

THE CAPITAL OBSERVER

September 2018



the technical analyst

AWARDS 2018

W I N N E R

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



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THE CAPITAL OBSERVER

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



CONTENTS

04 / Executive Summary

06 / Mapping the markets

12 / The brewing EM Crisis is a handiwork of the US Dollar; it will get worse, before it gets any better

17 / Timing and Tactical Insight

Flight to Safety is accelerating

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For nearly 10 years now, the flood of cash from global central banks has financed shopping malls in Istanbul, booming cities in China and 100-year bonds in Argentina. Today, many of the malls are empty, property developers in China are riddled with debt, and Argentina has just submitted to a bailout from the International Monetary Fund.

Now, the borrowing binge that fueled rapid growth in emerging markets and piled up returns for their investors is looking like a problem.

Landon Thomas JR.

24 / The signalling effect of oil inventories suggests further support for crude oil and E&P into late summer early autumn

28 / Timing and Tactical Insight

Last upside retest for Oil, before it follows other risk assets lower

33 / China's CNY, and Gold: linked at the hip, and hobbled by the US Dollar's ascendancy, China's growth implosion

35 / Timing and Tactical Insight

Gold is still stuck between a rock and a hard place

41/ Base metals face headwinds from China's slowing growth, firm US Dollar trend

44 / Timing and Tactical Insight

A Chinese hard landing is an increasing probability

51/ Splicing the markets
This time is probably not that much different

3/ Executive Summary

12 / The brewing EM Crisis is a handiwork of the US Dollar; it will get worse, before it gets any better - Emerging Market economies are in serious trouble. Increased US borrowing, which is helping power the US economy and its stock market for now, is hurting many other countries' currencies. Current EM problems can indeed merge into a much larger global debt crisis, just like the subprime crisis became a global financial crisis. The pain in the EM universe is widespread. Argentina is on the brink of total economic collapse. Turkey's currency has been steadily falling, recently exacerbated by Trump tweets. China's Shanghai Composite Index has fallen by more than 20% from its peak early this year, as the domestic currency devalued rapidly. News is plentiful about other Emerging Market (EM) currencies falling against the US dollar. China's yuan has declined by almost 10% against the dollar since February. The Indian rupee just also just hit a record-low against the dollar, though the pace cannot be compared to the Argentine peso or the Turkish lira. Many other EM currencies have been doing poorly in recent months. It seems that the whole world is fibrillating while the US economy is pumping ahead. However, the main problem, just like with the previous crisis, is too much debt all around the world. Last time, it was mostly about too much household debt in the US. This time around, it could be about too much borrowing, on a larger scale, in all sorts of places, from sovereign debt in EM, to corporate debt and household debt in both EM and DM. Emerging Market debt (including China) grew from \$21 trillion in 2007 to \$63 trillion in 2017. That, combined with the forced monetary tightening that is taking place in developed economies, could develop into something serious. Ultimately, the gorilla in the room is China. China, just like Japan before it, has been running, and growing, on selling to the rest of the world. It has also been using stimulus on a scale no other country has done until now for so long, and successfully, without being a DM economy. China hasn't had a recession for decades, and it has been able to achieve annual growth rates of more than 10% for many years (see chart below). Most of this success has been achieved through various stimulus activities, pushing total Chinese debt to over 300% of GDP according to reports of the Institute of International Finance. Most of the growth in China has been achieved through: (1) selling to the rest of the world, and (2) heavy stimulus measures after the financial crisis of 2008. Back in 2007, almost nobody thought what started as the subprime crisis could turn into a global debt crisis. Almost nobody fears what is now an Emerging Market crisis- which is in reality a debt crisis in the making for those countries- could turn into a much bigger global debt crisis again. But the ingredients seem to be there. And further US Dollar gains, which we expect to last until Q1 2019, will be there to make matters worst for the Rest of the World.

17 / Timing and Tactical Insight - Flight to Safety is accelerating - US Growth and Inflation perspectives remain strong, yet since May, the uptrend on US Treasury yields has stalled. This is quite peculiar, especially on the short end of the US yield curve, as until quite recently 2 to 5Y tenures were rising faster than Fed Fund rates. Indeed, since May, following a strong push up from late last year, the short term end of the US yield curve (3Y minus 3M) has started to flatten. We believe this initially reflects increasing Flight to Safety to the US Treasury market as investors start to exit Emerging Markets. In a way, this may spell the first stages of Contagion. Today, many risk assets show a similar profile as the flattening US3Y minus 3M spread, and in particular European markets. Our models suggests that these, along with the spread, could resume lower again, probably from late September at the latest and into November. US markets may then follow as their uptrends now seem exhausted. Going forward, following a bounce towards year-end, we expect further weakness on these assets into the Spring. Depending on the damage done, deleveraging may then spread to most asset classes and geographies.

24 / The signalling effect of oil inventories suggests further support for crude oil and E&P into late summer early autumn but the trend is extended - U.S. crude oil production is at the 11 million barrel per day level, deemed high by pundits, but the lack of sufficient pipeline networks in regions like the Permian basin and other areas has prevented stocks from exploding. At the same time, demand for gasoline and distillate products because of buoyant economic conditions has supported the price of the energy commodity, and refineries work overtime to keep pace with demand. Energy prices generally rose after those reports. You should not fear the build in petroleum and oil inventories. The build of inventories is a natural consequence of improving demand for oil crude oil and products. It is inventories being stockpiled in anticipation of near-term consumption. Moreover, the builds lag actual demand and consumption trends and therefore are not really part of the oil discovery process. The message: do not fear inventories; they can also be signs of good times. There is no single factor which will explain oil prices. The oil market is an economic system where changes in one element almost always affect all the other elements. Unfortunately, the system has no starting or ending point. At times, crude prices lead product prices. At other times, product prices lead crude prices. Nonetheless, it is clear to us: changes in spot product prices due to changes in product demand generally leads to changes in oil prices (and E&P equity prices). We came to this conclusion by modelling the relationship between the change in product prices and the change in crude values.

28 / Timing and Tactical Insight - Last upside retest for Oil, before it follows other risk assets lower - On our long term Bi-Monthly and Weekly graphs, Oil has probably reached an important intermediate top. The correction to the downside that follows should last at least into early next year, and potentially into the second half of 2019. The downside potential may be as low as the mid/high 50s USD/barrel on Brent, and the low 50s on WTI. We also expect Energy sectors in the US and Europe to enter a correction phase to the downside. The risk is probably between minus 10 and 20%. We also believe that these sector should under-perform their respective markets, at least into December, possibly year-end. Shorter term, until end September / early October, Oil may attempt a last upside retest. It may make new marginal highs on Brent (mid eastern political risk), yet probably won't on WTI. October and November should then see both benchmarks move lower into mid/late November in first instance.

4/ Executive Summary

33 / **China's CNY, and Gold: linked at the hip, and hobbled by the US Dollar's ascendancy, China's growth implosion** - Gold's future is generally tied to the trend of the US Dollar, but for practical purposes, gold is currently tied at the hip with the Chinese CNY. And the CNY is hostage to the escalating trade war between the Trump government and Chinese President Xi Jinping. Much of that weakness is reflected in EM currencies, and the price of gold suffered alongside them. China may again choose to continue to devalue the CNY on a sustained basis. Consequently, Gold could continue to decline further. The trade war and its effect on the USD/CNY exchange rate remain the immediate determinant of Gold prices in dollar terms. Until either the trade war ends or the dollar falls, either of its own accord or due to a Fed reversal in policy, CNY is likely to go lower, followed in its wake by the gold price. We therefore expect gold to briefly shine over the next two to three weeks, but could thereafter resume the downtrend until Q1 2019, when presumably (according to our models) the US Dollar bull trend could pause. That would be a period more apropos to investments in the precious metals sectors and in the Miners' equities.

