economic recovery will continue to do so, with the EU expected to grow at a similar pace as the US, while Japan will still grow but below 2%.
- Finally, emerging market economies such as Brazil and Russia are experiencing a return to positive growth, helped by a recovery of the energy sector;

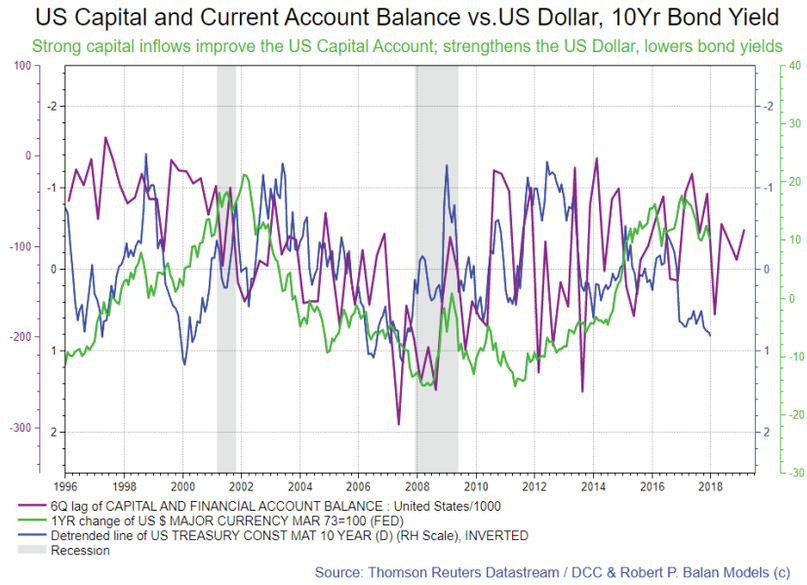
while China and India's slowdown appears to be stabilizing at about 6.5%.

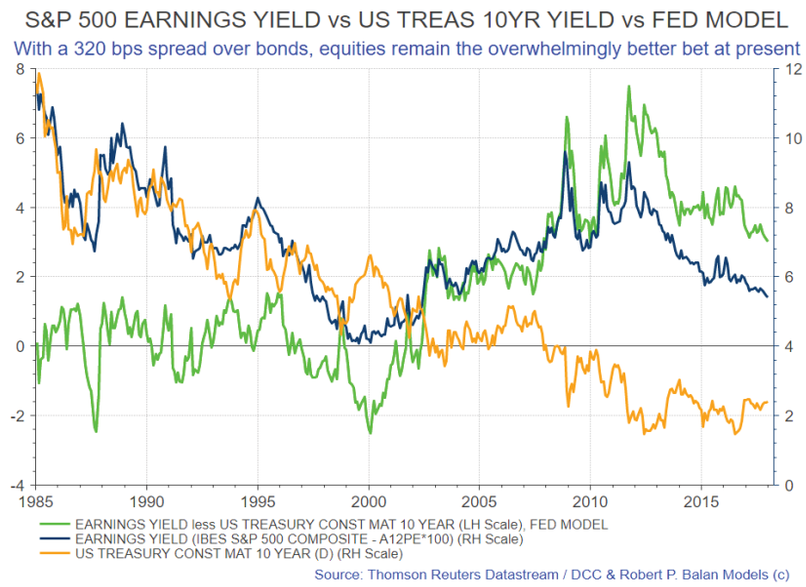
- All in, global real GDP growth is expected to come in at 3.6% in 2017, versus 3.1% in 2016. The OECD expects global gross domestic product growth projected to strengthen to 3.7 percent in 2018.
- On the negative side, New Normal pressures of aging demographics, high debt levels, and global excess capacity will likely weigh on long-term nominal growth.

The background macro data discussed above will set the tone for markets during the next 6 to 8 months. But it is what the main «structural» players will do in 2018 which will set the pace for the high-frequency moves of asset prices. This is what we expect of these "players" during the next 6 to 8 months:

The Trump administration -- 2018 will likely see a cyclical boost from Trump administration initiatives taken in 2017. The recently enacted US tax reforms will likely encourage capital repatriation to the US and encourage the inflow of foreign capital. The tax reform legislation´s main purpose was to make U.S. business (and the cost of investing in the U.S.) more competitive with the rest of the world. The corporate tax rate for U .S companies recently went from the highest rate of the G7 countries to the lowest. That is a game changer. **This has enormous scope to influence the course of US bond yields and the US Dollar during the year.** We believe that the US Dollar would be significantly stronger later in the year, even as long-term bond yield fall due to the influx of domestic and foreign capital *(see first graph on this page).*

In that respect, capital repatriation also matters to equity prices, which are of course tied to bond valuations. Government yields are typically used to measure the 'risk free' rate of return, a key component to estimating the discount rate used to value equities -- so it matters to stock markets where bond yields are going. If yields stay low, or go even lower, then equity valuations, even if they continue to rise over H1 2018 (as we expect) would not be that stretched. This claim is actually easy to show. The 12-months forward earnings yield on the S&P 500 (the so-called "Fed Model") is over 5%, which is more than twice the 10-year Treasury yield, a large gap by historical standards. This is what, in fact, has contributed significantly to the rise in equities in recent quarters *(see 2nd graph above)*. **The bond markets have been manipulated to offer no return, so investors are driven to stocks, and so far this preference has been rewarded, and will continue to do so for some time.**





The Trump government regulatory rollback is also bound to encourage Capital Expenditures at the expense of equity share buybacks and dividend payouts. Also, corporations have bought back their own shares over the past few years because their cost of capital is much less than the borrowing rate. With the Fed bent on increasing borrowing costs and with looser regulatory environment, Capital Expenditures will finally get a boost. This will inevitably cause a rotation in investors´ equity sector, and asset class, preferences. Corporate capital expenditures, in fact, have been rising since Q3 2016 – higher borrowing costs and looser regulatory environment, will further add to the already existing business plans to spend significantly more in the near-term *(see 1st graph on next page)*. Future Capital Spending

Diffusion Index reported by the Federal Reserve Bank of Philadelphia leads private fixed domestic fixed investments by a good 6 months.

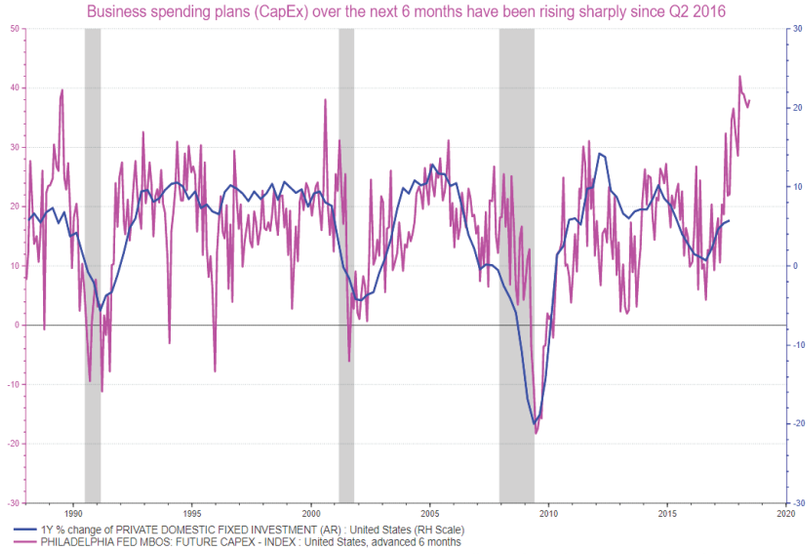
Here is one stark example: one significant item in the new tax bill will immediately boost the fortunes of the entire energy sector. The energy business is probably the most capital-intensive sector. Each year, companies across the sector invest billions of dollars into new projects (Chevron Corp. recently announced a 2018 budget for capital and exploration spending of $18.3 billion. ExxonMobil made $22 billion of capital expenditures this year). Under current tax law, these expenditures can't be deducted in the year they are incurred. But the new law allows capital expenditures to be deducted in the year of their occurrence. This change will further lower the tax burden for the energy sector while encouraging more capital spending. This is one reason (along with the rise in oil prices) for the spectacular rise in E&P equities since October. **The outperformance of the energy sector should extend into H1 2018.**

There is a lag between the market´s expectation of the economic impact from government policy and its eventual impact, and 2018 should provide more concrete results arising from the initiatives undertaken by the Trump administration in 2017.

The Federal Reserve -- how will the U.S. Federal Reserve enact its rate hike schedule in anticipation of rising US growth expectations, and in the face of a global economy that is heating up so late in what has been an elongated economic cycle? **The response of a new Federal Reserve Board (with new actors getting on board in early 2018) will be the biggest wildcard for asset valuations in H1 2018.** This has become even more significant, given the three rate hikes penciled in by the Fed, noting meanwhile that the Fed had been prone to overshoot on tightening (the last three recessions were partly caused by an overly aggressive Fed). The biggest wildcard therefore has the potential to morph into the biggest market risk this year. The tail-risk catalyst in 2018 may very well be shifting from the Trump administration to the Federal Reserve.

Future corporate CapEx plans are surging, presaging higher capital spending in 2018

Business spending plans (CapEx) over the next 6 months have been rising sharply since Q2 2016



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

The Fed is caught in a dilemma -- if the Federal Reserve acts too slowly, they run the risk of falling behind the inflation curve (if inflation rises significantly) and will be forced to play 'catch up' – this leads to a stagflationary scenario of higher inflation and weaker economic prospects. If the Fed tightens too much, the economy may slide into a recession. It all depends on whether these contingencies are adequate or will prove excessive. First, the Federal Reserve said they will raise the range of its policy rate of interest by 25 basis points three times in 2018. And second, the Fed will continue to reduce the size of its securities portfolio during the year.

And then, there is the uncertainty caused by a substantial change in the policymakers that make up the voting members of the Fed´s Federal Open Market Committee (FOMC), the body within the Fed that determines what the monetary policy of the U.S. central bank will be. This year, most of the Board of Governors of the Federal Reserve, five of the seven to be exact, will be appointments of President Donald Trump. And, of course, Mr. Jerome Powell, a sixth Governor, has been nominated to become the Chairman of the Fed. The FOMC, under Janet Yellen, has raised the Fed´s policy rate of interest during her tenure as Chair, but has always acted so as to err on the side of monetary ease. That has supported the confidence of the stock market and has resulted in the almost continuous rise in stock market prices over the past nine years.

We believe that the Trump appointees will be even more likely to err on the side of ease they the Yellen FOMC was. If anything, will be more reluctant to tighten policy – this raises the possibility (although not the likelihood) that the new Fed may not follow through with policy rate raises of three times this year or stay on the Fed´s intended schedule for reducing the size of the Fed´s securities portfolio.

China -- it appears that China's President Xi Jinping is following through on efforts to 'improve the quality of growth' rather than growth for its own sake. Such efforts include a regulatory crackdown on excess financial leverage as well as improving environmental conditions. Simply put, Xi´s government is dismantling the country´s shadow banking -- the major source of short-term financing for China´s largest commercial banks. It seems that China is having some success in controlling off-balance

sheet lending. The most recent report on Total Social Financing show only modest growth in all the lending conduits, except for stocks on non-financial enterprises, something that President Xi was eager to cultivate (see 1st graph on this page). It is too soon to make a judgment on this important issue. **How President Xi's program impacts the health of the large Chinese banks will have significant repercussions to global asset prices in 2018.**

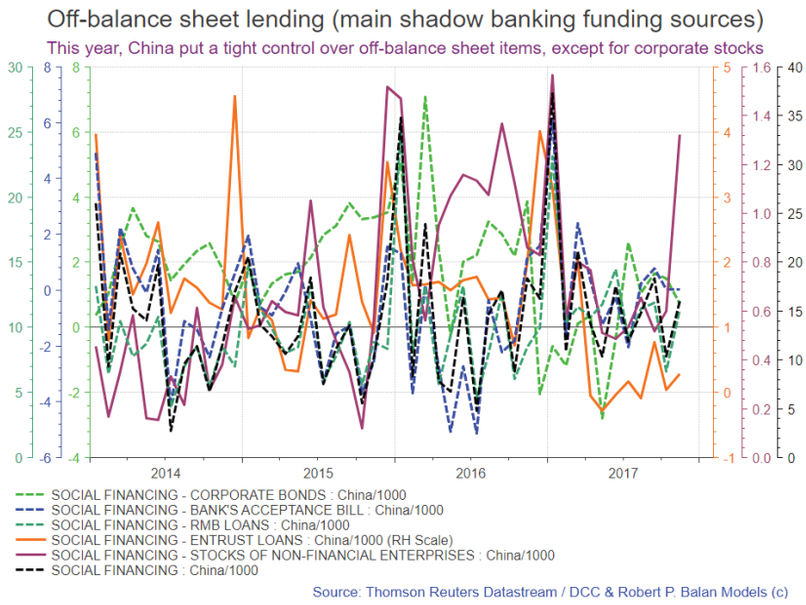
It is still not clear whether or not Xi´s initiatives will trigger major capital flight risk like what the global market experienced from August 2015 through February 2016. We believe that it is not likely, as the PBoC has been matching the Fed´s tighter policy (after a short time lag), **we believe that capital outflows out of China should stabilize, if not actually decrease.**

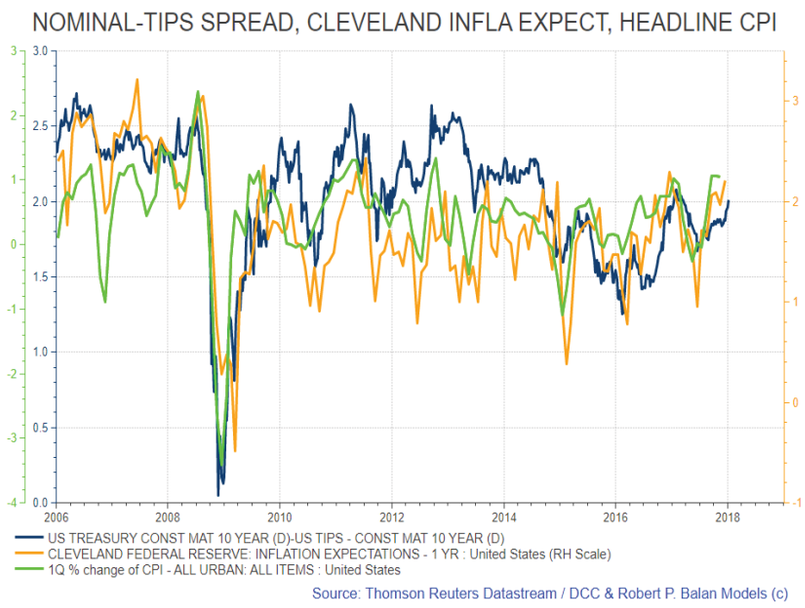
Emerging Markets – EM highly leveraged equity, sovereign debt, or local currency risks will be a focus in H1 2018, especially with a tightening U.S. Federal Reserve serving as the backdrop. **Nonetheless, the growth story for emerging markets should remain intact for H1 2018, but we may see some hiccups form as we go into mid-2018, especially if the US dollar will soar, as we expect it to.**

US macro conditions -- will be consistent with historical norms of the last stage of the cycle:

US business sentiment should continue to trend higher as reflected in manufacturing and services surveys as well as capital spending tracked by regional Federal Reserve surveys.

Inflation will likely rise in H1 2018. The Treasury market´s 10-year estimate of future inflation rose above the Federal Reserve´s 2% target in early January - the first time that level has been breached for this maturity since last March. The implied inflation forecast based on the yield spread for the nominal 10-year Treasury less its





inflation-indexed counterpart ticked up to 2.01% on Thursday (Jan. 4), the highest level in 10 months. The current five-year Treasury inflation forecast is slightly lower at 1.92%, although that´s a 10-month high too. Official inflation numbers, which are published with a lag, continue to reflect pricing pressures that are still modestly below the Fed´s target. The Treasury market, based on the spread of the nominal and TIPs yields, is however, betting that inflation will modestly rise over the medium-term (*see 2nd graph above*).

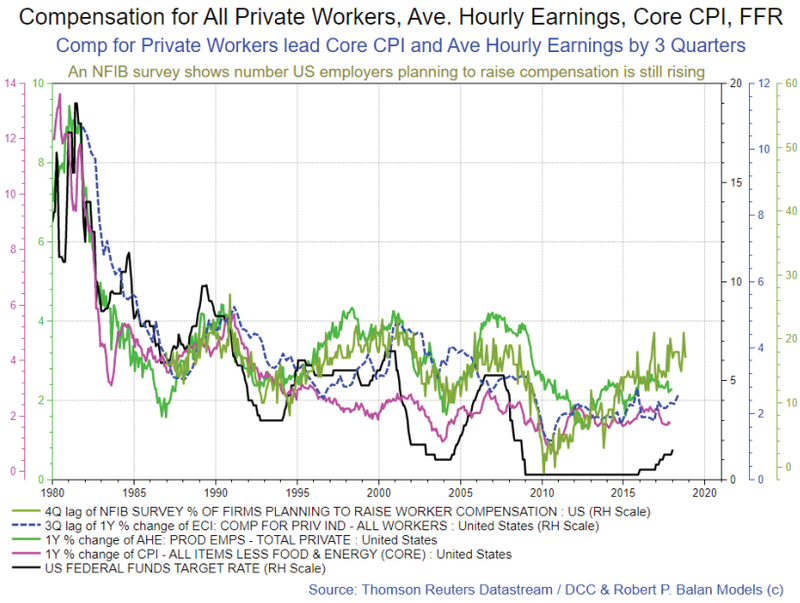
Our work indeed suggests there is scope for a surprise rise in CPI in H1 2018. Moreover, partly due to the expected cyclical boost from the corporate tax reform. Inflation in H1 2018 could be bumping against the markets modest view of inflationary risks.

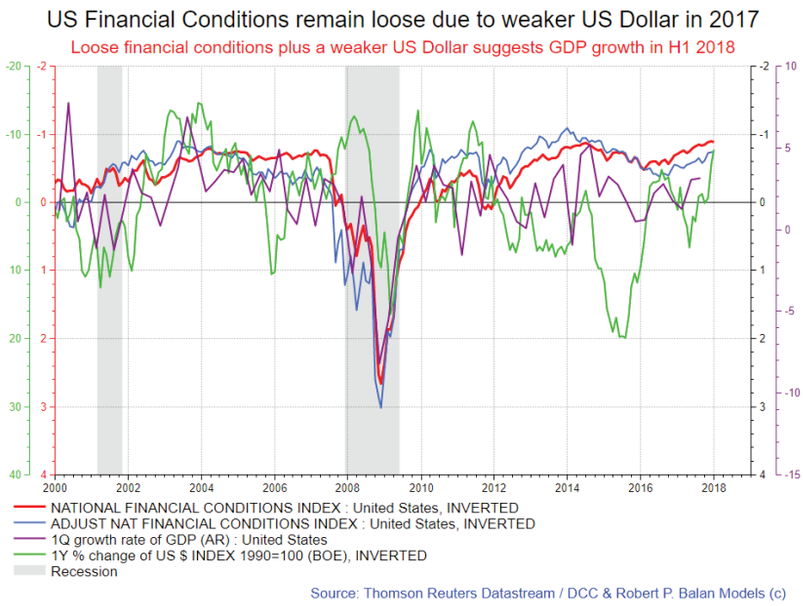
The sharp increases in energy prices should also prime an increase in Headline CPI (at least) in H1 2018. And then also, the Total Compensation of All Private Industry Workers has been rising steadily since Q1 2016. This compensation measure leads Ave. Hourly Earnings and Core CPI by a full 3 quarters. The implication is that of higher hourly earnings and Core CPI up to Q2 this year(*see 1st graph on next page*).

US financial market conditions are still relatively loose despite the Fed following through on its rate hike tightening schedule. This year the Fed hiked its benchmark rate three times

to 1.25-1.50% range and is expected to hike rates three more times in 2018 to 1.75-2.00% range. This has frustrated the Fed´ s effort so far to tighten financial conditions, which could lead to a dreaded over-reaction and tighten policy much more aggressively. **Reason: the decline in the US Dollar exchange rate in 2017 has also kept financial conditions easier than warranted by the Fed´s tight monetary stance. Further USD weakness actually encourages the Fed to keep policy even relatively tighter**. Financial conditions are crucial since they usually determine whether or not we get "garden variety" market corrections in the short-term; it is valuations and economic cycles which determine long term market performance. **Easier financial conditions, in concert with a weaker US Dollar, have provided the backdrop for higher GDP growth in H1 2018** *(see 2nd graph on this page)*.

For now, easy financial conditions have, so far, have yet to produce a credit bubble that would pose a systemic risk to the financial system. Most of this year´s corporate debt issuance has simply been the refinancing of existing debt at more favorable borrowing rates rather than in the issuance of new debt. The latter tends to be driven more by speculation than the former. Non-financial corporate credit is basically driven by the economy, with a 2 years lag, so we do not (yet) expect trouble from this front. **There could be credit revival in 2018, according to this lagged relationship. Credit issuance (adjusted for US GDP % changes) is nowhere near the levels seen in 2008, and in fact is mediocre relative to previous cycles**. Those bearish on the asset markets have to look elsewhere for source of trouble during the last stage of the current cycle *(see 1st graph on next page)*. **Moderate credit growth is also one reason why Core CPI was tame, but looks set for rises in H1 2018 nonetheless.**





There is also evidence that the same global liquidity from G5 central banks which power equities also drive the performance of the High Yield credit sub-sector (the one that usually gets into trouble). High Yield has been beaten down lately by a strong surge in short rates, but we expect this relationship to be superseded by strong global liquidity effects going into H1 2018 – High Yield should perform well starting sometime very soon *(see 2nd graph on next page)*.

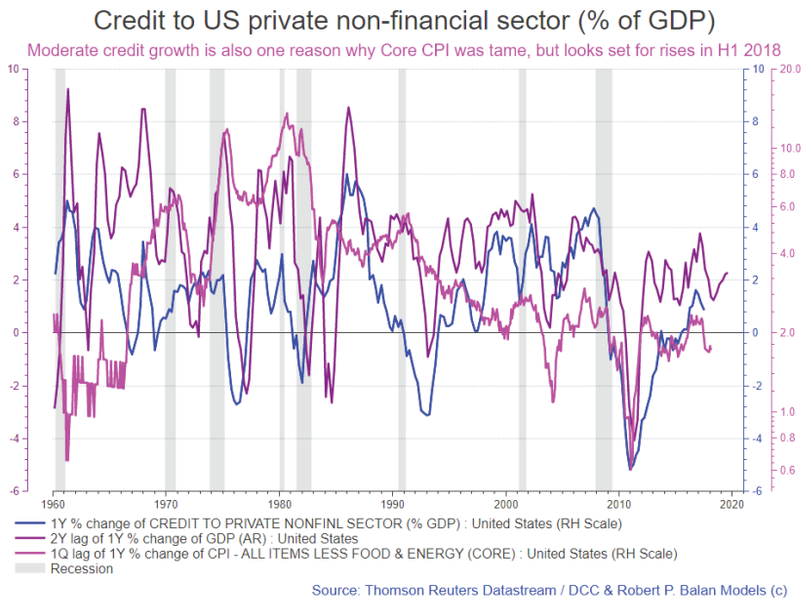
The End-Game scenario:

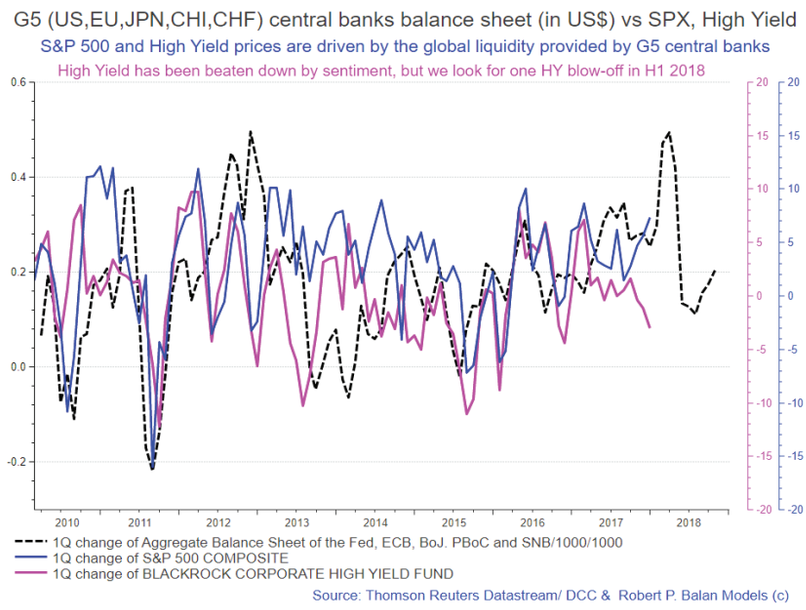
Only 18.7% of U.S. taxpayers directly own stocks, according to a recent Pew analysis of Census Bureau data. This percentage refer only to stock portfolios, and does not include the roughly half of Americans who participate in the stock market indirectly via employer-sponsored 401Ks. If the last stage of this cycle in indeed upon us, that percentage of stock ownership will significantly increase, leading to an equity boom ahead of a peak at some point in the medium term. A melt-up in the markets is in the making, if we believe fund manager Jeremy Grantham, who is long known for his bearish views on equity markets. He says the market's next move could take stocks higher, dramatically higher. Then, as dramatically, lower.

Grantham, the chief investment strategist for GMO in Boston, wrote in a letter to investors on January 3: "As a historian of the great equity bubbles, I also recognize

that we are currently showing signs of entering the blow-off or melt-up phase of this very long bull market." Grantham cited the recent acceleration of U.S. equity prices, a concentration of leadership in stocks and growing media coverage of events such as bitcoin's surge and Amazon.com Inc.'s success as signs that the final phase of a bubble could be coming in the next six months to two years.

Grantham's thesis parallel ours -- at some point, the late cycle stage blow-off turns into the initial stage of a downward cycle. One could point to Fed rate hikes as the likely proximate cause for that disaster-in-waiting, as it had been for the last three downturns. However, there could be other major factors coming into play such as excess credit bubbles (as in 2008, but unlikely in this cycle) which could exacerbate a slowdown. A lot will depend on how GDP growth (and inflation) is tracking as the Fed raises rates throughout 2018. Will we see the Fed raise rates well above the theoretical neutral real rate necessary to maintain economic growth without causing inflation? If so, then we would transition, not long after, into the initial stage of a downward cycle. **At that time, a more defensive positioning in equities, currencies, credit and commodities is warranted, and fixed income becomes the sole safe haven with gold and maybe agriculture sector.**



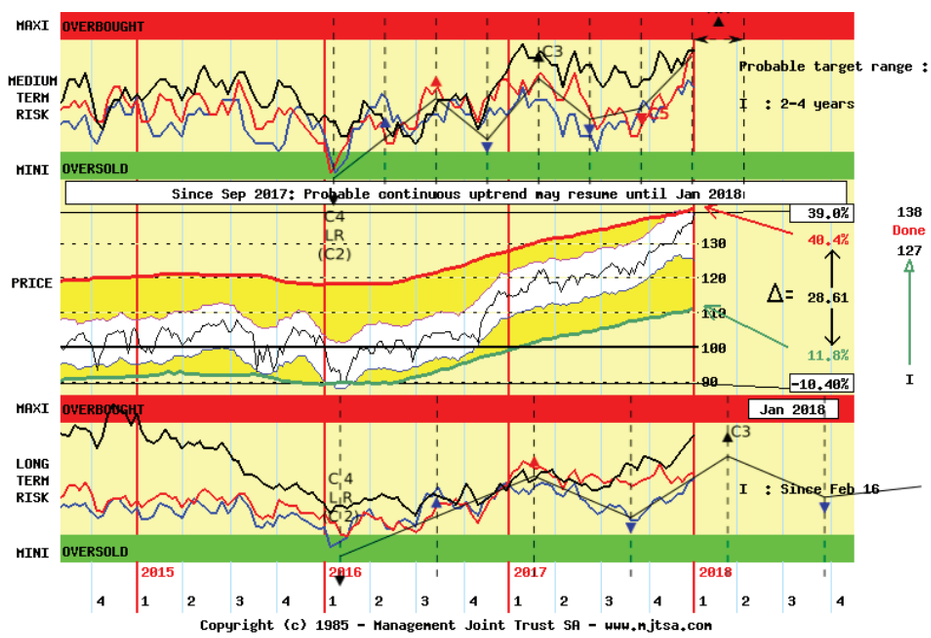


18 / MJT - TIMING AND TACTICAL INSIGHT

Since September, Inflation and Growth expectations have finally been pulling long term rates up, how long is this trend sustainable?

