THE CAPITAL OBSERVER

MAY 2019

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THE CAPITAL OBSERVER

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

MAY 15, 2019

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"Until recently, the G20 gathering was seen marking a possible venue for signing a trade deal.The question is whether the market remains overconfident that we can avoid an ugly mis-step or worse in the interim. The stakes are high for global investors and the market is rather poorly positioned after 'stockpiling complacency' in the wake of the Fed's dovish policy pivot since the beginning of the year"

Mr. John Hardy, Saxo

4/ Executive Summary

12 / **The Big Three economies: prospects for contributions to global growth this year and the next; US will remain the lead driver** - The US economy is being defined by its fantastic jobs situation, but there are worrying internal details elsewhere specially in the manufacturing sector. These numbers are being supported by the JOLTs data which serves as internal check for how good or bad the job situation is in reality (see below). There is a lot of talk about the Fed cutting rates soon, if the stock market hits a sinkhole, and falls. Or the stock market gets frightened due to the trade kerfuffle, and falls like 20%, the threshold for a bear market. With the jobs market this red-hot, the Fed is unlikely to cut to boost the markets.
Recent stimulus efforts appear to be having an impact on Chinese economic activity, with rebounds in manufacturing investment and new orders in recent months. And the Shanghai stock market rose a heady 30 percent in just a few months. But after a snappy start, and vigorous fiscal expenditures, the Chinese government started to pull back. But absent a shock from a non-agreement, the Chinese economy should start to benefit from previous stimulus efforts by the second half of 2019.
There have been a few economists characterizing the trouble of the Eurozone as the "Long Depression," that the Brussels directorate insists on zone-wide austerity because that's how the EU's current account surplus is maintained. However, collapsing corporate investment is the real story of the ongoing eurozone crisis. The Eurozone will be a drag to the global economy this year, and the euro will be very vulnerable to the kind of shocks that the British Pound has endured in the wake of Brexit, and from Brexit itself.

17 / **Timing and Tactical Insight - US reflationary assets could lead the market higher into the Summer -** Despite the strong rally since the beginning of the year, and considering for the current Trade War related market correction, which may continue a few more weeks, we expect US equity markets to remain strong into the Summer. Our targets for the S&P500 could see it reach above 3'100 by then. We also expect the US growth differential to China, Europe and the rest of the world, to resume its uptrend, into the Summer at least. US long term interest rates should also resume their uptrend, while the US yield curve could start to steepen quite rapidly, and the US Dollar remains strong. If correct, these developments could fuel further positive feedback loops for the US, as successive capital inflows exacerbate these trends. We are hence favoring US reflationary assets to lead global markets higher over the next few months at least.

24/ **No mystery: the yield curve is a creation of the bond term premium, which itself, is a creation of the Implicit Price Deflator** - We make a priori claim that the bond term premium drives the yield curve. If normalized properly it is clear that both the FFR and the bond term premium are sort of derivatives of the Implicit Price Deflator (IPD). It is clear that "internal" inflation (IPD) as proxy to the PCE, drives the rate policy reaction function of the Fed and FOMC, and whatever action they take is transmuted and manifests as the bond term premium. The significant point is that IPD leads the bond term premium (and the yield curve) by three quarters. The IPD change rate has been falling lately, and the term premium and yield curve are now at the previous inflection point of the IPD lower. Therefore, we can expect the term premium to start rising at some point in the immediate future. That means too that the yield curve should start steepening at that same point very shortly after the term premium starts rising.

26 / **Timing and Tactical Insight - Yields could reverse up soon and the time to take profit on duration is probably near** - US yields across the yield curve have been correcting down as expected since October. We believe they are now approaching important support and that their downside potential for has been pretty much achieved. We hence expect them to bottom out soon, probably towards late May, and initiate a reversal up towards the Summer. US yields may accelerate up quite strongly, potentially retesting last year's high towards late Summer / the Fall, while the correction could be weaker and/or shorter for other Sovereigns including Europe and Emerging markets. We hence also believe that the growth and interest rate differential between the US and Europe could rise once again. Shorter term, until late May, the risk of a last sell-off in yields remains. We believe it could accompany the risk asset correction, which is still underway, and may even overshoot it by a couple of weeks (similarly to what happened in January this year, or before, in early September 2017). Hence, over the next few weeks, we would remain prudent on yields, which could still make new lows. We would however consider such weakness as an opportunity to take profit on duration.

32 / **The S&P major sectors – how they are faring and why** - Financial stocks historically outperform in the end of most business cycle and when the net interest sprehad (NIM) that they earn rises and the economy is in full employment. The broad rise of the Net Income Margin has set the tone for better earning profile of the financials over the next 18 months at least. After the GFC recovery, lending has been a drag on financial earnings, and the evidence is the tremendous amounts of bank reserves the banks are parking at the Fed. Probably one reason why the banks are curtailing their loan portfolios, and likely hedging their risk exposure to other financial assets, is the poor outlook the banks have on the US economy.
The industrial sector is based in exports and given that president Trump has implemented the impose of tariffs in Europe and China and already its big trading partners have responded, the result will be lower exports for industrial companies, lower domestic gains and possibly higher inflation. If the negative correlation of the energy sector with the US Dollar comes back, and it does so intermittently, it will increase the opportunity cost of oil and most of the commodities. So, this sector reasonably has still a little upside unless Oil is able to push as a late cycle spike toward the $85/$90 range.
The underperformance of materials stems from the fact that materials' orders rate is higher than sales rate during a strong recovery. We have not seen that for some time, and judging from the limited period left of the upswing of the business cycle, the next 3 to 5 months seem to be the last window for this sector to perform before economic weakness forces the material sector to decline in the late part of the year.

5/ Executive Summary

35 / **Timing and Tactical Insight - The next leg up in equity market may be focused on US reflationary sectors**- We've concentrated our sector analysis on themes that usually benefit from reflationary trends. We've also decided to remain quite US centric. Indeed, the trends we highlight in other articles of this issue of The Capital Observer seem to favor such exposure into the Summer: we are expecting a reversal up in yields, a steepening yield curve, as well as renewed outperformance of US equity markets vs the rest of the world. Financials and Industrials would be our first choice, probably from late May, as in the meantime they could still retrace on both an absolute and relative basis during the current equity market correction. In Europe, these sectors also look quite interesting, although European Banks may take until June before they start rebounding vs the market. We've also looked at US Energy, which is very much Value driven and has been a persistent underperformer over the last couple of years. We believe it may also reverse up vs the market into the Summer, following the yield curve higher. Though, here also, the reversal point is probably slightly later, in June.

43 / **Gold marks time within the confines of a trading range, but expect support sometime in Q4 followed by a more positive outlook** - After the global central banks flooded the global financial system with liquidity to kickstart growth by deploying humongous amounts of money and quasi-money, the price of gold effectively decoupled from the US Dollar, and has acquired a strong, negative covariance with US bond yields. It is easy to demonstrate that lower interest rates promote stronger GDP growth. But since lower bond yields also push up the price of gold, necessarily, rising GDP growth has now become analogous to rising prices of gold. We expect a sharp sell-off in equity prices until late June-early July, and indeed gold may become a safe haven in conjunction with falling bond yields. Gold should begin to acquire stronger sentiment and fundamental support by circa early Q4 2019 and by Q2 2020, it may be finally break above the $1350 constraint and move towards the long-coveted $1500 level. China, Russia and other global central banks continue to build their gold reserves providing an underlying bid for the yellow metal. In fact, this would be the biggest single factor that would provide support for gold in the longer term.

46 / **Timing and Tactical Insight - Gold – a weak retest up and then a last downside retest into late Summer -**With the current sell-off in risk assets, Gold is attempting to retest up towards its February highs. It still has some way to go to reach these levels, and we believe it will probably fail to do so. Indeed, our timing for this move up is quite short, and should probably end over the next couple of weeks. Together, with this weak bounce in Gold, USD/JPY has been selling-off and EUR/USD has attempted to rebound. The former is probably close to being Oversold, while the later is still stuck around 1.12 (a very weak bounce for now). From late May, perhaps early June at the latest, we expect all three assets (Gold, the Yen and the Euro) to resume their downtrend vs the Dollar, probably towards mid/late Summer. Hence, Gold should retest down over the next few months as the US Dollar rises. However, longer term, on a cross-currencies basis, the intrinsic value of Gold may be starting to turn up. The uptrends of Gold vs the Euro or the Yuan for example, since last Fall, already seem quite strong. They could also retrace into the Summer, yet we do not believe these retracements will be very deep. Following that, Gold in EUR or CNY could start accelerating up quite strongly towards year-end and 2020, probably above their mid 2016 highs, thereby breaking out into a new secular uptrend. Gold in US Dollars, or vs defensive currencies such as the Yen, should follow with a few months lag.

54 / **Splicing the markets - Monitoring the current Trade War correction -** Over the next couple of weeks, we expect risk assets and especially the S&P500, the EuroStoxx 50 or Oil to find support (perhaps 2 to 5% below current levels) and gradually start to resume their uptrend towards the Summer. Our prices targets indicate that by then all three could retest / and perhaps markedly take out last year's highs. The prospects for the Shanghai Composite are less clear. Indeed, the correction down over the last few weeks has been quite deep, and the upside momentum, which prevailed during Q1 may now be broken, or could even start to reverse. We view levels around 2'700s on the Shanghai Composite as crucial support points, which if they break could confirm a deeper reversal, and possibly the beginning of a new longer term leg lower on Chinese equities.

6/ Mapping the markets

Last month, when we published on the 11th of April, we confirmed our call for a 3 to 6 weeks risk assets correction to the downside until late April, perhaps early/mid May. This correction has taken time to materialize on the main equity index, yet has been underway for almost a month on many sectors and geographies (e.g. Cyclical sectors, Materials, Energy, Healthcare, or Emerging Markets). We had expected retracement levels towards 2'750 - 2'650 on the S&P500, and towards 3'330 - 3'200 on the EuroStoxx 50. For now, we have tested down slightly above these, yet the downtrend could still extend lower over the next couple of weeks. A month ago, we also expected that interest rates could resume down and retest their March lows, that Gold could bounce, while Oil corrects, and that the US Dollar (which we considered to be rather pro-cyclical) may correct down slightly. These trades have taken until late April to get going, yet are currently underway.

Going forward, we expect this risk asset correction to continue for another couple of weeks, probably towards late May. The S&P500 and the EuroStoxx 50 could still reach down into the ranges already mentioned above. Defensive assets such as Treasuries, USD/JPY and to a certain extent the EUR could outperform slightly longer into early June. Gold, on the other hand, is attempting to retest up, yet already seems quite Overbought. It could top out late May, probably in the 1'320- 1'330 range. We do not expect it to make new highs. Note: this month, there is a slight discrepancy between our technical cyclical models, and the liquidity macro models we follow. Indeed, the negative impact of liquidity seems to persist until mid/late June (thereby pushing yields, the yield curve and risk assets lower until then), while our technical models would suggest support for risk assets towards late May, perhaps early June. Our consensus view would be to expect initial lows in equities towards next week, or the fourth week of May, a bounce into the first 2 weeks of June, and then some retracement into mid/late June. Following that, risk assets should resume up into the Summer.

From June, we would see some remaining upside potential for Cyclical themes. Indeed, we expect that by then, long term yields will have bottomed out, and that these could start reversing up into the Summer. The move could be quite strong with US yields, potentially retesting toward 3% on the US10Y. As a result, and with the FED "on halt", the US yield curve could steepen quite rapidly. This trend could benefit the Financials and Industrial sectors, and with a slight lag Energy into mid/late Summer. Indeed, we expect Oil to also find support towards late May, early June, and to potentially re-accelerate up into the Summer. It could retest last year's highs by late Summer. The US Dollar, as it has done over the last few years, should follow these cyclical assets higher. US equities should also outperform the rest of the world. Inversely, Gold, Defensive and Growth sectors, China and Emerging Markets could lag or underperform in this environment of rising yields.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	US Equity market may continue to sell off towards late May, and then should start to resume their uptrend during June (2 to 5% short term risk).	From mid /late June, US Equity should start to accelerate up again into mid/late Summer.
	Europe EuroStoxx50	European Equity market may continue to sell off towards late May, and then should start to resume their uptrend during June (2 to 5% short term risk).	From mid /late June, European Equity should attempt to move up again into mid/late Summer.
	EMs MSCIEM USD	Emerging Markets could continue to slide lower beyond May, and could find intermediate support towards mid/end June	From June, Emerging markets could enter a weak bounce towards mid Summer, Commodity producers should outperform.
Treasuries	US10Y Bond prices	US Treasuries yields are currently retesting their March lows and could make marginal new ones towards late May (2.4 - 2.2% range on US10Y).	From June, we expect Treasury yields to reverse up and move up during the Summer. Towards late Summer, the US10Y may reach back towards 3%.
	Germany 10Y Bund prices	German Bund yields are currently retesting their March lows and could bottom towards late May (towards -0.2% on the German 10Y).	From June, we expect Bund yields to reverse up and rebound into the Summer with 30 to 40 bps of upside potential.

Legend:	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight

Main Equities

World markets
p 17-21, 54-55

Equity markets have finally started down early May in the intermediate correction we had expected last month. We believe it should continue into second half of May. Initial targets in the low 2'800s or the high 2'700s on the S&P500 have been reached, yet a break below 2'780 could still trigger a further sell-off into the low 2'700s / high 2'600s. From late May, at the latest early June, we expect equities to start resuming their uptrend towards the Summer, with target towards 3'100 late Summer on the S&P500.

Main Regional picks
p 17-21

China started in its correction earlier than other markets towards mid April. We believe this is a sign of weakness, and our relative graph seems to confirm it into the Summer. More generally, on a relative basis, US markets seem to be resuming their uptrend vs other regions (following their underperformance in Q4 last year). We expect them to outperform once again into late Summer.

Emerging markets
p 18-20, 55

Emerging markets, which had lagged the S&P500 since the beginning of the year, are now accelerating lower in the wake of China, probably into June. We expect most of them to underperform the All Country World Index, and especially the S&P500 Index into late Summer. Oil exporters such as Brazil or Russia may be the exception, probably from June into the Summer.

Volatility

Volatility may retest its recent highs over the next week or so in the low 20s. Yet, from late May, should resume its downtrend into the Summer.

Government Bonds

US & European Benchmarks
p 22, 26-29

US and German Treasury yields made an initial bottom late March. Yet, a downside retest is underway, which could make marginal new lows until late May. Following that, we expect Treasuries to bounce strongly into the Summer. German Bund yields may correct up by 30 to 40 basis points, while the re-acceleration up on US Treasuries yields may be much stronger, possibly retesting above 3% on the US 10Y, and perhaps even above last year's highs.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	The ratio should bottom out towards late May with yields and as Equities start to resume their uptrend.	From June, the ratio should resume its uptrend into late Summer, along with equities and yields.
	Europe	The ratio should bottom out towards late May with yields and as Equities start to resume their uptrend.	From June, the ratio should resume its uptrend into late Summer, along with equities and yields.
Duration		The short term end of the yield curve (US3Y-US3M) continues to retest its lows until late May, while the median portion (US10Y-US3Y) retrace some of their recent rally.	From June, all Yield curve spreads should start to steepen towards the Summer, as long term yields reverse up and the FED is "on halt".
Credit		Credit follows a similar path than equities. Corporate spreads could hence bounce again until late May / early June.	From June, Credit spreads resume their downtrend, probably towards the Summer.
TIPs/Treasuries		Inflation expectations (TIPs vs Treasuries ratio) are retracing down with risk assets until late May.	The TIPs vs Treasury ratio then gradually resumes up during June, and could then start to accelerate up during the Summer.
Oil		Oil continues to correct down to late May, perhaps early June by an additional 2-3 USD/barrel.	During June, Oil resumes higher and then starts to accelerate in a strong rally towards late Summer. It may then retest last year's highs.
Industrial metals		Industrial metals reversed down in early April, and seem weaker than other commodities.They could continue to slide into mid/late June.	By late June, Industrial metals may attempt to bounce into mid Summer.
Gold		Gold attempts a last retest up over the next couple of weeks, but probably fails to make new YTD highs. From late May, it should start to resume lower.	From June, Gold moves down into the Summer, probably towards its long term support range between 1'200 and 1'150 USD/oz.

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

Equity to Bond Ratios

US & Eurozone Markets
p 30

Equity to Bond ratios in the US and Europe are correcting down along with equities, and falling yields. They could find support towards late May, and resume higher into late Summer and towards new highs.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 22, 27-29

Many portions of the yield curve are now inverted. With the FED "on halt", the US10Y yield is now the main driver for the US10Y – US3M spread. It is currently retesting down towards its March lows, along with the US10Y yield. The US10Y – US3Y on the other hand has been correcting up since December. Indeed, the US3Y yield has caught up to the downside with the US10Y since last October ("Bullish steepening", recently exacerbated by speculations of a rate cut later this year). These dynamics may change over the next few weeks with the reversal up in US10Y yields we expect. From June, following a few weeks of consolidation, we would hence expect the US10Y-US3Y spread to continue to steepen. Yet, we believe, it could then be driven by a rising long end ("Bearish steepening"), rather than a weakening short end.

Credit
p 31

The Credit market is currently correcting down vs Treasuries along with other risk assets. We also expect it to find support towards late May, perhaps early June. The dynamics are similar when comparing either High Grade Corporate Bonds to Treasuries, Investment Grade to High Grade or Junk to Investment Grade. From early June, we expect Credit to bounce again into the Summer.

Rate Differentials
p 22

We expect the US to Europe rate differential (and more widely vs the rest of the world) to resume its uptrend with US Yields. Indeed, these are more volatile (pro-cyclical) than European ones, and are hence driving the spread.

Tips
p 35

The TIPs / Treasury inflation breakeven ratio timidly followed risk assets up since early January. It has now entered an intermediate correction along with other risk-on themes. We expect the ratio to find support towards late May, and start resuming up into the Summer. As the rally in risk assets develops and Oil bounces, the ratio may gradually accelerate as the Summer progresses.

Commodities

Oil
p 23, 55

Oil also finally reacted down late April following the intermediate top we had identified a few weeks before. The correction could last into late May, perhaps early June, and could travel down the 68-67 USD/barrel range on Brent, 59-60 on WTI. Following that, from June, the trend should resume higher towards late Summer, and Oil could retest last year's highs.

Industrial metals
p 23

Copper and Industrial metals started to correct down early April. They may reach an intermediate low towards late May, yet the reversal looks quite strong and new lows may materialize into June. At the moment, and probably due to their link to China, Industrial metals are probably the weakest link of the Commodity space, until June at least.

Gold & PMs
p 46,47,49,50,52,53

Gold is attempting to move up to retest its February highs, yet on some measures, it is already looking Overbought. Hence, we believe that this retest up will probably die out over the next couple of weeks (towards 1'320, perhaps 1'330 range i.e. below its previous high). Gold should then retest down into late Summer probably towards the 1'200 – 1'150 range where it has found strong support over the last 3 years. Thereafter, from the Fall, Gold may see the beginning of a secular uptrend.

Agriculture

Agricultural Commodities have seen a very strong sell-off since February. It recently accelerated lower with the failure of the US / China Trade talks. The segment is however getting very Oversold and could start to bounce towards late May / June. The bounce could extend into the Summer, yet it is still too early to call for a proper reversal as the trend, for now, is still heading down quite strongly.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	EUR/USD could bounce until late May, perhaps early June, yet the potential is limited to 2 to 4 figures (1.13 - 1.15 range)	From late May / early June, EUR/USD resumes lower into late Summer, and will probably break below its long standing support around 1.11 - 1.10.
	GBP	Short term, Cable could find support towards 1.28 and then bounce back to above 1.30 towards late May / early June	GBP/USD probably resumes lower into the Summer (mid 1.20s), unless some positive Brexit news comes and lifts it up (seems rather unlikely)
	JPY	USD/JPY could continue lower within the 110-108 range until late May / early June.	From June, USD/JPY could resume its uptrend, probably into mid/late Summer and towards the 112-115 range
	CHF	USD/CHF probably retraces down towards late May / early June and the 0.99-0.98 range	From June, USD/CHF resumes up quite strongly into late Summer and the 1.03 - 1.05 range.
EUR vs	GBP	EUR/GBP probably bounces back towards the 0.88-0.89 range until late May / early June.	During the Summer, EUR/GBP probably works within the 0.87 -0.90 range. Brexit remains a strong factor of uncertainty.
	JPY	EUR/JPY remains under pressure into late May / early June and could push deeper into the 123 - 120 range.	EUR/JPY should find support in June and then bounces back during the Summer in the 123 - 126 range.
	CHF	EUR/CHF could retest its late March lows around 1.12 until late May, early June.	EUR/CHF should find support in June and then rises back into the 1.13-1.15 range during the Summer.
GBP vs	JPY	GBP/JPY continues to slide lower into late May / early June and towards the 140-139 range.	GBP/JPY should find support in June and then bounces back during the Summer in the 142 - 146 range. Brexit remains a strong factor of uncertainty.
	CHF	GBP/CHF continues to slide lower into late May / early June and towards the 1.29-1.28 range.	GBP/CHF should find support in June and then bounces back during the Summer in the 1.31-1.34 range.

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

US Dollar
p 23, 48

The USD may continue to correct slightly during the current risk-off period until late May, early June, probably into the 97-96 range. It then resumes higher into late Summer towards 100. Indeed, the US Dollar is pro-cyclical and should follow risk assets up into the Summer. Later on towards late Summer, inflation may come to be a concern.

Euro
p 51

The EUR/USD manages to bounce back slightly into late May, early June and the 1.13-1,15 range. It then resumes lower towards late Summer and probably breaks below its 1.11 – 1.10 longstanding support. EUR/JPY and EUR/CHF on the other hand, should follow risk assets lower into late May / early June, deeper into the 123-120 range on EUR/JPY and potentially back towards 1.12 on EUR/CHF. Both of them should then bounce back during the Summer.

Yen
p 46, 52

Between now and late May, early June, USD/JPY moves deeper into the 110-108 range. It then bounces back during the Summer towards the 112-115 range.

Sterling

The fate of Sterling is still hanging onto the inconclusive Brexit process. Yet, it seems unlikely that any closure can be reached over the next few months. The process remains a strong factor of uncertainty for the Pound. Until June, Cable probably dips down to 1.28 and then rebounds towards 1.30 early June. Thereafter, we expect it to resume lower again, potentially towards the mid 1.20s. EUR/GBP could reach back to the 0.88-0.89 range over the next few weeks, and then works within the 0.87 – 0.90 range during the Summer. Vs the Yen, GBP dips into the 140-139 range until late May, early June, it then rebounds back during the Summer in the 142-146 range.

Oil & Commodities currencies

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) could remain under pressure vs the USD, probably towards late Summer. RUB and BRL might be exceptions and could outperform the USD Dollar slightly from June into August. Vs the EUR, Commodity currencies could continue to slide into late May, early June, and then rebound into late Summer.

Asian currencies
p 51

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) probably continues lower vs both the USD and the EUR into mid/late Summer.

Equities Markets Segmentation

Core Sector Weightings			Next 2 months					3 to 6 months ahead				
US Sectors - S&P500 (general comment)			**Until late May, perhaps early June, Growth sectors could correct down, while Industrials and Energy retest down, Defensive sectors outperform and Financials start reversing up.**					**During June, Financials and Industrials and then also Energy gradualy take up the lead. They should outperform into late Summer, while Defensives underperform. Growth should be neutral.**				
Sectors	Proxy ETF symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Technology	XLK	21%										
Healthcare	XLV	15%										
Financials	XLF	14%										
Discretionary	XLY	10%										
Communication	XLC	10%										
Industrials	XLI	10%										
Staples	XLP	7%										
Energy	XLE	6%										

			Next 2 months					3 to 6 months ahead				
European Sectors - Europe Stoxx 600 (general comment)			**Until late May, perhaps early June, Financials and Energy could retest down and underperfom, while Defensives outperform.**					**During June, reflationary sectors (Financials, Industrials, Energy) reverse up and start outperforming towards mid/late Summer, HealthCare lags, F&B and P&HH are rather neutral.**				
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 36-42

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

The correction down on equities initiated late April / early May should probably continue until late May, perhaps early June. Hence, in the meantime, we will favor Defensive sectors (especially US Staples, or European F&B and Healthcare), and avoid Growth, which could retrace its year-to-date ouitperformance, as well as European Financials, US Industrials, and Global Energy, which could retest down once more.

From June, we expect reflationary / cyclical / value sectors to start to ourtperform. We would hence favor Global Financials, Industrials and Energy, and underweight Defensives. We would also neutralize Growth.

Countries allocation

Core Countries Weightings			Next 2 months					3 to 6 months ahead				
All World Country Index Currency hedged (general comment)			**Until late May, early June, we would avoid Europe (except for Switzerland) and China and favor the US**					**From June into late Summer, we would increase these bets given the US led reflationary rally we expect. We would neutralize France and Germany, which are quite cyclical.**				
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 17-21

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

During the current Equity market correction, probably towards late May / early June, the US seems to hold up better than Europe and China. We would hence Overweight it along with defensive Switzerland, and underweight the later two, as well as Japan.

From early June, we expect a new reflationary trend (i.e. in this case, a late cycle cyclical surprise) to materialize into the late Summer. We believe it will be led by the US, and we would hence further increase our exposure to it. China would remain underweight, as well as wider Europe, although we have neutralized France and Germany, which are rather cyclical.

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

Core factors and Themes

Core Factor/Themes Weightings	Next 2 months					3 to 6 months ahead				
General Comment	**Until late May, early June, we will favor Defensive Themes and underweight Cyclical and High Beta ones**					**From June, we expect Value to outperform Growth, and US Small Caps to outperform the S&P500**				
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

Until late May, early June, we would favor defensive assets sur as REITS, and would avoid high betas (e.g.Nasdaq) and Cyclical assets such as Global Small Caps, Diversified Mining, and to a certain extent the Dow Jones Industrial Index. Southern Europe is a mixed bag, with Spain and Italy, which seem to hold quite well, while Portugal and Greece are rather High Beta.

From June, we would gradually switch towards cyclical themes in the US such as Value sectors and Small Caps. Small Caps in Europe and in Japan remain neutral as their cyclicity may be balanced out by further strength in the US Dollar (which usually favors large exporting companies). Similarly, Diversified Mining could lag because of further weakness out of China. Finally, we would underweight Goldmines given the US driven reflationary environment we expect i.e. (strong US Dollar, risk-on, and lower Gold prices).

12 / The Big Three economies: prospects for contributions to global growth this year and the next; US will remain the lead driver

USA

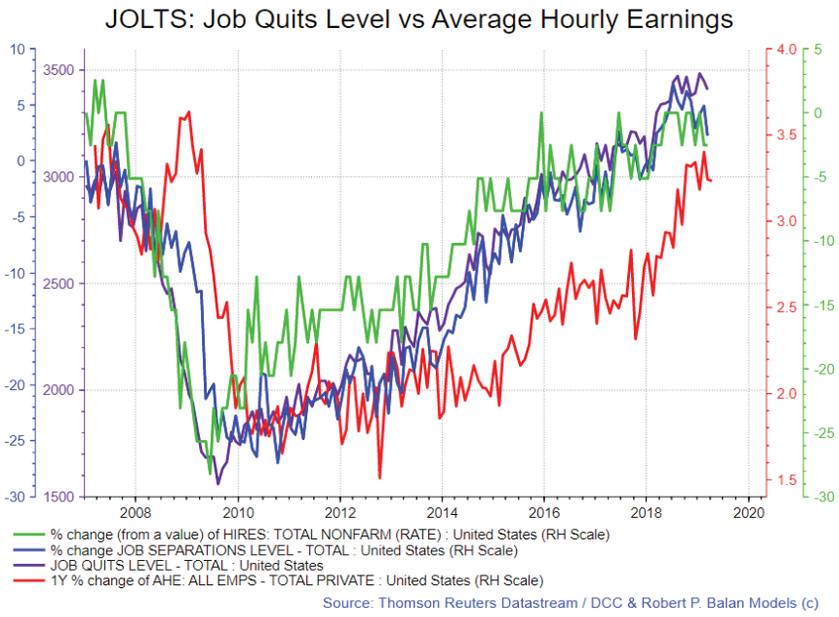
The US economy is being defined by its fantastic jobs situation, but there are worrying internal details elsewhere specially in the manufacturing sector. The April 2019 jobs report showed total non-farm payroll employment increased by 263,000, exceeding Wall Street forecasts of 190,000. The results also blew away the 196,000 jobs created in March. Jobs related to professional services led the way, rising by 76,000. Employment in construction was up by 33,000 with gains in nonresidential specialty trade contractors and civil engineering. Healthcare jobs grew by 27,000 after rising 49,000 in March.

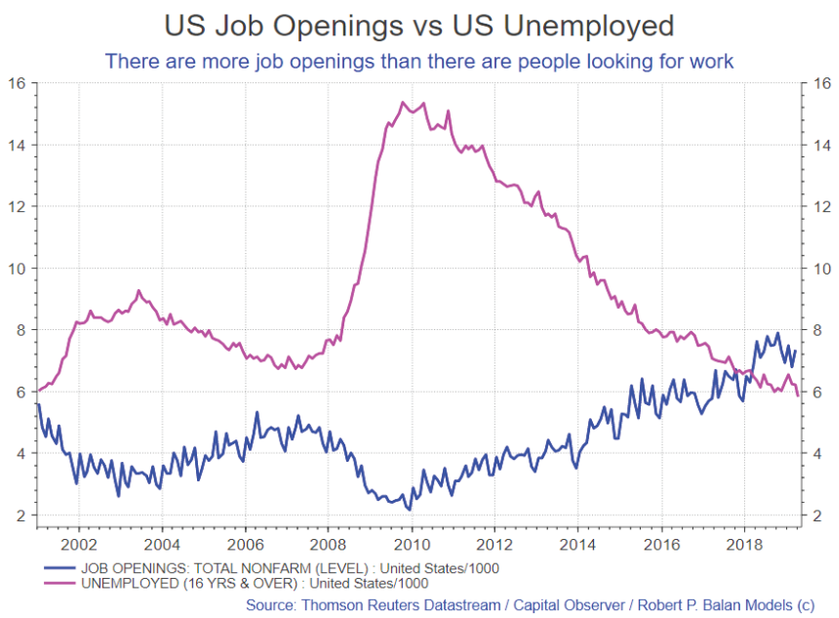
These numbers are being supported by the JOLTs data which serves as internal check for how good or bad the job situation is in reality (see 1st graph on this page). The quits rate is very important -- when workers feel very confident to quit jobs and look for something else (an attitude which is supported by the sharp wage growth), then all these suggest that the jobs situation is doing well and will be so for some time longer.

The unemployment rate was an eye-popping 3.6 percent - lower than the 3.8 percent recorded in March and the lowest it has been since December 1969. The rate is well below the 5.0 percent threshold considered full employment. Average hourly wages were $27.77, up 3.2 percent versus the year-earlier period.

Workers could potentially have enough leverage to demand higher wages, spurring wage growth even further. And basing it on the JOLTs data shown above, employees/workers are milking the situation – they are job-hopping at the fastest rate since the late 1980s. This, plus the fact that unemployment is very low makes the current environment the best time in many generations to be looking for a job.

There is a lot of talk about the Fed cutting rates soon, if the stock market hits a sinkhole, and falls. Or the stock market gets frightened due to the trade kerfuffle, and falls like 20%, the threshold for a bear market. With the jobs market this red-hot, the Fed is unlikely to cut to boost the markets. Imagine what kind of abuse the Fed will get if they cut rates under these conditions, especially as Mr. Donald Trump keeps on egging them to cut rates – and not being subtle about it. It would look like they have become the lapdogs of The Donald.

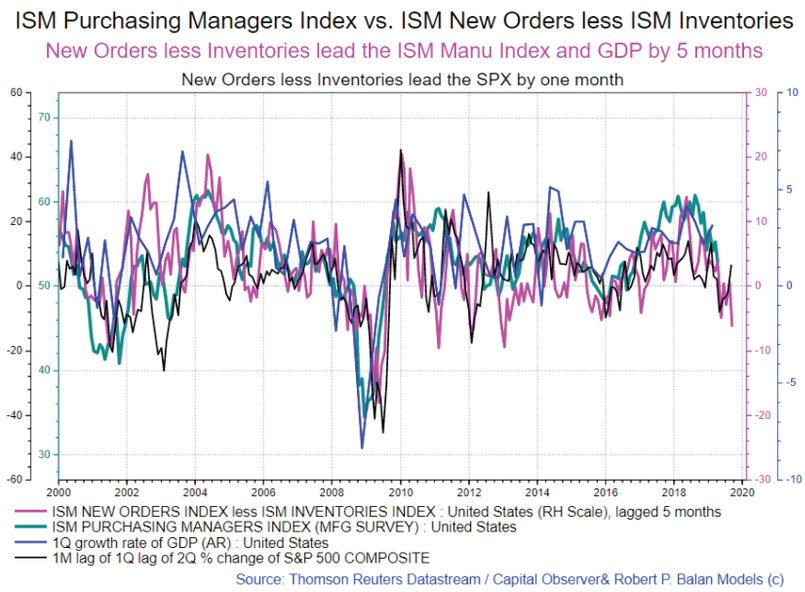


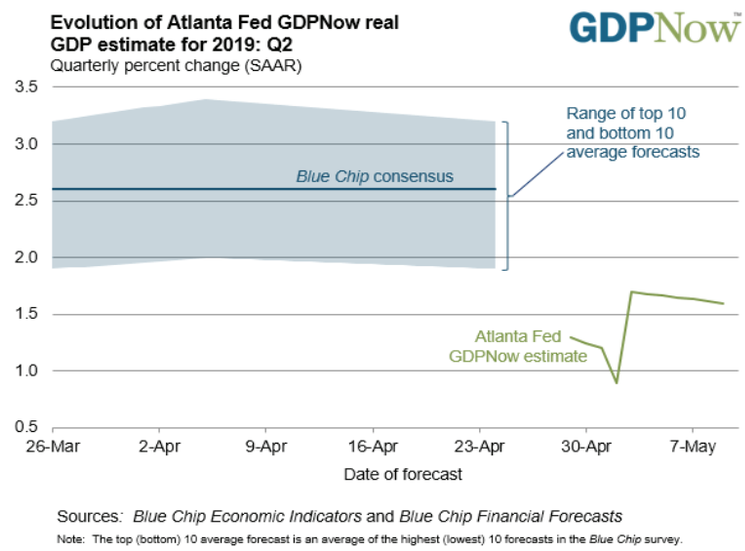


Think of this way --when there are more job openings than there are people looking for work, and the GDP is hitting quarterly rates above 3.00%, how can the Fed justify cutting rates? The fact is, the US economy remains on strong footing and the economic expansion could continue for a few quarters longer.