35 / **Timing and Tactical Insight - Gold is still stuck between a rock and a hard place** - The rebound on Gold since mid August is rather weak and bottom fishing it against its recent downtrend still seems quite uncomfortable. This is the case in US Dollar terms, but also in EUR or even CNY terms, as Gold is negatively correlated to the US Dollar, yet with a stronger volatility than these currencies. Going forward, we expect the US Dollar to remain strong, probably into Q1 2019 at least. This will put additional pressure on Gold, and in the current context, a capitulation below 1'000 USD/oz cannot be excluded. We would hence stay away from it for now, this despite the defensive cross asset shift we expect. It's a question of timing within the downtrend cycle. Gold is currently getting stronger vs Copper, which suggests the end of the reflation trade, yet it is also accelerating up vs Silver, which usually happens when both precious metals are declining. In 2008 for example, Gold and Silver started to react up very late in the year, following the Lehman crisis and only once the TARP rescue program was put in place. Gold and Silver then accelerated up during the first years of QE, Silver more than Gold, and the Gold to Silver ratio declined. Our graphs suggest that this is unlikely to happen at least until next year. The fact is that Gold is a monetary phenomenon, it reacts to the cure (monetary easing), rather than the crisis itself. With the FED and potentially the ECB still on the tightening path, Gold should remain under pressure for now. This will continue to be the case until these Central Banks start to flinch. Given our negative scenario on risk assets over the next few quarters, this is not implausible, yet it may take a few more months/quarters to actually materialize.

41 / **Base metals face headwinds from China's slowing growth, firm US Dollar trend** - It was common to see headlines like "Copper rises on strong Chinese growth and China's industrial profits rise the most in four years on commodity prices"? It is easy to show that there is a mutually supportive cycle of Chinese strong growth fuels rising commodity prices, and rising prices fuels strong China growth. But since early Q2 2018, there has been a softening in commodity prices and the former explanation has dominated (e.g., "Chinese demand concerns hit metals and related stocks"). The recent Chinese slowdown in oil imports has been instrumental in undercutting oil and base metal prices. Ironically, it is not the failure of the country's long-term, export-led growth model that is to blame. The culprit is slowing domestic consumption. Retail sales this year have grown at their slowest pace in more than a decade. Wages in the private sector are growing at their slowest pace since the global financial crisis. Most of China's current woes are self-inflicted. Government expenditures in China have virtually collapsed since January 2016. With China being such a significant driver of the base metals price structure and with such a negative outlook, it is not a surprise that we expect base metals and commodities to mark time over the next few quarters, a new upwards cycle in global and US growth probably awaits in the later part of 2020. That could initiate a widely expected new cycle of boom times for resource materials at that point in time.

44 / **Timing and Tactical Insight - A Chinese hard landing is an increasing probability** - The sell-off in Chinese equity seems far from over. The downtrend is especially clear on the Chinese domestic market where the Shanghai Composite could continue to slide towards the 2'000 mark by early next year, and perhaps even lower, later on in 2019. All attempts to bounce during the Summer were rapidly retraced, and we now expect that from late September at the latest, Chinese equity markets could accelerate down again into November/December. Chinese equities also seem very weak vs both other Emerging Markets and the MSCI World Index, and in general the sell-off in Chinese Equities looks more and more like a panic liquidation. The Chinese equity sell-off is also impacting all related themes. Industrial metals such as Copper or Zinc have started to accelerate lower, the US Diversified Mining, Steel or Coal sectors are gradually reversing down, and growth themes related to basic metals or China, such as Lithium or Alternative Energy, are also selling off. We see little respite for most of these themes until at least early next year, and probably until end 2019, and believe that their downtrends could see further acceleration during these periods. We would hence avoid any investment themes relating to China and Industrial metals over the next few months and probably the next few quarters, i.e. don't try to catch a falling knife.

51 / **Splicing the markets - This time is probably not that much different** - Given the long standing linear Bull market on US equities, a correction that could reach beyond minus 20% would feel like a surprising anomaly. Yet, such corrections have happened in the past and not so long ago in Europe, Emerging Markets or Japan. Financial crisis usually come from left-field and unexpectedly. This time may not be that much different and the current set-up, where longer term our oscillators on most markets are reaching important tops or are already descending, seems quite right for it to happen again.

6/ Mapping the markets

Last month, in early August, after having followed the risk asset rally up for the last 18 months, we decided to pull the take profit trigger. We could not exclude a further Growth extension into the Fall, but then believed, that the risk/reward perspectives were certainly worth adopting a more defensive stance. Shorter term, we expected a first sell-off on equities towards late August / early September, then a new upside retest possibly into October, at the latest into early November. During August, this first sell-off did materialize. It was relatively short in the US (until mid August). US markets then made marginal new highs late August. In Europe, new lows were registered early September. Going forward, we expect the current bounce in Europe and the current upside retest in the US to hold up a while longer, probably for another couple of weeks. Yet, by late September, we expect equity markets, and risk assets more generally, to resume lower, probably into mid/late November.

Early August, we also stressed that the Dollar could continue up for another 2 to 3 weeks, and that its strength would accompany the fall of risk assets such as Emerging Markets, Financials or Commodities, the so called “reflationary assets”. We also expected that, coming late August/September, these assets could bounce, along with EUR/USD, but believed that the rebound would probably resemble a dead cat bounce given that these assets weren’t leaders in the risk asset space anymore. For now, this is still the case.

As we write, the risk assets bounce is still under way, and will probably hold up for another couple of weeks. Yet, this move is most probably counter-trend, and “Reflationary assets” will probably resume their downtrend from late September into November. Once this starts, and similarly to what happened in August, we expect renewed Flight to Safety flows towards the US, and the US Dollar should resume its uptrend. This, in turn, will probably create a negative feedback loop that will put further pressure on Emerging Markets and Commodities, and indirectly on most risk assets as the Dollar continues to rise.

We however don’t believe that US equity markets will be on the recipient end of these flows any more. Indeed, we expect the upside retest on US indexes to also die out towards late September. Our oscillators are suggesting that they are nearing important tops and that their medium to long term risk/reward is exhausted. Rather, the beneficiary of these flows, should be the very liquid US Treasury markets. Yields should start to retrace, the yield curve should continue to flatten, while US equities gradually follow other equity markets lower (contagion). This defensive shift should find a first intermediate low for risk assets towards mid/late November, yet following a bounce, will probably continue into next year.

Hence going forward, from end September, we will especially avoid China, Emerging Markets and Commodities again. Oil, which is currently retesting up and could make marginal new highs, should also start to reverse down. More generally, given the negative feedback loops we anticipate, we would probably reduce risk on most risk assets and favor defensive ones such as Treasuries, the Yen or Defensive sectors vs the market. We are less comfortable with Gold, as it remains very much inversely correlated to the Dollar.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	US equities are attempting to retest their recent highs. A strong breakout is rather unlikely and by late September, they should start to correct down into November	While they may see intermediate lows towards mid/late November, US equities then probably resume lower in 2019 (more than -20% downside potential over the next 12m)
	Europe EuroStoxx50	European markets may bounce slightly towards late September. Following that they resume down in force until November.	They may see intermediate lows towards mid/late November, yet European markets then probably resume lower in 2019 (more than -20% downside potential over the next 12m)
	EMs MSCIEM USD	EMs are currently attempting to stabilize, from late September, they should resume their sell-off, probably into November.	Emerging markets continue to sell-off, probably until Spring next year
Treasuries	US10Y Bond prices	Following some retracement towards mid/late September, US Treasuries should probably start to reverse up again, probably until November.	10Y Yields may retrace 60 to 100 bps until Spring/Summer 2019.
	Germany 10Y Bund prices	Bund Futures are currently retracing, probably towards late September, they then reverse up towards November	From October / November, the Bund should start to resume up gain, probably toward Spring/Summer 2019

Legend: Strong Underweight Underweight Neutral Overweight Strong Overweight

Main Equities

World markets

p 20, 21, 23, 44, 45, 51, 52

Equities are reaching the last stages of their Bull market since early 2016. Over the next couple of weeks, US Equities may attempt to retest up once more, while other market may see a slight bounce. From late September, we expect all equity markets to top out or resume lower, probably into mid/late November in first instance and then probably into the Spring. Theoretically, the Bear market we expect could last between 12 and 18 months.

Main Regional picks

p 21

The US currently seems to be recipient of Flight to Safety flows, Given our scenario, which is defensive towards November, we would favor its equity market over Europe's or Japan's.

Emerging markets
p 21, 22, 44, 45

Essentially, Emerging markets remain in sell-off mode, probably into November and then into the Spring.

Volatility

Volatility is building a base again, slightly above the lows it made last year and during January. We believe that by end September, it could start to pick-up again.