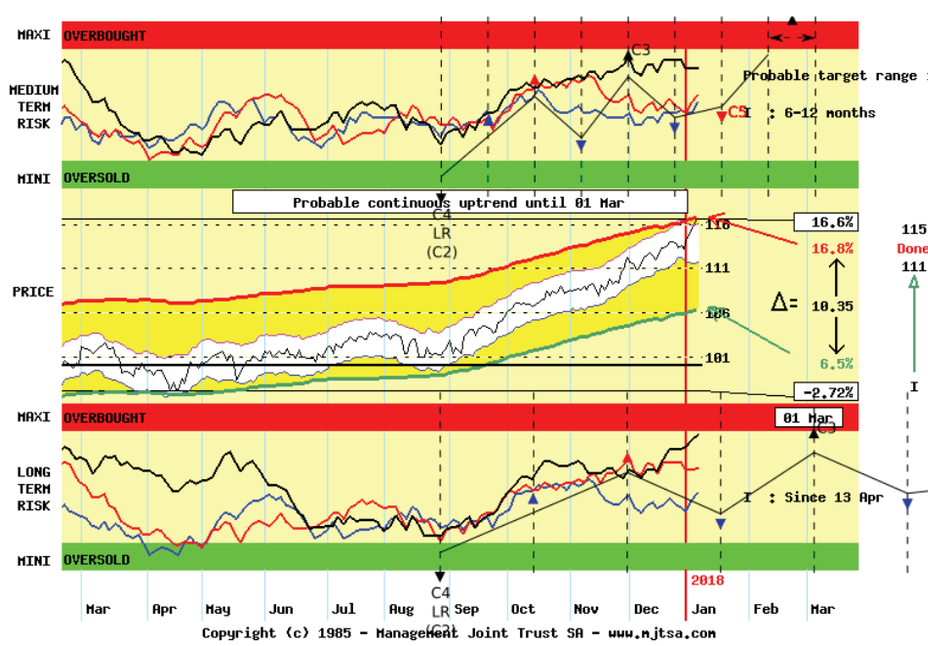
Following their strong retracement in the Spring, reflation trades bottomed between June (the commodity low) and September (the market expectations low). They have since been reaccelerating up again, led by China, Oil and Industrial metals. Inflation expectations are following suit, and are gradually lifting long term interest rates. These are now only a step away from their March highs (US10Y), which we believe will be taken out over the next few weeks. That said, we are probably already in the late stages of an equity Bull market, and we wonder how long this trend is sustainable, i.e. before it becomes counter-productive.

SPY - SPDR S&P 500 / IEF - iShares 7-10 Year Treasury Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



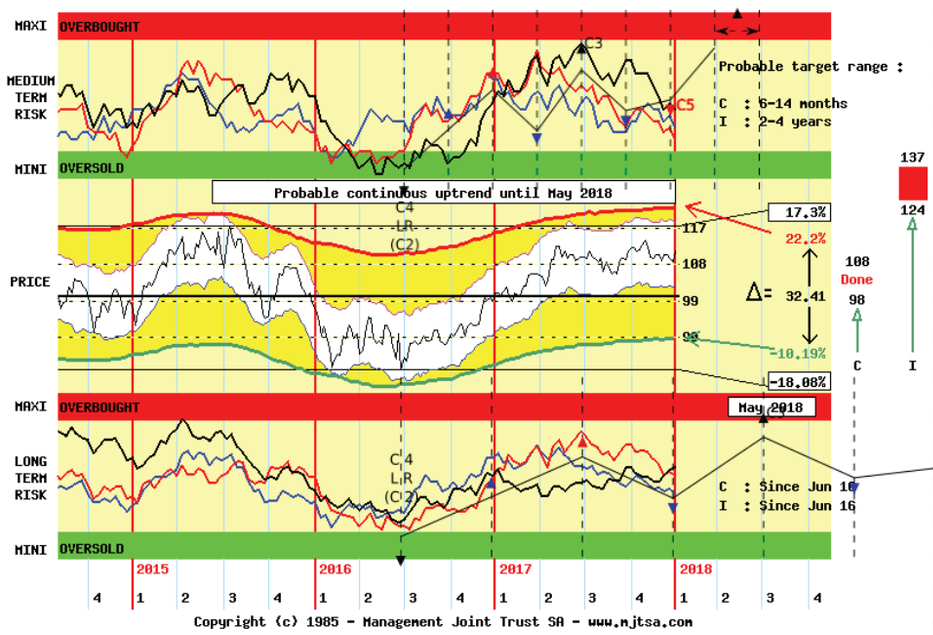
We will start this section with an asset allocation graph. Namely **the comparison between US Equity and long term Treasuries**. Since the start of the reflation trade in early 2016, Equities have been accelerating up vs Bonds. Their outperformance is above 50% over the last two years. That said, this trend may be nearing exhaustion. Indeed, on both our oscillator series (lower and upper rectangles), we would **expect important tops between now and late Q1 2018, while our I Impulsive targets to the upside have been achieved** (right-hand scale).

SPY - SPDR S&P 500 / IEF - iShares 7-10 Year Treasury Bond ETF
Daily Graph or the perspective over the next 2 to 3 months



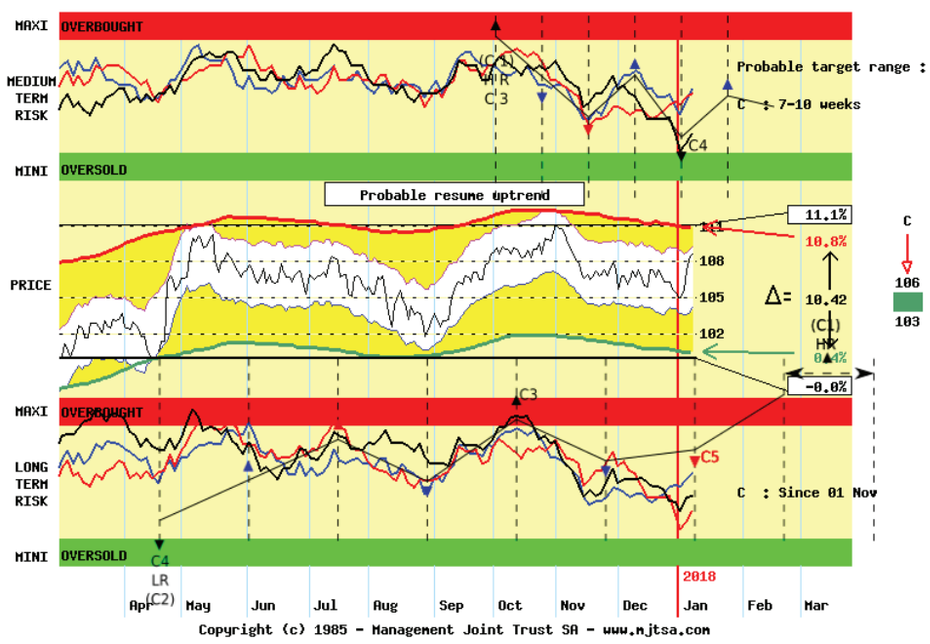
The Daily graph is also quite advanced as our I impulsive targets up have also been reached (right-hand scale). Yet, both our oscillators series suggest (lower and upper rectangles) that **the uptrend may carry on a while longer, at least until early March**. If we were to calculate our I2 Impulsive 2 extended targets, we may be able to justify another 5 to 10% of Equity outperformance vs bonds until March.

Euro Stoxx 50 Future (Mar) / Bund Future (Mar)
Weekly Graph or the perspective over the next 2 to 4 quarters



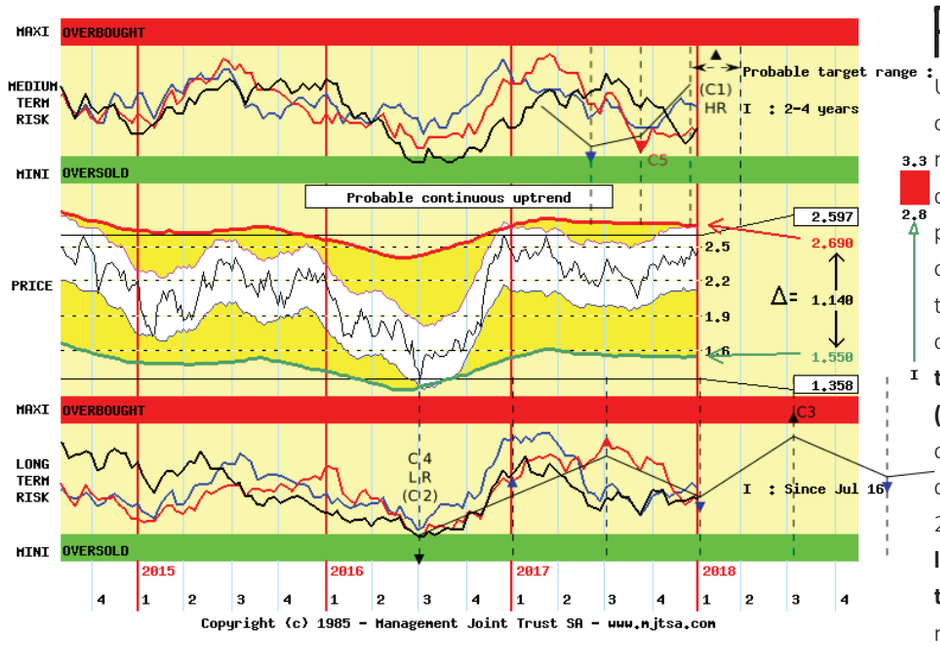
Switching to Europe, the situation looks rather different. Indeed, while the Bund has been strong over the last few quarters, EuroZone markets have suffered from a strong currency. On both our oscillator series (lower and upper rectangles), we are probably ending a retracement period since the Spring, and **getting ready to resume up, potentially until mid 2018. Our I Impulsive targets up (right-hand scale) would suggest a whopping further outperformance potential for European Equity vs Bonds, somewhere between 15 to 25% over the next 6 months.**

Euro Stoxx 50 Future (Mar) / Bund Future (Mar)
Daily Graph or the perspective over the next 2 to 3 months



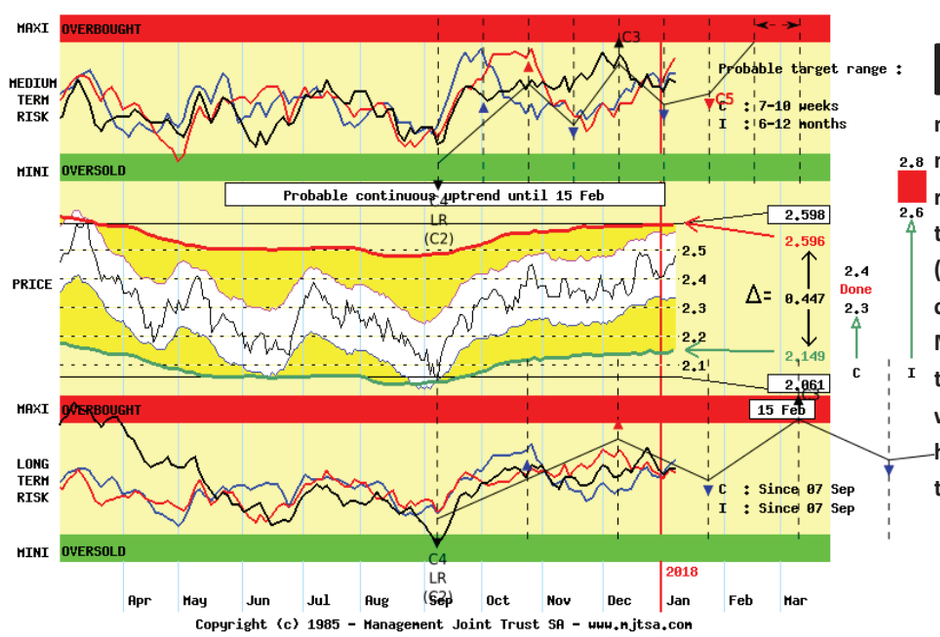
Following a painful Spring and Summer where it has gone nowhere, the Daily graph of the ratio should attempt to break-out to new highs over the next few weeks. **Our long term oscillator series (lower rectangle) have just a made a low, which is typical of the end of a correction period to the downside. The Trend should now rise into March as shown.** Our medium term oscillators (upper rectangle) are confirming this support point and the beginning of a re-acceleration phase.

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



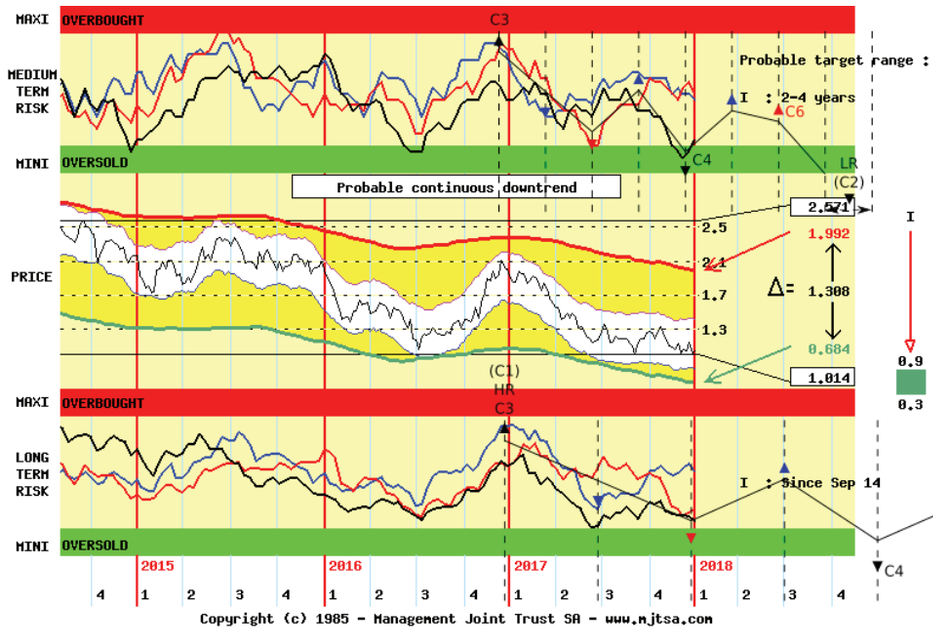
Following its strong acceleration up in late 2016, the US 10 years Treasury yield did consolidate at high levels for most of last year. On our medium term oscillator series (upper rectangle), we project the current re-acceleration from the September 2017 lows. It could lead us to **an important top over the next few months (late Q1)**. On our long term oscillators, we review the rather choppy uptrend since mid 2016. **Theoretically, it could lead us up towards another top mid year**. Both timing scenarios are possible, and they will potentially both materialize. Indeed, our view, is that **either the US 10 years yield makes a marginal new high in late Q1 (towards 2.8%), retraces into Q2, and then re-tests up mid year, but fails to make new highs (the less Bullish scenario corresponding to a Distribution top on risk assets). Or, it makes an intermediate top towards end Q1, corrects slightly and then re-accelerates up too much higher levels (above 3%) towards mid year (the more Bullish scenario, which may correspond to a late cycle Commodity spike)**. Our I Impulsive targets up (right-hand scale), and their wide 2.8 to 3.3% target range, could proxy both alternatives.

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



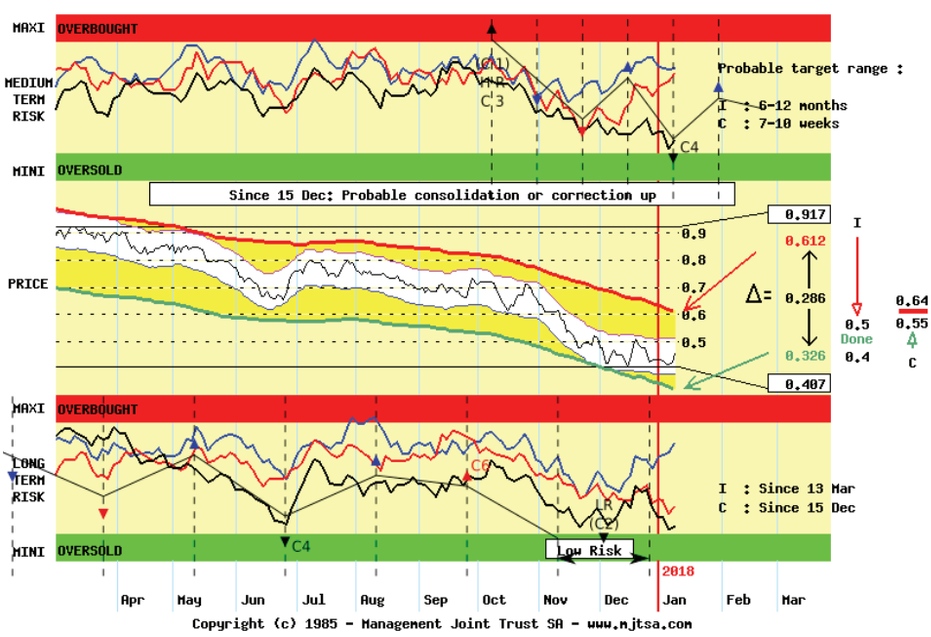
Before we can decide on either one of the scenarios, we will first have to monitor the current acceleration up, which according to both our oscillator series (lower and upper rectangles) could last into late February / March. Our I Impulsive targets to the upside (right-hand scale) **would point to marginal new highs between 2.6 and 2.8% towards March.**

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



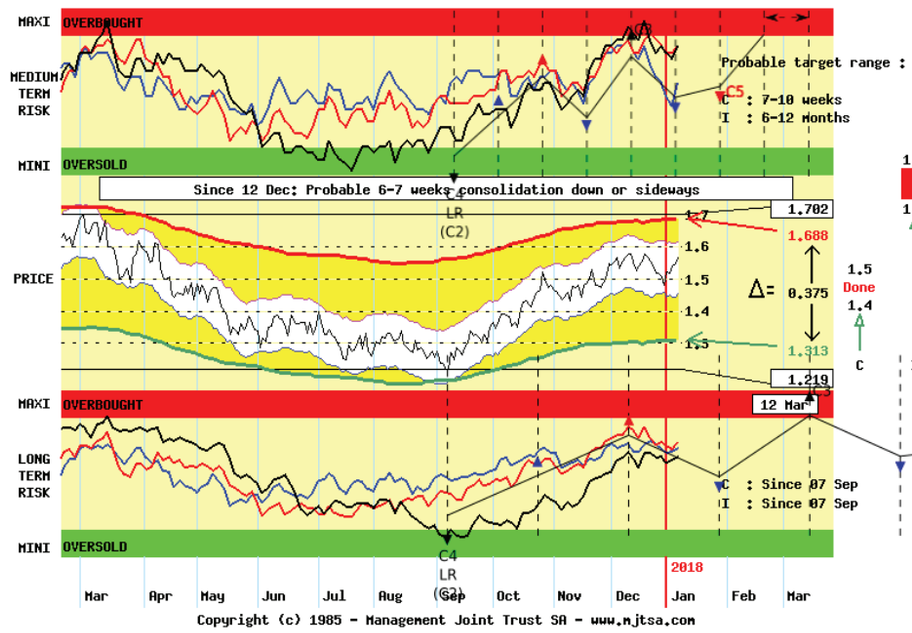
We now focus on the analysis of the US yield curve. We believe it is crucial in analyzing the dynamics above. Over the last couple of issues of the Capital Observer, we have been forecasting a steepening bounce, that could start late November, early December and last into late Q1. Although the yield curve has stabilized since, it is for now failing to steepen. According to both our oscillator series (lower and upper rectangles), we would confirm our view, once again. **The lows we are currently monitoring on the US 10Y minus 3M spread should trigger a bounce that could last into late Q1 (upper rectangle), possibly late Q2 (lower rectangle). These two different timing points correspond to the two scenarios outlined above on US 10 year yields. Consequently, from late Q1, or late Q2, the US Yield Curve should start to flatten again, possibly into year-end. .**

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



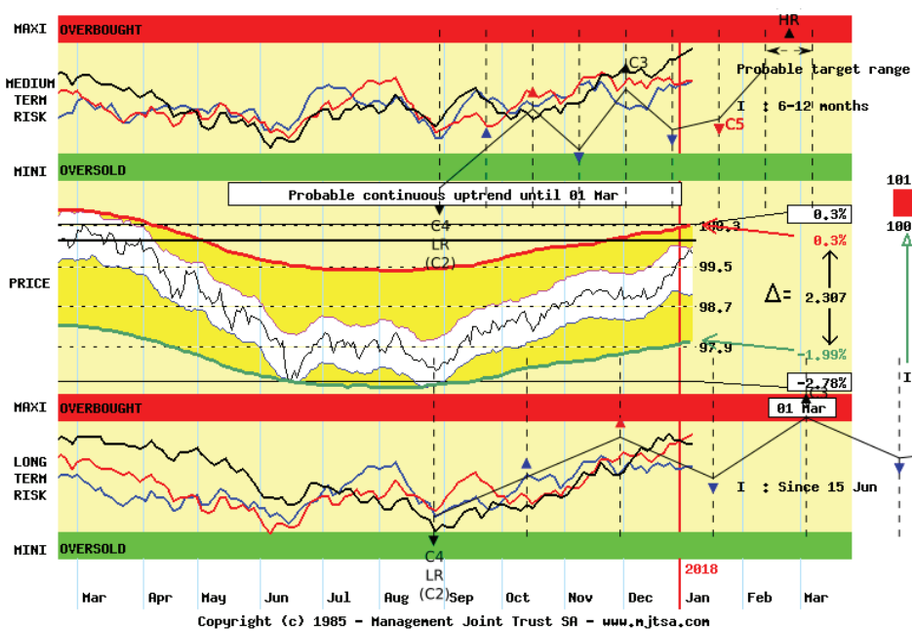
For the daily monitoring of the Yield Curve, we use the 10Y minus the 3Y spread as its trend seems to be more stable than on the 10Y-3M spread. On our long term oscillators (lower rectangle), we have reached a Low Risk position. Consequently, the yield curve spread has stabilized, but for now is failing to accelerate up. Over the next few days, it may find the support of a new low point on our medium term oscillators (upper rectangle). **That the yield curve could start to bounce for here, is an event that could bring crucial support to the continuation of our reflationary scenario over the next couple of months.**

USD Swap Rate 10 Years - EUR Swap Rate 10 Years
Daily Graph or the perspective over the next 2 to 3 months



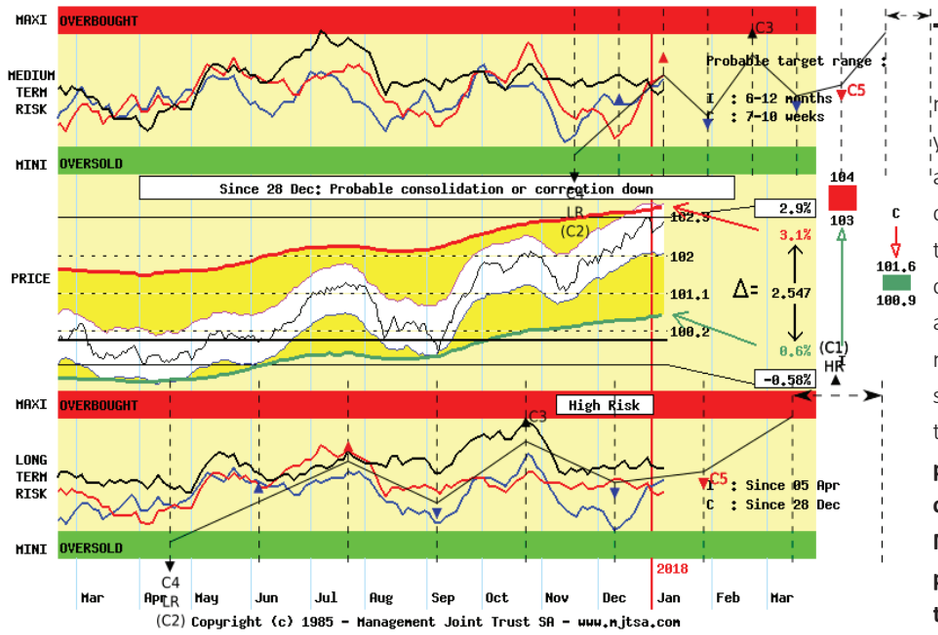
Another spread, which is currently worth monitoring is the USD vs EUR 10 year Interest Swap Rate spread. It should proxy the difference between Growth and Inflation expectations in the US vs the EuroZone. With the US historically being the more dynamic economy, its uptrend is supportive for the reflation trade. By extension, this uptrend should also be supportive for the USD, and since September, it has done so to a certain extent (no new downside breakout on the Dollar since September). On both our oscillator series (lower and upper rectangles), **the spread should continue up, possibly into March. According to our I Impulsive targets up (right-hand scale), it could rise another 15 to 30 basis points over the next couple of months. This should help the USD and the US Equity / Bond ratio, while in Europe, the Equity / Bond ratio may be more driven by the strength of Equity markets on the back of a stronger USD, than by a substantial sell-off in the Bund.**

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



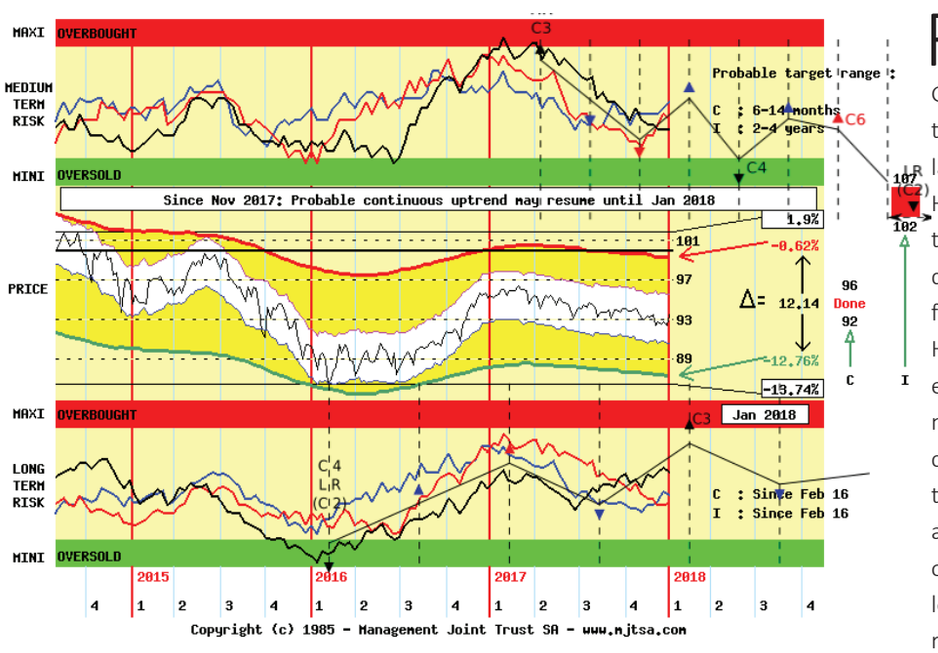
The 10Y US inflation breakeven spread is also interesting. It can simply be assessed by comparing the US TIPs tracker to the US IEF Treasury Tracker. Both bear similar durations, which make them adequate comparison instruments. When the spread rises, the market is buying TIPs vs Treasuries considering that the inflation priced into Treasuries is too low. Vis versa, when the spread falls, the market considers that there is too much inflation priced into Treasuries. Hence, a rising spread proxies a reflationary perception by the market, and often translates into future rises in long term interest rates. At times, the market's perception may be too optimistic, yet it is certainly an indicator worth looking at. On both our oscillator series (lower and upper rectangles), **the trend is up for TIPs vs Treasuries, possibly until March, confirming our anticipation of rising US long term yields until then.**

LQD - iShares Investment Grade Corp. Bond ETF / IEF - iShares 7-10 Year Treasury Bond ETF
Daily Graph or the perspective over the next 2 to 3 months



The Corporate Bond spread is also a good proxy to monitor reflationary trends. As yields rise, Corporate bonds are indeed more immune to downfalls that Treasuries. Both trackers we use bear similar duration, which makes them adequate comparison instruments. On both our oscillator series (lower and upper rectangles), **we expect this Corporate Bond spread proxy to continue upwards towards March at least, thereby supporting the reflation trade until then.**

HYG - iShares High Yield Corp. Bond ETF / LQD - iShares Investment Grade Corp. Bond ETF
Weekly Graph or the perspective over the next 2 to 4 quarters



Finally, we turn to the High Yield spread vs Investment Grade Corporate Bonds. For this comparison, we use the relative graph of HYG vs LQD. The HYG Tracker has a lower duration than the LQD one, yet this difference hasn't prevented it from underperforming during H1 2017, i.e. the credit element embedded in the spread seems much more compelling. Hence, comparing HYG vs LQD seems to be a worthwhile proxy when assessing the Credit element of the reflation trade. On our long term oscillators (lower rectangle), it has followed the reflation trade up from early 2016, yet, in these later stages of the reflationary Bull Equity market, it is lagging the rest of the risk universe. It may attempt to push higher again in Q1 2018, yet should start to fall thereafter. On our medium term oscillators (upper rectangle), **the spread is already in a downtrend. It could bounce slightly into Q1 2018, yet should fall again thereafter. Another bounce is possible towards mid Q2, into early Sumer. Credit is probably the "Canary in the Goldmine" for an early termination of reflation trades, late Q1.**

Concluding remarks

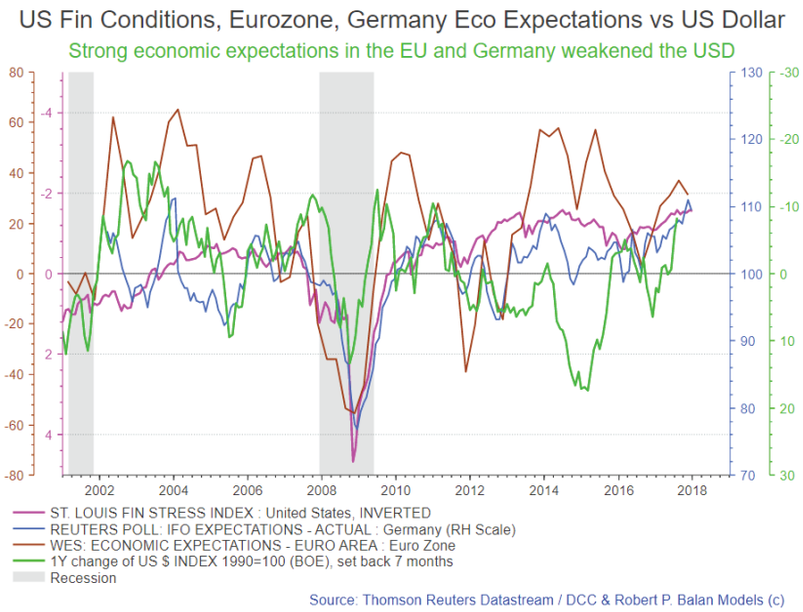
Equity to Bond ratios are still rising. From what we can assess today, until late Q1 for the US, and late Q2 for Europe. Both timing points correspond to potentially two tops on the US 10 year benchmark bond yield. For Q1, we are still very positive on the reflation trade. We would expect an environment of rising yields (towards 2.8% on the US 10Y), rising equity and probably a stronger US Dollar. Our perspective for Q2 are still split between two scenarios, one where markets start to distribute, US equities and yields first correct down, then re-retest up towards mid year, yet will not necessarily make new highs, the other, where the reflation trade follows through relatively unscathed into Q2, and ends with a late cycle Commodity blow-off, with US 10Y yield reaching above 3%. Perhaps, a mix of both.

