THE CAPITAL OBSERVER

AUGUST 2019

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

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THE CAPITAL OBSERVER

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

AUGUST 15, 2019

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The number of fund managers predicting a global recession has climbed to an eight-year high, according to the Bank of America Merrill Lynch (BofAML) August Fund Manager Survey, heightened by trade war concerns.

4/ Executive Summary

12 / **The market panics over yield curve inversion, rush headlong into defensive assets: this strategy is in its last inning** - The financial markets have been panicking following a new inversion of the yield curves, on the assumption that the sky is falling, or will soon fall. The market reaction is typical – we have been tracking the market for almost 5 decades, and inversion of the yield curve had always elicited the same panicky reaction from the market, every time. But there's no danger now. The historical evidence is very clear – recessions tend to occur 18 months on average after a 3M/10Y yield curve inversion. Moreover, there were false positives – not all past yield inversions have been followed by recessions. The current market panic is pervasive, but it is not unusual. We've seen the same situation happening during mid-year 1973, year-end of 1978, in the middle of 1980, to a lesser extent July 1989, in late 2000, and in December of 2006. But this panic scene will quickly pass – it always had. The current headlong rush for defensive assets (bonds, gold, Yen) will quickly dissipate, because the yield curve inversion does not last very long – especially with the current milieu of rising Core CPI. The currently favoured defensive asset, US government bonds, actually became even more sought after when the yield curve started to steepen. There is a lot to gain from these overbought conditions of the defensive assets, and from the oversold conditions of the cyclical assets. At this stage we remain very sanguine about the state of the economy. To us, the US economic sentiment indicators, even the S&P 500 Index, are not signalling imminent recession. With hedge funds frequently acting in concert, like lemmings, when these asset managers decide to exit these trades, it will be like a flood squeezing through a narrow outlet. There will be a massive and abrupt repricing of the prices of these assets. We wish our readers to look at these issues very carefully and subjectively, and consider getting out of the way before the Money Managers decide to do it themselves. It could save you more than a bundle.

15 / **Timing and Tactical Insight - Cyclicity is Oversold, yet its bottoming process is still underway** - Cyclical themes tend to outperform defensive ones and the general market in an environment where the yield curve is steepening or yields are rising, ideally both. This is because of the short duration feature of their cash flows. Last month, we expected the US yield curve to start to steepen in August following a sell-off towards late July (we use the short term US3Y-US3M spread as a proxy to monitor such reflationary trends). We then also believed that this sell-off in the yield curve, and more generally risk assets, could present a buying opportunity for Value and Cyclical themes. The sell-off has since materialized and has been quite strong, yet, for now, we would probably wait a few more weeks before switching from Defensives into Cyclicals themes. Indeed, the US yield curves and US Treasury yields have mostly made new lows and we believe that they are likely to continue to retest down into September, potentially early October. Furthermore, the Cyclical/Defensive ratios we monitor in this article all seem to point to late Q3 as a possible inflection point. Following that, we expect a more friendly environment for Cyclical assets, potentially towards year-end and perhaps Q1 2020.

22/ **The S&P500 has entered its corrective phase and the yields are pursuing their decline into a terminal phase: when, and where will this end?** - Last month when we discussed the US equity markets, we focused on the consensus S&P 500 earnings forecasts which were still materially too high for both the second half of 2019 and 2020.This is why we believed that we were looking at a correction phase in equity prices. Furthermore, our liquidity models also flagged some deterioration with the five-year averages of the liquidity sources from the Fed and the Treasury are all showing the market to be at the cusp of a veritable drought until September. Our conclusion was that the S&P 500 should fall until early August, rebound, then fall until September, when we believe falling economic activity in the US will bottom. We expect to see again the lows seen in the SP500 in early June-- that would be at circa 2730. The market could even have some slippage below that, but that is the appropriate downside target in the current down correction in equities. We also explained in previous issues of the Capital Observer that falling bond yields have been responding to the imperatives of declining growth, which we expect to bottom in Q3, this year. The rising stock market, on the other hand, has been responding to hopes that the Fed cut rates, in response to the dismal growth prospects which they believe face the US and global economy. The point was that the enthusiasm of equity investors was based on expected bad news, but the Fed can only do so much until those expectations are born out. The reality was that central bank won't be able to cut much in the face of still robust jobs situation. Therefore, any "insurance-based" rate-cut regime will be token at best. And that, indeed, came to pass. Looking ahead at Q4, past the current corrective phase for equities, we foresee happier times for risk assets and less for bonds with the Treasury and the Fed building-up cash balances for year-end demands on the back of Mr. Trump and Congress just agreeing on another round of two-year spending that will be larger than recent years. Talk about ultimate systemic liquidity, on steroids!

27 / **Timing and Tactical Insight - Monitoring the current Equity Market Correction** - The 3 to 5% correction to the downside we had forecast last month has found a strong catalyst with the resurgence of the US vs China Trade War. The current sell-off may find some support towards late August and a bounce may materialize. Yet, it could be retraced again during September (partially at least). Following that, US markets may attempt a last push higher to new highs into year-end and early 2020 as they long term uptrend still seems intact. This projection may however meet new headwinds from global markets. Indeed, equity markets configurations seem to have weakened in Europe. The DAX, and European Banks especially, could be downtrending towards year-end. Similarly, China and more generally Emerging markets, also seem to be resuming last year's downtrend, potentially with strong downside potential over the next few quarters. The US could still de-couple once again, and possibly help other markets hold. Yet, in this late cycle environment, probably not as strongly as it did last year. For now, at least, we would probably remain prudent into September.

5/ Executive Summary

33 / **The US Dollar has likely peaked for now, and should fall until September but after that the Dollar may rise with Core CPI and yields until Q1 2020 -** That USD correction outlook did not come to pass. The Dollar became firmer as safe haven destination, as US growth weakness showed signs of intensifying, and the China-US trade spat became even more heated. The US Dollar rose in July, and counter-intuitively started to weaken only after the Fed underwhelmed the financial markets with a 25 bp rate cut on July 31, instead of the 50 bp cut expected (and clamoured for) by the equity markets.
Nonetheless, the USD unfriendly environment is still with us: the lagged impact of declining capital account inflows is still negative for the US Dollar, and this time, we've added the nominal purchases of US Treasuries by foreigners (central banks and institutions) to add high-frequency clarity to the likely moves of the US Dollar. It is the change rate of the DXY which tallies well with the changes in Foreign Purchases of US Treasuries; and it is still apparent to us that the US Dollar could still fall from here until late September-early October, this year. There is also a wide gap between the rising DXY and the falling 10yr yield since early July. This outlier status suggests to us that the US Dollar (and DXY proxy) are due for a significant repricing lower over the next few weeks. This expected residual weakness in the US Dollar is expected as a matter of weeks, not months. But with Core CPI now threatening to surge for the rest of the year, further declines in yields (and the Dollar) should be short-lived. Thereafter, we expect both yields and the Dollar to rise alongside Core CPI from Q4 until the middle of Q1 2020 at least.

36 / **Timing and Tactical Insight - Defensiveness is sweeping through FX markets** - Defensiveness seems to be currently sweeping through currency markets as the Dollar seems to be consolidating further vs the Yen and Swiss Franc, and to a certain extend the Euro, while it has also recently shot up vs Emerging and Commodity currencies (e.g. CNY, BRL, TWD). We believe most of these trends are probably set to continue over next the month or so, , probably into late Q3, perhaps even Q4. We believe this is rather defensive in terms of risk asset positioning. In more detail, USD/JPY and USD/CHF could continue to slide into Q4, while EUR/USD may start to weaken earlier towards late August / September. The Yuan, Emerging markets and Commodities currencies seem to remain weak into late Q3 at least, but some may be already pointing to further weakness towards year-end. This would be very negative for Emerging Markets as their fate is very much related to their currencies. We will look to confirm or infirm these views towards early Fall, and in the meantime will retain a defensive bias on FX markets.

43 /**Oil prices are still in the bottoming process for this cycle – we still see Brent oil price rising to at least $90 by Q2 2020** - At the Capital Observer, we have been hammering on the primacy of the variance between global oil demand and oil supply as the prime mover for global oil prices in the longer run. We have not seen any other model yet that surpasses the efficacy of the simple equation having the changes in the delta of supply versus demand as proxy for the changes in global oil price. And the beauty of this simple equation is that the supply-demand delta leads changes in the global oil price by 7 to 8 months.
The market also focuses on the current changes in oil fundamental data rather than the lagged impact of the data on oil prices. Also, other elements like the outlook of future US and global growth (Rest of the World) has become important input in the current oil price oil discovery process. Oil prices have remained depressed on the low side of the cycle on fears of future global growth (the usual explanation for declining oil prices), we also argue that the lagged impact of oil fundamentals also exerted high-frequency changes in the global oil price development. For instance, there is a small upwards kink in the global oil supply in July which lasts until August ,as well as rising US oil supply and rising global oil production during the same period. It is easy to match the current oil price weakness with those factors which have negative impact on global oil prices. However this should prove temporary. We do believe that global growth is currently bottoming out as our real time global GDP proxy is showing positive signs. Furthermore, the PMI, which has been the bogeyman for the Fed's rate cuts, has already shown signs of bottoming out. In fact, we believe PMI has bottomed. If ISM PMI ratchets higher, then oil prices will have to be repriced higher as well. Consequently, our thesis remains valid: oil prices are in a bottoming phase, on the cycle low side of the price structure and we still expect Brent oil to rise to at least $90.00/bbl by Q2 2020.

47 / **Timing and Tactical Insight - Oil remains under pressure for now, yet may find support and rally from late Q3 -** Oil, the Energy sector and most related trades are currently retesting down. While WTI seems to be holding up rather well, Brent has broken below its June lows, while related trades are mostly below their December lows. Although we cannot exclude a strong sell-off towards year-end, our analysis suggests that following further retracement towards its December lows, Oil should find support during late Q3 and then probably bounce into year-end, perhaps even into next Spring. Related trades are already very Oversold and many of their downtrends are reaching exhaustion on the price target front. This could provide a strong base for the whole Oil nexus to move higher again in the not too distant future.

52 / **Splicing the markets - Credit may have topped out already, yet could see a good bounce during Q4** - As with other risk assets, the ratios of Credit products vs US Treasuries may see some consolidation to the downside into late Q3. They may then bounce during Q4 before resuming lower in 2020. From a targets perspective, we believe that Credit market probably topped out in early 2018, and that any positive move between now and year-end will probably not make new highs (on the ratios of Credit products vs US Treasuries). High Yield and local currency Emerging Markets debt seem especially weak vs US Treasuries. They could still see a bounce during Q4, but their downtrend into 2020 seems well in place. Inversely, these projections imply that Credit spreads probably bottomed in early 2018, and although they may see further retracement down towards year-end, should then move higher during most of 2020. On an absolute basis, Credit products may hold up though until year-end. First during Q3 as Treasury yields continue to retest lower, then during Q4 as cyclicity may see a last bounce, and credit spreads remain under pressure. 2020 should then spell a different, more negative story for the Credit markets.

6/ Mapping the markets

Last month, when we published on the 15th of July, we expected a 3 to 5% correction on equity markets into late July / early August. We believed this soft patch would hit mostly value and reflationary themes such for example Oil, or US Energy or European Banks, while Defensives sectors and more generally defensive assets such as Gold or Treasuries would outperform. These projections although they could have been even more aggressive to the downside, have all proven very much correct. What did surprise us however, was the resurgence of the US-China Trade war. Emerging Markets and China have since underperformed, which we hadn't expected.

Going forward, we now expect the current consolidation period on equity markets and more generally risk assets to last another few weeks and retest down into late August / early, perhaps mid September. The S&P500 could move down again into the 2'700s, while the EuroStoxx 50 may reach below 3'200. Cyclical assets (Oil, cyclical and value sectors vs their market indexes), which are already very Oversold may also retest down into September, yet with limited downside potential as their downtrends do seem very much exhausted in terms of scope. On the other hand, Defensive assets such as Gold or Treasuries as well as Defensive sectors vs the general market may also extend slightly higher into late August, perhaps early September. As for the Dollar, it should continue to correct down vs Yen and Swiss Franc into mid/early September, perhaps even into late September / early October as some residual risks could persist. EUR/USD could also see a slight bounce into September. Indeed, this Dollar weakness vs the majors has a defensive bias and it is interesting to note that on the contrary, the US Dollar could continue to strengthen vs Emerging markets, Commodity and Asian currencies. We would hence remain quite prudent on Emerging markets into September, perhaps even early October.

From late Q3, at the latest early Q4, we expect US Cyclicity to start to stabilize and recover. Bond yields should finally bottom out, while developed equity markets resume their uptrend. Indeed, we expect a US centric re-acceleration of cyclical assets during Q4 and perhaps into Q1 next year. US equity markets could see new highs, US Treasury could bounce back quite dynamically, the Dollar could resume its uptrend breaking above its year-to-date highs, while Oil, European equity markets and Bund yields should tag along. In this environment of rising cyclicity, rising yields and rising US Dollar, Defensive assets such as Gold could retrace down, possibly to their previous resistance levels in the mid/low 1'300s USD/oz, while Emerging markets, and especially Asian Growth themes should continue to underperform.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	US Equity markets may find support late August, yet could still retest down until September. Downside risk into the 2'700s on the S&P500.	From September, at the latest early October, US markets should resume their uptrend towards year-end and potentially new highs.
	Europe EuroStoxx50	European Equity markets may find support late August, yet could still retest down until September. Downside risk is probably below 3'200s on SX5E.	From September, at the latest early October, European markets should resume their uptrend towards year-end and potentially new year-to-date highs.
	EMs MSCIEM USD	Emerging Markets could continue to retest down into late August and potentially late September / early October, and could make new lows below their Q4 ones.	During Q4, Emerging markets may attempt to bounce, although we are prudent for now on the scope of this bounce.
Treasuries	US10Y Bond prices	US Treasury yields are quite Oversold (little downside potential left), yet our timing suggests that they may continue to slide into September, perhaps even early October	US Treasury yields should bounce during Q4 2019.
	Germany 10Y Bund prices	German Bund yields are quite Oversold (little downside potential left), yet our timing suggests that they may continue to slide into September, perhaps even early October.	Bund yields may bounce during Q4 2019, yet the scope of this countertrend may be quite limited.

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

Main Equities

World markets
p 19, 27-32

Last month, we expected Equity markets to consolidate into late July / early August with potentially 3 to 5% risk. The sell-off did materialize, was quite brief and did achieved slightly more downside (for the S&P500, 8% on the Futures from peak to through including afterhours trading, 6% on the cash market). Yet, one of the catalysts for this correction did surprise us negatively, namely the resurgence of the US-China Trade War. In this context, we would remain prudent over the coming weeks. Indeed, although we do expect some support into late August, a further Dip may materialize into September. Downside targets over the next 6 weeks may lead us back into the 2'700s on the S&P500. Following that, from late Q3, we expect equity markets to resume their uptrends towards year-end.

Main Regional picks
p 19, 27-32

US markets still look strong vs Europe, Japan or more generally the All Country World Index. The ratios may see some volatility until late Q3, but ultimately, US markets should continue to outperform towards year-end.

Emerging markets
p 32

Emerging Markets are Oversold vs Developed ones on Daily basis. Yet, for now, they are continuing to slide vs the All Country World Index. Our Weekly relative graph leaves little scope for a worthwhile bounce as according to it, Emerging Markets should continue to underperform from Q3 into year-end. We would hence avoid Emerging Markets for now, but will keep an eye open for positive developments on the US-China trade discussions.

Volatility
p 27

The short bounce in Volatility we expected last month towards late July did materialize. Yet, we are not sure it is quite over yet, and expect that it may retest up into late August, perhaps even September.

Government Bonds

US & European Benchmarks
p 16

US Treasury and German Bund yields are heavily Oversold after their recent sharp sell-off. Although their downside potential is probably limited at this stage, we expect them to continue to retest down, probably into September and perhaps even into early October. Following that, they should bounce into year-end. The rebound potential we calculate into Q4 is between 40 and 60 basis points in the US, probably less in Europe.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	The ratio could remain under pressure into late August, and enentually into late Q3.	During Q4, the ratio should resume its uptrend as US equities may rally to new highs, while Treasury yields bounce.
	Europe	The ratio could remain under pressure into late August, and eventually into late Q3.	During Q4, the ratio should resume its uptrend as European equities may rise again and Bund yields stabilize. It may however have difficulties making new year-to-date highs.
Duration		The US Yield Curve may continue to retest down until late Q3 as long term yields remain under pressure, yet the downside seems limited from here.	During Q4, the US Yield Curve may see a steepening bounce along with a rebound in long term yields.
Credit		Credit spreads may continue to consolidate up during August and eventually until late Q3.	During Q4, Credit spreads may then resume their downtrend, yet will probably not make new lows for this cycle (i.e the early 2018 lows should hold).
TIPs/Treasuries		For now, Inflation expectations (TIPs vs Treasuries ratio) are continuing to slide, probably towards late August and eventually even towards late Q3.	The TIPs vs Treasury ratio may then bounce during Q4, along with Oil and cyclical assets.
Oil		Oil probably finds some support towards late August, yet could remain under presure until late Q3.	Oil could then reverse up during Q4 and potentially make new year-to-date highs, at least.
Industrial metals		Industrial metals probably find support towards late August, but could remain under presure until late Q3.	Industrial metals may then bounce during Q4, although we are still prudent about the scope of this reaction given the ongoing US-China Trade War.
Gold		Gold probably continues slightly higher into late August, and eventually once more into late Q3.	Gold could then retrace down during Q4 as cyclical assets and yields rebound, and the US Dollar probably resumes its uptrend.

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

Equity to Bond Ratios

US & Eurozone Market
p 16

Equity to Bonds ratio in the US and Europe should also continue to consolidate until late Q3, before they resume their uptrend during Q4 as equities resume up and bond yields rebound. In the US, we expect the ratio to make new highs towards year-end, yet probably not in Europe.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 15

The short end of the US yield curve (US3y-US3m) retested down as expected. Yet, may continue to do so into September. We then expect a steepening move during Q4 along with the bounce in yields we expect. The long Duration trade is hence getting quite exhausted as we approach end Q3.

Credit
p 52-53

Credit markets did see a slight correction down as expected last month (credit spreads have bounced). Yet, we now believe that this rebound could continue into late August, perhaps even September. We then expect Credit markets to recuperate during Q4, but Credit spreads will probably not retest their early 2018 lows. Hence, we believe that the Credit cycle has probably already started to turn (although it may continue to hold up until year-end).

Rate Differentials
p 36

The US rate differential vs the rest of the world should continue to retest down, probably until late Q3 and perhaps even into early Q4. Following that, we expect a year-end bounce towards year-end and perhaps Q1 2020.

Tips

The TIPs / Treasury inflation breakeven ratio retested down as expected into late July / early August, yet it could continue to do so into September. We then expect it to find support towards late Q3 and then bounce towards year-end.

Commodities

Oil
p 47-48

Oil is currently testing its June lows, may find some support towards late August, but could remain under pressure until late Q3. It then rises again during Q4 and should make new year-to-date highs, at least.

Industrial metals
p 17

Industrial metals, and Copper especially, seem to be suffering from the resurgence of the US-China Trade war. We expect them to remain under pressure until late Q3, and then to bounce during Q4.

Gold & PMs

Gold extended higher as expected and may continue to push into mlate August, perhaps even September, possibly into the mid/high 1'500s. It then corrects down during Q4 as risk assets and the US Dollar resume their uptrend and yields bounce. It may drop back to its previous resistance levels (circa 1'350) towards year-end, but then resumes higher again during 2020.

Agriculture

Agriculture Commodities corrected down quite sharply during late July / early August. This move was rather surprising to us. Going forward, we do expect them to remain under pressure towards late Q3 at least.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	EUR/USD is attempting to build a base and should resume its rebound probably into late August, eventually into mid/late September (1.13 - 1.145 targets).	EUR/USD then probably resumes its downtrend towards year-end and tests crucial support towards 1.11. It may indeed break below 1.10.
	GBP	GBP/USD is Oversold and may stabilize towards late August and perhaps into early September.	GBP/USD then resumes lower towards year-end and towards 1.15.
	JPY	USD/JPY probably continues to test down into September, perhaps even into late Q3 / early Q4. Downside targets are still towards 104, perhaps even lower.	During Q4 (early/mid Q4), USD/JPY may find support and attempt to bounce towards year-end and early 2020.
	CHF	USD/CHF probably continues to test down into September, perhaps even into late Q3 / early Q4. Downside targets are in the 0.96 - 0.94 range.	USD/CHF should resume up from early Q4 into year-end, could reach parity again and eventually new year-to-date highs.
EUR vs	GBP	EUR/GBP probably remains strong into mid/late September and could reach the 0.94 - 0.96 range.	EUR/GBP probably remains strong during Q4 and may reach parity by year-end / early 2020.
	JPY	EUR/JPY probably continues to slide towards 115 into late Q3 / early Q4.	EUR/JPY may attempt to bounce from mid Q4, but probably with limited scope.
	CHF	EUR/CHF probably continues to slide into September, potentially towards 1.07.	EUR/CHF could attempt to bounce during Q4, but probably with limited scope.
GBP vs	JPY	GBP/JPY probably continues to slide into October and the low 120s.	GBP/JPY probably continues lower below 120 into year-end, perhaps even towards 110.
	CHF	GBP/CHF probably continues lower towards circa 1.12 into October.	GBP/CHF probably continues lower below 1.10 into year-end, perhaps even towards 1.05.

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

US Dollar
p37

The US Dollar retested up quite strongly during July and made marginal new highs on the Dollar Index. We now expect it to see another dip, which could last into late August, perhaps mid September. The Dollar Index then probably resumes higher towards year-end and probably above 100.

Euro
p 37

EUR/USD retested down late July to new marginal lows. We now expect it to perform a weak bounce into late August, perhaps mid September. The EUR should however remain quite weak vs defensive currencies such as JPY or CHF, probably into late Q3, perhaps even early Q4. It may then attempt to bounce vs them in Q4, but with limited scope.

Yen
p 18, 36, 39

The Yen should remain strong into late Q3, perhaps even early Q4. It may then weaken a bit towards mid/late Q4 vs USD and the Euro (a weak countertrend bounce for EUR/JPY, perhaps a bit more for USD/JPY).

Sterling

Sterling continues to weaken vs most currencies as a no-deal Brexit now seems ever more likely. Cable could eventually stabilize as the US Dollar consolidates down towards late August, but then probably resumes lower from September. Sterling probably continues to sell-off vs most currencies towards year-end and early 2020.

Oil & Commodities currencies
p 40, 49

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) have broken down quite strongly vs both the EUR and USD during July and early August. We would probably wait for them to stabilize into late August / September before confirming (or not) the possibility of a bounce towards year-end

Asian currencies
p 41, 42

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) also broke down vs the EUR and USD into late July / early August. We expect it to remain under pressure for now, probably towards late Q3 at least.

Equities Markets Segmentation

Core Sector Weightings			Next 2 months					3 to 6 months ahead				
US Sectors - S&P500 (general comment)			**A rather Neutral sector allocation until end August / early September with cyclical sectors slightly Underweight and Defensive ones slightly Overweight.**					**From late August / September, Defensive profiles could underperform, while Growth seems to maintain its momentum and Cyclicals make a comeback. We especially like Energy which is now very Oversold.**				
Sectors	Proxy ETF symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Technology	XLK	21%										
Healthcare	XLV	15%										
Financials	XLF	14%										
Discretionary	XLY	10%										
Communication	XLC	10%										
Industrials	XLI	10%										
Staples	XLP	7%										
Energy	XLE	6%										

			Next 2 months					3 to 6 months ahead				
European Sectors - Europe Stoxx 600 (general comment)			**A rather Neutral sector allocation until end August / early September, with cyclical sectors slightly Underweight and Defensive ones slightly Overweight.**					**From late August / September, Defensive profiles could underperform, while Growth seems to maintain its momentum and Cyclicals make a comeback.**				
Sectors	Index symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Banks	SX7P	13%										
Industrials	SXNP	12%										
HealthCare	SXDP	11%										
Pers. & HH Goods	SXQP	9%										
Food & Beverage	SX3P	7%										
Insurance	SXIP	6%										
Energy	SXEP	6%										

Main Sectors Allocation
p 20, 21, 30, 50, 51

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

Last month, we expected a short retracement period towards late July / early August and had decided to remain rather defensive. Indeed, we believed that Cyclical / Value themes could make a last dip on a relative basis, while Defensive profiles could perform a last come-back. The correction down that we have seen has been slightly stronger that what we had anticipated, and for now, we would expect it to probably continue into late August, perhaps even into September. We would hence reconfirm our short term prudent bias for yet another month.

From late August, perhaps during September, we would then expect risk assets to gradually resume their uptrend into Q4 and probably towards year-end. We will then gradually look to Overweight Cyclical and Value sectors, keep growth sectors at Neutral and Underweight defensive ones.

Countries allocation

Core Countries Weightings			Next 2 months					3 to 6 months ahead				
All World Country Index Currency hedged (general comment)			**We are keeping a neutral / slightly defensive stance for now as we believe the current market correction may extend into late August, perhaps into early September.**					**Towards late Summer, we expect equity markets to resume their uptrend. For now, the US probably remains the market with the most resiliency to the upside.**				
Countries	Index symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
US	S&P 500	52%										
Canada	TSX	3%										
Europe	SXXP	21%										
-UK	FTSE	6%										
-France	CAC40	3%										
-Germany	DAX	3%										
-Switzerland	SMI	3%										
Japan	N225	8%										
China	MSCICN	3%										

Main Country Allocation
p 19, 27-32

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

The correction to the downside we expected towards late July / early August has materialized. Yet, we believe that it may continue to retest down towards late August, perhaps September. We will hence keep a rather neutral stance for now, with a slight defensive Overweight on Switzerland and Canada.

From late August / September, we expect equity markets to resume their uptrend, probably towards year-end. We will Overweight the US again as it has showed the most resiliency to the upside year-to-date. On a relative basis, it could also benefit from the Dollar, which following a further dip into late August / early September, could resume its uptrend towards year-end. We have slightly underweighted other markets, except for the UK, which could benefit from a declining Pound, as well as China, which we will keep at neutral given the persistent uncertainty around the US-China Trade talks.

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

Core factors and Themes

Core Factor/Themes Weightings	**Next 2 months**					**3 to 6 months ahead**				
General Comment	**We continue to remain prudent on high beta and cyclicals, probably until late August.**					**We will gradually turn to more pro-cyclical profiles from late August / September.**				
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

We are re-conducting our Defensive bias until late August / early September, avoiding higher beta trades such as the European and US Small caps or Metals & Mining Companies. Goldmines are still positive, yet already quite Overbought, we will keep them at neutral.

From late August, early September, we will Overweight cyclical and High beta trades such as Small caps, Value, Southern Europe or Diversified Metals & Mining. We would look to take profit on Goldmines, probably towards late August.

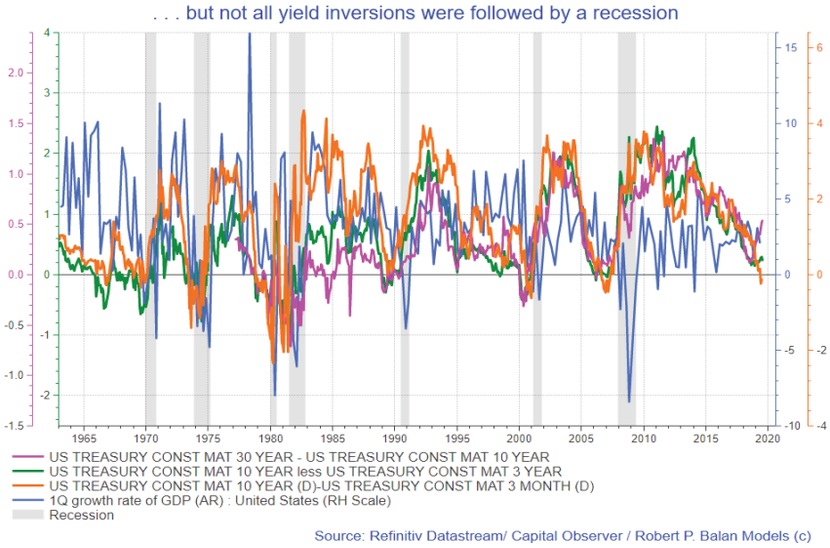
12 / The market panics over yield curve inversion, rush headlong into defensive assets: this strategy is in its last inning; there's danger of being trampled by exiting Money Managers

The financial markets have been panicking following a new inversion of the yield curves, on the assumption that the sky is falling, or will soon fall. **The market reaction is typical – we have been tracking the market for almost 5 decades, and inversion of the yield curve had always elicited the same panicky reaction from the market, every time. But there's no danger now. The historical evidence is very clear – recessions tend to occur 18 months on average after a 3M/10Y yield curve inversion. Moreover, there were false positives – not all past yield inversions have been followed by recessions** (*see 1st graph on this page*).

There were also a lot of articles and conversations over the fact that 30yr yields were beaten down so badly that 30yrs fell to their lowest levels in market history. On top of that, the markets are making a big deal of the 10yr/30Yr yield curve starting to flatten due to the severe decline in the back-end rate. This, too, has a mundane explanation. The fall in the 30yr, and the flattening of the back-end curve, have origins in the unexpected rise in Core CPI in July – the second surprise in two consecutive months. The 10Yr/30Yr yield curve always flattens when Core CPI starts to rise (*see 2nd graph on this page*) – that pressures the 30yr yield lower.

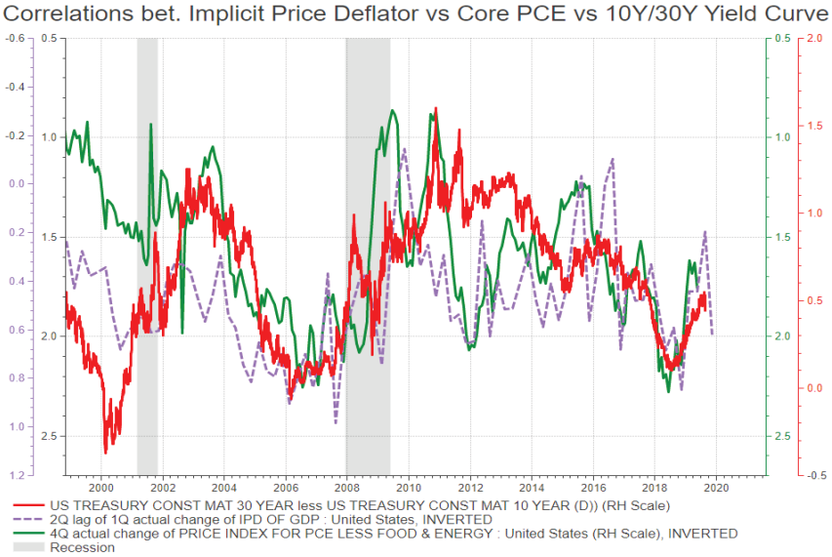
The current market panic is pervasive, but it is not unusual. We've seen the same situation happening during mid-year 1973, year-end of 1978, in the middle of 1980, to a lesser extent July 1989, in late 2000, and in December of 2006. But this panic scene will quickly pass – it always had. **The current headlong rush for defensive assets (bonds, gold, Yen) will quickly dissipate, because the yield curve inversion does not last very long – especially with the current milieu of rising Core CPI. The currently favoured defensive asset,**

Recession occurs 18 months on average after a 3M/10Y yield inversion . . .
. . . but not all yield inversions were followed by a recession



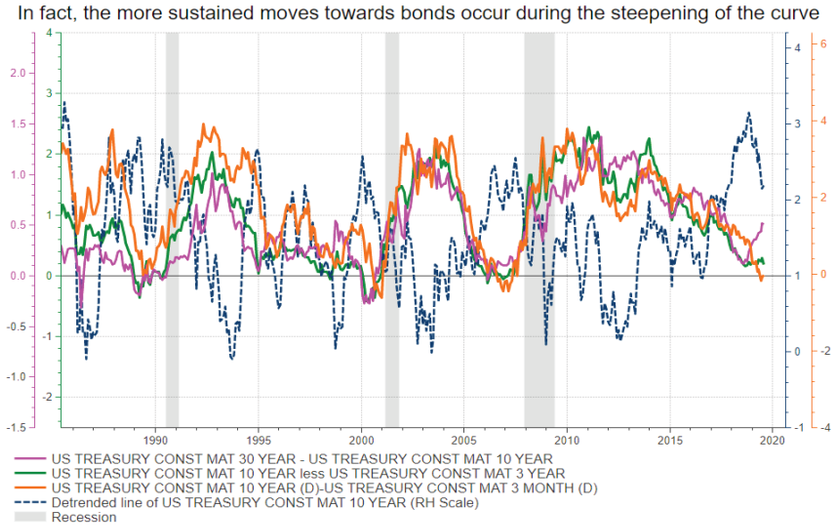
Source: Refinitiv Datastream/ Capital Observer / Robert P. Balan Models (c)

Correlations bet. Implicit Price Deflator vs Core PCE vs 10Y/30Y Yield Curve



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

Rush for defensive assets quickly waned; yield inversion does not last long
In fact, the more sustained moves towards bonds occur during the steepening of the curve



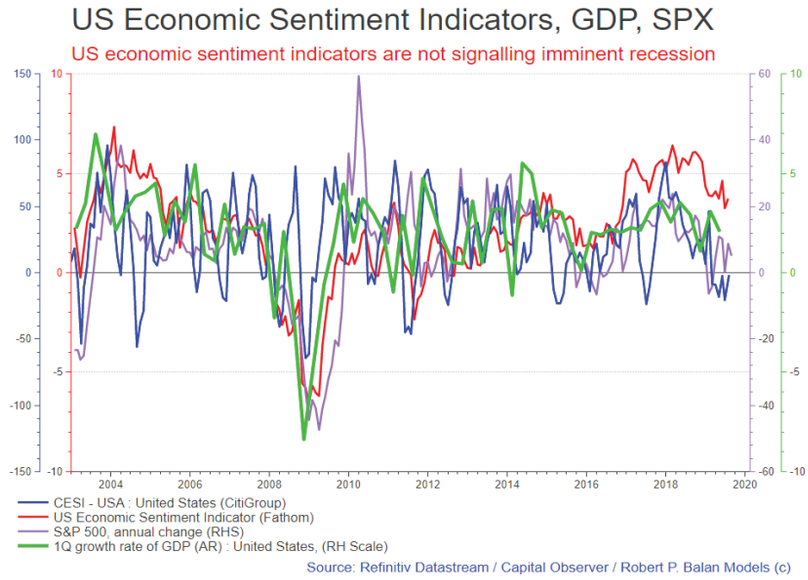
Source: Refinitiv Datastream/ Capital Observer / Robert P. Balan Models (c)

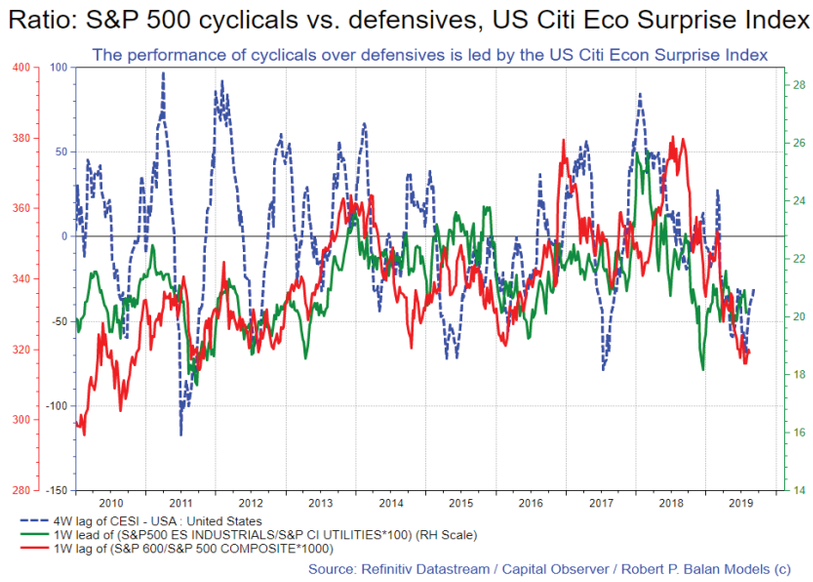
US government bonds, actually became even more sought after when the yield curve started to steepen (*see 3rd graph on previous page*). The reason for that may be due the fact that it is when the yield curves steepen following an inversion, that recession becomes a distinct reality not long thereafter (*see 3rd graph on previous page*).