Nonetheless, the conditions are not ripe for a perfect slam dunk. The manufacturing sector is ailing. Although manufacturing is now much smaller compared to the services sector, manufacturing is important as signalling device for the entire economy. There is plenty of evidence that manufacturing activity is slowing down (*see 1st chart on this page*) – the ISM Purchasing Managers Index has been slowing down for the past four quarters – that provides clear evidence of stress in the manufacturing sector. **The ISM Purchasing Managers survey also provides a good approximation of the state of the GDP. But there is a better metric, which not only provides a long lead into the GDP mechanics, but also provide a short lead into stock market trends.**

That is the ISM New Orders less ISM Inventories *(see 1st chart on this page*)**. It leads the ISM survey index by at least three months, and the GDP by almost 2 quarters.** This metric has been falling for some time, in fact since peaking in December 2017. If we allow for the lead, then we can forecast with some certainty that the 4.16% GDP reading on Q2 2018 will be the highest reading we will see until at least September this year. That means the ISM PM Index survey will also be falling until then. The 3.172% GDP reading in Q1 this year is an aberration. Q2 GDP will be significantly lower, and the current read of just above 1.5% by the Atlanta Fed's GDP Nowcast will not probably improve much in its final level(*see 2nd chart on this page*). The modified new orders data is also indicating that the stock market will probably be on a downwards or at least sideways, mode until September.





Nonetheless, the US will be the significant driver of global growth in the medium-term, and US dollar denominated risk assets will attract a significant portion of global risk capital due to superior yield returns. That would keep the US Dollar strong in the medium-term at least.

China

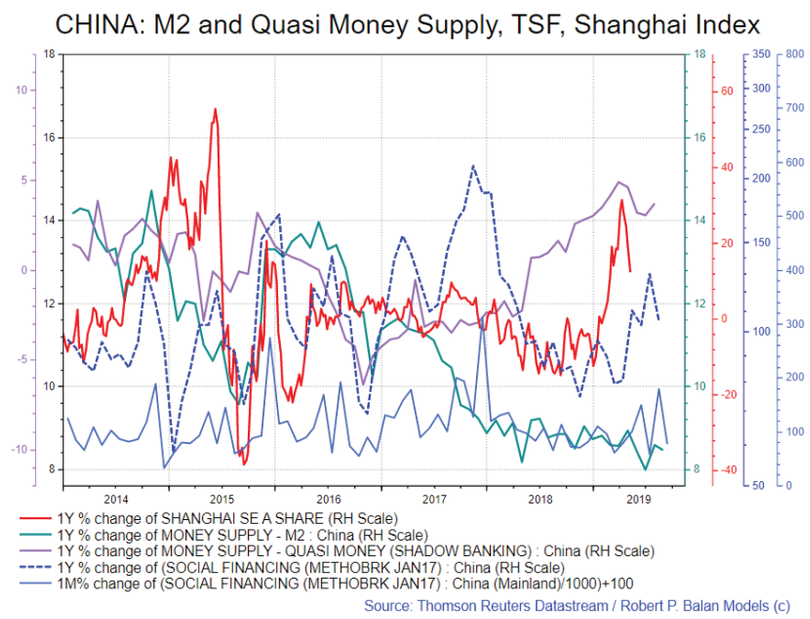
The more or less "rosy" growth and economic outlook in the US provides a stark contrast to what is happening in China on the ground. Policymakers have introduced measures to address excess leverage, with a particular focus on the financing provided by the "shadow banking" sector. For a while, it worked – it was producing good results (*see 1st chart on the next page*). **Recent stimulus efforts appear to be having an impact on Chinese economic activity, with rebounds in manufacturing investment and new orders in recent months. And the Shanghai stock market rose a heady 30 percent in just a few months. But after a snappy start, and vigorous**

fiscal expenditures, the Chinese government started to pull back (*see 1st chart on this page*). Unlike previous stimulus efforts, policymakers appear to be using a "drip" method rather than a "big bazooka." Certain stimulus measures that were once effective no longer appear to be having the same impact.

We can see the impact the quick-start-then-slowdown on key China metrics. There was a tremendous growth in quasi-money supply, even as the official M1 and M2 money supplies dried out (*see 2nd chart on this page*). T**he uneven, inconsistent application of monetary stimulus can be seen from the year on year growth of Total Social Financing (TSF)**. This metric has largely supplanted both the M2 and M1 Money Supplies as a yardstick for monetary conditions in the domestic system. The year on year change in TSF has been like the track of a roller-coaster and that inconsistency is also visible in the monthly nominal changes in the TSF.

Its is like, as we described earlier, using drip method rather a sustained push until desired results are achieved. This contrasts clearly with the growth of quasi-money supply which has helped power the Shanghai market to a heady rally in recent weeks. But even the quasi-money supply is petering out – and if the TSF falls as well, the Shanghai index will fall sharply.

What is causing this stop-go process in China's monetary and fiscal stimuli? How are China's current stimulus efforts different from previous measures? We can only speculate, but it may have origins in the Chinese government's effort to reduce the excess leverage of the financial system. Policymakers have introduced measures to address excess leverage, with a particular focus on the financing provided by the "shadow banking" sector. This generally refers to financial intermediaries that facilitate the creation of credit across the financial system but whose members are not subject to regulatory oversight.



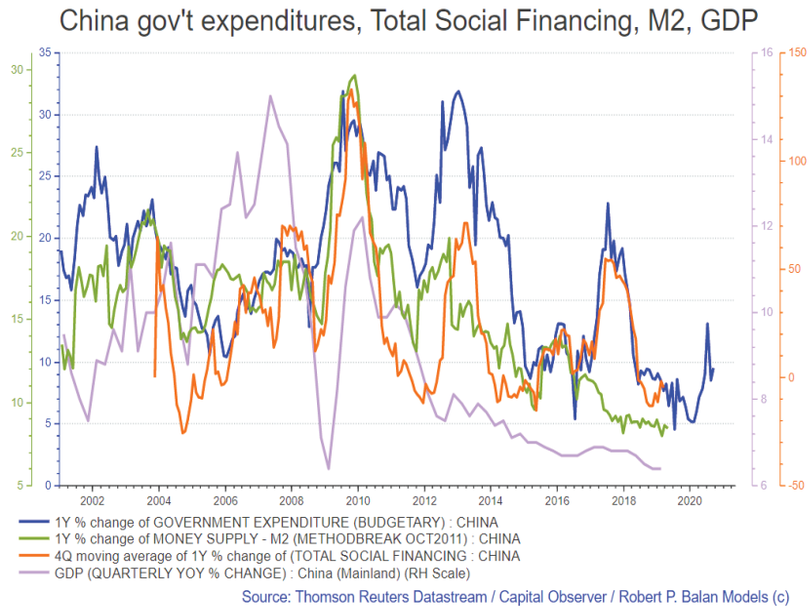
Unlike state-owned enterprises (SOEs), private companies have long relied on the shadow banking sector for financing, as banks have been more reluctant to lend to these higher-risk companies. Removing this financing channel has resulted in a credit crunch in the private sector, resulting in a higher cost of financing since the deleveraging drive began. **We believe, given the importance of the private sector in China's transition to a consumer-led economy, this lack of credit has significantly contributed to the growth slowdown in China. That credit flow is strongly influenced by the changes in Total Social Financing, which in turn is merely a lagged representation of the government expenditure in the previous year** (*see 1st chart on the next page*).

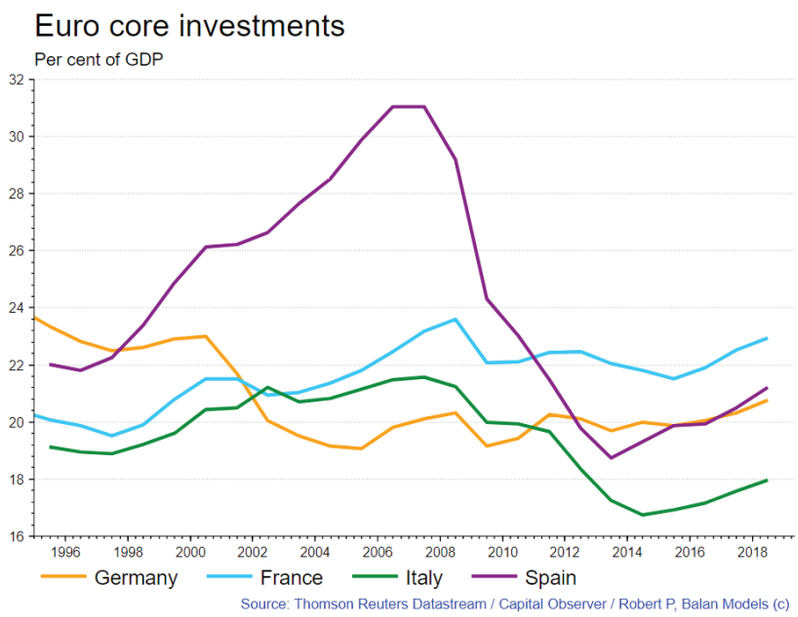
Meanwhile, SOEs, which themselves generally exhibit high debt levels, have continued to access credit through the banking sector at funding costs that have remained steady. But even this favoured sector may come under pressure as well. **The evolving structure of the Chinese economy, from one led by investment and large SOEs to one driven by consumption and the growing importance of a more dynamic private sector, is creating new issues**. For instance, financial conditions have not eased despite multiple cuts to banks' required reserve ratio (RRR). Credit supply to the private sector has not increased, and funding costs have remained elevated.

Due to these issues, the government seems to be taking a multi-layered approach and appear to be willing to experiment with different initiatives. Recently, they announced bank lending targets and increased limits for loans to small companies, and a medium-term lending facility that links the provision of funding for banks to their supply of loans to small and medium enterprises. That initiative is heading away from the government-owned SOEs.

In the past, fiscal stimulus relied primarily on additional government spending. Recent measures centered around tax cuts. This is a more orthodox approach, which may provide longer-lasting impact and recognizes the growing role of consumption and services in China's economy today.

Bottom line: China will in due time sort out the inconsistencies that are plaguing their reflation efforts, and we expect the Chinese economy to contribute to global growth by Q3 this year. That of course depends on how the trade agreement discussions between China and the US will turn out. **But absent a shock from a non-agreement, the Chinese economy should start to benefit from previous stimulus efforts by the second half of 2019.**





Eurozone

There have been a few economists characterizing the trouble of the Eurozone as the "Long Depression," that the Brussels directorate insists on zone-wide austerity because that's how the EU's current account surplus is maintained. However, collapsing corporate investment is the real story of the ongoing eurozone crisis. European corporations all but stopped investing in the eurozone since 2012-13. Even now, corporate investment in the eurozone is barely higher than it was in 2011, in the wake of the Great Financial Crisis. (*see 2nd chart on this page*)

To top it up, government investment is all but absent, as balanced-budget rules proliferate across the eurozone and Brussels threatens to impose draconian sanctions on any country that dares run much of a deficit. **Meanwhile, external investors stay away, put off by the eurozone's poor growth prospects and rising political risks**. Those risks are not trivial – if the Brexit disease proliferates, it could mean the dissolution of the EU.

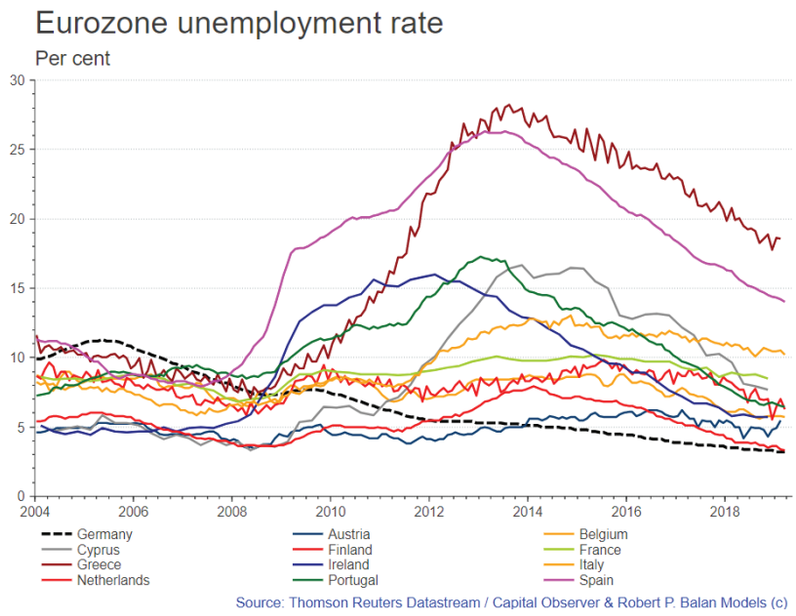
The irony is that European corporations didn't stop investing -- they simply invested somewhere else. Net savings, the wherewithal for investments, didn't fall during this current eurozone crisis -- the associated investment no longer went into the eurozone economy. It flowed out of the eurozone to the rest of the world. Ever since the crisis, as net saving has increased in the eurozone, the rest of the world has benefited from its rising exports of capital.

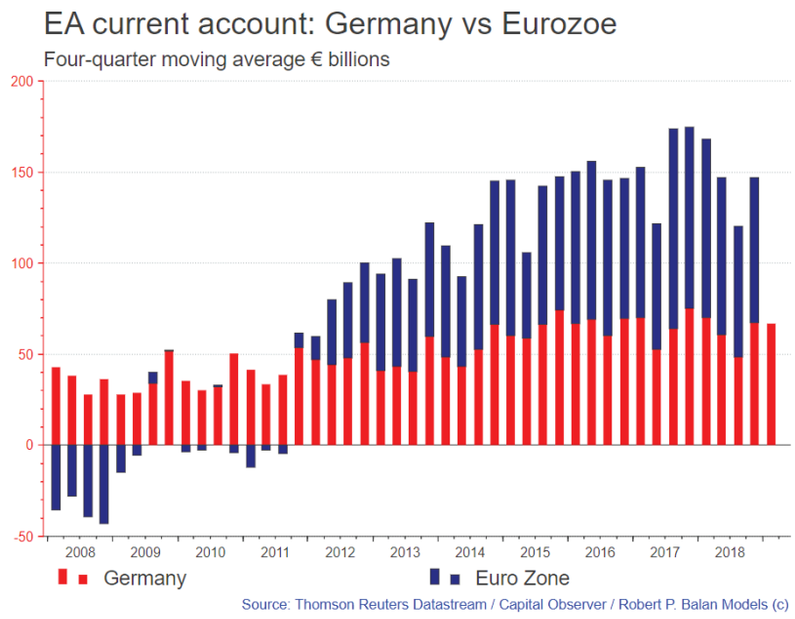
Meanwhile, domestic economies in the EU are withering due to lack of investments. And government in the EU have stopped investing as well. The growing external surplus is the flip side of the eurozone's current account balance, and evidence of the lack of fiscal expenditures on fixed assets. **Perhaps eurozone leaders think**

the investment chill that is causing the eurozone's poor growth, high unemployment and stubbornly low inflation is a fair price to pay to keep the eurozone together. *(see 1st graph on this page)*

Many in the Brussels directorate argue that the current account surplus, and associated capital exports, are protective (*see 2nd chart on this page*). After all, if you never borrow from the outside world, they can't hurt you. And if you are a net lender to the outside world, you have some leverage over them. And if the EU does not have to service external debt, that should not cause you a major problem, even if the zone-wide economies are suffering. Just as developing countries pursued export-led growth strategies and built up large FX reserves to protect themselves from sudden stop in investment flows, so now the eurozone, scarred by its own "sudden stop" in investment flows in 2012-2013, is doing the same.

Bottom line: the "Long Depression" in the Eurozone will continue for a while. It is very telling that the ECB says that EU households are still deleveraging from the excesses that led to the Great Financial Crisis of 2008. **The Eurozone will be a drag to the global economy this year, and the euro will be very vulnerable to the kind of shocks that the British Pound has endured in the wake of Brexit, and from Brexit itself.**



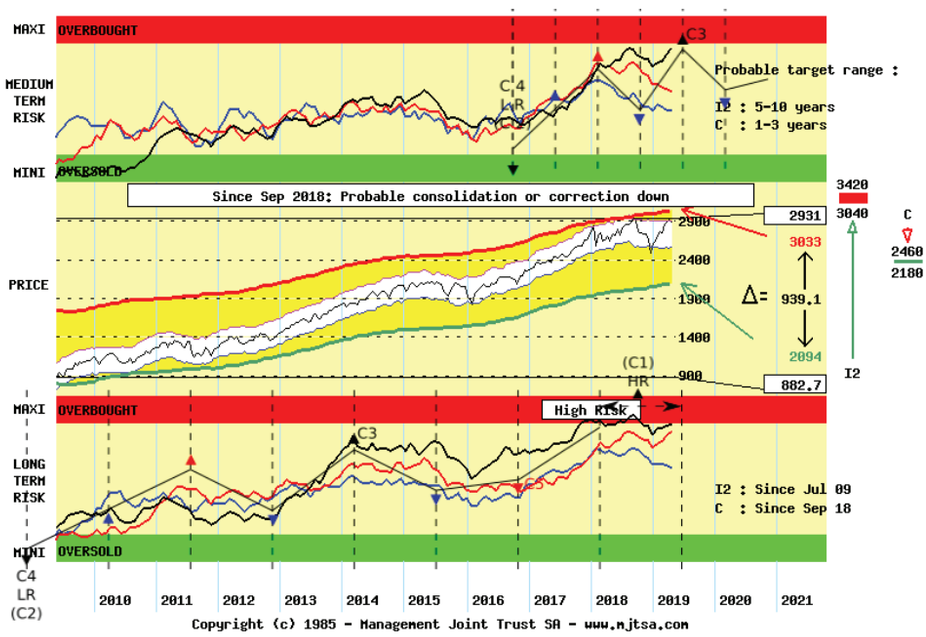


17 / MJT - TIMING AND TACTICAL INSIGHT

US reflationary assets could lead the market higher into the Summer

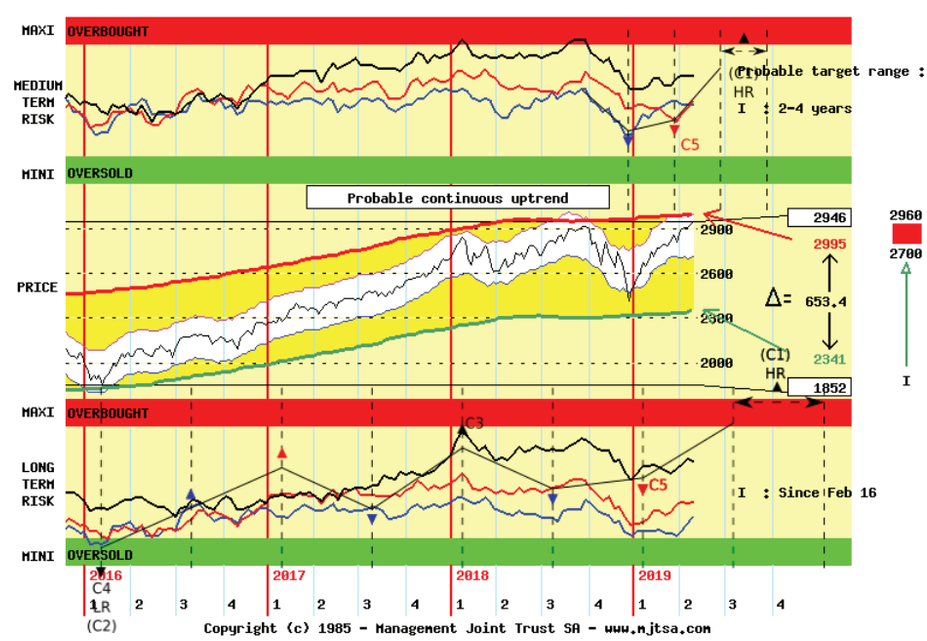
A dovish FED, strong stimulus in China and the promise of a Trade deal have powered the strong and coordinated equity markets' recovery since the beginning of the year. Yet, the possible breakdown of the US-China trade talks last week has come as an unpleasant surprise. While the equity correction is still new and relatively shallow in the US, interestingly, it has been underway for several weeks in China, and the strong momentum in Chinese equities into mid April seems to be rapidly reversing. In this context, one may wonder how far and how long the current bull trend may continue, and especially if it will be equally shared among the different regions (the US, China, Europe and the Rest of the World).

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



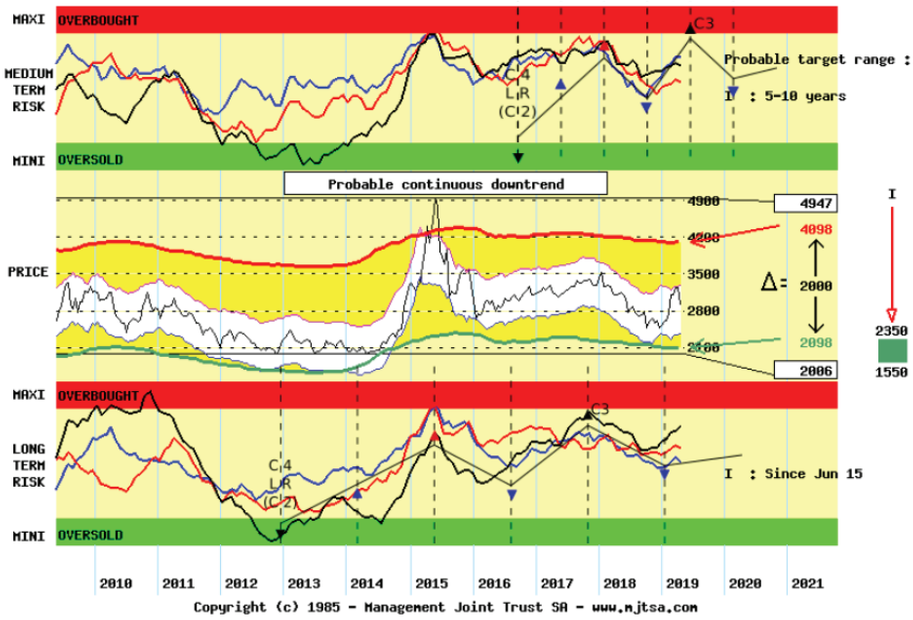
The strength and pace of the recovery since the beginning of the year has come has a bit of a surprise, especially in the context of the High Risk situation identified in October last year on our long term oscillators (lower rectangle). Yet, such configurations do not necessarily preclude further upside retests, nor slightly higher new highs. They rather signal that the market has entered a period exaggeration, and that over the following 1 to 2.5 years, at some point, it may suffer a substantial correction. **For now, the S&P500 could continue to push higher. The uptrend sequence we show on our medium term oscillators (upper rectangle) suggests that it may continue to do so into the summer**. Our upside targets (right-hand scale) are now above our I Impulsive targets to the upside and eyeing our extended I2 Impulsive targets up. This is fairly rare on our longer term bi-monthly graphs. Fulfilling the full extent of such extended targets is even rarer. Yet, they do provide some guidance as **to the upside potential left in this long term uptrend. We would guess that it could reach towards the 3'100s levels in first instance**. This is what our Daily graph of the S&P500 Index on page 54 of this issue of The Capital Observer seems to confirm.

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



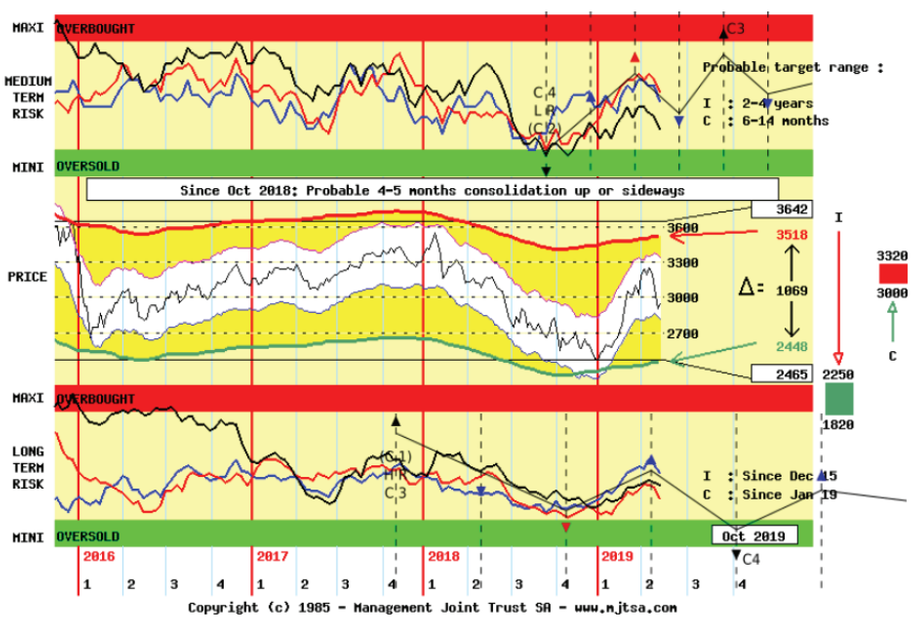
The Weekly graph of the S&P500 has fulfilled its I Impulsive targets to the upside (right-hand scale), and the configuration may resemble a double top. This is especially true as our envelopes are touching each other to the upside again (middle rectangle), which is a sign of exaggeration in an uptrend. **Yet, both our oscillators series (lower and upper rectangles) are still showing strong uptrend configurations. These could extend towards the Summer on our medium term oscillators (upper rectangle), and perhaps even towards the fall on our long term ones**. Hence, the current exaggerations may be signaling the possibility of an intermediate correction. However, our longer term perspectives are still uptrending for now, and we do not believe that the consolidation will be long lasting, as detailed on our Daily S&P500 graph on page 54 of this issue of The Capital Observer.

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



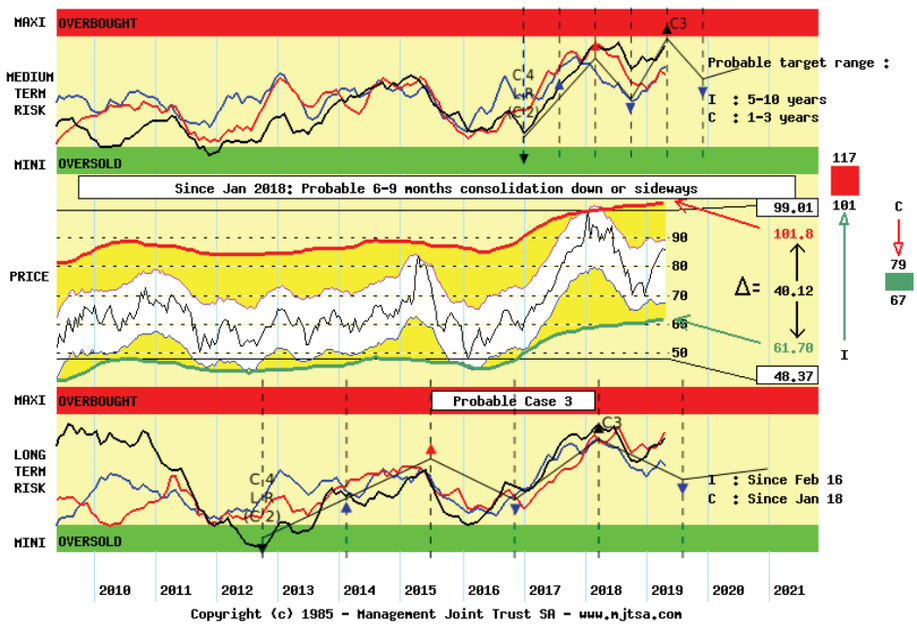
We now turn to the Shanghai Composite, which has had a very different path that other equity markets over the last 10 years. For now, we believe that the downtrend since 2015, may still be in place. Indeed, on our long term oscillators (lower rectangle), the uptrend during 2016 and 2017 wasn't able to create new highs. This lower top, positioned in a downtrend, triggered the strong sell-off that followed during most of 2018. Finally, late last year, the Shanghai Composite found support, and has since been rebounding. Yet, on our medium term oscillators (upper rectangle), a new top may be already approaching (early Summer). It will probably come in lower than the one made last year, and, as it is still positioned in a long term downtrend, may trigger a new sell-off towards year-end. Our targets are indeed still pointing lower, towards our I Impulsive targets to the downside in the 2'350-1'550 range (right-hand scale). These may be achieved **in a further leg down that may start over the next few months and extend lower into 2020.**

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



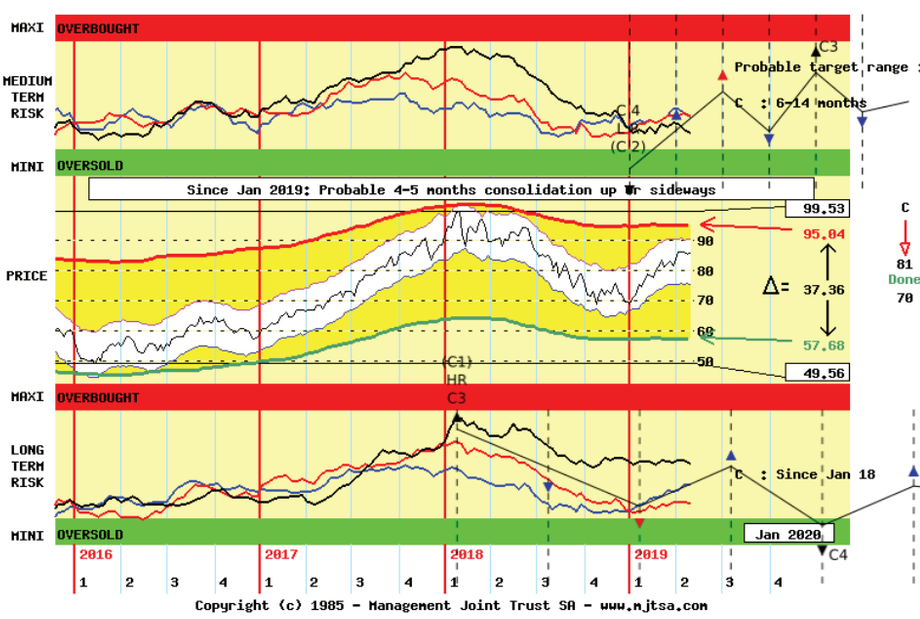
The rebound on the Weekly graph of the Shanghai Composite has nevertheless been quite strong. Yet, it reached the resistance of the upper end of our C Corrective targets to the upside around 3'300 (right-hand scale), and has since started to retrace. This reversal down is turning out to be quite deep, and on our longer term oscillators (lower rectangle), it could mark the end of a rebound since late last year. According to this sequence, the Shanghai Composite may now resume its downtrend, possibly towards late this year and new lows (our I Impulsive targets to the downside; right-hand scale). Our medium term oscillators (upper rectangle) show a slightly more constructive sequence, where following a correction down into mid/late Q2, the Shanghai Composite manages to resume higher into the Summer. It could then break above its C Corrective targets to the upside (right-hand scale) around the 3'300 mark, and eventually start reversing it long term downtrend. **For now, when considering both, the rebound since earlier this year has met important resistance, and a worthwhile top. A reacceleration higher into the Summer is hence far from certain, and the probability that the Shanghai Composite could resume its long term downtrend is quite high.**

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



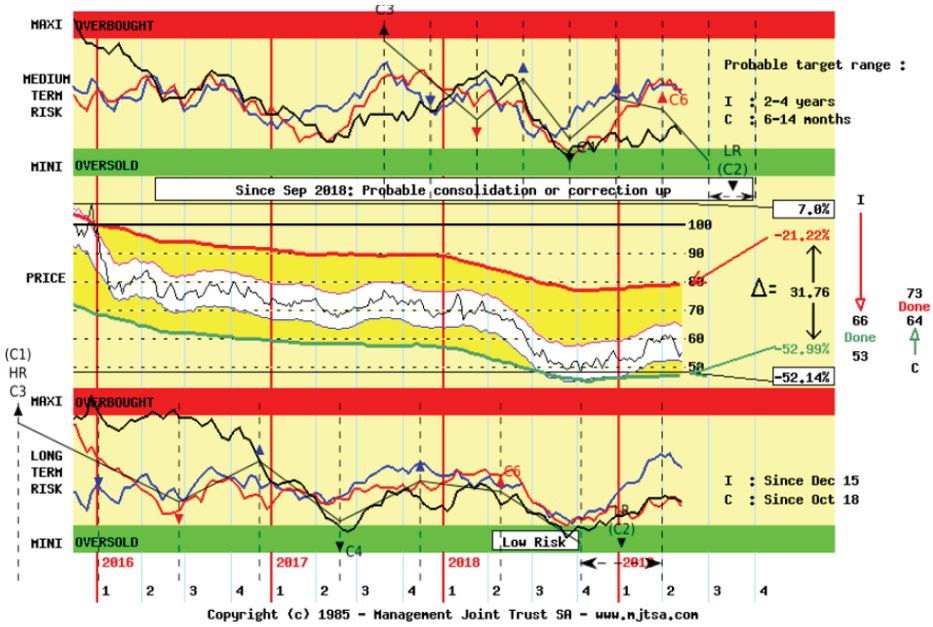
We now consider the MSCI China Index, which comprises the more international Chinese companies, and especially the large Growth oriented BATs (Baidu, Alibaba, Tencent). Its performance since 2016 has been much more dynamic than the Shanghai Composite, and theoretically, the long term uptrend on our long term oscillators (lower rectangle) is still in place. Indeed, while the index topped out on a strong intermediate top in January 2018 ("Case 3"), for now, it has held the support of our C Corrective targets to the downside (right-hand scale). The sequence now suggests that it could find renewed support towards the Summer, and then attempt to resume its long term uptrend. On our medium term oscillators (upper rectangle), however, show a more negative sequence. Indeed, on these, the index is still quite Overbought, and may soon reach a new intermediate top. Prices are below the ones achieved early last year, which may be signaling a loss of momentum in the long term uptrend. According to this sequence, the MSCI China may soon enter a new phase of correction to the downside into year-end. This scenario is closer to the one we expect on the Shanghai Composite. **Comparatively, this uptrend going forward also seems less resilient/likely that in the US.**

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



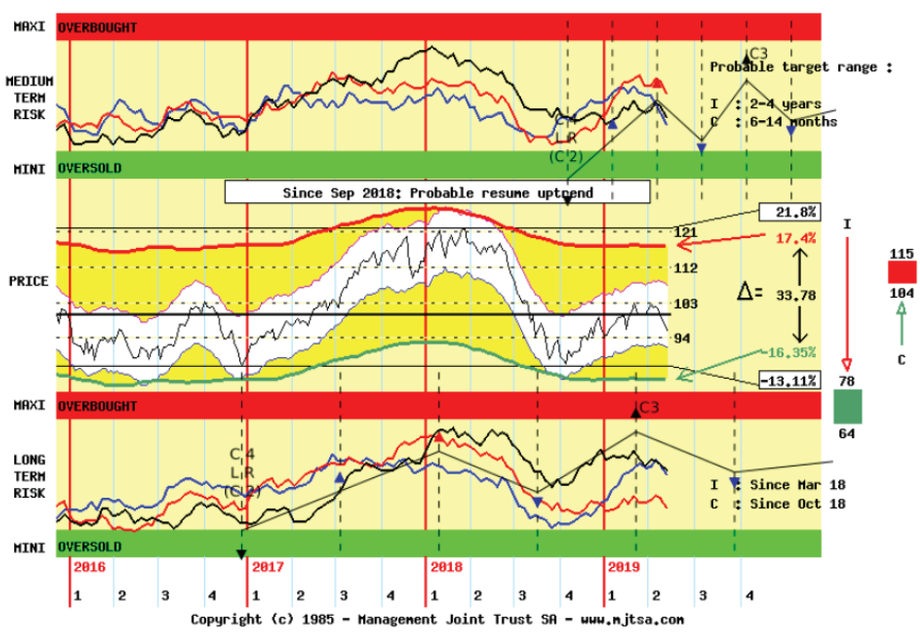
We now shift to the Weekly graph of the MSCI China Index in order to zoom into this ambiguous situation. **On our long term oscillators (lower rectangle), the rebound since early this year still seems countertrend. Indeed, although it may still continue higher into midyear, we believe it should then resume its downtrend until year-end**. On our medium term oscillators (upper rectangle), we show a more bullish view with an uptrend sequence making higher highs into midyear and perhaps even towards year end. For now, we would favor the more negative scenario. Indeed, the downtrend since early 2018 for now is still in place. This is also what our automatic messaging is suggesting with a further low expected in January 2020 (lower rectangle; right-hand side).