24 / The US Dollar will be boosted by capital inflows in 2018 and should rise again – that could push the economy, markets over the tipping point.

The dollar has weakened for most of 2017, and did so in several waves. It fell broadly from mid-April last year through early September and then again in November, and during the last two weeks of December. It fell further during the first week of January, but the disappointing December jobs report headline and the distraction of a new book claiming to portray inside the administration in an unflattering way did not do that much damage. FX technical newsflow took that as a sign that the US Dollar appears to be overextended, and are anticipating that an upside consolidative or correction stage is near. These high-frequency moves do not in any way represent the likely course of the US unit during the rest of 2018.

While the longer term macro fundamentals are beneficial later in the year, the foreign exchange markets had been shaped by two powerful, less friendly micro forces in the past few months, which explains a large part of the US Dollar's decline in 2017.

First is the still very accommodative global monetary policy stance. Country- or region- specific fiscal conditions have seen some variances – some relatively tighter, some relatively looser. The "looser" countries include the United States, where despite delivering the fifth rate hike in the cycle, policy rates adjusted by headline CPI remain negative. True, the Fed's balance sheet has seen a few months of reduction, on top of policy rate tightening, but financial conditions in the US are easier now than a year ago, nonetheless. One consequence of the year-long weaker USD has been the loose US financial conditions. Meanwhile economic expectations in German and the Eurozone have been rising strongly since Q3 last year. Historically, the greenback weakens as those metrics rise, on market perception that financial conditions in the EU will be correspondingly tighten much faster relative to the US *(see chart above).*



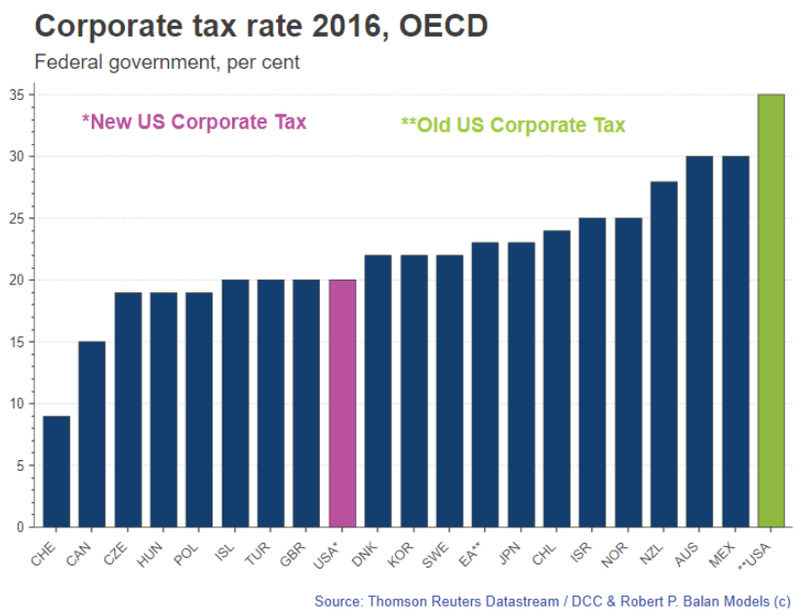
Here is the ostensive reason for that belief: the ECB´s bond purchase program has been cut in half to 30 bln euros a month starting January (which contributed to recent EUR strength and USD weakness). However, that is the most visible part of the ECB's extraordinary monetary policy. Not so spoken about (and not so visible) are other elements which belies the apparent tightening of ECB policy, and that includes the minus 40 bp deposit rate, the full allotment of fixed rate refi operations, and the quality of the assets and collateral (which leaves much to be desired).

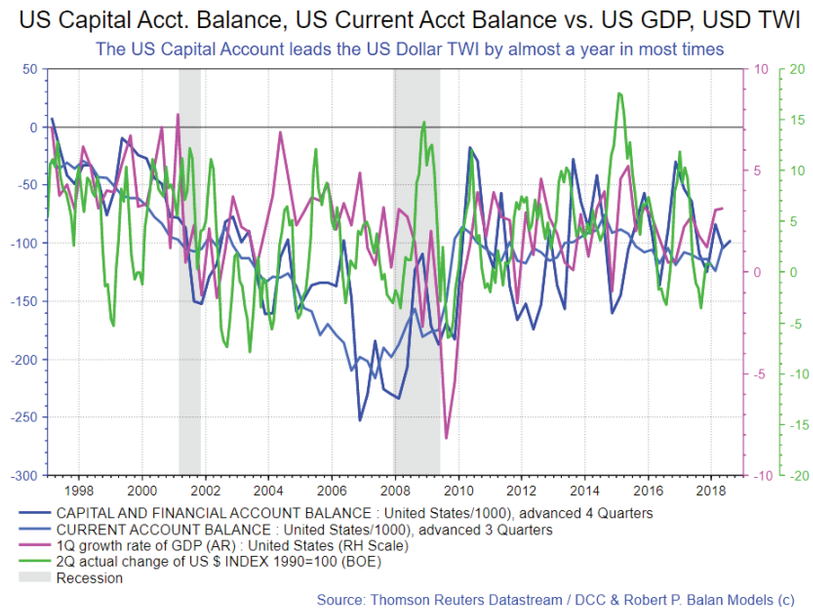
Here is another factor that was largely low-visibility to the FX markets: EU banks will be able to pay back Targeted Long-Term Repos outstanding borrowings (estimated at EUR750 bln) early, starting around mid-year. Given that there is a dearth of strong borrowing demand in the EU, and given further the negative rates at the ECB, we suspect that that some banks will take advantage of the opportunity to return funds back to the central bank. Even a conservative estimate of 10% being returned would still offset 2.5 months of ECB asset purchases, expanding the ECB´s balance sheet. It would be doing so at a time that ECB officials will be considering what to do post-September, the current program's soft end-date. **Given all these factors, the recent appreciation of the EUR, which was based on perceived ECB policy tightening, was likely based on false premises. The EUR's perceived advantages should wilt under closer scrutiny, further out.**

Second, the response by investors to the incentives partly created by the combination of monetary and fiscal policy will soon determine the near-term course of the US Dollar and its counterparts. This is an aspect where the US is ahead of G5 countries, by a mile. The US just announced significant tax cuts even as the economy showed signs of accelerating. **The reduced corporate tax should encouraged capital repatriation and**

new inflows of foreign capital. The US has morphed from having the highest tax regime in the G5 to the lowest *(see 1st graph on this page).* **This could be a game-changer for Foreign Direct Investments (FDIs) which play a large part in a currency's long term valuation.** And even though it does not make it into the headlines often, the deregulation efforts by the Trump government are significant. On top of this, an infrastructure initiative is expected to be unveiled shortly. **Furthermore, the first official read of Q4 GDP is due at the end of the month, and GDP growth higher than 3% would be the third consecutive such quarter, the longest streak since H2 2004 and Q1 2005.** Collectively, these factors should provide a firm floor to the US currency sometime soon.

The longer-term (12 to 16 months) fortune of the greenback may depend less on what the Fed and its global counterparts will do, but may depend more on the lagged effect of the fiscal policy measures taken by the Trump administration last year. The recently enacted US tax reforms will likely encourage capital repatriation to the US and encourage the inflow of foreign capital. This will have significant impact on the course of US bond yields and the US Dollar during 2018 and perhaps beyond. The transmission mechanism of those capital inflows is via the US Capital Account, which at its simplest definition is the net change in ownership of national assets, i.e. whether there is surplus or there is deficit. A surplus (or improvement) in the capital account balance means money is flowing into the country, the inbound flows represent non-resident borrowings or purchases of assets. A deficit (or deterioration) in the capital account means resident capital is flowing out of the country, in the pursuit of ownership of foreign assets. These statements are simplification of relatively intricate balance sheet operations, but they describe the flows well. **We believe that the US Dollar would be significantly stronger later in the year and beyond, due to the influx of domestic and foreign capital during the year.**



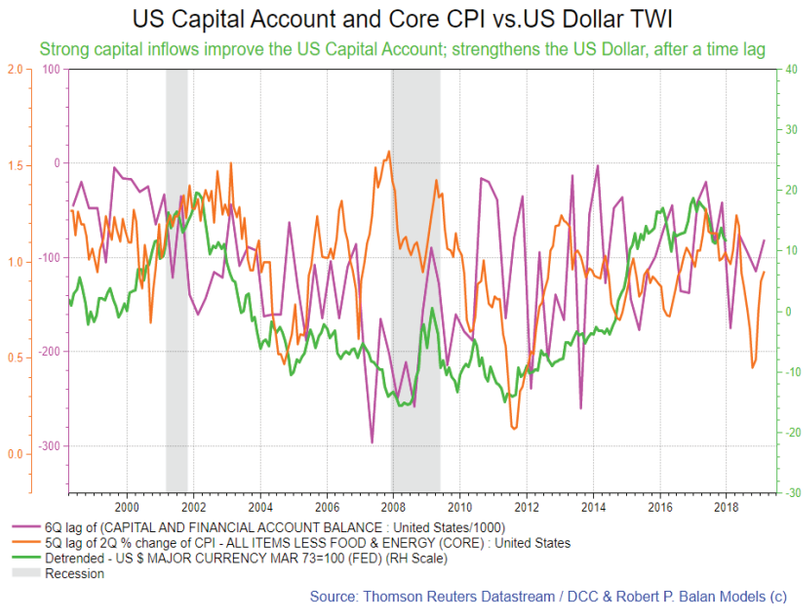


A currency's higher valuation due to improvement of the country's capital account generally keeps its uptrend for longer, when compared to improvement in valuation brought about by interest rate differentials. Although a higher interest rates relative to those of other major central banks tends to attract funds via the capital account, which acts to raise the value of the domestic currency, changes in inflows via this channel tend to be volatile. **Moreover, since the capital account has a distributed lag of circa 4 to 6 quarters, once this channel sets the currency valuation dynamics in motion, the directional bias stays on for at least a year** *(see graph on next page)*. The Capital Account has been rising since Q3, so the end of the distributed lag of 4 to 6 quarters will soon redound to a firmer US currency.

The US Capital Account surplus has been increasing for some time and will likely increase even more this year. So if we fall back on classic definitions, that means foreigners have been investing more in the US than Americans are investing outside it. More foreign money has been coming in to finance the US economy than there is flowing out -- thus there are more infrastructures being built, more factories started. This of course means an increase in employment, and it will

also lead to an increase in wages – as well as inflationary pressures generated by rising workers' compensations *(see graph on the right).*

The combination of rising US Dollar and rising inflation, which we both expect to see not so long from here, will lead to tighter financial conditions later in the year. If the Fed follows through with its self-imposed regimen of three policy rate increases of 25 basis points for 2018, it may just push the financial markets and the economy over the tipping point. The US dollar is the most important asset class to watch in 2018.



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

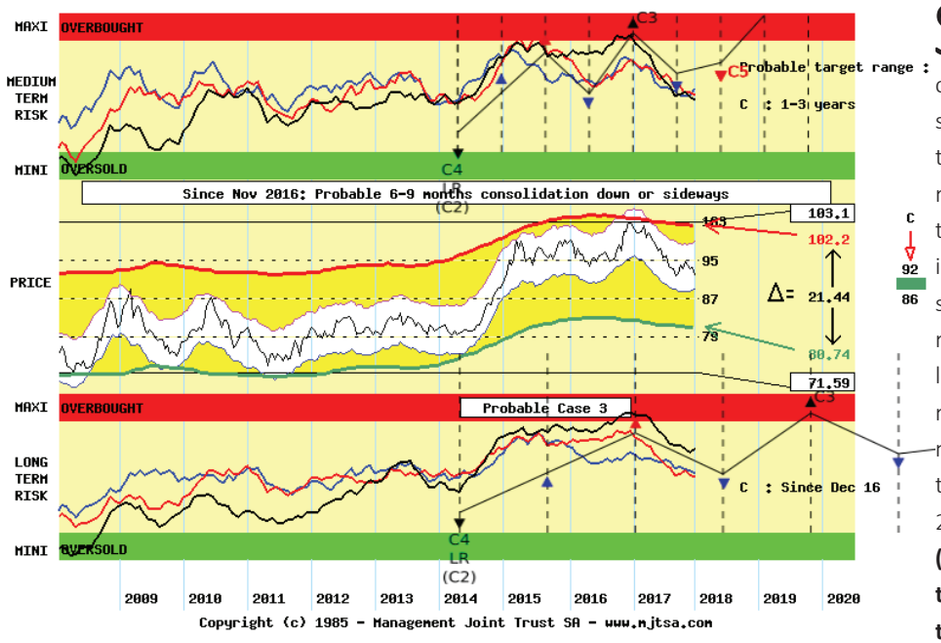
27 / MJT - TIMING AND TACTICAL INSIGHT

The US Dollar could bounce in Q1, re-test down in Q2 and then accelerate up in H2 2018

The US Dollar finished off 2017 as it started it, on the weak side. This late 2017 weakness would be typical of the late stage Equity Bull market we are probably in. December was particularly relevant, with most USD denominated assets - US Equities, Emerging Markets, Oil, Industrial Metals and even Gold - all moving up in sync vs USD. Understanding the US Dollar over the next few months/quarters (and other currency moves) will hence be crucial in assessing How, and How Long, these trends can carry on.

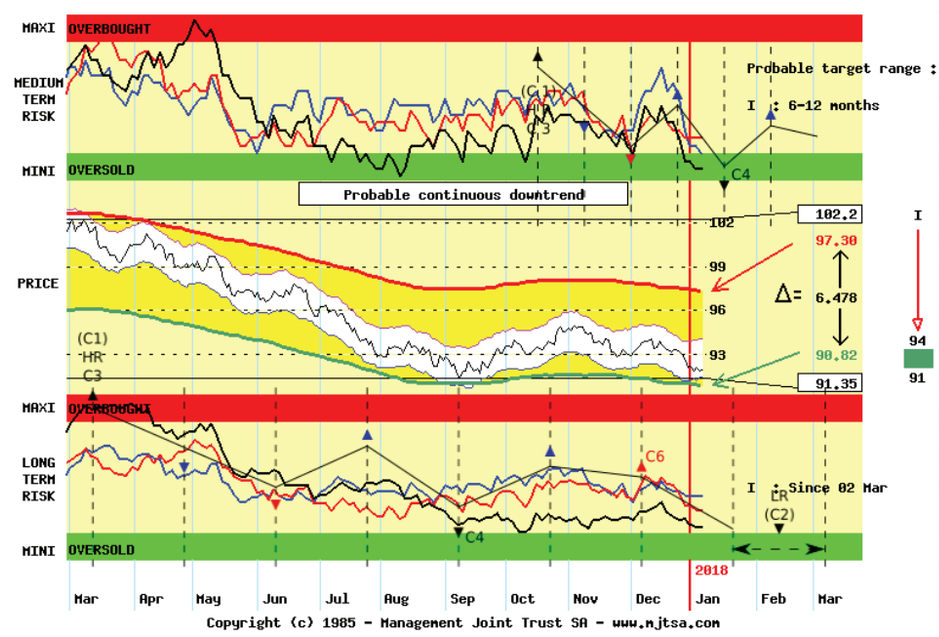
Dollar Index

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



Since it peaked in December 2016, the Dollar has been correcting down in a quasi straight-line. On our medium term oscillators (upper rectangle), we are currently re-testing the support point we identified last September, yet should now hold, and gradually resume up during 2018. On our long term oscillators (lower rectangle), the correction down may continue lower, probably towards late Q2 / mid year 2018. **Whatever the scenario (Dollar holds or pushes lower towards late Q2), we believe the whole move down since late 2016 is only a correction, and that from mid 2018, the US Dollar should resume up towards mid/late 2019** (as shown on both oscillator series). Indeed, for now, we are still above our "C" Corrective targets down (right-hand scale). These should provide strong support. Their upper boundary (92 level) provided support last September. Their lower boundary **(86 level) proxies the risk of a last sell-off (minus 5 to 6%) if indeed our long term bullish scenario from H2 2018 is correct.**

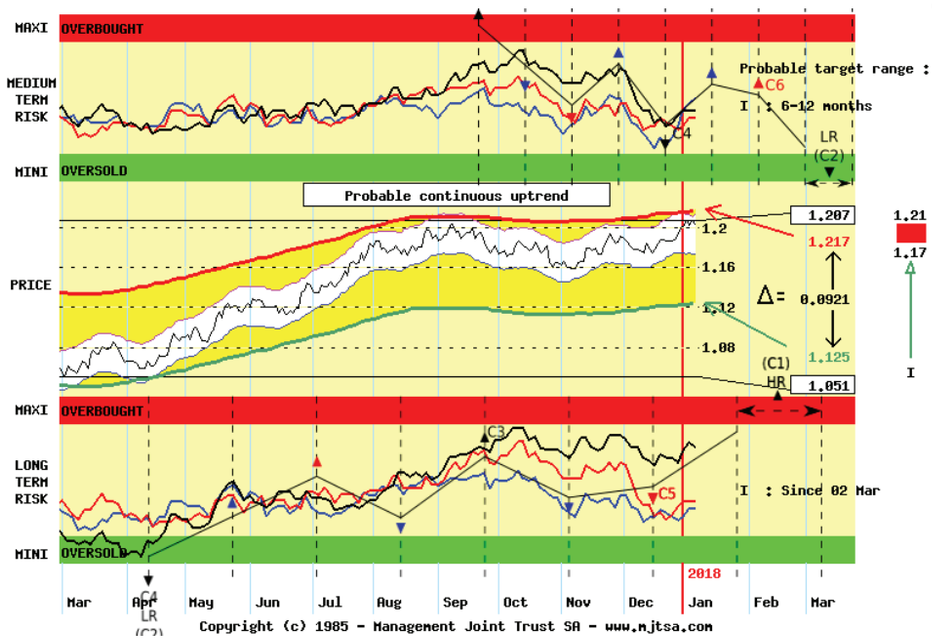
Dollar Index - Daily Graph or the perspective over the next 2 to 3 months



The Dollar Index is currently re-testing its September lows. The move is however pretty much exhausted as it is back within its I Impulsive targets to the downside (94 - 91 range; right-hand scale). On our long term oscillator series (lower rectangle), we would expect a Low Risk situation between late January and February. On our medium term oscillators (upper rectangle), the support point is rather closer as it is expected mid January. Such Low Risk situations usually trigger bounces lasting 1.5 – 3 months. **We would hence expect the Dollar to bottom out over the next few weeks. The bounce could last into March and add 3 to 5 figures** (i.e. 0.5 to 0.8 times our historical volatility calculation of 6.478; middle graph, right-hand side).

The Dollar Index is getting ready to bounce. It should find a low mid/late January and could move up 3 to 5 figures towards early March. Late Q1 and Q2 should then see some retracement and a possible new downside re-test. We would then be bullish for the Dollar from mid 2018 into 2019.

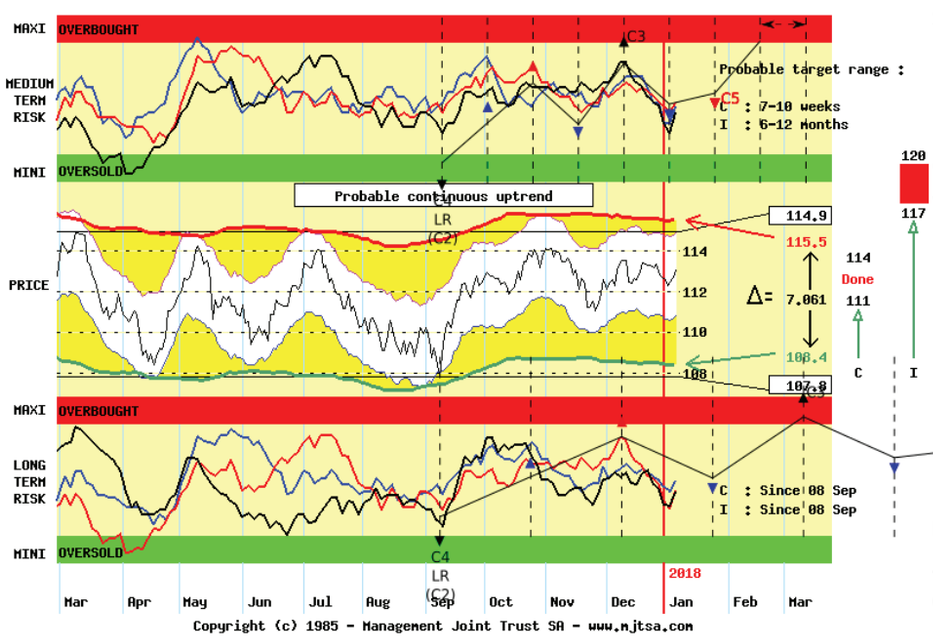
EUR/USD
Daily Graph or the perspective over the next 2 to 3 months



EUR/USD recently retested its September highs and made a marginal new high on an end of day basis (same levels were reached on an intraday basis around 1.2090). On this Daily graph (as with the Dollar Index), the uptrend is close to exhaustion (our I Impulsive targets to the upside between 1.17 and 1.21 have been fulfilled; right-hand scale). On our medium term oscillators (upper rectangle) we still show a downtrend model, which we believe best fits the consolidation at high levels we have been in since September.

According to this scenario, **the current upside re-test should gradually lose steam over the next few weeks, and then start to reverse down until early March**. Given our historical volatility measure "Delta" (0.0921; middle rectangle; right-hand side), the correction to the downside that follows could bring EUR/USD **back towards the 1.16 – 1.13 range** (or minus 0.5 to 0.8 times "Delta" from the graph's top slightly below 1.21). Our long term oscillators could justify that the uptrend carries on into February, yet again the potential up seems exhausted.

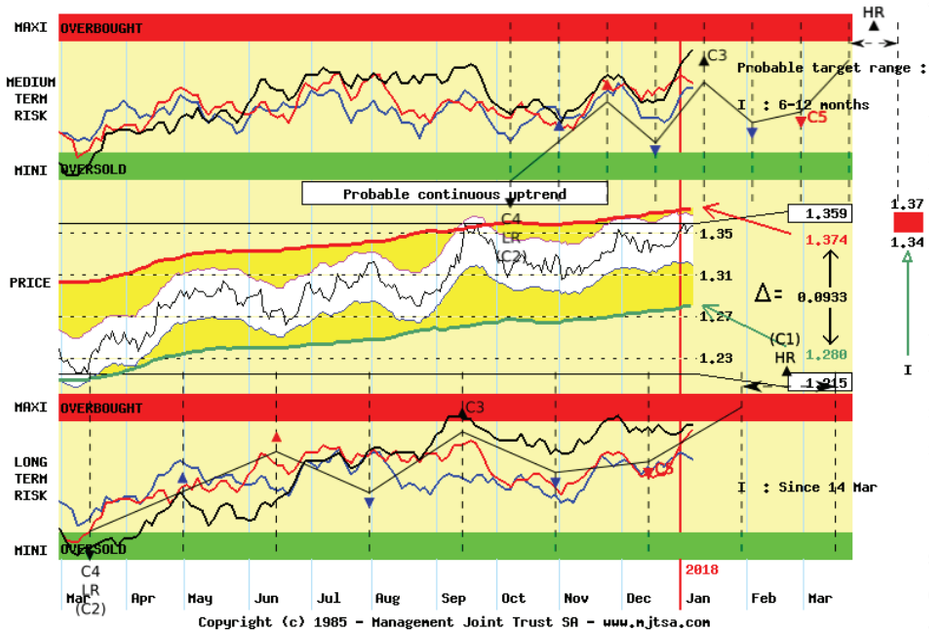
USD/JPY
Daily graph or the perspective over the next 2 to 3 months



Since early September, the Yen has been weaker across the board, vs the Dollar and vs the Euro. Following some consolidation since early November, we now believe that USD/JPY is getting ready to accelerate up again. On both our oscillator series (lower and upper rectangles), we are reaching "resume Uptrend" situations between now (upper rectangle) and late January (lower rectangle). **From now to early March, we would expect USD/JPY to break back above its C Corrective targets up (above 114) and accelerate up to reach its I Impulsive targets up towards the 117 – 120 range** (right-hand scale).

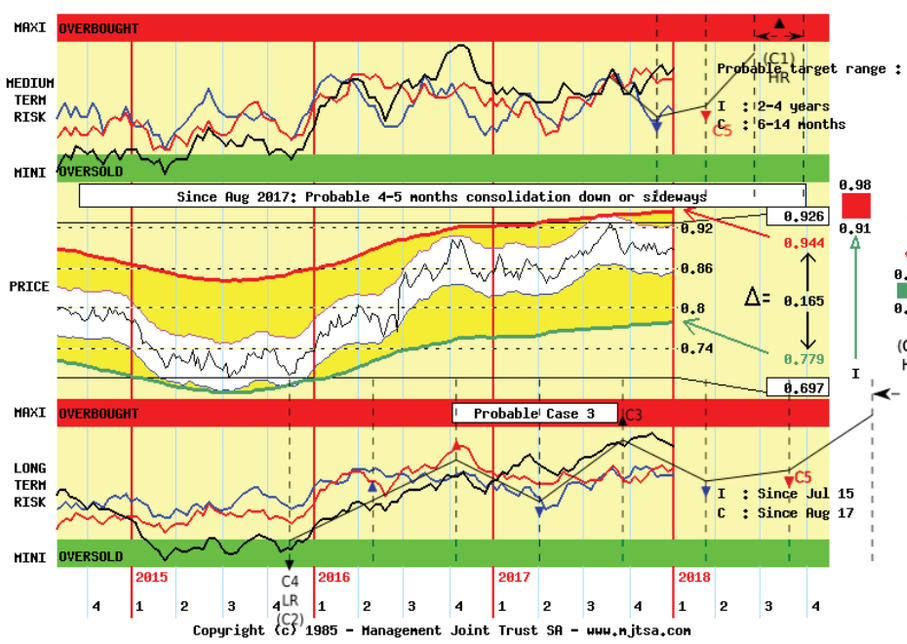
The Euro has been strong across the board. Against USD, it recently retested its September Intraday highs around 1.2090. We believe that over the next few weeks, this upside re-test should die out, and that EUR/USD should start to correct to the downside towards March and the 1.16-1.13 range. The Yen has been weaker, and USD/JPY could also find a low in January and accelerate up to reach the 1.17 – 1.20 range by March.