Government Bonds

US & European Benchmarks
p 17

US 10Y yields are still in the process of topping out for this cycle and may start to reverse down from late September. We expect them to retrace 60 to 100 basis points towards Spring next year. European long term yields topped out in January and have since been trending lower. This downtrend is currently pausing, yet should resume lower from late September, probably into November and then Spring next year.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	The current uptrend has been resilient, yet the risk/reward for US Equity vs Bonds is stretched and we expect the ratio to top out towards late September	Following its top late September, the ratio could correct down into next year as the environment turns more defensive and rates start to retrace.
	Europe	The ratio, may bounce slightly until late September, but then resumes lower into November.	The ratio continues to Fall into next year as the environment turns more Defensive and rates continue to retrace.
Duration		US and European yield curves continue to flatten while long term yields resume lower from late September. Longer Durations can be considered.	Yields curves continue to flatten, while long term yields continue to retrace probably until year-end at least (favorable for defensive long Duration trades).
Credit		Credit spreads are currently retracing yet, they could start to resume higher from late September into November.	We believe the Credit cycle has turned and that Credit spreads should continue to widen into next year. We would stick to High Quality issuers over the next few quarters.
TIPs/Treasuries		TIPs vs Treasuries could bounce moderately towards end September, and then resume down into November.	The TIPs/Treasury ratio probably continues to retrace into next year.
Oil		The current upside retest on Oil should die out towards early October. Oil then starts to correct towards mid/late November.	Oil continues to correct down into early next year (Brent probably breaks back down below 60 USD/barrel).
Industrial metals		Industrial metals and Copper may still attempt to bounce during September, yet they then resume lower towards November	Industrial metals and Copper probably continue lower into next year and could retrace most of their uptrend since early 2016.
Gold		Gold is currently bouncing, yet could resume lower from late September, as the Dollar rises again into November	Gold probably remains under pressure towards year-end and possibly towards Spring next year, i.e. as long as Central Banks are tightening.

Legend:

Strong Underweight

Underweight

Neutral

Overweight

Strong Overweight

Equity to Bond Ratios

US & Eurozone Markets

We expect equity markets in the US to top out, while in Europe they resume lower, towards end September. Treasuries and Bunds on the other hand should start reversing up again. Equity to Bond ratios should start to weaken, first into November, then again towards next year.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 17- 19

We expect Yields curves in the US and Europe to continue to flatten, while US long term yields start to reverse down and German ones resume lower (from end September). This is a rather friendly environment for Duration. The Shorter term end of the US yield curve (US3Y-US3M) is quite interesting as it may flatten quite aggressively (it's catching up with the long term end, US10y-US3y, which has already flattened substantially). We believe this translates into an increase in the Flight to Safety flows towards the US Treasury market.

Credit	During the Fall we expect High Yield to top out vs Investment Grade. We also expect Sovereign spreads to widen again. Overall, we believe that Credit is topping out for this cycle.
Rate Differentials	The uptrend on the US rate differential vs other regions is starting to look extended, yet for now it is still uptrending.
Tips p 19	TIPs are still resuming lower as inflation expectations are receding, yet real rates seem to continue to push higher. Both Tips and Treasuries should start reversing up this Fall, but Tips will probably lag Treasuries in doing so. Hence, the TIPs/Treasuries ratio has started to reverse. We believe it could resume lower again from late September into November.
Commodities	
Oil p 28 - 32	Brent is still retesting its May and late June highs and may continue to do so until late September / early October. WTI is also bouncing, but should fail to make new highs. This probably reflects the political risk on international Oil markets (mid eastern tensions, e.g. Syria and Persian Gulf). Both Brent and WTI should top out between late September and early October and start correcting down towards November and then early next year. By then, Brent may revisit the the mid/high 50s, while WTI the mid/low 50s USD/barrel.
Industrial metals p 20, 39, 47- 50	Industrial metals continue to sell-off along with Chinese equities. A slight bounce may materialize over the next couple of weeks, yet by late September, the trend resumes lower towards November and then again into Spring next year. By then, Industrial Metals may revisit their early 2016 lows.
Gold & PMs p 35, 36, 39, 40	Gold is currently bouncing from its mid August lows, along with EUR and most currencies against the US Dollar. Yet, it should resume lower from late September as the US Dolllar resumes its uptrend. We believe it will remain under pressure as long as the FED continues to tighten (as long as the ECB is considering it).
Agriculture	Agricultural Commodities are typical late cycle commodities. They are more defensive than Energy or Industrial Metals and should perform better than them in the upcoming environment. That said on an absolute basis, they remain under pressure in an environment where the Dollar is still strong and the Yuan is still declining.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	The current rebound on EUR/USD may continue until late September towards the 1.17-1.19 range. From end September, EUR/USD resumes its downtrend towards the 1.13 - 1.10 range	EUR/USD remains under pressure until at least Q1 2019 and could break below the 1.10
	GBP	The current rebound on GBP/USD may continue until late September towards the 1.31- 1.33 range. From end September GBP/USD resumes its downtrend towards the 1.27- 1.22 range	GBP/USD remains under pressure until at least Q1 2019 and could break below the 1.20
	JPY	USD/JPY could push back into the 112 - 113 range. By early October, it starts to resume lower towards 110	The Yen gradually strengthens as a defensive cross asset shift materializes. USD/JPY moves back below 110, and potentially towards 105.
	CHF	USD/CHF is consolidating, probably until November within the 0.97 - 0.95 range	USD/CHF should resume up towards parity between November and the Spring
EUR vs	GBP	EUR/GBP continues to consolidate during September (89-88 range), before it resumes its uptrend into November	EUR/GBP continues higher towards year-end and 2019, and towards the 0.92 - 0.95 range
	JPY	EUR/JPY continues to bounce towards the 130 - 132 range. By late September, it tops out and resumes lower towards November (towards the 126 -122 range).	EUR/JPY continues to fall until Spring next year and should move below 120, possibly even lower.
	CHF	EUR/CHF may bounce slightly until late September, but it then resumes lower into November towards the 1.11 - 1.09 range.	EUR/CHF continues its fall into the Spring, probably below 1.10 and potentially towards 1.05.
GBP vs	JPY	GBP/JPY continues to bounce towards the 146 - 148 range. By late September, it tops out and resumes lower towards November (towards the 141 -136 range).	GBP/JPY continues to fall until Spring next year and should move below 135, possibly even lower.
	CHF	GBP/CHF may bounce slightly until late September, but it then resumes lower into November towards the 1.25 - 1.21 range.	GBP/CHF continues its fall into the Spring, probably below 1.20 and potentially towards 1.15

Legend:
Strong Underweight
Underweight
Neutral
Overweight
Strong Overweight

US Dollar p 37	We believe the US Dollar has turned up for this cycle and that it will continue to strengthen in successive stages towards mid/late 2019. Shorter term, the US Dollar is currently correcting and could continue to do so over the next couple of weeks. From late September, however, we expect it to resume higher first towards year-end and then into next Spring on Flight to Safety concerns.
Euro p 23, 37	The upside momentum on EUR/USD that prevailed throughout 2017 has reversed. The pair has since seen a first leg down, which was probably completed mid August. The current bounce is rather unconvincing, yet it may linger on up and retest the 1.17 – 1.19 range. From late September, at the latest, we expect EUR/USD to resume its downtrend towards late November and possibly year-end, and the 1.13 – 1.10 range. Vs CHF, EUR has clearly reversed down. EUR/CHF may stabilize slightly over the next couple of weeks, yet should also resume lower from late September, at the latest, probably towards November and the 1.11 – 1.09 range. EUR/GBP may see a slight correction to the downside in the 0.89 – 0.88 range over the next couple of weeks, yet should resume up thereafter into November and possibly year-end towards the 0.92 – 0.95 range. Obviously the conclusion (or not) of Brexit talks are going to have a strong impact on the pair and its volatility.
Yen p 38	USD/JPY is still trying to push higher as risk-ON considerations are still present in the US and in Japan at least. The pair may push back up into the 112 – 113 range over the next couple of weeks. From late September/early October however, we expect the Yen to start regaining its risk-OFF profile as the cross asset environment gradually turns more defensive. Vs the Euro and Sterling, the Yen may also continue to retrace into late September, but should then accelerate up into October and November (i.e. lower EUR/JPY and GBP/JPY from late September).
Sterling	The fate of Sterling is hanging onto the current Brexit negotiations, to their successful conclusion and to the details of this deal. For now, the bounce in Cable (GBP/USD) is rather unconvincing. It may continue to push slightly higher over the next couple of weeks (towards the 1.31 – 1.33 range), yet from end September, we expect it to resume lower towards late November, possibly year-end and back into the 1.27 – 1.22 range. Vs EUR or the Yen, Sterling may also continue to bounce over the next couple of weeks, yet should also resume lower thereafter.
Oil & Commodities currencies	Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) topped out in early February against the Dollar and has been selling off since. They are currently attempting to make an intermediate low, yet by late September, we expect them to resume lower into October/November and then possibly again into Spring next year. Similarly, we expect them to remain weak vs all the major currencies.
Asian currencies p 38	Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) shows a similar profile as our Commodity currencies portfolio above, yet with less volatility (i.e. it is more defensive on a relative basis). It may attempt to bounce slightly over the next couple of weeks, yet remains weak until the Spring vs all the major currencies.