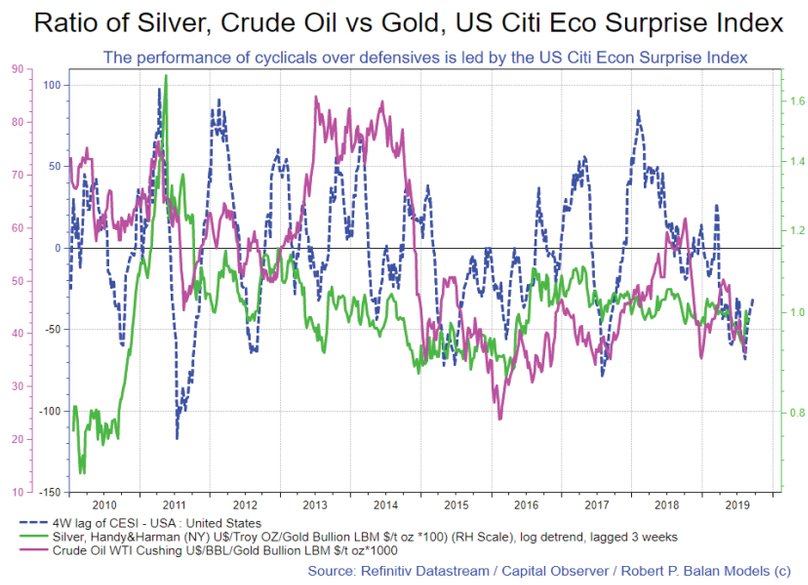
Lesson: fear the steepening of the curve instead of the inversion; position to gain from unwinding of the defensive trades when the inversion goes away, and the panic subsides. **There is a lot to gain from the overbought conditions of the defensive assets, and from the oversold conditions of the cyclical assets. The next question is "when" to do this?**

At this stage we remain very sanguine about the state of the economy, as we have explained in several articles in this issue, and in issues during the past few months. One graphical way to illustrate this view is with the use of various economic sentiment indicators we have used successfully in the past. We added equity prices to this mix, as we believe the US stock market has predictive properties with regards to US GDP growth. **To us, the US economic sentiment indicators, even the S&P 500 Index, are not signalling imminent recession**. The key to using stock values in this manner is to use the change rates, so there is consistency in the mathematical form among the various data used in the process (*see 1st graph on this page*). Then we can compare apples to apples.

We also use high-frequency formats of the economic indicators shown above to time the exit from defensive assets accumulated during the current market panic. In fact, these indicators have also been useful to us when timing the switch from defensive to cyclicals, and vice versa. **As we see these indicators today, the time to exit from defensive assets and return to cyclical assets are nigh. For instance, the Citi US Economic Surprise Index may have bottomed, and that should favour cyclicals over the next few months**. That is especially true for the equity-based sectors (*see 2nd graph on this page*). The message is clear from the chart below: with US economic surprises starting to become more numerous, it is time to switch from industrials, and to turn away from utilities.







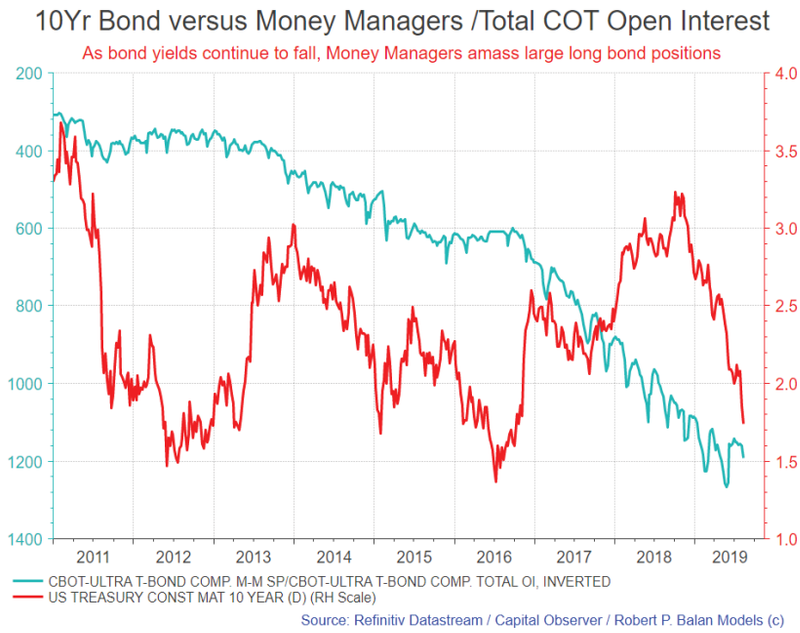
Commodity based strategies, which play-off defensives (proxy: Gold) against cyclicals (Crude Oil, Silver,Nickel), are providing similar messages. The time is nigh to start favouring Crude Oil and Silver over Gold (*see 3rd graph above*).

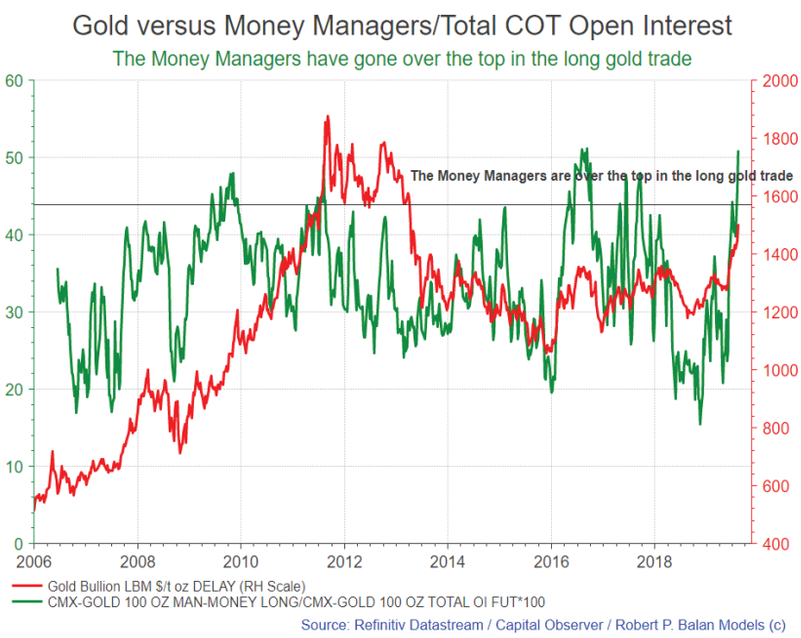
To round up the argument why cyclicals should soon be favoured over defensives, we believe, for one, that the strategy to load up on bonds will soon prove counter-productive. Money Managers (Hedge Funds) have been loading up on long bond positions (*see 1st graph below*)**, and we just believe that this focus of HF on bonds will soon reach an unwind**. With such huge positions to exit from, the counter-move (of rising yields) should be quite spectacular. The bond positions of HF are presented in the inverse in the 1st chart of this page, juxtaposed against falling yields.

The other darling of Money Managers is Gold. The prices of Gold and its corresponding open interest have exploded since early Q2, this year. The share of the Money Managers in gold's open interest is now reaching levels which have seen prices meet a brick wall in the past. We fear that the same thing is about to happen this year (*see 2nd graph on this page*).

Finally, the Money Managers also picked on a common cyclical asset, Copper, to short massively. Nonetheless, despite the long and sharp build-up of short positions, Copper prices managed to stabilize although showing a declining bias. This is a sign of internal strength in Copper prices.

The point in these last two graphs is that the massive positioning of the Hedge Funds in these defensive and cyclical assets have been brought way beyond normal. **With HFs frequently acting in concert, like lemmings, when these asset managers decide to exit these trades, it will be like a flood squeezing through a narrow outlet. There will be a massive and abrupt repricing of the prices of these assets. We wish our readers to look at these issues very carefully and subjectively, and consider getting out of the way before the Money Managers decide to do it themselves. It could save you more than a bundle.**



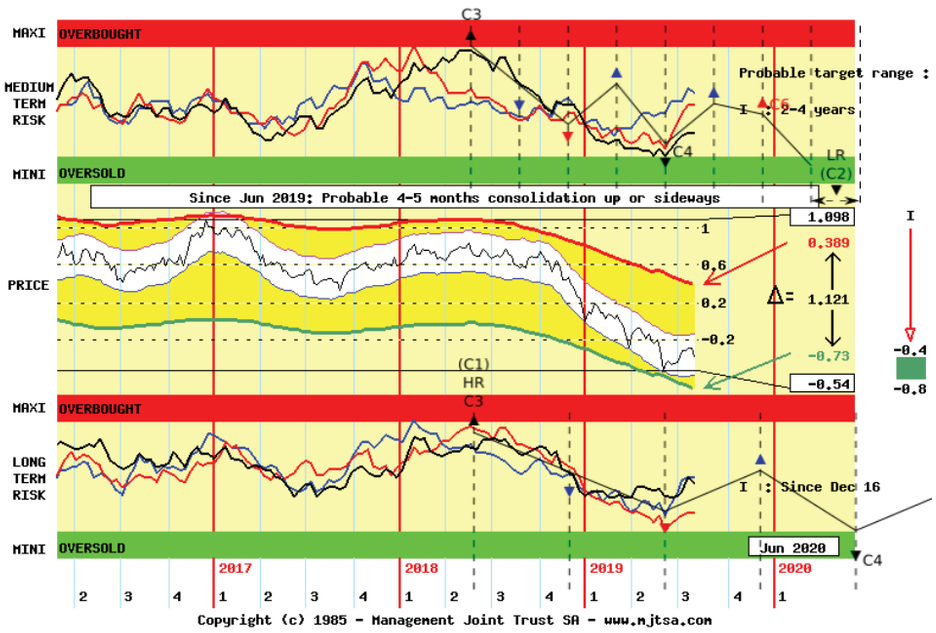


15 / MJT - TIMING AND TACTICAL INSIGHT

Cyclicity is Oversold, yet its bottoming process is still underway

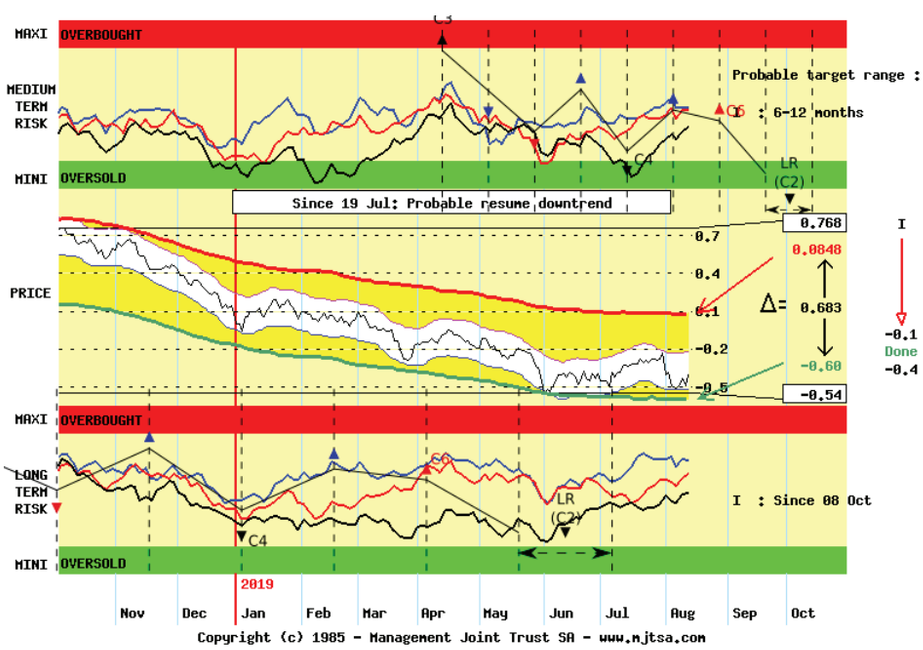
Last month, we looked into the yield curve, which we believed was starting to steepen. We also expected a correction down on risk assets towards late July / early August and considered that it could represent an opportunity to enter value and cyclical trades. This month, we review this theme in light of the recent market sell-off. Cyclical themes are indeed very Oversold, yet a bit more patience may be warranted before over-weighting them vs Defensive assets.

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



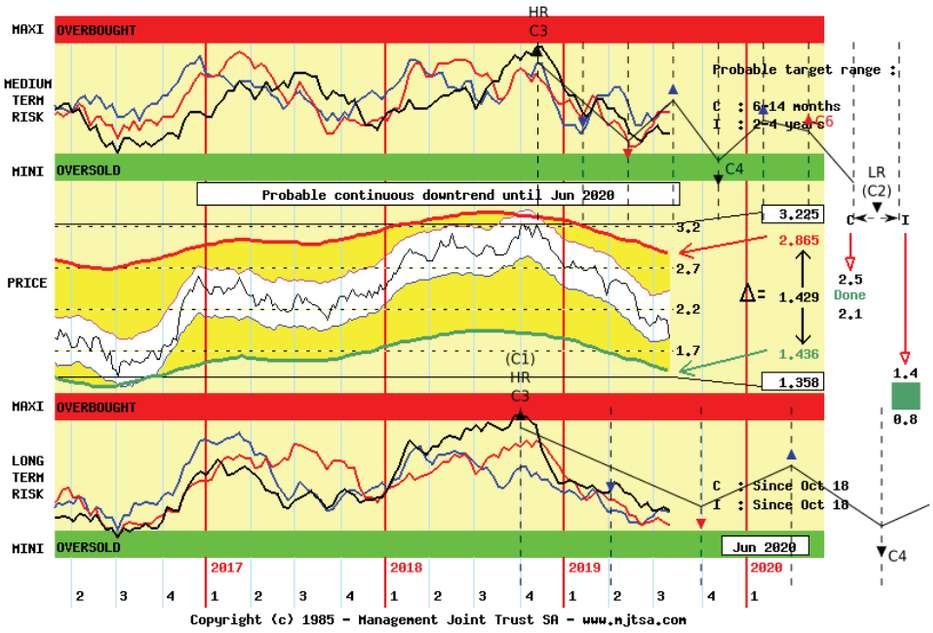
The short end of the US yield curve is probably the most sensitive to a rise in cyclicity. Indeed, when the US3M captures anticipations of futures rate policy, restrictive or lenient, the US3Y represents the most liquid portion of the US yield curve, where most of new emissions are priced and Flight to Safety flows can find a home in period of market stress. **This differential started to bounce early June from an intermediate Oversold position**. The downtrend was temporarily exhausted as it had reached our I Impulsive targets to the downside (right-hand scale). According to both our oscillator series (lower and upper rectangle), **this bounce could continue towards September (upper rectangle) and possibly towards November / December (lower rectangle). This is the time window we currently expect for a potential cyclical bounce. It is relatively short.**

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



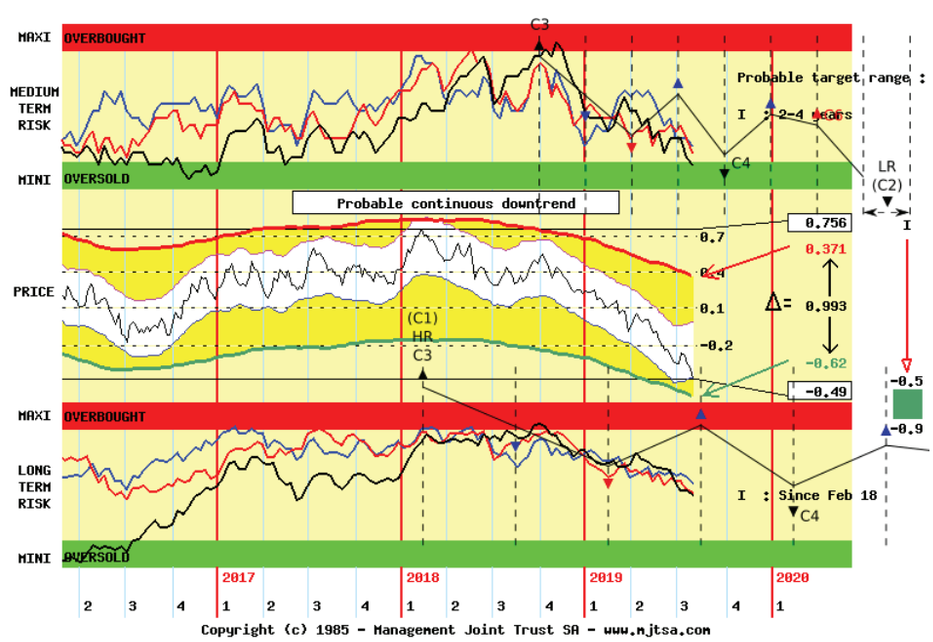
Shorter term, the US3Y-US3M interest rate differential is currently retesting down. On our long term oscillators (lower rectangle), it had reached a Low Risk position in June, well below our I Impulsive targets to the downside (right-hand scale). Hence, **despite the current downside retest, the Daily downtrend is still very much exhausted, and its downside potential over the next few months is probably limited**. Nevertheless our medium term oscillators (upper rectangle) do suggest **more downside retesting, probably into September. This would leave a rather short time window for a bounce between mid/late September and November/ December** (as mentioned in our Weekly graph above).

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



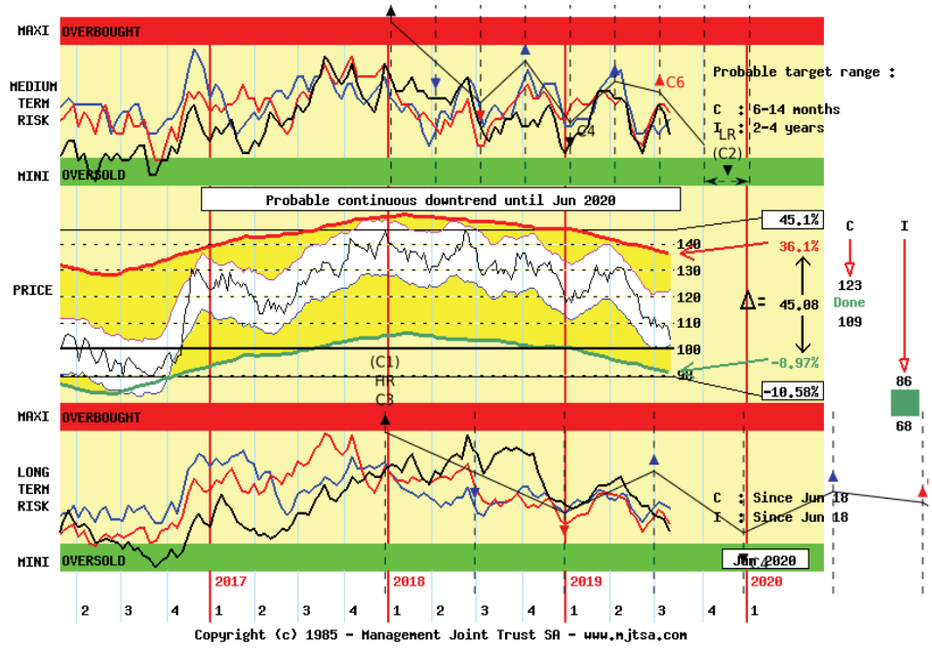
Cyclical sectors are quite sensitive to positive developments in the yield curve (steepening), yet they are ultimately a short duration play and hence do perform at their best when both yields are rising and the yield curve is steepening (as in H2 2016 or Q4 2017 for example). If one of these two factors is missing, Cyclical sectors may still outperform, yet to a lesser extend. Following their sell-off since last October, yields certainly appear very Oversold (on a Daily graph for example). Yet, for now, **this Weekly graph of the US 10Y benchmark bond yield still suggests further downside pressure, possibly towards late Q3 at least** on our long term oscillator (lower rectangle), potentially slightly longer on our medium term ones (upper rectangle). A bounce could then materialize into year-end and possibly late Q1, before a new downtrend resumes towards late 2020/21 and much lower levels (our I Impulsive targets to the downside pointing to the 1.4 – 0.8% range over the next 12 to 18 months; right-hand scale). Hence, here also, the time window for a cyclical bounce is quite short, between late Q3 / early Q4 and early next year. Combining these projections on US10Y benchmark yields and the US3Y-US3M differential above, this leaves **a time span between now (or more likely September) and late Q1 next year when at least one positive factor (rising yields and/or steepening yield curve) could help cyclical themes outperform.**

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



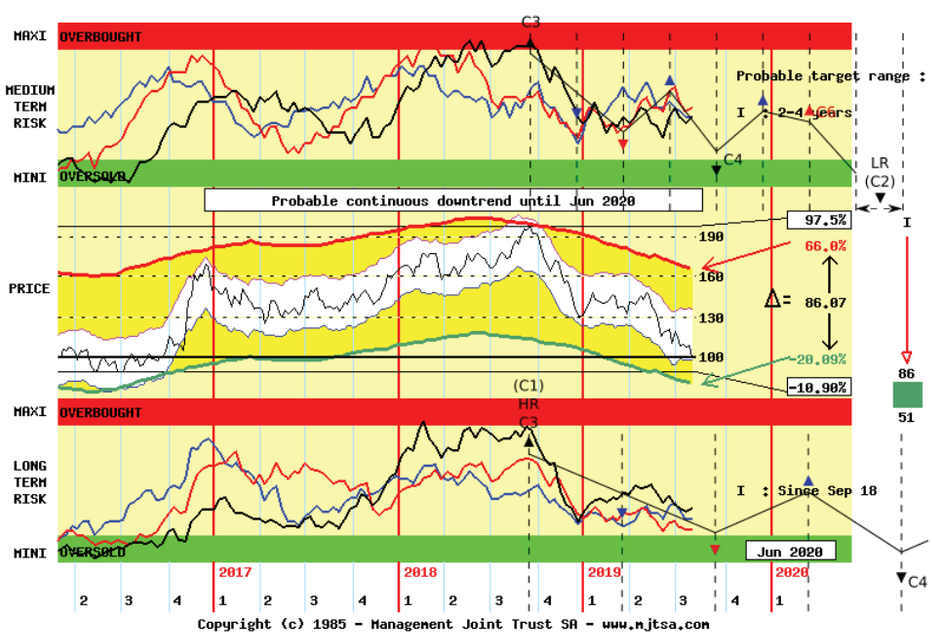
In Europe, the German Bund yield has been a downtrend for more than 18 months. While the sequence we show on our medium term oscillators (upper rectangle) also points to an intermediate low towards late Q3, and to a subsequent rebound into year-end / perhaps extending into Q1, our long term oscillators (lower rectangle) would suggest further downside pressure into early next year. Combining both, **we do expect a Q4/Q1 rebound, yet it will probably be more subdued than in the US**. This has indeed been the case over the last 3 years, when generally upside reactions in European yields have been more subdued than in the US. **Hence, a cyclical bounce may also materialize in Europe. Yet, on a relative basis, it will probably show less amplitude and persistence than in the US.**

Copper to Gold ratio
Weekly graph or the perspective over the next 2 to 4 quarters



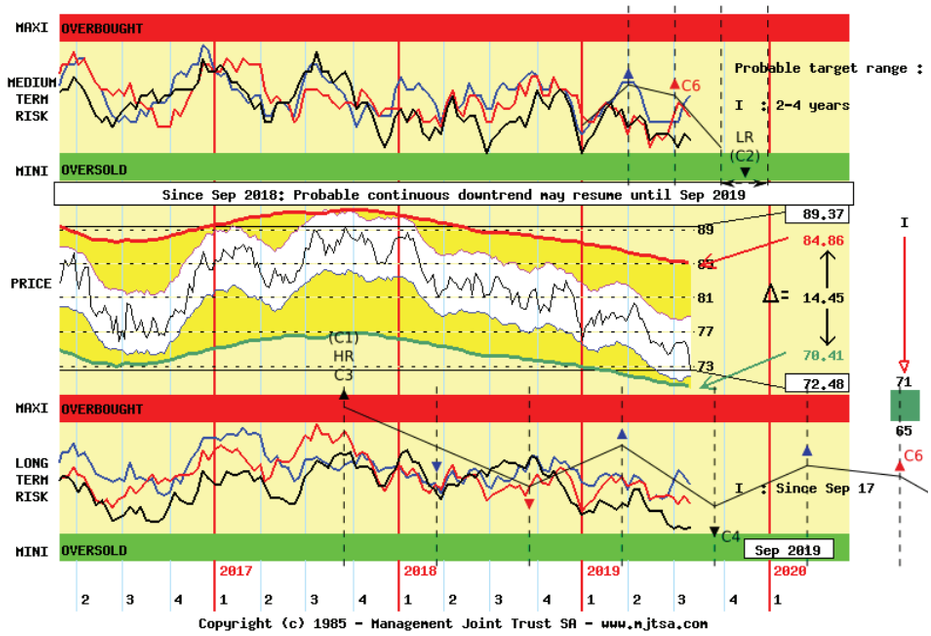
When talking about cyclical accelerations, or more generally reflationary vs deflationary influences, the Copper to Gold ratio is often used as a worthwhile proxy. Currently, the ratio may be skewed to the downside by specific geopolitical and monetary developments: the resurgence of the US-China Trade War (negatively affecting Copper) and the beginning of what could turn out to be a global easing effort by Central Banks (positively affecting Gold). Nevertheless, it is still an interesting gauge to follow to understand how cyclicity is reacting to these factors. For now, the trend is still heading lower and has recently broken through the support of our C Corrective targets to the downside (right-hand scale), opening the door to **much lower targets over the next 12 to 18 months. Both oscillator series would suggest that it could however find intermediate support into Q4 (upper rectangle), at worse into year-end (lower rectangle). The bounce that follows would typically last 3 to 6 months. Hence, from Q4, at the latest year-end, there could be a temporary bounce in reflationary factors vs deflationary ones.**

Diversified Mining vs Gold Mining
Weekly graph or the perspective over the next 2 to 4 quarters



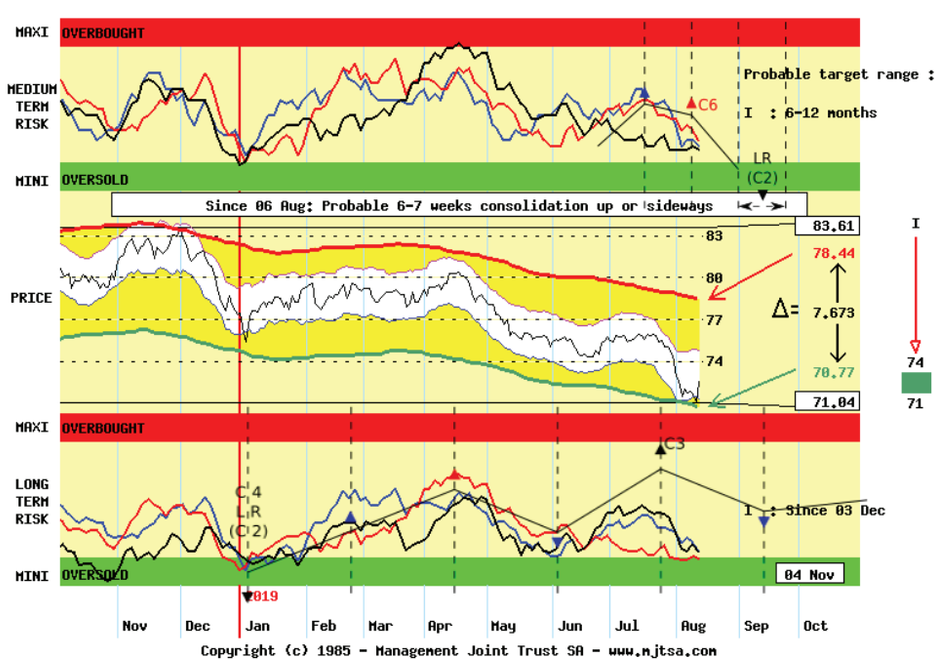
Similarly to the Copper to Gold ratio, yet possibly less influenced by geopolitical and monetary developments, we now consider the ratio of Diversified Mining companies (XME ETF) vs Gold Mining Companies (GDX ETF). On both oscillator series (lower and upper rectangles), **we can spot an intermediate low towards late Q3 on the ratio. The bounce that follows may last into late Q4, possibly even into late Q1**. Following that, the trend probably resumes lower towards late 2020 and according to our I Impulsive targets to the downside (right-hand scale) with more downside risk. In the meantime, however, a 3 to 6 months bounce may indeed materialize from late Q3.