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



The Pound is also re-testing its September highs vs the Dollar. Our long term oscillators (lower rectangle) would suggest that it could continue to do so until late January/February and possibly towards 1.37 (I Impulsive targets up; right-hand scale). Our medium term oscillators (upper rectangle), however, would rather suggest a mid January top and some consolidation until early March. Whatever the outcome, **Cable (GBP/USD) should see some consolidation to the downside during February. In the meantime, the upside potential seems rather limited.**

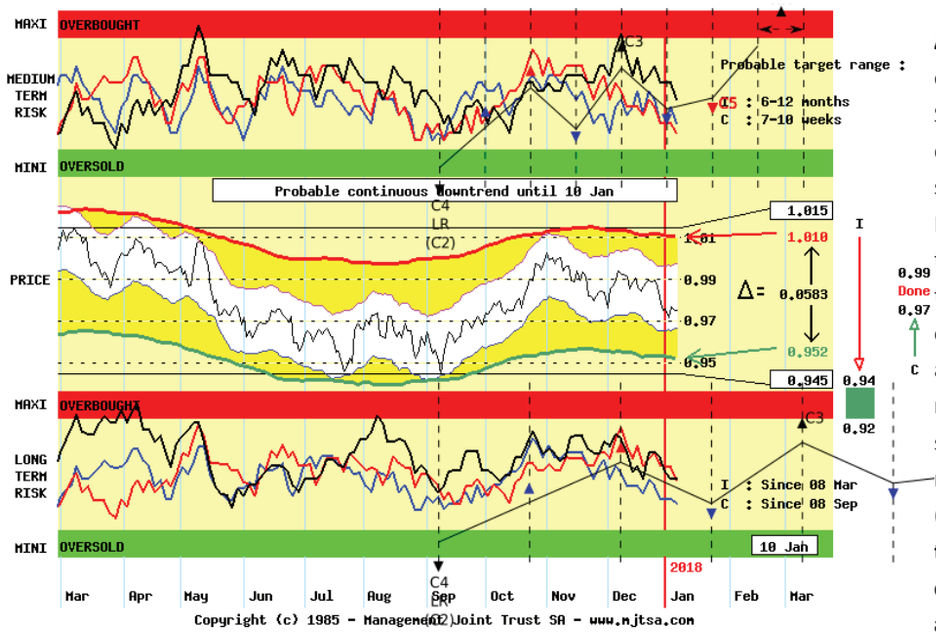
EUR/GBP
Weekly graph or the perspective over the next 2 to 4 quarters



EUR/GBP recently turned down (top late August). Since then, the Cross has been consolidating at high levels. On both oscillator series (lower and upper rectangles), it could continue to be under pressure until late Q1. We believe that in worst cases, the C correction potential to the downside is in the low 0.80s (right-hand scale). From late Q1, and from Q3 especially,we expect the EUR to strengthen again vs the Pound, probably reaching parity by 2019.

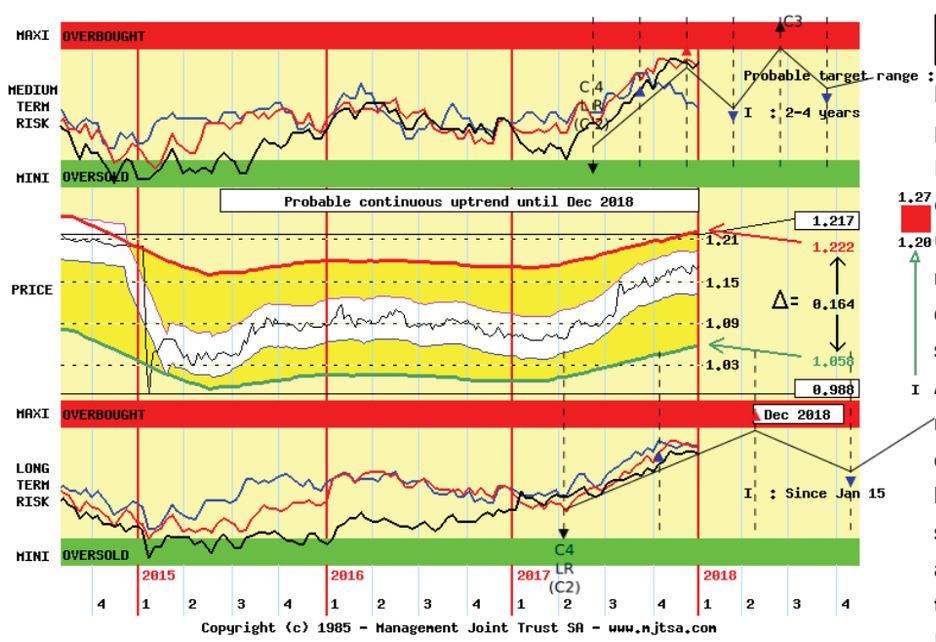
Over the next couple of months, the Pound may also correct down vs the Dollar. In this initial time-frame, it should however remain more resilient than the Euro (weaker Euro and limited downside potential for the Pound vs the Dollar, perhaps 3 to 4 figures max). Following that, and from this Summer especially, the Pound should start to weaken again vs the Euro and the Dollar, probably into 2019.

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



As with the Yen, Swiss Franc has also been quite weak overall: vs the Dollar since September, and vs the Euro during most of 2017. Following some consolidation since early November, we now believe that USD/CHF is getting ready to accelerate up again. On both our oscillator series (lower and upper rectangles), we are reaching "resume Uptrend" situations between now (upper rectangle) and late January (lower rectangle). **From now to early March, we would expect USD/CHF to move back above its C Corrective target to the upside (0.99; right-hand scale) and possibly re-test its 2017 highs around 1.015.**

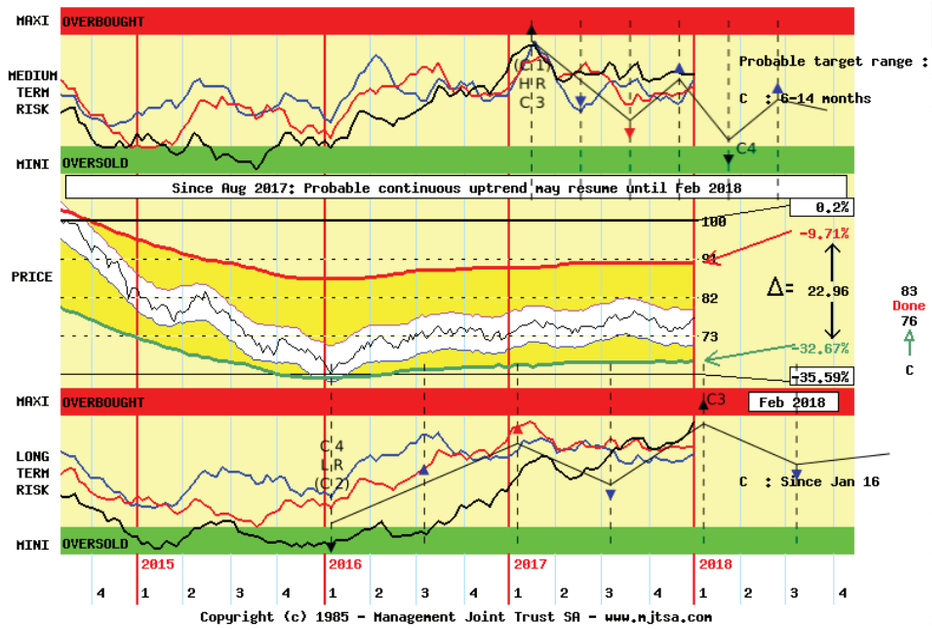
EUR/CHF
Weekly graph or the perspective over the next 2 to 4 quarters



During 2017, EUR/CHF has accelerated up on the back of the loose monetary policies conducted by the Swiss National Bank. On both our oscillators series (lower and upper rectangles), **it may have reached an intermediate top during Q4 around 1.17 and has shown little progression since. A high level consolidation may continue over the next couple of months. From mid/late Q1, however, EUR/CHF should start to accelerate up again, probably reaching into the mid 1.20s during Q2 2018.** During the second half of the year, we would then expect the Swiss Franc to regain some of its defensive bias.

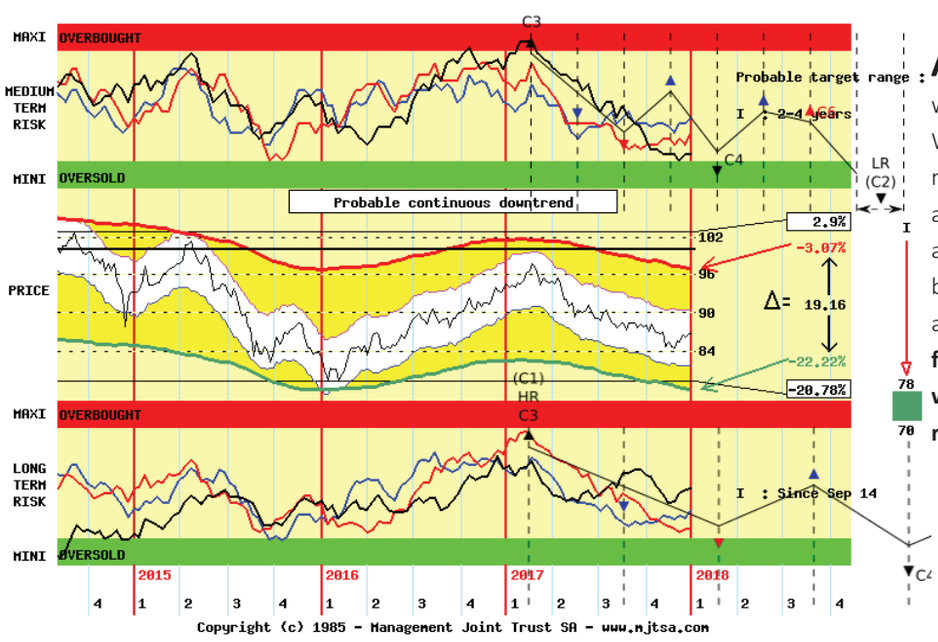
The Swiss Franc has been relatively weak vs the Dollar and the Euro. This should continue to be the case until mid/late Q2.

Commodity Currencies vs USD
Weekly Graph or the perspective over the next 2 to 4 quarters
(Portfolio Equal weighted: AUD, BRL, CAD, NOK, NZD, RUB, ZAR)



Late in the business cycle, such as today, Commodities are usually quite strong. The graph above compares an equal weighted portfolio of Commodity currency vs the USD. On our long term oscillator series (lower rectangle), Commodity currencies may be reaching an intermediate top, sometime between now and February vs the USD. On our medium term oscillators (upper rectangle), however, we would expect them to rebound quite strongly from late Q1 to mid year. Hence, **we expect some consolidation of Commodity currency vs the Dollar in Q1, but believe the uptrend should then carry on during Q2, probably towards mid year.**

Commodity Currencies vs EUR
Weekly Graph or the perspective over the next 2 to 4 quarters
(Portfolio Equal weighted: AUD, BRL, CAD, NOK, NZD, RUB, ZAR)



Against the Euro, Commodity currencies have been weaker during most of 2017. We believe they are currently making a base (or finishing off a downtrend) between now and mid/late Q1 as shown on both oscillator series (lower and upper rectangles). Indeed, **from late Q1 into mid year, we would expect Commodity Currencies to bounce vs the Euro.**

Concluding remarks

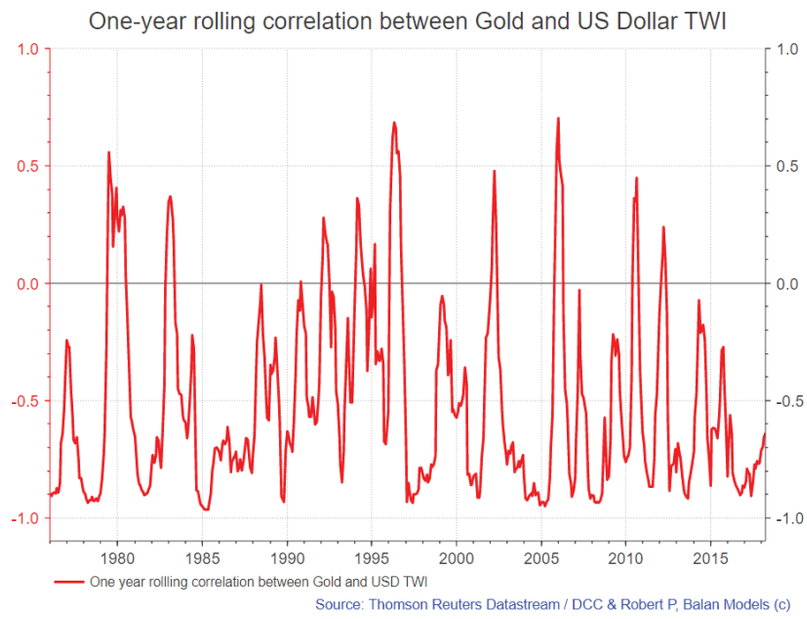
Over the last few weeks, the Dollar has sold off against most currencies as well as against most USD denominated assets. We believe it is now Oversold, and that, over the next few weeks, it could initiate a bounce, which could last into March and travel 3 to 5 figures vs other Major currencies. Following that, the Dollar could retrace back down during Q2, before it accelerate up again from mid 2018 towards 2019. On the sidelines, Commodity currencies, could correct until mid/late Q1, yet should be particularly strong vs the Majors, between late Q1 and mid year, probably a sign of a late cycle Commodity blow-off.

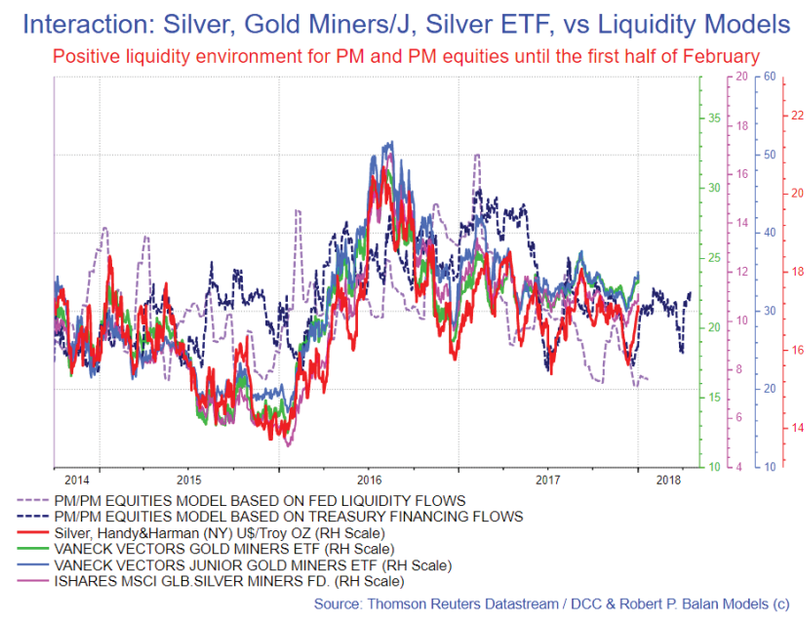
32 / Medium-term prospects for Gold, Silver and Gold Miner Equities : Q1 should not be supportive for the precious metal sector

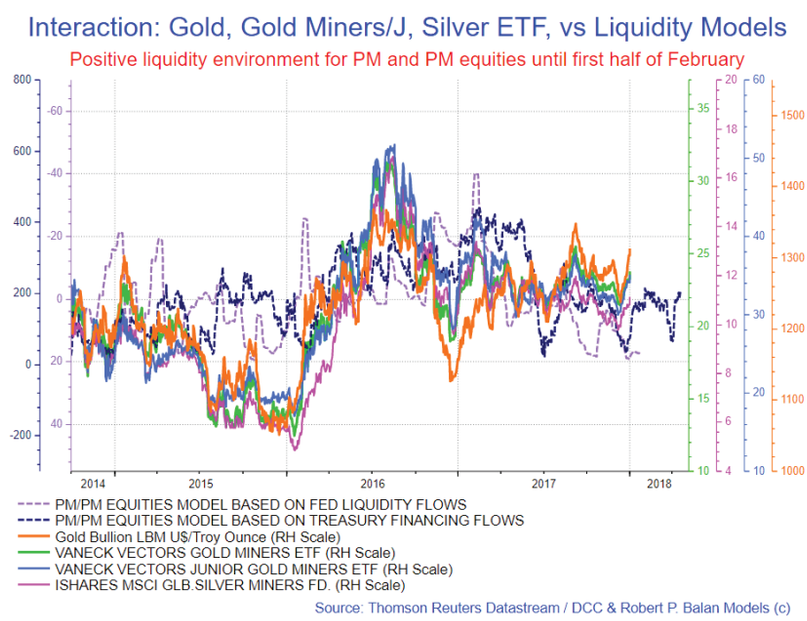
The precious metals sector rose 5.23% in Q4 2017. Precious metals rallied 13.4% higher in 2017 (DCI Precious Metal index), thereby posting its second consecutive annual gain -- precious metals gained 11.50 % in 2016. **It was also the best yearly performance for gold since 2010**. The precious metals sector has generally moved inversely to the changes in the US Dollar TWI. The USD has been falling steadily lower throughout the year, providing the positive bias for Gold, Silver and the rest of the precious metals sector, enabling the sector to perform well despite generally low inflationary pressures during last year. But that relationship will likely become negative from here, so we will have to look for other primary determinants of the gold price *(see 1st chart on this page)* in the near-term. .

The US Dollar and precious metals (as well as a host of other cyclical assets) have also been very responsive to the changes in liquidity funding measures being provided by the Federal Reserve and the US Treasury. Although the impact of liquidity on asset prices is short-lived (from 3 to 6 months), the distributed, lagged effect could sometimes be profound, and could be a determinant of the high-frequency changes in precious metals and some cyclical assets. In graph two and three provided on this page, we show the impact of these measures of liquidity funding from the Fed and Treasury on Silver, Gold and the Gold/ Silver Miner equities and ETFs.

Based on the distributed and lagged effect of the liquidity funding, silver has risen in the past several weeks, but could enter into a consolidation phase soon. A brief pause of a week or so, however, may give way to another sequential upmove which could top shortly. Following the trajectory of the liquidity funding model, a top in January early February should be followed by a PM sector sell off until the early Q2 *(see 2nd graph on this page).*





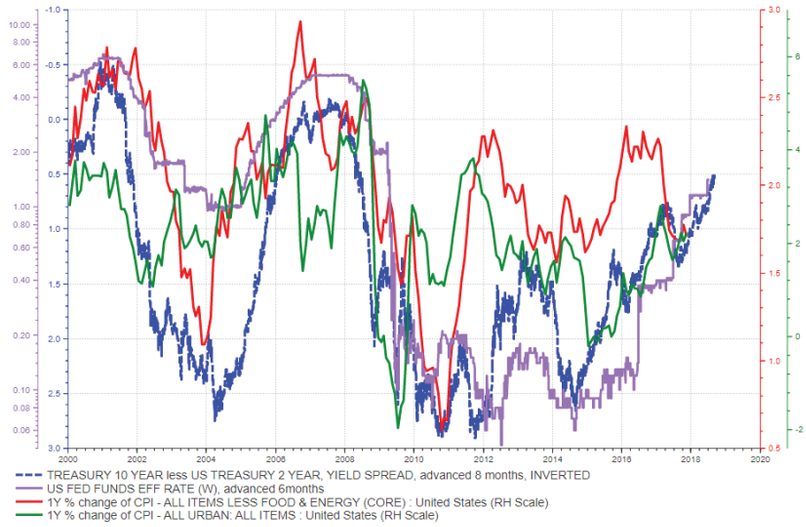


That should hold true for Gold and the various Gold Miner equities and ETFs as well. The sequential move for Gold is exactly the same as that for Silver, but Gold is skewed higher – which has been the source of Gold's outperformance relative to Silver *(see last graph on previous page)*. Political instability in Asia as a result of North Korea's nuclear ambitions, and the brewing tension between Saudi Arabia and Iran continue to be positive factors for precious metals. Now, we have the Iran uprising as well to contend with. These issues have the potential to foster fear and uncertainty in markets across all asset classes. That may benefit Gold especially among the precious metals – but we have no way of knowing whether these issues will come to a head this year or the next.

Gold has been buoyant last year even in the absence of CPI inflation, and it is intriguing to think how much better the yellow metal can perform in the actual presence of CPI inflation. And by some measures which we have been tracking, there is potential for CPI inflation (both Core and Headline) to rise this year, at least during H1 2018. **The Quantitative Easing program and balance sheet stimulus coming from the Fed during the last several years have skewed many of the relationships between macro factors and monetary data, or amplified the relationships. One such example is the inverse relationship between the Fed Funds rate and the bond yield curve (the 2Y/10Y spread as proxy).**

Tighter monetary policy has always flattened the yield curve, but in this cycle of Fed tightening, the relationship has become even starker. The flattening of the curve intensified when the Fed made clear of their intention to tighten policy regardless of tepid inflationary pressures and modest progress on US GDP growth. The short end of the curve is being pushed up by the Fed tight stance, while the long end of the curve has been falling in fear of consequences the tightening has on asset prices and growth.

Sequence: Fed tightens, yield curve flattens, CPI inflation rise after a time lag



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

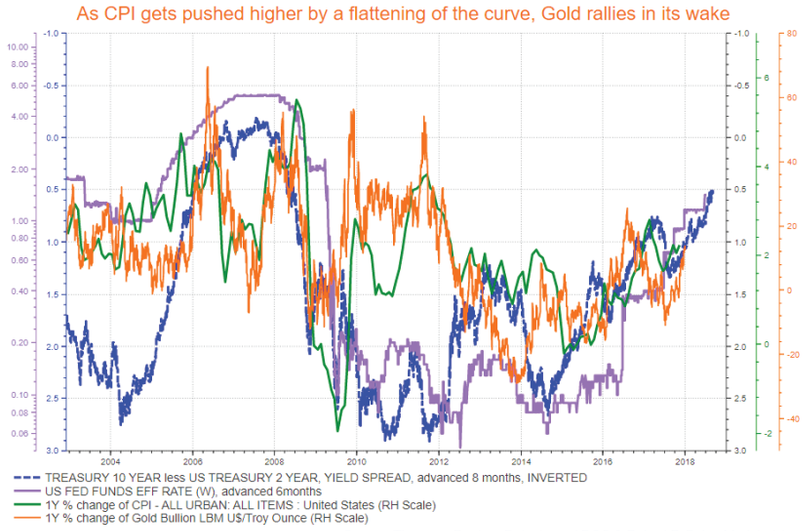
Interestingly, the dynamics of yield curve flattening/steepening of the past few years has also driven the CPI inflation trajectory. Falling long term yields have driven inflationary tendencies higher along with actual CPI measures (both headline and CPI). So we now have a counter-intuitive situation where higher FFR driven by the Fed, results in a flatter yield curve, which in turn provokes a rise in CPI inflation after about 3 quarters *(see graph above)* time lag. This has deep implications for the medium-term outlook in Gold and precious metals, as we expect both CPI inflation measures to rise from here until the middle of the year at least. Gold should derive some measure of strength from rising CPI inflation during Q2 of 2018 *(see graph below)*.

Gold and crude oil are classified as commodities, but in reality both assets have been so heavily financialized that monetary and interest rate developments have inevitably impacted their pricing mechanisms. Pursuing the negative correlation of precious metals and the slope of the yield curve, we find that the relationship is sufficient, per se, to be a determinant of gold prices.

For instance, flattening of the yield curve today is enough to impart positive impulse on the gold price over a distributed lag of 30 days – the optimal impact coming at the end of that 30 day lag. Gold is not alone in this situation, which basically tells us that the inverse relationship between a cyclical commodity and the yield curve is not spurious. We find the

Sequence: Fed tightens, yield curve flattens, CPI inflation rise after a time lag

As CPI gets pushed higher by a flattening of the curve, Gold rallies in its wake



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

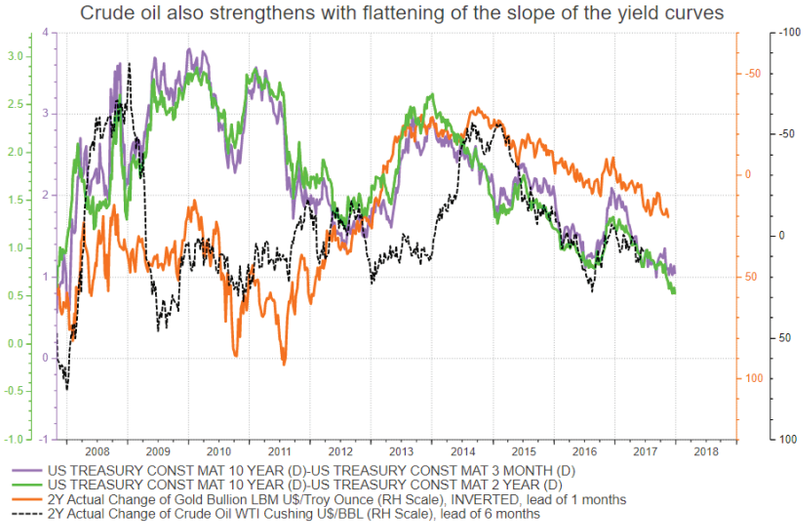
same inverse relationship between the yield curve and crude oil prices.

This crude oil-yield curve inverse relationship provides another added value in the sense that it lags behind the gold-yield curve inverse correlation by 5 months. Put simply, how gold behaved in the relationship 5 months ago provides strong clues as to how crude oil will perform over the next 5 months vis-a-vis the yield curve *(see graph on this page)*.

Our liquidity funding models (derived from Fed and Treasury provided financing flows) suggest that precious metals (especially Silver and Gold) are still getting some support on the very short term, then it should be followed by a likely decline in the price of those assets until the first half of April. These projections have been provided by the evolution of our liquidity funding models which were based on Fed market liquidity flows and Treasury financing outflows. We also get a sense of strength for gold prices later in 2018 based on the lagged, inverse relationship between gold prices and the currently strong flattening of the yield curve. As bonus, we also derived a basis for an outlook of firmer crude oil prices during the first half of the 2018 year. Since these relationships are not perfectly deterministic, those relationships need to be watched closely as there could be needed adjustments as the price determination dynamic of these commodities evolve.