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



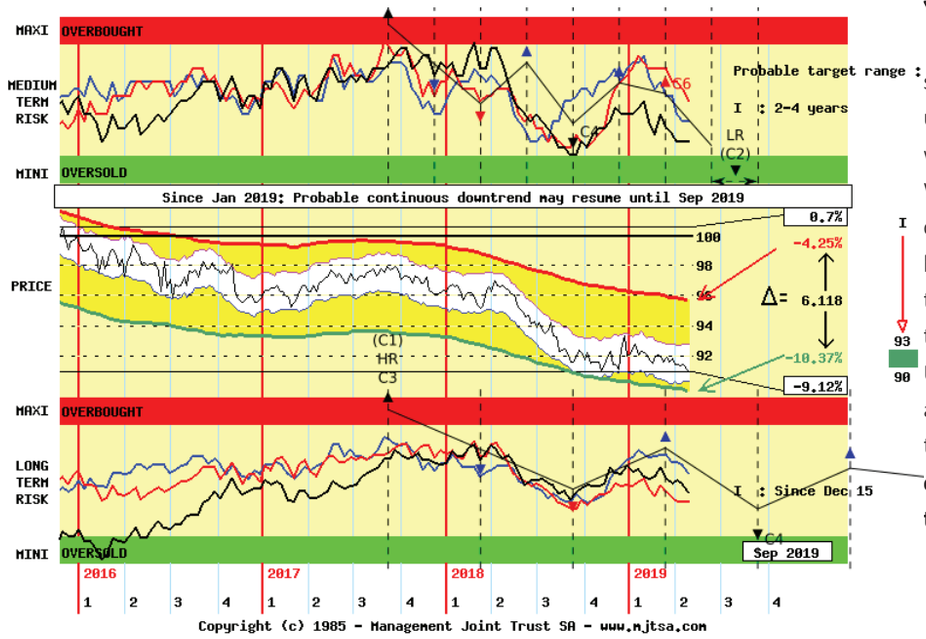
To get a better sense of the relative picture of the US vs the Shanghai Composite, we now compare both markets. The ratio was very much Oversold in late Q3 / Q4 last year on our long term oscillators (lower rectangle). Yet, our medium ones (upper rectangle) now suggest that following its recent bounce, **the ratio could be reserving lower again, probably into the Summer**. The downside potential may be somewhat limited (our I Impulsive targets to the downside have been reached; right-hand scale), yet the trend is still negative for now.

MSCI China Index vs the S&P500 Index (in US Dollars)
Weekly graph or the perspective over the next 2 to 4 quarters



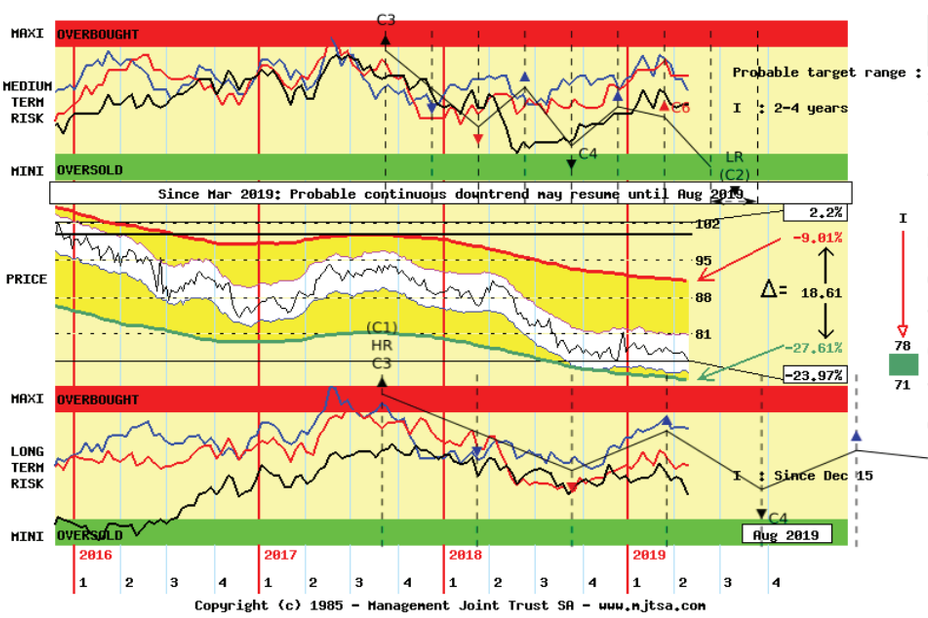
Similarly, we compare the MSCI China Index vs the S&P500. Here also, the bounce since last Fall was most probably countertrend. Our medium term oscillators (upper rectangle) suggest at least some underperformance until early Summer, and then perhaps a bounce. Our long term oscillators (lower rectangle) are more negative, and point to further weakness for the ratio at least into late Q3. Our I Impulsive targets to the downside (right-hand scale) also point to compelling downside potential until then. Hence, **both in terms of timing and price targets, we would expect China to underperform the US into the Summer.**

MSCI World Index vs S&P500 (in US Dollars)
Weekly graph or the perspective over the next 2 to 4 quarters



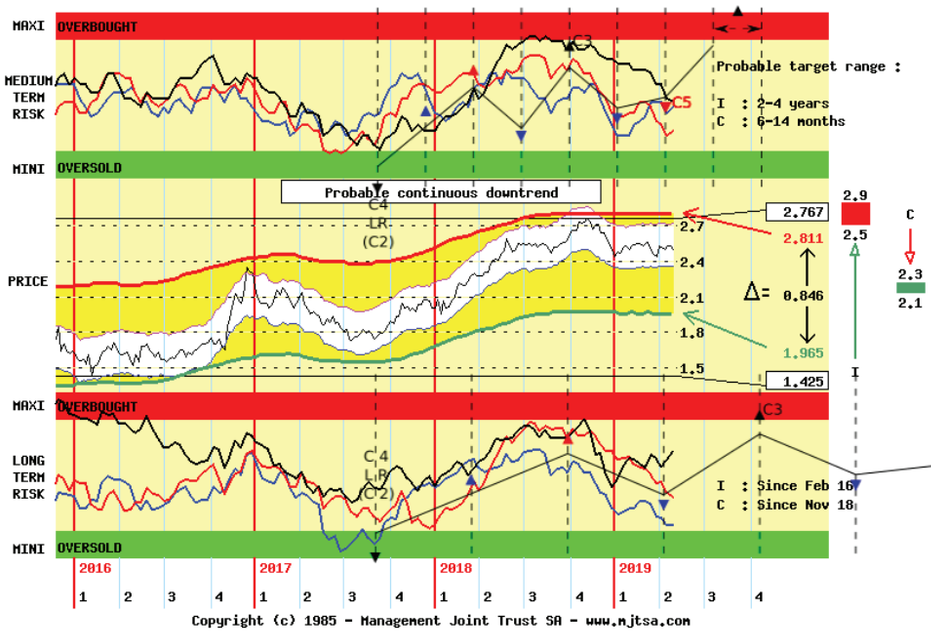
Yet, China is not an isolated case. Other markets seem that they could also underperform the US. Indeed, when comparing the All Country World Index to the S&P500, we can also notice a late Q4 2018 bounce. Since then, however, the rest of the world has started to resume lower again vs the US. Both oscillator series (lower and upper rectangle) indicate that **this underperformance could continue at least into the Summer**.

Europe Stoxx 600 vs the S&P500 (in US Dollars)
Weekly graph or the perspective over the next 2 to 4 quarters



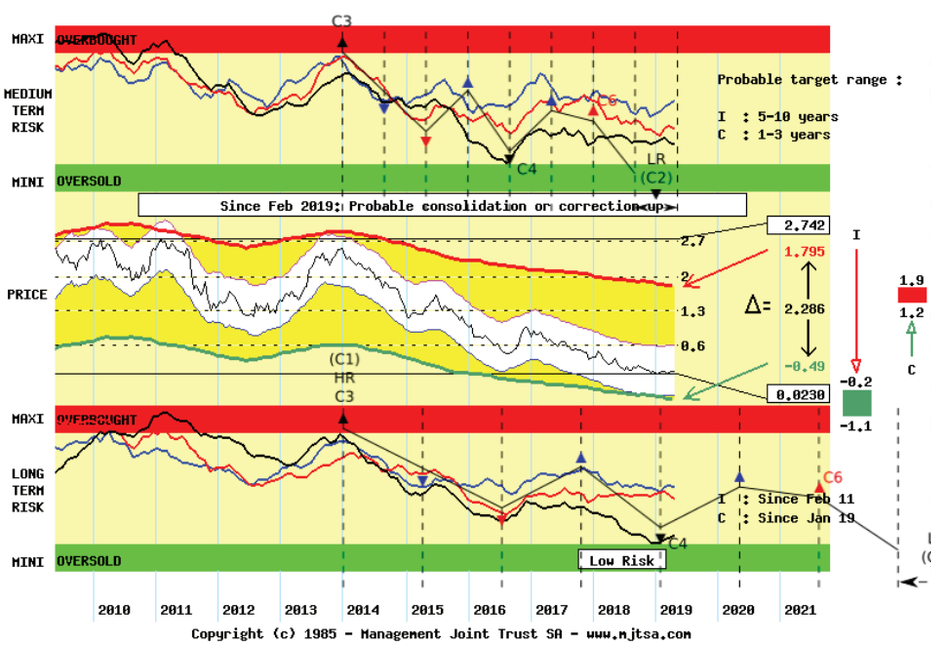
More specifically, European equity markets also seem weaker than their US counterparts. Indeed, as the All Country World Index, **the EuroStoxx 600 Index started to resume lower vs the S&P500 during Q1 2019, and according to both our oscillators series (lower and upper rectangle), this downtrend may now continue into the Summer**. As in 2018, this underperformance may highlight the persistent negative growth differential between Europe and the US.

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



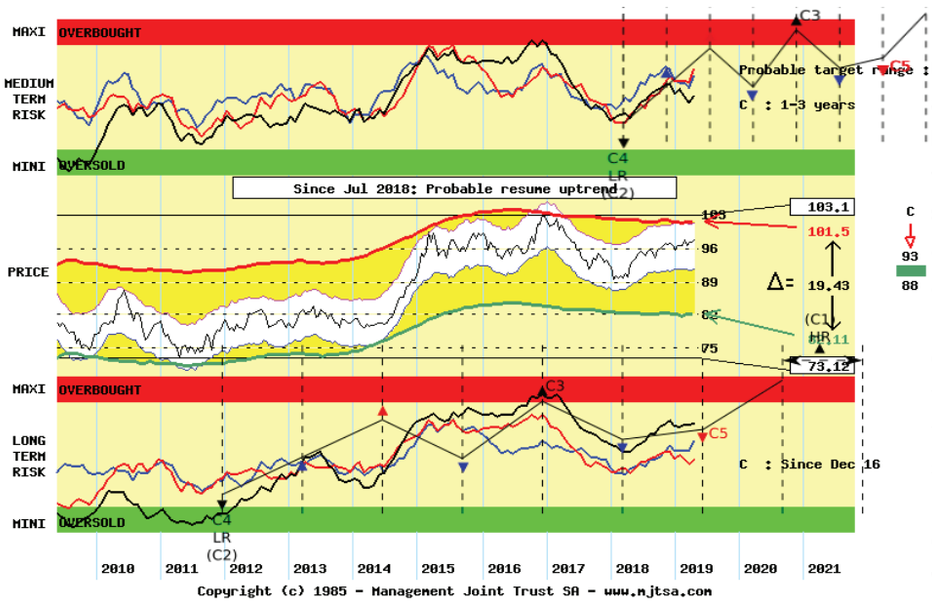
Interestingly, the interest rates differential is also following a similar path. Indeed, in this graph featuring the US minus the German 10Y Treasury spread, we are probably looking at the reverse picture of the graphs above. The spread softened during Q4 2018 and Q1 2019, as interest rates and growth expectations were correcting worldwide, yet this corrective move was stronger in the US. Indeed, over the last few years, the US economy has certainly been more pro-cyclical than the European one, and its interest rates do seem to react with more volatility to the ups and downs of its economy. In Europe, however, over the last few years, interest rates never really moved out of recession territory, and hence their reactions up or down are more subdued. Both our oscillator series (lower and upper rectangles) now suggest that **the spread should widen again into the Summer, probably suggesting that the strong trend in current US economic growth probably continues, and that the growth differential between both regions probably resumes higher. Our I impulsive targets to the upside (right-hand scale) suggest a 20 to 40 bps pickup in the spread until the Summer.**

USD Interest Swap Rate 10 Years - 2 Years
Bi-monthly graph or the perspective over the next 1 to 2 years



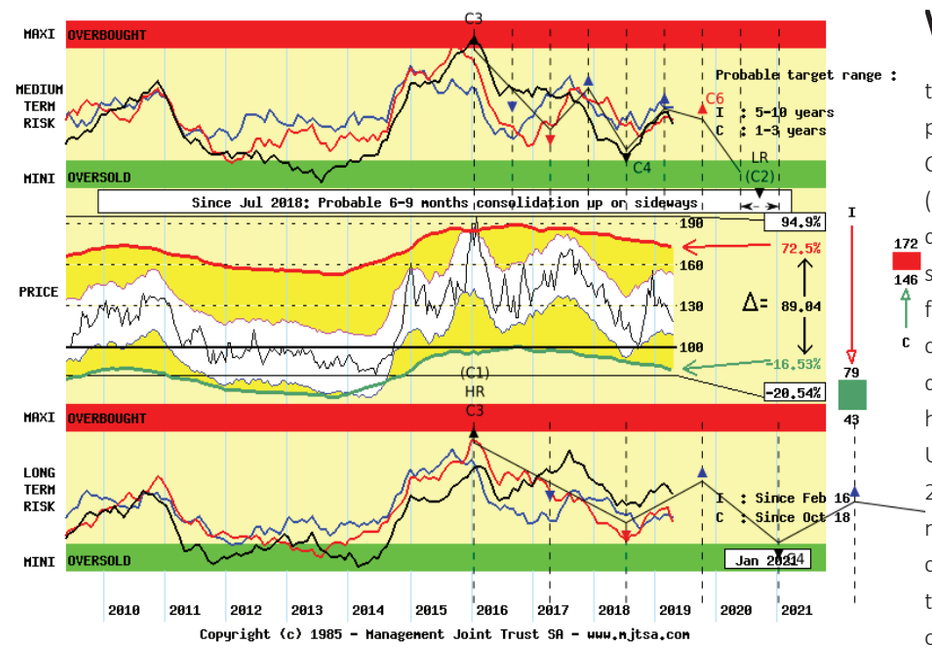
Another fixed income trend, we see developing over the next few quarters, is the potential steepening of the US yield curve. Given that the FED is officially on rate hike halt, and that we believe that a cut in short term US interest rates is rather unlikely, this steepening will be driven by the long end. Indeed, with much of the curve in inversion, the situation is quite Oversold, and both our oscillator series (lower and upper rectangles) are currently in Low Risk situations. Our long term oscillators (lower rectangle) suggest that **this steepening may last well into 2019, possibly even into 2020, and according to our C Corrective targets to the upside (right-hand scale), the move may be quite substantial**. This recalls a situation last seen in mid 2016, and we believe this scenario probably translates into a further pick up in US growth over the next few quarters.

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



The trends mentioned above (rising US growth and interest differentials vs the rest of the world over the next few quarters, and a steepening yield curve) should both benefit the US Dollar. This should continue to be the case as long as US inflation doesn't start to accelerate up. For now, such an acceleration seems at least several months away. In the meantime, the US Dollar should remain strong, and this is what both our oscillator series are showing. Our medium term ones (upper rectangles) suggest at least a few more months of Dollar strength, while the sequence we show on our long term oscillators (upper rectangle) implies that the Dollar could continue higher well into 2020. **For now, we would hence remain bullish on the US Dollar at least into the Summer**. We believe this situation may benefit from positive feedback loops between the US currency, the US Growth differential to other regions, and the likely continued outperformance of US equity markets, thereby fueling continued flows of capital to the region.

Copper Spot (USD/ton, LME) vs Brent Oil Spot (USD/barrel)
Bi-monthly graph or the perspective over the next 1 to 2 years



We end this longer term cross asset overview with the long term graph of the ratio of Copper vs Oil. In recent history, the price of Copper has been very much related to Chinese growth decelerations and accelerations (China is by far the largest source of Copper demand), while the Oil market is probably still dominated by US demand. Over the last few years, both regions have been rather countercyclical. For example, while the US was decelerating in 2014 and 2015, Chinese stimulus had reached its climax. More recently, while the US was benefiting from the Trump tax reform in 2018, China was attempting to pursue fiscal and monetary austerity. The Copper to Oil ratio has captured /anticipated most of these conflicting trends over the last few years. Both our oscillators series (lower and upper rectangles) now suggest that following **its bounce late last year, the ratio has probably started to roll over again. The downside potential over the next couple of years may be substantial (I Impulsive targets to the downside; right-hand scale). Our view is that this comparison provides further confirmation of the US growth and equity outperformance potential we expect over the next few quarters, perhaps the next couple of years.**

Concluding remarks

Despite the strong rally since the beginning of the year, and considering for the current Trade War related market correction, which may continue a few more weeks, we expect US equity markets to remain strong into the Summer. Our targets for the S&P500 could see it reach above 3'100 by then. We also expect the US growth differential to China, Europe and the rest of the world, to resume its uptrend, into the Summer at least. US long term interest rates should also resume their uptrend, while the US yield curve could start to steepen quite rapidly, and the US Dollar remains strong. If correct, these developments could fuel further positive feedback loops for the US, as successive capital inflows exacerbate these trends. We are hence favoring US reflationary assets to lead global markets higher over the next few months at least.

24 / No mystery: the yield curve is a creation of the bond term premium, which itself, is a creation of the Implicit Price Deflator

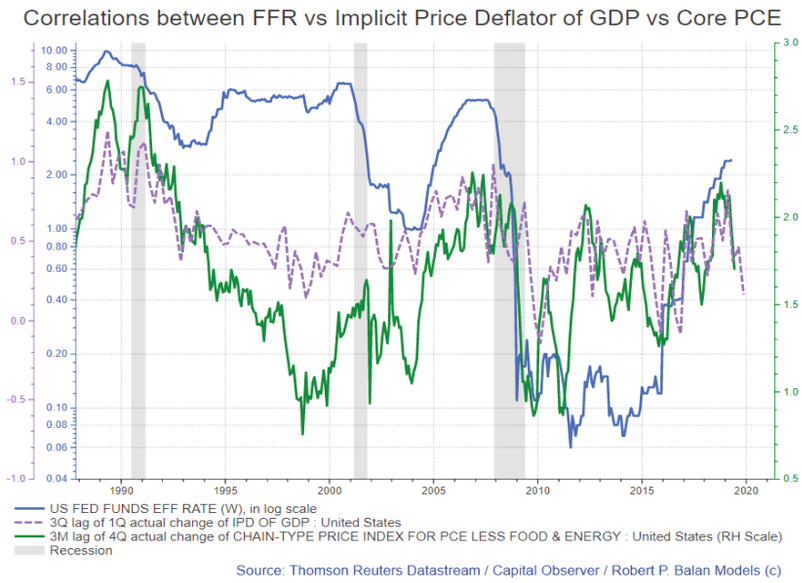
There is so much digital ink wasted on the discussion of the yield curve and the portents an inverted yield structure brings. But lost in the brouhaha is why yield curves do what they do (like invert, for one) and why the inversion of the curve is so devastating (like bring on a recession). We explained some portions of the yield curve dynamics on several issues of the Capital Observer, but have never made a full presentation which answers the questions asked above.

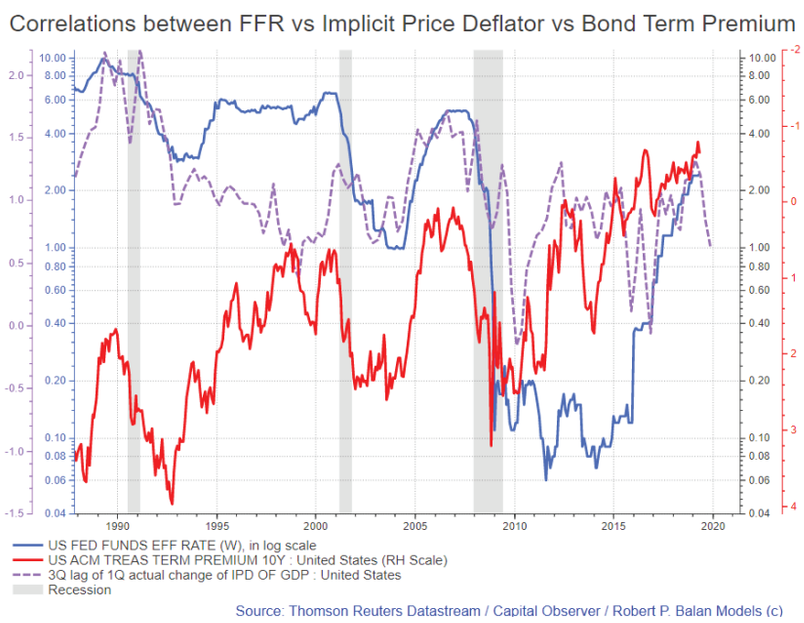
We make a priori claim that the bond term premium drives the yield curve. But that is not very helpful because the bond term premium is an even more mysterious term to many investors than the bond yield curve itself.

To show the claimed relationship between the term premium and yield curve, we have to first establish where the term premium is coming from, and from there, the background info will help in clarifying the linkages among the data.

When the Fed formulates policy and inflation is a concern, they use the Core PCE as the inflation benchmark (*green line in the fist chart on this page*). Now, a variant analogous to the PCE is also being used to calculate the so-called "real GDP", the nominal GDP less the internal inflation of the economy – the Implicit Price Deflator (IPD). IPD is officially defined as "as a price index for all final goods and services produced, is the ratio of nominal GDP to real GDP.

A more precise definition puts IPD as "a measure of the level of prices of all new, domestically produced, final goods and services in an economy in a year. That operation is Nominal GDP/ Real GDP = Implicit Price Deflator. So do a little math transposition, and that formula becomes Nominal GDP/ Implicit Price Deflator = Real GDP. Now, IPD is shown as a real deflator vector; it reduces the inflationary component of the Nominal GDP so that we get the "real" GDP.





As you can see, PCE is analogous to IPD, only it is more volatile. A qoq change in the IPD is tracing out like a 4Q change in the PCE. The point is that they are analogous (*see 1st chart above*). If one transmutes the PCE properly, you obtain a value that not far from the values of the IPD, which was optimized to match the frequency of the quarterly GDP.

The next step is to modify the change rate of the IPD to match the frequency of the changes in the Fed Funds Rate – that is to a 2-quarter change rate. And this is what we get on the 2nd chart above. Then we put the bond term premium data into juxtaposition with the Fed Fuds Rate (FFR).

If normalized properly it is clear that both the FFR and the bond term premium are sort of derivatives of the Implicit Price Deflator (IPD). We invert the chart so we can add the yield curves. And this is what we get. (*see first chart on next page*)

Now the cast is complete. **It is clear that "internal" inflation (IPD, purple line on the 1st graph next page) as proxy to the PCE, drives the rate policy reaction function of the Fed and FOMC (blue line on the 1st graph next page), and whatever action they take is transmuted and manifests as the bond term premium (red line on the 1st graph next page).**

And the bond term premium helps drive the yield curve. Bond term premium composes the largest part of the several elements which composes a bond yield. The bond term premium is compensation for the inflation risk that the bond faces until maturity.

The significant point is that IPD leads the bond term premium (and the yield curve) by three quarters. Plenty of time to tell you what to expect of the yield curve or potential monetary policy changes that may be brought about by changes in inflation trends.

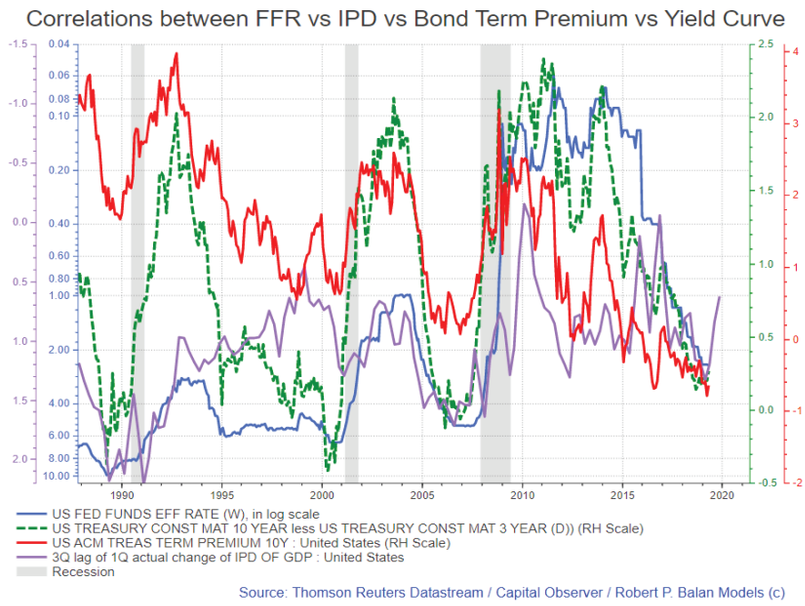
Hence, the yield curve is a creation of the bond term premium which in turn is a creation of the Implied Price Deflator.

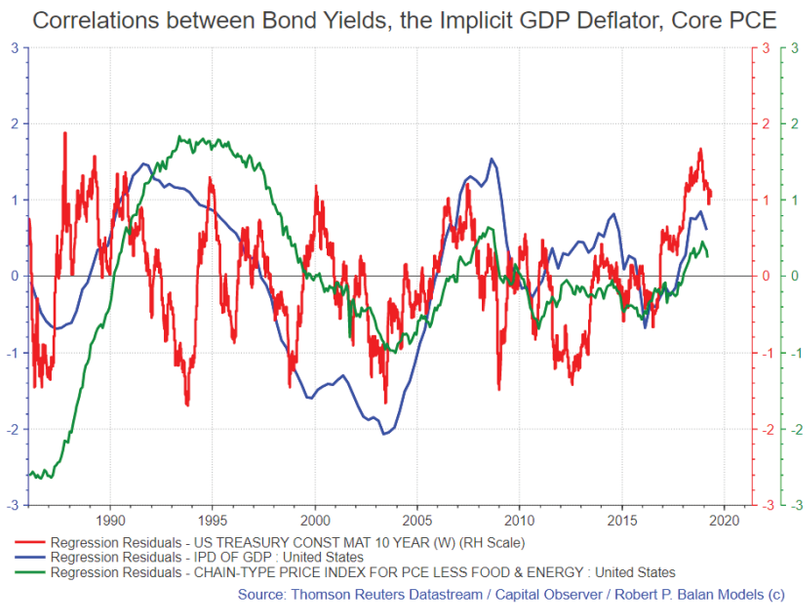
There are significant take-aways from the series of charts:

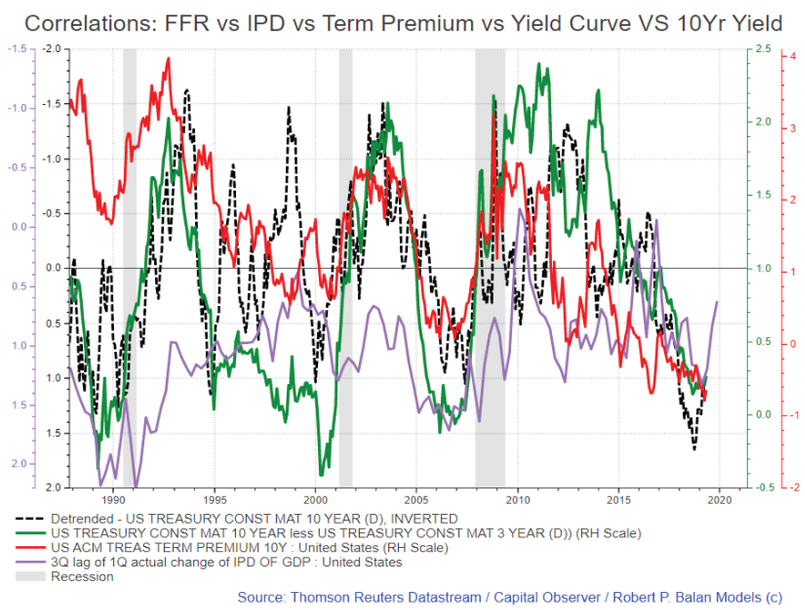
(1) the IPD change rate has been falling lately, and the term premium and yield curve are now at the previous inflection point of the IPD lower. Therefore, we can expect the term premium to start rising at some point in the immediate future. That means too that the yield curve should start steepening at that same point very shortly after the term premium starts rising.

When it comes to the bond yields, there is a clear link between the IPD, Core PCE and bony yields. The relationships are reasonably tight. (*see 2nd graph on this page*)

Therefore, in the context of the original matrices with the yield curve, where the IPD provided a clear lead on the yield curve, bond yields should lag behind the IPD and Core PCE. The lead function provided by the IPD to the yield curve should also provide direction cues as to where bonds are going. This is simply from the function of the inflation driving the trajectory of yields. See 3rd graph on this page.