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



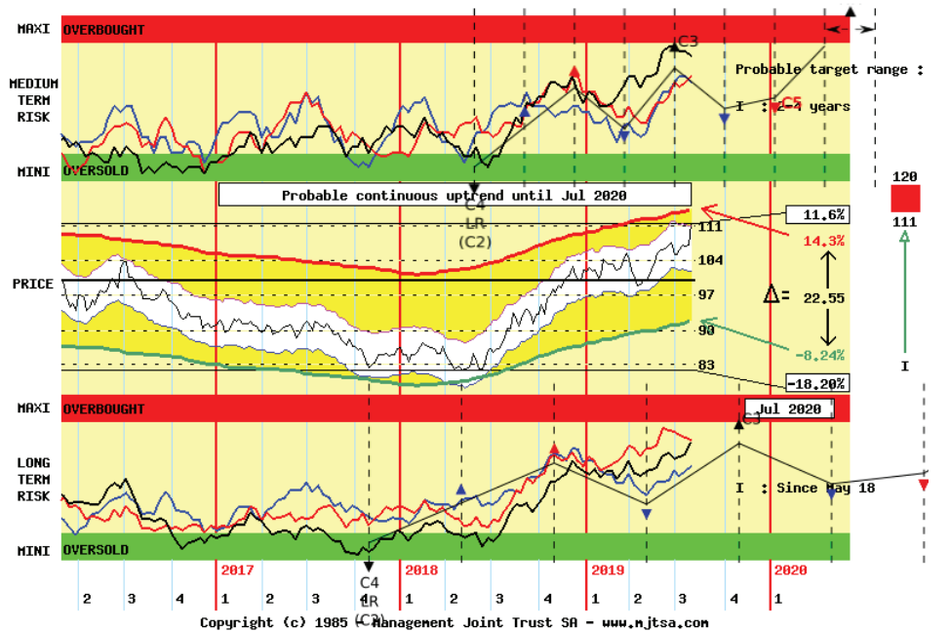
AUD/JPY has traditionally been an indicator of cyclicity in FX markets. Indeed, the Australian Economy is quite closely tied to its commodity exports to China, while the Japanese Yen is considered the ultimate defensive currency. Since, the recent resurgence of the US to China trade war, the pair has indeed been falling like a knife. Both oscillator series would suggest that the pair has further to drop short term, but **that its could find support during September on our long term oscillators (lower rectangle), possibly at the latest during Q4 on our medium term ones (upper rectangle). A 3 to 6 months bounce may materialize thereafter, which could confirm a period of increase cyclicity into year-end and perhaps early 2020.**

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



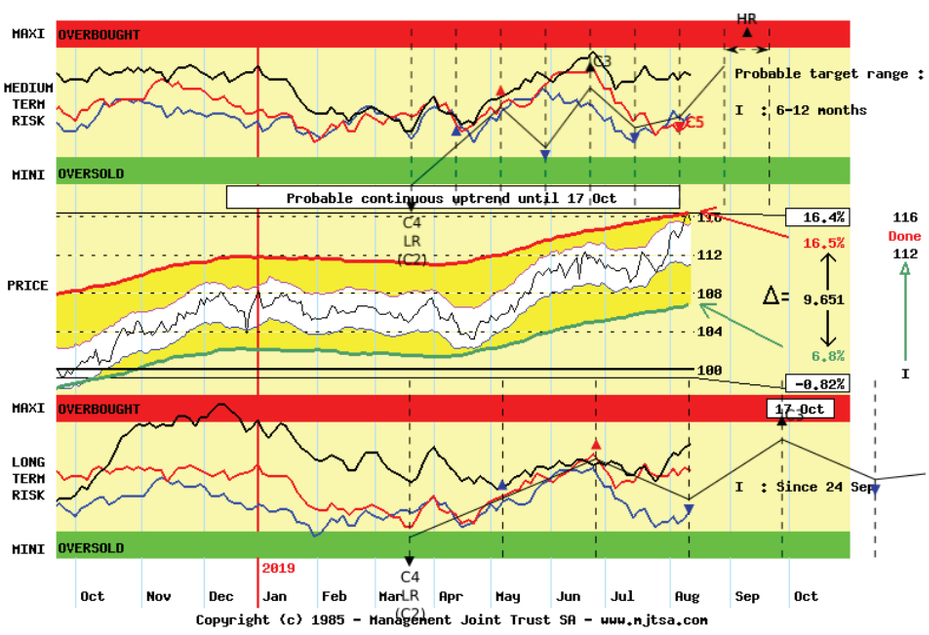
Shorter term, the pair already feels quite Oversold given the low level of our long term oscillator series (lower rectangle). Furthermore, this downtrend has now fulfilled our I Impulsive targets to the downside (right-hand scale), a sign of trend exhaustion. Yet, the sequences we show on both oscillator series (lower and upper rectangle) still seems to suggest **more downside pressure, probably into early/ mid September. We would hence expect AUD/JPY to retest down until then, and then start to bounce, in line with our analysis on the Weekly graph above.**

Swiss Market Index vs the Dax Kurs Index
Weekly graph or the perspective over the next 2 to 4 quarters



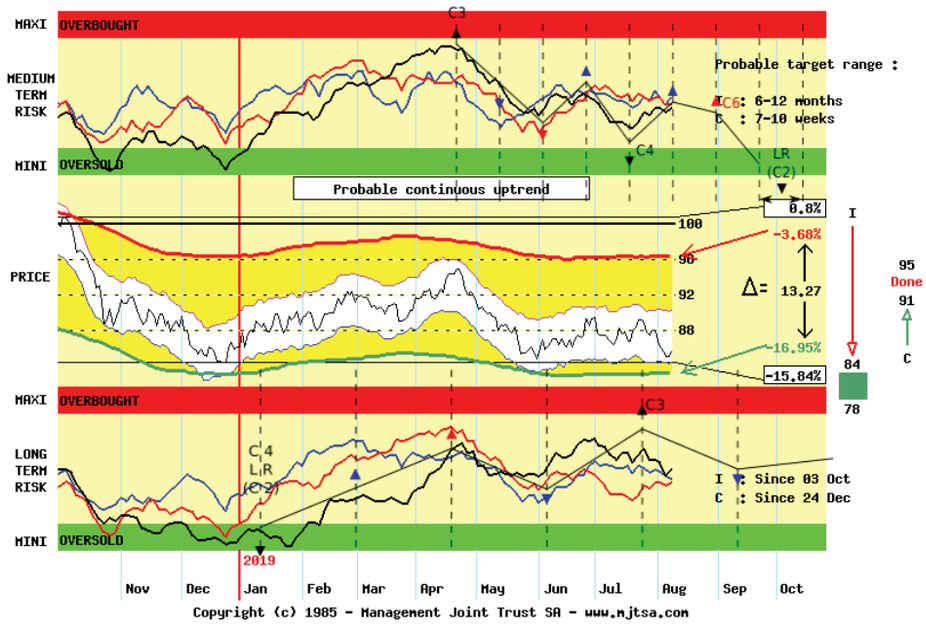
On a geographical basis, we now compare defensive Switzerland (a market denominated in a defensive currency and with large exposure to the Healthcare and Food & Beverage sectors) to the German Dax (an economy mostly driven by exports of cyclical goods). In the last issue of The Capital Observer, we were expecting Swiss equities to top out vs European ones and possibly retrace down into year-end (lower rectangle). Yet, this retracement has for now not materialized. This graph offers a possible explanation with two uptrending sequences running through it. One which started in mid 2018 and which recently made an intermediate top (upper rectangle), another which started in Q4 2017 and could still rise into October before correcting down towards early next year. **Such situations with multiple uptrending sequences are usually a sign of a strong uptrend, yet they do leave a short window between early Q4 and early next year when the SMI may momentarily underperform the DAX.**

Swiss Market Index / Europe Stoxx 600 Index
Daily graph or the perspective over the next 2 to 3 months



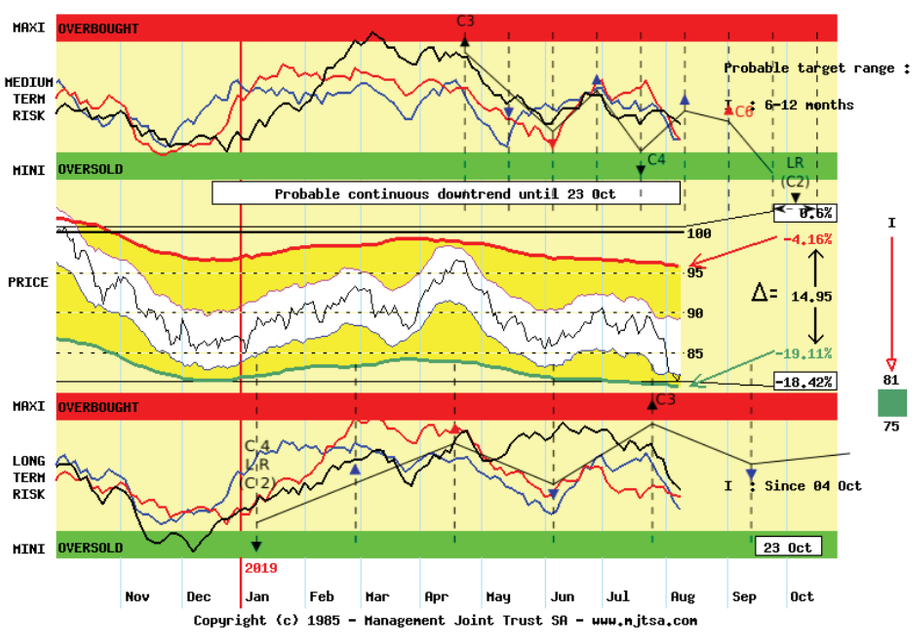
Given this information, we now consider the Daily graph of the defensive Swiss Market Index vs the general Europe Stoxx 600 Index. The uptrend on this ratio has now reached our I Impulsive targets to the upside (right-hand scale) so that the upside potential is relatively limited. On both oscillator series (lower and upper rectangles), however, **the SMI probably extends higher vs the Europe Stoxx 600 towards mid/late September. This projections implies that the current defensive environment may continue until then.**

US Cyclical vs Defensive Sectors
Daily graph or the perspective over the next 2 to 3 months



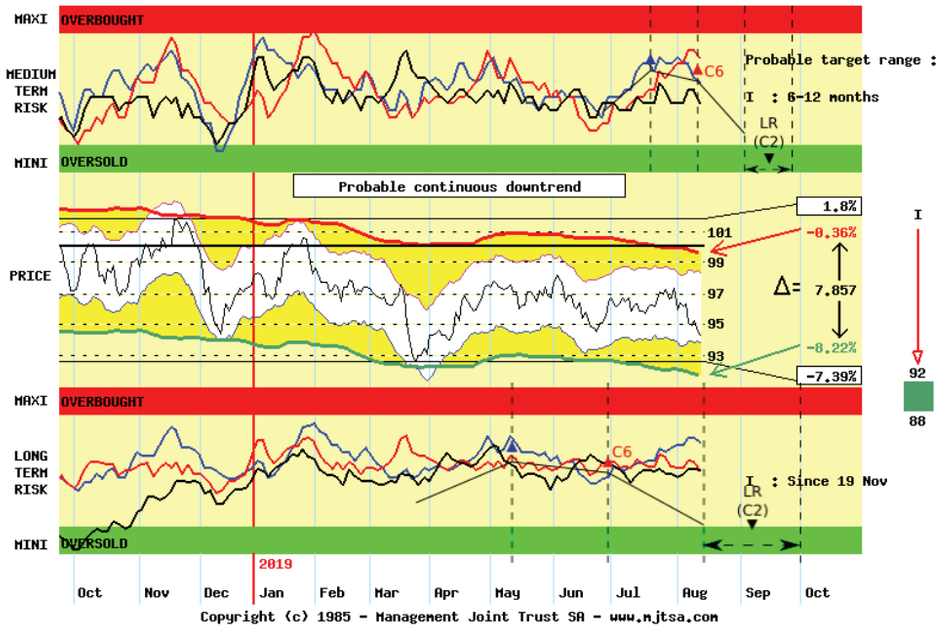
Moving into the sectors, we compare an equal weighted portfolio of US Cyclical sectors (Industrials, Materials and Energy) vs a Defensive one (Staples, Healthcare, Utilities, Telecom and Real Estate). Last month we had expected Defensive sectors to bounce one last time vs the S&P500, while Cyclical ones could see one last period of underperformance. The strength of these moves has however surprised us, and today, when comparing both extremes (Cyclicals vs Defensives), we believe that the current Defensive environment may extend a while longer. Both our oscillator series on this ratio (lower and upper rectangles) indicate that **Cyclicals may indeed underperform Defensives slightly longer into mid/late September, perhaps early October. The downside potential until then is still relatively compelling, between 3 and 10% according to our I impulsive targets tot the downside. Following that, Cyclical sectors could start to outperform into Q4.**

European Cyclical vs Defensive Sectors
Daily graph or the perspective over the next 2 to 3 months



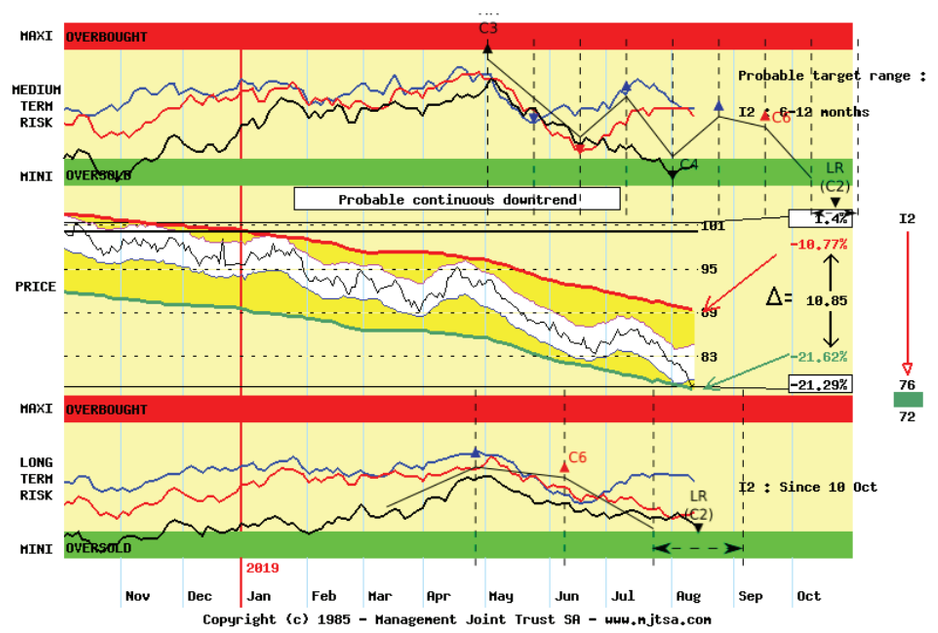
We perform the same analysis in Europe and compare an equal weighted Cyclical sector portfolio (Automobiles, Chemicals, Basic resources, Energy) vs a Defensive one (Food & Beverage, Healthcare and Utilities). The resulting ratio is very similar to the one above on US markets. Here also, we would expect **a further period of cyclical underperformance into mid/late September, perhaps early October, before Cyclical sectors start to outperform again into Q4. According to our I Impulsive targets to the downside (right-hand scale), the remaining downside potential here is between 2 and 8%**

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



We finally look at the Financials sector. The ratio featured here compares the US S&P Financials sector vs the S&P500 Index. Since late March, the ratio has managed to bounce and hold its gains. That said, the sequences we show on both oscillator series (lower and upper rectangles) suggests that **the risk of a further downside retest is still possible, potentially towards early/mid September**. According to our I Impulsive targets to the downside, this underperformance risk is between 4 and 7% (right-hand scale). Following that, US Financials could start to outperform the S&P500 into Q4.

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



Looking at the European Banking sector vs the Europe Stoxx 600 Index, the ratio is now very Oversold. Our I Impulsive targets to the downside have also been reached (right-hand scale). According to our medium oscillators (upper rectangle), we would probably expect an initial bounce towards late August. Yet, **we would still be cautious of a further sell-off during September and possibly early October**. This is in line with what we expect on other cyclical sectors. Further, as shown on page 30 of this issue of The Capital Observer, the Weekly graph of European banks still looks quite ugly.

Concluding remarks:

Cyclical themes tend to outperform defensive ones and the general market in an environment where the yield curve is steepening or yields are rising, ideally both. This is because of the short duration feature of their cash flows. Last month, we expected the US yield curve to start to steepen in August following a sell-off towards late July (we use the short term US3Y-US3M spread as a proxy to monitor such reflationary trends). We then also believed that this sell-off in the yield curve, and more generally risk assets, could present a buying opportunity for Value and Cyclical themes. The sell-off has since materialized and has been quite strong, yet, for now, we would probably wait a few more weeks before switching from Defensives into Cyclicals themes. Indeed, the US yield curves and US Treasury yields have mostly made new lows and we believe that they are likely to continue to retest down into September, potentially early October. Furthermore, the Cyclical/Defensive ratios we monitor in this article all seem to point to late Q3 as a possible inflection point. Following that, we expect a more friendly environment for Cyclical assets, potentially towards year-end and perhaps Q1 2020.

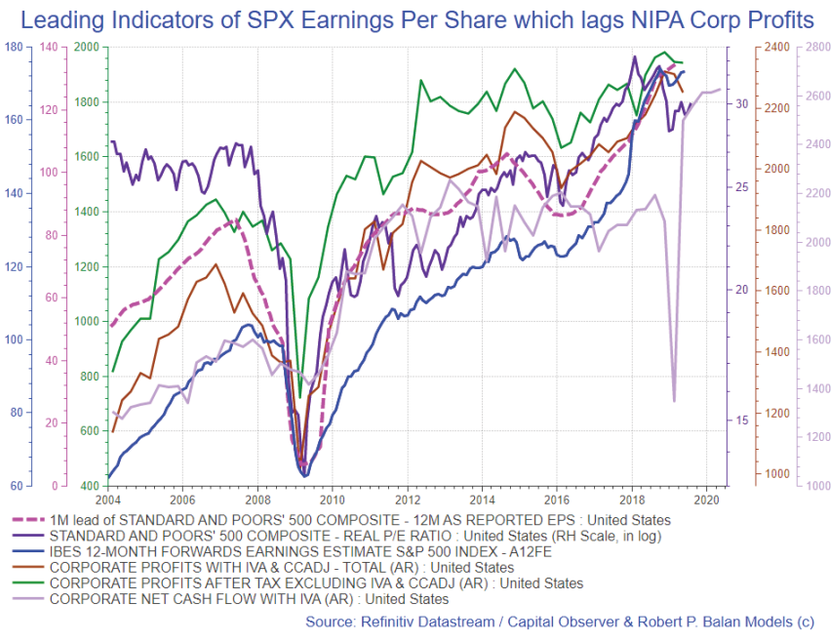
22 / The S&P500 has entered is corrective phase and the yields are pursuing their decline: when, and where will this end?

The last time we discussed the US equity markets, we focused on the consensus S&P 500 earnings forecasts were still materially too high for both the second half of 2019 and 2020, which is why we believed that we were looking at a correction phase in equity prices. This is what we said in the July 2019 Capital Observer: :

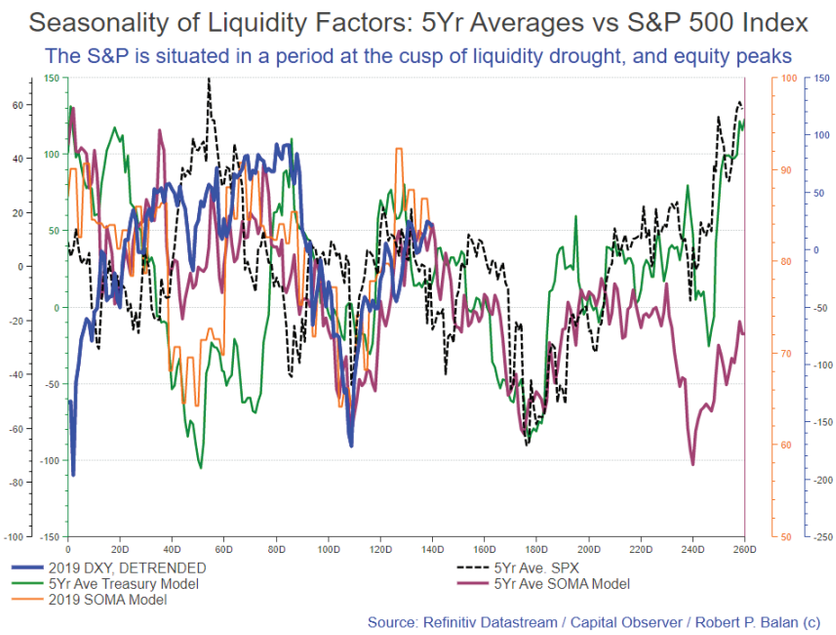
Analysts have been fretting about the results expected to be reported by the corporate world this earnings season, that there is the possibility of poor earnings at this time. Analysts estimate S&P 500 profits in the Q2 contracted 4.2% from a year earlier, according to FactSet. They expect that will be also followed by slow growth in the third quarter. That puts the broad index at risk of continuing poor earnings growth — the case if there is two or more consecutive quarters of declining earnings (see 1st chart on this page).

The fear of many analysts will likely be borne out – NIPA corporate profits are still climbing out of a well, caused by a massive flash crash of NIPA corporate net cash flow about a year ago (see 1st chart on this page). That will likely crimp earnings during this season, and the next one. Disappointment with earnings could be a catalyst for a move lower for the S&P 500 in the short-term (next few weeks), which is also being flagged by our liquidity models . . . the five-year averages of the liquidity sources from the Fed and the Treasury are all showing the market to be at the cusp of a veritable drought until late September. We believe that weak earnings plus drying up of systemic liquidity are enough to offset the positive sentiment and buzz that has been generated by the outlook of Fed rate cuts in the immediate future.

Original chart from July 2019 Capital Observer



Original chart from July 2019 Capital Observer



Our conclusions in July 2019: Based on these models, the S&P 500 should fall until early August, rebound, then fall until September, when we believe falling activity in the US will bottom.

Our conclusions in the July Capital Observer seem to be on track, and we are confident that this scenario will continue to describe future market action, right until the market bottom, which is expected in September.

A series of jackhammer blows felled the markets after the Fed cut rates

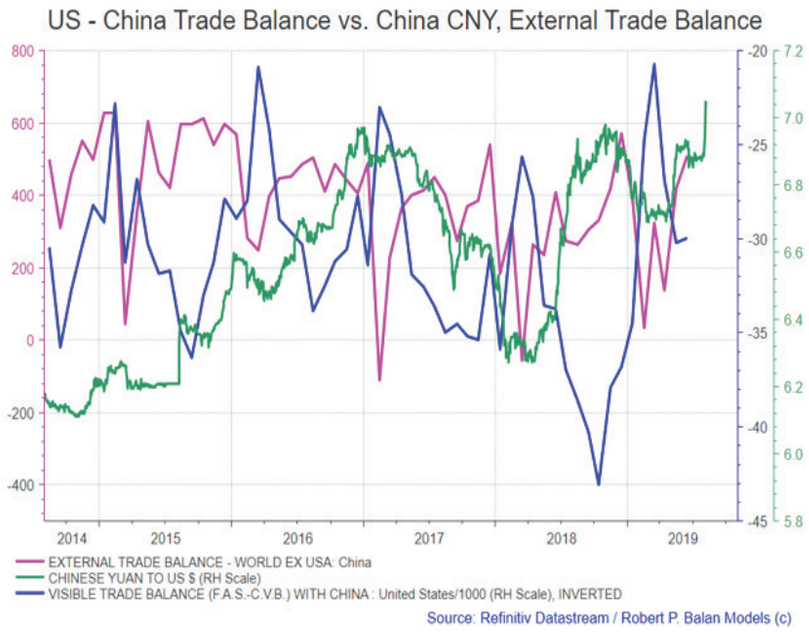
We explained in previous issues of the Capital Observer that falling bond yields have been responding to the imperatives of declining growth, which we expect to bottom in Q3, this year.. The rising stock market, on the other hand, has been responding to hopes that the Fed cut rates, in response to the dismal

growth prospects which they believe face the US and global economy. The point was that the enthusiasm of equity investors was based on expected bad news, but the Fed can only do so much until those expectations are born out. **The reality was that central bank won't be able to cut much in the face of still robust jobs situation. Therefore, any "insurance-based" rate-cut regime will be token at best. And that, indeed, came to pass**.

There were large moves in equities and yields early in the next week following the sell-off which started with the Fed's underwhelming 25 basis points rate cut On July 31. Those declines were further reinforced by President Donald Trump's imposition of new tariffs on a batch of China's export to the US. The markets were further hammered when China allowed the CNY to fall below its 7.00 valuation versus the US Dollar, and that is also on top of the escalation of the turmoil in Hongkong. The sharp devaluation of the CNY inflicted a lot of damage to market sentiment. Yields and all risk assets fell; gold and the rest of the Precious Metal sector soared. The S&P futures were also down heavily after the New York market closed on the Monday following the rate cut.

The critical point about the breach of 7.00 in the USD/CNY FX rate was the fear of market traders that a currency war was about to explode. But that's an over-reaction to something that has been simmering under the surface for a while. **A currency war has been brewing since QE was implemented globally and competitively by central banks in November 2008. What is new is China's overt participation in a currency war -- but that too should not be a surprise. China has been managing the CNY lower since the country joined the World Trade Organization (WTO); the CNY's supposed undervaluation has been a constant irritant with its trading partners. But in this new case, China had no choice -- it had to devalue quickly.**

China's CNY devaluation is self-preservation



If China cannot sell to the US, then it will sell to the Rest of the World. Therefore, it must have a very competitive currency to do that. China-US trade balance has fallen significantly since Q1 this year, although it has already stabilized. But China's trade deficit with the rest of the world is actually increasing (see graph above). What the US is not buying, the rest of the world is purchasing. For China to sell well to the RoW, the CNY has to very competitive. China has been able to sell to the RoW because of the progressively weaker domestic currency. There is actually nothing wrong with total world trade from this perspective -- the slack between US and China trade is apparently being made up for by China's increased trade volumes with the RoW. **Therefore, the impact of a currency war, if it comes to that, would not be as big a jolt to the global economy as feared by many.**

China and US step back from the brink

For a few hours on that Monday, it looked like the FX traders' worst nightmares were coming true. But China actually walked back from the brink later in the day, by guiding Tuesday's CNY fixing above 7.00. The USD/CNY rate has been steadily falling since then, and with it, risk assets and yields correspondingly rose. We speculate that China intended the 7.00 breach as a warning shot, but the US Treasury responded very quickly with an even more emphatic warning shot of their own by branding China as a currency manipulator. That carries big, possible repercussions to China within the World Trade Organization if the US pursues a redress process. With China's move to guide the CNY back above 7.00, and by desistance of the US Treasury from pursuing the matter further, the world was given respite from the jackhammer blows that were dealt the markets since the Fed underwhelmed market expectations on July 31.

If the fears of a currency war and the deleterious impact it has on world trade are baseless, then the genesis of the current market sell-off does not have structural roots. If, so forecasting the events which follow the sell-off becomes more tractable. Off-hand, a significant part of the market damage seems to have been caused by market sentiment's rapid rise to panic. All of this is happening during a periodic systemic liquidity drought, which is further exacerbated by bond market travails due to the US debt ceiling cap.

With Armageddon stayed, liquidity models can do their job properly

Put another way, if there are no state sponsors which are proactively involved in tangential destruction of the markets, then normal analytical tools should be able to project what could happen

next. **The tools we speak about include the seasonality profile of systemic liquidity flows from the Federal Reserve and the US Treasury.**

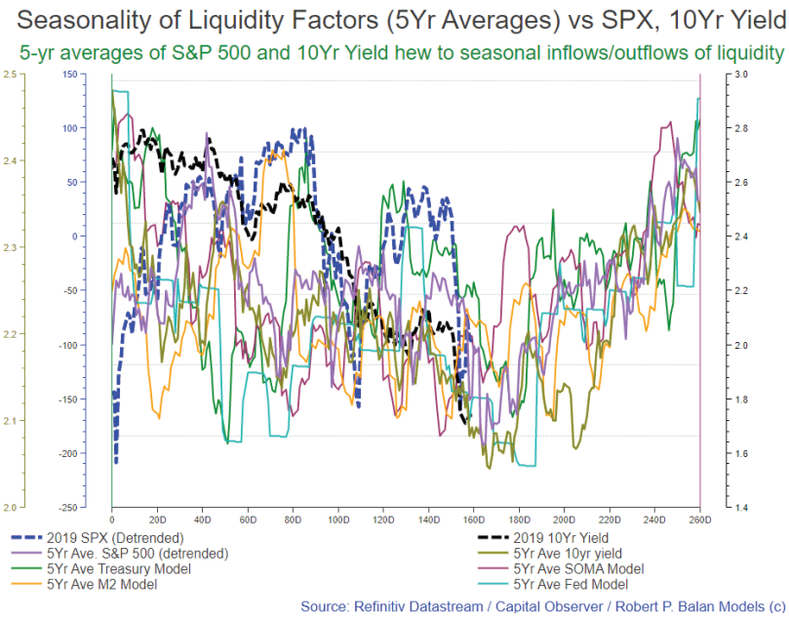
Systemic liquidity models, in this instance, the liquidity flows from the NY Fed's **SOMA transactions, and the US Treasury's Cash Balances at the Federal Reserve comprise the bulk of "money" which greases the skids of the asset markets. Our work has shown that those flows have a tremendous impact on the high-frequency turns of the major stock indices (and bond yields).** The impact of the liquidity flows is consistent historically, and since the seasonality of the release in liquidity is constant, year-in and year-out, models can be devised to anticipate their impact on asset prices (*see 1st chart on this page*).

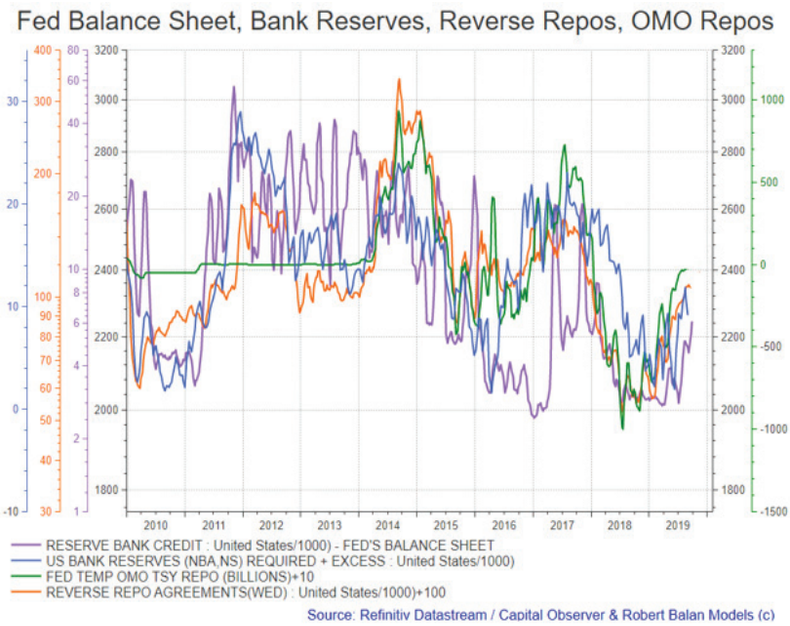
Systemic liquidity flows are important to banks

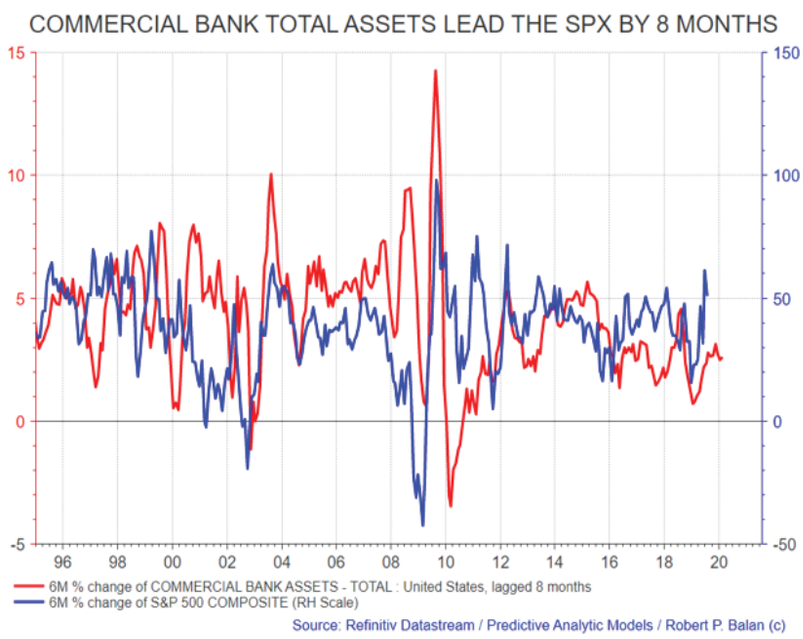
In many respects, the ebb and flow of money from the US Treasury and the Fed, into and out of the US financial system, have even more immediate consequences on risk assets than the manipulation of the policy rate rates (Fed Funds Rate), which is a blunt and slow-acting instrument.

For one, the Fed's Balance Sheet, and the Bank Reserves (Required+Excess) determine the underlying costs of Temporary OMO Repos and Reverse Repo Agreements, and the structure of various term (money) market rates (*see 2nd chart on this page*).

These flows fund the US shadow banking sectors' collateralized borrowing and lending—in particular, repurchase agreements (repos) and reverse repurchase agreements (reverse repos) -- transactions in which the borrower of funds provides securities as collateral. These short-term borrowing transactions help commercial and investment banks adjust the leverage of their balance sheets (Adrian, Shin 2008). Adrian and Shin defined "leverage" as the ratio of total assets to equity (net worth). Changes in the banks' leverage has a large impact on risk assets like equities. **In fact, changes in aggregate commercial bank total assets is a reliable gauge of how the S&P 500 Index performs in about 8 months** (*see last chart above*).







Laying the analytical groundwork in the July 2019 Capital Observer

In the final analysis, the utility of systemic liquidity flows depends on how the information they provide can help the investor navigate around what we call "liquidity sink holes" distributed in the financial calendar. The well-defined seasonality of liquidity ebb and flow can provide a roadmap to avoid, or in most cases, actually benefit from those flows. For instance, the stock market sell-off in August, right after the Fed underwhelmed market expectations, has been flagged in advance by the very well-known seasonal liquidity drought from early August to early September *(see second chart of this article*).