Equities Markets Segmentation

Core Sector Weightings			Next 2 months					3 to 6 months ahead				
US Sectors - S&P500			Growth sectors may still hold up during September along with US equity markets. From October, they correct down with them. We remain Overweight Defensives.					We would favour Defensive sectors, first towards mid/late November and then again into the Spring				
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	26%										
Financials	XLF	15%										
HealthCare	XLV	14%										
Discretionary	XLY	12%										
Industrials	XLI	10%										
Staples	XLP	8%										
Energy	XLE	6%										

			Next 2 months					3 to 6 months ahead				
European Sectors - Europe Stoxx 600			Industrials and Energy may hold up until end September along with equities and Oil, yet looking into October/November, we remain Overweight Defensives					We would favour Defensive sectors, first towards mid/late November and then again into the Spring				
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 16, 19, 20, 21, 31, 44, 45, 55, 56

While US equity markets attempt to retest their highs during the next couple of weeks and European markets make a slight rebound, Growth sectors in the US (Technology and Consumer Discretionary) and Industrials in Europe may continue to hold up against the market. Given that Oil is attempting to retest up until late September / early October, we would also include European Energy in this Neutral allocation (US Energy could bounce, yet without much amplitude). Yet, from late September, we expect equity markets on both side of the Altantic to reverse down into November and these sectors should start to underperform. Overall, we remain Overweight defensive sectors as we believe they could break-out vs the market, probably from late September into November

Going forward, if the reversal down in the market we anticipate materializes, we expect a first support point towards mid/late November and perhaps a bounce into December. Yet, we also believe that this bounce will probably be short lived and that by early next year at the latest, equity market should resume down again into the Spring. Hence, our sector mix will probably remain rather defensive until then.

Countries allocation

Core Countries Weightings			Next 2 months					3 to 6 months ahead				
All World Country Index Currency hedged			We continue to avavoid China and Canada, would neutralize Europe until late September and remain Overweight the US					We expect equity markets to correct in- to the Spring, the US should benefit from Flight to safety flows. This should also be the case for Switzerland to a certain extent.				
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
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 22, 31, 32, 33, 34

Over the next couple of weeks, a slight rebound in global market may benefit the RoW vs the US, yet from late September, we expect all markets to reverse down again, probably until mid/late November, and although the US should also correct it may resist slightly better on a relative basis. Given this scenario with a slight rebound and then a sell-off into November, we have neutralized most developed international markets for now vs ACWI and will reconsider early October. We remain underweight China and Canada for now given their links to the Commodity/Emerging markets space, and the fact that the downside risk in our view remains greater than the risk of a rebound.,

Looking into October/ November and then into next year, we will remain Overweight the US for now as we expect the US Dollar to remain strong, while Global Equity markets should continue to correct. In such circumstances, the US should continue to benefit from Flight to Safety flows. That said, we notice that the MSCI World is looking very Oversold already vs the S&P500 on a long term basis, yet we expect this trend to push slightly further into early 2019 (we may reconsider this view towards year-end). We remain underweight China and Canada as we expect the commodity/emerging markets sell-off to continue into the Spring. We will Underweight Japan as a stronger Yen should negatively impact its large export industry and will keep Switzerland as Neutral as its Defensive mix of sector exposure will be compensated by the negative effects of a stronger currency.

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.

Core factors and Themes

Core Factor/Themes Weightings	Next 2 months					3 to 6 months ahead				
General Comment	Despite the slight bounce that may materialize over the next couple of weeks, our Factors and Themes Allocation into October/November avoids high beta risk.					Into year-end, we continue to avoid high beta risk and will underweight the Nasdaq as it seems extended vs the market.				
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)										
Goldmines										
Diversified Mining										

Core factors and Themes

Despite the slight bounce on risk assets that may materialize over the next couple of weeks, we will avoid high beta plays over the next couple of months. Indeed, from late September, we expect equity market to start to correct into December. We have gone underweight US Small caps as their cyclical bias should now outweigh any benefits from a stronger US Dollar.

From late September into year-end, we will underweight the Nasdaq as it is probably quite extended vs the S&P500, and will continue to avoid high beta plays given the equity market correction we expect. We will overweight Japanese small caps as these are usually rather defensive, especially if a rising Yen negatively impact Japan’s large export businesses.

12 / The brewing EM Crisis is a handiwork of the US Dollar; it will get worse, before it gets any better

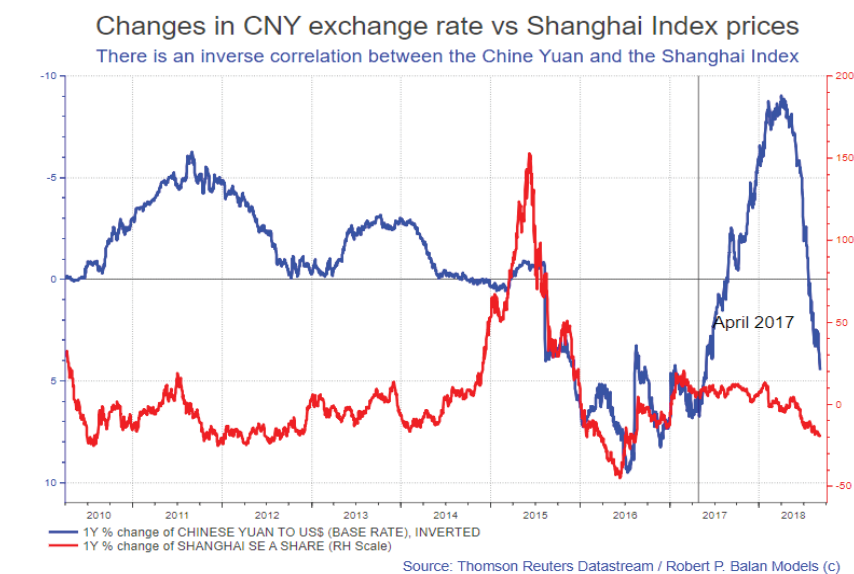
Emerging Market economies are in serious trouble. Increased US borrowing, which is helping power the US economy and its stock market for now, is hurting many other countries' currencies. Current EM problems can indeed merge into a much larger global debt crisis, just like the subprime crisis became a global financial crisis. As the US Dollar continues to strengthen, as we believe it would, then there are valid reasons to be concerned.

As late as February this year, the EM sector was still doing very well. The February edition of The Capital Observer featured an article with this title: "EM economies and assets are outperforming, but a US dollar resurgence in Q2 may derail MSCI EM\$ and EM currencies."

We quote from the February issue of the Capital Observer:

"Will the outperformance of EM assets continue? Cheap EM valuations are disappearing and easy US and global financial conditions are being whittled away. Bond yields in the US are rising sharply, the Fed has embarked on a Quantitative Tightening cycle, the Bank of Japan is slowing its monetary stimulus, and the European Central Bank has slowed some of its own Quantitative Easing. Of course, all risk assets are in danger if global monetary policy reverts to tight pre-GFC status, but we believe EM risk assets will likely be in a more precarious situation. Global monetary policy changes are usually first reflected through the valuation of the US Dollar, so an EM watch is tantamount to a US dollar watch."