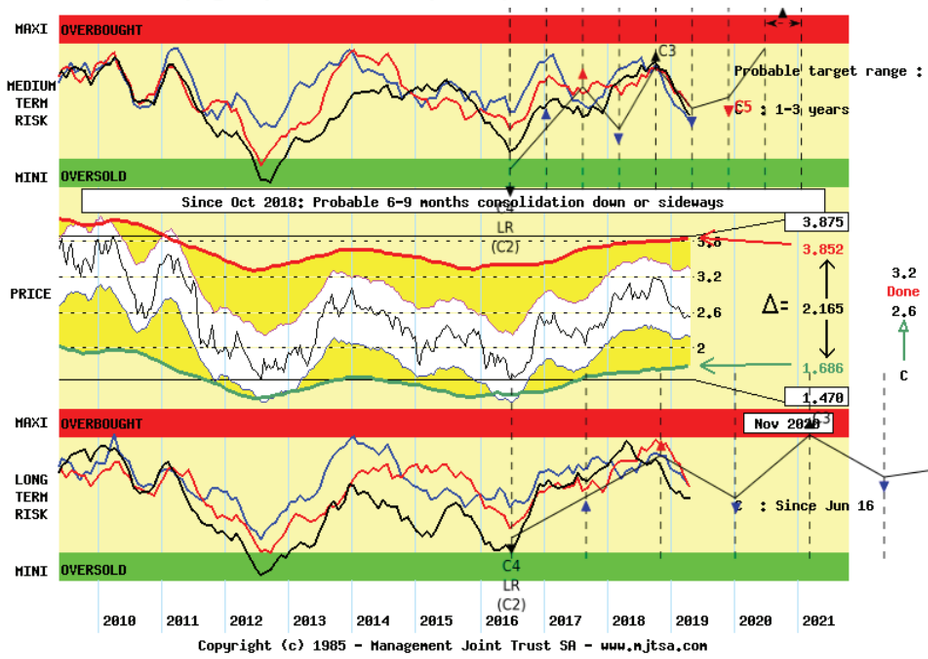
The direction of inflation is clear at this juncture – inflation is in a declining phase. The IPD has been falling for some time, and the recent decline of the bond yield has not fully reflected the full extent of the IPD's decline. **We expect bond yields (10yr yield as proxy) to fall further over the next weeks or so, and the inflection point higher will probably sometime in early July. The tendency will likely be higher for yields, from that point on, until year-end.**

26 / MJT - TIMING AND TACTICAL INSIGHT

Yields could reverse up soon and the time to take profit on duration is probably near

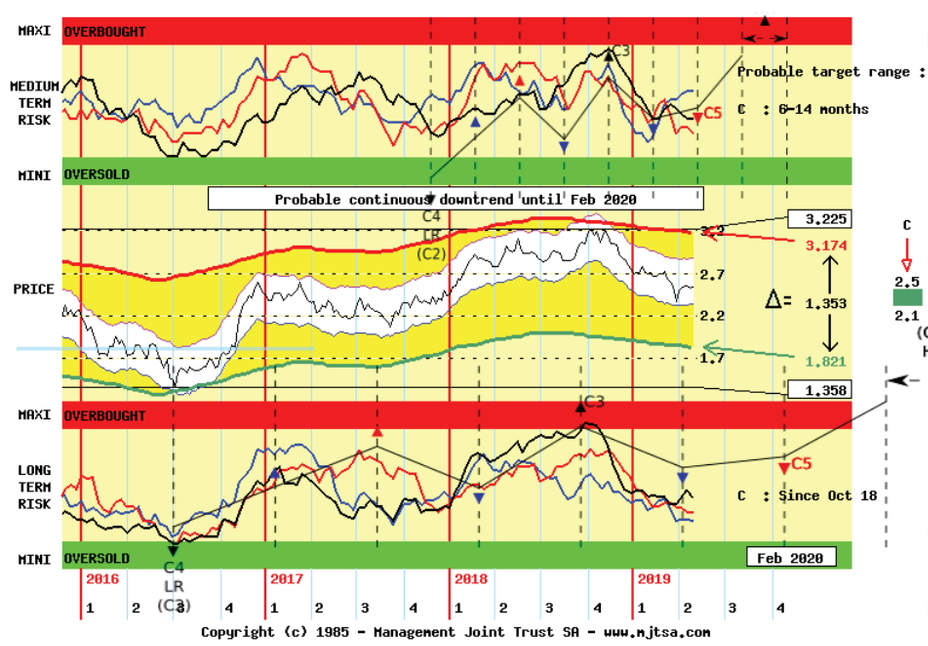
Last October when rates topped out above 3.2% on new 7 years highs, we had expected that they could retrace down by 60 to 100 basis points within 6 to 12 months. These targets have now pretty much been achieved and we believe that rates could soon start to reverse up. Indeed, as we had then forecast back in early Q4, rates first dropped on flight to safety concerns as risk assets corrected. Since then, the FED's dovish U-turn, and more recently, Trump led speculations about potential rate cuts have contributed to push the whole yields curve to Oversold levels. The bond market is now probably priced close to perfection, and any positive surprises on the persistence of US Growth, a resolution of the Trade War, and/or a possible pick up in inflation could fuel a new rally in rates, probably over the next couple of quarters.

US 10 years Benchmark Bond Yield
Bi-monthly graph or the perspective over the next 1 to 2 years



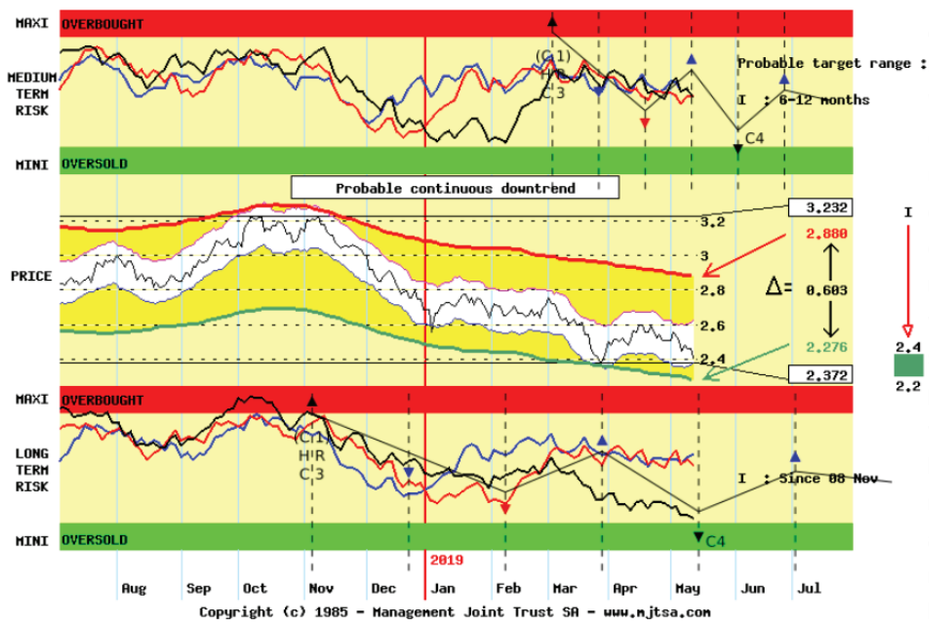
The breakout in US 10Y rates late last year is significant. It seems to conclude a long term bottoming process, which had been developing since 2012. Interestingly, it met resistance around the upper end of our C Corrective targets to the upside (right-hand scale), and has since been reversing down. Yet, **the move between 2016 and 2018 is very promising. It did indeed create the first uptrend sequence in years on our long term oscillators** (higher red top than the previous blue one; lower rectangle). **This theoretically implies that further upside breakouts are likely over the next couple of years**. Shorter term, our long term oscillators (lower rectangle) suggest that the current retracement may continue during most of 2019. However, our medium term oscillators (upper rectangle) show a more dynamic sequence: **US10Y yields may have reached important support and a possible reversal point to the upside. They could soon start to resume higher, potentially towards late 2019 and even 2020**. We believe that resistance around 3.2% could be retested sooner that the market currently expects.

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



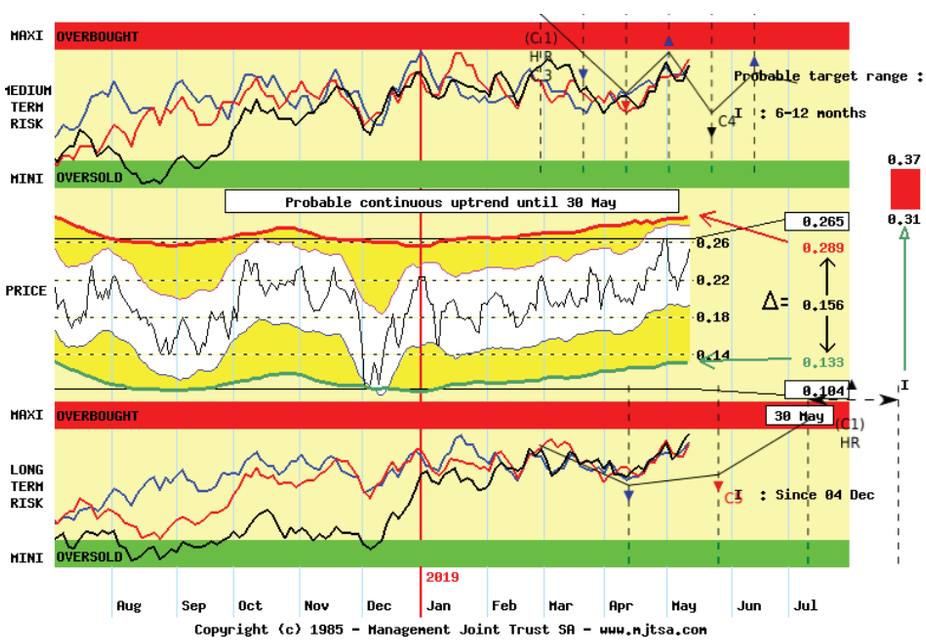
On the Weekly graph, we can identify the intermediate tops made on both oscillator series last October (lower and upper rectangles). While the retracement period on our medium term oscillators (upper rectangle) is probably coming to an end, the sequence on our long term oscillators (lower suggest) also suggests that we have probably reached an initial support point. Both sequences, would suggest that the trend could starts to resume higher soon, probably into the Summer in first instance. On the target front, the retracement potential has pretty much been fulfilled. **We cannot exclude a last push lower towards the bottom of the 2.5%- 2.1% range over the next few weeks, probably as equities markets complete their current intermediate correction. Yet, following that, US long terms yields should indeed start to reverse up and could potentially reach back towards last year's highs, probably over the next couple of quarters.**

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



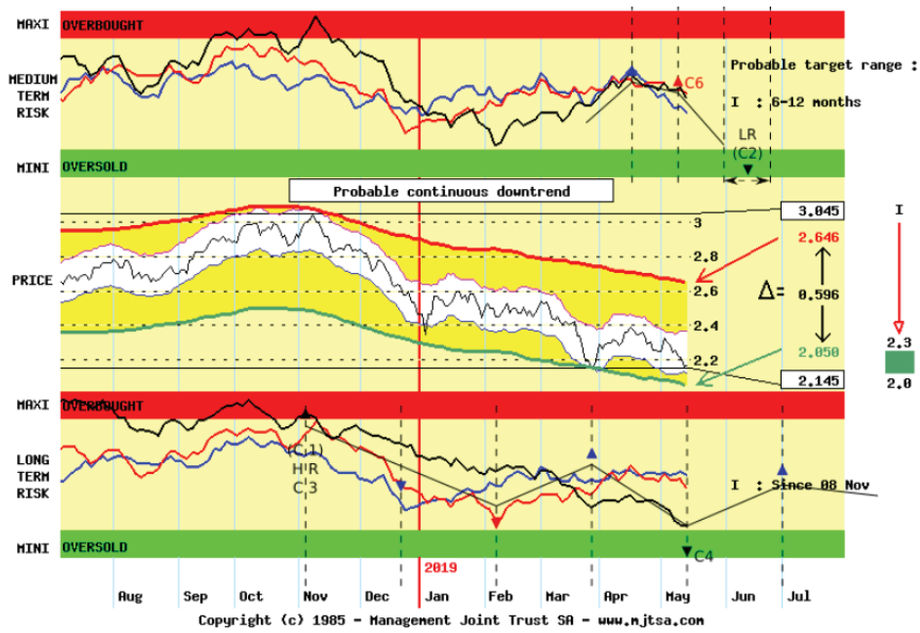
As we mentioned last month, we expected US10Y yields to retrace down once more into May. While on our long term oscillators (lower rectangle), this retracement may be coming to an end, our medium term oscillators, do leave the door open **for further downside retests into the end of this month**. On the target front (right-hand scale), **US10Y yields may indeed push back into our I Impulsive target range to the downside between 2.4 – 2.2%, before they reverse back up towards midyear and early Summer into our C Corrective target range to the upside between 2.7 and 2.9%.**

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



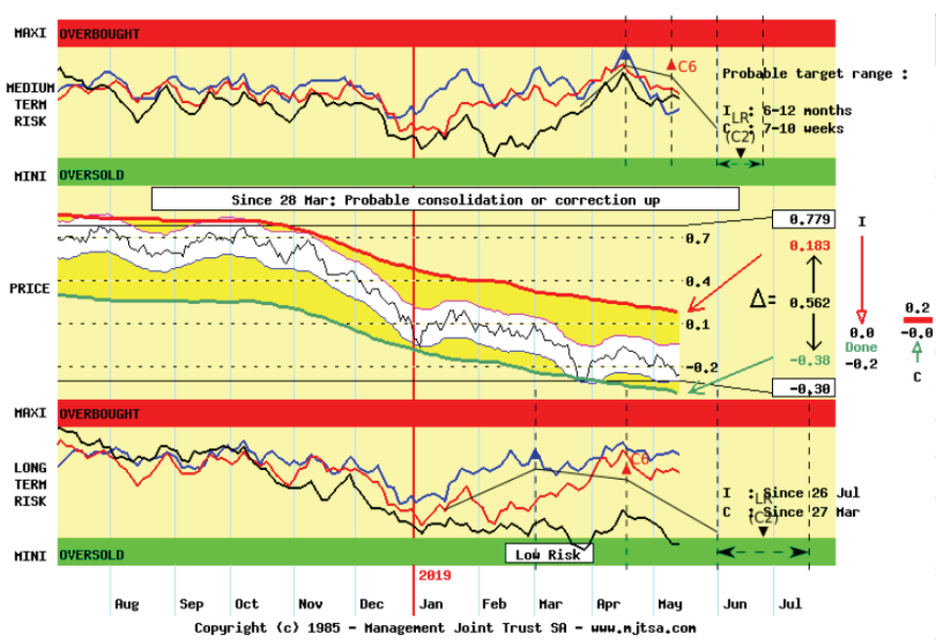
Over the last few issues of The Capital Observer, we had been arguing that with the FED "on halt", long term yields could soon start to surprise to the upside (from mid Q2), and that the yield curve would then steepen. Yet, this steepening seems to be already happening, since December, and quite subtly. Interestingly, for now, it has been driven by short term rates, as these have been falling faster than long term ones. Such steepening, which is labelled a "Bullish steepening", is usually driven by the prospects of future rate cuts. We believe it is quite remarkable that this theme has gained so much traction over the last couple of months given that the US economy is still growing strongly and that US equity markets have recently retested all time highs. We hence remain true to our initial scenario. Hence, **following a brief correction, which we expect on both oscillators series (lower and upper rectangles) into late May, we still believe that the yield curve could then continue to steepen. This new steepening move, however, could be driven mostly by the long end where we expect an upside reversal (a so called "Bearish steepening").**

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



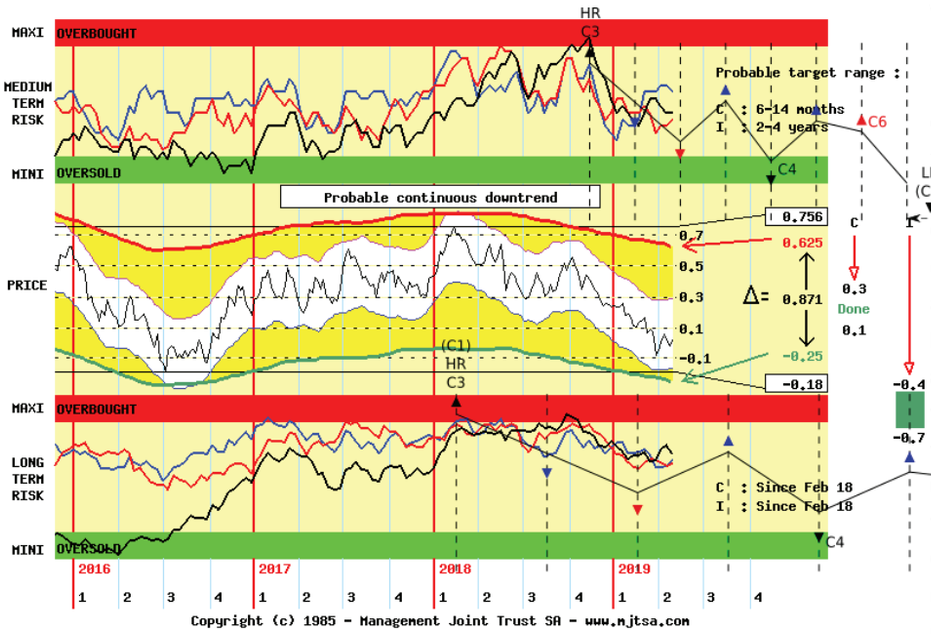
As a confirmation, we now consider US3Y yields. Indeed, on these, our long term oscillators (lower rectangle) could be reaching an important low over the next few days and should hence bottom out soon. At the latest, our medium term oscillators (upper rectangle) suggest possible downside retests into late May. Our I Impulsive targets to the downside may justify another 10bps of downside (right-hand scale), yet not much more. **Following that, we expect US3Y yields to start reversing up towards midyear and the Summer.** This move may be fueled by the prospects of sustained US economic growth (as with US10Y yields), yet possibly also by the growing US deficit and its financing needs (which is mostly financed by 2 to 5 years issuances). This is especially true given the current geopolitical context, as some larger traditional buyers may decide to forego the coming auctions. Indeed, given the renewed tensions on the Trade War front, similarly to Russia a year ago, China may substantially reduce its purchases of US Treasuries, and eventually, could even consider to start reducing its holdings. This could push US3Y yields substantially higher.

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



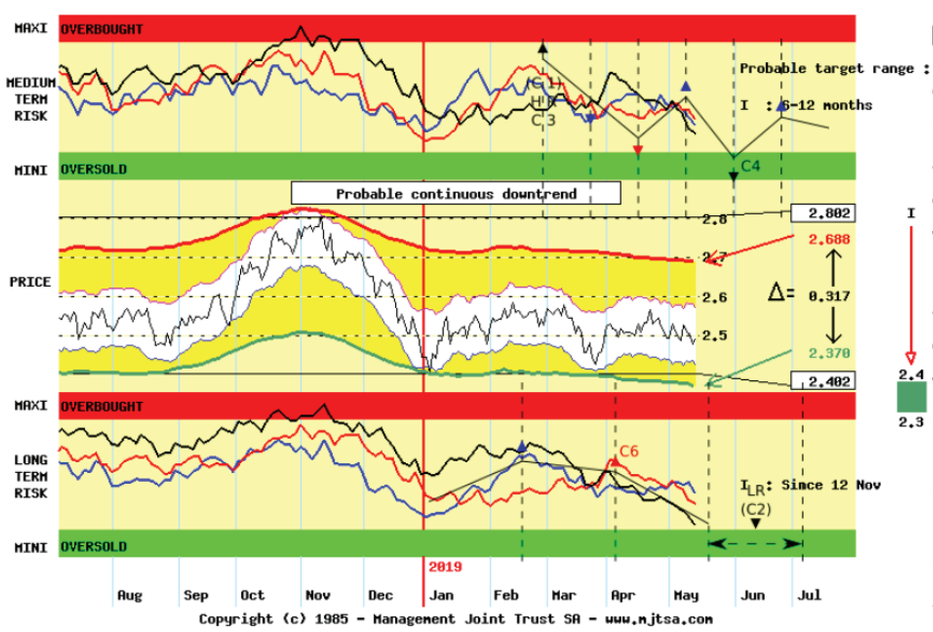
Indeed, the short term end of the yield curve (US3Y-US3M) has probably reached its full flattening potential for now. Our I Impulsive targets to the downside (right-hand scale) have been achieved, and our C Corrective targets to the upside are already eyeing a potential correction up towards 0.2%, or some 40 basis points above current levels (probably into the Summer). From a timing perspective, we expect that the downtrend may retest lower one last time, probably into late May according to both our oscillator series (lower and upper rectangles). Following that, the spread should then start to reverse up. Over the last few years, this spread on the short term end of the curve has been the most sensitive to dis-inflationary busts and reflationary accelerations. Indeed, 2 to 5Y tenures are not only the most liquid, and hence the ones that benefit the most from flight to safety flows when risk assets correct, there are also, as mentioned above, where most of the current issuance is being done in order to finance the growing US budget deficit. They hence rise and fall quite drastically with cyclicity. Hence, a reversal up in this spread could deliver a strong signal for rising yields across the yield curve.

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



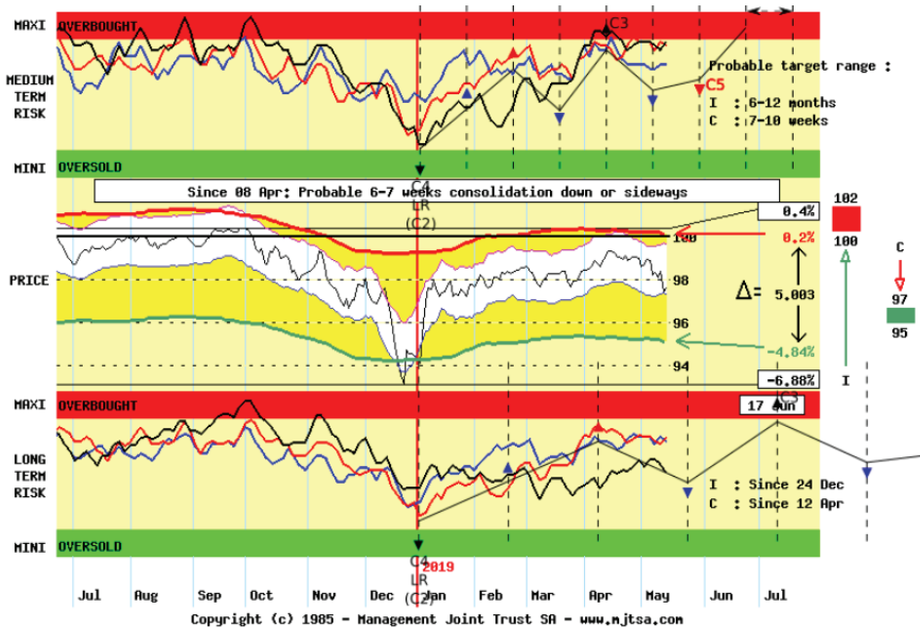
We now shift to Europe and look at the 10Y German Bund yield. While the sequence on our long term oscillators (lower rectangle) suggest than these yields should have started to bounce mid Q1, our medium term oscillators (upper rectangle) are currently also approaching a new support point. **Both oscillator series now suggest a bounce in German yields into the Summer. We believe it could travel 30 to 40 basis points to the upside, before it resumes lower from mid Summer into next year**. Our targets over the next 12 to 24 months are indeed pointing to very negative levels towards the minus 0.4 to minus 0.7% range (I Impulsive targets to the downside; right-hand scale).

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



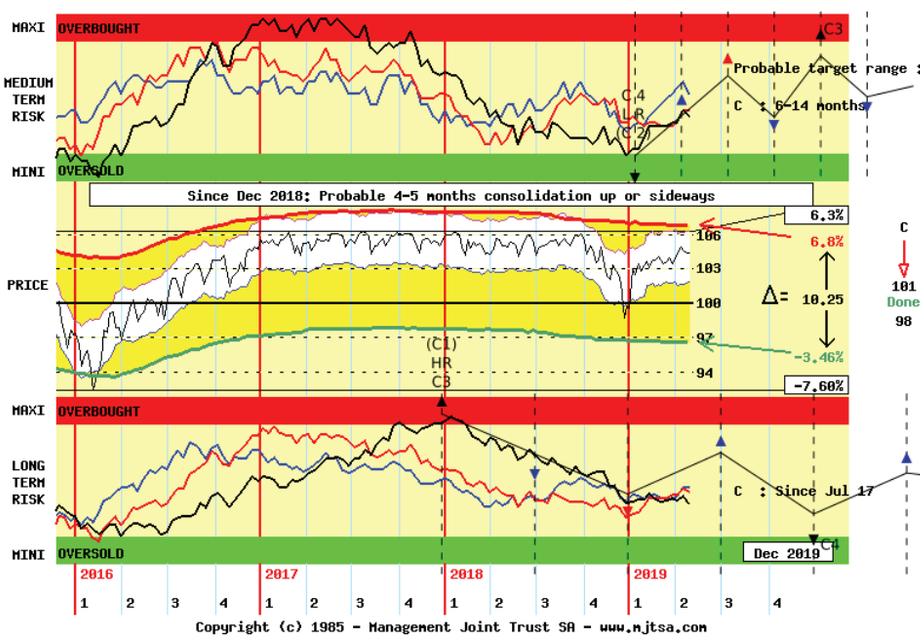
Comparing the spread between the US and Europe, we can draw similar conclusions. Indeed, US yields have been more volatile and cyclical than European ones over the last few years as European yields have remained in recessionary territory throughout the cycle and now seem less reactive to cyclical ups and downs. Hence, when yields fall or rise, the US to Europe interest rates differential usually moves with them (US yields are the main driver of the differential). This may also explain why the Dollar has been very pro-cyclical over the last 3 years. **Similarly, to what we expect on yields, we are awaiting a last retest down on the spread, probably towards late May** on our medium term oscillators (upper rectangle), perhaps sliding a bit into June on our long term ones (lower rectangle). **Following that, the spreads should then resume higher into the Summer**. Our I Impulsive targets to the downside (right-hand scale) suggest 10 to 20 basis points of additional downside potential, before the spread bounces back quite strongly into the Summer (C Corrective targets to the upside).

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



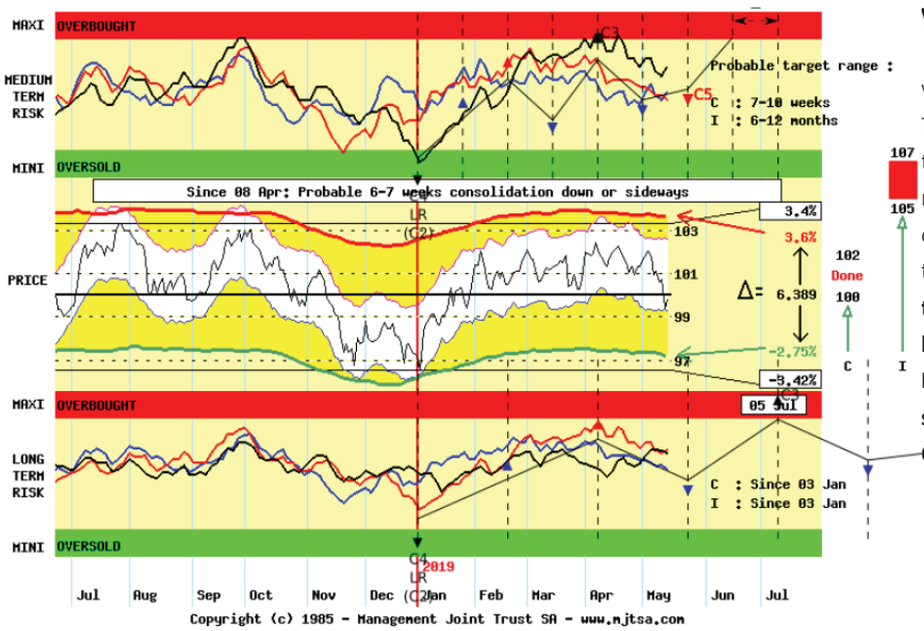
We now consider credit and compare US High Yield bonds vs US Investment grade ones of similar duration. The ratio also took time to correct down following the intermediate top, which we had identified early April. Both our oscillator series (lower and upper rectangles) now suggest that it **could continue lower towards late May, before the trend resumes higher into the Summer**. Over the next couple of weeks, the downside risk may amount to 1 to 3% according to our C Corrective targets to the downside (right-hand scale). Following that, High Yield may outperform once again, and according to our I Impulsive targets to the upside (right-hand scale), the ratio may reach back towards its highs made last October.

HYG - iShares High Yield Corp. Bond ETF / VCSH - Vanguard Short-Term Corp. Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



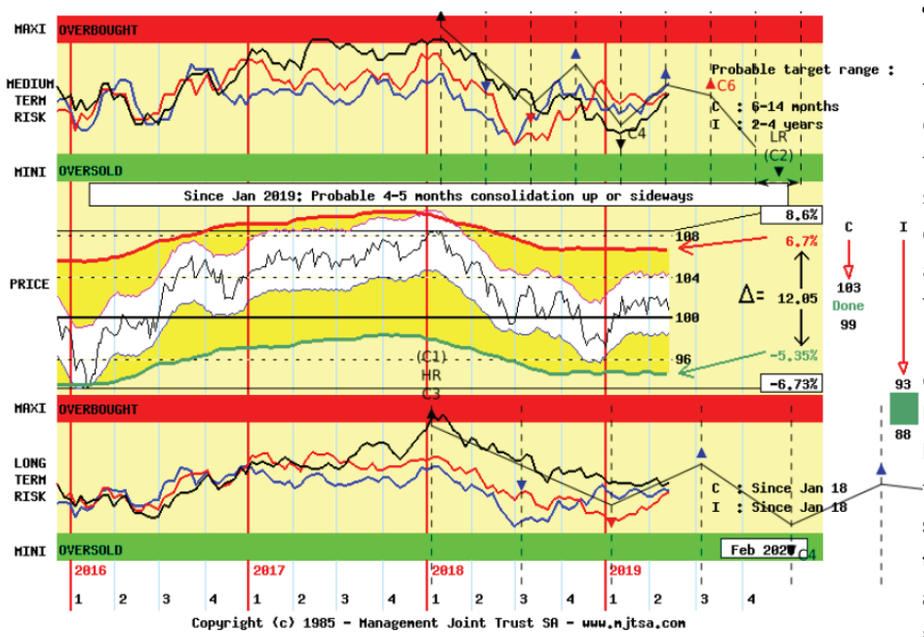
Longer term, the ratio may appear slightly more menacing. Yet, during the sell-off late last year, it did manage to hold the support of our C Corrective targets to the downside (right-hand scale), and hence the uptrend since 2016 is theoretically still in place. On both oscillator series (lower and upper rectangles), the rebound / upside retest since early this year, could continue into midyear / early Summer at least. Hence, **following the short term intermediate top currently seen on our medium term oscillators (upper rectangle), we would expect the ratio to find support over the next few weeks and then resume higher into the Summer.**

PCY - PowerShares EM Sovereign Debt PF ETF / IEF - iShares 7-10 Year Treasury Bond ETF
Daily graph or the perspective over the next 2 to 3 months



We turn to Sovereign Credit and compare USD denominated Emerging Markets Sovereign debt vs Treasuries of similar duration. The ratio has followed risk assets higher since the beginning of the year and started to correct early April in line with an intermediate top on both oscillator series (lower and upper rectangles). **Going forward, our projection is that the ratio could find support towards late May, before it resumes higher into the Summer. Our I Impulsive targets to the upside (right-hand scale) suggest that it may then test above last October's highs.**

PCY - PowerShares EM Sovereign Debt PF ETF / IEF - iShares 7-10 Year Treasury Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



The long term graph of EM Sovereign bonds vs US Treasuries does cast some doubt on the long term perspectives for the ratio. On both oscillator series (lower and upper rectangles), the ratio did find support early this year and has since been bouncing. Yet, this bounce pales in comparison to the downtrend suffered in 2018, and the trend is probably still heading lower. This is what our targets are also suggesting. Indeed, late last year, the ratio made it below our C Corrective targets to the downside (right-hand scale), thereby opening the door to much lower I Impulsive targets to the downside over the next 1 to 2 years. Hence, **the sequences we show our on both oscillator series does point to a bounce into midyear / early Summer along with other risk assets (lower rectangle), at worse, the ratio could hold up until then (upper rectangle). Yet, following that, it will probably start resuming lower**. This future weakness on a relative basis probably matches our negative relative views on China and Emerging Markets vs the US over the next couple of quarters. It probably also confirms the US Dollar strength we expect.

Concluding remarks

US yields across the yield curve have been correcting down as expected since October. We believe they are now approaching important support and that their downside potential for has been pretty much achieved. We hence expect them to bottom out soon, probably towards late May, and initiate a reversal up towards the Summer. US yields may accelerate up quite strongly, potentially retesting last year's high towards late Summer / the Fall, while the correction could be weaker and/or shorter for other Sovereigns including Europe and Emerging markets. We hence also believe that the growth and interest rate differential between the US and Europe could rise once again. Shorter term, until late May, the risk of a last sell-off in yields remains. We believe it could accompany the risk asset correction, which is still underway, and may even overshoot it by a couple of weeks (similarly to what happened in January this year, or before, in early September 2017). Hence, over the next few weeks, we would remain prudent on yields, which could still make new lows. We would however consider such weakness as an opportunity to take profit on duration.