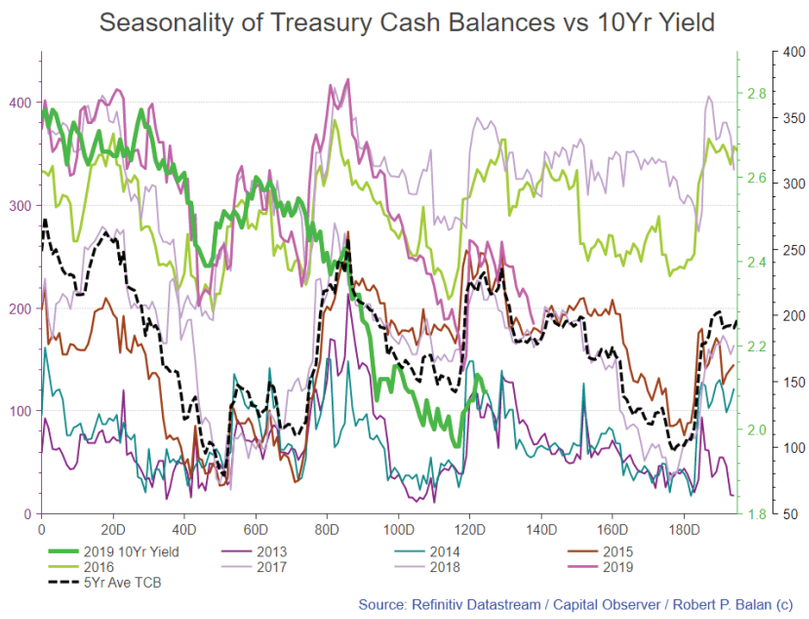
The liquidity models also called the sharp decline in yields following the Fed's rate cut. We documented this possibility, saying that:

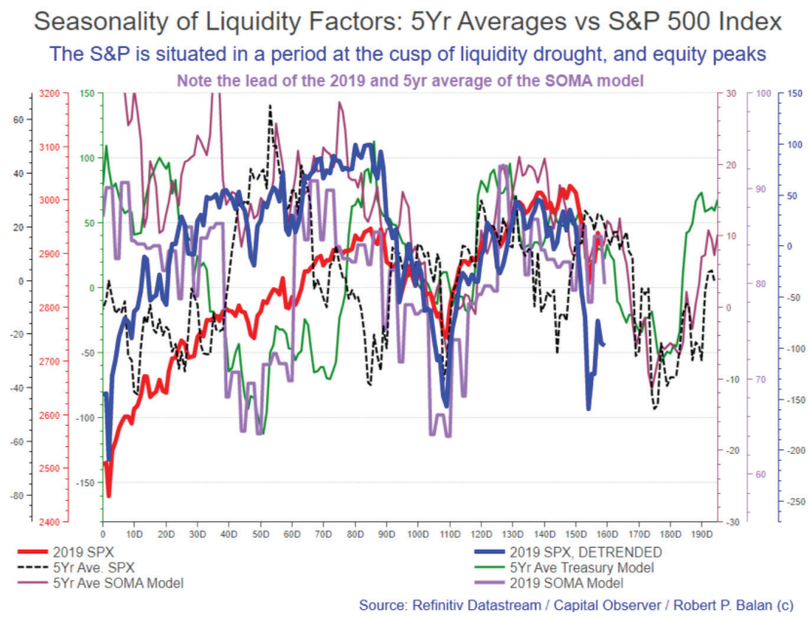
Bonds yields are at the cusp of falling further, and this is illustrated by the impact of declining Treasury Cash Balances from here until late September (*see 1st chart on this page*).

We have been tracking the covariance of the Treasury Cash Balances and the long bond yield for many years, and there are only very few times when yields deviated very much from the seasonality of the largesse from the US Treasury. Given likewise the drought of securities from the ongoing Debt Ceiling Crisis, it really makes sense to assume that yields will be falling from here until late Q3. What that does to equities, once this obsession with the Fed cuts wane, is probably to undercut stocks. We believe that theme will result in a re-convergence between stock and bonds, and most of the adjustment being done by equities.

In July, we expected the ongoing sell-off to bottom during the first week of August; followed by a rebound on the upside correction (which the market is doing now), then finally, further sell-off until the first week of September. These updated graphs reaffirm those forecasts(*see 2nd chart on this page*).

Original chart from July 2019 Capital Observer





The weekly SPX change covaries well with weekly changes in SOMA Model. The high-frequency analysis mentioned above includes a numerical decomposition of both the SPX, and the SOMA Model. Per this model, , this high-frequency approach already flags a sharp sell-off in equities after August 20.

We expect to see again the lows seen in the SP500 in early June -- that would be at circa 2730. The market could even have some slippage below that, but that is the appropriate downside target in the current down correction in equities.

It also happens that the current yield (2019 10yr yield) is tracking the 2015 yield performance very well. We have been keeping an eye on it for a while, and we believe it is a good template for what to expect for the 10yr yield this year (*see the 1st chart on this page*).

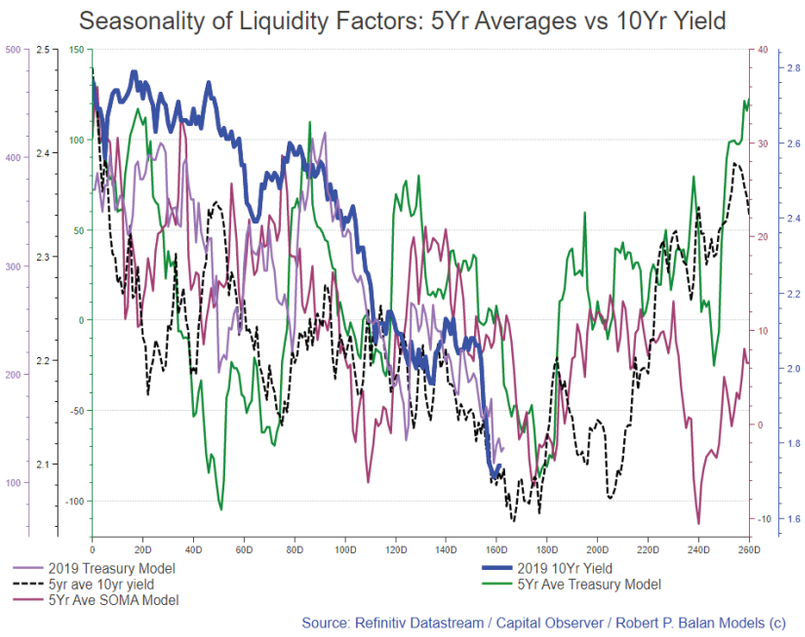
Conclusion: Happier times in Q4 with systemic liquidity on steroids

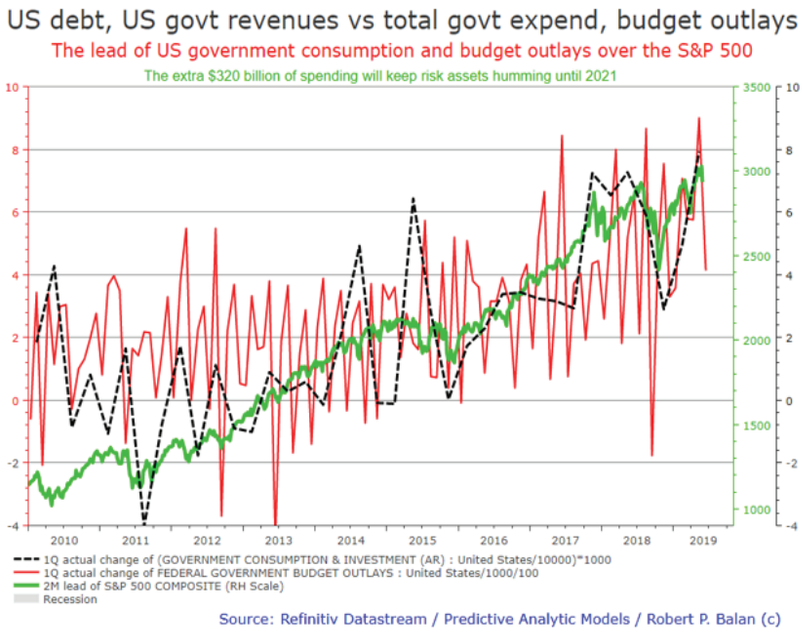
By Q4, yields and equity markets should be upwards bound, as the Treasury and the Fed, at that time, build-up cash balances for the forthcoming Christmas season, and year-end demands for cash by enterprises and the private sector. Moreover, Mr. Trump and Congress just agreed on another round of two-year spending that will be larger than recent years. Talk about ultimate systemic liquidity, on steroids. That should be excellent for risk assets, but bad for bonds (*see 2nd chart on this page*).

The last quarterly change in the federal gov's outlays was actually negative, and it is probably contributing to the misery that the market is feeling right now. **But we are very certain that the next quarterly change up will be positive, and that should help drive the markets higher from whatever lows we may see over the next few weeks.**

We should have a nice year end stock market rally this year !

The 10yr yield looks headed for %1.6, or even slightly lower.





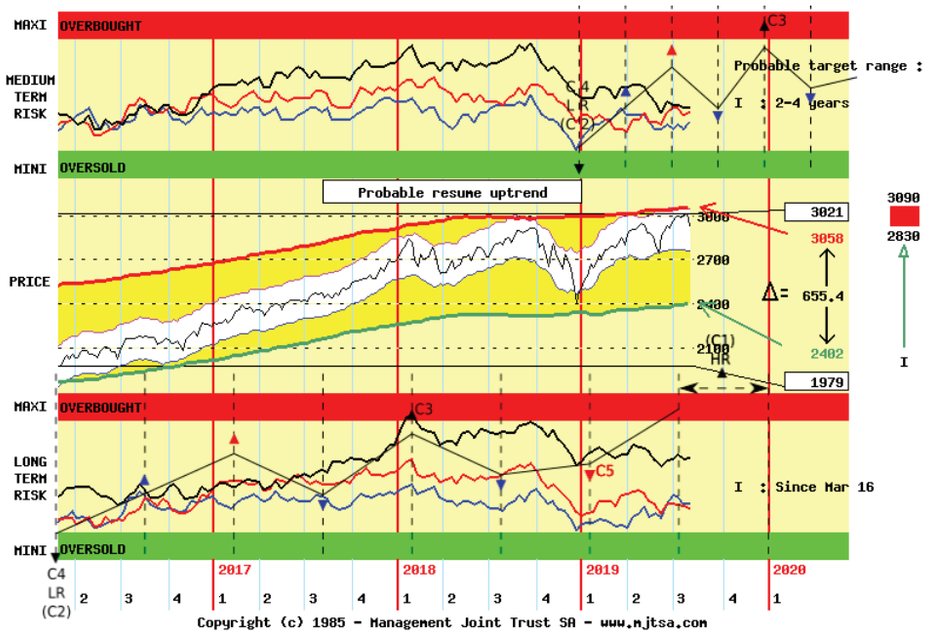
27 / MJT - TIMING AND TACTICAL INSIGHT

Monitoring the current Equity Market Correction

Last month, in our July issue, published on the 15th of July, we were rather prudent on equity markets. Our assessment was that at levels above 3'000 on the S&P500 and above 3'500 on the EuroStoxx 50, equity markets were fully priced for now. We then believed that a 3 to 5 % downside risk could materialize towards late July / early August, probably on the back of disappointing earnings as well as the possibility of that the FED could turn out slightly less dovish than the market expected. As we write, the S&P500 is around 2'850 and briefly reached circa 2'780 overnight on Monday evening, the 5th of August. This was slightly lower that we had originally anticipated, and in fact, the sudden resurgence of the US-Chinese Trade War did surprise us. In this article, we review the situation on main equity markets, attempt to identify short term support points as well as assess medium term perspectives into year-end.

S&P500 Index

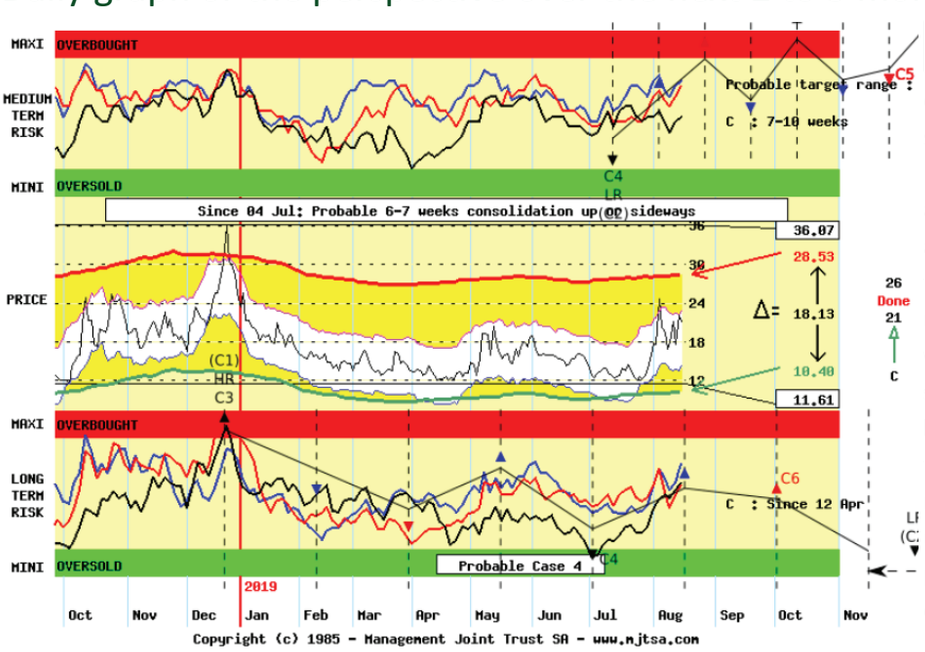
Weekly graph or the perspective over the next 2 to 4 quarters



Looking at the Weekly graph of the S&P500 Index, we can first note that the current market correction is starting from an extended market position. Indeed, over the last couple of years, our thinner white envelope made contact several times to the upside with our wider yellow one (middle rectangle). Such situations pointing to multiple exaggerations to the upside in an uptrend usually signal that the trend is getting exhausted, and that it might start to reverse down. Our price targets also suggest a certain degree of exhaustion. Indeed, our I Impulsive targets to the upside (right-hand scale) have been reached. Their upper end could still justify levels towards 3'090 (even 3'200 on the Daily graph on the next page), but in the wider perspective of things, this is limited medium term reward for the risk of suffering a major reversal. On the oscillator front (lower and upper rectangles), the situation is less dire. Our long term oscillators (lower rectangle) still suggest the possibility of a continuation of the uptrend towards year-end, while our medium term ones (upper rectangle) point to some consolidation into late Summer, but do not exclude a last push higher into year-end. **For now, certainly a delicate situation which probably calls for prudence over the next month or so, but no confirmation yet that a long term reversal to the downside is underway.**

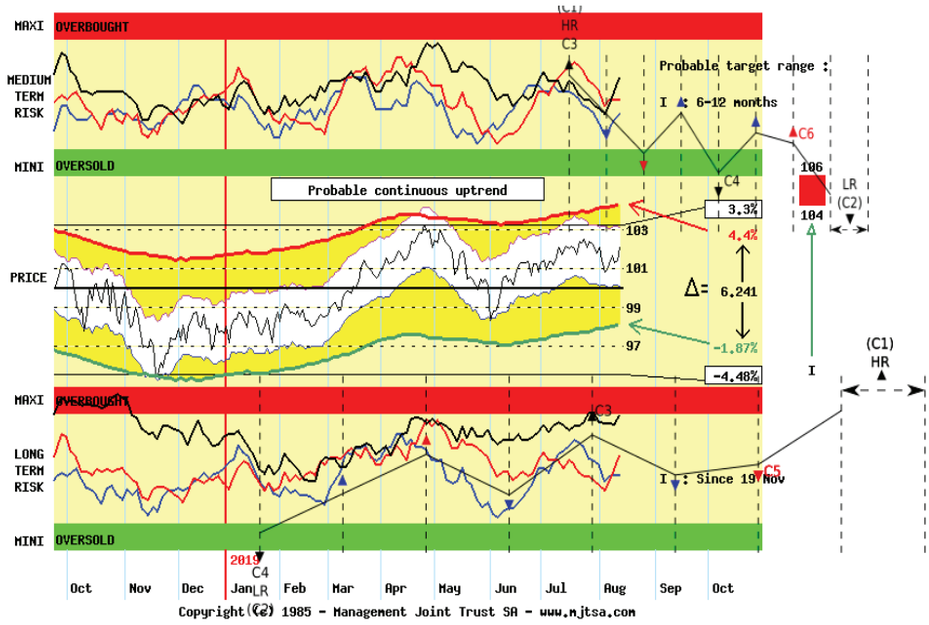
VIX CBOE Volatility Index

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



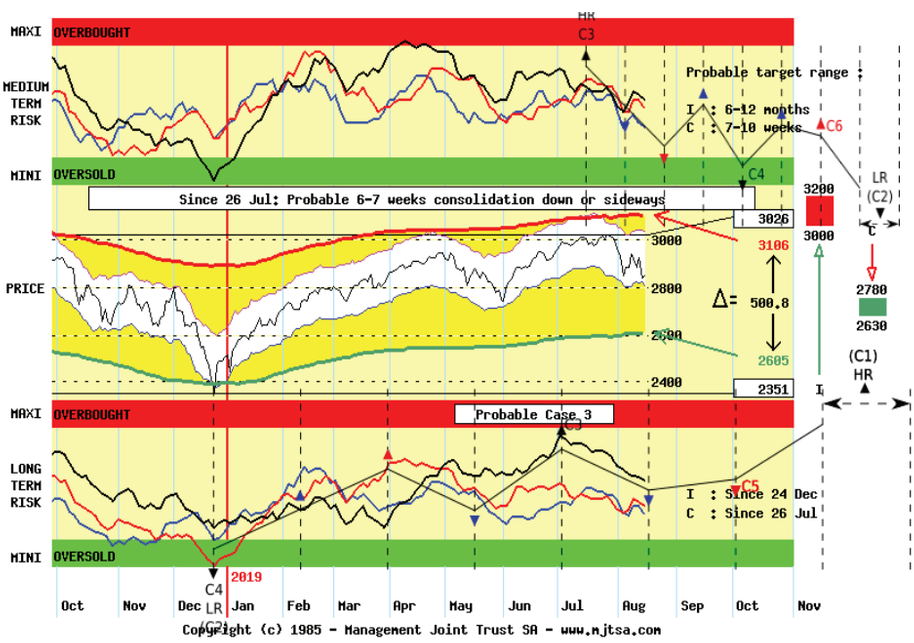
Forecasting VIX using our oscillators does call for some approximation. Yet, these do help us identify Overbought and Oversold conditions as was the case last month. For now, both our oscillator series (lower and upper rectangles) are still mid range and the sequences we show, suggest further upside pressure into late August, perhaps then again during September. **This would suggest that the current equity sell-off is still underway, possibly into late August in first instance**. On the target front (right-hand scale), a break above the resistance of our C Corrective targets to the upside (i.e. above 26) would probably imply further upside potential and possibly a deeper equity market correction.

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



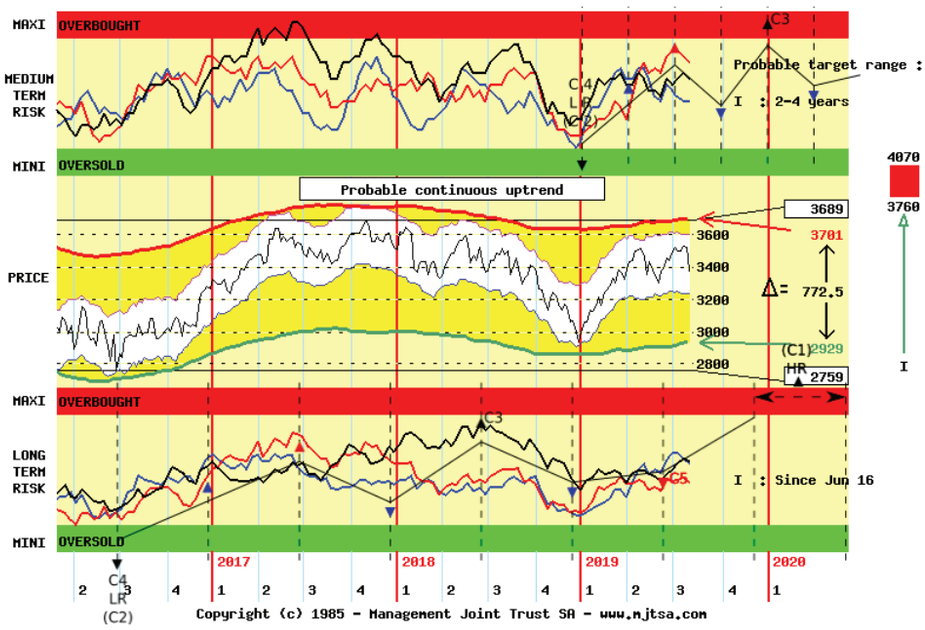
Another factor, which may weigh on US equity markets going forward is that they may have lost their big Tech/Growth leadership. Indeed, looking at the ratio of the Nasdaq 100 vs the S&P500 Index, we can note that it did not make new highs in July. On our medium term oscillators (upper rectangle), the ratio could find support towards mid/late August, yet may then correct down again during September, while on our long term oscillators (lower rectangle), the sequence we show suggests a more linearperiod of underperformance, into mid September at least. **Our view is that the Nasdaq 100 will find it hard to outperform strongly and durability over the next couple of months, and this may translate into a lack of upside leadership during this period** (on the other hand, cyclical stocks are still trying to build a base on a relative basis, see first article in this issue of the The Capital Observer).

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



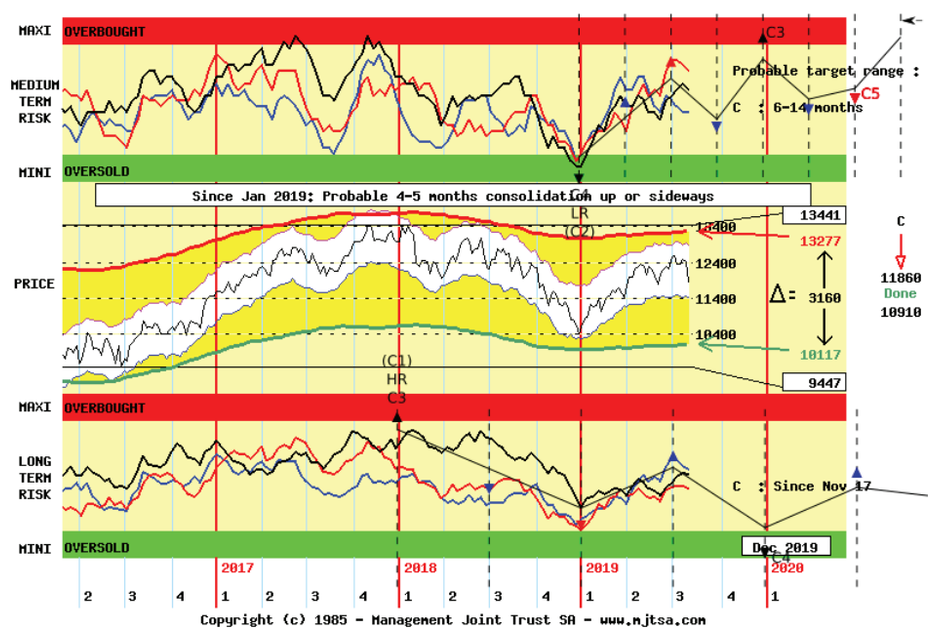
Given the above, we remain prudent on the S&P500 in the near term. On both oscillator series (lower and upper rectangles), we believethat the S&P500 should find support towards August, yet may still retrace down one last time during September (probably with higher lows). Impulsive Upside potential 3 to 6 months out could still justify a rally into the 3'200s (right-hand side). Yet, in the meantime, the S&P500 may first revisit our C Corrective targets to the downside between 2'780 and 2'620. **We would hence remain defensive, probably into late August in first instance, and then again, potentially into late September as an initial rally could see further downside retests**. Following that, developments on the macro or the Central Banks policy side may provide justification for a stronger rally towards year-end.

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



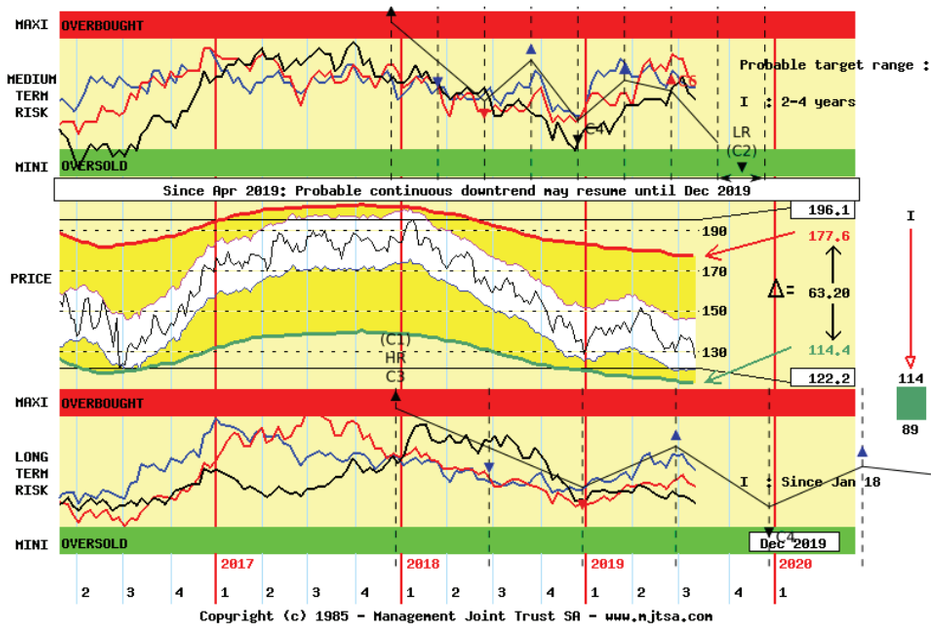
We now switch to Europe and the Weekly graph of the EuroStoxx 50. It is showing similar features than the S&P500, although it is harder to consider its trend as a clear uptrend yet. Hence, although not impossible to achieve, we are dismissing our aggressive I Impulsive targets to the upside for now (above 3'750; right-hand scale). These could still be justified in the perspective of a strong re-acceleration to the upside, perhaps later this year, as suggested by our long term oscillators (lower rectangle). Yet, for now, we are relying on our medium term ones (upper rectangle), which point to **a period of intermediate correction, at least, over the next month or so. We would hence remain rather defensive on Europe markets until late Q3.**

DAX 30 Index
Weekly graph or the perspective over the next 2 to 4 quarters



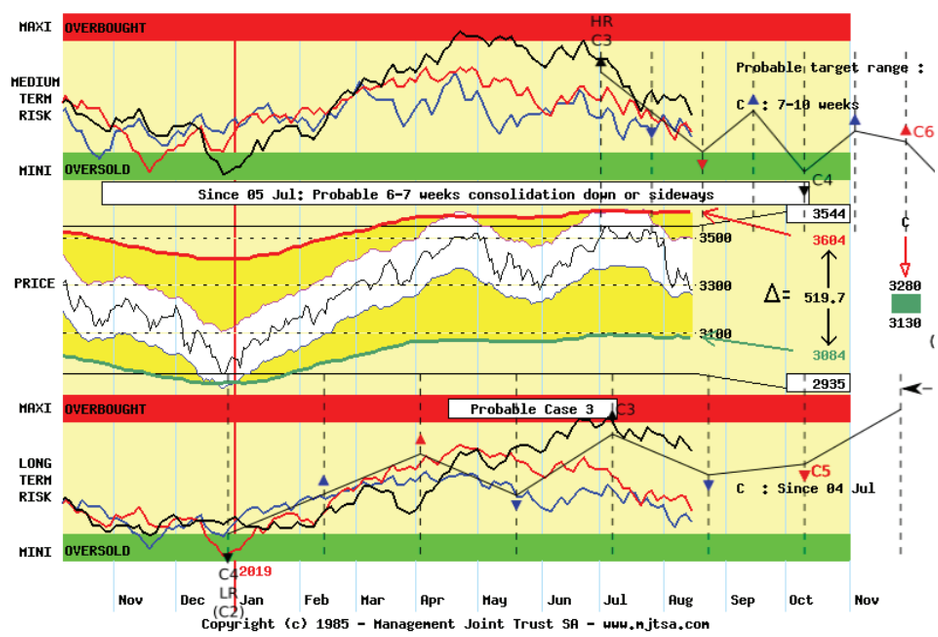
We seek to confirm this rather defensive bias by considering the DAX 30 Index. Indeed, the German DAX has traditionally been a cyclical / high beta component of European markets. It is also heavily geared towards exporting companies, which have a lot to lose from a messy Brexit process, or from further escalations in the US vs China (and potentially US vs Europe) Trade Wars. As with the EuroStoxx 50, the sequence we show on our medium term oscillators (upper rectangle) does point to a period of correction until late Q3, and then, towards a possible rally into year-end. Yet, the alternative scenario we present here on our long term oscillators (lower rectangle) is more negative. The sequence, which is quite clear, suggests further downside for the DAX into year-end. This is also corroborated by our targets (right-hand scale), which may suggest a deeper retest down. For now, we are still undecided between these two scenarios, and **in doubt would tactically remain prudent until the retracement period we expect on our medium term oscillator is behind us (upper rectangle), i.e. until late Q3.**

Banking Sector – Europe Stoxx 600 (SX7P)
Weekly graph or the perspective over the next 2 to 4 quarters



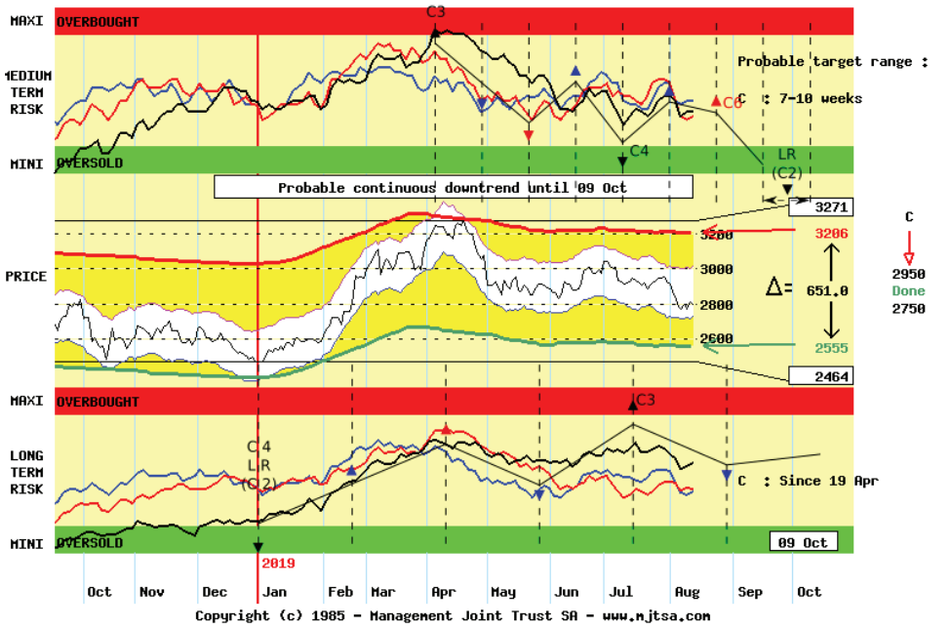
Last month, we wrote that, European banking stocks could become quite oversold towards the end of July vs the Europe Stoxx 600, and we suggested that a bounce could materialize during August on a relative basis. This may still be the case short term as Europe Banks are very Oversold on our Daily graphs vs the EuroStoxx 600. Longer term however, on a standalone basis, we believe that European Banks remain a proxy for much of the European negative sentiment and underperformance since early 2018. We hence consider their Weekly chart here to assess if their downtrend, and their negative influence on European markets, are set to continue. For now, both our oscillator series (lower and upper rectangles) remain negative, probably into Q4, and perhaps towards year-end, with strong downside potential left, between minus 15 to 30% according to our I Impulsive targets to the downside (right-hand scale). **Hence, for now, this graph suggests that European Banks should continue to be a drag on Europe's market performance**, or is it rather European markets as a whole, which are headed their way?

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



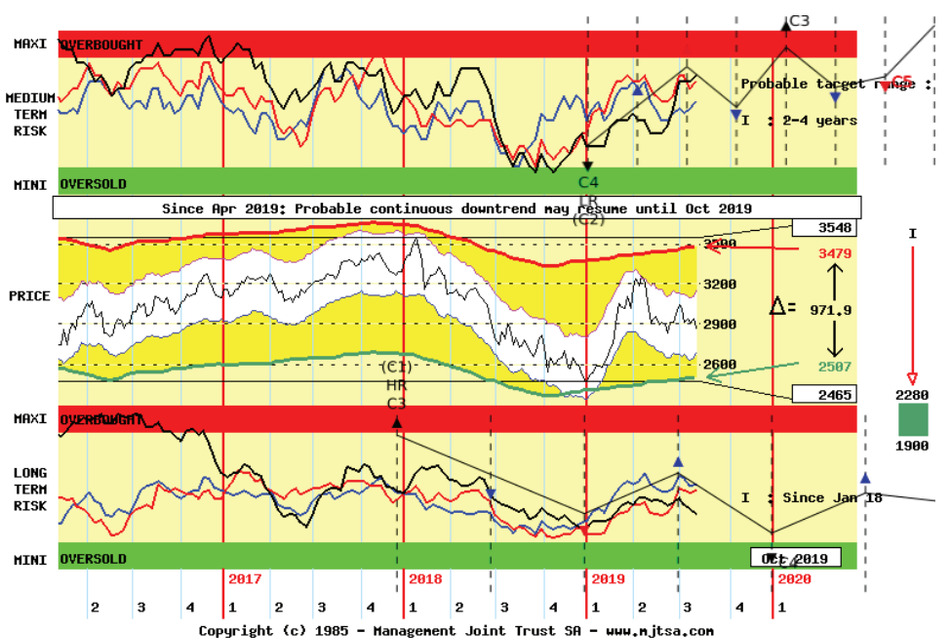
As you can note from the Weekly graphs above (EuroStoxx 50, the DAX Index or European Banks), the prospects for European markets into year-end are still uncertain, and prudence would hence guide us to remain relatively defensive into late Q3 for now. This Daily graph may be suggesting the same. Indeed, on both oscillator series (lower and upper rectangles), the correction to the downside that started in July doesn't seem over yet. **We expect an initial support point towards late August, and then following an initial rebound, further retest down during September** (potentially with higher lows). Following that, the EuroStoxx 50 should attempt to move higher again into year-end. For now, our C Corrective targets to the downside (right-hand scale) still suggest **some risk to the downside during the rest of Q3, possibly down to 3'200 or slightly below**. Thereafter, our I Impulsive targets to the upside could justify a new move up towards new highs and possibly towards the 3'600 – 3'800 range. Yet, we would first need to get through the next couple of months before we can confirm such positive forecasts.