Gold performs well, whenever the US yield curve slopes flatten or decline

Crude oil also strengthens with flattening of the slope of the yield curves



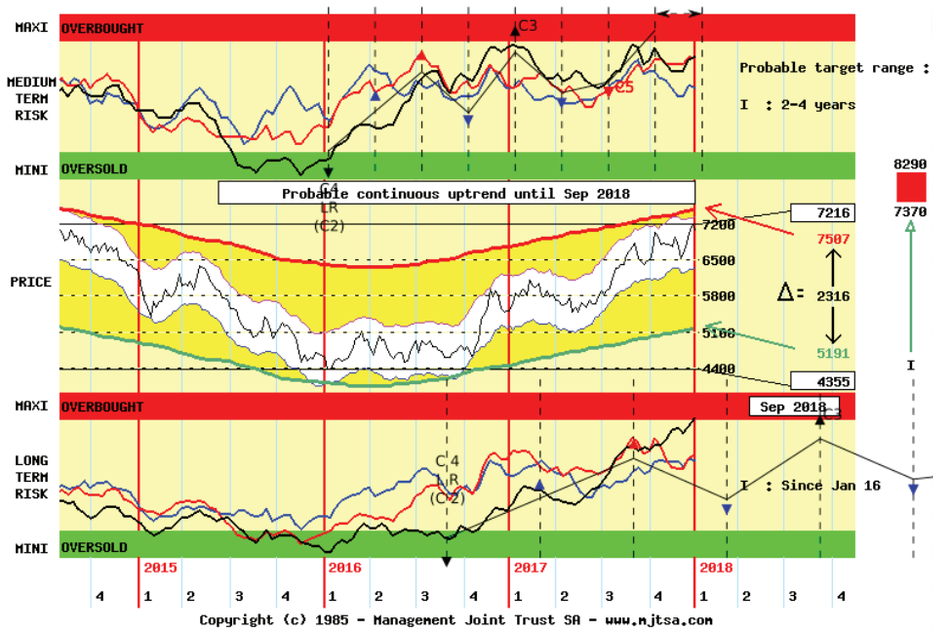
Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

35 / MJT - TIMING AND TACTICAL INSIGHT

Commodities have re-synched in December, yet should diverge again in Q1

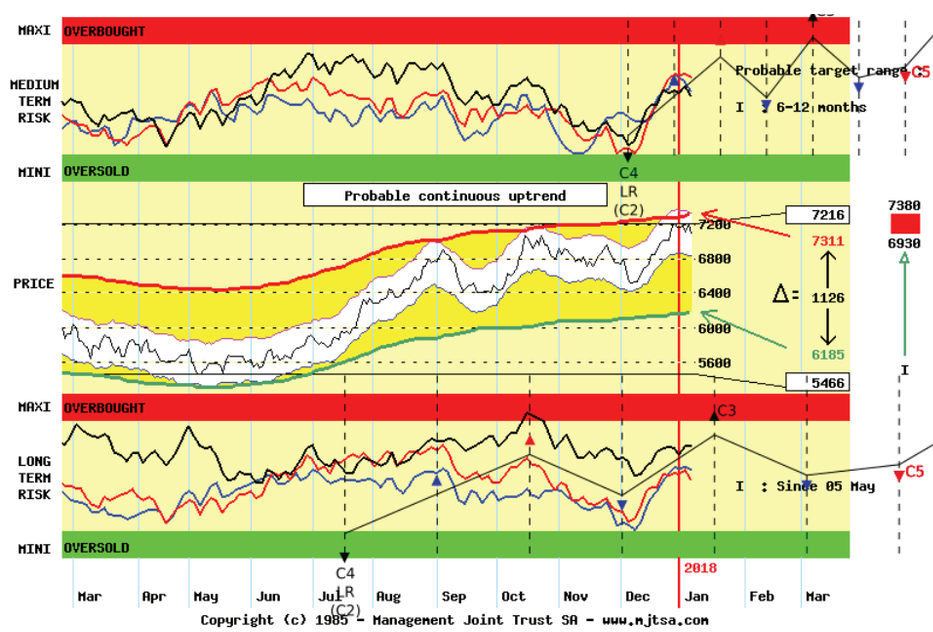
Since early December, the Dollar has started to sell-off again, while Oil, Copper and Gold have been rising together. Since the Reflation trade started in early 2016, such upside coordination has happened only episodically (Q1 2016, June/July 2017, December 2017), and only during periods of Dollar weakness. With the rebound we expect on the Dollar in Q1, these commodities should diverge again.

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



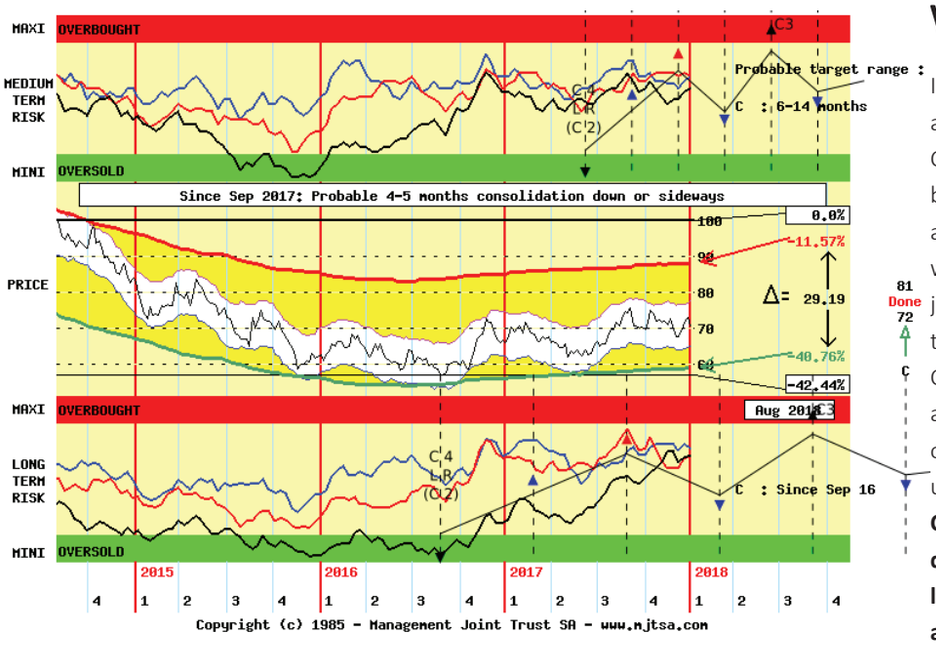
Copper started its uptrend in early 2016 and may be finishing this move now with the current blow-off. This is the sequence we show on our medium term oscillators (upper rectangle). That said, the move doesn't seem exhausted yet. Indeed, our I Impulsive targets to the upside (right-hand scale) still show more potential, possibly towards 8'000 USD/t and above. **A second sequence is probably under way. We show it on our long term oscillators (lower rectangle). It stems from late Q3 2016, just before Copper really started to take-off, and may extend into this Summer. In the meantime, during Q1 2018, Copper may experience a downside consolidation.**

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



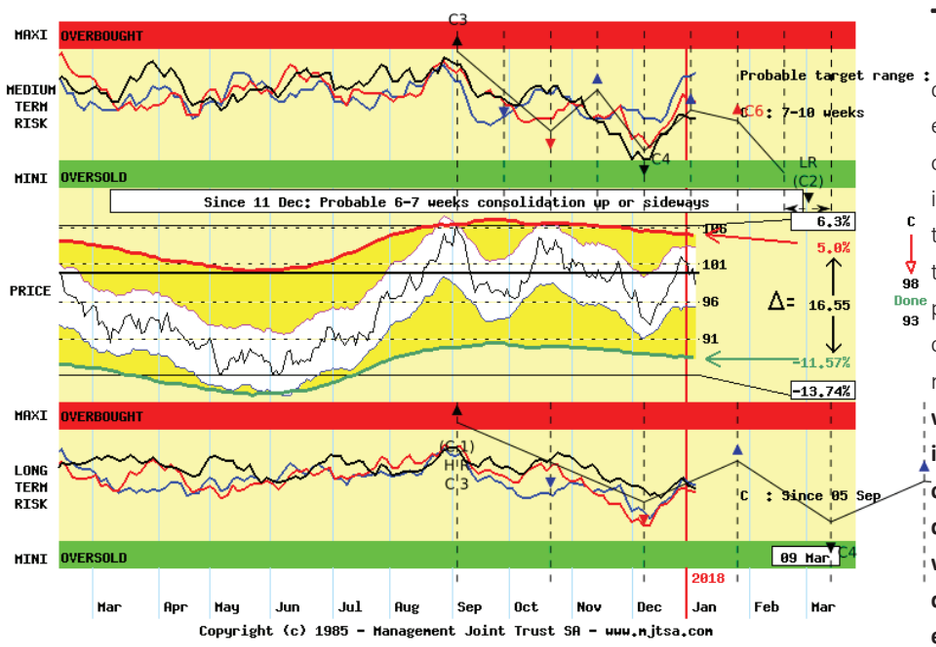
Switching to the Daily graph, Copper's uptrend does seem a bit exhausted for now. It has reached its I Impulsive targets up (right-hand scale), and both our envelopes are touching each other to the upside (middle rectangle), which is usually a sign of exaggeration. This fits the sequence we show on our long term oscillators (lower rectangle), where **Copper could top out towards mid January and then consolidate down towards early March**. The correction potential is between 550 and 900 USD/t (or 0.5 to 0.8 times 1'126, our historical volatility measure "Delta", middle graph, right-hand side). **On our medium term oscillators (upper rectangle), we show an alternative sequence where Copper lingers on in an uptrend. Yet again, we see little upside potential for now vs the risk of a correction. Our view is to Buy the Dips on Copper towards March, rather than follow the break-outs now.**

Copper Spot (LME) / SPY - SPDR S&P 500 ETF
Weekly graph or the perspective over the next 2 to 4 quarters



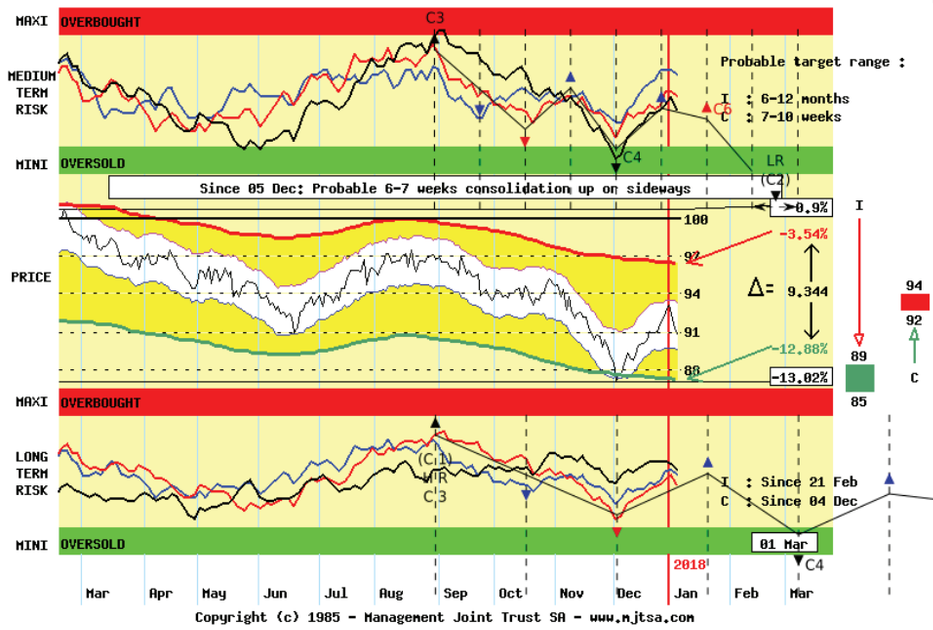
We now compare Copper to the S&P500 Index. Indeed, as we write in another article in this edition of the Capital Observer, we are still bullish on equities until March at least, possibly mid year. We would also validate this projection for most risk assets. In this cross-assets context, will Copper be a lagger or a leader as we enter Q1 2018? On both our oscillator series (lower and upper rectangle), we show that **Copper should probably underperform the S&P500 until late Q1, before it outperforms again during Q2 2018.**

Copper Spot (LME) / SPY - SPDR S&P 500 ETF
Daily graph or the perspective over the next 2 to 3 months



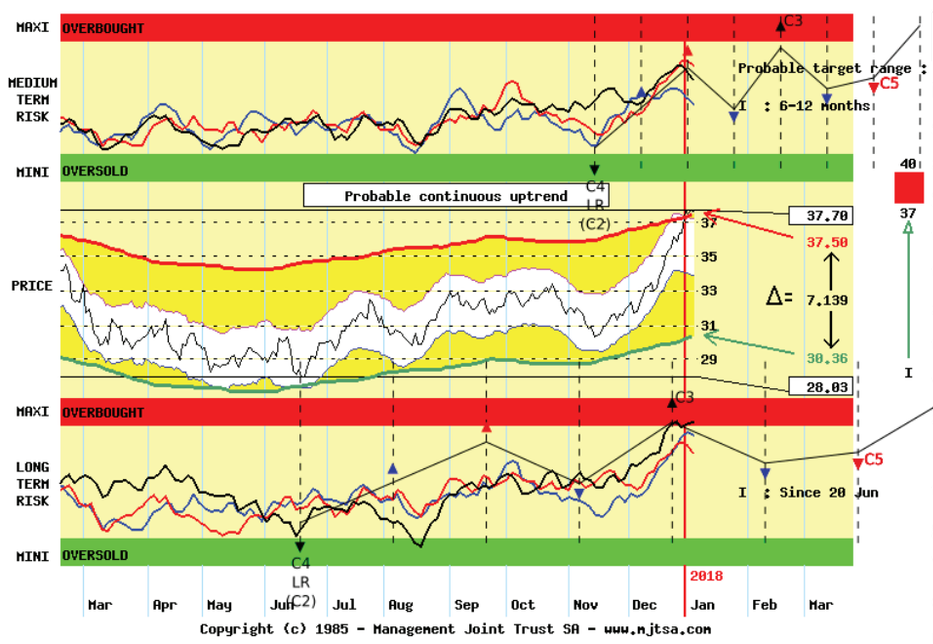
The Daily graph of the Copper / S&P500 gives us more details on the dynamics we expect over the next couple of months. This articulation is one we will see many times throughout the remaining sections of this edition of the Capital Observer. On both our oscillator series (lower and upper rectangles), **the downtrend, which started in September initiated a rebound in December. This rebound should die out over the next few weeks and Copper should underperform the S&P500 until early March, before the ratio resumes up late Q1 for a strong Q2 2018 rally.**

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



Taking this relationship a bit further, we look at the S&P Global Clean Energy Index vs the All Country World Index. Indeed, **along with China, alternative energies (batteries, solar panels) have been a key "Growth" driver for industrial metals during this late reflationary cycle. As with the ratio of Copper vs the S&P500 above, Clean Energy vs ACWI started to sell-off again in September, bounced in December, and should now gradually roll-over during January into a sell-off that could last until early March.** These dynamics are shown on both our oscillator series (lower and upper rectangles).

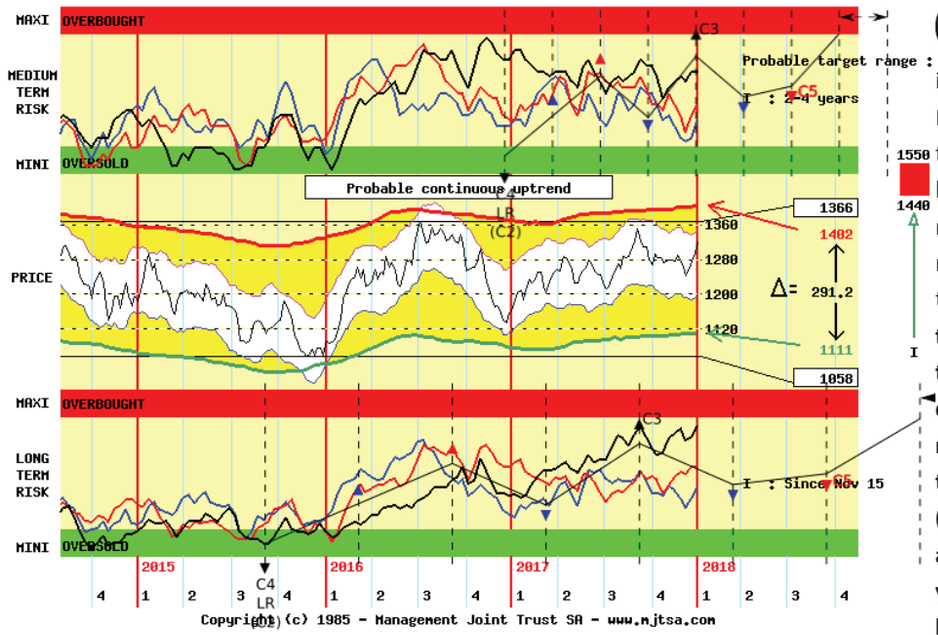
XME - SPDR S&P Metals & Mining ETF
Daily graph or the perspective over the next 2 to 3 months



Finally, we look at the XME Metals & Mining Tracker. It is the US equity resultant of the strong performance of Copper and Industrial Metals since late Spring. As with Industrial Metals, its uptrend is slowly getting exhausted. Our envelopes are touching each other to the upside (middle rectangle), which is a sign of exaggeration, and the I Impulsive price potential left (right-hand scale) is less than 10% (which is moderate given the volatility of XME). When combining both our oscillator projections (lower and upper rectangles), **we would probably expect a high level consolidation, or at best, a slight uptrend on XME over the next couple of months. Given our Bullish scenario on equities, this translates into a "Market Neutral" position for XME until March, before it outperforms sharply again in Q2 2018.**

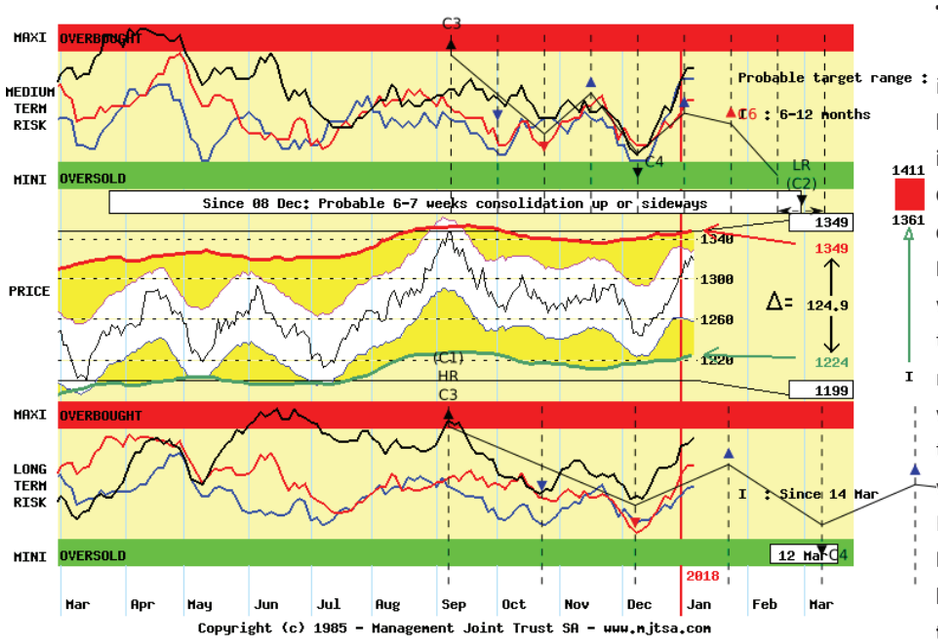
Following their great run to the upside since late Spring, Copper and by extension Industrial Metals, may take a pause in Q1 2018. Indeed, in this late stage of the cycle, their profile is rather Growth than Value, especially given their linkage to China and Alternative Energy. On the other hand, the Dollar bounce we expect in Q1 is rather favorable to Value. From late Q1, however, the late cycle Commodity acceleration should resume, and Copper, Industrial metals and related equity segments should outperform again towards mid year / the Summer.

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



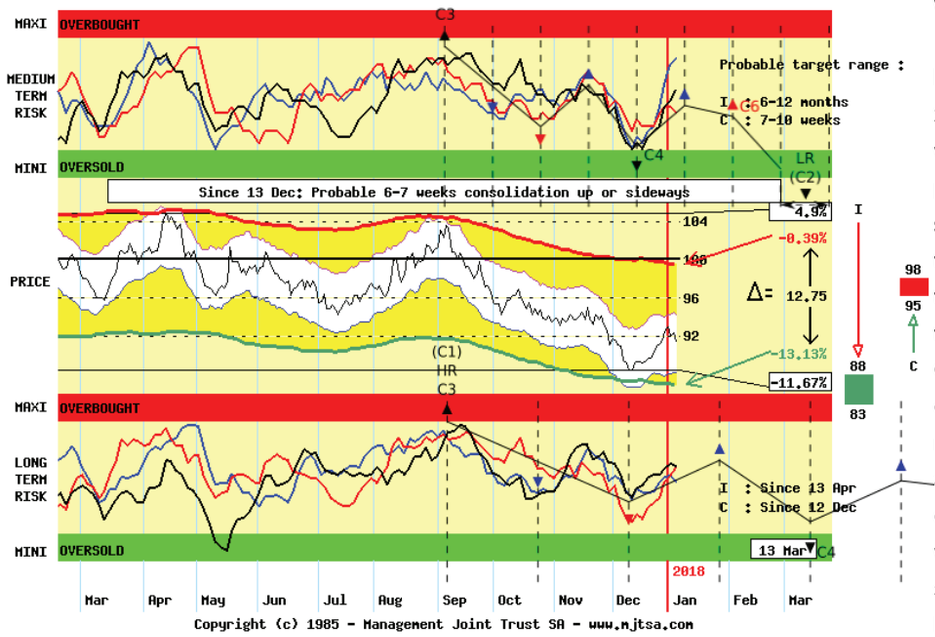
Gold is a defensive commodity. In this reflation cycle, it is inversely correlated to the Dollar as well as long term interest rates. On both our oscillator series (lower and upper rectangles), we believe it has recently reached intermediate tops. **We hence expect Gold to correct once more in USD terms during Q1, before it gradually accelerates up for the rest of 2018. I Impulsive price targets towards year-end (right-hand scale) are back above 1'500 USD/oz towards year-end. We would hence look to Buy the Dips on Gold in USD terms between late Q1 and mid year.**

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



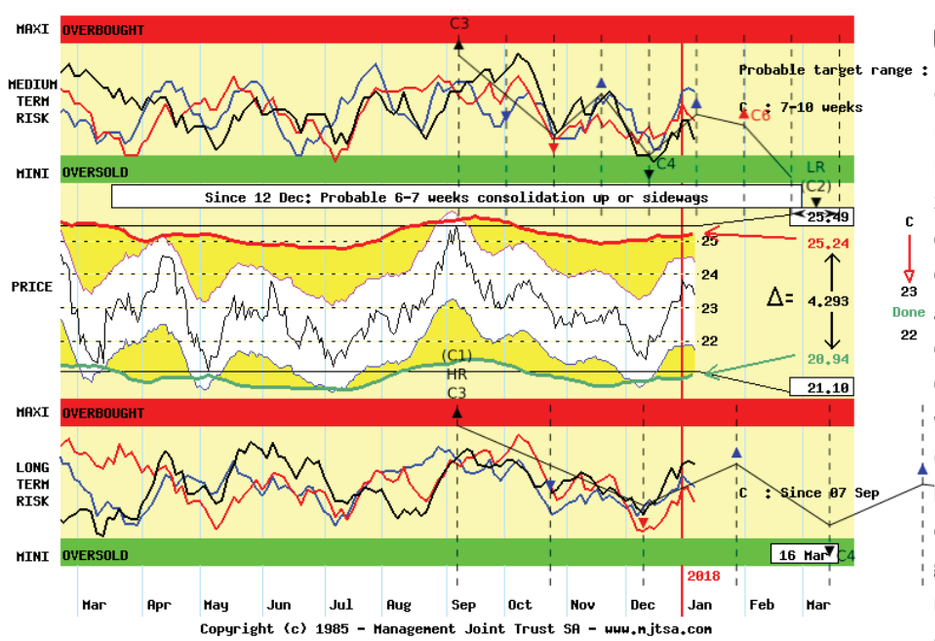
The daily graph of Gold started to correct down in September. **Although the bounce in December has been impressive, we believe that Gold should now resume its downtrend towards early March.** This is the sequence we show on both our oscillator series (lower and upper rectangles). More precisely we expect Gold prices to start to roll-over over the next few weeks, before they sell-off in February. **We believe that the December 2017 lows will probably be re-tested, and that the sell-off may even carry on below 1'200 USD/oz.**

Gold Spot (USD/oz) / SPY - SPDR S&P 500 ETF
Daily graph or the perspective over the next 2 to 3 months



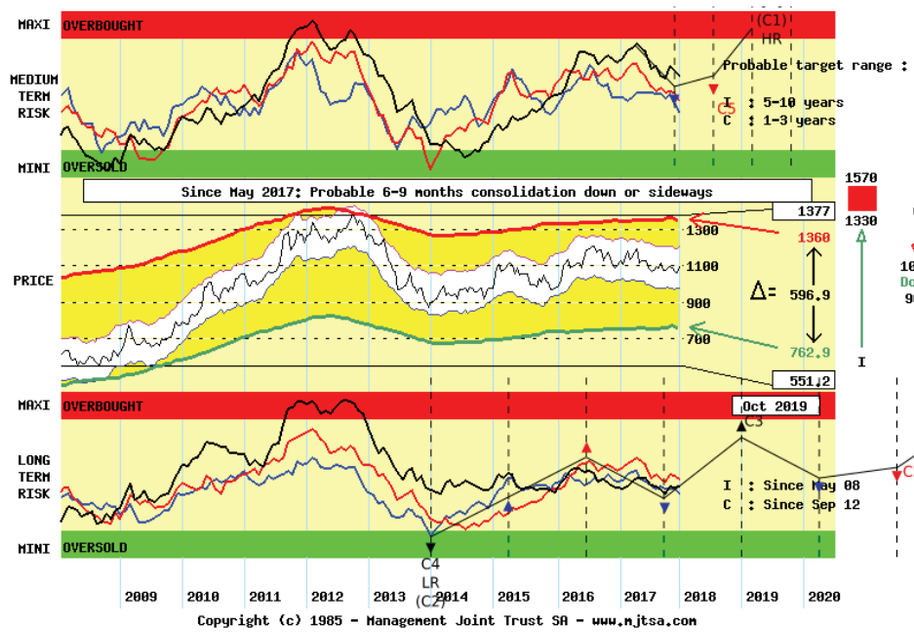
We attempt to corroborate our scenario above by comparing Gold to the S&P500 Index. The ratio delivers a typical risk-on / risk-off proxy. **On both our oscillator series (lower and upper rectangles), we would confirm the dynamics mentioned in the previous graph**. Indeed, Gold started to underperform equities early September, saw a moderate bounce in December, and should start to resume its downtrend over the next few weeks. The sell-off that follows should lead us into early/mid March, when Gold could start bounce again vs the S&P500.

GDX - Market Vectors Gold Miners ETF
Daily graph or the perspective over the next 2 to 3 months



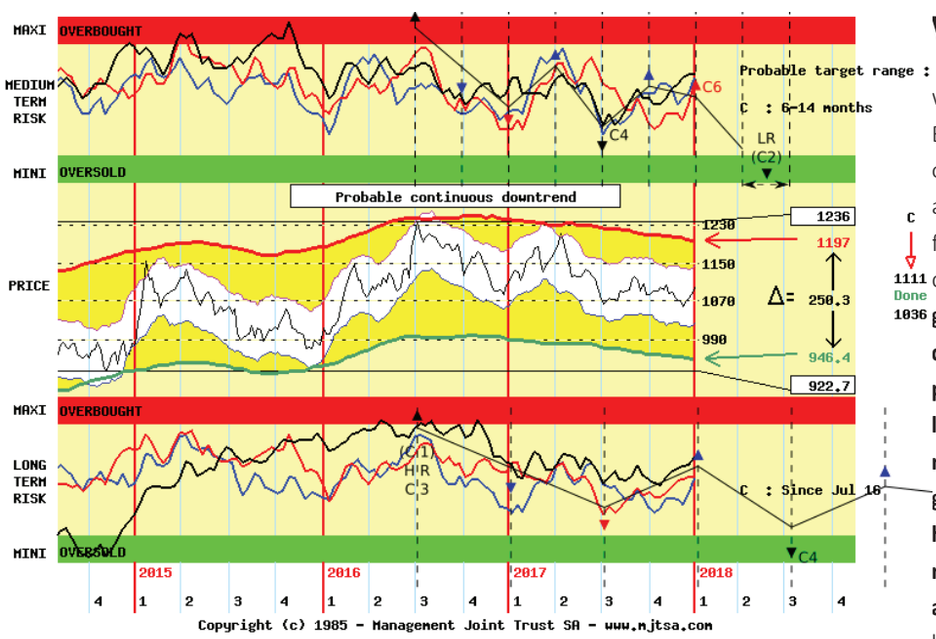
Gold Mines are following a similar pattern. On both our oscillator series (lower and upper rectangles), GDX has been correcting down since September. **Following its December bounce, we believe GDX should roll-over during January, before it accelerates down into early/mid March. Our C Corrective targets down will probably be re-tested (23-22 range) and most likely broken. Below that, we would calculate our I Impulsive targets to the downside in a range between 18 and 20**, i.e. our historical volatility measure "Delta" (4.308, middle chart; right-hand side) times 1.3 to 1.7, subtracted from the 25.49 highs.