32 / The S&P major sectors – how they are faring and why

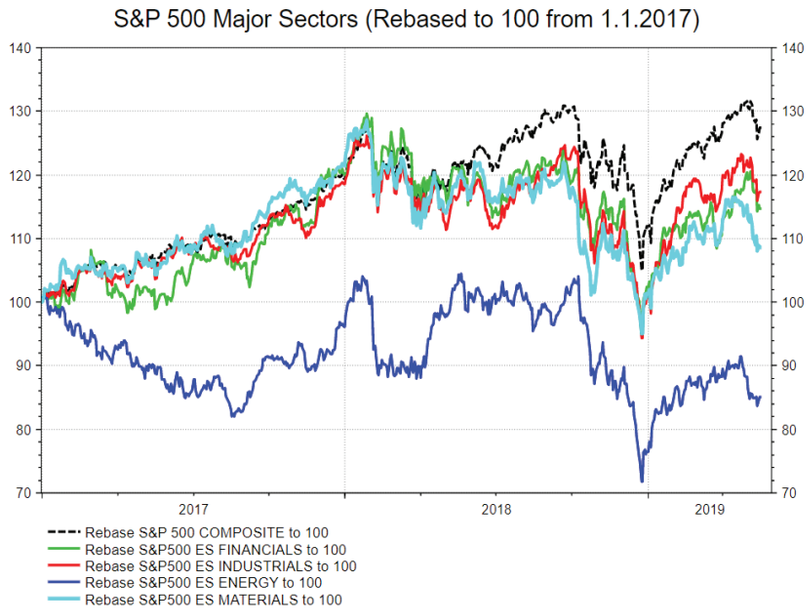
This is an overview of the major sectors of the S&P 500. It is obvious that the major sectors, excepting Utilities, Health and InfoTech, have been underperforming the broad index. We set out to find out the reasons for these unremarkable performance. (*see 1st graph on this page*)

The financial sector has not performed year to date very well and this is not a good sign, because **financial stocks historically outperform in the end of most business cycle and when the net interest spread (NIM) that they earn rises and the economy is in full employment.** However, it may not be that bad because the share prices lag behind these vectors by more than a year, by 5 quarters (*see 2nd graph on this page*).

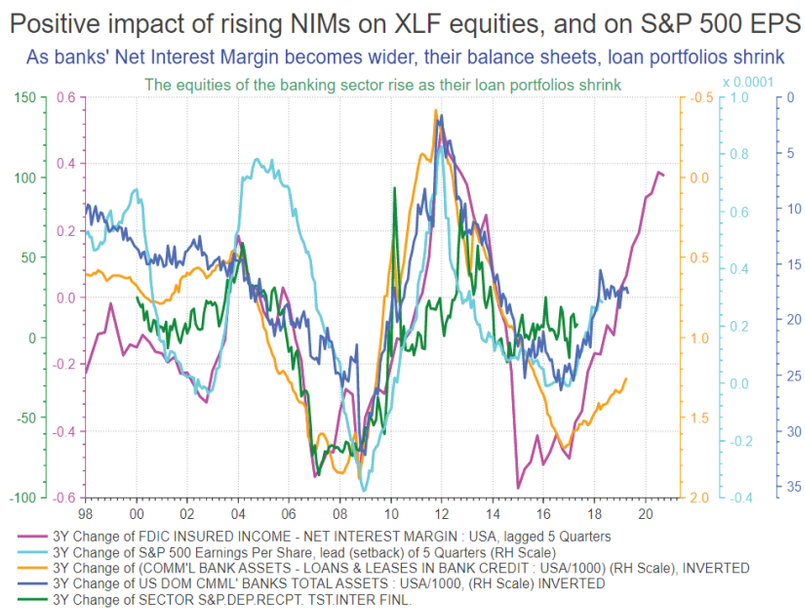
The take away from the chart above is that the broad rise of the Net Income Margin has set the tone for better earning profile over the next 18 months at least. And the counter intuitive reason for that is a cut down on loans and leases due to the previous flattening of the yield curve. **In essence, less lending activity and smaller accumulation of loan assets provides a significant boost to banks' earnings profile on a lagged basis, following the turns of the Net Income Margin.**

The previous flattening of the yield curve will redound to a significant decline in loans over the next few quarters. That is just not being felt yet because the impact of the flat curve takes several quarters before it shows up in the loan books. (*see 3rd chart on this page*).

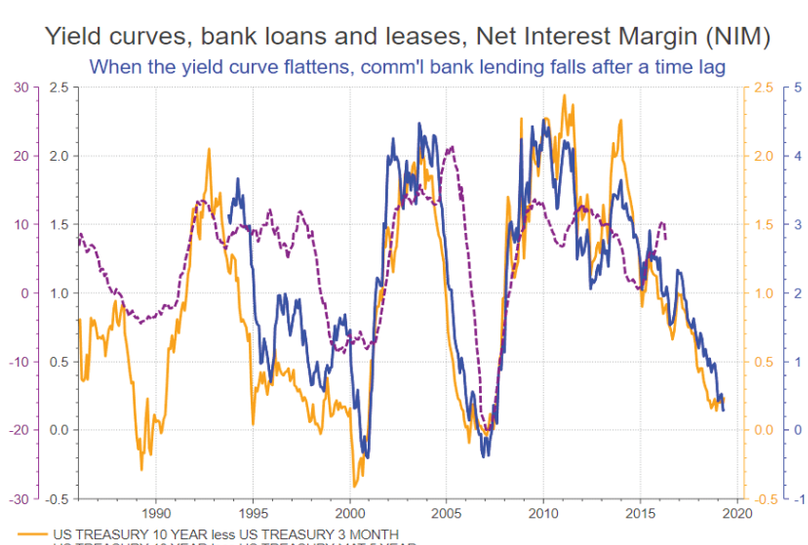
The mantra has been that the historically low interest rates and the big flattening of US yield curve, does not permit remarkable earnings for financial institutions by borrowing short term and lending long term. But that is patently false, at least after the recovery from the Great Financial Crisis in early 2009. **After the GFC recovery, lending has been a drag on financial**



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



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



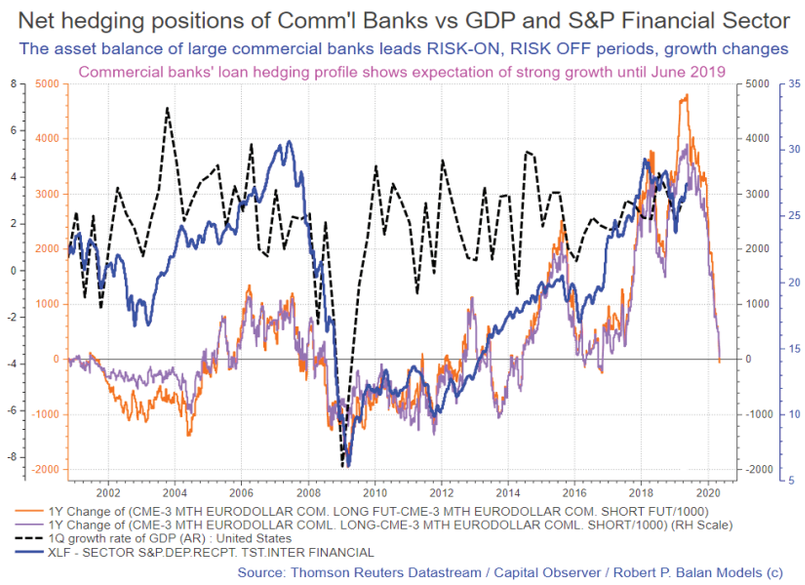
Source: Thomson Reuters Datastream / Copyright: Robert P. Balan Models (c)

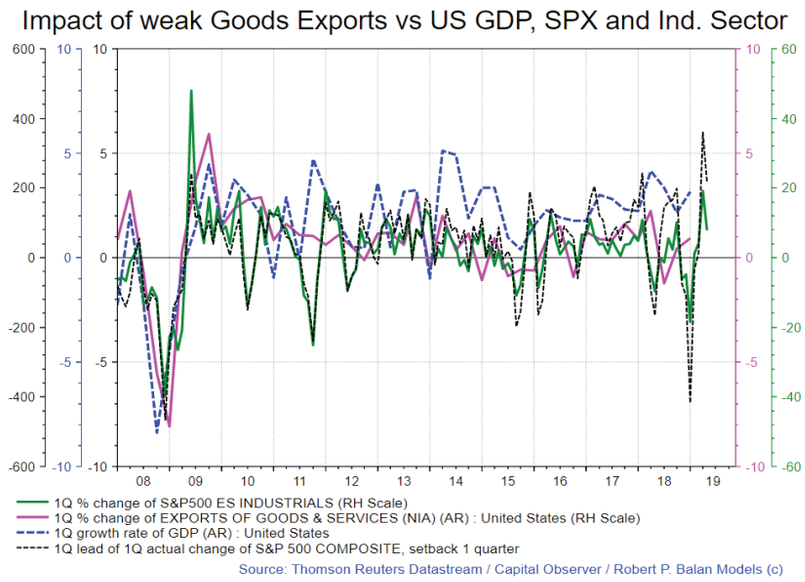
earnings, and the evidence is the tremendous amounts of bank reserves the banks are parking at the Fed. Those amounts could have gone to lending, but the banks chose to put their money in guaranteed, riskless investment, like bank reserves.

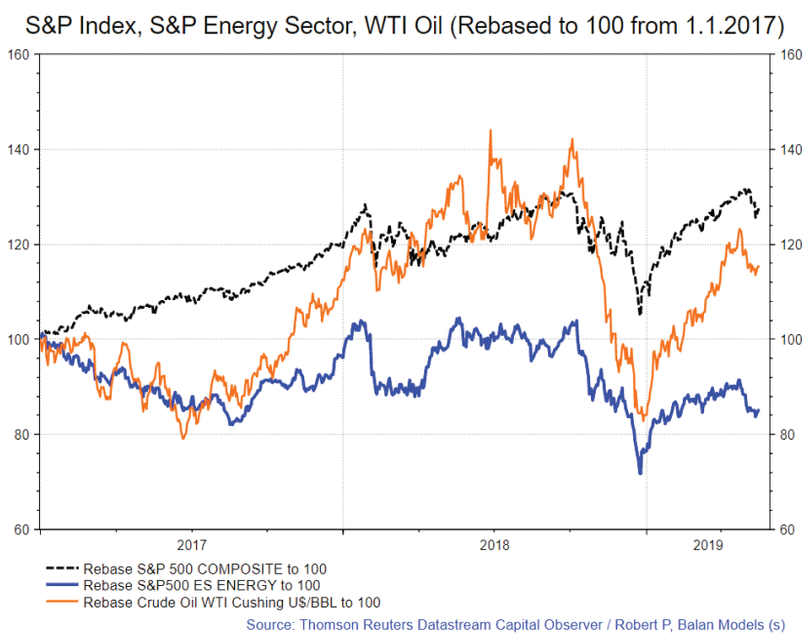
Probably one reason why the banks are curtailing their loan portfolios, and likely hedging their risk exposure to other financial assets, is the poor outlook the banks have on the US economy. We show below the hedging profile of the US commercial banks which they do via the US Eurodollar futures (*see 1st chart on this page*).

The key take-away from this hedging profile is that banks expect the economy to spiral into trouble as from the middle of this year. That means the banks also expect their shares to decline thereafter. That does not provide good portents to US growth because the banks' hedging activity tends to lead the changes in US GDP, and have had a very good track record. It also projects weak broad market potential at some point in H2 2019, may be from late Q3/Q4 because the changes in the valuation of the financial sector equities usually leads the broader S&P 500 Composite Index.

The industrial sector has not performed as one would expect, since it is considered a cyclical sector and is supposed to outperform in the late upswing of the business cycle, as the US economy is probably in now. **This sector is based in exports and given that president Trump has implemented the impose of tariffs in Europe and China and already its big trading partners have responded, the result will be lower exports for industrial companies, lower domestic gains and possibly higher inflation**. It is also feared that the trade wars may absorb the benefits of the implemented of tax cuts, through higher bond yields and interest rates, although those speculations are not being borne out yet. What is clear is that lower exports will negatively impact GDP, and therefore this sector should continue to trail the broad index.(*see 2nd graph on this page*)



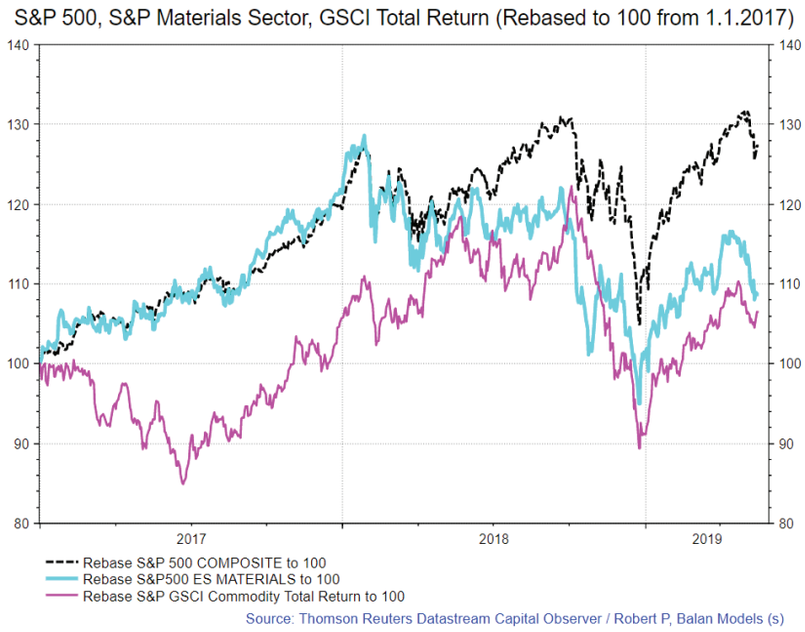




The energy sector has not performed so well until now (*see 3rd graph on this page*), given that oil prices went heavily down in Q4 2018 and have only started to recover. But this sector usually outperforms during a stagflation period, when the inflation rises, the economy is weak and the US dollar falls or remains stable. However, the US Dollar's negative impact has not

been strong on oil prices in previous quarters. **If the negative correlation with the US Dollar comes back, and it does so intermittently, it will increase the opportunity cost of oil and most of the commodities. So, this sector reasonably has still a little upside but the low global growth rate is not so supportive for accomplishing this milestone. Only a push toward the $85/90 for oil would trigger the necessary catalyst for this sector to catch up.**

The materials sectorseverely underperforms the broad S&P 500 Index, which reveals how sluggish is the 10-yr years economic recovery has been. And this is a drag in the hopes for the continuation of the stock bull market. Why? Because typically in the late upswing of the most business cycles, as where the economy is at this stage, this sector should be posting outperformance. **That condition stems from the fact that materials' orders rate is higher than sales rate during a strong recovery. We have not seen that for some time, and judging from the limited period left of the upswing of the business cycle, the next 3 to 5 months seem to be the last window for this sector to perform before economic weakness forces the material sector to decline in the late part of the year.** (*see graph on this page*)

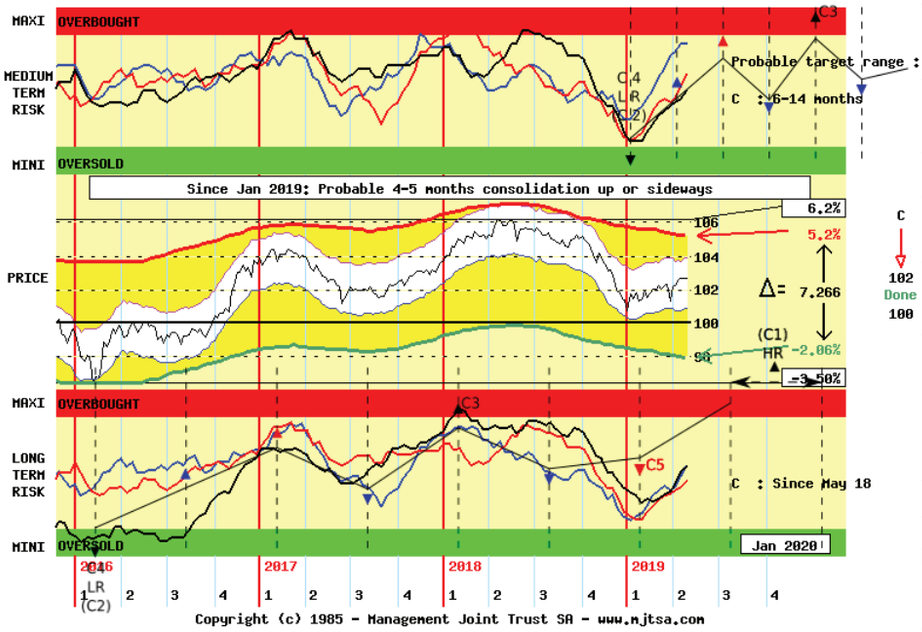


35 / MJT - TIMING AND TACTICAL INSIGHT

The next leg up in equity market may be focused on US reflationary sectors

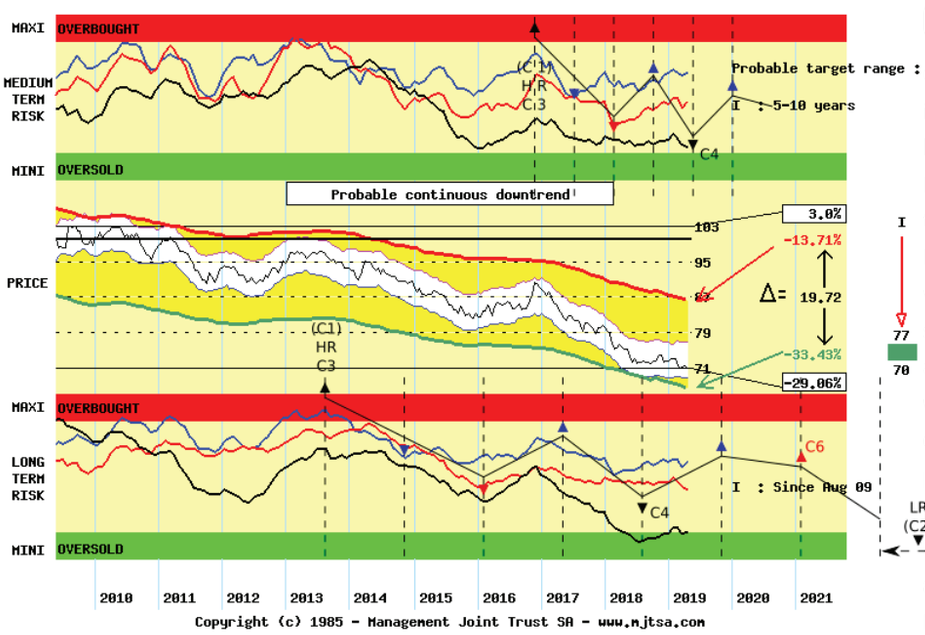
In other articles of this The Capital Observer issue we have focused on comparing the long term uptrend in US equities vs other regions of the world. For now, we believe their outperformance should continue/resume into the Summer, at least. We also considered the yield curve, which seems very much Oversold. Long term yield may be finishing their correction down since October, they could soon start to reverse up quite strongly, and with the FED on halt, the yield curve could steepen quite rapidly. In this article, we will hence concentrate on US sectors, which we believe should benefit from these trends, namely US Financials, US Industrials and US Energy.

TIP - iShares TIPS Bond ETF / IEF - iShares 7-10 Year Treasury Bond ETF
Weekly graphs or the perspective over the next 2 to 4 quarters



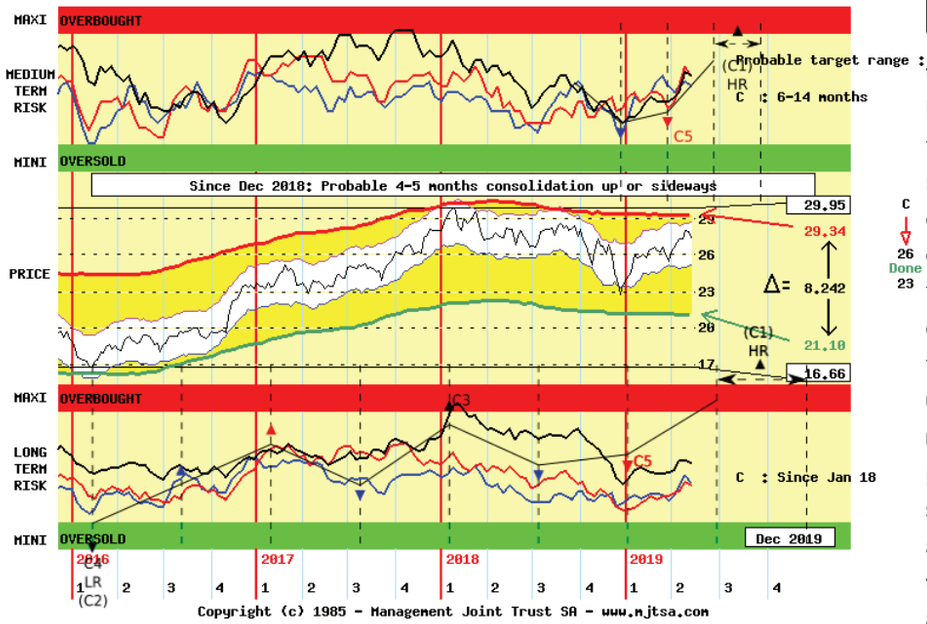
We will first review inflation expectations by looking at the breakeven ratio of US Tips vs US Treasuries. Indeed, if US reflationary sectors are meant to outperform, this outperformance will probably be accompanied, or followed, by a substantial increase in inflation expectations. The ratio was very much Oversold late last year. For now however, the rebound has been quite weak. Yet, some positive signs can be read in the graph. Indeed, despite the velocity of its downward revision in Q4, the ratio did hold the support of our C Corrective targets to the downside (right-hand scale). Hence, theoretically, **the uptrend since early 2016 is still in place**. Further, **both oscillators series (lower and upper rectangles) still suggest a resume uptrend situation into the Summer, possibly even towards year-end**. So yes, inflation expectations have been quite subdued throughout the Q1 and early Q2 risk asset rally. Yet, as we can notice from the graph, **over the last few years, inflation expectations have had a tendency to be slow starters when reflationary trends start to resume their uptrends. Usually, they would then catch up quite rapidly once the reversal is confirmed. We believe this could be the case from late May / June into the Summer.**

IVE- iShares S&P 500 Value ETF / IVW- iShares S&P 500 Growth ETF
Bi-monthly graph or the perspective over the next 1 to 2 years



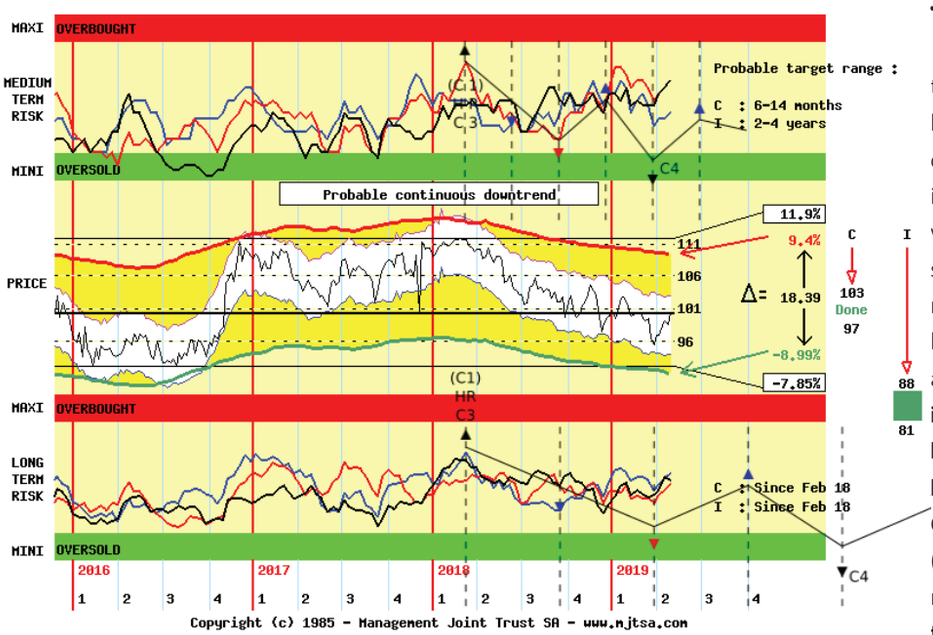
Our long term analysis of the US yield curve on page 22 of this issue of The Capital Observer, indicates that the 10y-2y is very Oversold and that it should start to bounce soon, probably for several quarters. In this respect, we now focus on the Value to Growth relationship within the S&P500. Indeed, it usually synchronizes quite closely with the ups and downs of US Yield curve spreads. On both oscillators series (lower and upper rectangles), **the ratio is now very Oversold. The bounce we expect could start soon and may then continue probably towards year-end. In terms of targets, the long term downtrend of Value vs Growth also seems quite exhausted as it has reached the lower end of our I Impulsive targets to the downside** (right-hand scale).

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



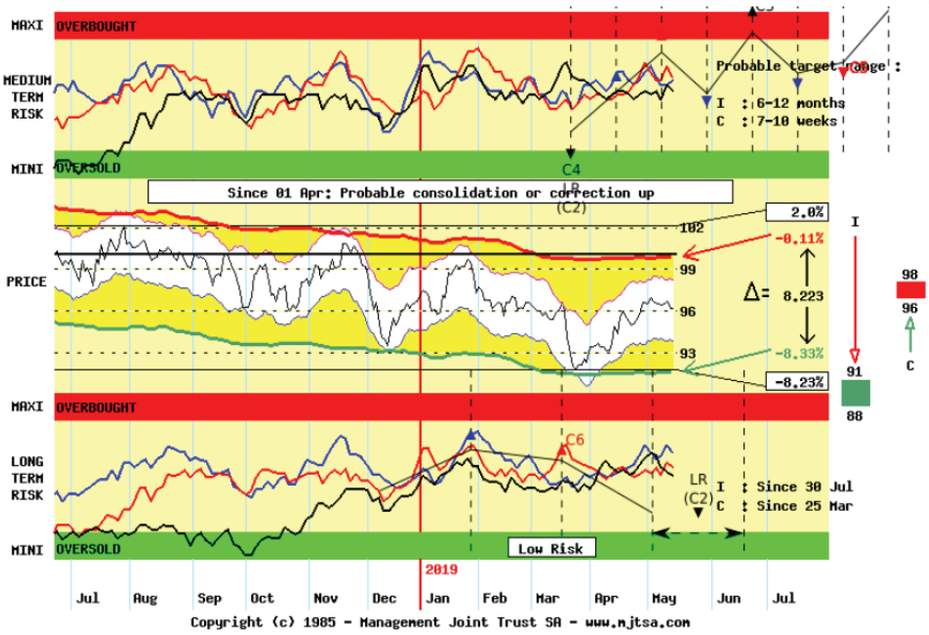
US Financials are probably the most emblematic Value sector in the US. They usually outperform when long term yields are moving up and the yield curve steepens. This is pretty much what we expect could happen over the next couple of quarters. Since early this year, US Financials have been following the market higher. Both our oscillator series (lower and upper rectangles) are now in **strong resume uptrend situations towards the Summer** and prices are still quite low compared to some other sectors as we are still below the peaks made in October and January last year. More generally, **the uptrend since 2016 is still in place** as during last year's Q4 market correction, the sector did manage to hold above the lower end of our C Corrective targets to the downside (right-hand scale).

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



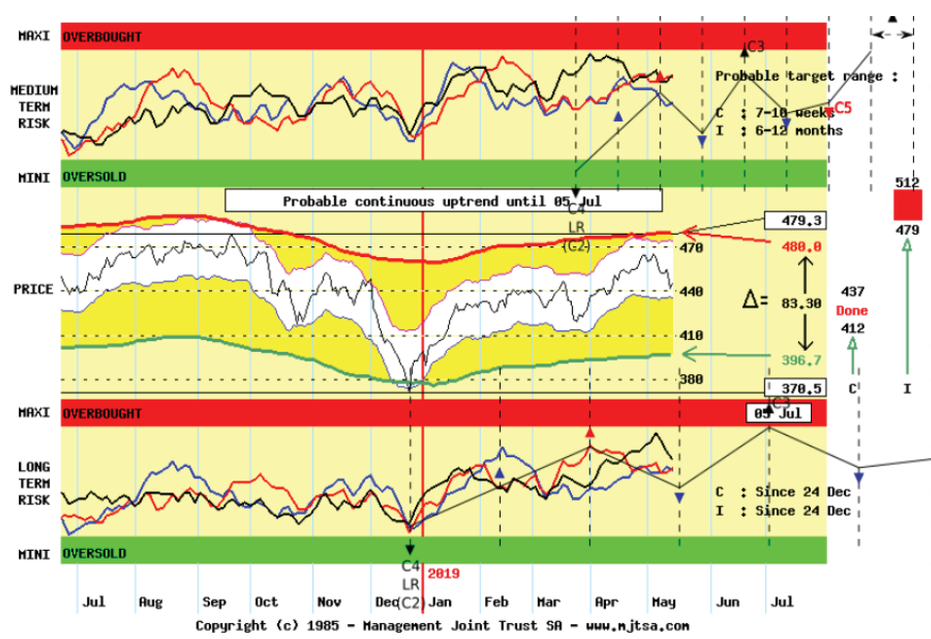
The relative graph vs the S&P500 does give us more insight about the dynamics driving the sector. It highlights how much US Financials out- or underperformance vs the S&P500 is related to developments in the US yield curve. Following a sharp drop since Q1 2018, the ratio seems to have reached an important intermediate low on both our oscillator series (lower and upper rectangles), **We now expect it to rebound towards midyear at least (upper rectangle), perhaps into late Summer (lower rectangle)**. Our C Corrective targets to the downside (right-hand scale) were slightly broken recently, so that **we cannot exclude further underperformance once the sector reverses lower vs the S&P500, potentially from late Summer / the Fall. For now, however, we expect an interesting window of opportunity over the next few months for US Financials vs the market.**

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



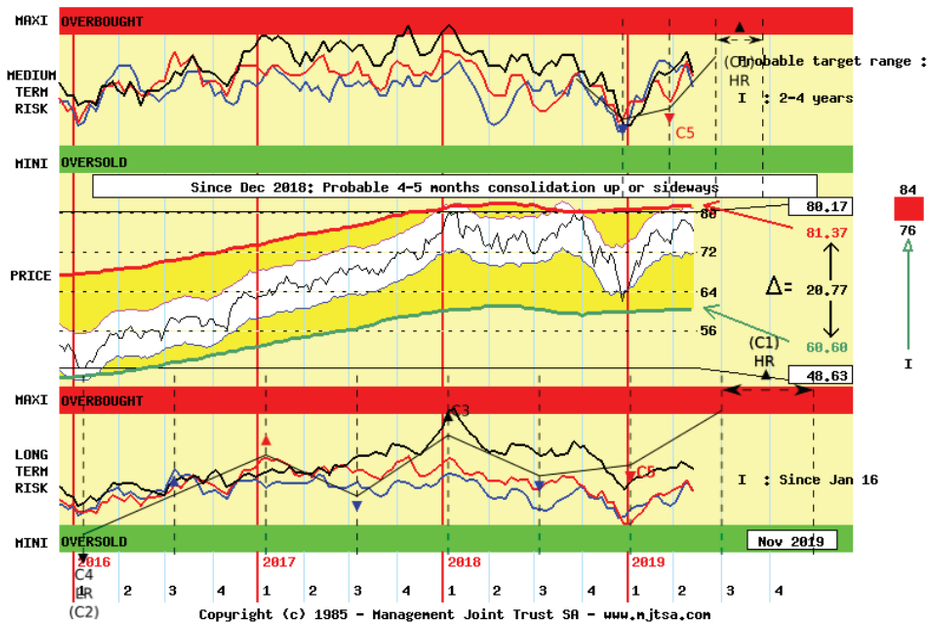
The Daily relative graph of US Financials vs the S&P500 has indeed already started to bounce. Although on our long term oscillators (lower rectangle) we cannot exclude a last retest lower into late May / early June, for now, the ratio seems quite resilient to the recent market correction. Hence, the sequence we show on our medium oscillators (upper rectangle) may be a better match for the current situation. It suggests that **US Financials may retrace a bit until late May vs the market, yet without making new lows. Following that from late May, early June, the sector then starts to outperform, probably into the Summer. In a way, the downside momentum for the sector vs the S&P500 may have already started to reverse. This is quite promising for US Financials over the next few months.**

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



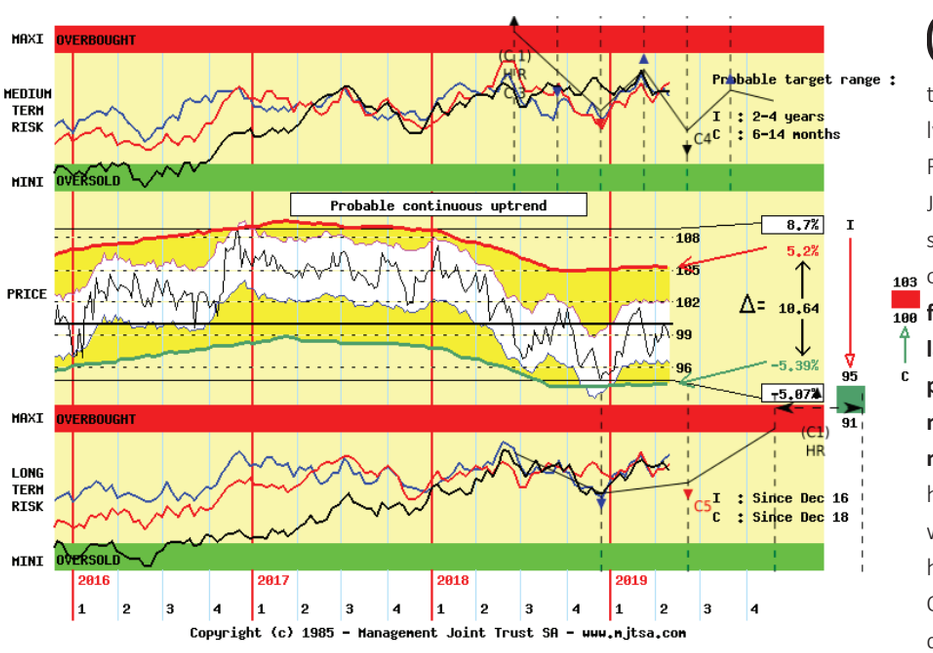
The Daily graph of the sector on a standalone basis is similar to the one of the S&P500. Following an intermediate top on our long term oscillator series (lower rectangle), the sector has overshot quite substantially. Its retracement since early May, for now, is still relatively contained. We would tend to see these developments as a sign of strength. The sequence on our medium term oscillators (upper rectangle) may be showing the way forward with **a short correction into mid/late May, and then a resume uptrend situation, first into June, and then into the Summer. Our I Impulsive targets to the upside (right-hand scale) suggest that the sector could rise another 5 to 12% by then.**

S&P US Industrials Sector Index
Weekly graph or the perspective over the next 2 to 4 quarters



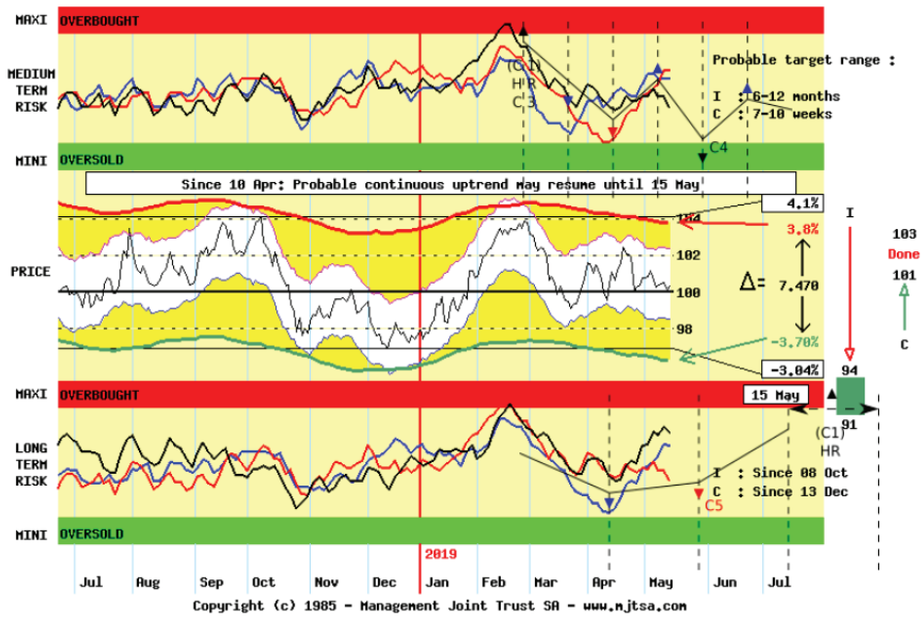
US Industrials is another sector that usually profits from reflationary trends, as well as during periods when the yield curve is steepening. Following its strong correction to the downside last year, the sector is back in an uptrend, and both our oscillator series (lower and upper rectangles) are **pointing towards further upside into the Summer. Our I impulsive targets to the upside are still showing more upside price potential, potentially up to 10%** (right-hand scale).