And, indeed, we hark back to the title of this article: the brewing EM crisis is a handiwork of the US Dollar; it will get worse, before it gets any better because the US Dollar rampage is not close to winding down. And worse, it looks like the Trump administration has



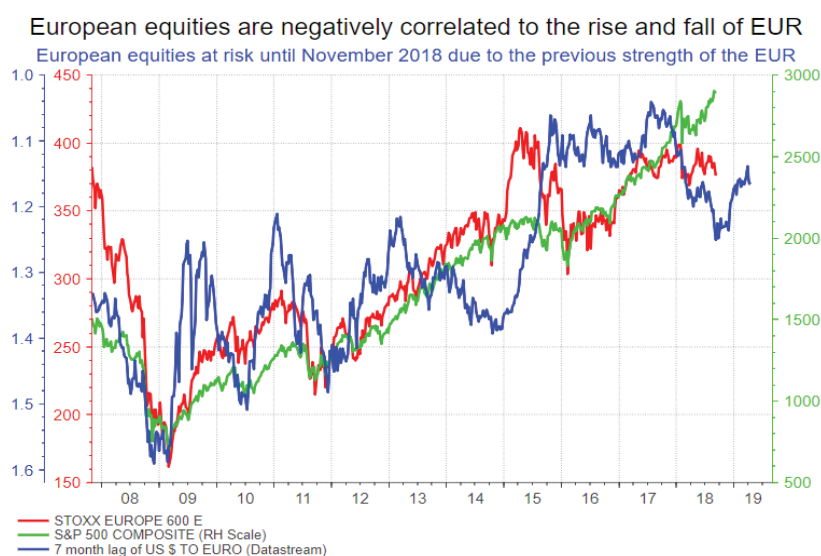
weaponized the US currency. It is no surprise then that the pain in the EM universe is widespread. Argentina is on the brink of total economic collapse. Turkey's currency has been steadily falling, recently exacerbated by Trump tweets. China's Shanghai Composite Index has fallen by more than 20% from its peak early this year (see 1st graph on this page), as the domestic currency devalued rapidly.

News is plentiful about other Emerging Market (EM) currencies falling against the US dollar. China's yuan has declined by almost 10% against the dollar since February. The Indian rupee just also just hit a record-low against the dollar, though the pace cannot be compared

to the Argentine peso or the Turkish lira. Many other EM currencies have been doing poorly in recent months.

Europe's equity markets are not doing very well either, a victim of currency valuation – its own. European equity markets fell the pain from a strong EUR two quarters after the fact (see 2nd chart on this page).

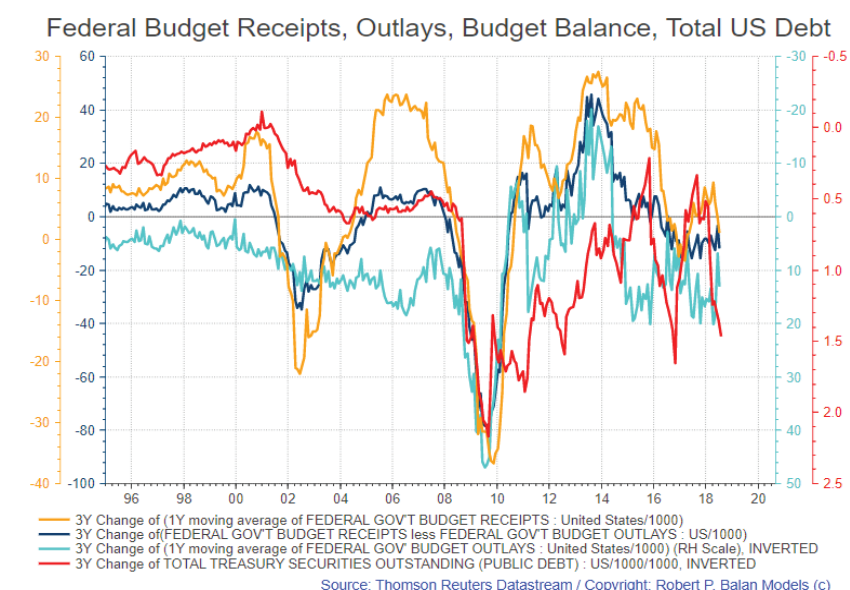
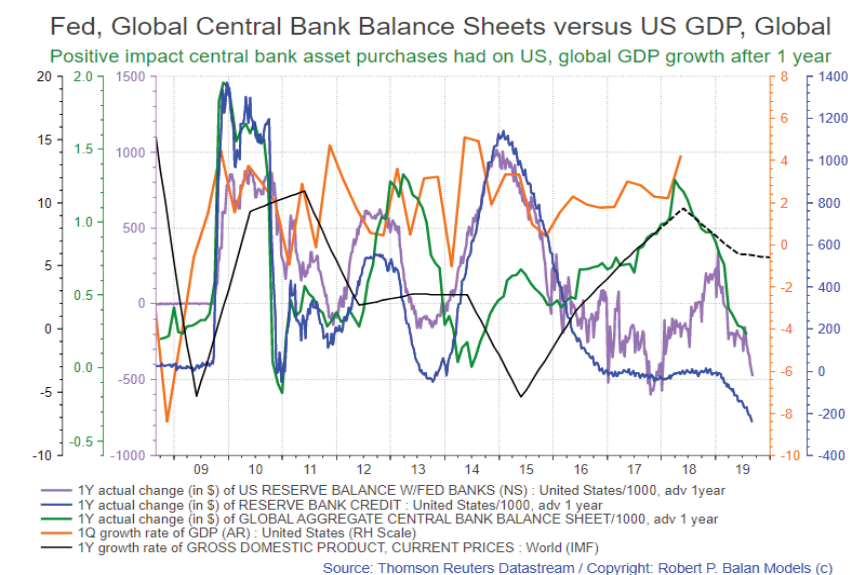
It seems that the whole world is fibrillating while the US economy is pumping ahead. Why isn't the US economic growth helping others grow as well? One reason may very well be that the US is, at least partially, growing at the expense of many other countries. Also, the US economy has



benefitted from the Fed's radical QE programs during the Great Financial Crisis (GFC), the impact of which is just starting to show. Other global central banks also applied stimulus measures, but the aggregate global central bank balance sheet has arguably benefited the U.S. economy and financial markets the most (see first chart on this page). Me-too monetary stimulus may have even hurt countries other than the US because that has depressed their domestic bond yields, depriving their commercial banks the incentive and the capability to lend to the general economy, hurting their domestic growth. The US economic cycle, in that sense, has taken off earlier than those of the rest of the global economy.

Other economic expansions in our recent past seemed to be shared in a more balanced fashion. During the dotcom years, and especially during the mid-2000s housing boom, most countries, EM or Developed Market (DM), were enjoying good times together. Now, it seems there is something that the US is doing that other countries are either unable to do, or they just don't know how to do it. Or maybe, it's rather some kind of a zero-sum game in which the US is winning, and others are losing to the US. There may actually be some truth to this, and not necessarily because the US is causing it intentionally. As the business cycle has matured and money (especially the US dollar) has become dearer (because of higher interest rates), there isn't that much room left for growth using debt, because servicing debt has become more expensive. And the US is on an unprecedented debt-fuelled growth at a time of tightening monetary policy, which is indeed aggravating the situation for many other countries. That needs some explanations.

A significant portion of the current US economic growth is provided by the US government running a larger budget deficit than any other major DM economy. That was true during the GFC; that's true as well today. President Trump



has provided the economy with a massive late-cycle fiscal stimulus, cutting taxes deeply. For 2018, it is estimated that the budget deficit will be 4.2% of GDP. It was 3.4% for 2017. It was smaller for 2016, at 3.2%. **The 4.2% of GDP deficit for 2018 is around \$833 billion. That is a huge amount of stimulus.**

The US government has, through its new fiscal stimulus program under president Trump, injected an extra 0.8% of GDP (4.2% minus 3.4%) into the US economy, which has helped improve the economy (growing by an enviable 4.2% recently) and pushed the stock market to record high levels. Previous economic expansions did not see additional fiscal stimulus when times were good, which is what usually happens toward the final years of a business cycle. **As it can be seen in the second chart above, year 2000 saw a budget surplus, 2% of GDP,**

while the boom years of the housing bubble witnessed a shrinking of the Federal deficit until 2007.

It is not possible for many countries to replicate the US recipe of endless fiscal stimulus. Many other countries get into trouble in case they do not balance their budgets and their borrowing over a few years' time.

Europe has serious political issues, hindering the possibility of a coordinated fiscal stimulus program that would be acceptable and appropriate to all those who share the same currency but have very different economic and budgetary conditions. Some of the other countries who could have copied the stimulate-to-the-end recipe of the Trump administration seem to have run out of ammunition already. First ones that come to mind are the ones mentioned at the beginning, Turkey and Argentina.