Gold Spot in EUR/oz
Bi-monthly graph or the perspective over the next 1 to 2 years



We now widen the perspective by looking at the longer term graph of Gold in EUR. This bi-monthly graph has been in an uptrend since late 2013. Following a correction down from mid 2016, it is now getting ready to resume its uptrend on both oscillator series (lower and upper rectangles). **The acceleration could start between now and mid year and last into 2019. According to our I Impulsive targets up (right-hand scale), the upside potential is between 20 and 40%.**

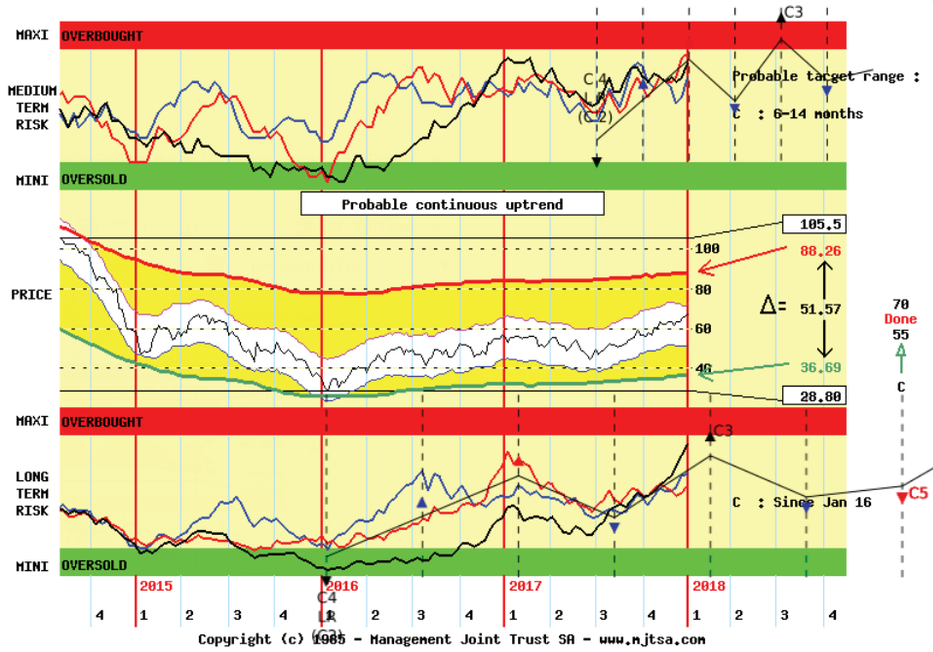
Gold Spot in EUR/oz
Weekly graph or the perspective over the next 2 to 4 quarters



We fine tune the Gold in EUR analysis with this weekly graph. For now, vs the Euro, Gold is still in a downtrend on both oscillator series (lower and upper rectangles). Indeed, following a sideways bounce during H2 2017, **Gold is now getting ready to resume its downtrend towards Q2, and possibly even mid 2018. Ideally, and given our Bullish scenario on the previous bi-monthly graph, we would expect it to hold the support of its C Corrective targets down slightly above 1'000 EUR/oz** (right-hand scale).

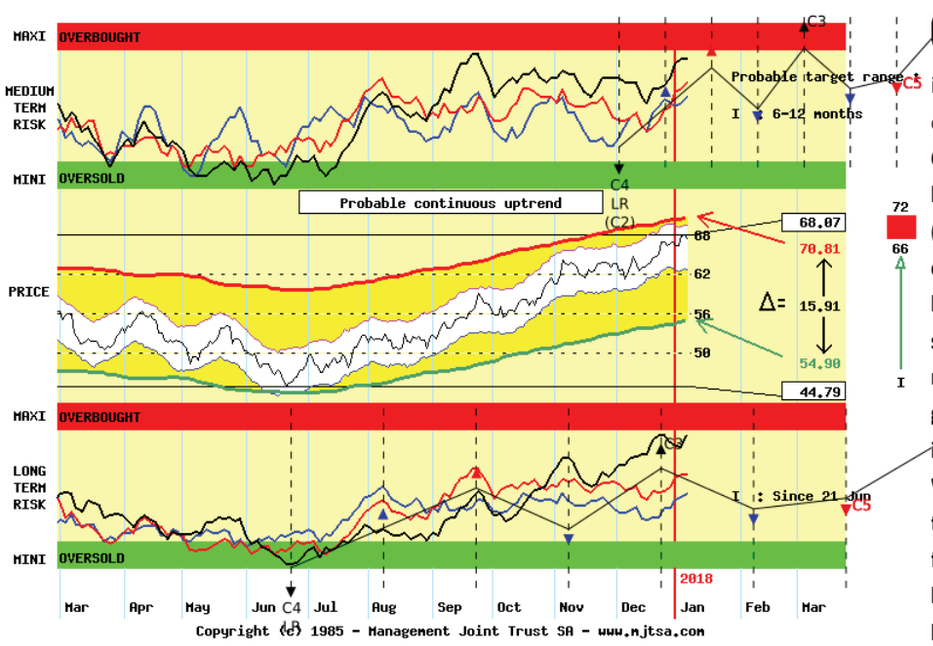
Gold has had a strong rebound during December, yet we believe its downtrend towards March is still intact. 1'250/oz should be re-tested, yet Gold could easily break down to 1'200 USD/oz and slightly below. Goldmines are also vulnerable and GDX could sell-off to below 20. That said, following this Q1 sell-off, we are very constructive on Gold for the rest of 2018. Ideally, in Dollar terms, we would look to Buy the Dip late Q1. In Euro terms, we would wait slightly longer into late Q2.

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



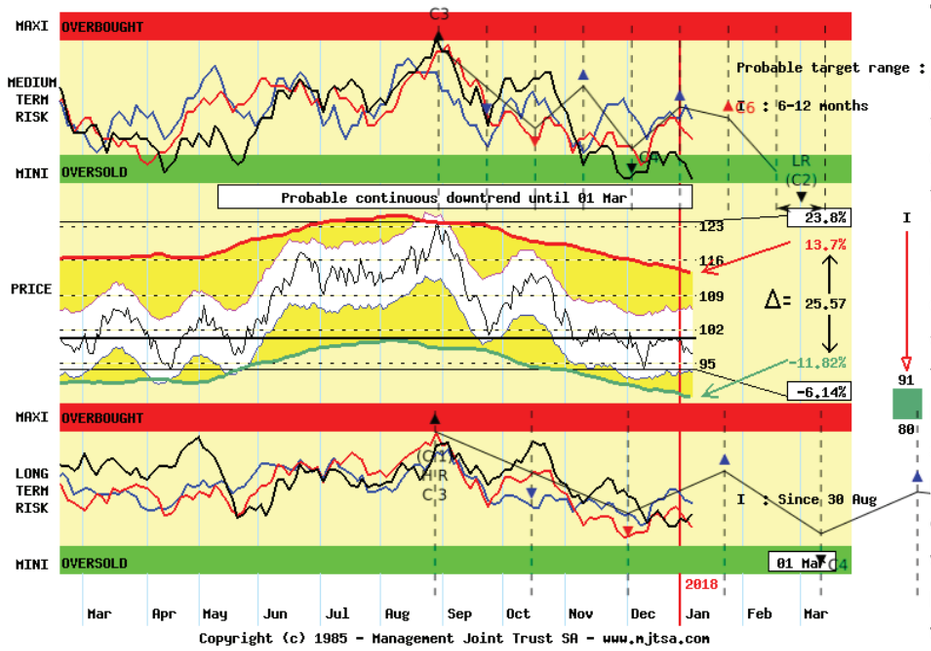
Finally, we turn to Oil. The C Corrective price targets to the upside we had been forecasting throughout 2017 (higher 60s, lower 70s USD/barrel) have now been reached. Similarly, the tops, we had been expecting in early Q1 2018 on our long term oscillators (lower rectangle), are now almost upon us. That said, given our global commodity acceleration scenario towards mid year, we are now wondering if perhaps more upside can be expected during 2018. This is what we show on our medium term oscillators (upper rectangle), i.e. **following what we believe will be a high level consolidation in Q1, Oil will potentially accelerate up again into mid 2018. We will wait until we can confirm a break-out above 70 before we articulate further upside price targets.**

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



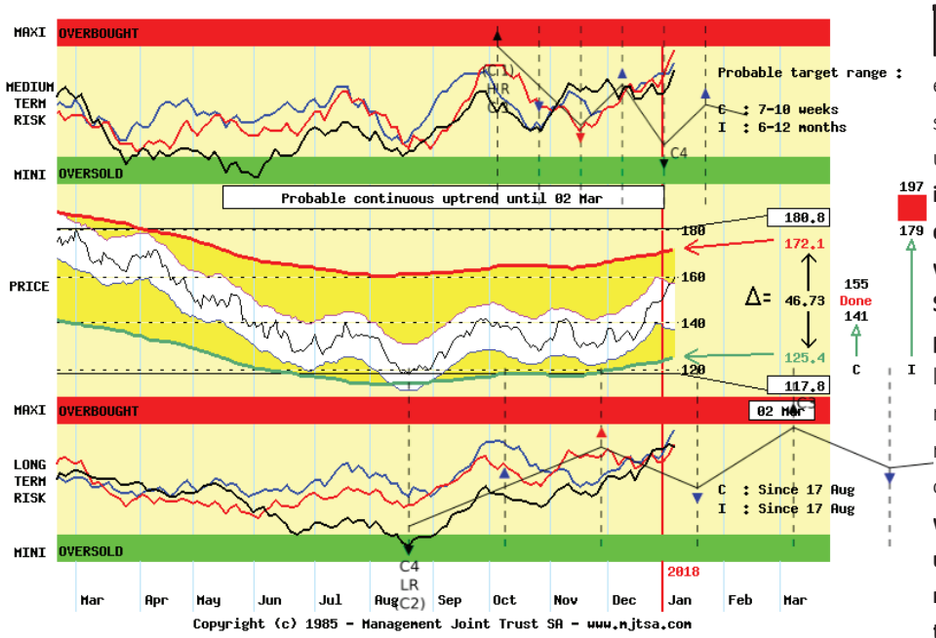
On the daily graph of Brent, we may have reached an intermediate top. As shown on our long term oscillators, **Oil could now consolidate at high levels until late March (lower rectangle). That said, on our medium term oscillators (upper rectangle), we show a more positive alternative scenario, where Oil lingers on up during Q1, before it accelerates up in early Q2. We've considered a similar alternative scenario on Copper further up in this article, yet believe that it is even more likely to happen on Oil.** The first graph on the following page explain why.

Copper Spot (LME) / Brent Oil
Daily graph or the perspective over the next 2 to 3 months



This graph considers the ratio between Copper and Oil. As with many daily graphs we have seen in this article, Copper started to underperform Brent in early September. Following a weak December bounce, it should resume its downtrend over the next few weeks towards early March. This sequence is shown on both oscillator series (lower and upper rectangles). **Our I Impulsive targets to the downside (right-hand scale) would suggest further underperformance of between 10 to 20% for Copper vs Brent until March.**

OSX - PHLX Oil Service Sector
Daily graph or the perspective over the next 2 to 3 months



Looking into the Energy sector, XLE (the large US Energy sector ETF, which is not shown here) is now in a stable uptrend. **Yet, we believe that it is now time to start considering some of Energy's deep value sector. The graph of Oil Services, for example, is very promising**. These are currently leaving a base as shown on our medium term oscillators (upper rectangle). On our long term oscillators (lower rectangle), **we expect them to accelerate up towards early March (lower rectangle). Upside price potential is compelling as shown by our I Impulsive targets to the upside (right-hand scale), somewhere between 15 and 25%.**

Concluding remarks:

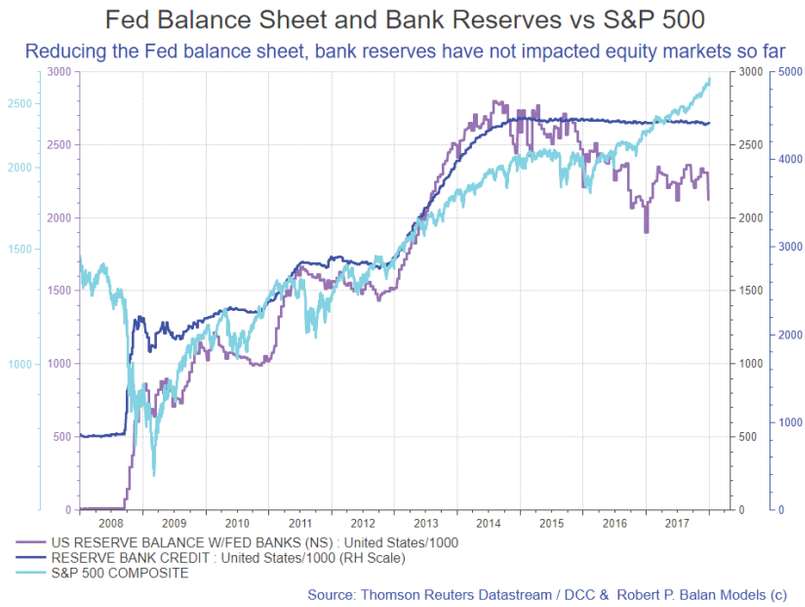
As the Dollar sold off again in December, Copper, Gold and Oil have all been on the rise. Yet, the Dollar bounce we expect over the next couple of months should bring some differentiation within the Commodity space. Indeed, during Q1, Oil should continue to perform, while Copper consolidates at high levels and Gold sells off. From Q2, Copper should take the lead while Oil continues to perform and Gold stabilizes. Finally, from mid year, we would be buyers of Gold, while selling Oil and Copper. On the equity side, we would favour Energy (and especially its deep value segments) in Q1, Diversified Metals & Mining in Q2 and Gold mines for the rest of 2018.

43 / These hurdles should not stop investors from engaging the equity markets this year

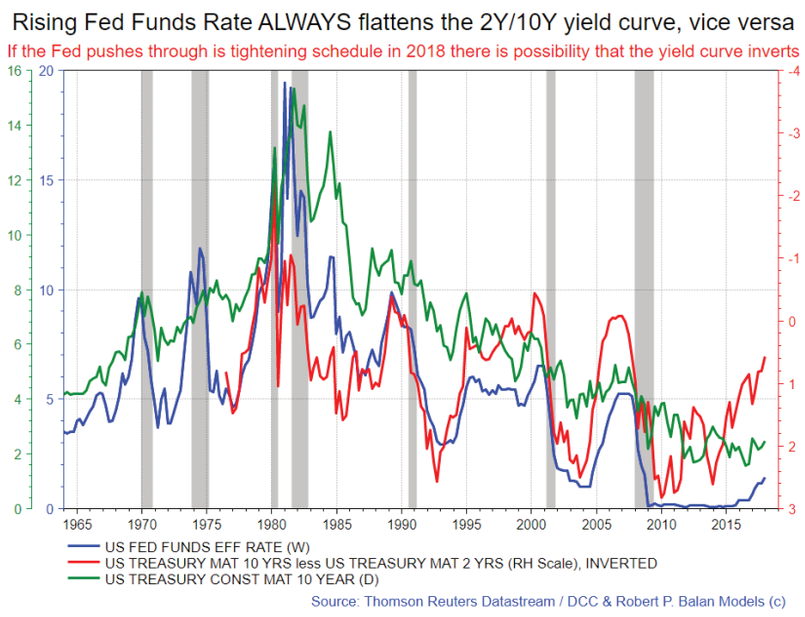
Forecasting «macro regimes» is difficult enough but predicting how the equity asset class and styles would behave in that regime is even more difficult. With the business cycle transitioning into its late stage, the task is set to become more difficult in 2018. Replicating last year's equity performance won' t be an easy task. Goldman Sachs in a report said that realized volatility for the S&P 500 was 6.7% last year, the second lowest on record. **2017 was also the only year on record in which the S&P 500 delivered a positive total return in every month of the year. A 20% return with very little downside is as good as it can get**. This of course leaves us wondering if there is any chance investors will be equally lucky in 2018.

There are no guarantees, but the start to the year is auspicious. **2018 seems to be starting where 2017 ended -- a synchronized global recovery with low inflation is taking place, and US financial market conditions remain benign**. True, US equity valuations became even more elevated during the first week of the year, but we cannot extrapolate that performance over the next few quarters. There are high hurdles for continued equity markets appreciation over the next 12 months, not least is the monetary tightening regimen that the Fed has published, and the systematic reduction of its balance sheet over time.

The Federal Reserve stated in several post-FOMC meeting statements that they will continue to reduce the size of its securities portfolio systematically over time. The Fed has been reducing the size of its securities portfolio -- From the Fed´s H.4.1 statistical data base, we see that since September 27, 2017, the Federal Reserve has reduced the size of its securities portfolio by $22.8 billion. During this time, however, reserve balances at Federal Reserve banks, a proxy for excess reserves, have remained roughly constant – and in fact, actually increasing by a modest $15.9 billion. **The Federal Reserve has overseen the reduction in its securities portfolio without undue disturbances. And apparently, investors liked that, as no ill effects has been seen from this limited example of Quantitative Tightening (QT). Put simply, the feared market disruptions emanating from the Fed's systematic QT did not materialize, and, indeed, it may not materialize at all** *(see 1st graph above)*.

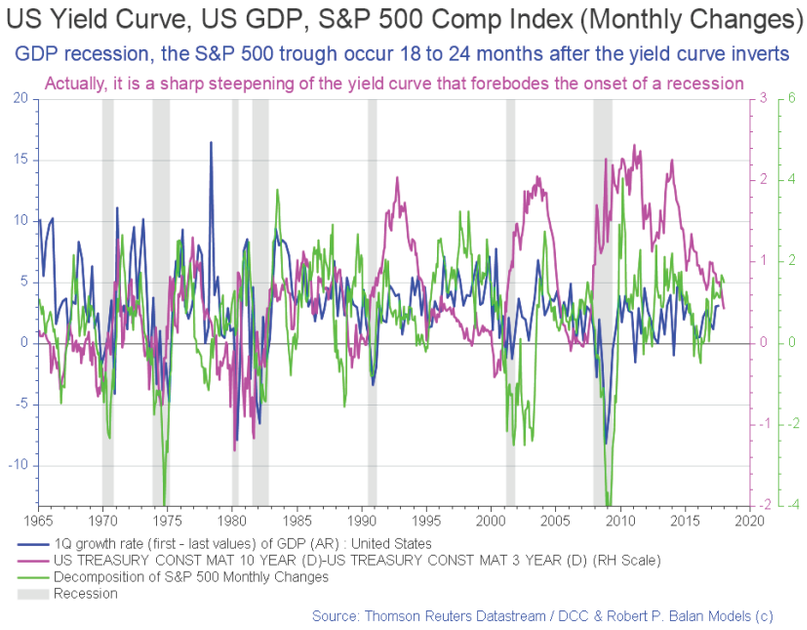


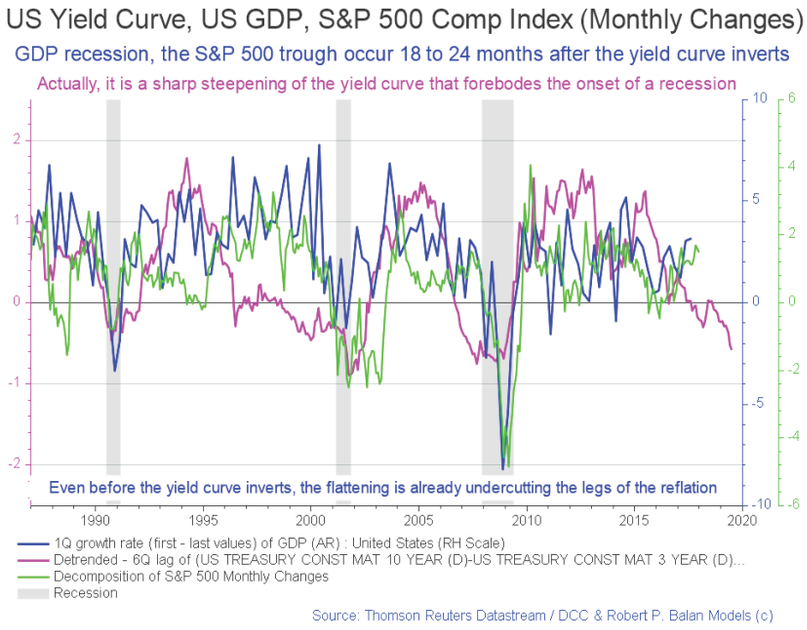
The other buzz words which investor cite for their wariness of the market is the flattening and eventual inversion of the yield curve. There's a reason for being cautious -- each of the past seven recessions has been preceded by an inverted yield curve. With the curve—the spread between the two-year and 10-year Treasuries—flattening of late, there's growing nervousness about an inverted yield curve this year, and a recession not long thereafter. The spread has dropped to about 51 basis points from 120 basis points 12 months ago. While nowhere near the inversion level, the sharp declines in the slope of the curve over the past few weeks does invite some vigilance *(see graph below)*.



The spread is flattening as the Federal Reserve pushes up short-term rates, which it controls through the Fed Funds Rate. The faster the Fed pushes up the policy rates, the flatter the yield curve becomes. Reason: the primary movement is happening at the short end of the curve. At the same time, 10-year Treasury yields—which are set by the market and respond to inflationary threats—have remained stable over the past 12 months, at about 2.41%. The Fed is expected to raise the Fed Funds Rate by 0.75 percentage point to 2% to 2.25% by year-end 2018, and some even expect a 1 percentage point increase. That translates into two-year Treasury yield at about 1.89%. Therefore, if the current 10-year yield doesn't move much, then a flat or even inverted yield curve is almost inevitable in 2018.

The flattening of the yield curve toward inversion has not only had a consistent long-term track record of predicting the onset of economic recessions, it has also done well in providing a leading signal of an impending bull market peak and subsequent bear market decline *(see 1st graph on this page)*. **While the premise is generally true, the devil is in the details. A US GDP recession, and the S&P 500 trough occur 18 to 24 months (even 32 months thereafter) after the yield curve first inverts. Investors will have plenty of time to curb their bullish sentiments** (*see 1st graph on this page)*. The message -- the yield curve inversion and the bottom of the market do not happen simultaneously. In fact, some of the strongest gains in the SPX happened after the yield curve inverted (e.g., Sept 1988 - Sept 1999). No need to panic when (if) the yield curve inverts. If at all, be glad when you see a yield curve inversion -- you know a market top is just a matter of time, and you can use other tools to determine the top of the bull market.





There is actually a procedure to see the impact of the yield curve on the stock market and GDP without waiting for an inversion of the curve. Supposing we do a simple extrapolation work after a simple regression procedure, using the same yield curve, GDP and stock market data we used in the 1st chart of this page. The next step is to move forward the yield curve by 6 quarters, the average time lag between the trough of a yield curve inversion and the GDP trough following recession. The results are illustrated in the 2nd graph of this page. So you can have all the trappings of growth, even as the flattening yield curve is already cutting down the legs of the recovery. If the yield curve is to sharply steepen today (an indication of a likely onset of a recession), it simply means that the middle of the recession will be sometime in May 2019.

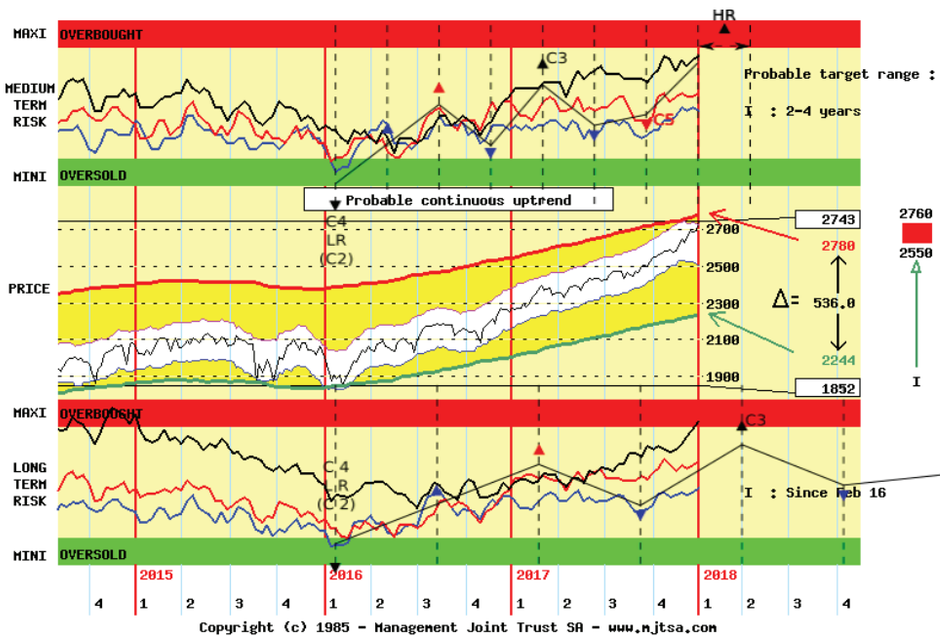
The message that we are trying to get across is that Quantitative Tightening being conducted by the Fed, and that the dynamics of flattening of the yield curve or even an inversion of the yield curve are so well known that they should not be feared. In fact, these developments often provide opportunities with very quantifiable risks, just because their mechanics are so well-known. **These macro hurdles are not insurmountable, and these factors should not stop investors from participating in a blow-off last stage of the business cycle later in the first part of the year.**

45 / MJT - TIMING AND TACTICAL INSIGHT

Equity markets have now entered the latest stages of their uptrend, they should top out between March and mid year

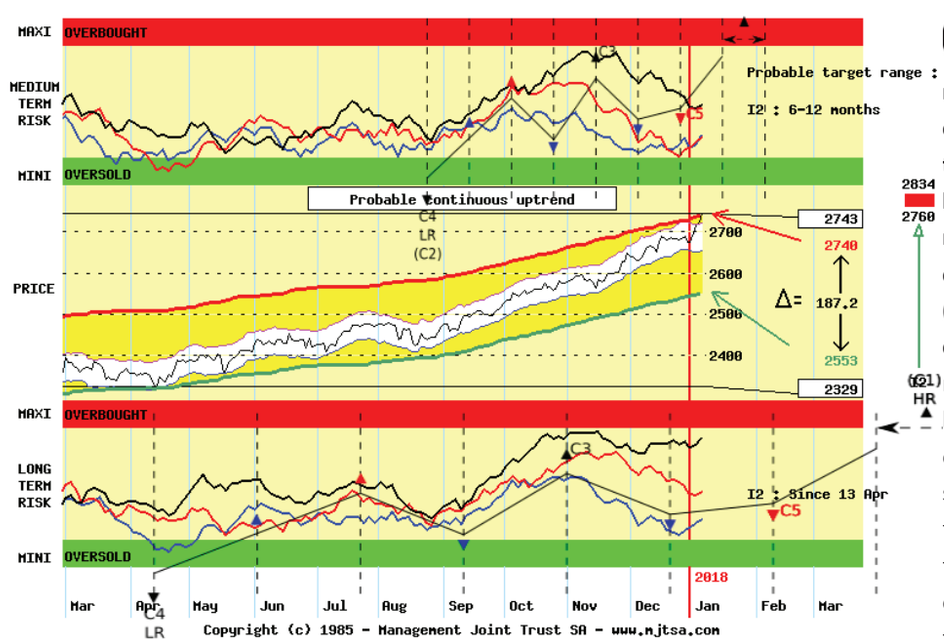
Throughout 2017, we have been planning for Equity markets to top out during late Q1 and late Q2 2018. Now that this schedule is almost upon us, we reconfirm this view. In this article, we review the different geographical regions in search for out-performance potential. We expect currency moves in H1 2018 ,and a possible blow off in commodities in Q2 2018, to be key differentiating factors in the performance of the various equity markets.

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



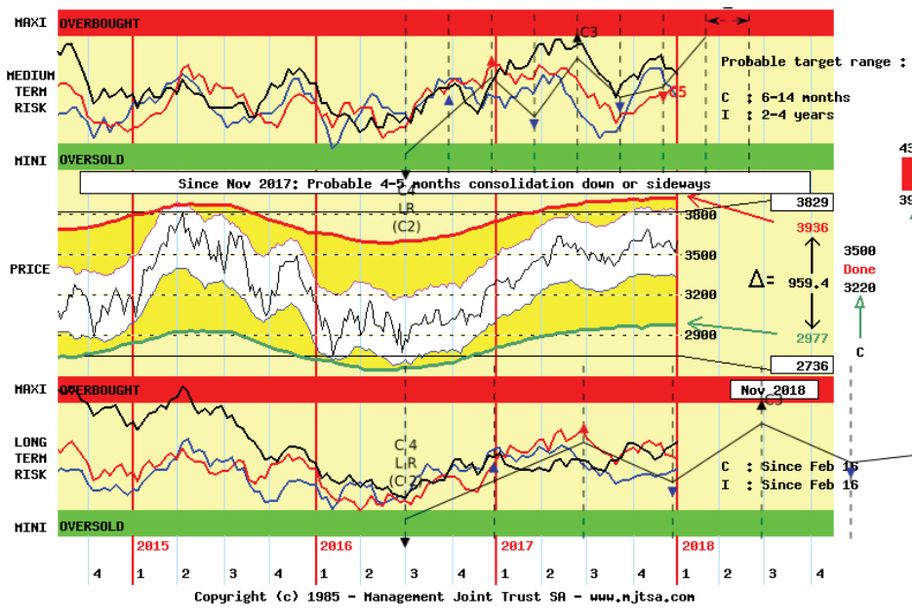
The Weekly graph (perspective over the next few quarters) of the S&P500 seems exhausted in USD terms. I Impulsive targets to the upside have been met (right-hand scale), and both our oscillator series (lower and upper rectangle) are suggesting that **important tops should materialize towards late Q1 / early Q2. Following that, we would probably expect a high level distribution until mid year as other equity markets make a run (see our perspective on other equity markets below in this article). Thereafter, global equity markets should correct down substantially towards 2019**. There is currently much talk about a potential equity "blow-off" (a final spike before a drastic reversal). If it were to happen, we believe its timing would probably be during Q2 2018. I2 Impulsive 2 extended targets we can calculate for this potential move are between 3'000 and 3'500 (or 2.3 to 2.7 times 536 our historical volatility measure "Delta" - middle graph, right-hand side – added to 1'852, the graph's low point). We will wait towards end Q1 to decide if Q2 2018 will see a "blow-off" or a "distribution phase".