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



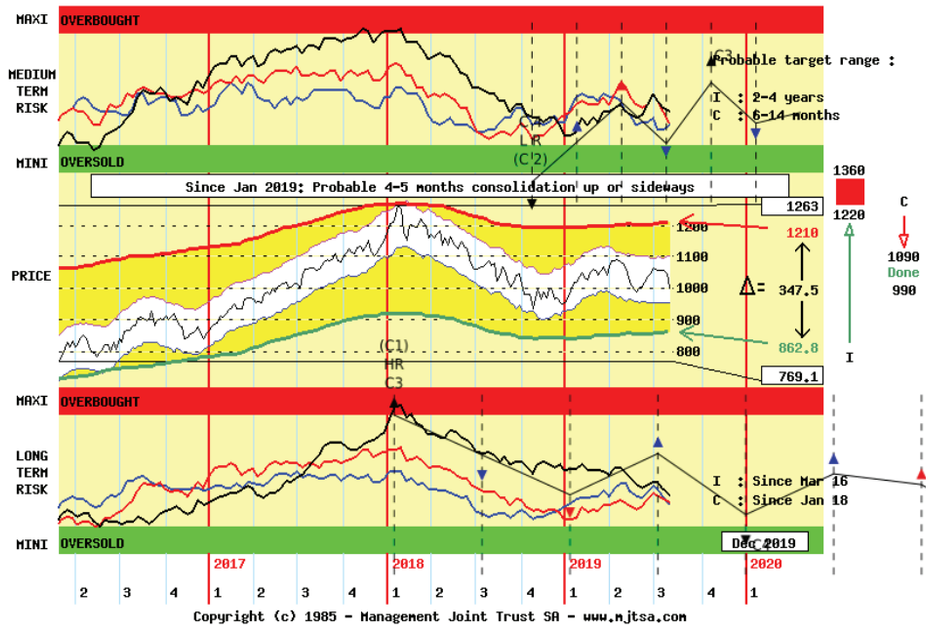
Since April, the Shanghai Composite had been correcting down. It had reached the support of our C Corrective targets to the downside (right-hand scale), where it appeared to be building a base (from May into July). Yet, since late July, Chinese markets broke through these levels. In retrospect, this is quite understandable given the sudden resurgence of the US-China Trade war. Both our oscillator series (lower and upper rectangles) now suggest possible further downside into late August at least, possibly into late September / early October. **Further, the Shanghai Composite is now also getting awfully close to the support of the lower end of our C Corrective targets to the downside (right-hand scale). If these do break, the index may revisit its January lows over the next 3 to 6 months. We are hence turning very prudent on China, probably over the next couple of months at least, but eventually also towards year-end.**

Shanghai Composite
Weekly graph or the perspective over the next 2 to 4 quarters



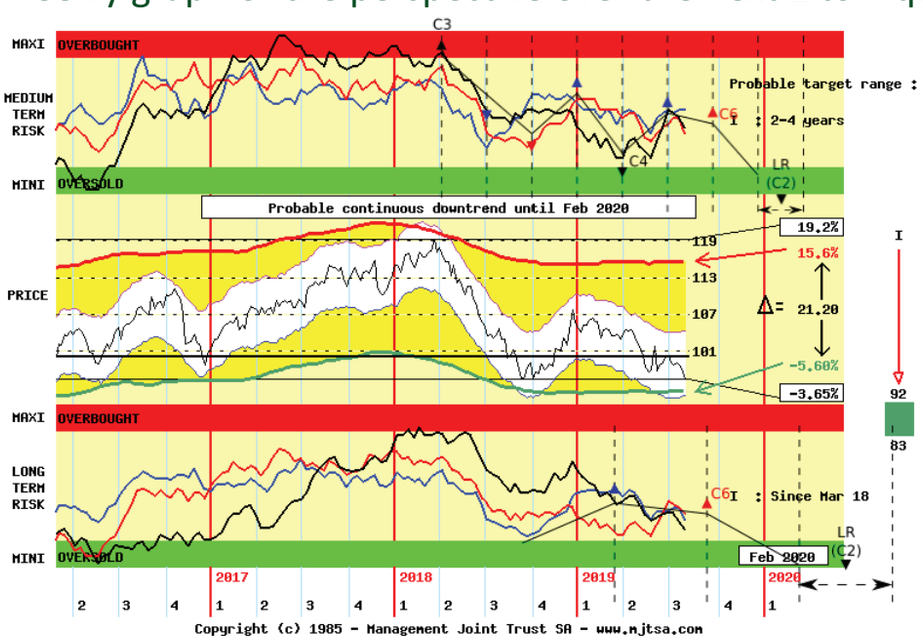
Longer term, our Weekly graph does indeed leave little opportunity for a year-end rally. Our medium term oscillators (upper rectangle) may still justify that following some correction during Q3, the Shanghai Composite then rallies into year-end. Yet, such configurations are usually accompanied by rising prices, not declining tops, as appears to be the case now. We hence need to consider a more negative scenario, as shown on our long term oscillators (lower rectangle), and it suggests a continuation of the current downtrend into year-end. Our I Impulsive targets to the downside for this move are quite scary, potentially down to the 2'280 - 1'900 range (right-hand scale). **As long as there are no positive surprises on the Trade war front, we will probably remain defensive on China towards year-end ("in doubt, stay out").**

MSCI Emerging Markets Index
Weekly graph or the perspective over the next 2 to 4 quarters



As China goes, so goes the MSCI Emerging Markets index. Indeed, China and neighboring countries (South Korea and Taiwan) account for more than 50% of the index. On our medium term oscillators (upper rectangle), the sequence may still find some support to move higher towards Q4. Yet, the recent sell-off has severely dented this possibility. Our longer term oscillators (lower rectangle) could now be providing a clearer picture. They suggest **further downside for Emerging markets towards year-end. Here also, we are rapidly approaching the support of our C Corrective targets to the downside around 990 (right-hand scale). If these do break, the next level of targets we can calculate is probably much lower, towards levels not seen since 2016.** As for our I Impulsive targets to the upside (right-hand scale), they are currently much too aggressive (mot likely to be achieved) given current oscillator configurations.

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



Finally, we consider the MSCI Emerging Markets Index vs the MSCI World Index. Both our oscillator series could still leave the possibility of a weak bounce into late Q3. Yet, given recent price action, the scope of such a rebound is probably limited. Short term, our Daily graph (not shown here) is very Oversold, and the ratio may bounce at some point during August. Yet, on this Weekly graph, both oscillator series (lower and upper rectangles) suggest **that by September, Emerging markets should resume / continue their underperformance, probably into next year.** Our I Impulsive targets to the downside indicate that their underperformance could be between 5 and 15% until then (right-hand scale).

Concluding remarks:

The 3 to 5% correction to the downside we had forecast last month has found a strong catalyst with the resurgence of the US vs China Trade War. The current sell-off may find some support towards late August and a bounce may materialize. Yet, it could be retraced again during September (partially at least). Following that, US markets may attempt a last push higher to new highs into year-end and early 2020 as they long term uptrend still seems intact. This projection may however meet new headwinds from global markets. Indeed, equity markets configurations seem to have weakened in Europe. The DAX, and European Banks especially, could be downtrending towards year-end. Similarly, China and more generally Emerging markets, also seem to be resuming last year's downtrend, potentially with strong downside potential over the next few quarters. The US could still de-couple once again, and possibly help other markets hold. Yet, in this late cycle environment, probably not as strongly as it did last year. For now, at least, we would probably remain prudent into September.

33 / The US Dollar has likely peaked for now, and should fall until September but after that the Dollar may rise with Core CPI and yields until Q1 2020

In the June 2019 Capital Observer, we believed that the US Dollar will be weaker for most of Q3. This is what we said then:

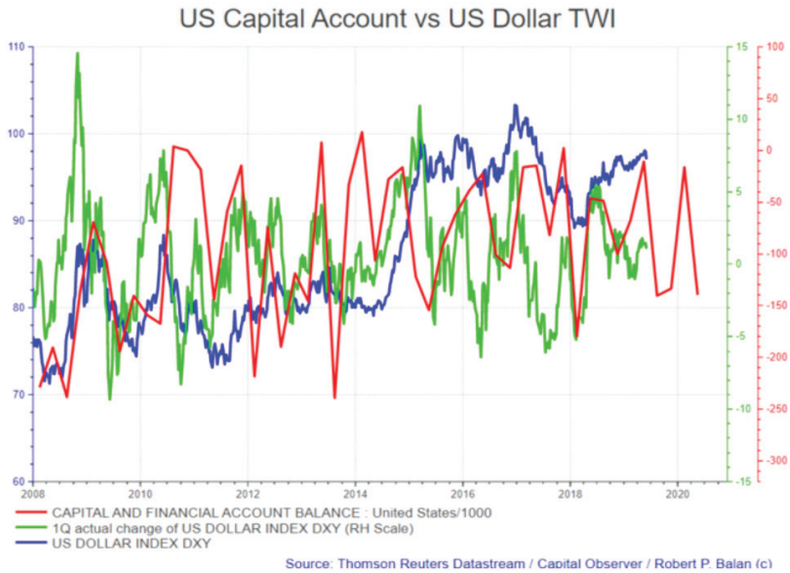
More significantly, US Capital Account inflows which buttressed the US Dollar since early this year, has turned less friendly (see 1st chart on this page). The impact of capital inflows manifest in US Dollar weakness or strength 6 to 8 quarters after the fact, and it just so happens a turn lower has for the US Dollar from this factor. Changes in the US capital account have large impact on the US Dollar exchange rate, and their long lead on USD valuation has made Capital Account a valuable tool for forecasting US Dollar future valuation from way up ahead,

Capital accounts improve when non-resident (external) capital inflows increase or resident (domestic) capital outflows slow. The deceleration in the domestic capital account from June will therefore likely to result in a decline of the US dollar until probably September.

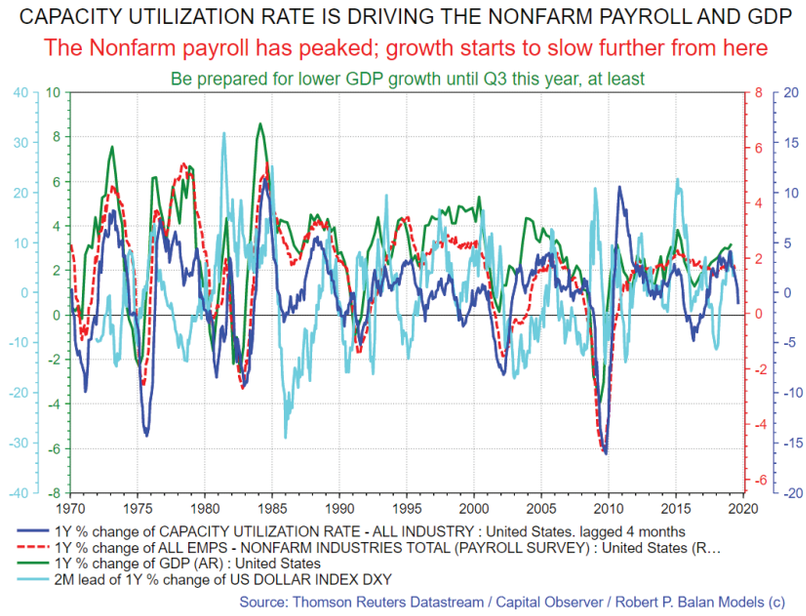
US domestic growth is decelerating. The Capacity Utilization peaked as far back as August 2018, and the rest of the economy is only catching up to that structural weakness now. Nonfarm payroll will follow lower, and this month, it is the US Dollar turn to fall from the combined signalling effect of declining CapU and peaking payrolls. In the July report, Q2 GDP should fall as well, and may bottom during Q3.

Due to the outlook of a brief economic downturn, the Fed is now willing to err on the side of easier policy. We see the Fed sidestepping June, but will very likely start cutting rates in July and will do it again in September. Animal spirits should come back to the markets and the economy, given assurances of a looser and more cooperative Federal Reserve at this juncture.

Original chart from the June 2019 issue of Capital Observer



Original chart from the June 2019 issue of The Capital Observer



That USD correction outlook did not come to pass. The Dollar became firmer as safe haven destination, as US growth weakness showed signs of intensifying, and the China-US trade spat became even more heated. **The US Dollar rose in July, and counter-intuitively started to weaken only after the Fed underwhelmed the financial markets with a 25 bp rate cut on July 31, instead of the 50 bp cut expected (and clamoured for) by the equity markets.**

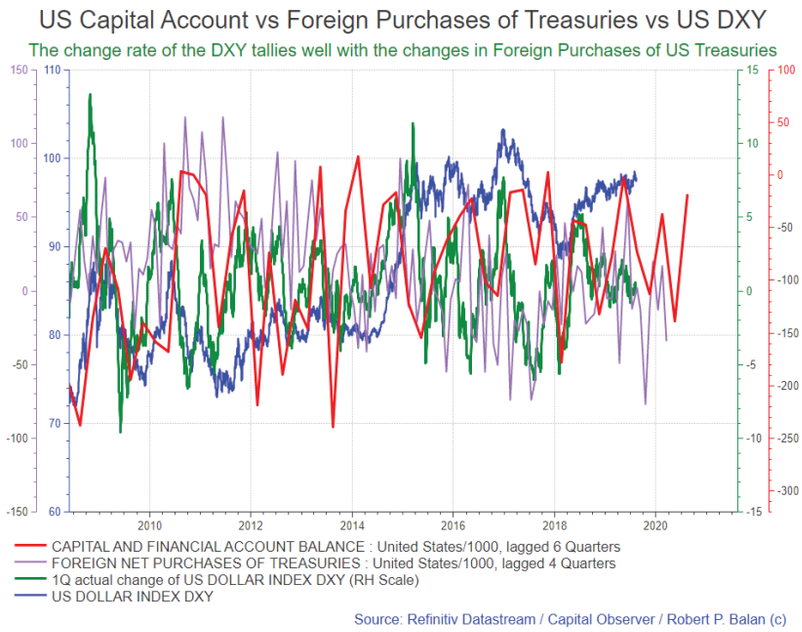
Nonetheless, the USD unfriendly environment is still with us: the lagged impact of declining capital account inflows is still negative for the US Dollar, and this time, we've added the nominal purchases of US Treasuries by foreigners (central banks and institutions) to add high-frequency clarity to the likely moves of the US Dollar (see c2hart below). It is the change rate of the DXY which tallies well with the changes in Foreign Purchases of US Treasuries; and **it is still apparent to us that the US Dollar could still fall**

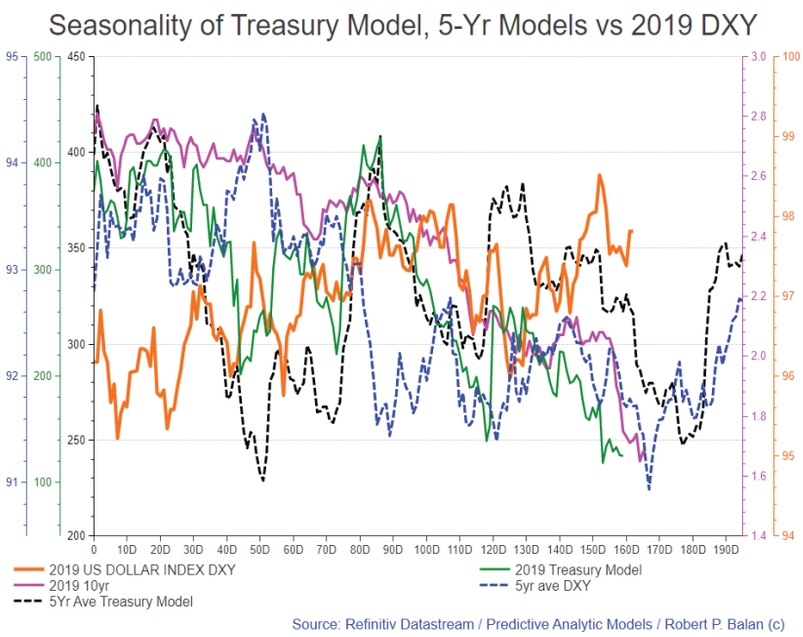
from here until late September-early October, this year (*see 1st graph on this page*).

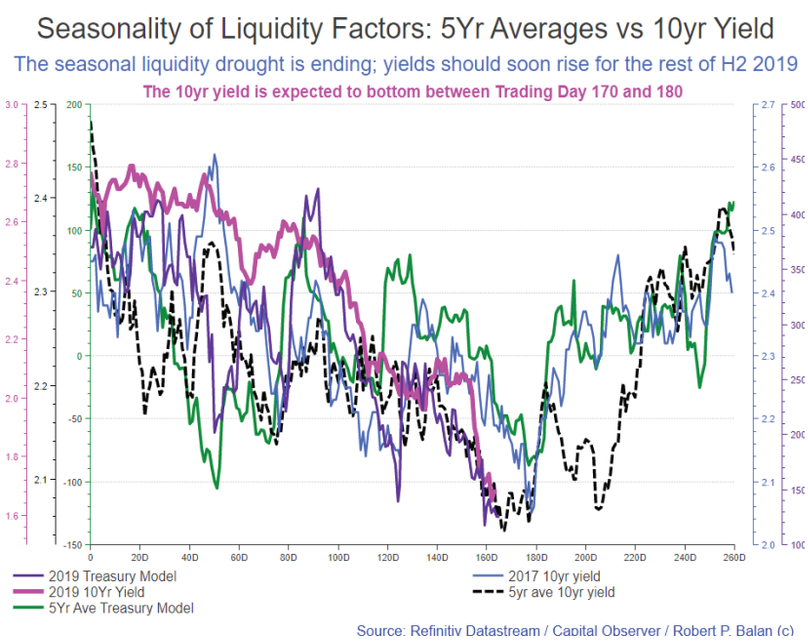
There is also evidence that the DXY rally in July was an outlier, and the DXY has gone way beyond its historical valuation (5-year average), and its historical, positive (but lagged) covariance with the 10yr yield. **There is a wide gap between the rising DXY and the falling 10yr yield since early July. This outlier status suggests to us that the US Dollar (and DXY proxy) are due for a significant repricing lower over the next few weeks** (*see 2nd graph on this page*).

The expected residual weakness in the US Dollar is expected as a matter of weeks, not months. The sharp dive in bond yield is about to end. As we have shown in the article about equities elsewhere in this issue of the Capital Observer, any further declines in both yields and stocks are also measured in matter of few weeks. The systemic liquidity drought currently pervading the financial markets will start to disappear once the US Treasury's paper issuance come into full swing, following the removal of debt ceiling cap (*see 3rd graph on this page*). The Treasury has been unable to issue debt paper during the time the debt ceiling cap was being negotiated by lawmakers. That has crimped systemic liquidity, which further added to the allure of US government bonds, at a time when geopolitical events triggered flight to safe destinations, like US government bonds. But the bottom in the 10yr yield will probably occur between Trading Day 170 and 180(*see 3rd graph on this page*).

If that is the case, any US Dollar weakness should also cease a few days after the 10yr yield starts rising. A new upcycle in yields and the US Dollar is also supported by the threat of the US Core CPI to rise during the rest of the year (*see 1st graph on the next page*).



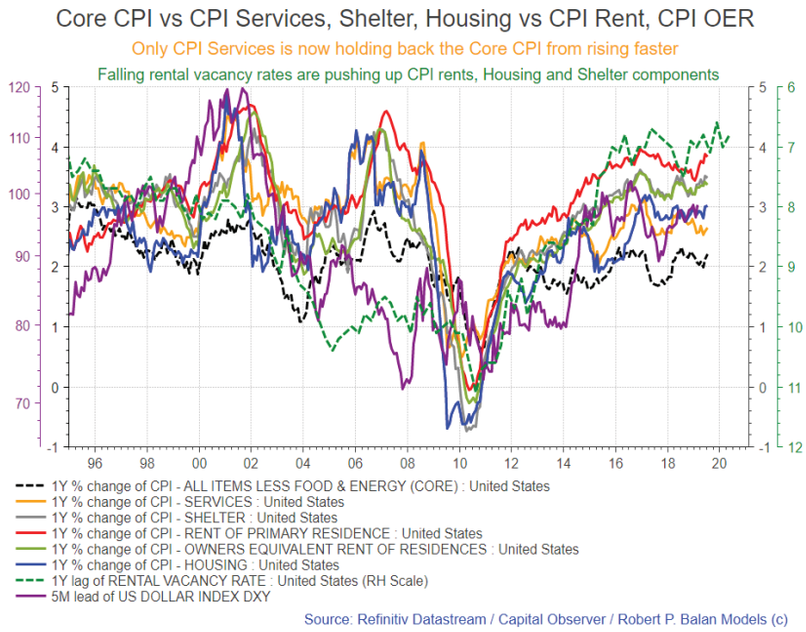


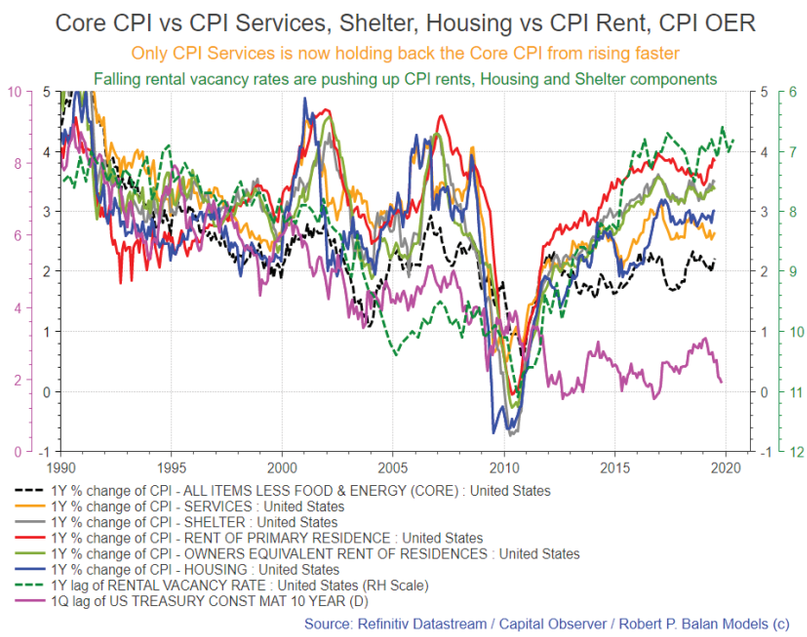


The US Dollar (DXY as proxy) also lags behind Core CPI by several months, so the current rise in Core CPI should be a positive factor for the US Dollar two to three months from now. We have shown our Core CPI analysis elsewhere in this Capital Observer issue, our conclusion being a sustained rise in the Core CPI until the middle of Q1 2010 at least. That should also help the US Dollar, after a few months of lag (*see 1st graph on this page*).

The US Dollar prime mover over the near-term is the differential between US yields and comparative yields of other currencies. And yields are also driven in large part by inflation expectations via the term premium component of yields. The term premium is, in significant part, driven in turn by outlook for inflation over the life of the bond. Bond yields, therefore, tend to follow the course of core inflation, although with a short lag (*see 2nd chart on this page*). The relevant point today is that if US Core CPI is expected to rise further into Q1 2020, then yields should be impacted by that event and should tend to rise as from the next month or so, from this factor alone. **That should support the DXY after September-October time frame until Q1 2020, which is consistent with the capital account model.**

Summary: With geopolitical events cooling down somewhat, the US Dollar's role as safe haven destination (as happened in July) will be de-emphasized. The Dollar should therefore fall, and should be re-priced accordingly with the recent sharp declines in US yields. US yields may still fall until early September, and the Dollar should follow suit. But with Core CPI now threatening to surge for the rest of the year, further declines in yields (and the Dollar) should be short-lived. Thereafter, we expect both yields and the Dollar to rise alongside Core CPI until the middle of Q1 2020 at least.





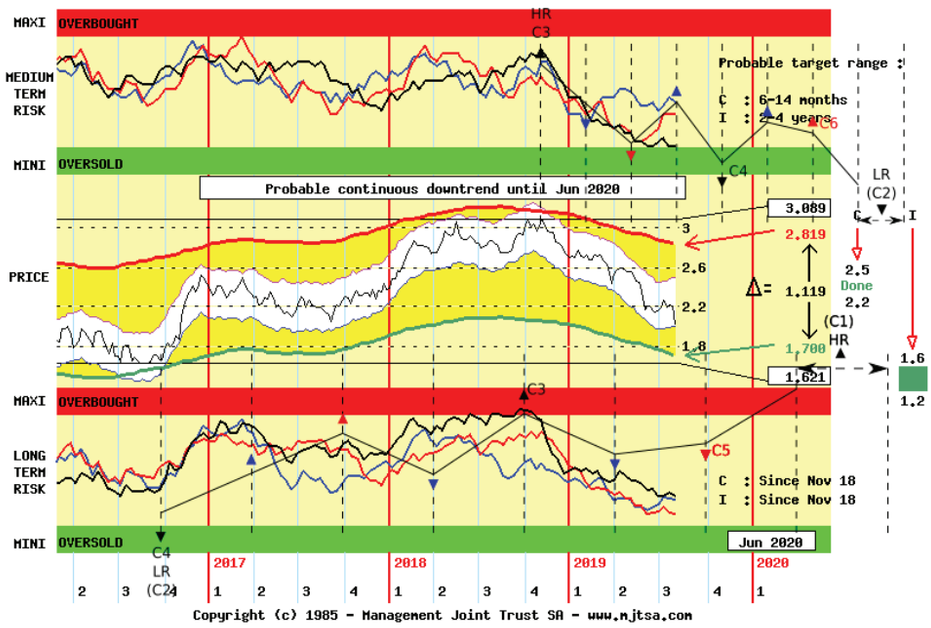
36 / MJT - TIMING AND TACTICAL INSIGHT

Defensiveness is sweeping through FX markets

Despite a rather hawkish FED and a last spike up on July 31st, the US Dollar has since started to correct down again vs the Euro, Swiss Franc or the Yen. This follows the resurgence of the US vs China Trade War early August, and as a consequence, defensiveness is sweeping through FX markets: the rather pro-cyclical US Dollar is under pressure again, while Emerging markets and Commodity currencies are faring even worse. Indeed, as the People's Bank of China is letting the Yuan weaken past the symbolic 7.0 mark (resulting in the US Treasury naming them as a currency manipulator), other Central Banks are following the US and China in their easing efforts. Most are surprising the market in their aggressiveness to do so (recently Brazil, New Zealand, Thailand, India). This trend also follows easing efforts from Australia, Malaysia, Indonesia, South Korea or South Africa in recent months. Despite the reluctance of the FED to abide, a new global easing cycle may be under way. In this article, we will review the US Dollar vs the Yen, the Euro or the Swiss Franc, and then vs the Real, the Yuan and the Taiwanese Dollar.end.

US 10 years - Japan 10 Years Benchmark Bond Yields

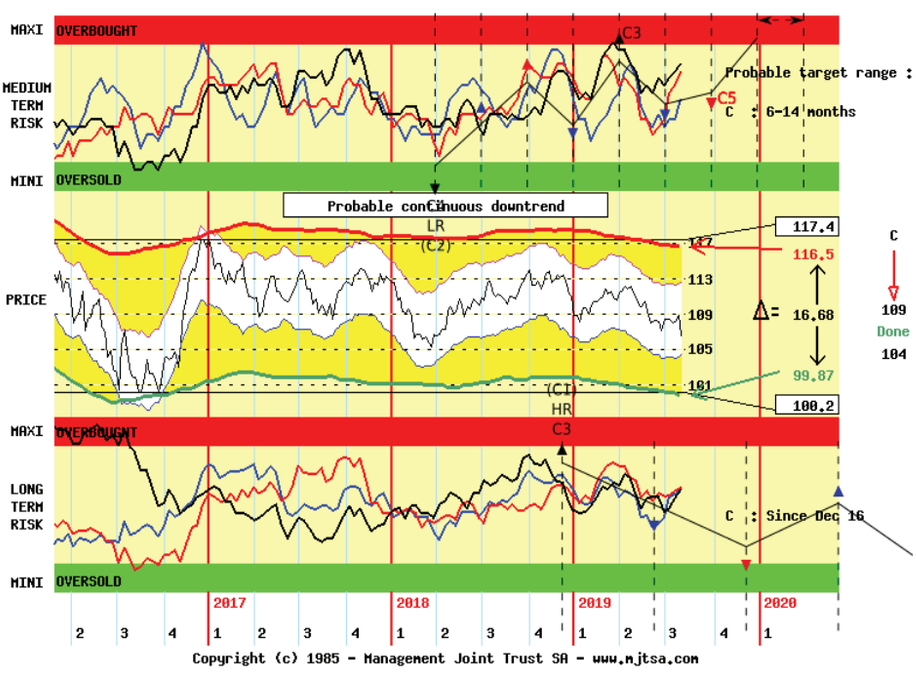
Weekly graph or the perspective over the next 2 to 4 quarters



On USD/JPY, we will use the US to Japan 10 Years interest rate differential as a starting point of our analysis. Indeed, as defensiveness rises and US yields fall, the Yen rises as investments in US Treasuries become less attractive. The negative feedback loops then endanger Yen carry trades vs most currencies, thereby fueling more defensiveness. The process has been underway for more than 9 months now, and both our oscillator series (lower and upper rectangles) **point to further downside pressure into late Q3 / early Q4**. While the sequence we show on our long term oscillators (lower rectangle) would then suggest a strong reversal up into Spring 2020, the one on our medium term ones (upper rectangle) is more cautious, indicating a mere **bounce into early 2020**. We believe this second, more negative scenario is more likely. Indeed, on this interest rate differential, we have now broken below the support of our C Corrective targets to the downside (right-hand scale), and hence, **theoretically, the move has now turned impulsive to the downside. Rebounds may still materialize (Q4/Q1 2020?), but the end-game is likely to be a continuation of the downtrend into late 2020, and possibly towards the 1.6 – 1.2 % range.**