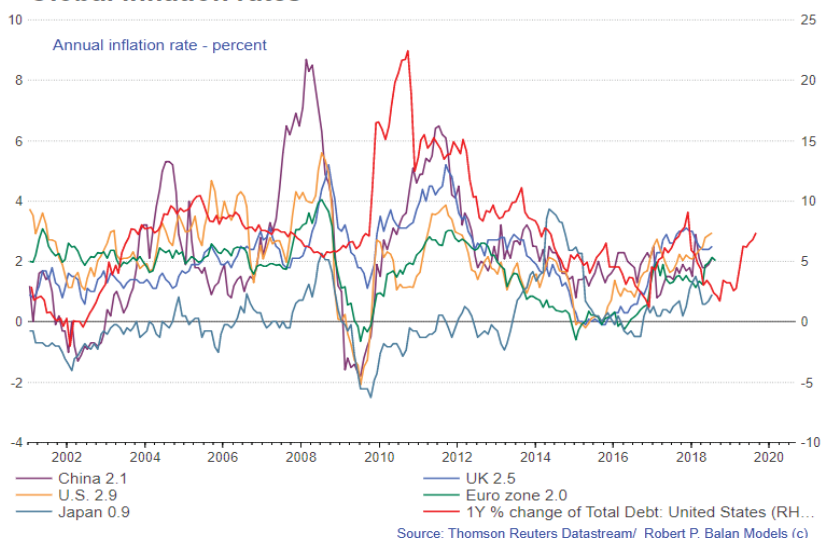
They didn't have the luxury of owning the world's reserve currency, the US dollar. At some point, their public and private borrowing could not continue without getting their currencies hammered.

Just like when a private company, or individual, starts to lose credibility after borrowing too much for too long and their IOU's (their corporate bonds, or their credit scores etc.) start to become worthless. The US, on the other hand, acts rather like a central bank printing IOU's. Its IOU's don't do any harm to the central bank itself but create inflation for everyone else (their goods and services become expensive). Similarly, increased US borrowing is contributing to higher inflation in other countries, after a lag of one year.

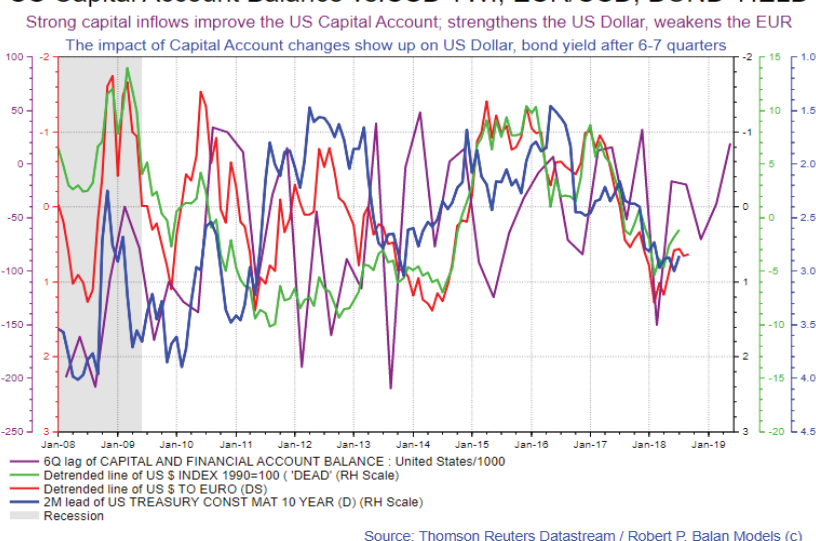
The US can borrow as much as it wants. The US can, theoretically, run even a much larger deficit than it is running already and its currency would not lose in valuation. A larger US budget deficit doesn't exactly have the ability to push either inflation, or interest rates, much higher in the US, as it does in all the countries who are currently feeling the heat from currency depreciation, inflation and higher interest rates. US short term interest rates are set by the Federal Reserve, which is independent from the government. Longer term US treasury yields (which are the benchmark for other money market instruments), on the other hand, are considered safe haven bets (and with a pretty good yield) for the whole world and any pressure for them to go higher attracts funds from all around the world chasing safe yields.

A larger US federal borrowing (and therefore wider Federal deficit), therefore, by attracting funds from other countries, pushes the dollar higher and other countries' currencies lower. The US borrows more but doesn't invest more abroad (which should even out the effects — the US capital account improves as consequence), and this has an upward pressure on treasury yields. Higher US treasury yields attract even more capital flows to the US, which boosts the US Dollar (see 2nd chart

Global inflation rates



US Capital Account Balance vs.USD TWI, EUR/USD, BOND YIELD



on this page), and specially weakens currencies of the countries who are also running significant deficits (borrowing more than they are selling/making), and this in turn forces those counties to raise interest rates to defend their currencies.

Higher interest rates in those countries (which are always much higher than the US) weakens their economy further, and it all turns into a vicious circle. **US long-term rates, as it has been seen from the beginnings of this year, haven't been able to rise much despite record supply of treasuries and also record heavy bets by speculators. The reason being the unique position that the US dollar has, through its ability to attract funds/resources from other economies/countries.** Therefore, an increased borrowing by the US has been seriously felt in economies who had hoped to try a similar path (of borrowing), for longer. Because they have lately had

a truly ferocious competitor for funds/resources — the US government. US government borrowing tightens global liquidity, and when that happens, the US Dollar becomes stronger, and the double whammy devastates EM financial assets and ultimately the local economies (see 1st chart on next page).

The 10-year yield has been stuck mostly around 2.9% since February (see 2nd chart on next page), despite a sharp surge in the front end of yield term structure as the 3yr yield rises in cadence with the Fed's talks of tightening monetary policy.

It is true that nobody can blame the US for deciding to run a larger budget deficit. But that is one of the reasons EM currencies are falling. The other factor putting pressure on EM currencies is higher rates from the Fed. Of course, it has been reckless policies by many EM

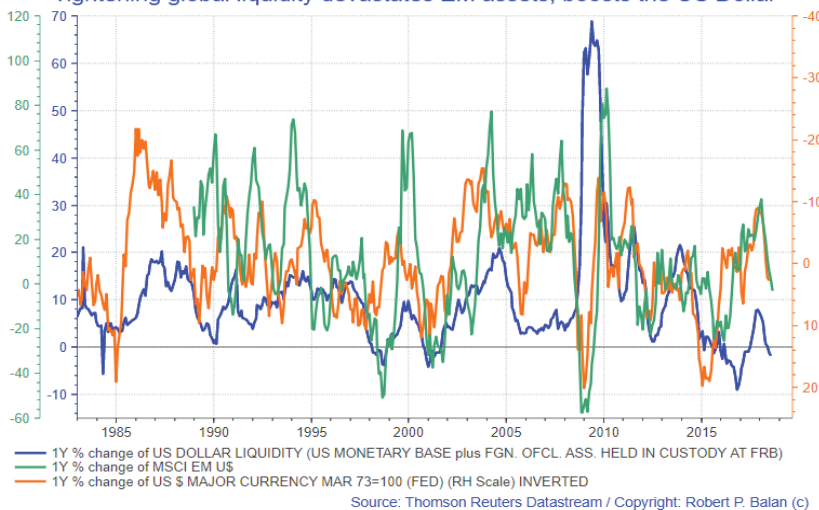
countries that have led to their current troubles, but let's not fool ourselves – those exactly the same reckless policies are mostly what is powering the US growth. America is running the world's largest current account deficit and the world's largest budget deficit in nominal terms, by far.

According to the CIA's World Factbook, the US ran a current account deficit of more than \$466 billion in 2017, followed by the UK (over \$100 billion), India, Canada, Turkey, France, Australia, and then Argentina. Obviously, the only EM countries in the list above, running highest current account deficits, are on the brink of economic collapse, while America is doing great, simply doing the same thing on a much larger scale.