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



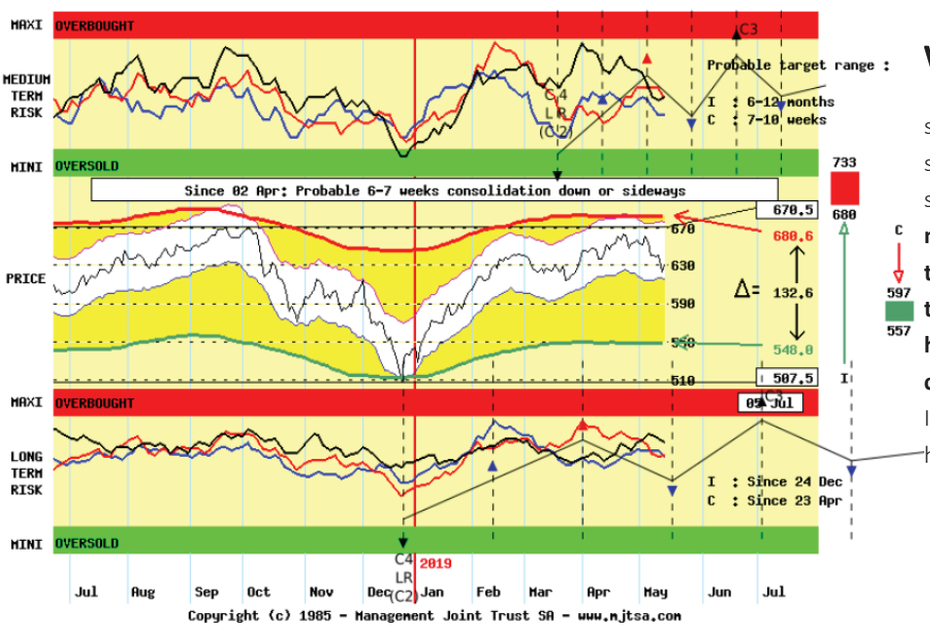
On a relative basis, Industrials have started to recover from their downtrend which started early last year, perhaps even late 2016. Following a strong bounce during January and February, the ratio has since been consolidating. Both our oscillators suggest that it **could soon find new support, probably towards late May / early June. We then expect the sector to outperform vs the market, probably towards late Summer / the Fall**. On the target front, the higher end of our I Impulsive targets were reached last December (right-hand scale). Although not extremely Oversold, the downtrend is already quite exhausted.

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



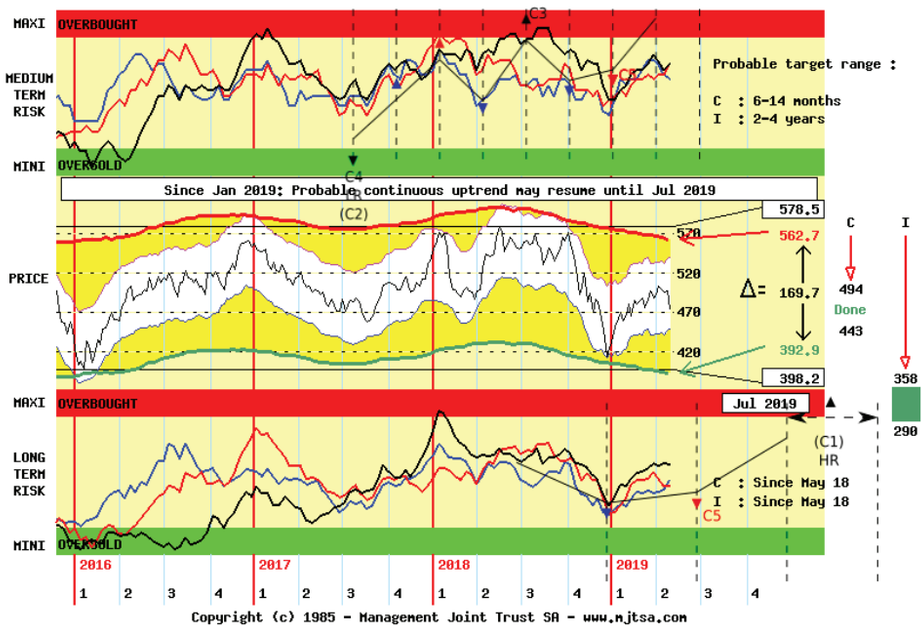
Short term, the ratio of US Industrials vs the market is consolidating, following a strong initial rebound into late February. According to both our oscillator series (lower and upper rectangles), **this consolidation may last a few more weeks, probably towards late May. Following that, Industrials should start to outperform again, probably into the Summer**. Making it above our C Corrective targets to upside (right-hand scale), possibly during June, would confirm this second leg up we expect.

S&P US Industrials Sector Index
Daily graph or the perspective over the next 2 to 3 months



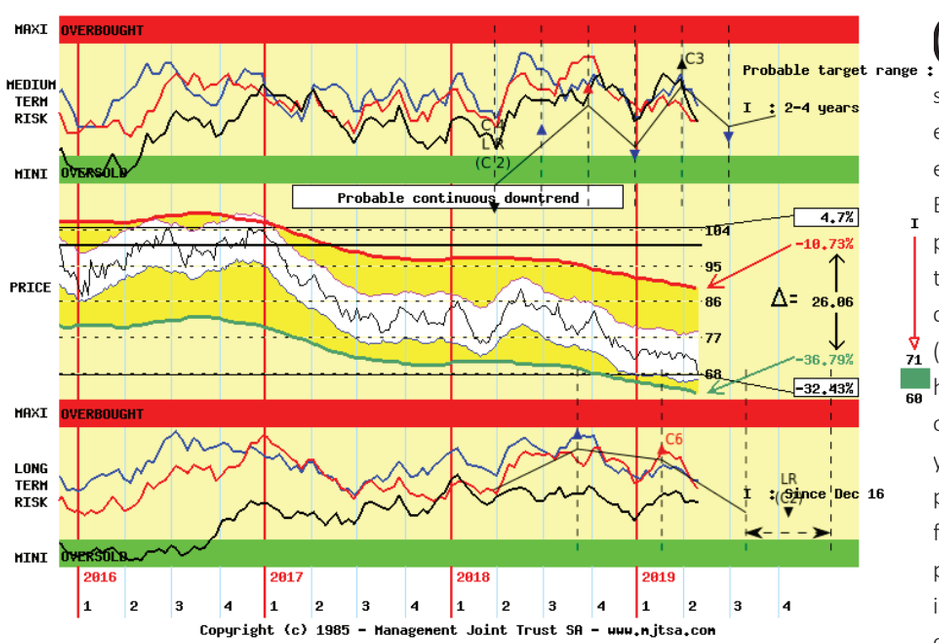
We are now back with the absolute graph of US Industrials. The sequences we show on both oscillator series (lower and upper rectangles) suggest **some correction down into mid/late May. Following that, the trend probably resumes higher into the Summer. The upside potential here is quite compelling, between circa 10 and 15%** according to our I Impulsive targets to the upside (right-hand scale).

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



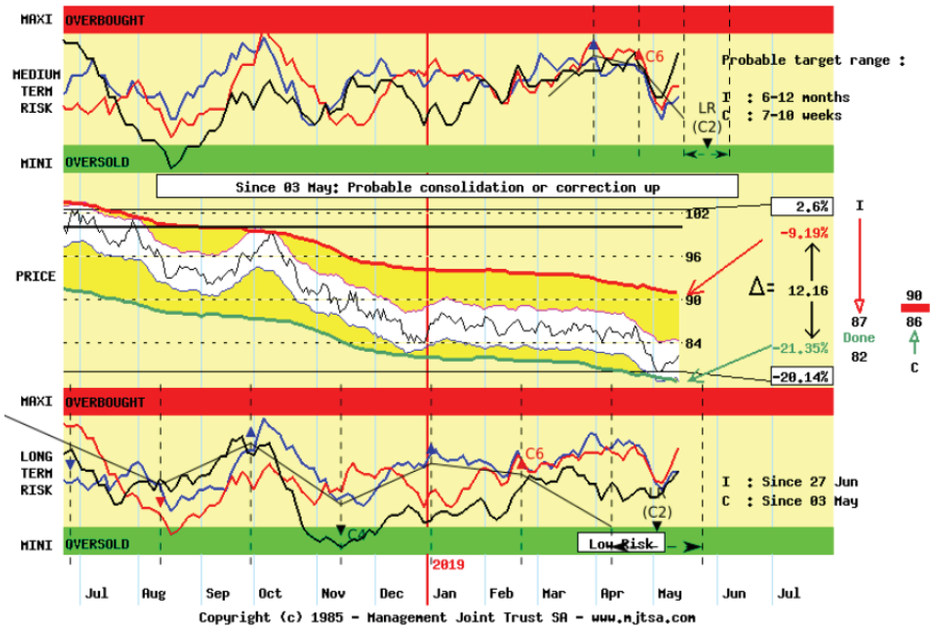
We now consider the US Energy sector. Despite Oil's strong performance over the last three years, the US Energy sector has widely lagged behind Oil and the general market. Indeed, its highs made last October are only marginally higher than the ones made in late 2016. Worse, following the strong sell-off in Q4 last year, the sector is still very far below last year's highs. Yet, since December, it has been rebounding, and although our medium term term oscillators (upper rectangle) are rather in a top situation, our long term ones (lower rectangle) suggest than **US Energy could find support towards late Q2. The sector may then bounce, or even accelerate up into late Summer / the Fall. US Energy does seem weaker than the other US sectors (Financials, Industrials) we feature in this article, yet could also react quite positively if the reflationary acceleration we expect starts to materialize, perhaps with a slight lag to Financials and industrials.**

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



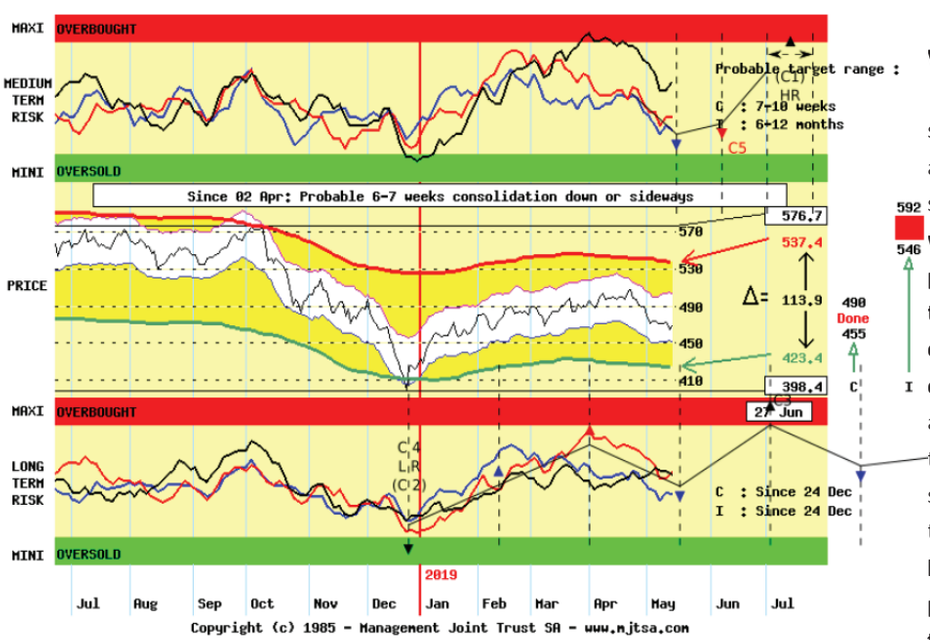
On a relative, US Energy's underperformance has been very persistent since late 2016. This may be explained by the fact that the US Energy sector is weighted towards many Exploration and Production Oil companies (the sector is less integrated than in Europe), which are very cyclical. Hence, their profile is Value driven (vs Growth), and their performance is hence very much linked to the shape of the yield curve. With a flattening yield over the last 2 years, the sector's performance has been weak. Going forward, on both oscillator series (upper and lower rectangles), the sector is still in a downtrend vs the market. It could start to form a bottom from late Q2 / early Q3 on a relative basis. On the target front, however, the move seems already quite exhausted, as the ratio has now reached into our I Impulsive targets to the downside (right-hand scale). **Energy is still downtrending vs the market on a relative basis, yet we believe it could also react up during the Summer. Yet, it will probably lag Financials and Industrials by 1 or 2 months.**

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



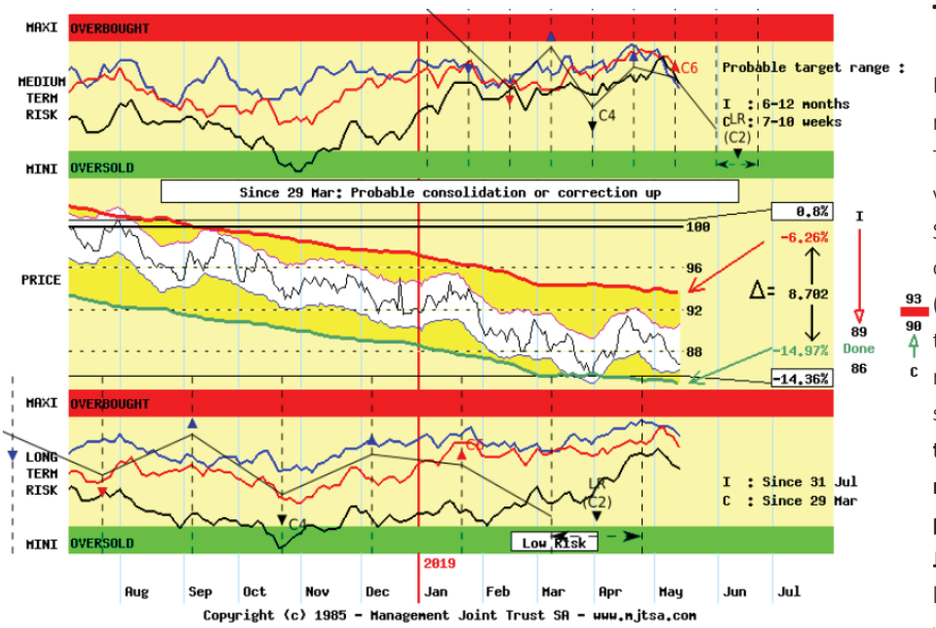
The Daily of US Energy vs the market does seem very Oversold. Indeed, on our long term oscillators (lower rectangle), it has reached a Low Risk situation. Our medium term ones (upper rectangle), however, would suggest **one last period of underperformance, probably into late May / early June**. On the target front, **the downside may be limited**. Indeed, the ratio is now below our I Impulsive targets to the downside (right-hand scale), and hence the trend is probably close to exhaustion.

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



We now turn to the Daily graph of US Energy on a standalone basis, which has been retracing for now almost three weeks. On both oscillator series (lower and upper rectangles), **we believe it could reach initial support over the next week or so. It may then retest down on our medium oscillators (upper rectangle) towards early June**. Given our relative graphs analyzed above, which are still negative, as well as our Weekly one on a standalone basis, which could still retest down into late Q2, **we would probably wait for these second support points early June to start considering the sector.**

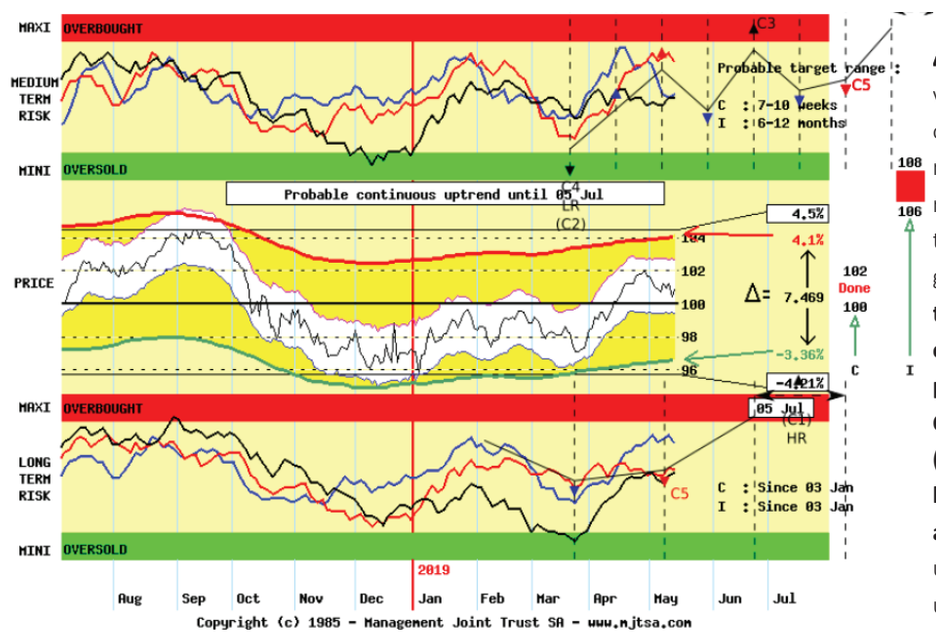
Europe Stoxx Banking sector vs the Europe Stoxx 600 Index
Daily graph or the perspective over the next 2 to 3 months



To conclude this article, we now focus on the relative graphs of the Banking and Industrial sectors in Europe vs the Europe Stoxx 600 index. The European Banking sector is also very much Oversold vs the Europe Stoxx 600 Index. Indeed, our long term oscillator are in a Low Risk position (lower rectangle) and our I Impulsive targets to the downside have been reached (right-hand scale). However, shorter term, **our medium oscillators (upper rectangle) suggest a few more weeks of underperformance probably towards late May, early June**. This is in line with the last retest lower we generally expect for yields to which the ratio is very much related.

Following that, from June, we expect European banks to start to bounce vs the market probably into the Summer.

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



As for the Industrial sector in Europe, it is already in an uptrend vs the market. On our medium term oscillators (upper rectangle), the ratio may have entered a few weeks of correction towards late May. Yet, our long term oscillators seem to have build a good base (lower rectangle), and **from the end of this month, we would expect the sector to resume its outperformance towards the Summer. Our I Impulsive targets to the upside (right-hand scale) suggest strong relative upside potential (between 5 and 10%)**, once the resistance of the upper end of our C Corrective targets up is taken out.

Concluding remarks

We've concentrated our sector analysis on themes that usually benefit from reflationary trends. We've also decided to remain quite US centric. Indeed, the trends we highlight in other articles of this issue of The Capital Observer seem to favor such exposure into the Summer: we are expecting a reversal up in yields, a steepening yield curve, as well as renewed outperformance of US equity markets vs the rest of the world. Financials and Industrials do look positioned for a further move up, probably from late May, as in the meantime they could still retrace on both an absolute and relative basis during the current equity market correction. In Europe, these sectors also look quite interesting, although European Banks may take until June before they start rebounding vs the market. We've also looked at US Energy, which is very much Value driven and has been a persistent underperformer over the last couple of years. We believe it may also reverse up vs the market into the Summer, following the yield curve higher. Though, here also, the reversal point is probably slightly later, in June.

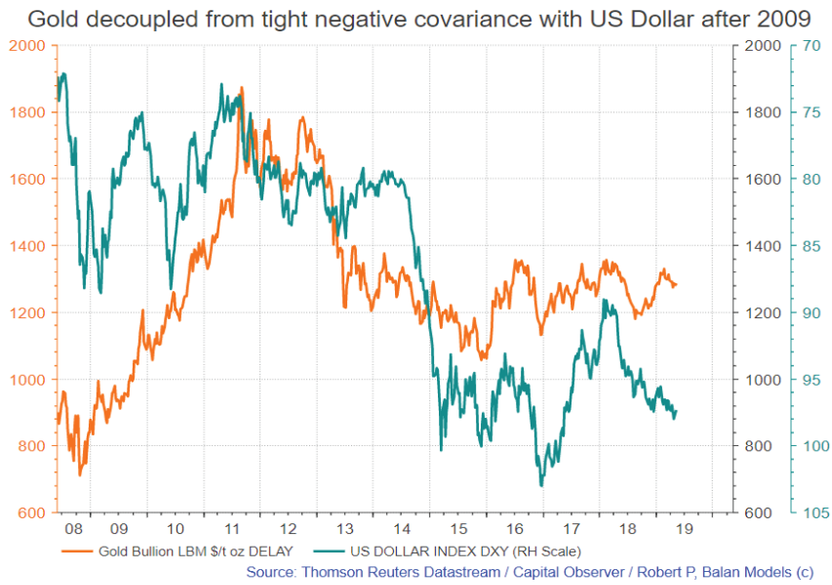
43 / Gold marks time within the confines of a trading range, but expect support sometime in Q4 followed by a more positive outlook

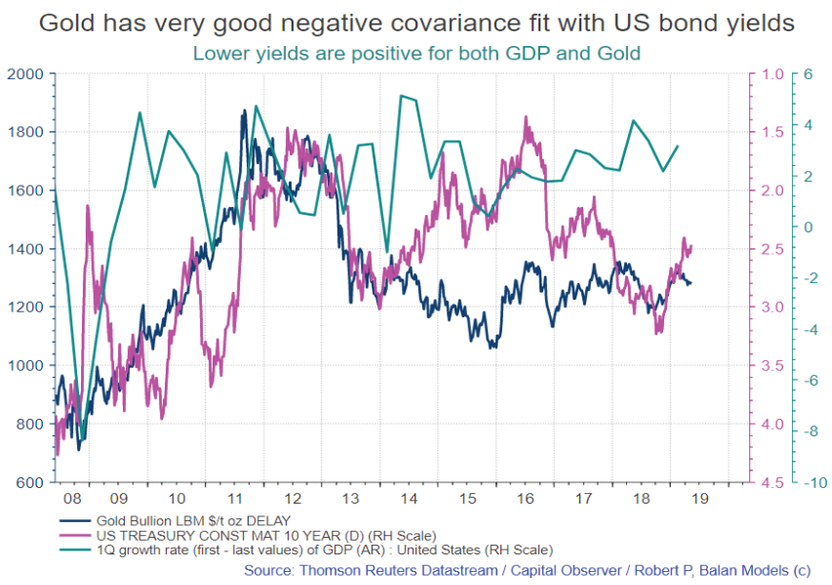
Gold is a metal that historically tends to move higher during periods of uncertainty, and lower when market participants are feeling good about other asset classes. That is why the behaviour of Gold in the past two weeks since the US-China trade kerfuffle is mystifying – it is severely underperforming, especially when it is juxtaposed against the sharp decline of US bond yields since the trade tensions arose. And to add to the puzzle, the sharp decline of the US Dollar since the trade skirmishes started did not seem to have any positive effect on gold at all. Taken in the previous historical context, that behaviour seems anomalous. But if we take it in the context of the changed behaviour of certain risk assets to each other since the advent of Quantitative Easing in September 2008, that looks normal.

After the global central banks flooded the global financial system with liquidity to kickstart growth by deploying humongous amounts of money and quasi-money, the price of gold effectively decoupled from the US Dollar (*see 1st chart on this page*), and has acquired a strong, negative covariance with US bond yields (proxy: the US 10yr yield); *see 2nd chart on this page*. This has tremendous implications on the pre-QE negative relationship between GDP and Gold..

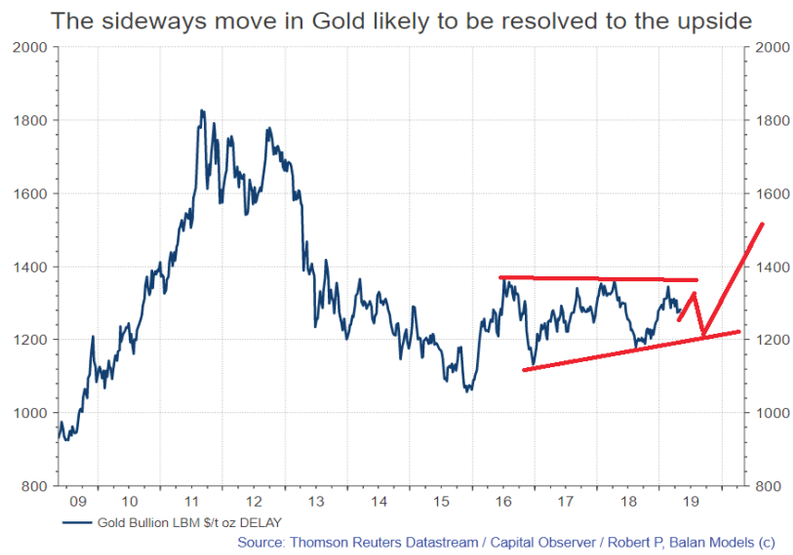
It is easy to demonstrate that lower interest rates promote stronger GDP growth (*see 2nd chart on this page*). **But since lower bond yields also push up the price of gold, necessarily, rising GDP growth has now become analogous to rising prices of gold, as the 2nd chart of this page illustrates.**

Since 2013, the 10yr yield has been mired in a narrow trading range of 3.25% and 1.25%, and that shows in the behaviour of US GDP since then, which was likewise limited to circa 4.00% and 0% growth rate. It is not a surprise therefore to see gold prices act likewise in a narrow range (*see 3rd chart on this page*). The trade kerfuffle between the





US and China, while inciting sharp volatility in equity prices, may not do much to move gold prices. **We expect a sharp sell-off in equity prices until late June-early July, and indeed gold may become a safe haven in conjunction with falling bond yields**. But that may just push up gold prices towards a level that is lower than the previous high in February, and may not even threaten the recent $1350 resistance level defined by the upper trendline of a huge triangle structure hat defines the gold price since the middle of 2016 (*see 3rd chart on previous page*).



Defining a gold strategy in the light of these relationships and gold's covariance with US yields and GDP growth is therefore slightly complicated, but generally we can summarize it in three points:

1. Further sell-offs in equities may not benefit gold very much in that a rally from recent lows just before the equity sell-off begun, will be constrained by strong resistance between $1325 and $1350 levels.
2. There is a tendency to mover lower after that, probably in response to recovering bond yields after a brief (perhaps month-long) stock market decline. However, gold should find strong support between the levels of $1250 – $1225.
3. **Gold should begin to acquire stronger sentiment and fundamental support by circa early Q4 2019 and by Q2 2020, it may be finally break above the $1350 constraint and move towards the long-coveted $1500 level** (*see 1st chart on this page*).

The outlook of stronger gold prices starting in early Q4 this year may be in response to lower bond yields and weaker US Dollar as a result of declining yields. There is also some preliminary evidence that these putative yield declines may be caused by trouble in risk assets going into year-end. This topic is discussed elsewhere in this edition of the Capital Observer. **Therefore, if a rally from a base at circa $1225 finally manages to break out from the confines of the triangle structure from 2016, gold prices will shift to another level of equilibrium** (*see 1st chart on this page*). **There are many reasons for gold to outperform in the medium-term.**

There are several issues indeed that can propel gold higher further out, given that the current low level of open interest could limit the potential downside and could bring buyers back quickly if there are triggers for them to do so. There are several issues that could make this happen.

The first issue is the ongoing trade dispute between the US and China which caused selling in the stock market on May 6 after President Trump told markets that tariffs would increase to 25% on Friday, May 10. The bloodletting is still ongoing, but there might be a temporary hiatus over the next two to three weeks. The seeming breakdown in talks on trade has already led to an escalation of tit-for-tat in tariffs for products of China and the US that are being exported to each other. The link to gold is not only the perception of gold as safe haven destination, but also the fact that in situations like this, bond yields also fall, and that mechanically accrues as positive for gold prices. A fall in yields also tends to undercut the strength of the US Dollar, so those are double positive factors for gold. The Trump administration also makes no secret of their desire to keep the dollar as low as possible to make US exports more competitive in global markets and take market share away from China. Therefore, it is possible that intervention in the currency markets will send the dollar index lower which would provide support for the price of gold.

The second issue that supports gold prices is the increasing tension in the Middle East. A few weeks ago, the Trump administration refused to extend exemptions to those nations purchasing crude oil from Iran. The US also designated the Iranian Revolutionary Guard as a terrorist organization. In a retaliatory move, Iran declared that all US troops in the Middle East are terrorists and the theocracy in Teheran has been threatening military action against the US or American interests in the region. At the same time, around 20% of the worlds crude oil travels through the Strait of Hormuz each day. The Strait is a strategic chokepoint for Iran. On May 6, the US dispatched the USS Abraham Lincoln Carrier Strike Group and bomber task force as a warning to Iran. Already, there are four cases of sabotage to Saudi and UAE

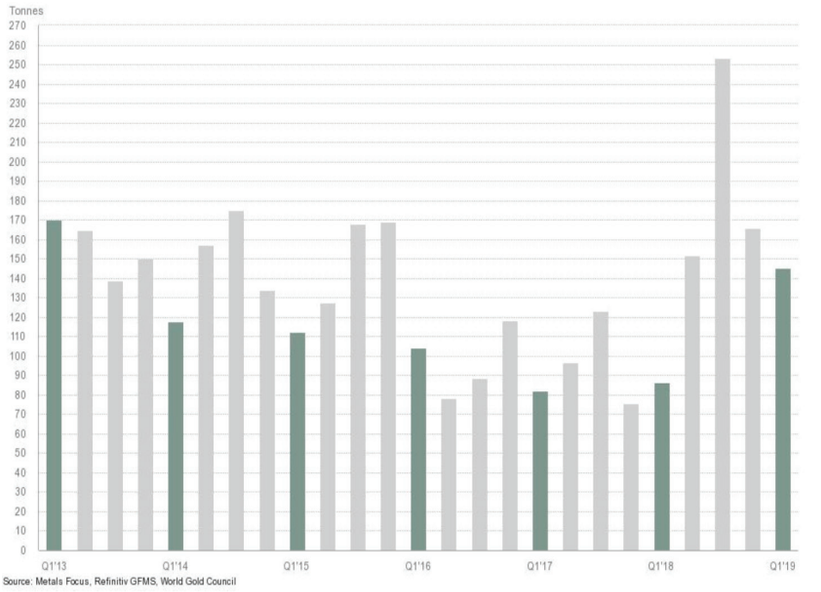
oil tankers, damaging the ships, and temporarily making oil prices surge. These sabotage acts could continue, as Iran tries to bump up oil prices to spite President Donald Trump. As tensions build in the region, gold is likely to find support and buying if the temperature continues to rise leading to any form of hostilities.