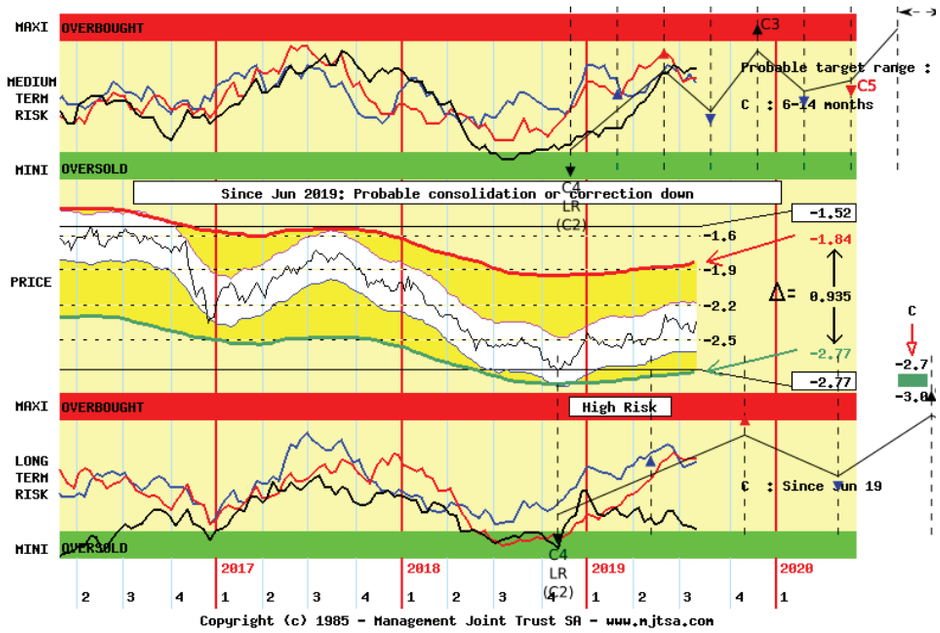
USD/JPY

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



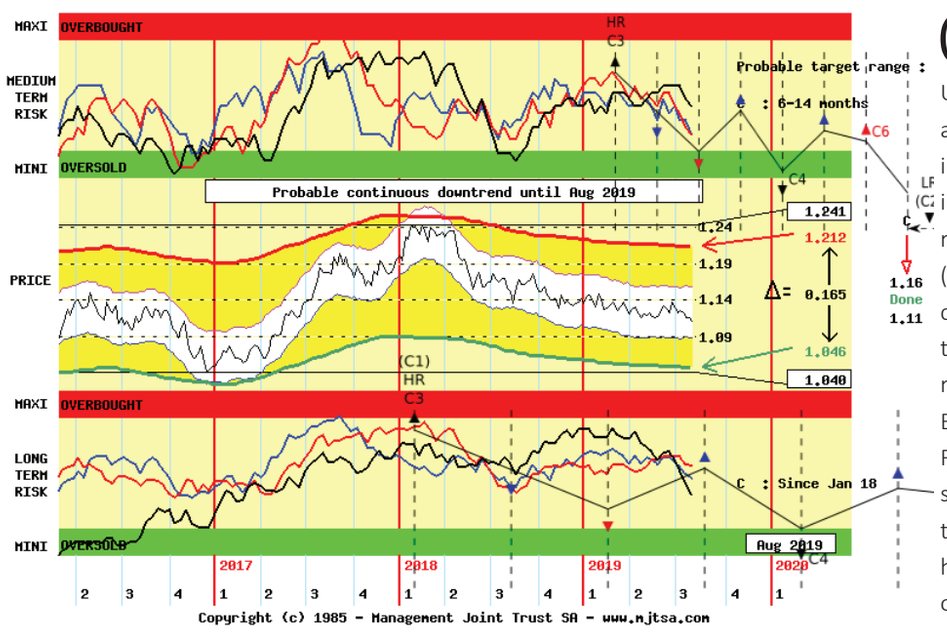
Over the last month, USD/JPY seems to have indeed broken support. On our long term oscillators (lower rectangle), our June intermediate low was broken through, suggesting further downside into mid/late Q4. The sequence we show on our medium term oscillators (upper rectangle) is more positive and could find support towards late Q3 and then bounce towards year-end. Yet, this is far from certain as the downtrend now seems well in place. Bottom line, **we will remain prudent on USD/JPY until late Q3 at least, possibly into mid Q4. For now, we are still above the support of the lower end of our C Corrective targets to the downside (which stands at circa 104; right-hand scale). If these levels were to break, the downside potential could be much lower over the next 12 to 18 months, into the mid 90s at least. We believe that the question is not if, but when these levels will be reached, possibly this year, but most probably towards mid/late 2020.**

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



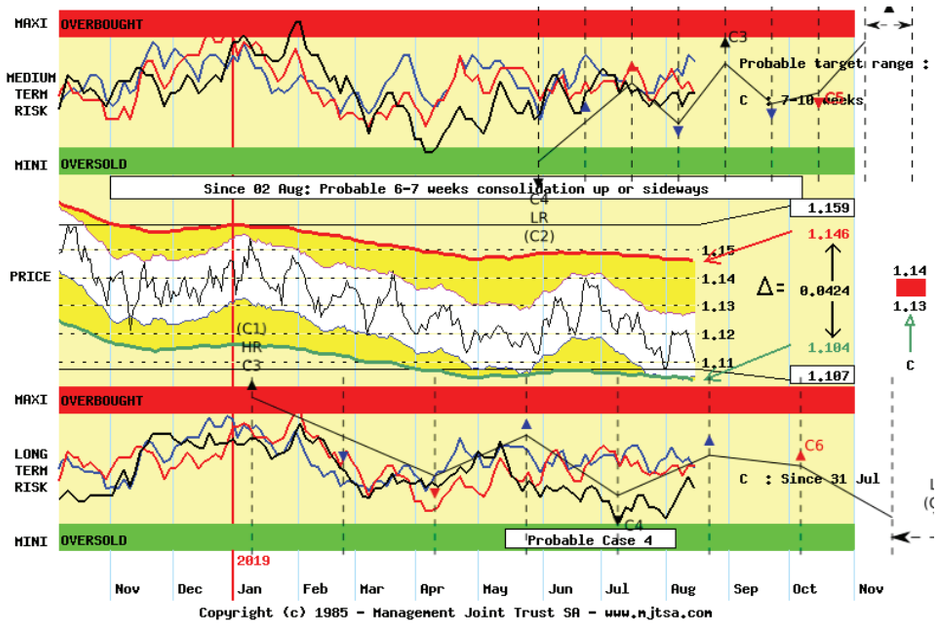
We perform the same analysis on the interest differential between the EuroZone (Germany) and the US. Since Q4 last year, the differential has been climbing back up as US long term interest rates have been catching up to the downside with European ones. This is due to the 180 degrees U-turn at the FED since October, but also to the slowing US macro indicators and to the on-going US - China Trade War. **For now, both oscillator series (lower and upper rectangles) suggest that the current move up may continue into early/mid Q4. Following that, we expect the differential to retest down into early / Spring 2020**. This retest down could find its causes in a pick-up in 10Y US yields (re-acceleration of the US economy, rise in inflation expectations, yield curve steepening, resolution of the Trade War), but also in a more aggressive drop in German 10Y Bunds yields (the ECB follows suit on its easing promises, the political and economic situation takes a turn for the worse in Europe), perhaps both.

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



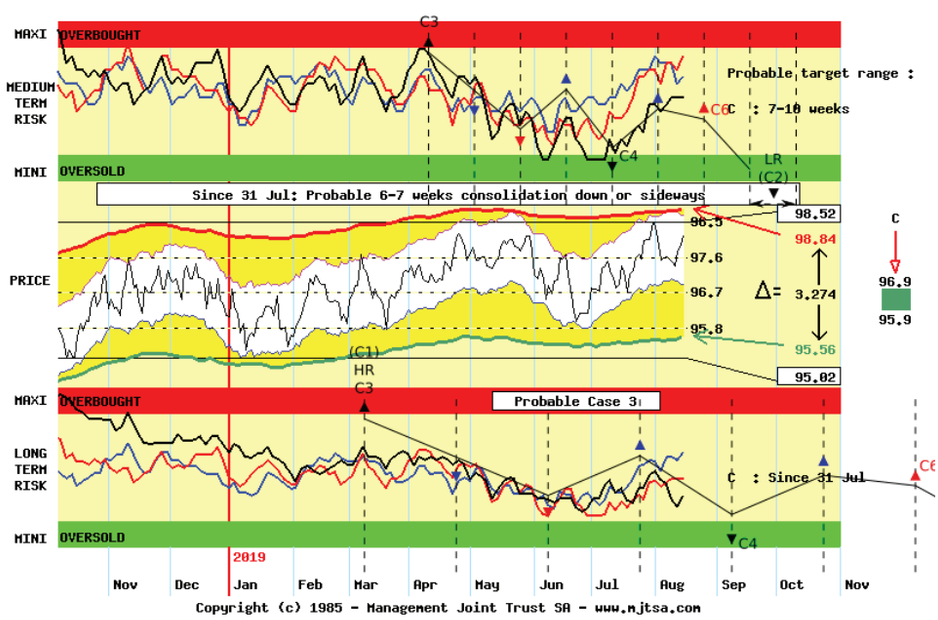
Over the last few years, the parallel between the German to US 10Y interest rates differential and EUR/USD has been rather weak in terms of scope. Yet, most of the inflection points on the interest rates differential can be identified (even if weak) on the EUR/USD exchange rate. Since the beginning of the year the German to US interest rate differential has been bouncing. EUR/USD has managed to hold up. For now, it is still working around the support of our C Corrective targets to the downside (around 1.11, right-hand scale), but holding. Both our oscillator series (lower and upper rectangles) suggest that **the current bounce in EUR/USD may extend slightly further, a few more weeks on our long term oscillators (lower rectangle), perhaps a couple more months on our medium term ones (upper rectangle). Following that, from late Q3, and especially early Q4 (in line with the interest rates differential above), EUR/USD should resume its downtrend into early next year.** By then, it may break clearly below 1.11, opening the door the much lower targets over the next 12 to 18 months (towards parity).

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



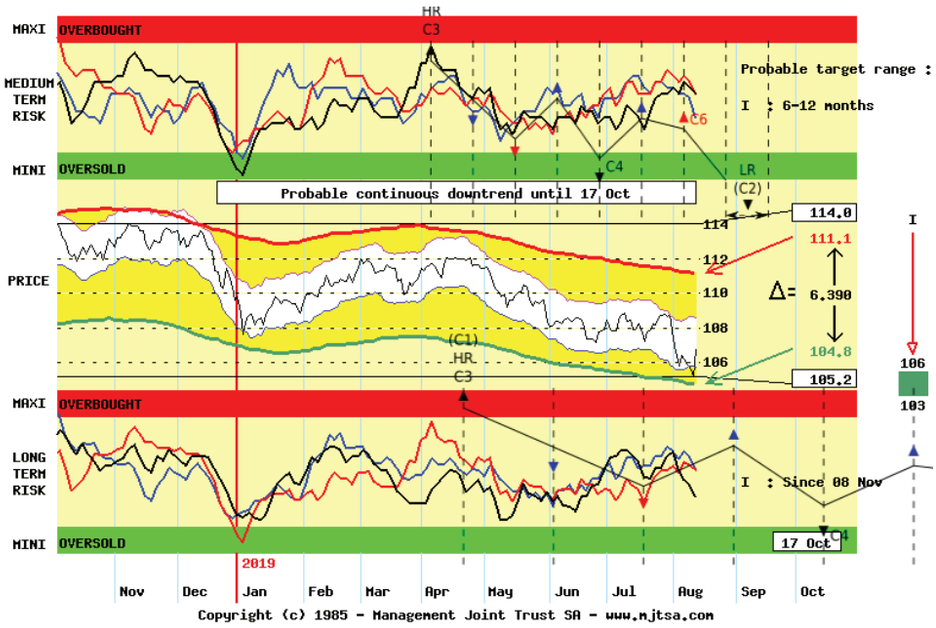
On its Daily graph, EUR/USD seems to have built a base between May and late July and **could bounce into late August on our medium term oscillators (upper rectangle). On our long term oscillators (lower rectangle), this bounce may extend into early/mid September. The C Corrective targets to the upside we can calculate are between 2.5 to 3.5 figures** (circa 0.5 to 0.8 times our historical volatility measure "Delta", here at 4.24 figures - middle graph, right-hand side), **which added to the recent lows at 1.107 give us a target range between 1.13 and 1.145**. Following that, from early/mid September, EUR/USD probably resumes lower into the Fall. Our I Impulsive targets to the downside (right-hand side) are pointing to the 1.10 – 1.09 range. This would probably open the door to much lower targets over the next 12 to 18 months as it would represent a break below important Weekly support levels around 1.11 (see EUR/USD Weekly graph, 2 pages above).

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



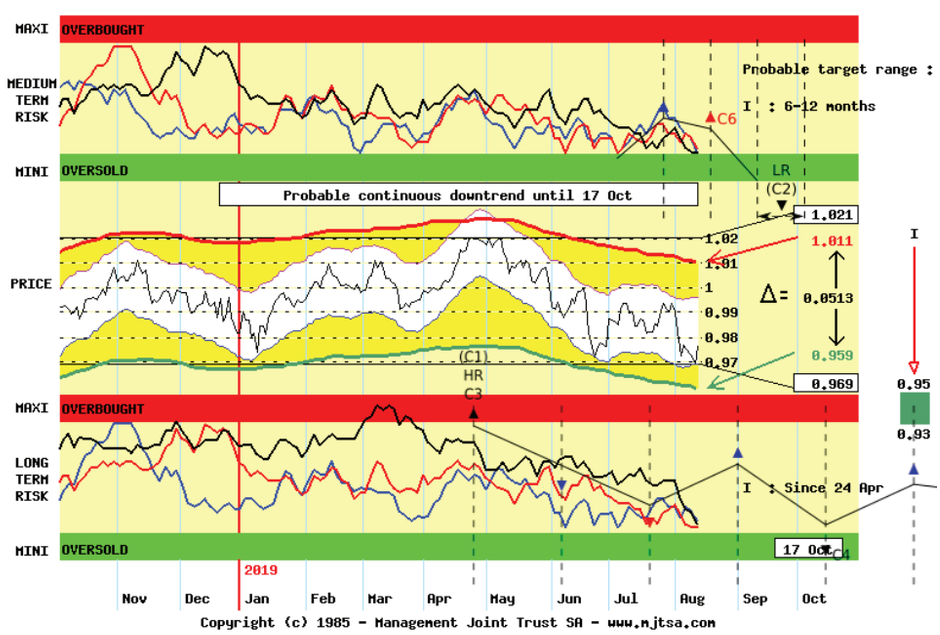
The Dollar Index shows a similar configuration in reverse. Both oscillator series point to **a new period of retracement during August, and potentially into early/mid September. Our C Corrective targets to the downside suggest that this dip could match the previous one and find support in the 0.97 – 0.96 range** (right-hand scale). Following that, from late September, the US Dollar probably resumes higher into Q4.

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



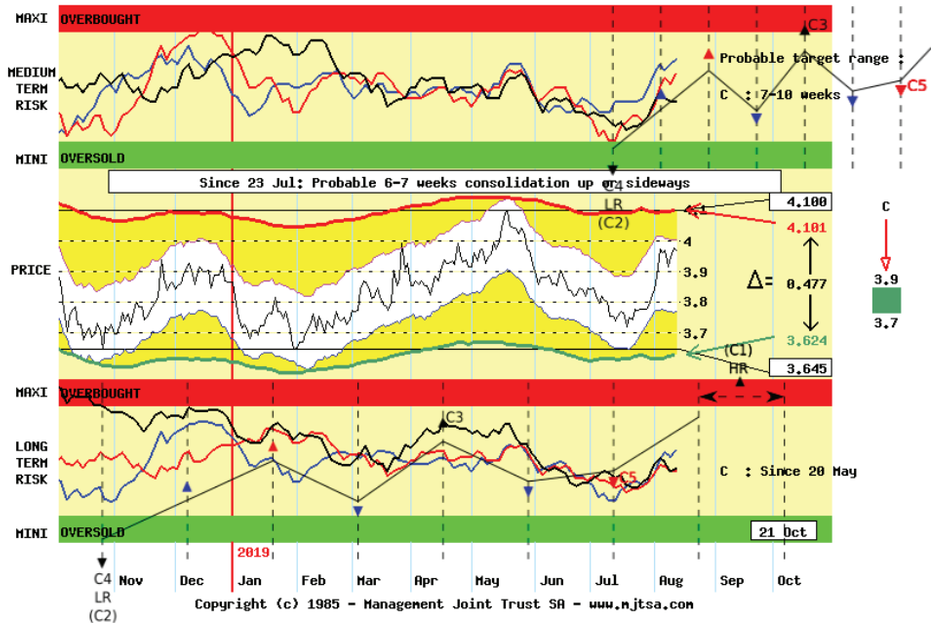
We now switch to the Daily graphs of more pro-cyclical pairs, i.e. the USD vs JPY and CHF. Indeed, these usually fall during risk-off periods. Although, USD/JPY has come some way down since October, on both oscillator series (lower and upper rectangles), we believe this downtrend is not quite finished yet. Indeed, while on our medium term oscillators (upper rectangle), this downtrend may extend into late August / early September, on our long term ones (lower rectangle) USD/JPY may continue to be under pressure until early October. **Our I Impulsive targets to the downside (right-hand scale) suggest further downside, possibly towards 103**. This would test the support of our Weekly C Corrective targets to the downside mentioned a few pages above in this article. If these do break, it would open the door to much lower targets over the next 12 to 18 months.

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



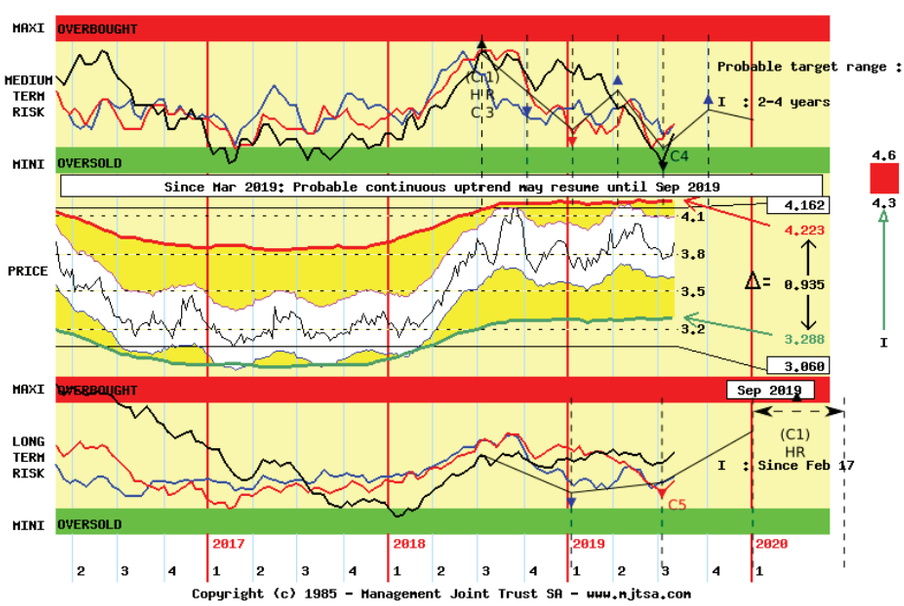
USD/CHF shows similar dynamics than USD/JPY. According to both our medium term oscillator series (upper rectangles), **it may start to stabilize towards early September, while our long term oscillators (lower rectangle) would suggest more downside pressure into early October. Our I Impulsive targets to the downside here (right-hand scale) also suggest further downside potential towards the 0.95 – 0.93 range.**

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



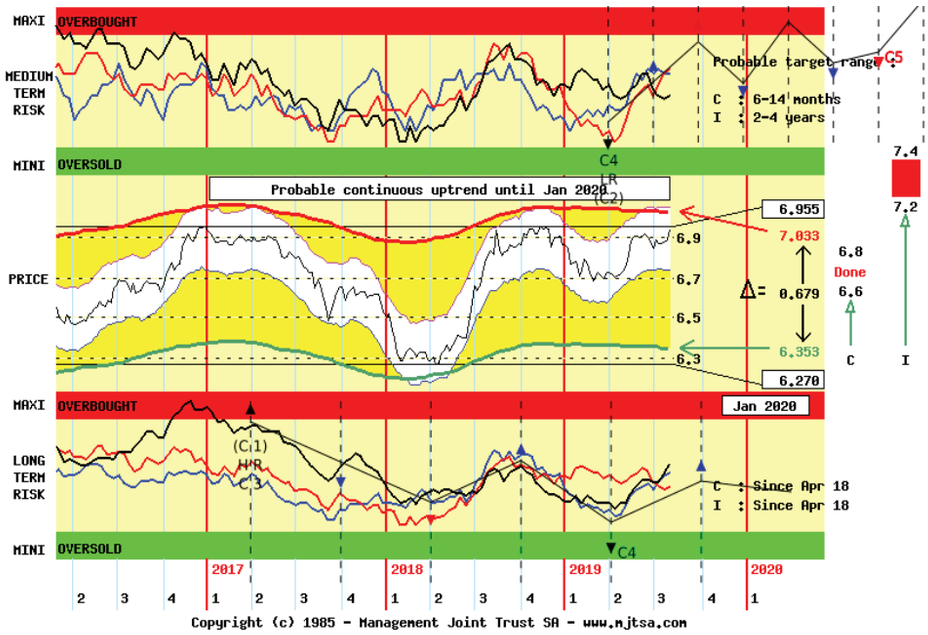
We now shift to Emerging Markets and the US Dollar to Brazilian Real exchange rate. **The sequences we show on both oscillator series (lower and upper rectangle) suggest that the bounce since mid July is probably still underway. We believe it may extend into late August, perhaps into late September / October**. We see similar configurations on the US Dollar vs most commodity currencies such as on USD/AUD, USD/NZD, USD/RUB, USD/CAD, USD/CLP or USD/ZAR.

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



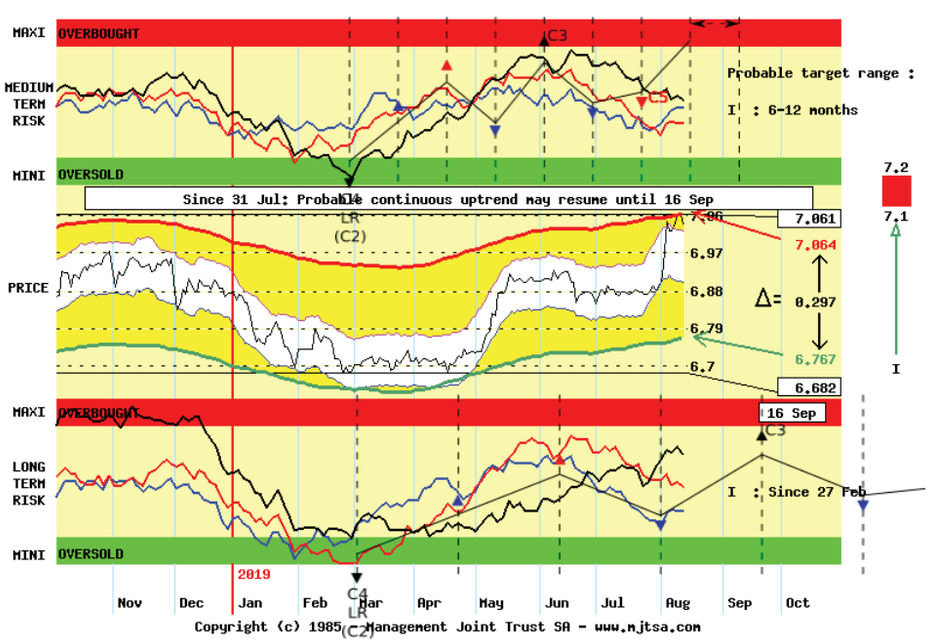
The Weekly graph of BRL/USD (and of the USD vs most other Commodity currencies) seems to be resuming higher on our long term oscillators (lower rectangle), possibly towards early / Spring next year. Our I Impulsive targets to the upside suggest much higher levels in the 4.3 – 4.6 range (right-hand scale). On our medium term ones (upper rectangle), we present a more prudent view with USD/BRL moving up towards late Q3 and then retracing down again towards year-end. Nevertheless, both projections seem to point **to a strong Dollar vs the Real into late Q3 at least, which is rather risk-off in our view.**

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



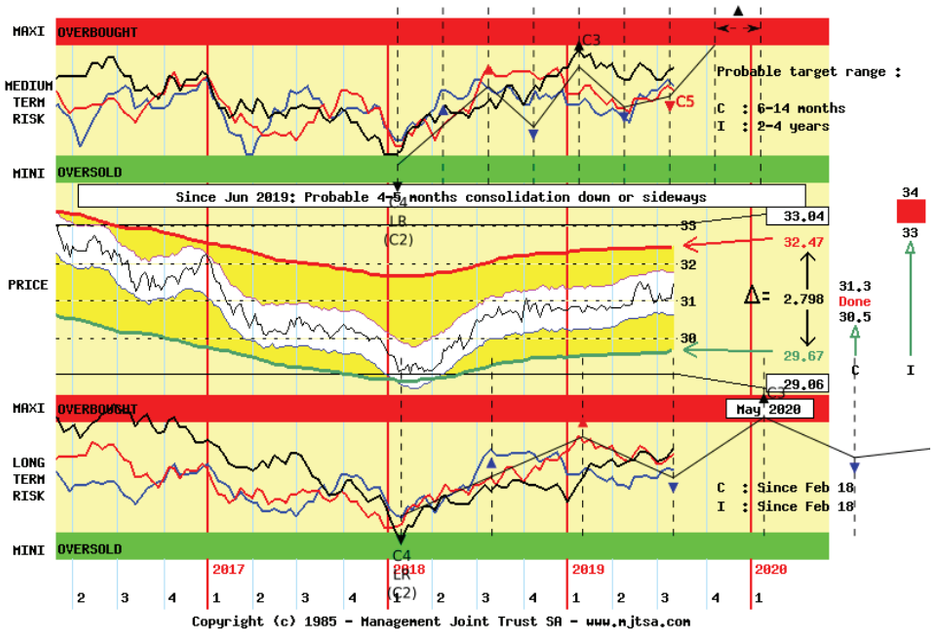
We now turn to the USD/CNY, which the People's Bank of China is currently letting move above the symbolic 7.0 mark. **On both oscillator series (upper and lower rectangles), we expect the Yuan to continue to weaken into late Q3. Following some retracement towards year-end, we then expect further Yuan devaluation into next Spring. Our I Impulsive targets to the upside (right-hand scale) are quite aggressive suggesting that USD/CNY could reach the 7.2 – 7.4 range over the next 12 to 18 months.**

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



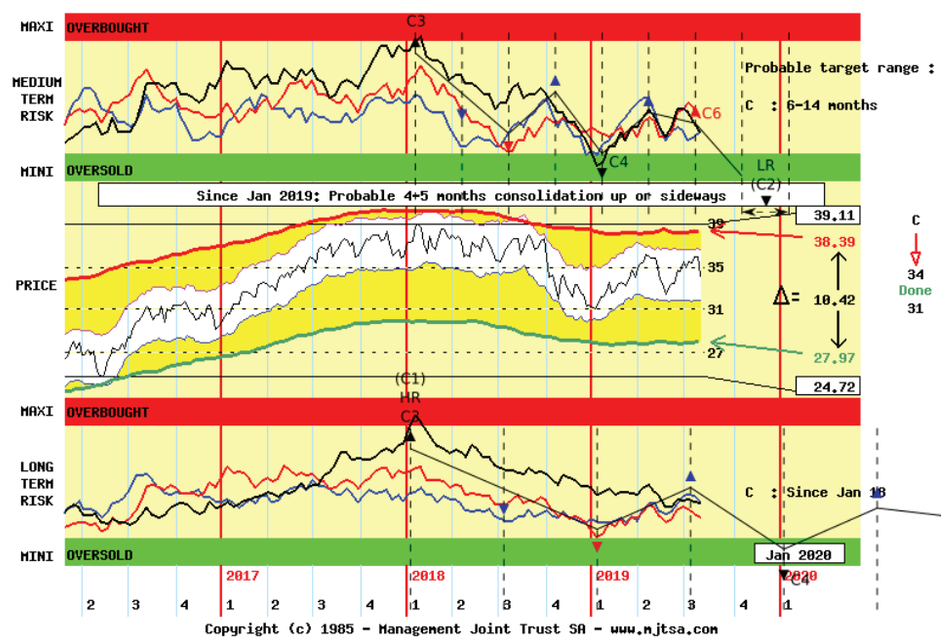
Shorter term, the Yuan is resuming its previous downtrend (uptrend on USD/CNY). This graph is quite telling of the current state of the FX market as the Yuan and most Emerging and Commodity currencies are currently falling against the US Dollar, while the US Dollar itself is consolidating down vs the Swiss Franc, the Yen and to a certain extent the Euro. This environment indeed does seem rather risk-off. According to both our oscillator series (lower and upper rectangles), USD/CNY is meant to **continue higher into late August, perhaps early/mid September, potentially up to the 7.2** mark according to our I Impulsive targets to the upside (right-hand scale). Hence, over the next few weeks, we would probably expect more ring-fencing between the US and China over the value of the US Dollar to Yuan exchange rate.

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



We finish off this currency overview with the example of Taiwan, considering both its currency and its equity market. Indeed, in many developing countries, equity markets is still closely related to the performance of their country's currency vs the US Dollar. On this Weekly graph of USD/TWD, following several quarters of "flattish" consolidation, the uptrend is currently starting to resume higher in full strength. On both oscillator series (lower and upper rectangles), we expect the **US Dollar to continue to strengthen vs TWD probably towards year-end and early 2020**. On the target front (right-hand scale), **we are now above the resistance of our C Corrective targets to the upside, and can hence consider our I Impulsive targets to the upside towards the 33 – 34 range, some 5 to 10% above current levels.**

EWT - iShares MSCI Taiwan Index Fund
Weekly graph or the perspective over the next 2 to 4 quarters



We now consider the graph of the Taiwan Stock exchange in US Dollars (EWT ETF). This graph is to be put in the perspective of the one of the MSCI Emerging Markets Index presented on page 32 of this issue of The Capital Observer. Our interpretation here is more negative though, given the negative view we have on TWD vs USD in the graph above. From what we can read from both oscillator series, **the current correction seems far from over. It extends into Q4 on our medium term oscillators (upper rectangle) and possibly towards early next year on our long term ones (in line with a weakening TWD). This example on the Taiwanese markets and its related currency pair is worrisome for the fate of most Emerging markets over the next few months**. Although we are still some ways away, breaking below our C Corrective targets to the downside (below 31; right-hand scale) would be dramatic, as it would open the door to much lower targets over the new few quarters.

Concluding remarks

Defensiveness seems to be currently sweeping through currency markets as the Dollar seems to be consolidating further vs the Yen and Swiss Franc, and to a certain extend the Euro, while it has also recently shot up vs Emerging and Commodity currencies (e.g. CNY, BRL, TWD). We believe most of these trends are probably set to continue over next the month or so, , probably into late Q3, perhaps even Q4. We believe this is rather defensive in terms of risk asset positioning. In more detail, USD/JPY and USD/CHF could continue to slide into Q4, while EUR/USD may start to weaken earlier towards late August / September. The Yuan, Emerging markets and Commodities currencies seem to remain weak into late Q3 at least, but some may be already pointing to further weakness towards year-end. This would be very negative for Emerging Markets as their fate is very much related to their currencies. We will look to confirm or infirm these views towards early Fall, and in the meantime will retain a defensive bias on FX markets.

43 / Oil prices are still in the bottoming process for this cycle – we still see Brent oil price rising to at least $90 by Q2 2020

We discussed crude oil prices in the June 2019 issue, and prior to that time, the oil sector was dealt hammer blows from weakening US and global activity. Earlier, in the April 2019 edition, we forecasted that Brent Oil was going to fall to circa $50.00/bbl by late May-early June before oil prices stabilize. Indeed, that is what happened. But by early June, the Capital Observer has this to say:

This is the current global oil supply-demand situation (see 1st graph on this page). The second part of the hypothesis is about to take place – that is, oil prices will soon take off as the receding supply/output due to the previous OPEC and NOPEC initiative hits the system in full. Furthermore, OPEC and NOPEC are scheduled to meet later in the month to decide whether or not to renew the output cut agreement until the end of 2019. If the group decides to extend the agreement, the supply situation will be further crimped during a condition of relatively benevolent global demand conditions. We expect to see at least $90.00 in Brent during Q2 2020.

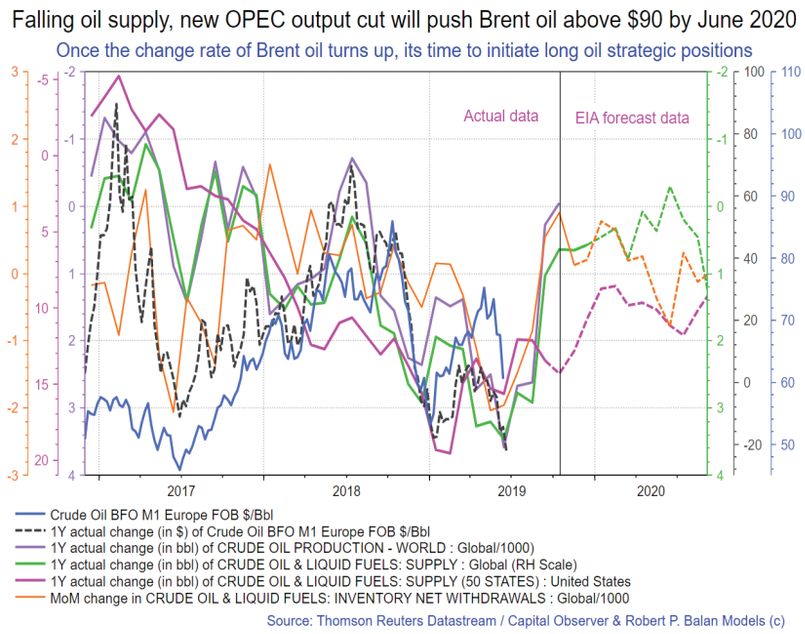
This template for an oil recovery until mid-2020 is not mainstream at all. *But neither was our call in early April for oil prices to fall to circa $50/bbl by late May-early June. We puzzle over the persistent misrepresentation of the oil discovery process, where oil investors and analysts fail to allow for the lagged effect of changes in oil fundamentals on oil price changes, as if current oil fundamentals will magically transform oil prices instantaneously.*

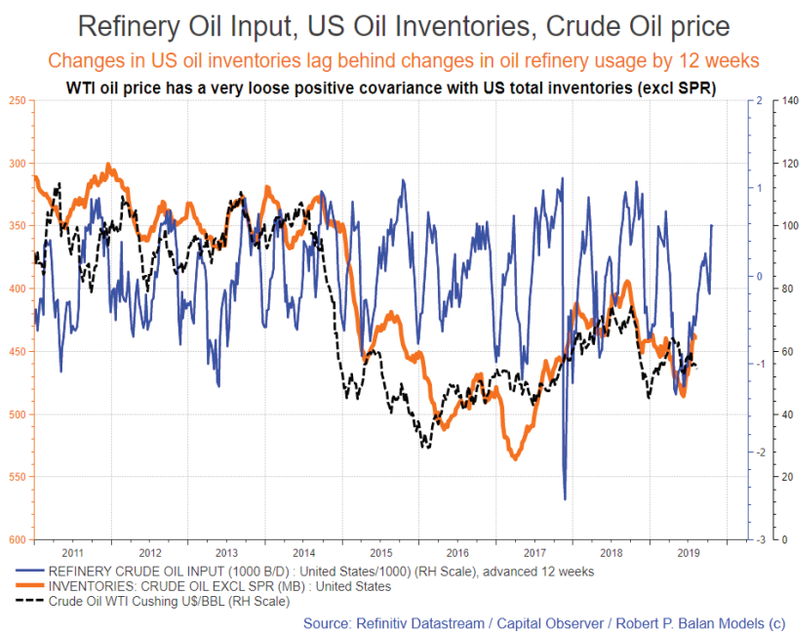
We argued in June 2019 that the US-centric oil data analysis was skewing the global oil price outlook.