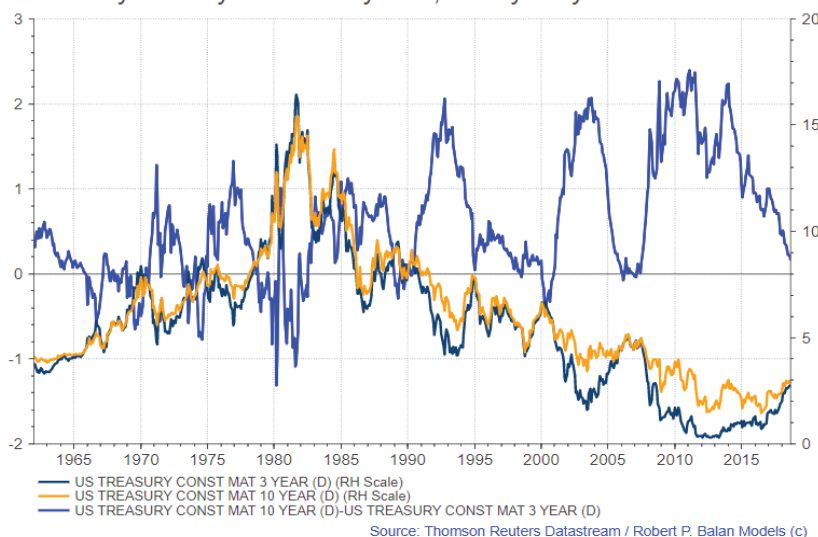
At some point, the US will also run out of ammunition, but not because of a falling currency. It is also quite possible that the US, through its increased borrowing, will “corner” the world’s “investible funds” and push other countries into trouble so badly that their troubles will eventually catch up to the US economy. Every economic cycle reaches its limits at some point and a quickly flattening yield curve (around 25 basis points now) is harbinger of slower GDP growth going forward, with or without a yield curve inversion (see 3rd chart on this page). **Mr Trump can also decide to add to the stimulus even more -- sucking funds from all around the world -- and putting pressure on other currencies.**

However, the main problem, just like with the previous crisis, is too much debt all around the world. Last time, it was mostly about too much household debt in the US. This time around, it could be about too much borrowing, on a larger scale, in all sorts of places, from sovereign debt in EM, to corporate debt and household debt in both EM and DM. **Emerging Market debt (including China) grew from \$21 trillion in 2007 to \$63 trillion in 2017. That, combined with the forced monetary tightening that is taking place in developed economies, could develop into something serious.**

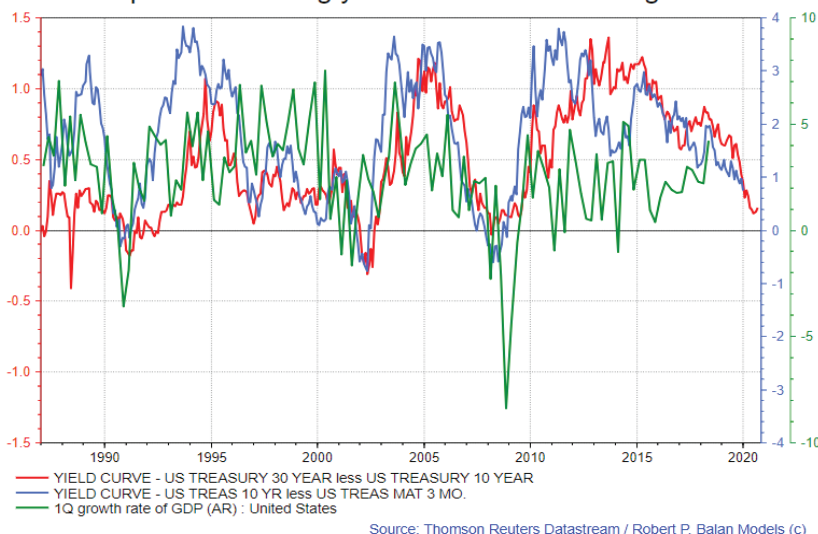
GLOBAL US DOLLAR LIQUIDITY VS. MSCI EM\$, USD (INV)
Tightening global liquidity devastates EM assets; boosts the US Dollar



10yr and 3yr US bond yields, the 3yr/10yr Yield Curve



The impact of flattening yield curves on US GDP growth rate



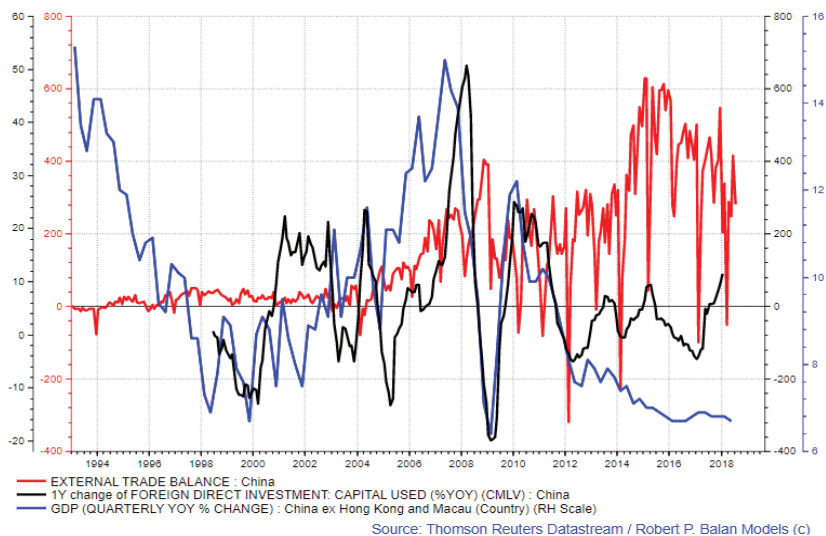
In any case, it seems clear that what has been a great year for the US economy and especially the US stock market, has been at least partially to blame for the woes of the rest of the world who have been trying to apply the same recipe Mr Trump has been applying, successfully. We have written extensively, in detail, before that we expect the US dollar to strengthen further, as neither the US fiscal stimulus nor the Fed tightening will see any reprieve in the coming months. This will put further pressures on weaker currencies.

However, the gorilla in the room is China. China, just like Japan before it, has been running, and growing, on selling to the rest of the world. It has also been using stimulus on a scale no other country has done until now for so long, and successfully, without being a DM economy. China hasn't had a recession for decades, and it has been able to achieve annual growth rates of more than 10% for many years (see 1st chart on this page). Most of this success has been achieved through various stimulus activities, pushing total Chinese debt to over 300% of GDP according to reports of the Institute of International Finance.

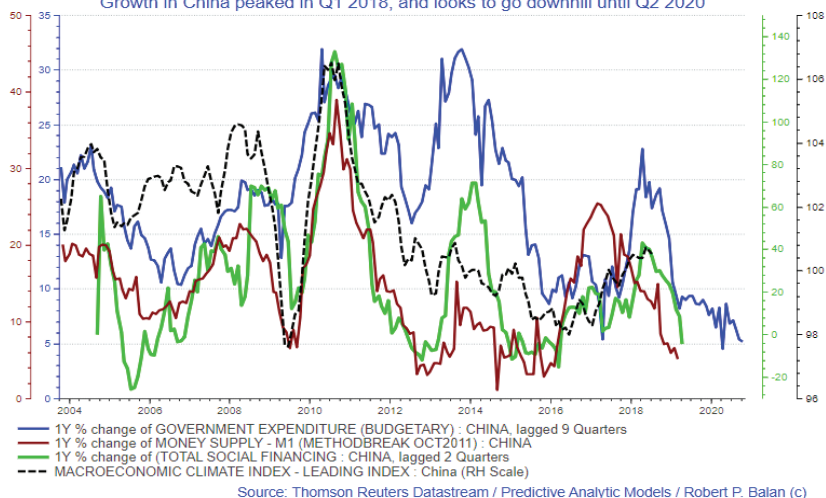
Most of the growth in China has been achieved through: (1) selling to the rest of the world, and (2) heavy stimulus measures after the financial crisis of 2008. As the Chinese economy has grown, American-style stimulus (lowering interest rates and borrowing more) has become a more necessary method of achieving desired economic growth. It is not unreasonable to assume now that China, just like Turkey or Argentina, eventually risks to run out of ammo if it will not be able to maintain a trade surplus. Of course, we shall keep in mind that Turkish, or Argentinian, economies are peanuts compared to China. China would need serious funding from abroad in case it didn't sell enough to the rest of the world. And, the world seems to be completely unprepared for a China running on foreign money as the US is already sucking in too much, crushing the currencies of other deficit-running countries.

To make matters worse, China has severely tightened fiscal policy over the past two year, going on three years. They have belatedly recognized that the domestic economy has been starved of funds, but the harm has been done. Total Social Financing expenditures have collapsed, and with it most of China's economic activity. The effect has been baked in the cake, so to speak, and so China's economy will likely spiral lower until first half of 2020, at least.

China GDP vs External Trade Balance vs FDI



China Gov't Expenditures, Total Social Financing, LEI, M1 Money Supply
Crucial metric for systemic liquidity and LEI is Total Social Financing, which has already peaked
Growth in China peaked in Q1 2018, and looks to go downhill until Q2 2020



Unsurprisingly, the latest news is Chinese currency as it will materially impact China's ability to sell to the US and maintain its badly needed engine of stability, its export prowess. Tariffs of 25% for \$200 billion on Chinese goods might go into effect in a few days. One gets the feeling that the US government wants to redress the skewness of the US-China trade balance all in one go.