Third, political divisiveness in the US continues to put the House of Representatives against the Trump Administration. After refusing to release an unredacted copy of the Mueller report to the House Judiciary Committee, Chairman Jerold Nadler is preparing to hold Attorney General Barr in contempt of Congress. With the 2020 Presidential election season shifting into high gear, uncertainty about the political future of the US could weigh on the dollar and support gold prices over the coming weeks and months.

Finally, North Korea has begun to test missiles again, China, Russia and other global central banks continue to build their gold reserves providing an underlying bid for the yellow metal. In fact, this would be the biggest single factor that would provide support for gold in the longer term. According to the World Gold Council, global central banks purchased an incredible 715.7 metric tons of gold bullion (with a market value of roughly $29.4 billion) during the 12-month period ending on March 31st (*see chart on this page*). Net purchases for the first quarter also rose to the highest levels in six years, so this frame of reference deserves to be watched for clues on how much more gold will the global central banks buy.

Remember, central banks are the financial bodies which have the potential to influence market prices more than any other entity. So, as long as this heightened buying activity amongst official names continues, it will be difficult for the market to consign gold within the tightening structure that has been seen since 2016.

Central banks drive global growth with Q1 net purchases hitting six-year high



The best way to approach gold is to trade the brief ups and downs while the price remains within the huge triangle structure. But if gold price drift down to the levels of $1250 – 1225, there is potential value there, looking for a strong likelihood of subsequent test and breach of $1350 resistance. A breach could eventually yield the lofty targets of $1500.

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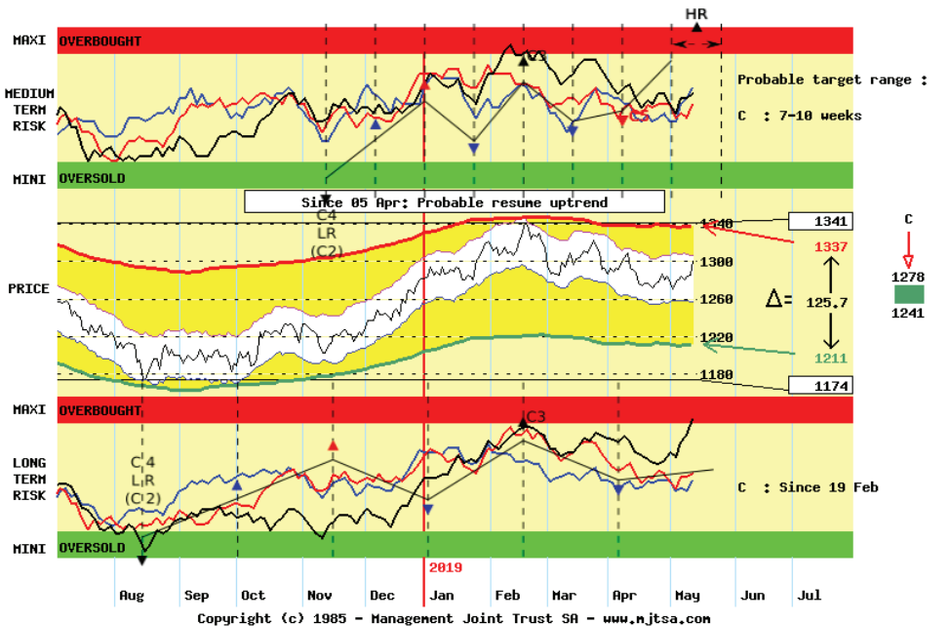
Gold – a weak retest up and then a last downside retest into late Summer

Since its initial reaction from late 2015 into mid 2016, Gold has been in sideways consolidation. Indeed, since then, it never achieved to make new highs (above 1'366 USD/oz on an EoD basis), while support in the 1'200 – 1'150 USD/ oz range has been strong. Ultimately, Gold will break out at some point, below or above this range. In this article, we look at Gold denominated in various currencies and compared it to the S&P500, Silver and Treasuries.

Gold spot (USD/oz)

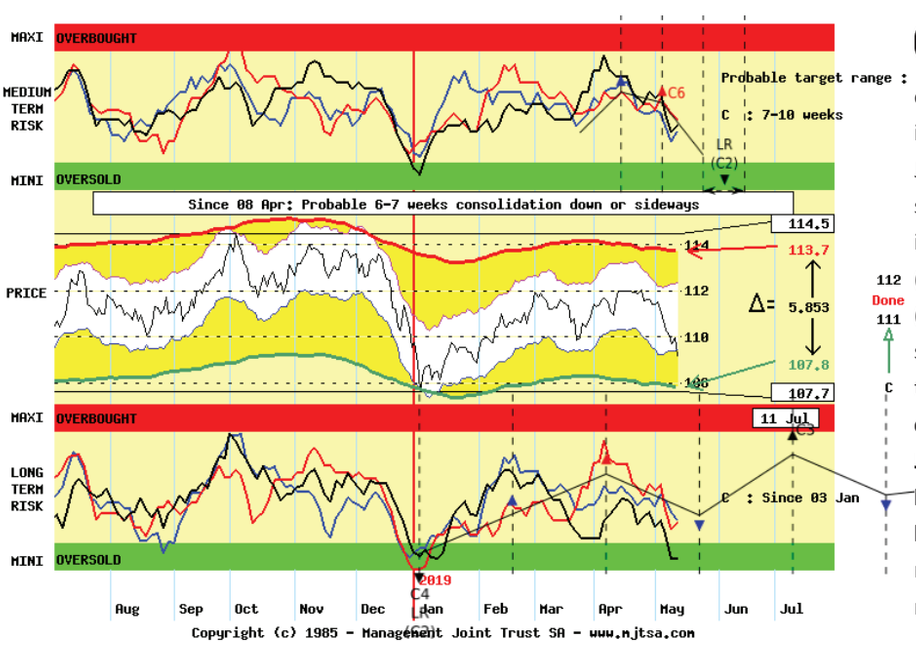
Daily graph or the perspective over the next 2 to 3 months



As we show on our long term oscillators (lower rectangle), Gold's reaction up started last year in August, and probably topped out in February. It has since been consolidating down. Going forward, our medium term oscillators (upper rectangle) suggest that **a retest to the upside is currently underway. Yet, it may be short lived, and we doubt it could retest its February highs as the time left to achieve these is quite short** (a couple of weeks max until our medium term oscillators top out again; upper rectangle). Our long term oscillators (lower rectangle) provide further confirmation of the limited upside potential we expect in the short run (1'320, perhaps 1'330 USD/oz) as our longer term black oscillator is already Overbought again. Hence, **from late May, early June, we expect a new leg down to materialize into mid/late Summer. We believe, it will probably test the support of our C Corrective targets to the downside in the 1'240s (right-hand scale). Below these, the I Impulsive targets down we can calculate would imply a deeper retest into the 1'177 – 1'127 range** (i.e. 1.3 to 1.7 times our historical volatility measure "Delta"- here at 125.7, middle rectangle; right-hand side- subtracted from the 1'341 top). **These levels have served as strong support previously in late 2016 and in August 2018. They could do so again.**

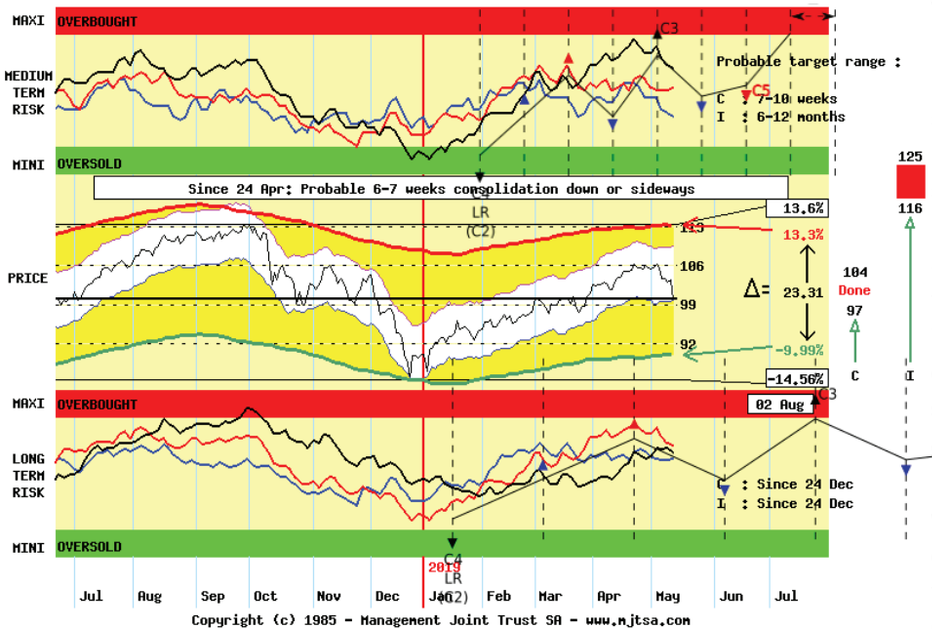
USD/JPY

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



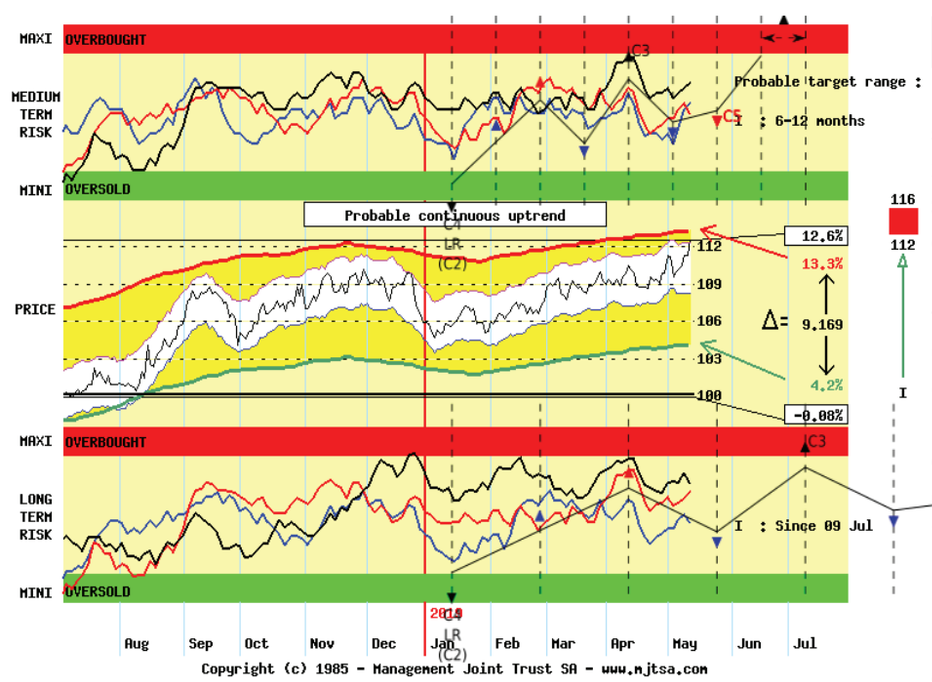
Gold is a defensive asset denominated in US Dollars. In this respect, it is often compared to the Yen. USD/JPY and Gold are indeed quite well inversely correlated. USD/JPY bottomed, in early January in an impressive climax sell-off. Following a rebound into its C Corrective targets to the upside (right-hand scale), it is now selling off again (as Gold is retesting up). Both our oscillator series (lower and upper rectangles) suggest that **this retracement down could find closure towards late May, perhaps early June. The downside potential is probably limited at this stage as the longer term black oscillator is already Oversold** (lower rectangle). Hence, from June, we expect a new bounce to materialize on USD/JPY.

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



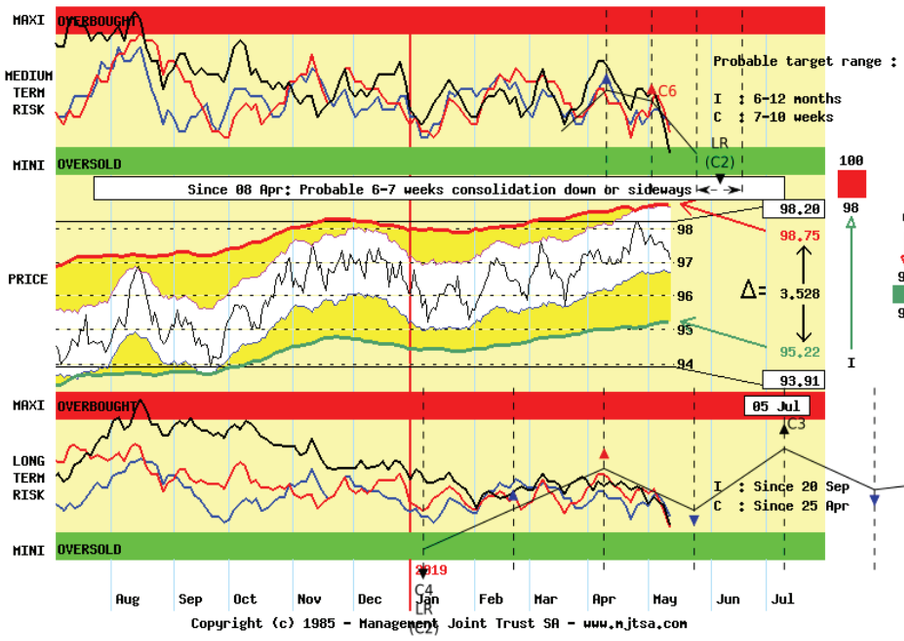
We now compare S&P500 Index to Gold. The graph is similar to the ones of equities standalone given the strong rally we have had on the S&P500 since the beginning of the year. Both our oscillator series (lower and upper rectangle) suggest that **the ratio is currently in an intermediate correction to the downside, which could find support towards late May, early June. Following that, the ratio resumes higher along with equities and while Gold correct back down**. Late April, the ratio did break above our C Corrective targets to the upside (right-hand scale). This opens the door to **potentially much higher targets (I Impulsive targets to the upside) 15 to 25% above current levels.**

Gold to Silver ratio
Daily graph or the perspective over the next 2 to 3 quarters



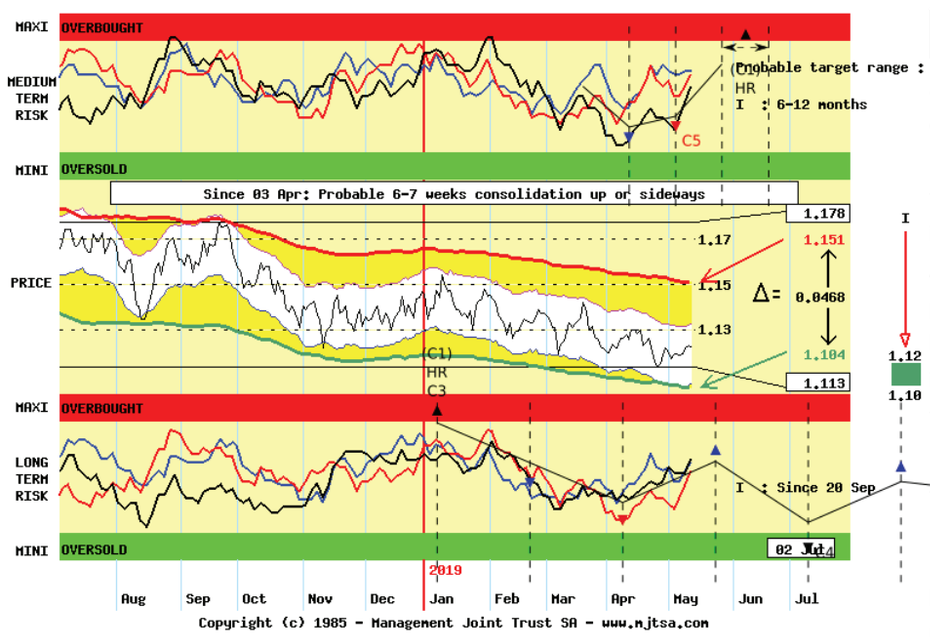
Historically, strong moves in precious metals have been initiated by monetary stimulus ("à la late 2008 – 2012"). During these period Silver usually outperforms Gold as it is more volatile. For now, however, according to this graph, Gold still has the upper hand. According to both our oscillator series (lower and upper rectangles)**, the ratio of Gold to Silver is in a strong uptrend that could continue into the Summer. A slight dip may be expected over the next couple of weeks, yet thereafter, from late May, Gold should resume its outperformance**. Our I Impulsive targets to the upside (right-hand scale) also suggest further outperformance potential. Hence, considering this ratio, the current upside retest of precious metals does appear quite weak and temporary. In fact, Silver has barely reacted. Our view is that the great currency debasement that may at some point materialize over the next few years, hasn't started yet.

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



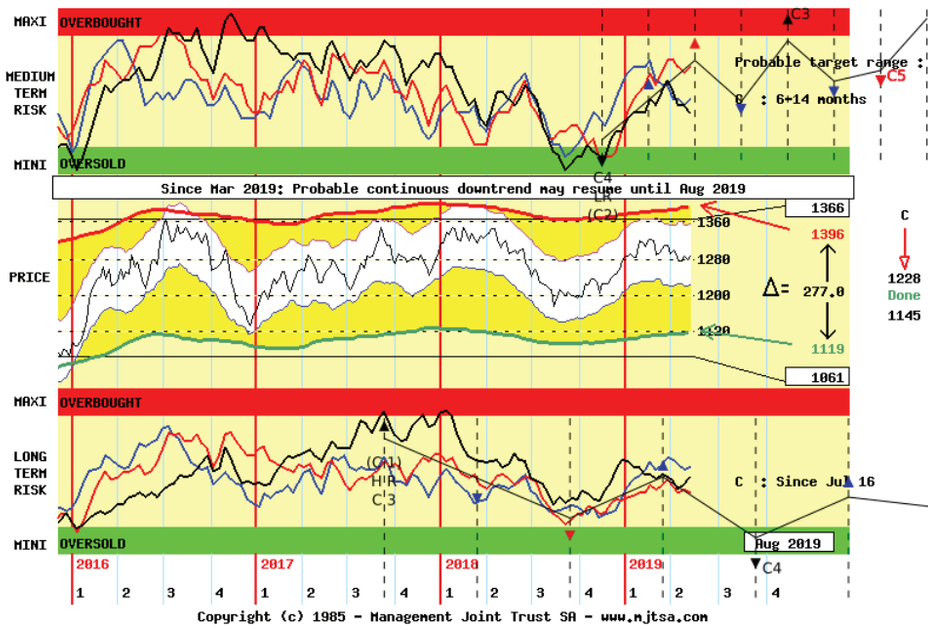
In fact, except for the last few weeks, the Gold to Silver ratio has been very much correlated to the US Dollar Index. Indeed, as the Dollar rises, Silver which is more volatile than Gold underperforms. On both oscillator series (lower and upper rectangles), **we do expect a slight correction in the US Dollar towards late May, early June. It seems to have already started (and for now is mostly driven by a strengthening of the Yen), and according to our C Corrective targets to the downside (right-hand scale), the Dollar Index could retrace back into the 96-95 support range. Following that, we expect the Dollar Index to resume its uptrend into the Summer**, along with risk assets. Indeed, the Dollar Index for now is still quite pro-cyclical.

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



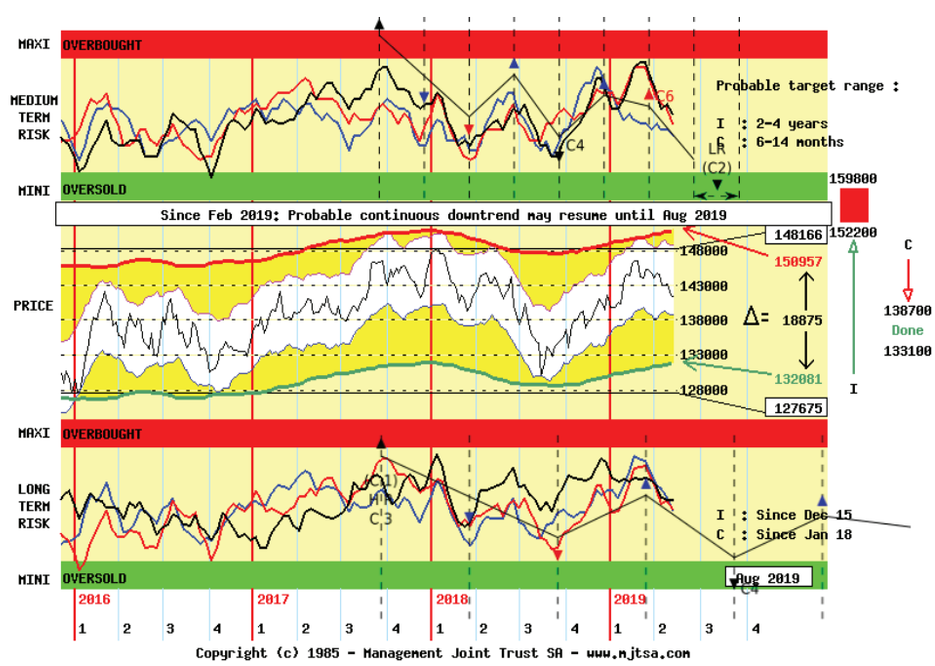
EUR/USD shows a similar picture in reverse, yet with a weaker bounce. Both our oscillator series (lower and upper rectangles) do confirm however that **this bounce may continue into late May, perhaps early June. The upside corrective potential we can calculate is between 2 to 3.5 figures, or into the 1.13 – 1.15 range** (0.5 to 0.8 times our historical volatility measure Delta, here at 4.68 figures – middle graph; right- hand side – added to the low of the graph at 1.113). **Following that, from early June, EUR/USD probably resumes its downtrend into the Summer, and towards the lower end of our I Impulsive targets to the downside around 1.10** (right-hand scale). Gold should then also follow EUR/USD lower.

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



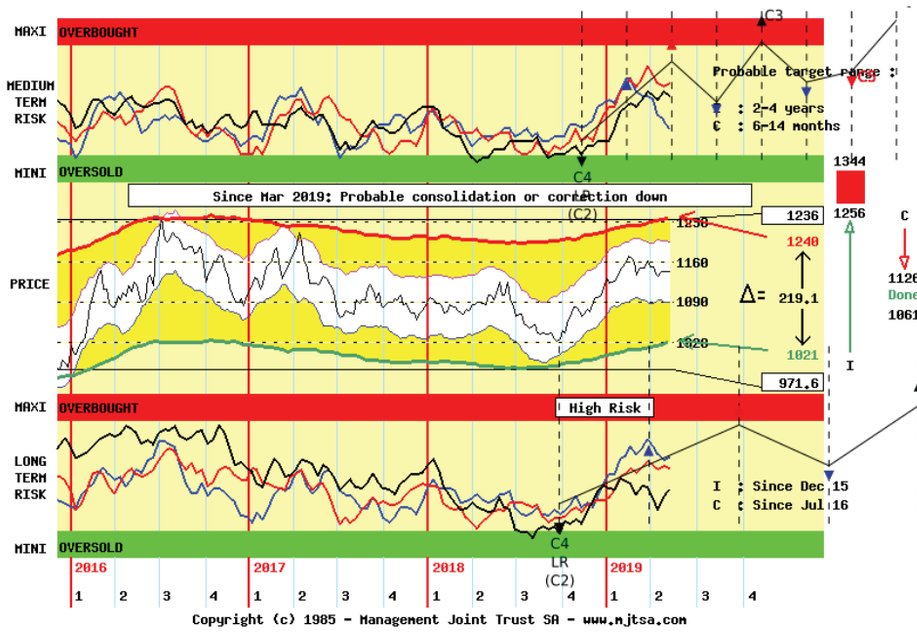
We now consider the longer term perspective for Gold, which is more promising. On this Weekly graph the consolidation range we have been working through since mid 2016 is clear to see. While our medium term oscillators (upper rectangle) would suggest that Gold's long term uptrend may have resumed, it however point to **an intermediate correction down, which could develop between now and late Summer. The sequence we show on our long term oscillators (lower rectangle) is more negative, and suggests a deeper retest down into late August / September, potentially testing back into the support of our C Corrective targets to the downside in the 1'228 – 1'145 range** (right-hand scale).

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



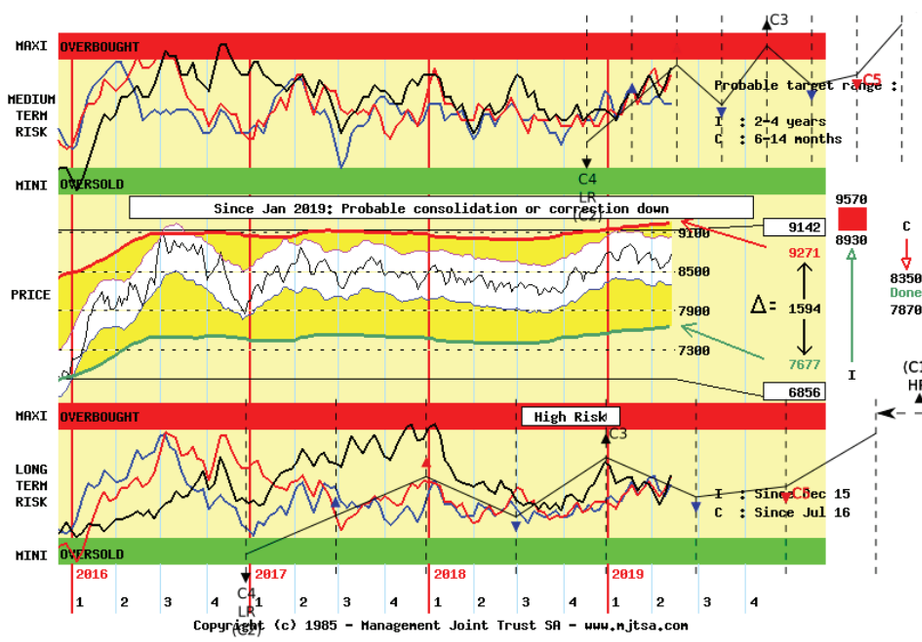
We now consider Gold in other currencies. We believe these comparisons do highlight its underlying medium term strength, probably not as of today, but probably from this Summer. Vs the Yen, Gold appears to show similar dynamics as vs the US Dollar. The rally since last August has been strong, yet it probably topped out in mid Q1. Both oscillator series (lower and upper rectangles), now suggest that **Gold in Yen could resume down into the Summer, probably towards late August / September according to our long term oscillators (lower rectangle). According to our C Corrective targets to the downside (right-hand scale), Gold may retest down towards last year's low by then. Following that it probably resumes up to new highs towards year-end and 2020, and our I Impulsive targets to the upside** (right-hand scale).

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



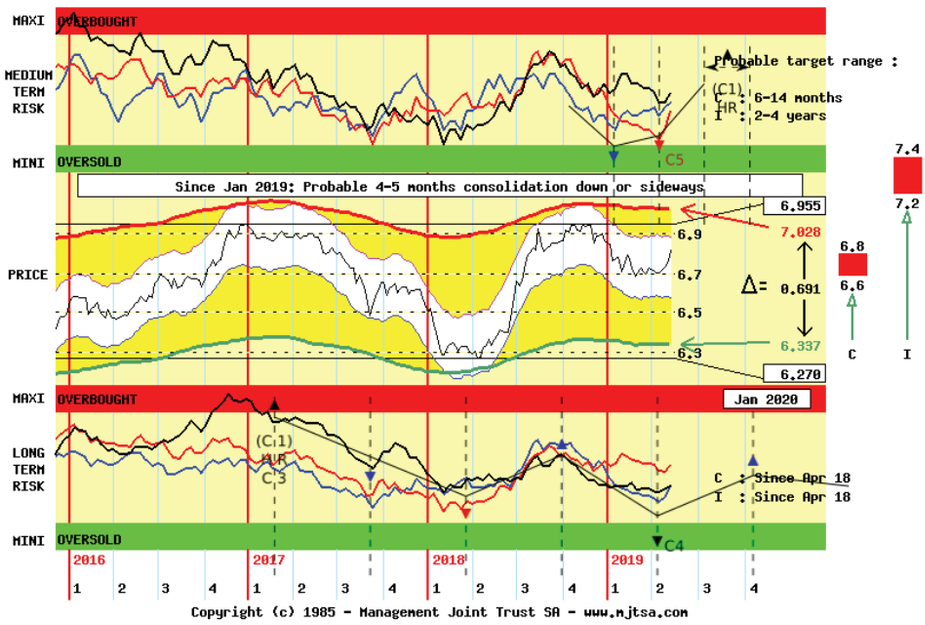
Gold seems stronger vs Euro than vs the US Dollar or the Yen. Both our oscillators series (lower and upper rectangles) are already showing new uptrends. In our view, this highlight the inherent weakness of the Euro over the next few months. Shorter term, the rally since last Summer has been strong, and as our long term oscillators (lower rectangle) seem to indicate, Gold in Euros may have entered a "High Risk" position. Indeed, according to the sequence we show on our medium term oscillators (lower rectangle), **Gold could be also topping out in Euros, and could now enter an intermediate correction until mid Summer**. Its retracement potential is in the 1'126 – 1'061 range (right-hand scale) or above last year's lows. **It then probably resume higher from mid Summer into year-end and 2020 and towards the 1'256 -1'344** I Impulsive target range to the upside (right-hand scale).

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



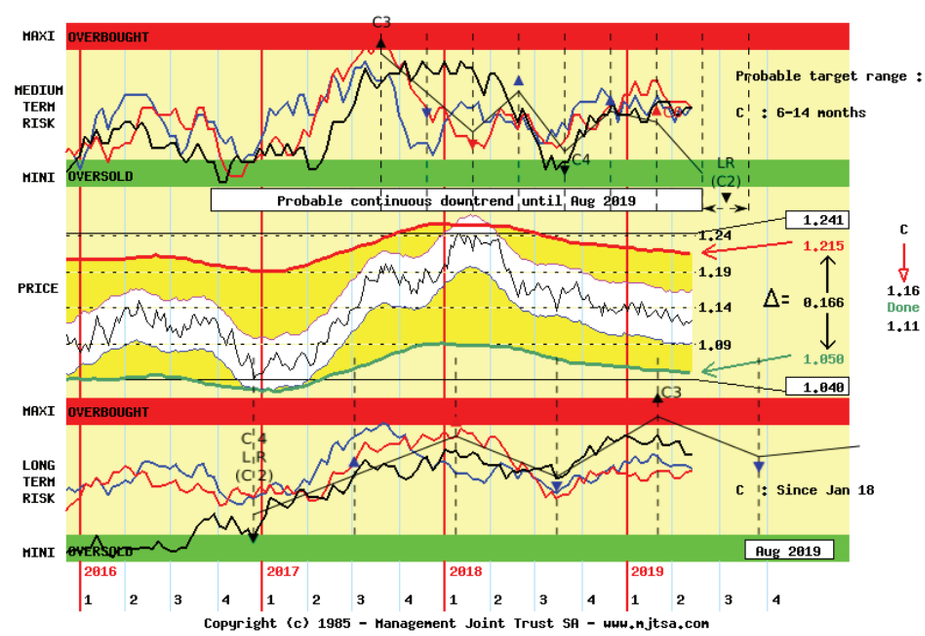
Gold in Yuan looks even stronger, and it is also getting quite close now to its 2016 highs. Both our oscillators series (lower and upper rectangles) are in uptrend configurations, and **the potential for a break to new highs over the next few quarters** is quite high**. In the meantime, however, Gold may also be approaching an intermediate top on our medium term oscillators (upper rectangle), and could correct down into the Summer**. Our C Corrective targets to the downside (right-hand scale) do seem aggressive, yet our Daily graph (not shown here) could certainly justify a retracement down to 8'500. Following that, from mid Summer, Gold in Yuan probably accelerates up again towards year-end and 2020, and to new highs, potentially towards 9'500 (I Impulsive targets to the upside; right-hand scale).