We said:

Global oil traders seem intent on focusing on the trends of US oil inventories, and are not giving heed to actual global supply and demand data. The reason is obvious: we get weekly storage numbers from the EIA, and that data is conflated as supply for the entire US, which then becomes proxy for global supply and demand. That is totally wrong. It is very easy to prove that oil inventory trends are, at the root, a function of changes in oil refinery usage (see 2nd chart above), and usage leads by inventories by several weeks. The use of current US total oil inventories as proxy for current US oil supply is therefore wrong. And use of US oil supply as proxy for global supply is just as wrong, even worse.

Original chart from June 2019 issue of Capital Observer





That last comment in the June issue is especially relevant today. **At this time, US oil inventories, save a few weekly hiccups every now and then, are falling, and will very likely be on downwards trend at least until October 25, 2019 (the last data point on the refinery usage data in the 2nd graph above)**. But oil prices have been drooping in the past couple of weeks, signifying that global prices are driven by different factors, as inventories have been falling. This should put an end to the false market meme that US oil

inventories have a significant role to play in the global oil price discovery process.

At The Capital Observer, we have been hammering on the primacy of the variance between global oil demand and oil supply as the prime mover for global oil prices in the longer run. We have not seen any other model yet that surpasses the efficacy of the simple equation having the changes in the delta of supply versus demand as proxy for the changes in global oil price. And the beauty of this simple equation is that the supply-demand delta leads changes in the global oil price by 7 to 8 months (*see 1st graph on this page*).

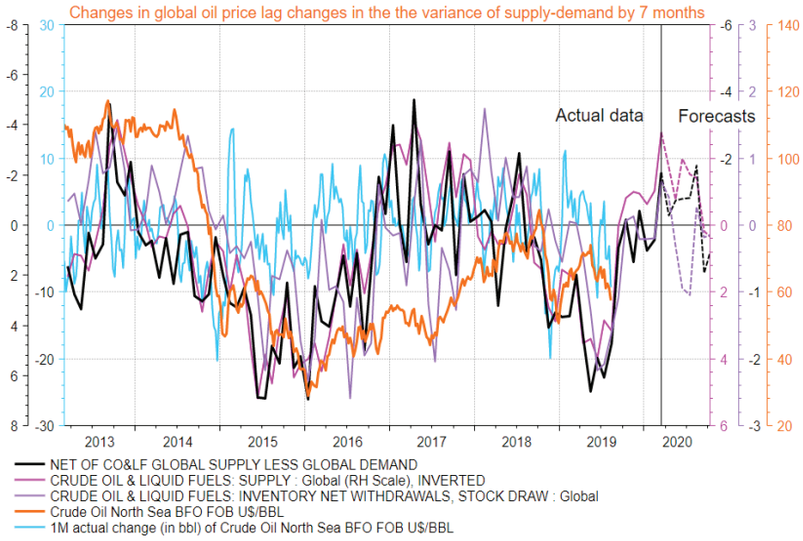
Nonetheless, trading oil requires more than having the knowledge that global prices are indeed moving your way, in this case higher, when the market becomes volatile, like at present. **The market focuses on the current changes in oil fundamental data rather than the lagged impact of the data on oil prices; also, other elements like the outlook of future US and global growth (Rest of the World) also become important input in the current oil price oil discovery process.**

What is keeping oil prices depressed over the past several weeks? Aside from fears of future global growth (the usual explanation for declining oil prices), we also argue that the lagged impact of oil fundamentals also exerted high-frequency changes in the global oil price development. For instance, there is a small upwards kink in the global oil supply in July which lasts until August (green line in the *2nd chart of this page)*, as well as rising US oil supply (pink line) and rising global oil production (purple line) during the same period. It is easy to match the current oil price weakness with those factors which have negative impact on global oil prices.

Nonetheless, the fact remains that the lagged impact of the reduced oil output and supply from OPEC+NOPEC, which started in October 2018, will very soon manifest in the current oil price (see 2nd graph above). We envision nearly

Impact of global oil supply and demand variance on Brent Oil price

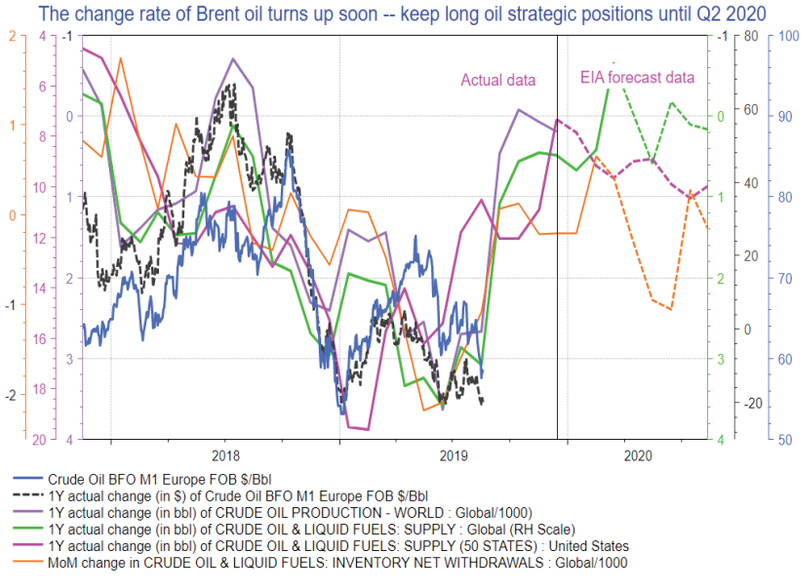
It's the change rate of the Brent Oil which corresponds to the changes in supply and demand



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

Falling oil supply, new OPEC output cut will push Brent oil above $90 by June 2020

The change rate of Brent oil turns up soon -- keep long oil strategic positions until Q2 2020



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

vertical oil price gains over the next two to three months, and probably well into year end. If we focus on diminished global oil supply as price prime mover from here on, oil prices should be ascendant until late Q1 2020.

The bugaboo, of course, is how well does global growth support this positive view of oil prices. **We do believe that we have seen the bottom of global growth in Q2 2019. IMF provides the rationale, and we discussed that issue in the July edition**:

After the weak H1 2019 start, growth is projected to pick up in the second half of 2019. This pickup is supported by significant monetary policy accommodation by major economies, made possible by the absence of inflationary pressures despite growing at near potential. ***The US Federal Reserve, the European Central Bank, the Bank of Japan, and the Bank of England have all shifted to a more accommodative stance. China has ramped up its fiscal and monetary stimulus to counter the negative effect of trade tariffs****. Furthermore, the outlook for US–China trade tensions has improved as the prospects of a trade agreement take shape.*

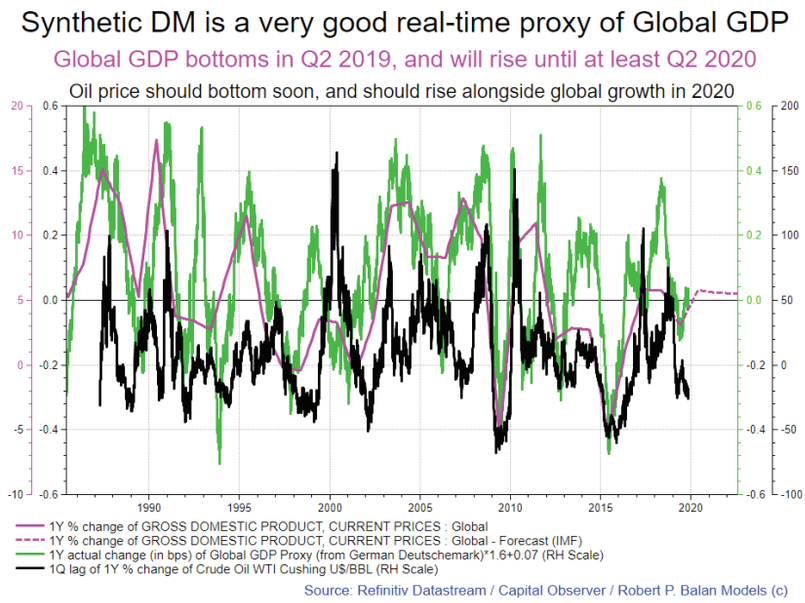
The IMF says that with improved prospects for the second half of 2019, global growth in 2020 is projected to return to 3.6 percent. This recovery nonetheless is precarious and predicated on a rebound in emerging market and developing economies, where growth is projected to increase from 4.4 percent in 2019 to 4.8 percent in 2020.

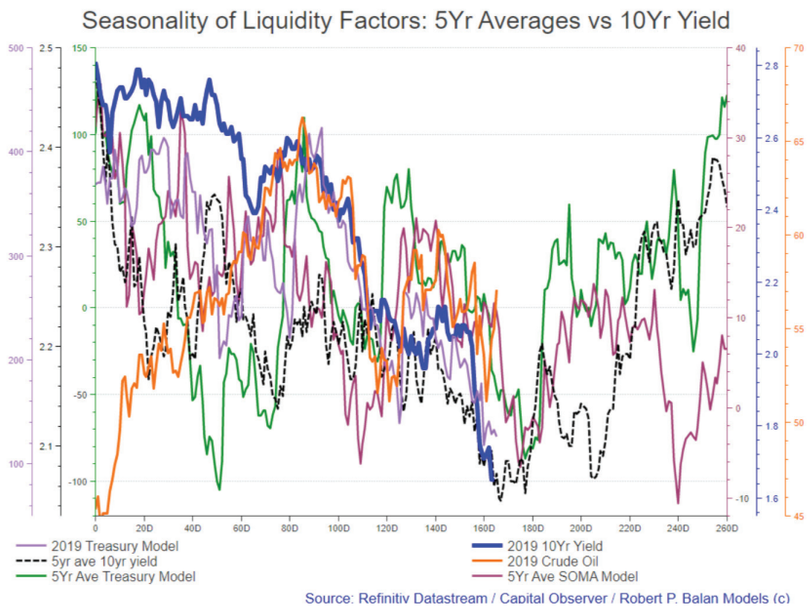
The Capital Observer decided to test the IMF's thesis of global GDP bottoming, and subsequently growing, as from the middle of 2019. We have previously created a real-time proxy of global GDP growth by taking elements from the German Deutschemark and from the Hong Kong Dollar. **This synthetic currency has back tested very well, and has been out-of-sample for more than five years. It mimics global GDP very well, and as proxy, it has the advantage of providing real-time "updates" to global GDP**. We show the results at the 1st chart on this page (green line). If global growth, indeed, develops the way the IMF suggests it would, we should also see oil prices rise accordingly.

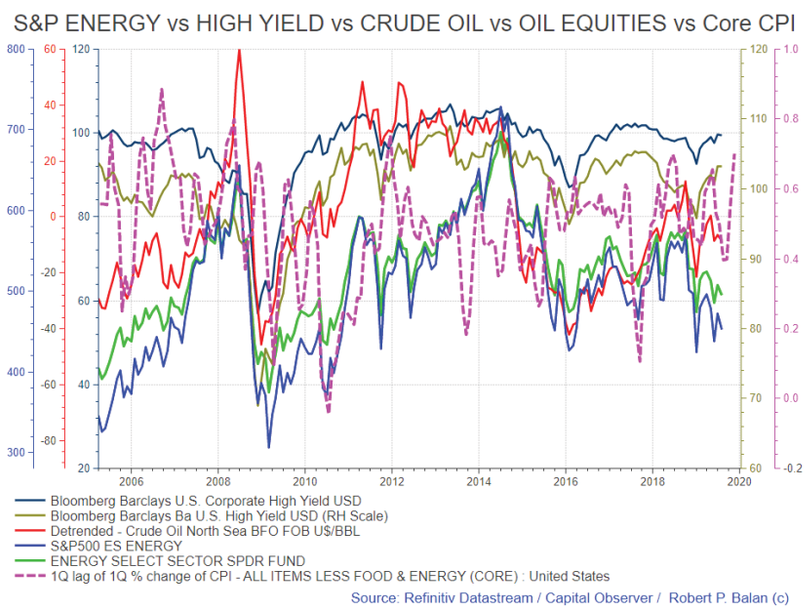
Another dampener in oil price growth had been the dismal state of the US ISM, which was (and still is) a primary reason for the sharp decline in yields. Oil has been having good positive covariance with yields, yields in this case becoming proxies for US and global growth expectations in the near term. This has been the case since late Q1 2019. It was only this week that a clear break from that covariance has happened (*see 2nd chart on this page*).

There were two factors that broke the relationship between oil and yields this week: sharp rise in Core CPI for July, and the fact that ISM manufacturing has been showing signs of bottoming.

Rising Core CPI inflation has very salubrious effect on US High Yields. Rising inflation signals better economic and market conditions; high yield issuance typically expands along with economic growth, when investors' appetite for risk often increases, and wane in deflationary or recessionary conditions when investors are more cautious.







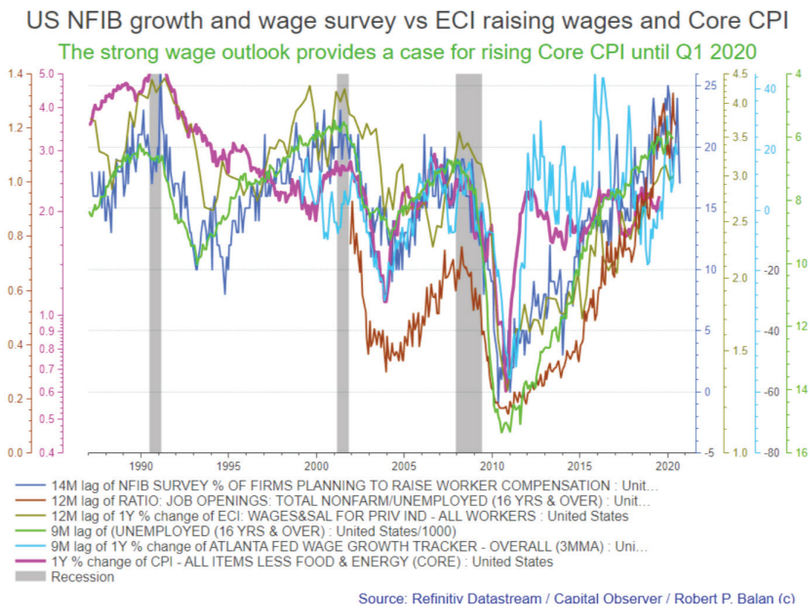
The link between HY and oil equities are well-known *(see 3rd graph on this page)*. Oil E&P companies depend largely on the HY market for a significant part in financing their operations.

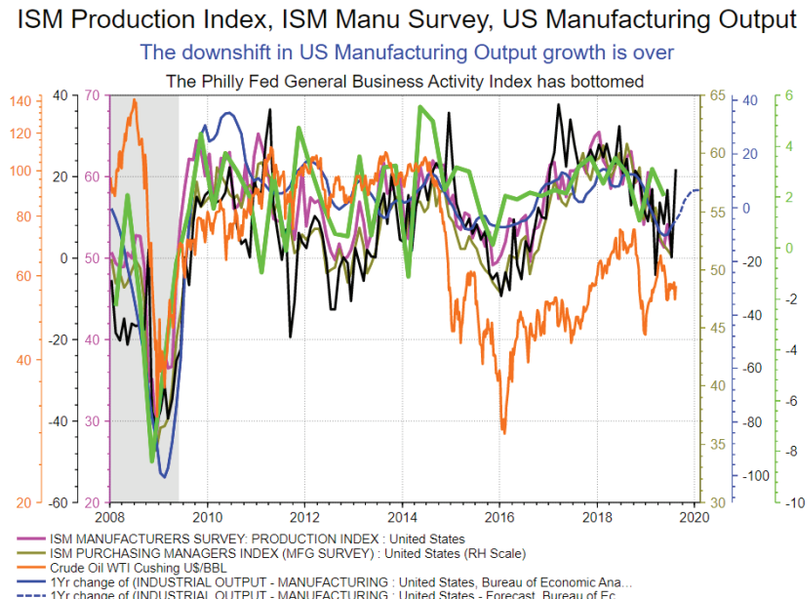
Moreover, rising Core CPI per se, has been positive for oil prices due to the growth implications of rising inflation (*(see 3rd graph on the previous page*).

Moreover, it also happens that we believe that inflation is about to take off in the US. This is a topic that we have been flogging for a long while. The rapid rise in wage growth and all the data that are allied with it, bakes in the cake a higher Core CPI until at least the middle of Q1 2020. This has been a staple of our argument that Core CPI will explode later in the year (*see 1st graph on this page*).

We also believe that the PMI, which has been the bogeyman for the Fed's rate cuts, has already shown signs of bottoming out. In fact, we believe PMI has bottomed. If ISM PMI ratchets higher, then oil prices will have to be repriced higher as well (*see 2nd graph n this page*).

Our thesis from April 2019 remains valid: oil prices are in a bottoming phase, on the cycle low side and we still expect Brent oil to rise to at least $90.00/bbl by Q2 2020.



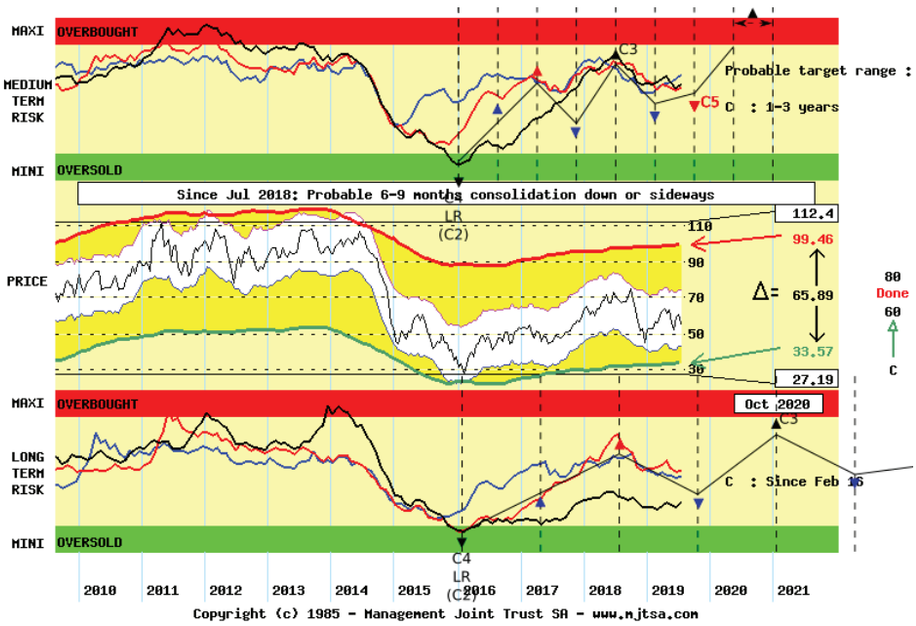


47 / MJT - TIMING AND TACTICAL INSIGHT

Oil remains under pressure for now, yet may find support and rally from late Q3

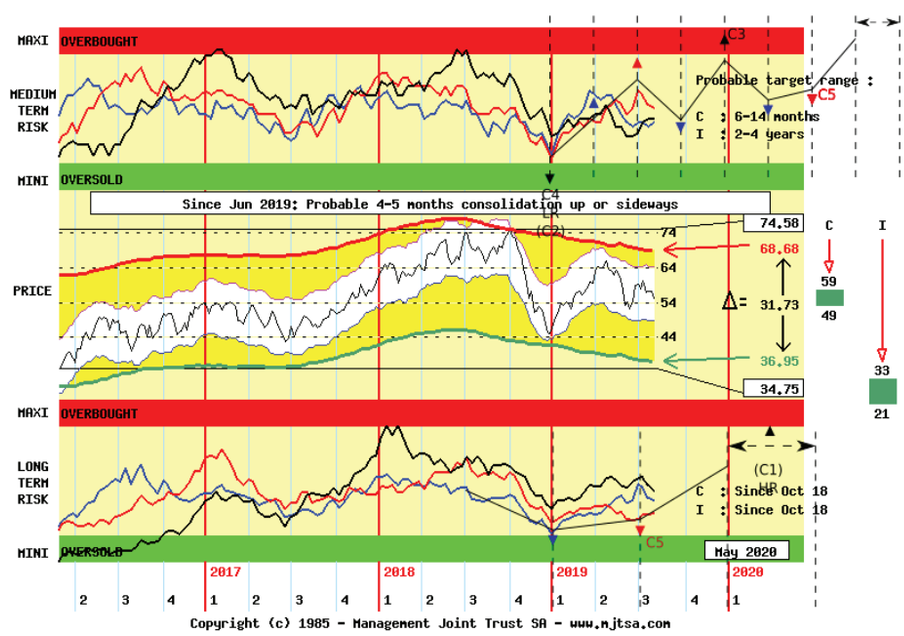
Following its strong April/May sell-off, Oil found support in June and bounced into July. Yet, it is currently retesting down, broke below its June lows on Brent, but seems to hold on WTI. In this article we analyze Oil and related trades in an attempt to assess the scope and length of the current sell-off as well as the possibility of Oil rallying again towards year-end.

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



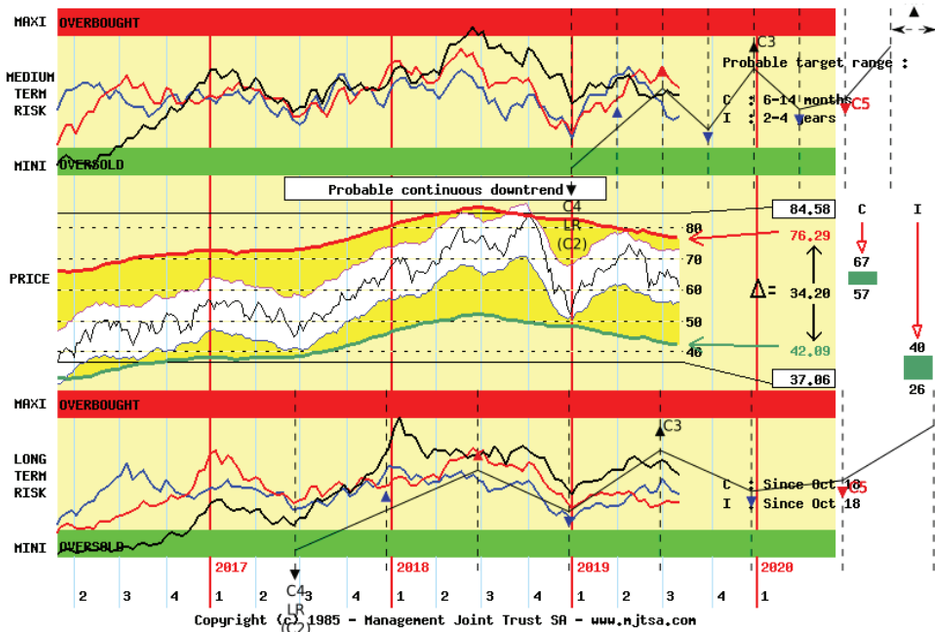
Both oscillator series (lower and upper rectangles) on this long term bi-monthly graph of light Crude Oil do support the possibility of a further upswing in Oil, probably from late Q3 / early Q4 into Spring 2020 at least. We hence believe that the uptrend since early 2016 is still underway and alive. Yet, we can also notice that it is still corrective for now, i.e. it never managed to make it above the resistance our C Corrective targets to the upside around 80 USD/barrel (right-hand scale). In this context, we will trust our oscillators, but remain conscious that for now this is theoretically just a correction to the upside, and that a reversal of trend to the downside is still a fair possibility.

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



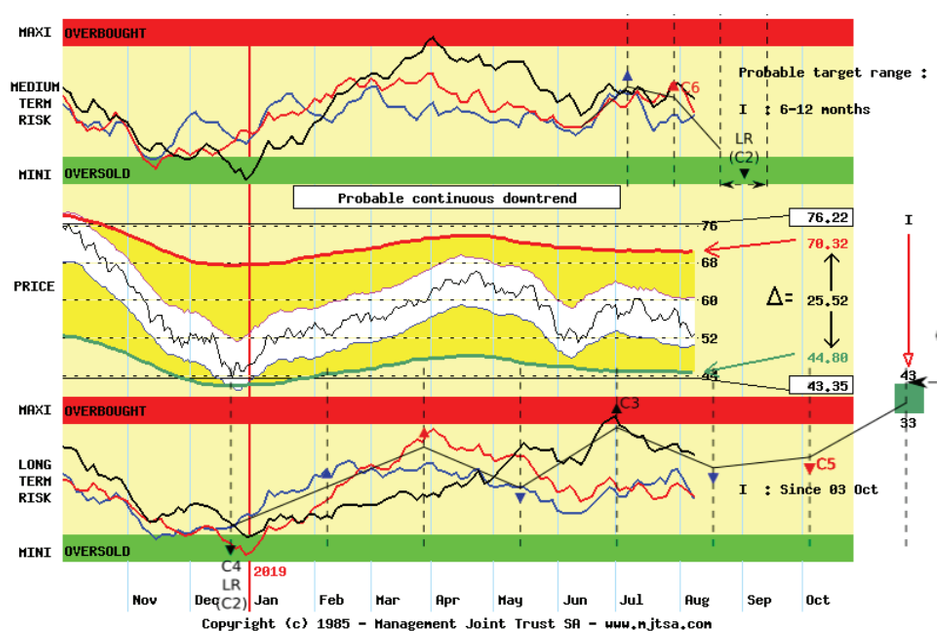
For now, on this Weekly graph, Light Crude Oil is still holding its corrective support (the lower end of our C Corrective targets to the downside, around 49 USD/barrel; right-hand scale). It did break briefly below these levels in December. Yet, this break down was rather short lived, and prices did rebound nicely thereafter. Our I Impulsive targets to the downside (right-hand scale) do however give us a clew as to the downside if these levels are broken to the downside once again. Yet, for now, we believe that our oscillator series are still relatively supportive. **Our long term oscillators (lower rectangle) would still justify a further acceleration to the upside into year-end / early 2020, while on our medium term ones, we would expect some downside retesting into late Q3, but following that a new rally should materialize into year-end.**

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



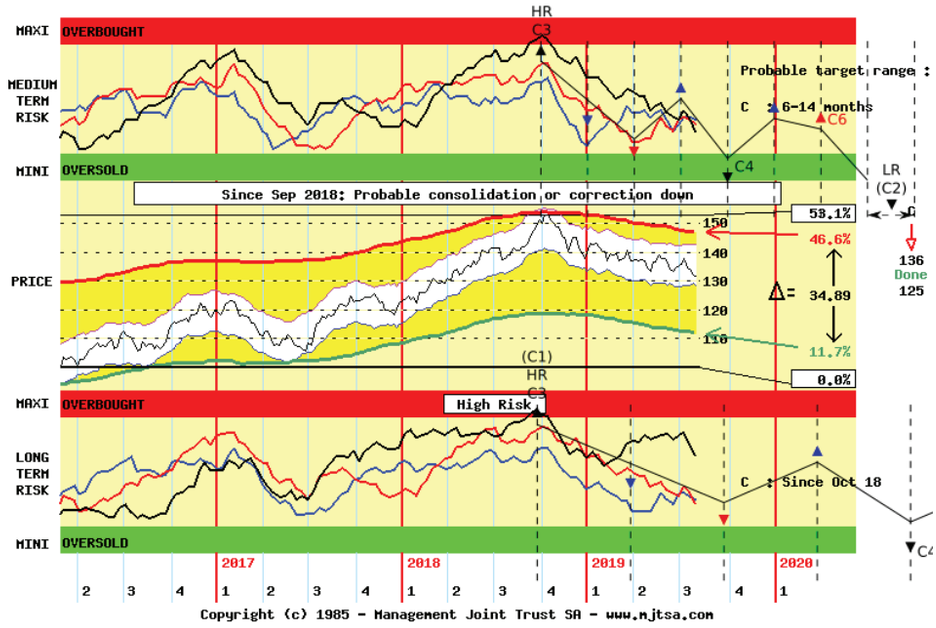
The recent sell-off on Brent Oil has been sharper and Brent is now below its June lows. Further, on a Weekly and End of Day basis, it is barely holding above the support of the lower end of our C Corrective targets to the downside around 57 (right-hand scale). Indeed, on an intraday basis, it actually broke below it on Wednesday the 7th of August.. Although our targets are not an exact science, they are rather good indicators of support and resistance levels, and Brent flirting with these is rather worrying. Hence, while on our medium term oscillators (upper rectangle), we would expect a correction down into late Q3, followed by a Q4 rally (as with WTI in the graph above), on our long term oscillators (lower rectangle), we would leave the door open to a more substantial correction into year-end. We would probably validate this more negative scenario if in terms of targets, Brent does retest down below its December lows, while, in terms of timing, we would probably be worried if Brent continues to slide beyond the late Q3 inflection point to the upside we expect. **For now, we remain constructive: we expect Brent to remain weak until late Q3 when it could start rallying again into year-end.**

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



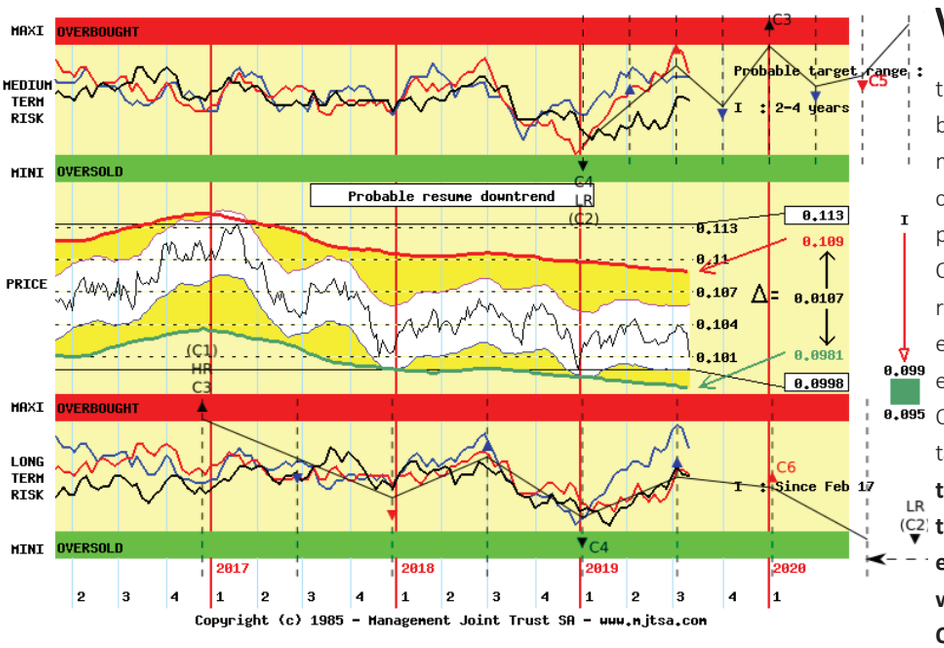
On this Daily graph of WTI, we picture our oscillator model as an uptrend on our long term oscillators (lower rectangle). This is rather positively aggressive. Yet, this model does give us the support points we will be looking for over the next couple of months. On both oscillator series (lower and upper rectangles), **we would expect to find initial support towards late August, perhaps early September. Following that, a further retest down, ideally with higher lows,may materialize towards late September / early October before Oil starts rallying into Q4. In the meantime, we will remain prudent as Oil eventually builds its base. Indeed, our I Impulsive targets to the downside (right-hand scale) are still very menacing.**

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



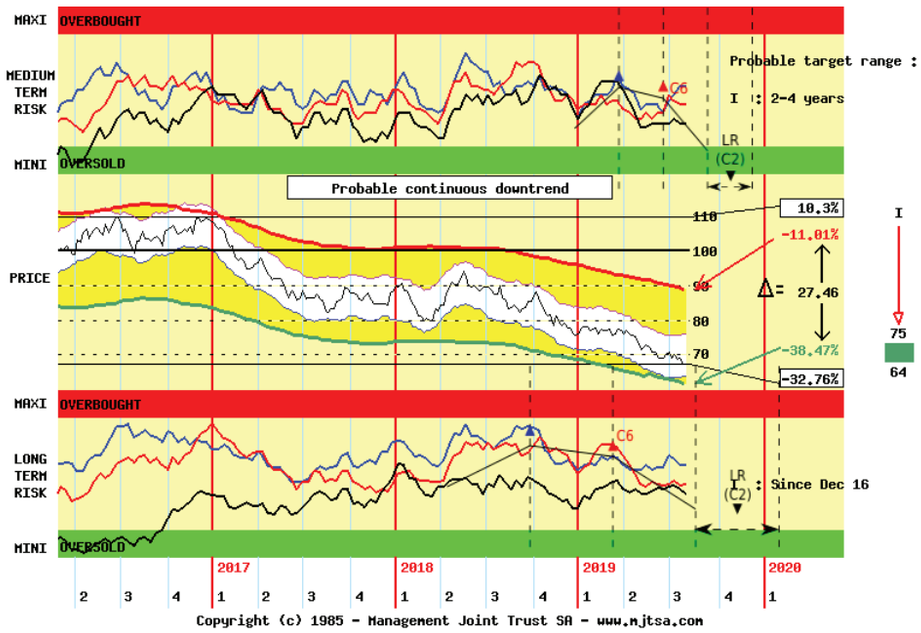
We seek to confirm this scenario by analyzing related geographical exposures. To this effect, it is interesting to compare Oil sensitive Norway with the Europe Stoxx 600 Index. The ratio is a rather pure play on Oil, and indeed, it has been moving lower since Oil topped out last year. According to both our oscillator series (lower and upper rectangles), **the ratio could continue to retest down until late Q3, when it could make an intermediate low. We then expect a 3 to 6 months bounce into year-end and early 2020**. These projections do confirm our prudent bias on Oil over the next couple of months, but they also back the probability of a new move higher from late Q3 into year-end and early 2020.