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



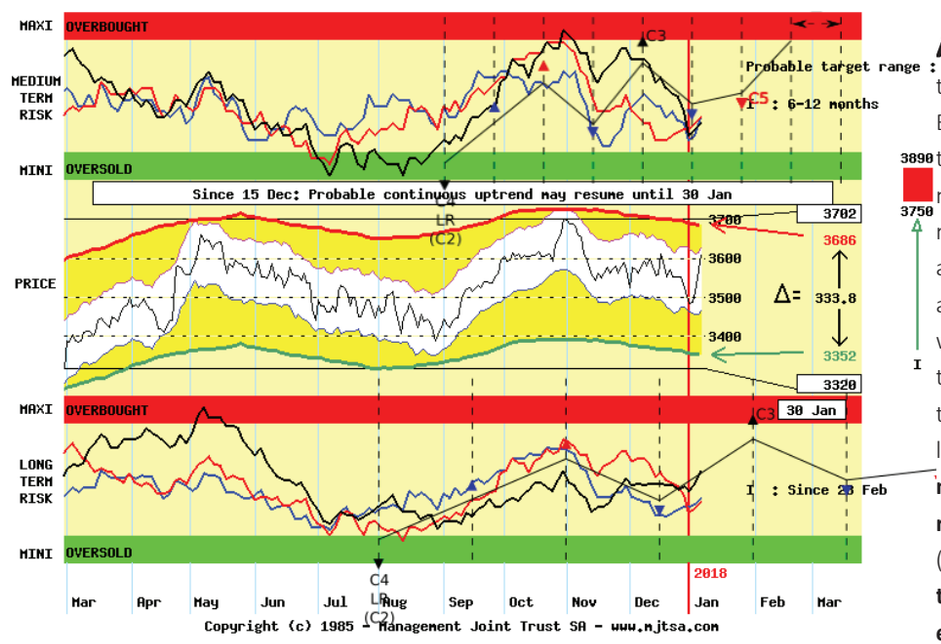
On the Daily graph, US equity markets are still moving up, and according to our I2 Impulsive 2 extended targets to the upside (right-hand scale), they could reach 2'800 and even 2'850 over the next few months (2 to 4% upside on our I2 extended targets). This is moderate, yet still compelling if it is to happen until early March. Our oscillator series (lower and upper rectangles) would suggest that the current acceleration dies out mid/late January and then resumes up again from early/mid February until March.

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



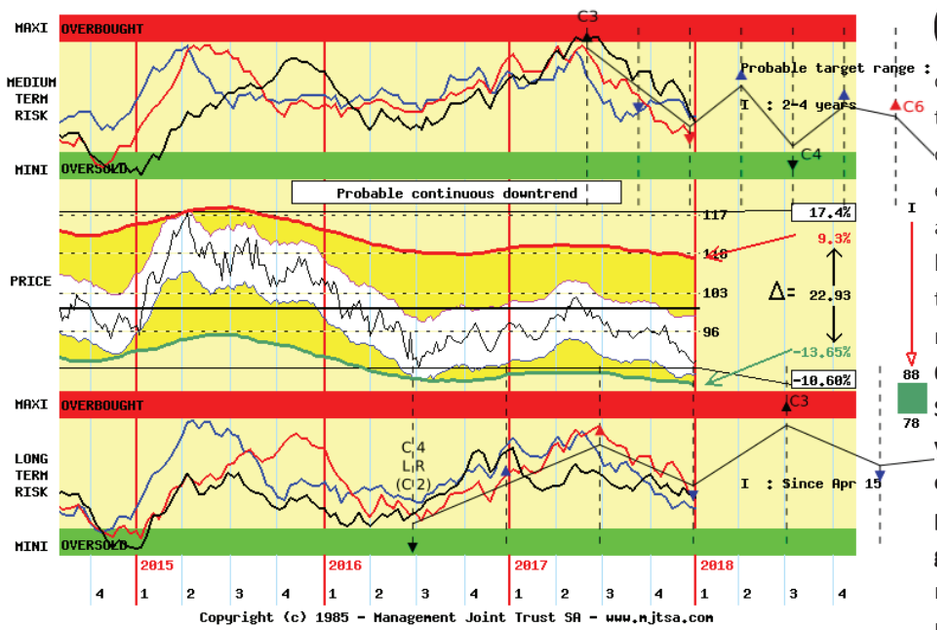
On the EuroStoxx 50, the upside potential left is still compelling. Our I Impulsive targets to the upside (right-hand scale) indicate that it could reach the 4'000 – 4'400 range over the next few quarters (between 10 and 25% more upside). From a timing perspective, our oscillator series (lower and upper rectangle) suggest that a top is awaited between late Q1 and mid 2018. Given the bounce we expect during Q1 on the US Dollar, much of the performance potential may be fulfilled over the next few months.

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



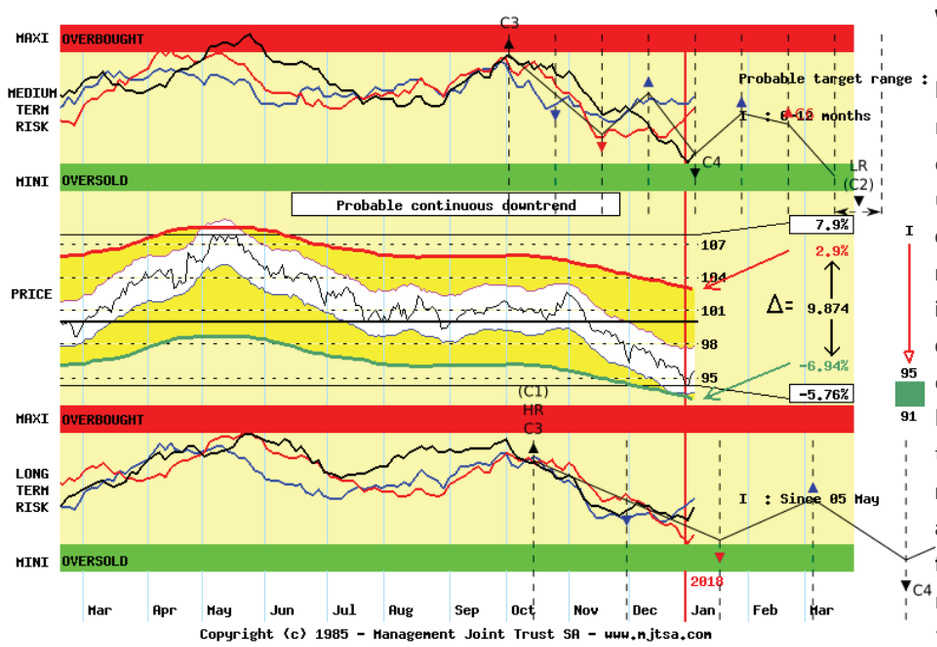
As we suggested in our last edition of The Capital Observer, we expected the EuroStoxx 50 to make an attempt to the upside towards mid December and then correct slightly into early January, and then start to accelerate up again. The late December dip was a bit stronger than expected, yet the scenario holds, and the EuroStoxx 50 is now accelerating up. **We expect it to move higher into late January** on our long term oscillators (lower rectangle) **and potentially towards late February / early March on our medium term oscillators (our preferred scenario; upper rectangle). I Impulsive price targets up for this move (right-hand scale) could reach into the 3'800s and possibly towards 3'900, or 6 to 8% above current levels.**

EuroStoxx 600 Index vs S&P500 index (ratio hedged for currency risk) Weekly graph or the perspective over the next 2 to 4 quarters



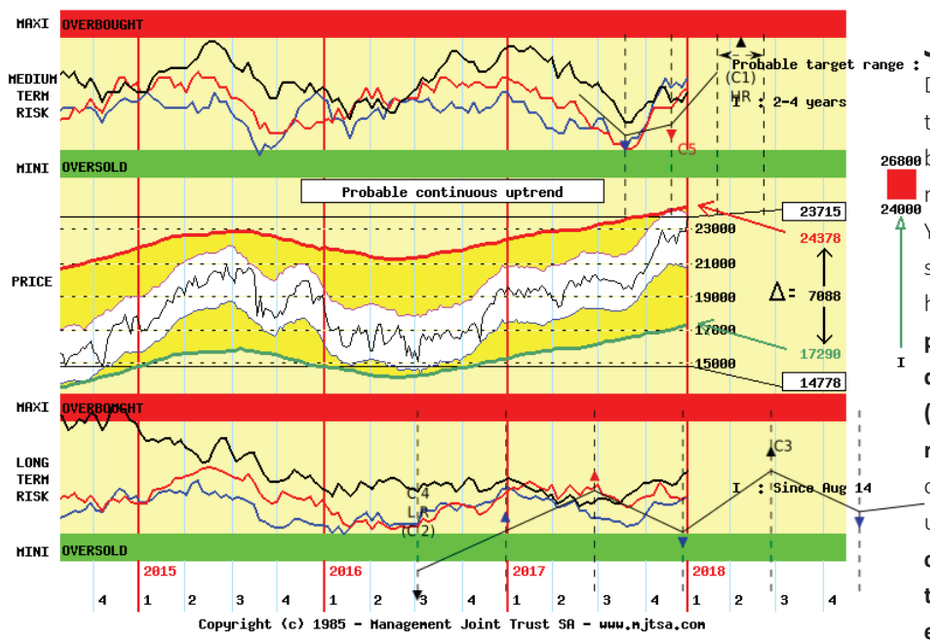
Currencies will certainly play a crucial role in the out-performance of Europe vs the US (with the background of the 3 to 5% USD bounce we expect in Q1 2018). The graph attempts to measure its effect by comparing both indexes like to like (i.e. on a hedged currency basis). **The EuroStoxx 600 has underperformed the S&P500 throughout H2 2017, yet according to both our oscillators series (lower and upper rectangles), it may now be getting ready to bounce**. Our medium term oscillators (upper rectangle) suggest that the bounce could last into late Q1, while our long term oscillators (lower rectangle) would see it continue towards late Q2. We will weigh on the side of prudence and reconsider late Q1 as a potential time target. Given our historical volatility measure "Delta", here at 22.93% (middle rectangle, right-hand side), **the rebound could theoretically amount to 11 to 18% of out-performance** (or 0.5 to 0.8 times "Delta").

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



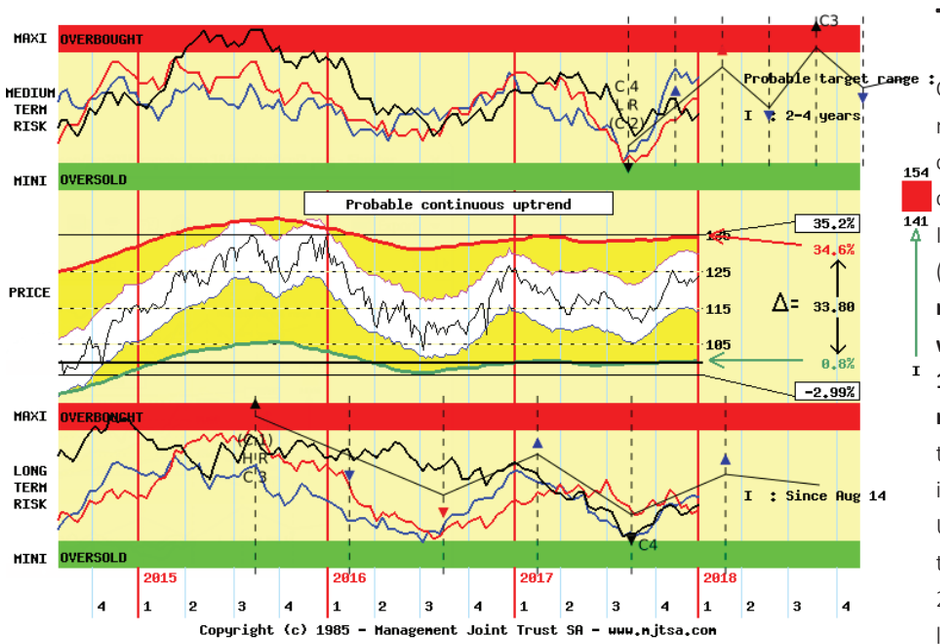
We now consider the same graph on a Daily basis (perspective over the next few months). On both our oscillator series (lower and upper rectangle), **the ratio is currently reaching an intermediate low, which could see it bounce into late February / early March**. Given our historical volatility measure "Delta", here at 9.874% (middle rectangle, right-hand side), **the rebound could theoretically amount to 5 to 8% of out-performance** for European vs US markets (or 0.5 to 0.8 times "Delta"). This is less aggressive that the Weekly projections above, but probably a better guidance for Q1 2018. If the Dollar rebound then accelerates up again in Q2 (we see it rather retracing and make a base), the weekly targets in the graph above would then be valid.

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



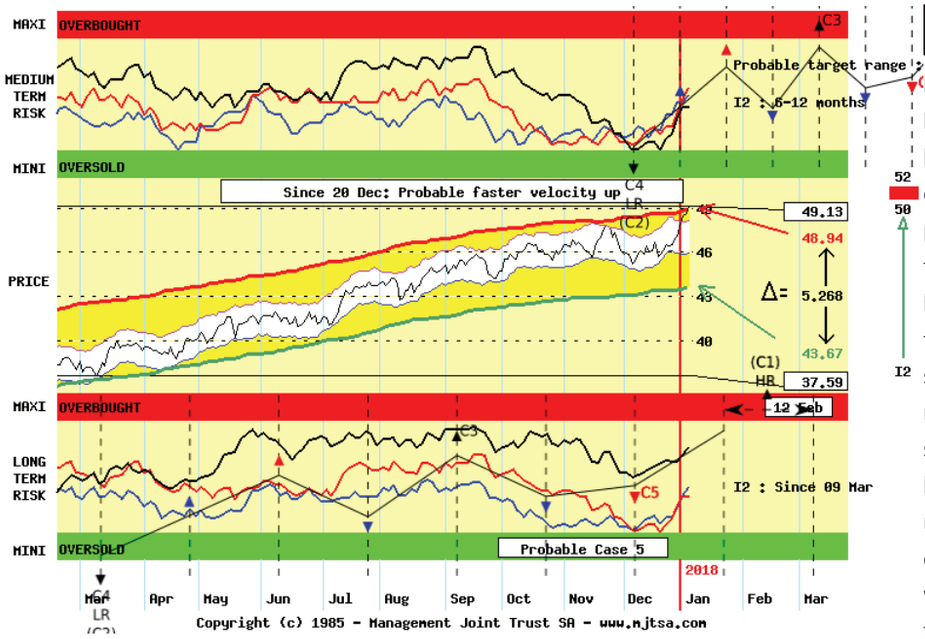
Japanese equity markets should also benefit from a Dollar bounce in Q1. Recently, the Nikkei's performance has been stronger that European markets, especially in H2 2017. Yet, according to our I Impulsive targets to the upside (right-hand scale), **there is still some potential left, possibly towards the 24'000 – 26'800 range (or possibly 10% above current levels)**. According to both our oscillator series (lower and upper rectangles), **the uptrend of the Nikkei 225 could extend towards late Q1 and possibly even mid year.**

Nikkei 225 / iShares MSCI All Country World Index Fund (ratio hedged for currency risk)
Weekly graph or the perspective over the next 2 to 4 quarters



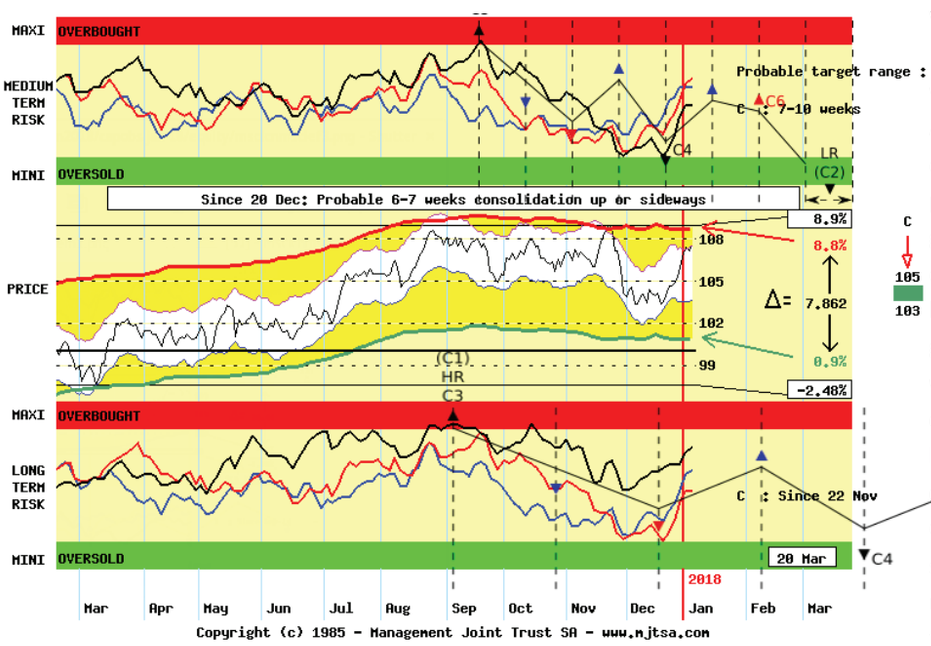
This graph compares the Nikkei225 against the All Country World Index (denominated in USD) on a hedged currency basis (like to like index comparison). According to our I Impulsive targets to the upside (right-hand scale), **Japanese markets could outperform world markets by a further 10 to 15% on this hedged currency basis**. As we mention in the Currency section of this issue of The Capital Observer, USD/JPY could reach the 1.17 to 1.20 range by the end of Q1 2018 (or 5 to 7% above current levels). The rest of the potential outperformance is probably attributable to the strong performance of the Nikkei on itself (Independent of the compensation effect for a weaker currency). Our oscillators series (lower and upper rectangles) suggest a first timing point for a top towards late Q1 2018 and then a second one towards the Summer.

EEM - iShares MSCI Emerging Index Fund
Daily graph or the perspective over the next 2 to 3 months



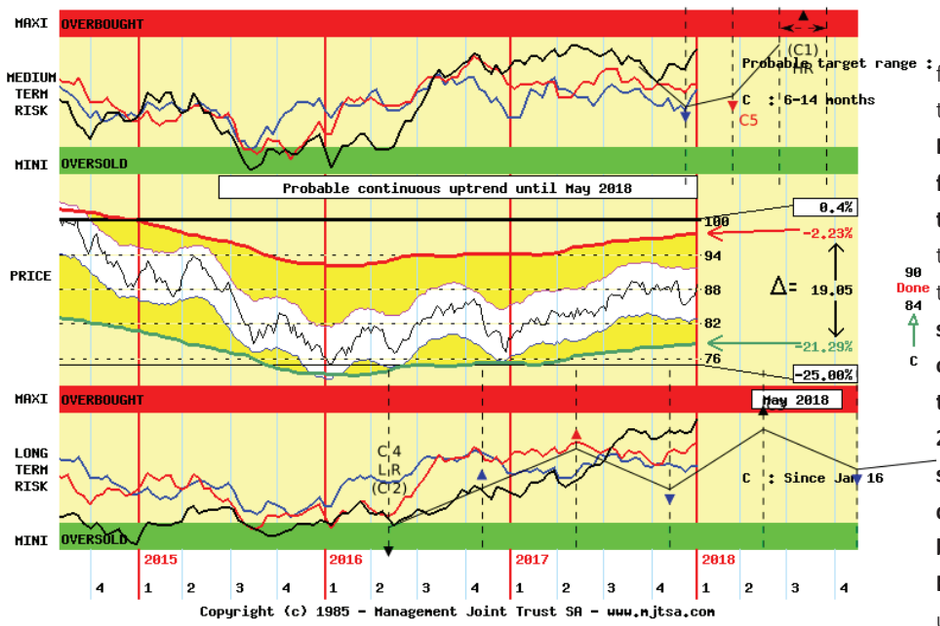
Emerging markets have recently re-accelerated on the back of the December US Dollar weakness. Their uptrend, however, is now showing signs of exhaustion with their I2 Impulsive 2 extended targets to the upside having now almost been reached. On the timing front, the latest acceleration since December should be coming to an end towards the second half of January on our long term oscillators (lower rectangle). Our medium term oscillators (upper rectangle) would also suggest a first inflexion point to the downside around that period. **With the US Dollar rebound we expect in Q1 2018, we believe that Emerging markets are at risk of a correction, while the remaining potential is very limited, i.e. the risk/reward is negative over the next few months.**

EEM - iShares MSCI Emerging Index Fund / ACWI - iShares MSCI ACWI Index Fund
Daily graph or the perspective over the next 2 to 3 months



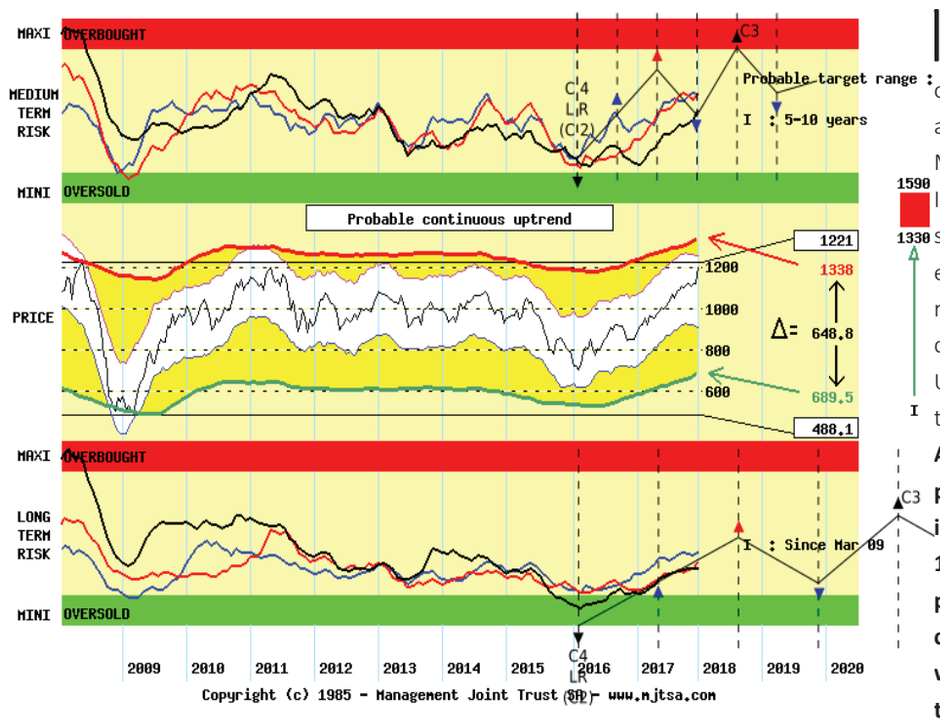
We now look at the same EEM graph as above, yet on a relative basis vs the All Country World Index. It confirms that investors should probably under-weigh Emerging markets over the next couple of months. Indeed, both our oscillator series suggest that **over the next few weeks, Emerging markets could roll-over again on a relative basis, and probably underperform until March**. Our C Corrective targets to the downside (right-hand scale) show a retracement potential, which is for now limited (between 2 and 4% vs world markets). If we were to break below these, the risk is more compelling (probably between minus 7 to 10% from current levels). **Without wanting to be too alarmist, we would probably underweight Emerging Markets until March, rather than support that risk.**

EEM - iShares MSCI Emerging Index Fund / ACWI - iShares MSCI ACWI Index Fund
Weekly graph or the perspective over the next 2 to 4 quarters



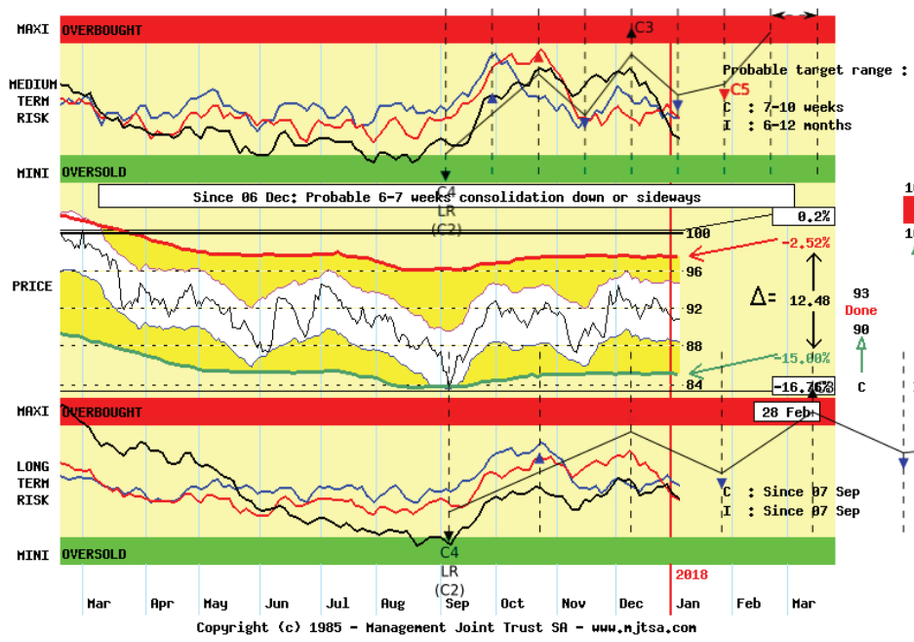
The same graph on a Weekly basis would suggest that following a retracement over the next couple of months, **Emerging Markets should find a base vs World markets towards late Q1** (our medium term oscillators; upper rectangle). **Both our oscillator series suggest that from then on, Emerging Markets should then outperform until mid 2018. These dynamics may suggest a late stage Commodity and Emerging markets blow-off, as was the case in H1 2008**. We will however wait until late Q1 to confirm this scenario.