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



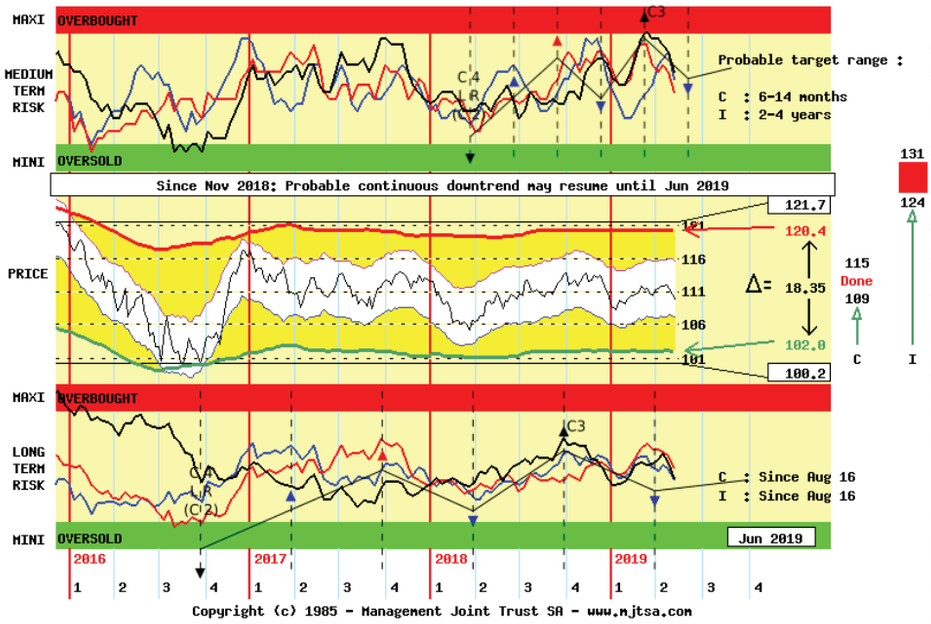
Indeed, **looking at the US Dollar vs Yuan, the US Dollar seems to be resuming its uptrend**. On both oscillator series (lower and upper rectangles), following its correction since Q4, **USD/CNY has recently found support and could accelerate higher into the Summer**. It is now back above our C Corrective targets to the upside (right-hand scale), and **could rise to reach our I Impulsive targets over the next couple of quarters, in the 7.2 – 7.4**. These projections relay our concerns on China and its equity markets mentioned in an other article of this issue of The Capital Observer.

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



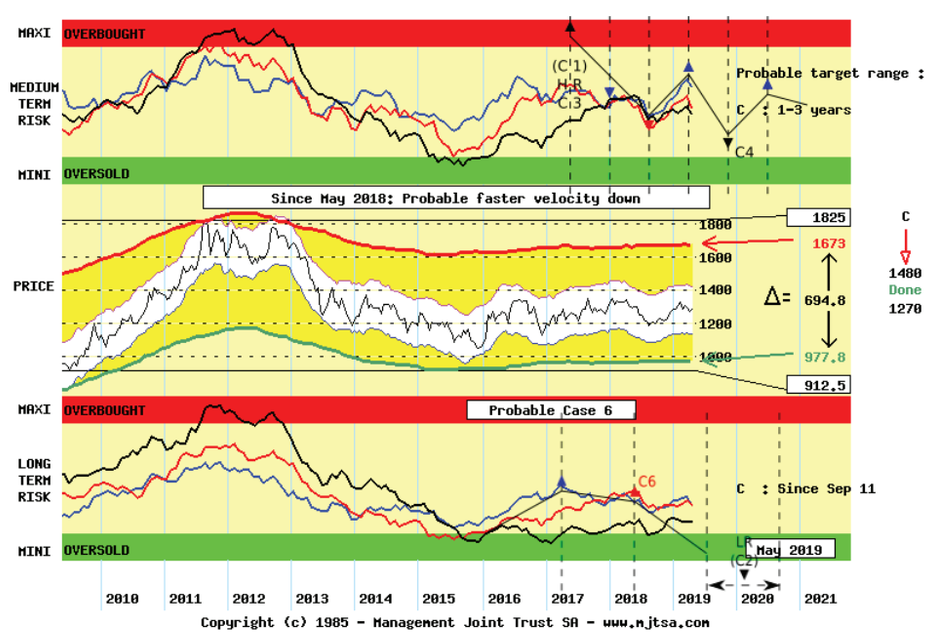
EUR/USD also seems quite weak. Indeed, while both our oscillator series (upper and lower rectangles) have risen since the Summer (i.e. risk has risen) , prices have continued to slide. Both the sequences we show now suggest that **EUR/USD could continue its downtrend into late Summer, probably towards August / September** as indicated on our long term oscillators (lower rectangle). By then, **we believe it may break the lower end of our C Corrective targets to the downside (around 1.11), which has served as support over the last 3 quarters, potentially triggering a sell-off towards its late 2016 lows.**

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



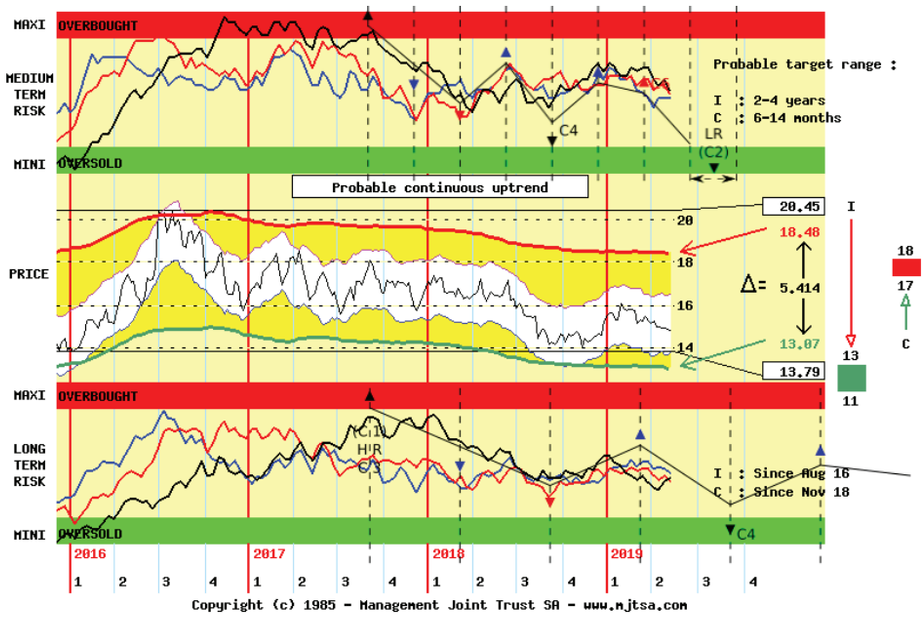
As shown above, when comparing the different currencies vs Gold, **the Yen seemed more resilient than the Euro or the Yuan. Both our oscillator series (upper and lower rectangle) still suggest that USD/JPY could attempt to bounce once more into the Summer. Yet, as time advances, the sideways pattern since late 2016 has been weakening, and at some some point, probably from late Summer, it may start to break to the downside**. In the meantime, USD/JPY may crawl back one last time, potentially retesting into the higher end of C Corrective targets to the upside (112 - 115; right-hand scale). We don't think, USD/JPY will manage to break above these though, and hence for now, we would dismiss our I Impulsive targets to the upside, which seem much too aggressive given the weakening position of the USD/JPY trend.

Gold (USD/oz)
Bi-monthly graph or the perspective over the next 1 to 2 years



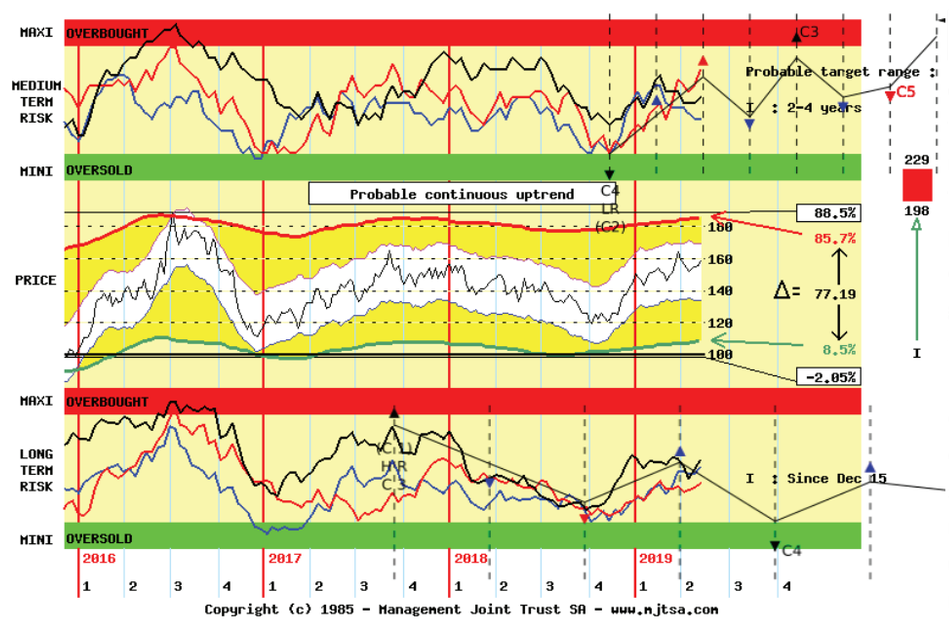
As a summary of the above, we now consider the long term bi-monthly graph of Gold in US Dollars. Following its strong 2012 – 2015 sell-off, it has since been forming a base. Both our oscillator series (lower and upper rectangles) would suggest a **last retest down into the second half of the year. Following that, at the latest towards year-end, we believe Gold should start to bounce, probably well into 2020. It could then break above its 2016 highs, which may confirm that a new secular uptrend could start to unfold.**

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



Finally as further confirmation of the timing points mentioned above, we consider two additional Weekly graphs; silver, in first instance, which has been weaker than Gold. Both our oscillator series (lower and upper rectangles) are suggesting that following a weak rebound from mid Q4 into mid Q1, **Silver has since started to resume its downtrend, probably towards late Summer** (late August / September)**. The downtrend seems clearer here than on Gold, and hence ,Silver does provide a confirmation of further weakness over the next few months. Our I Impulsive targets to the downside (right-hand scale) are also quite menacing, with a target range around the 13 to 11 USD/oz levels.**

Gold Spot (USD/oz) vs TBT - ProShares UltraShort Barclays 20+ Year Treasury
Weekly graph or the perspective over the next 2 to 4 quarters



Finally, we look at the inverse relation of Gold and yields, which has been quite strong over the last few years. For this comparison, we use Gold vs a leveraged short ETF on 20 years Treasuries. The ratio should be quite reactive and provide interesting timing points. Its recent price action has been slightly stronger than Gold itself, as it is currently retesting its February highs. That said, the pattern is quite similar, and the intermediate top which we are approaching on our medium term oscillators (right-hand scale) is quite clear. It suggests that **Gold may correct down, or that yields move up, or both between now and mid Summer.** This retracement may extend into late Summer on our long term oscillators (lower rectangle). **Following that, Gold starts to outperform again (Gold rises, rates fall or both), probably into year-end and into 2020.**

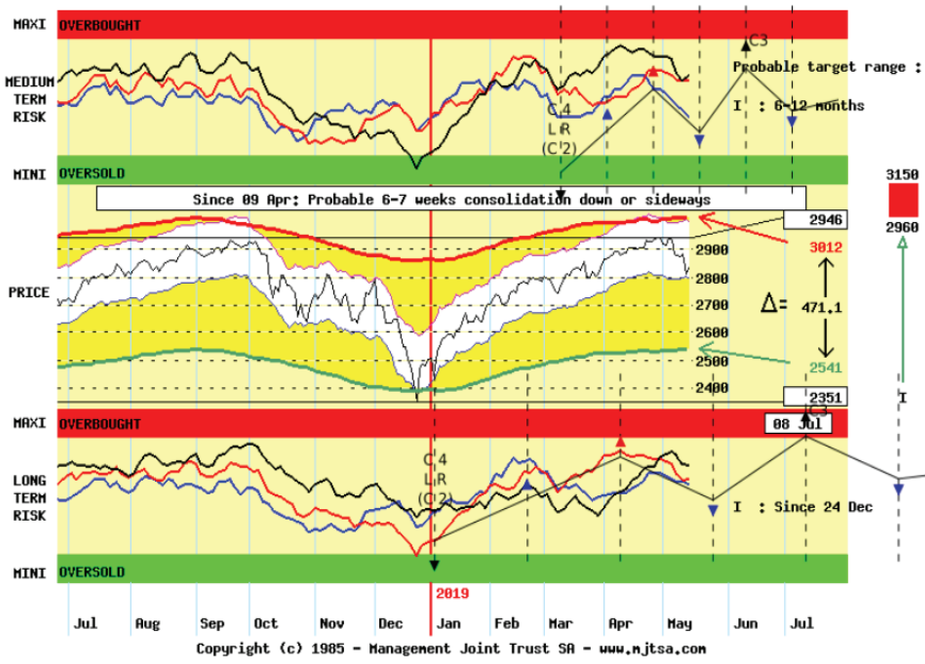
Concluding remarks

With the current sell-off in risk assets, Gold is attempting to retest up towards its February highs. It still has some way to go to reach these levels, and we believe it will probably fail to do so. Indeed, our timing for this move up is quite short, and should probably end over the next couple of weeks. Together, with this weak bounce in Gold, USD/JPY has been selling-off and EUR/USD has attempted to rebound. The former is probably close to being Oversold, while the later is still stuck around 1.12 (a very weak bounce for now). From late May, perhaps early June at the latest, we expect all three assets (Gold, the Yen and the Euro) to resume their downtrend vs the Dollar, probably towards mid/late Summer. Hence, Gold should retest down over the next few months as the US Dollar rises. However, longer term, on a cross-currencies basis, the intrinsic value of Gold may be starting to turn up. The uptrends of Gold vs the Euro or the Yuan for example, since last Fall, already seem quite strong. They could also retrace into the Summer, yet we do not believe these retracements will be very deep. Following that, Gold in EUR or CNY could start accelerating up quite strongly towards year-end and 2020, probably above their mid 2016 highs, thereby breaking out into a new secular uptrend. Gold in US Dollars, or vs defensive currencies such as the Yen, should follow with a few months lag.

54 / Splicing the markets – Monitoring the current Trade War correction

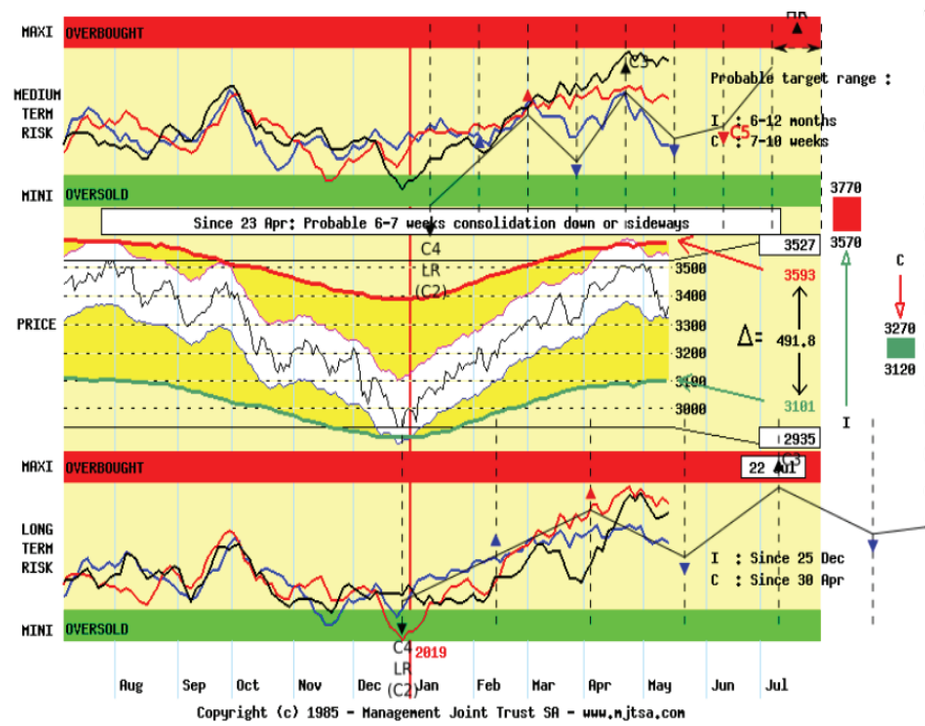
This month's Splicing the market is dedicated to monitoring the current Trade War related correction. It comes as a complement of the long term cross asset overview presented in the article "US reflationary assets could lead the market higher into the Summer" further up in this issue of The Capital Observer. Our general view indeed is that US equity markets in particular could lead other risk asset higher into the Summer. Yet, the next couple of weeks could remain quite choppy and treacherous.

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



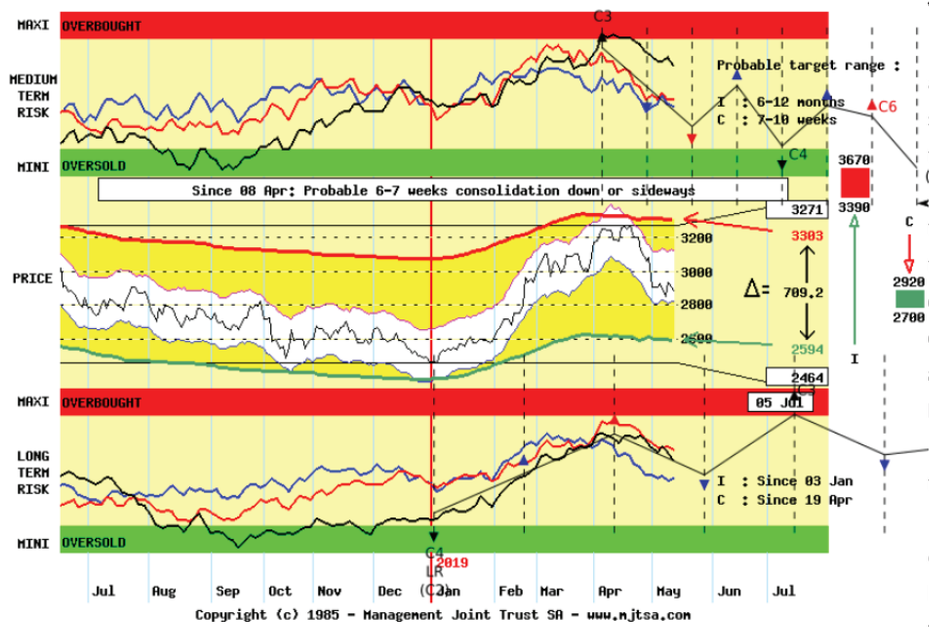
The rally since late December has been extraordinarily linear. Our first intermediate top late February created only a mild consolidation, while our latest top expected early April has taken much time to trigger any reaction. Yet, over the last two weeks, US equity markets have started to correct. According to both our oscillator series (lower and upper rectangles), **the current correction could last into mid, perhaps late May (support should be found over the next couple of weeks)**. The targets to the downside on our Hourly graph (not shown here) **suggest that the S&P500 may reach back into the low 2'800s / high 2'700s. A more negative scenario would be that the S&P500 retraces towards our Daily C (Corrective target range). These would calculate into the low 2'700s/high 2'600s. Yet, the S&P500 would probably first need to drop below 2'780 to activate these. From late May, the S&P500 could start to resume higher again, probably into the Summer. Our I Impulsive targets to the upside (right-hand scale) indicate that it could reach towards the 3'100s by then.**

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



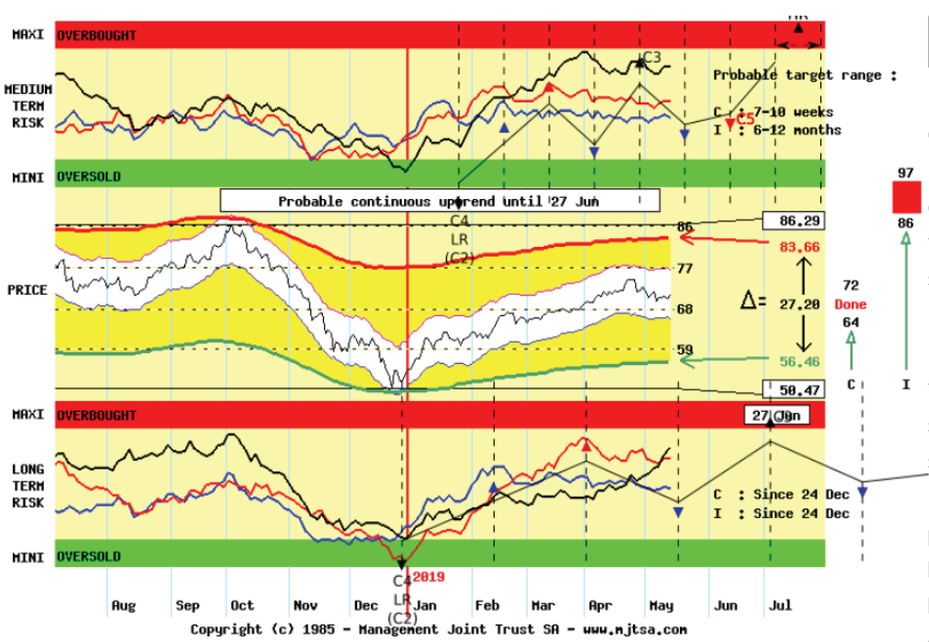
The EuroStoxx 50 has also taken time to initiate an intermediate correction. It is now underway and could also last into mid May, perhaps early June. Our Daily graph suggests C Corrective targets to the downside between 3'270 and 3'120 (right hand scale). From late May/early June, the EuroStoxx 50 could gradually start to resume its uptrend towards the Summer. Our I Impulsive targets to the upside (right-hand scale) suggest that it could reach into the 3'600s / 3'700s by then.

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



The Shanghai Composite topped out earlier, three weeks ago, and has since corrected down quite sharply. This is almost as if it had anticipated the breakdown of US-China trade talks. It has now reached the range of our C Corrective targets to the downside. **Although the sequence we show on our long term oscillators (lower rectangle) would also suggest a new uptrend from late May into the Summer**, and potentially new highs (I Impulsive targets to the upside; right-hand scale), we will be watching the current price action quite closely over the next few weeks. Indeed, **if as shown on our medium term oscillators (upper rectangle), the current correction continues to slide lower over the next few weeks**, prices may eventually break below our C Corrective targets to the downside around 2'700 (right-hand scale). **This would probably confirm the more negative longer term prospects we are considering for China in our introductory article in this issue of The Capital Observer. Recent history suggests that this may not be incompatible with further upside in US equities as both regions have often been counter-cyclical over the last few years.**

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



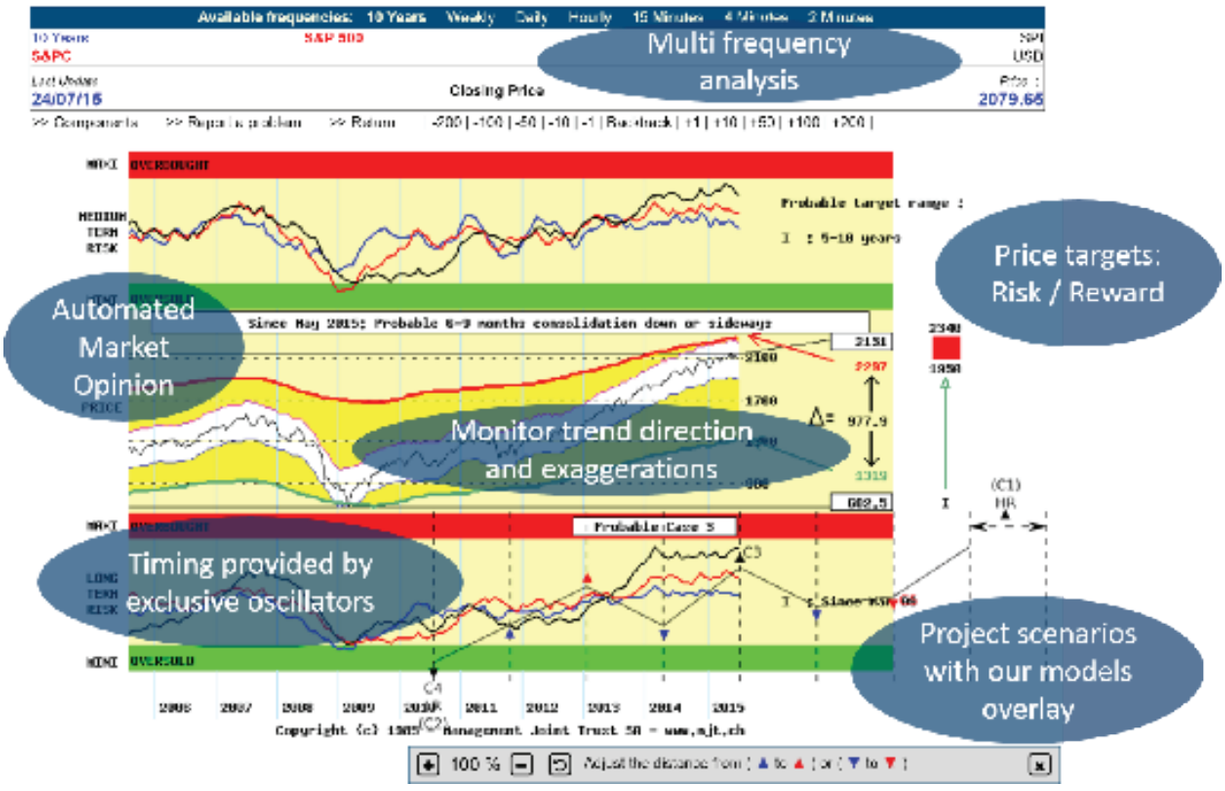
Finally, we look at Oil, which we believe should accompany US markets higher into the Summer. The intermediate top expected early April on our long term oscillators (lower rectangle) did also take quite some time here to finally trigger a correction to the downside. Indeed, in retrospect, another uptrend sequence was probably still underway, as shown on our medium term oscillators (upper rectangle). The sequences we show on both oscillator series (lower and upper rectangles) now suggest that **Oil could find support over the couple of weeks, at the latest, early June, and start to resume higher into the Summer. Our I Impulsive targets to the upside (right-hand scale) are pointing to a retest of last year's highs by then.**

Concluding remarks:

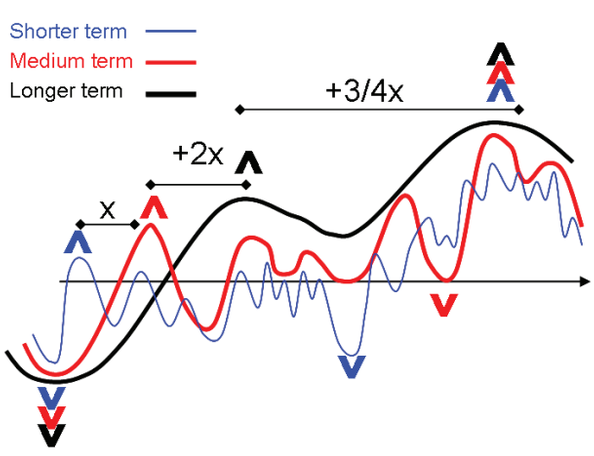
Over the next couple of weeks, we expect risk assets and especially the S&P500, the EuroStoxx 50 or Oil to find support (perhaps 2 to 5% below current levels) and gradually start to resume their uptrend towards the Summer. Our prices targets indicate that by then all three could retest / and for the S&P500 perhaps markedly take out last year's highs. The prospects for the Shanghai Composite are less clear. Indeed, the correction down over the last few weeks has been quite deep, and the upside momentum, which prevailed during Q1 may now be broken, or could even start to reverse. We view levels around 2'700s on the Shanghai Composite as crucial support points, which if they break could confirm a deeper reversal, and possibly the beginning of a new longer term leg lower on Chinese equities.

56/ METHODOLOGY

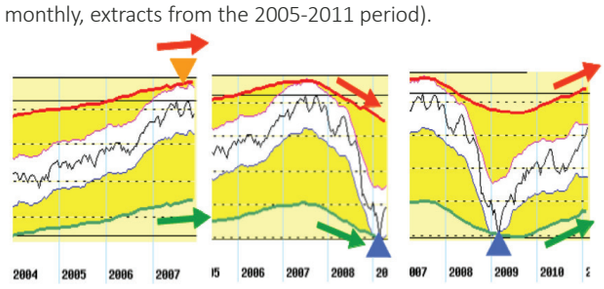
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



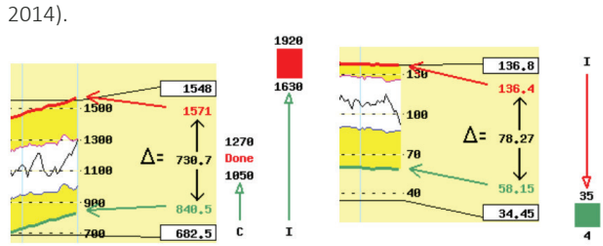
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)



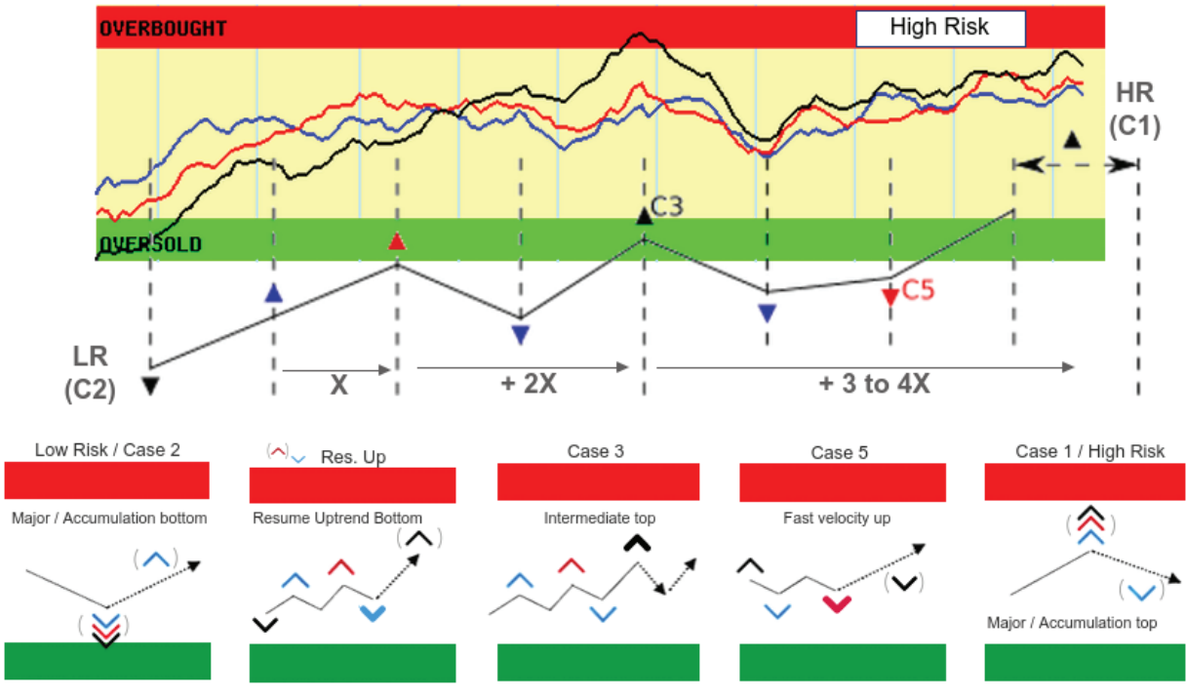
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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).

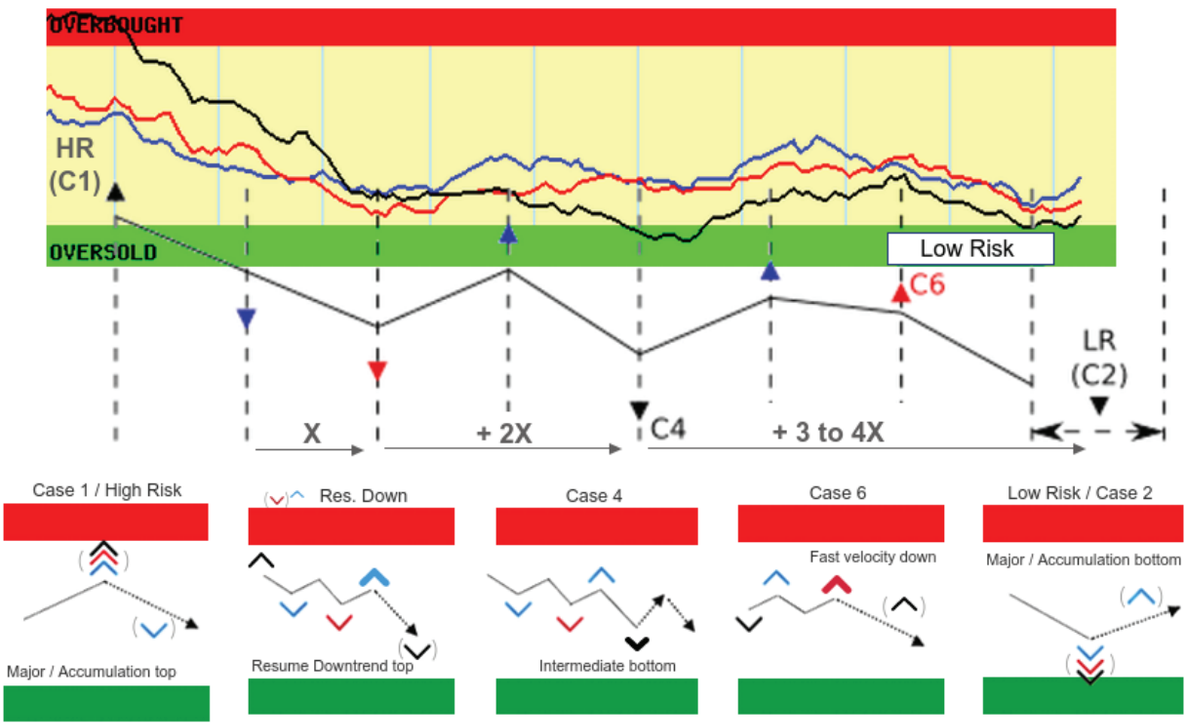


Ideal Uptrend Model



(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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