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



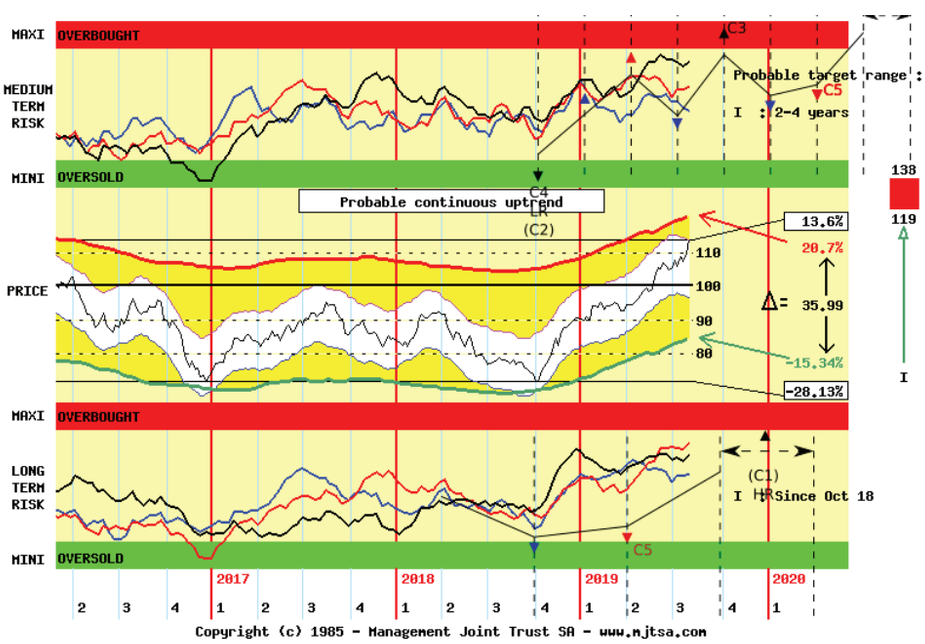
We now take this comparison on the currency front and review the NOK to EUR exchange rate. It has been fairly well synchronized with Oil movements over the last 3 years (except for late 2017), although the amplitude of its moves is more subdued. On our long term oscillators (lower rectangle), we expect the NOK to EUR exchange rate to hold up until year-end and then resume lower into 2020. On our medium term ones (upper rectangle), **we expect the current sell-off to continue until late Q3, and then, the pair should bounce into year-end. This again is pretty much in line with the market timing we expect on Oil prices.**

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



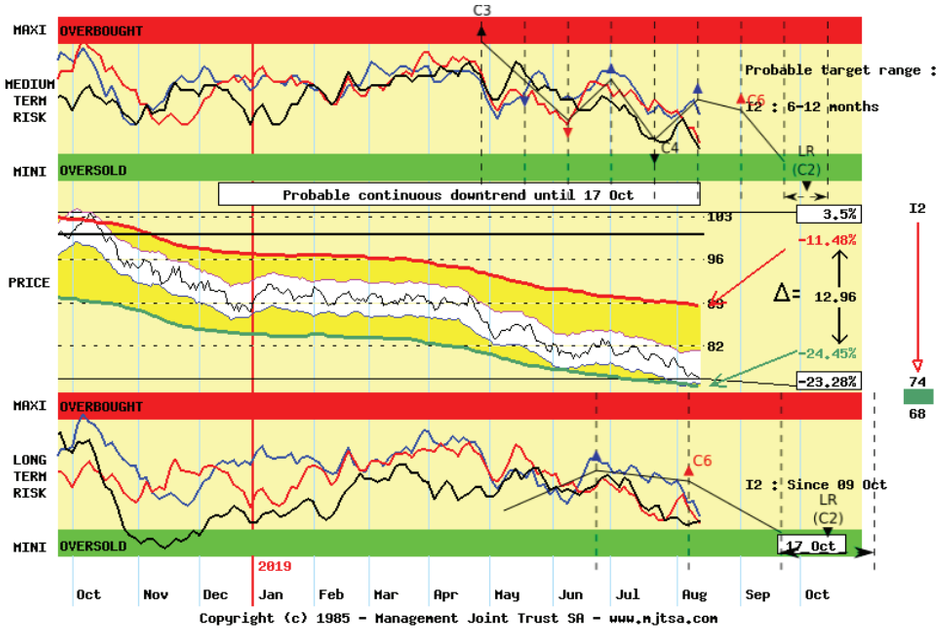
We now turn to the US Energy sector and its relative performance vs the S&P500. The ratio has timidly followed Oil in its upswings, while it has widely underperformed during periods of Oil weakness. This is due to the strong value characteristics of the US Energy sector, which with other value sectors has suffered since late 2016 from a flattening yield curve. Both oscillator series (lower and upper rectangles) suggest that **the US Energy sector could build a base starting soon, perhaps from late Q3. This timing could coincide with a pick-up in Oil prices, as well as more generally to the cyclical/value bounce that may materialize during Q4 (see article: "** Cyclicity is Oversold, yet its bottoming process is still underway **" p15 in this issue of The Capital Observer)**. It is also interesting to note that our I Impulsive targets to the downside have been reached (right-hand scale). Hence, in terms of price potential, the current downtrend should be pretty much exhausted.

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



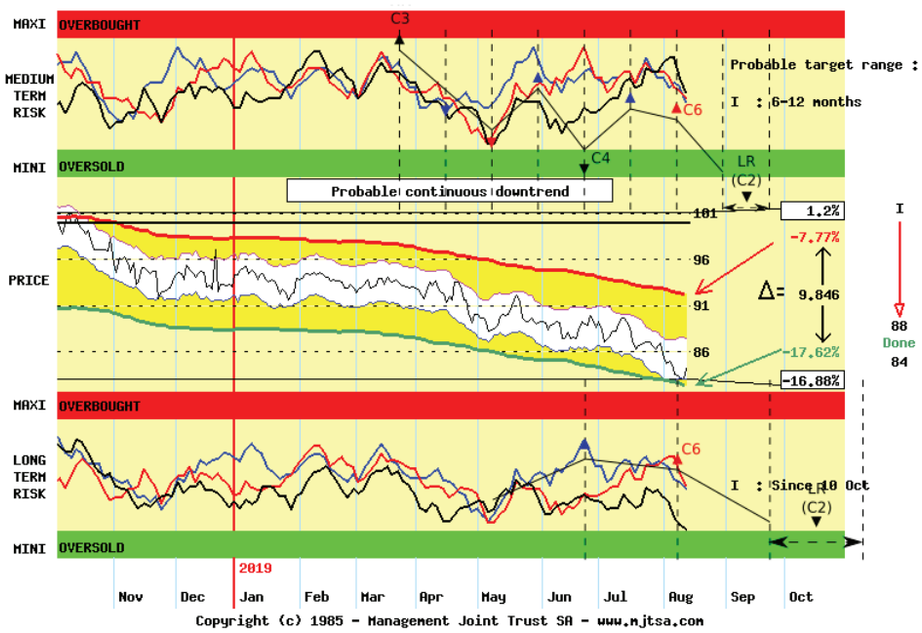
We now compare the Global Alternative/Clean Energy segment (ICLN ETF) vs the Global Energy sector (IXC ETF). Alternative Energy has been a strong performer this year while Energy has lagged quite substantially. Indeed, **the ratio is very much inversely correlated to Oil prices as Alternative Energy represents the Growth / Defensive component of the sector (it outperforms when the prospect for the wider Energy sector are bleak)**. For now, the ratio is still in a strong uptrend (Alternative Energy is widely outperforming the Energy sector). Yet, on both our oscillator series (lower and upper rectangles), **we expect it to reach an intermediate top towards late Q3. It could then retrace down into year-end, perhaps late Q1 2020** before it finally resumes higher into late 2020**. This is indeed pretty much the opposite of what we expect on Oil and on the US Energy sector vs the S&P500, which seems to confirm our scenario.**

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



We now consider the Daily graph of the US Energy sector vs the S&P500 index. For now, on both oscillator series (lower and upper rectangles), we expect **a continuation of the current downtrend, probably towards mid/late September, perhaps into October**. Yet, as with the Weekly graph, the downtrend here is pretty much exhausted in terms of targets. Indeed, **the ratio is approaching our I2 Impulsive 2 targets to the downside (right-hand scale). These are our more extended targets, and when reaching these, trends usually have a strong likelihood to pause, usually for 2 to 3 months at least. This ratio hence confirms that the underperformance of the US Energy sector should at least take a pause during Q4.**

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



Similarly, we look at the European Energy sector vs the Europe Stoxx 600 Index. The downtrend is probably also reaching exhaustion as our I Impulsive targets to the downside (right-hand scale) have been fulfilled and even slightly overridden. On the oscillator front, however, the sequences we show on both oscillator series (lower and upper rectangles) still suggest **further weakness into September and perhaps even October. Following that, we expect the ratio to be in a Low Risk position and potentially start to bounce during Q4.**

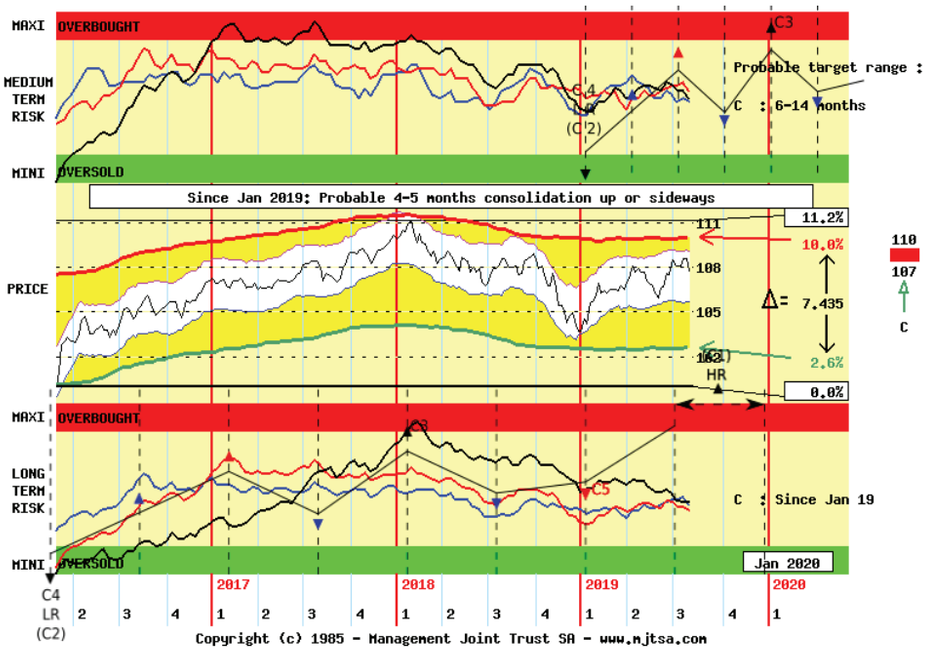
Concluding remarks

Oil, the Energy sector and most related trades are currently retesting down. While WTI seems to be holding up rather well, Brent has broken below its June lows, while related trades are mostly below their December lows. Although we cannot exclude a strong sell-off towards year-end, our analysis suggests that following further retracement towards its December lows, Oil should find support during late Q3 and then probably bounce into year-end, perhaps even into next Spring. Related trades are already very Oversold and many of their downtrends are reaching exhaustion on the price target front. This could provide a strong base for the whole Oil nexus to move higher again in the not too distant future.

52 / Splicing the markets – Credit may have topped out already, yet could see a good bounce during Q4

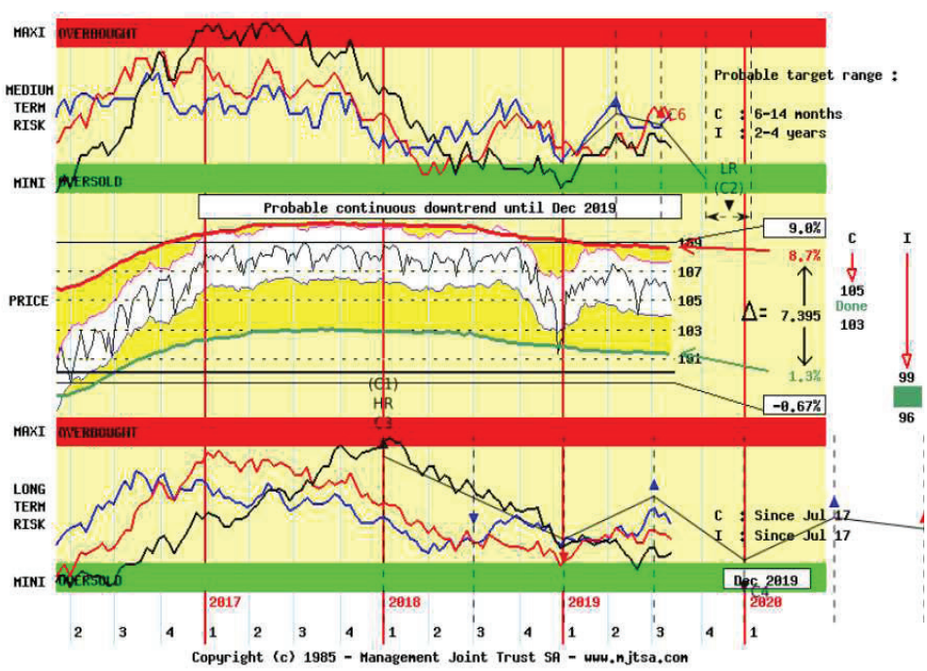
Throughout this issue of The Capital Observer, we expect risk assets such as Oil or equity markets to continue their current consolidation, probably for the next month or so, to find support towards late Q3, and then rally towards year-end. Credit markets are usually well correlated with other risk assets and in this article, we will seek to confirm a similar scenario for them.

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



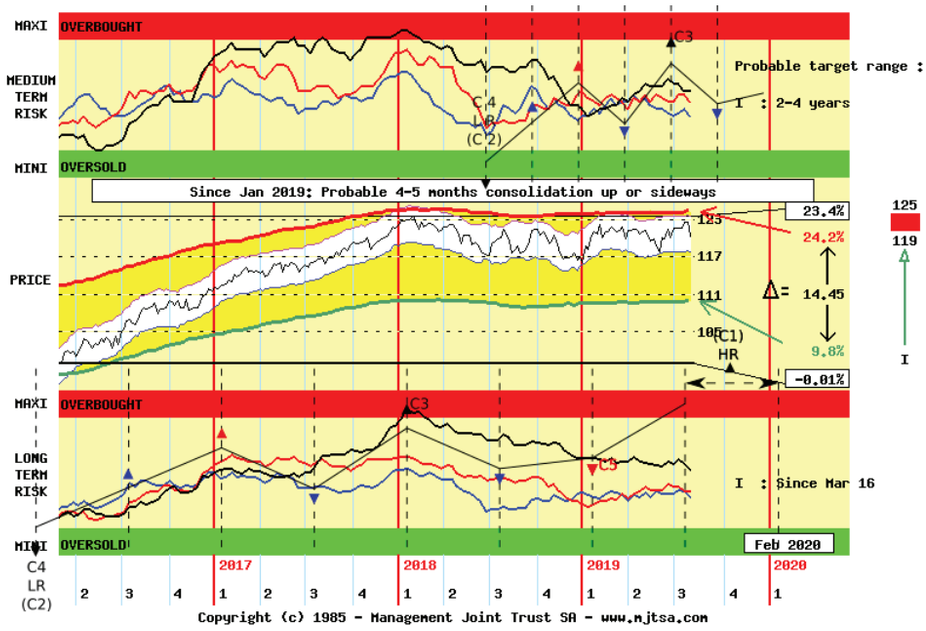
The ratio comparing US Investment Grade Corporate debt (LQD ETF) to US Treasuries of similar duration (IEF ETF) is indeed still uptrending on both oscillator series (lower and upper rectangles). On our long term oscillators (lower rectangle), it should continue higher, possibly towards year-end. On our medium term ones, as with other risk assets, we would expect **some consolidation to the downside until late Q3, before the ratio then resumes up again during Q4. From a target perspective, however, we are not convinced that the ratio will make new highs**, i.e. make it above its early 2018 top. Indeed, the correction late last year was quite deep, and the rebound that followed has been rather weak. For now, it is still a corrective bounce and still some ways away of breaking above the resistance of the upper end of our C Corrective targets to the upside (right-hand scale). On investment grade spreads, we hence expect a retest down during Q4, but probably no new lows.

US High Yield Bonds vs US Corporate Bonds
Weekly graph or the perspective over the next 2 to 4 quarters



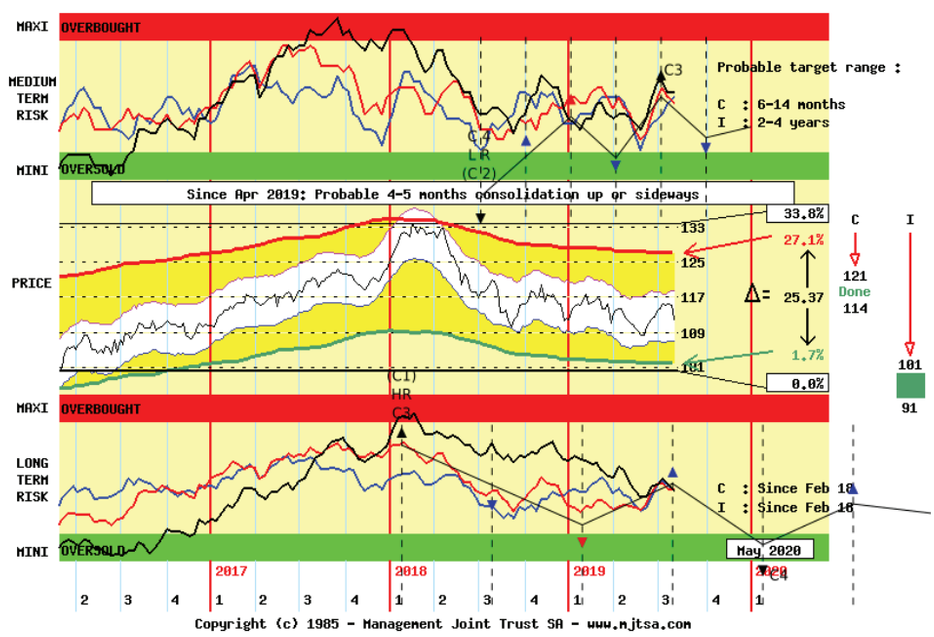
The ratio of US High Yield Corporate debt (HYG ETF) vs Investment Grade debt of similar duration (VSCH ETF) is weaker. On our medium term oscillators (upper rectangle), we expect it to **correct down into Q4, while this move may even extend into year-end** on our long term oscillators (lower rectangle). **For now, this deterioration in High Yield credit spreads is still in its early stages** as we are still above the support of our C Corrective targets to the downside (right-hand scale). Hence, a bounce during Q4 is still very much possible. This is similar to what we expect on the ratio above, yet probably weaker. However, if over the next few months, the ratio does break below the lower boundaries of our C Corrective targets to the downside, it would be more worrisome for the state of the US High Yield market.

US Dollar denominated Emerging Sovereign debt vs US Treasuries
Weekly graph or the perspective over the next 2 to 4 quarters



Emerging Markets Sovereign Bonds denominated in US Dollars (EMB ETF) are still uptrending for now vs US Treasuries of similar duration (IEF ETF) on our long term oscillators (lower rectangle). **Yet the move is probably getting rather exhausted**. Indeed, on our medium term oscillators (upper rectangle) we expect some correction into late Q3, but are not convinced that following that the spread can then make it back up to new highs. Indeed, this oscillator configuration already seems quite advanced (medium term black top). Furthermore, in term of targets, there is little potential left to the upside as our I Impulsive targets up (right-hand scale) have pretty much been fulfilled.

Emerging Markets local currency Sovereign Debt vs US Treasuries
Weekly graph or the perspective over the next 2 to 4 quarters



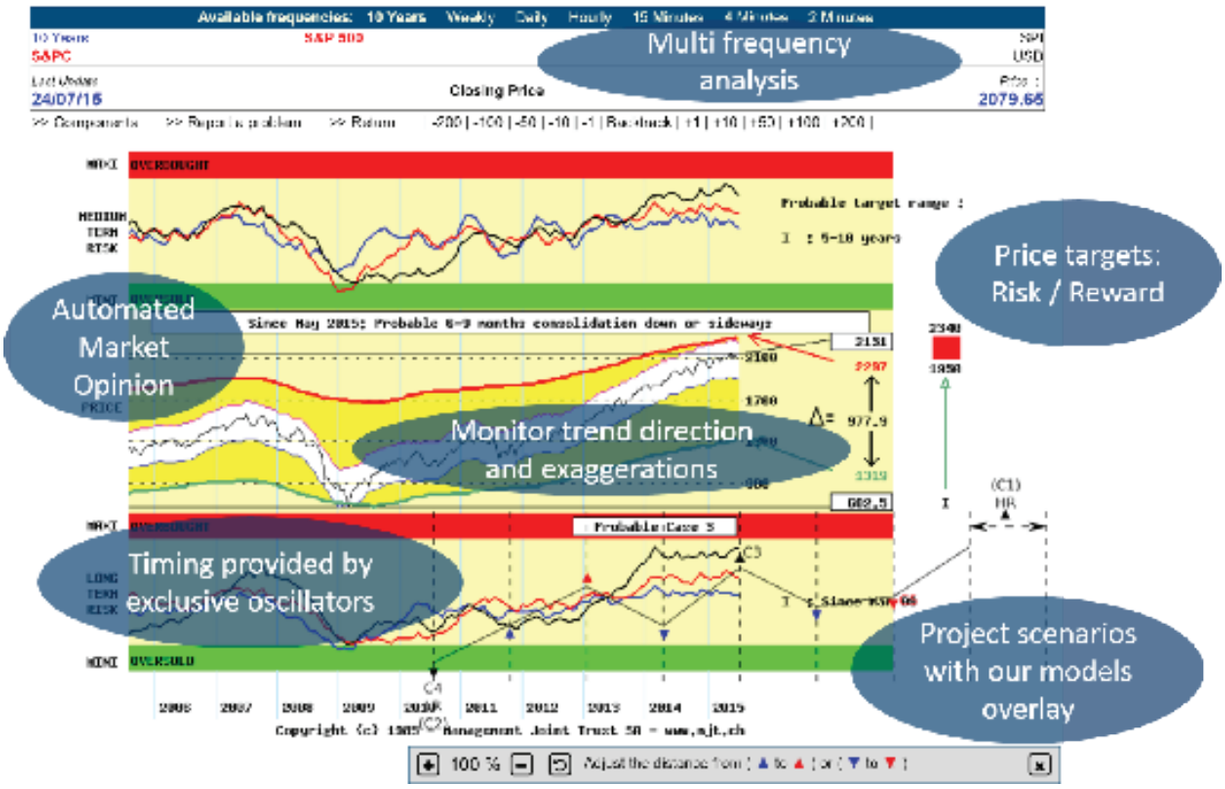
Our prudence in the graph above is partly explained by the one of Emerging Markets Sovereign debt denominated in local currencies and expressed in US Dollars (LEM ETF) vs US Treasury yields (IEF ETF). . On our long term oscillator series (lower rectangle), the downtrend is well established and **we expect it to resume lower into early next year. On our medium term ones (upper rectangle), we expect the ratio to remain under pressure until late Q3. It may then bounce into Q4, yet probably with limited scope, before it resumes lower into 2020. On the targets front (right-hand scale), the move does seem clearly impulsive to the downside as we have tested multiple times below our C Corrective targets to the downside** (right-hand scale). The next levels of downside targets, our I Impulsive targets to the downside (right-hand scale) are **pointing to much lower levels. These could be achieved over the next 12 to 18 months.**

Concluding remarks:

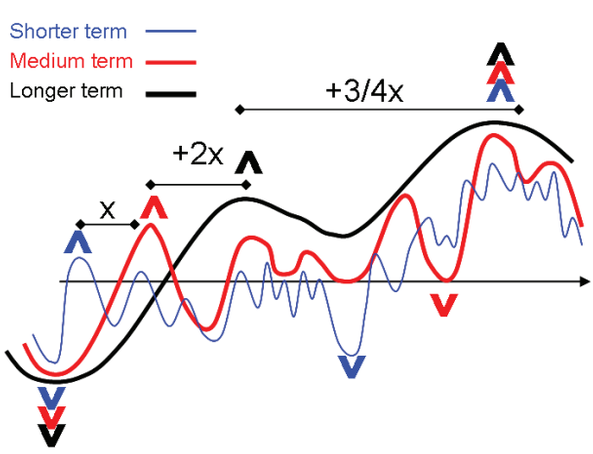
As with other risk assets, the ratios of Credit products vs US Treasuries may see some consolidation to the downside into late Q3. They may then bounce during Q4 before resuming lower in 2020. From a targets perspective, we believe that Credit market probably topped out in early 2018, and that any positive move between now and year-end will probably not make new highs (on the ratios of Credit products vs US Treasuries). High Yield and local currency Emerging Markets debt seem especially weak vs US Treasuries. They could still see a bounce during Q4, but their downtrend into 2020 seems well in place. Inversely, these projections imply that Credit spreads probably bottomed in early 2018, and although they may see further retracement down towards year-end, should then move higher during most of 2020. On an absolute basis, Credit products may hold up though until year-end. First during Q3 as Treasury yields continue to retest lower, then during Q4 as cyclicity may see a last bounce, and credit spreads remain under pressure. 2020 should then spell a different, more negative story for the Credit markets.

54/ METHODOLOGY

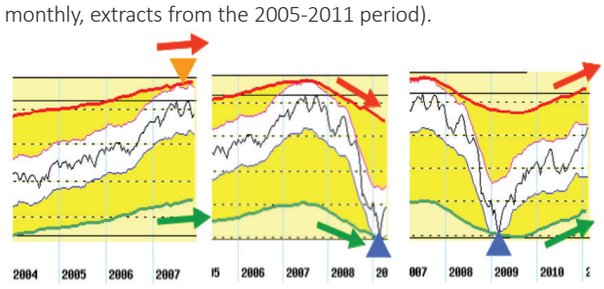
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



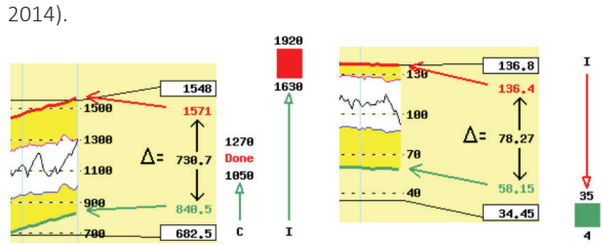
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)



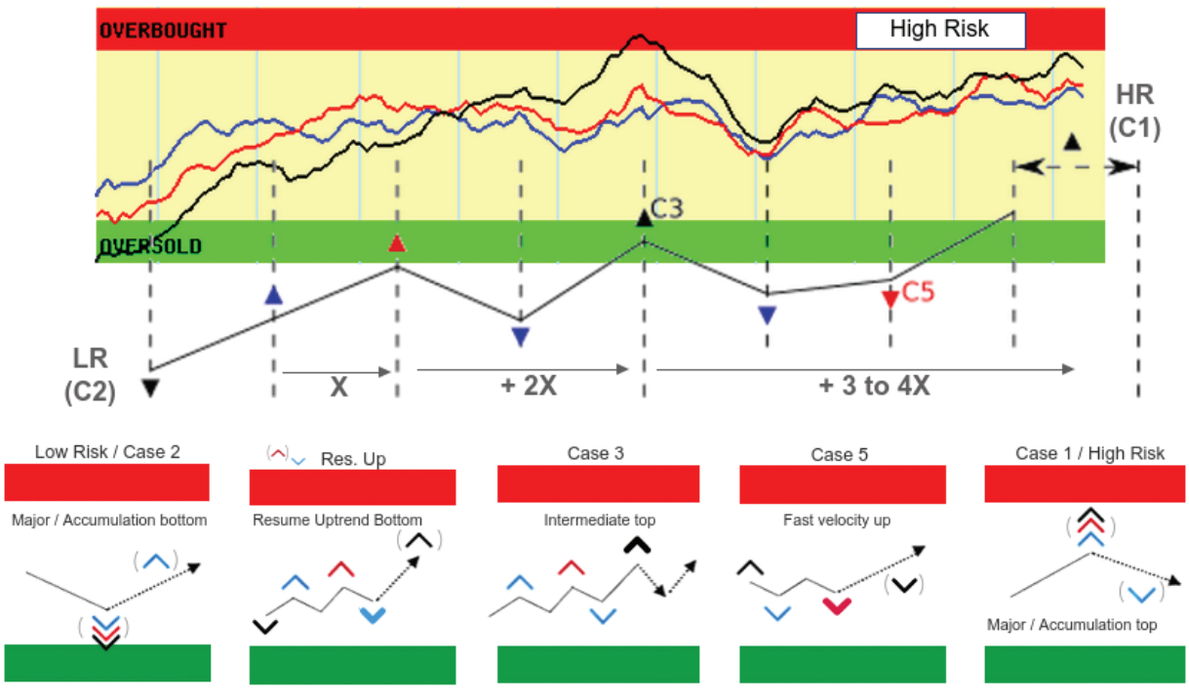
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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

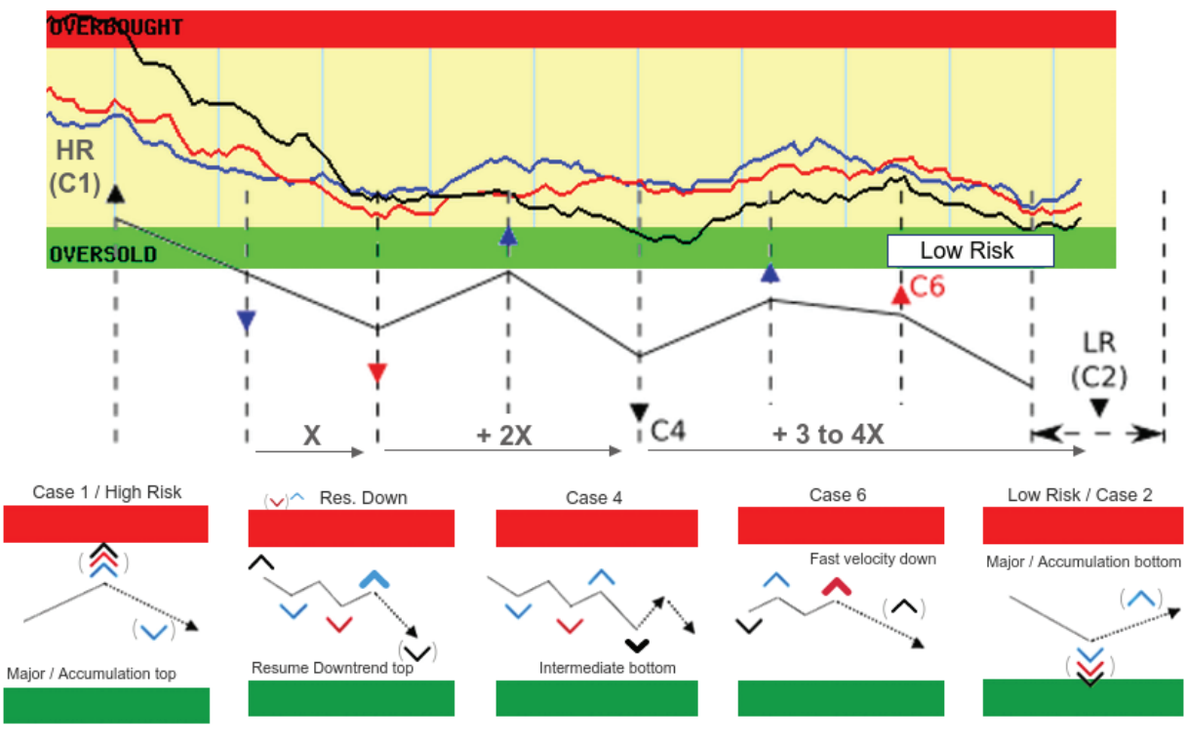


Ideal Uptrend Model



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

Ideal Downtrend Model



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

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