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



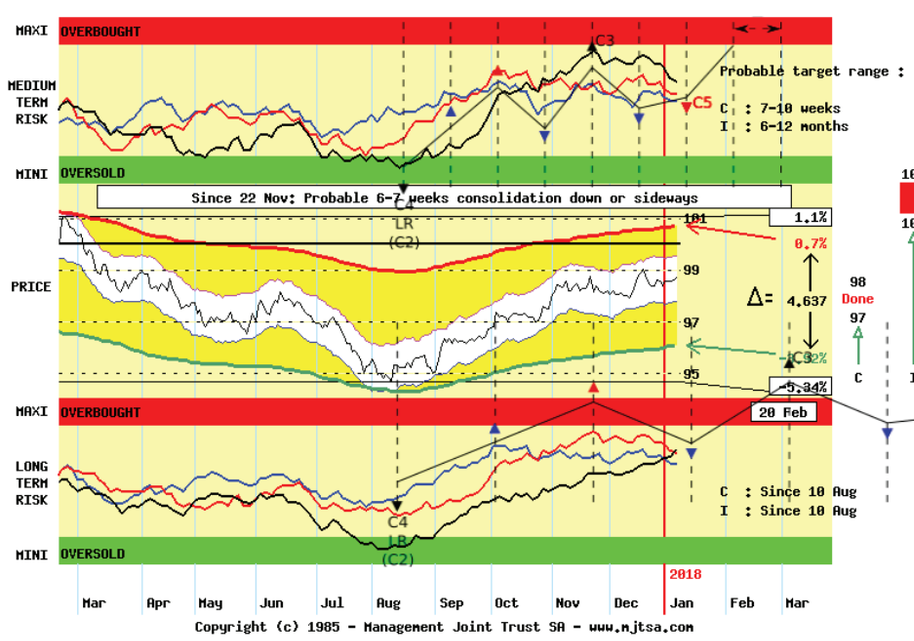
In order to consider the possibility of a potential EM blow-off in Q2 2018, we now look at the bi-monthly graph of the MSCI Emerging Markets index. If, indeed, we were to map our sequences up from the lows in early 2016, both oscillators series could suggest a top towards mid / the Summer of 2018. Under this scenario, price potential could be substantial. **According to our I Impulsive price targets to the upside, it could amount to between 10 and 25% of additional EM performance over the next couple of quarters. Again, we will probably wait till late Q1 to confirm this scenario.**

KBE - SPDR S&P Bank ETF / SPY - SPDR S&P 500
Daily graph or the perspective over the next 2 to 3 months



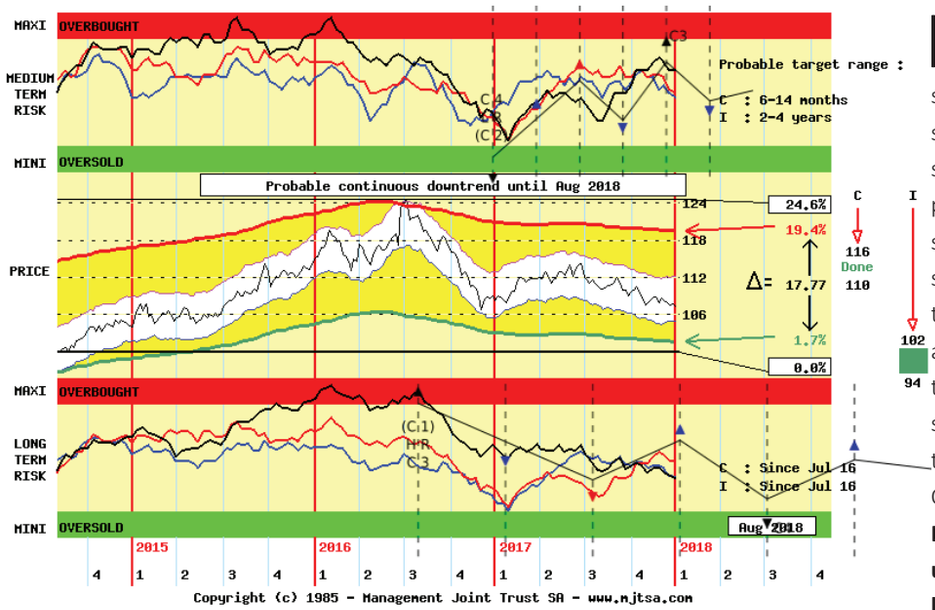
The environment we suggest over the next couple of months for US markets (rising markets, yet with little potential, rebound in the Dollar) should be particularly friendly to Value trades. Among them, US banks look quite interesting. This graph compares the KBE US Bank ETF to the S&P500 Index. Following an initial bounce in September, the ratio has been moving sideways ever since. **Both our oscillator series would suggest that it could re-accelerate up between now (our medium term oscillators; upper rectangle) and late January (our long term oscillators; lower rectangle). The outperformance potential into March is between 10 and 15%.**

EWG - iShares MSCI Germany Index Fund / EZU - iShares MSCI EMU Index Fund
Daily graph or the perspective over the next 2 to 3 months



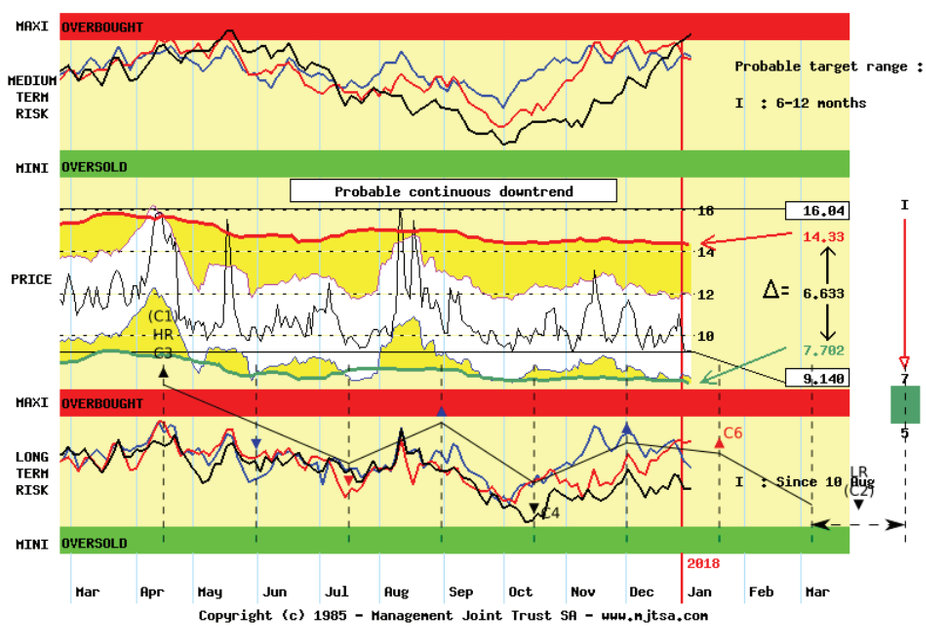
In Europe, most sectors seem well positioned on an absolute basis, yet as we generally expect European markets to rise on the back on a stronger US Dollar, we have refrained in this issue to hand pick specific ones (the devil is often in the details). Indeed, we would rather focus our strategy on Core Europe, and especially Core Eurozone (EUR crosses may also consolidate at high levels until March). We would also avoid most of Southern Europe for now, as it is more cyclical and less influenced by EUR/USD variations. We would ideally want to pick a strong export market with a slightly higher beta. Germany and the Dax seem to fit this profile. The graph above compares the German iShares ETF to the EuroZone one (we use this comparison to avoid the problem of the Dax being a total return index, while other European indexes are not). According to our I Impulsive targets up (right-hand scale) as well as both our oscillator series (lower and upper rectangles), **over the next couple of months, the DAX could add a further 2 to 4% of outperformance to the Eurozone markets, which themselves already look very strong. We believe this is a low risk and rather rewarding strategy.**

Equal weighted large European Defensive sectors / Stoxx Europe 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



In our argumentation above, we refrained from being too sector specific on Europe. That said, given our overall bullish scenario on Europe, we would probably still try to carve out some of the defensive exposures in our portfolio. To illustrate this, we hereby compared a cap. weighted portfolio of the larger European Defensive sectors (SXDP, SXQP, SX3P) vs the Europe Stoxx 600 index. On both oscillator series, **the Defensive portfolio should underperform until late Q1 at least** (our medium oscillators, upper rectangle), **and probably into mid year** (our long term oscillators; lower rectangle). According to our I Impulsive targets to the downside (right-hand scale), **the underperformance potential is between minus 5 and 10%.**

VIX CBOE Volatility Index
Daily graph or the perspective over the next 2 to 3 months



Finally, we shift back to the US and look at VIX. Although its price action is quite choppy, the downtrend throughout 2017 is visible (despite the periodical spikes). On our long term oscillator series (lower rectangle), **the sequence down is quite compelling. It should extend lower into late March. This is in accordance with the positive equity market environment we expect until then.**

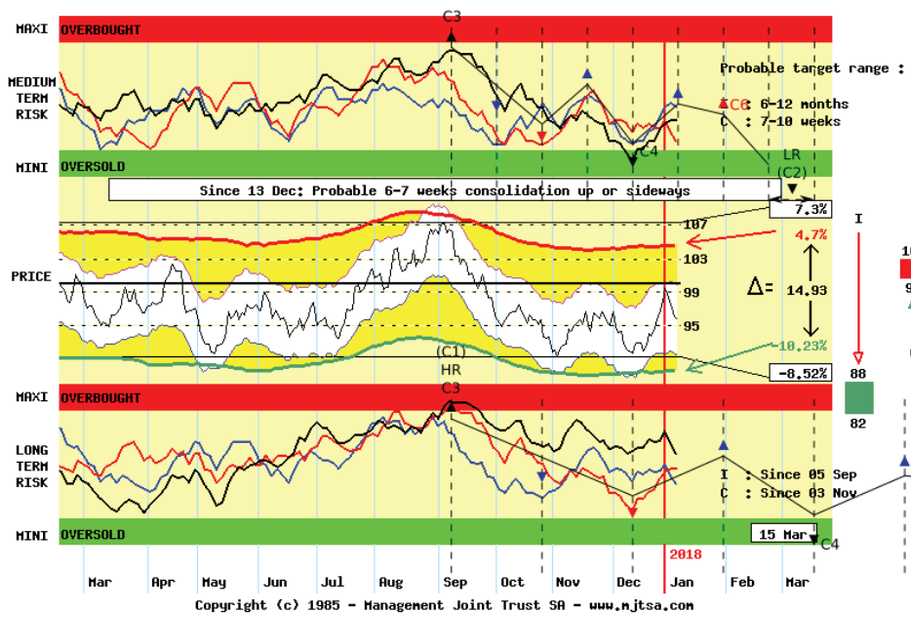
Concluding remarks

Equity markets are entering the late stages of their 9 years Bull market. We expect them to top out in 2018, sometime between late Q1 and mid year. The correction that follows could be quite compelling and could last into mid / late 2019. In the meantime, during Q1, we would favour European and Japanese equity markets, which should outperform on the back of the US Dollar rebound we expect. Q2 may see a last extension up, which could be fuelled by a typical late cycle Commodity and Emerging markets boom.

53 / Splicing the markets – Avoid negative USD correlations until March

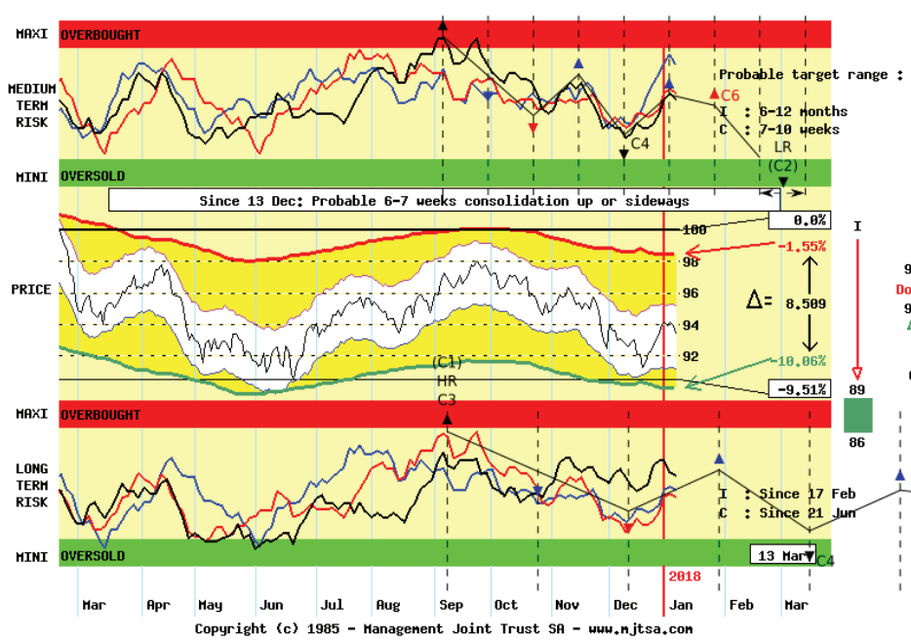
Throughout this edition of The Capital Observer, we have detailed our projection for a rebound in Dollar during Q1 (Note: the Dollar could then retrace down into Q2, and possibly accelerate up again in H2 2018). We will use this Splicing the Markets section, to highlight some of the trades we believe could be negatively impacted over the next couple of months by this initial Dollar bounce. Some of them may seem counter-intuitive at this late, and positive, stage of the Commodity cycle, yet they may be only transitory, and could deliver new buying opportunities towards early/mid March.

Gold Spot (USD/Oz) / DAX Kurs Index
Daily graph or the perspective over the next 2 to 3 months



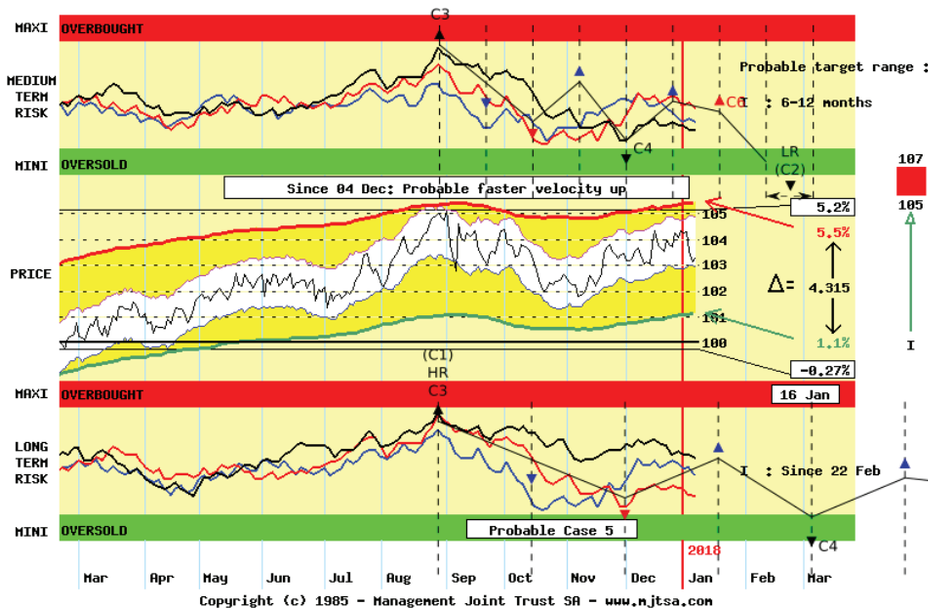
We will start by comparing Gold, which for now is strongly negatively correlated with the US Dollar (this correlation may shift to positive as the year advances) and the Dax Index, which we believe should strongly benefit for a stronger Dollar in Q1. The ratio is done on a currency hedged basis (like to like comparison of prices, no currency effect). It topped out in September, just saw a sharp rebound in December, and according to both our oscillator series (lower and upper rectangles), should roll-over again during January and then accelerate down towards late February / March. **Favoring European markets and avoiding Defensive assets over the next couple months, is one of the main focuses of this monthly issue.**

EWC - iShares MSCI Canada Index Fund / SPY - SPDR S&P 500
Daily graph or the perspective over the next 2 to 3 months



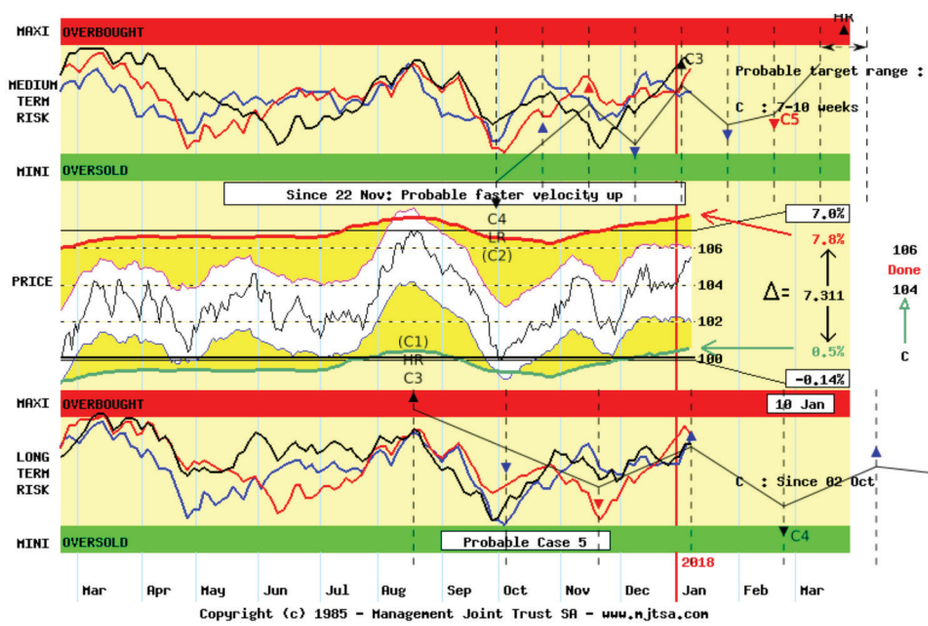
Similarly, we now compare the Canadian market EWC ETF vs the SP500 SPY ETF. It shows a dynamic, which is very similar to the one above. A top in September, a bounce in December, and from what we can judge on both our oscillator series (lower and upper rectangles), a roll-over phase in January **and a new sell-off towards late February / March. We will hence avoid all USD Commodity countries ETFs over the next couple of months. March may then present a new buying opportunity.**

SCJ - iShares MSCI Japan Small Cap / EWJ - iShares MSCI Japan Index Fund
Daily graph or the perspective over the next 2 to 3 months



On the back of a stronger Dollar, developed international markets should outperform US ones during Q1. We would hence favor larger, internationally exposed companies, and sectors, in these markets (especially in Europe and Japan). We hereby compare the Japanese SCJ Small Cap ETF vs the Japanese EWJ main market ETF. Inversely to recent Dollar weakness, it has re-tested up in December. Yet, now, on both our oscillator series (lower and upper rectangles), the ratio could be getting ready to resume down towards late February / March. **Our view is hence to avoid Small Caps ETFs outside of the US over the next couple of months.**

S&P 100 / IWM - iShares Russell 2000 ETF
Daily graph or the perspective over the next 2 to 3 months



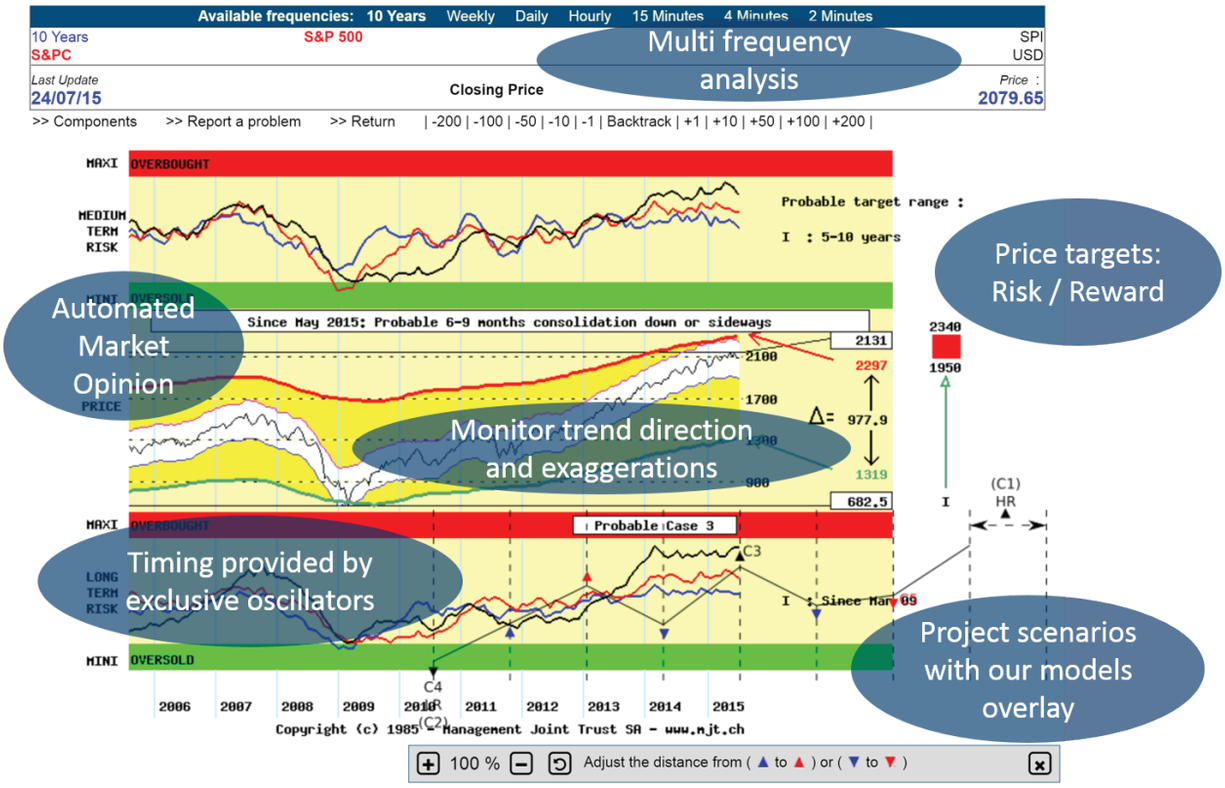
On the contrary, we would tend to favor domestic profiles in the US. These are usually more abundant in the small cap universe. We hereby compare the large Cap S&P100 Index vs the Russell 2000 ETF. The top happened in mid August, then the ratio bounced in October, and then again in December. On both oscillator series (lower and upper rectangles), **we would now expect this Large Cap. to Small Cap. Ratio to retrace down, probably into mid /late February.** This ratio is skewed slightly to the upside vs the others. It also seems to lead them by a few weeks in its timing. It could be good one to monitor come late February to signal renewed USD weakness (or not).

Concluding remarks

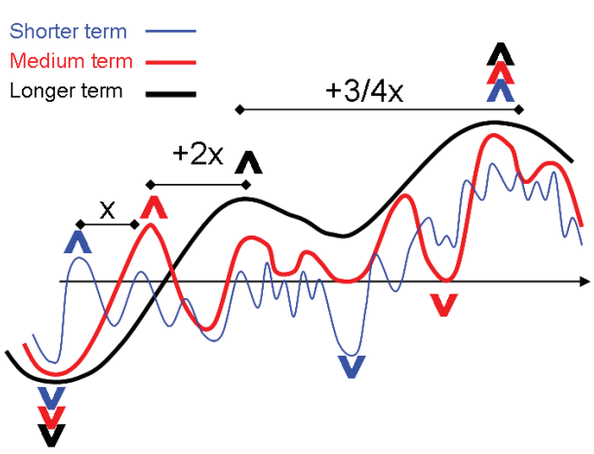
On the back of the US Dollar rebound we expect over the next couple months, we would hence avoid Defensive assets and Commodity related geographies. We would also favour large International Companies in Europe and Japan, and smaller domestic companies in the US. Coming March, we may decide to reverse this market positioning, especially if our global markets scenario then favours a late stage Commodity blow-off in Q2, rather than a dull Distribution phase.

55/ METHODOLOGY

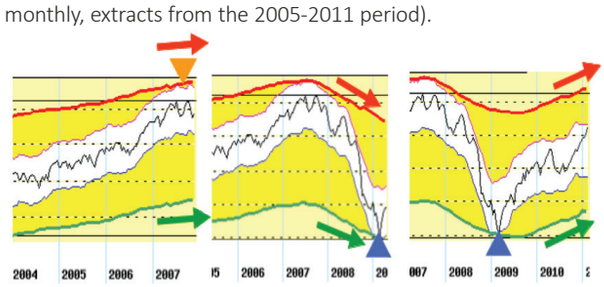
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



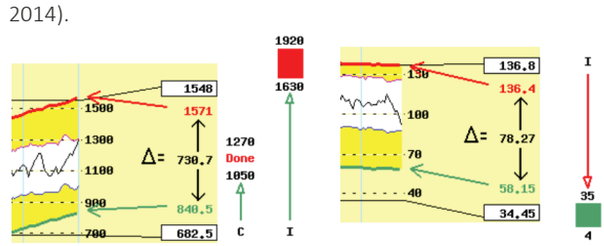
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)



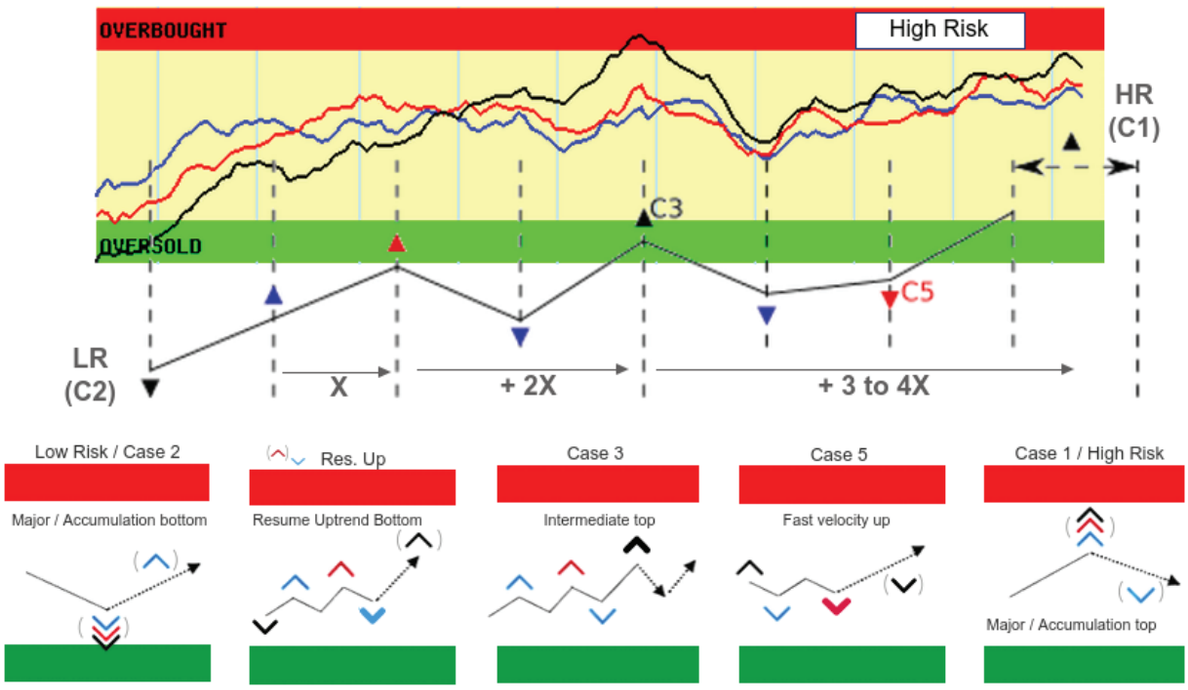
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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

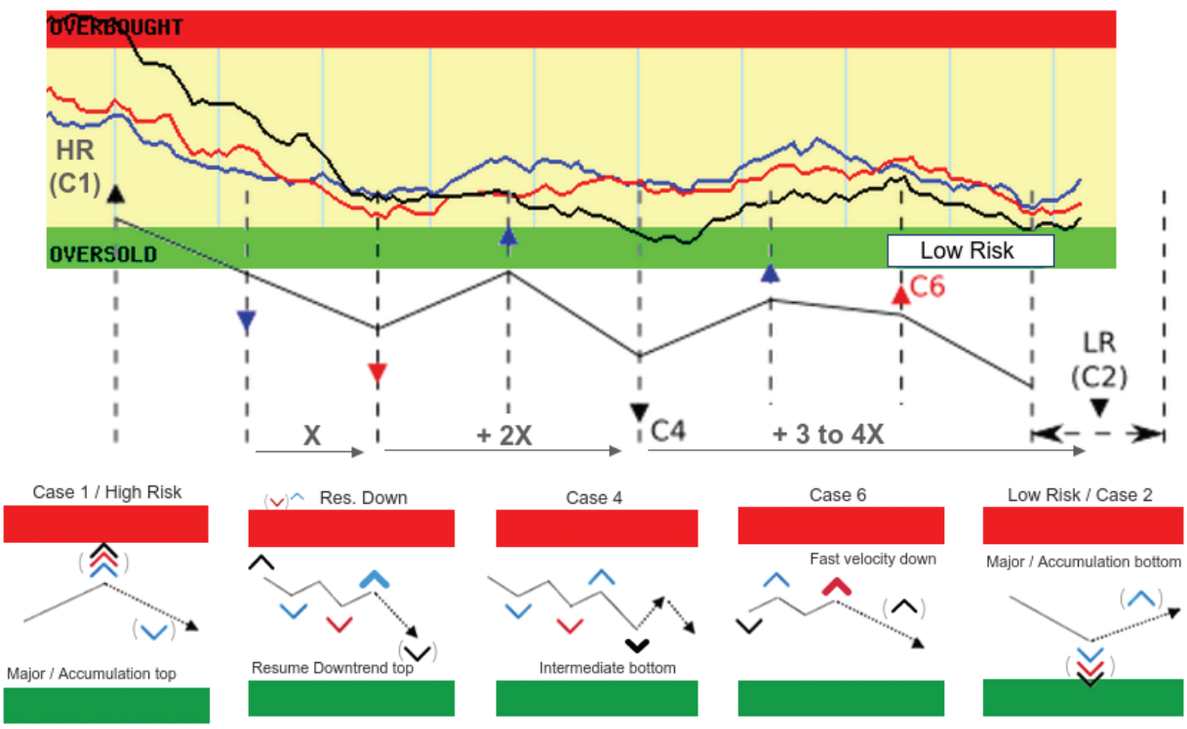


Ideal Uptrend Model



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

Ideal Downtrend Model



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

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