Back in 2007, almost nobody thought what started as the subprime crisis could turn into a global debt crisis. Almost nobody fears what is now an Emerging Market crisis - which is in reality a debt crisis in the making for those countries - could turn into a much bigger global debt crisis again. But the ingredients seem to be there. And further US Dollar gains, which we expect to last until Q1 2019, will be there to makes matters worst for the Rest of the World.

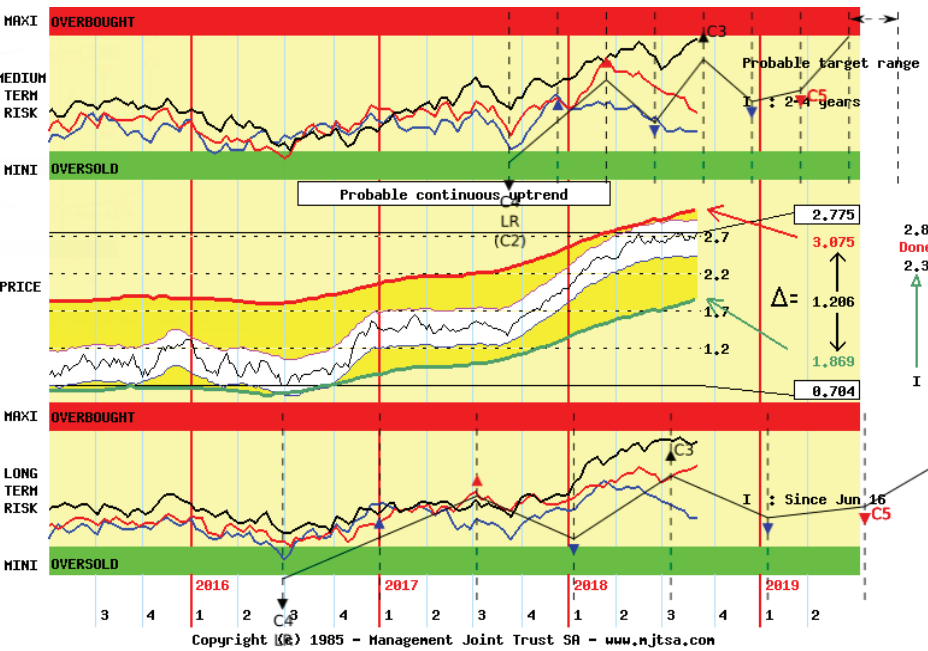
The Trump administration seems to be very serious about its imposition of heavy tariffs on China, and this will surely exacerbate the situation. Another round of tariffs on \$200 billion worth of goods can be a serious blow to the

17 / MJT - TIMING AND TACTICAL INSIGHT

Flight to Safety is accelerating

Since May, the rise in US Treasury yields has stalled. This is rather surprising given strong US GDP growth, a tight labour market, a Fed, which seems committed to several more rate hikes, and further increases in the supply of US Treasury Bonds. Consolidation or Distribution? In this article, we consider why US Treasury yields may getting ready to roll over and review what this implies for other asset classes such as developing and emerging equities and currencies.

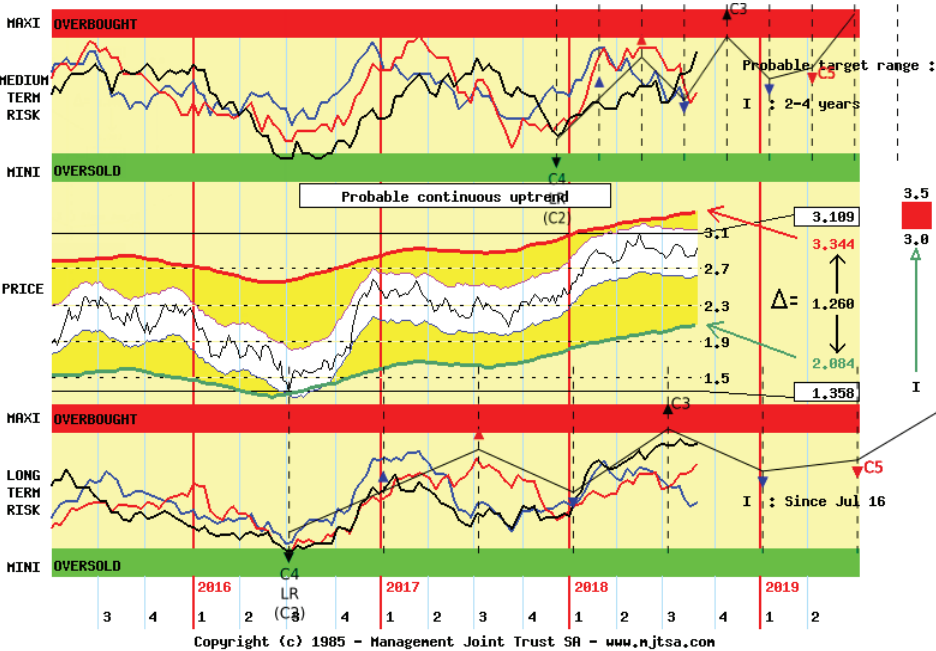
US 3 years Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



US 3 years Treasury yields have pretty much stalled since mid Q2, this despite an acceleration in Treasury issuance on the 2 to 5 years tenures (+ 1 billion USD a month on each on the 2Y, 3Y and 5Y issues). Indeed, while our I Impulsive targets to the upside between 2.3 and 2.8% have been achieved (right-hand scale), both our oscillator series (lower and upper rectangles), also seem to have reached important intermediate tops. Both sequences suggest that a 6 to 12 months consolidation to the downside may be coming. During this period, US3Y Treasury yields may correct between 60 and 100 basis points

(0.5 to 0.8 times our historical volatility measure "Delta", here at 1.206%; right-hand side, middle rectangle).

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

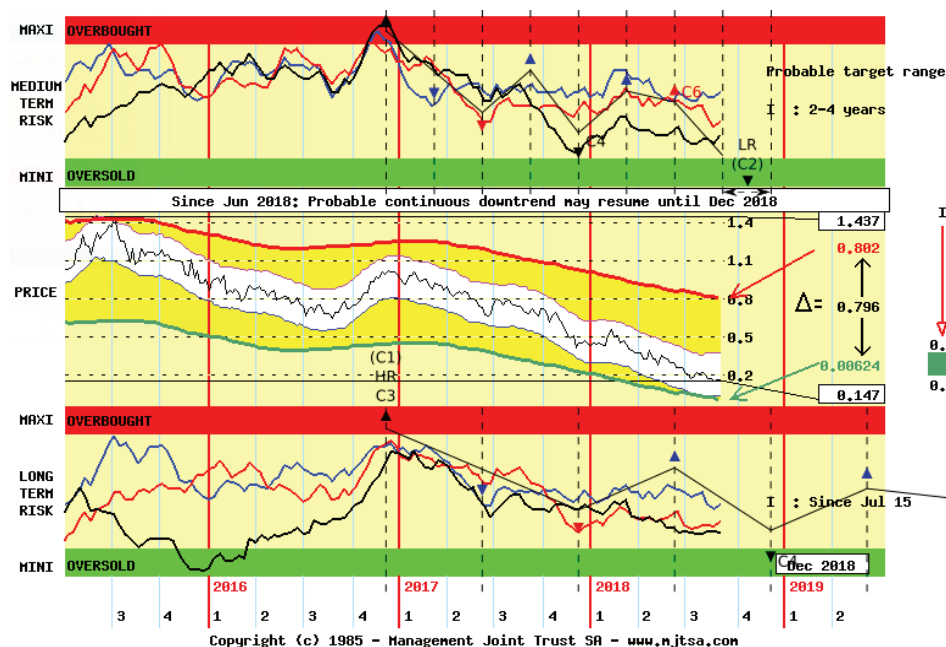


On US10Y Treasuries yields, the sequences we show on both oscillator series (lower and upper rectangle) could also be topping out soon. Our long term oscillators (lower rectangle) may have already done so this Summer, while our medium term oscillators (upper rectangle) would suggest a last upside retest until early Q4. On the target front, the lower end of our I Impulsive targets to the upside was achieved above 3.0% in May. The higher end, around 3.5%, now seems very aggressive, given the limited time left to achieve these. At best, we expect marginal new highs within the next few weeks and then 6 to 12 months

consolidation to the downside. During this period US10 Year yields could retrace between 65 and 100 basis points (0.5 to 0.8 times our historical volatility measure "Delta", here at 1.26%; right-hand side, middle rectangle).

US 10 years minus US 3 years Benchmark Bond Yield

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

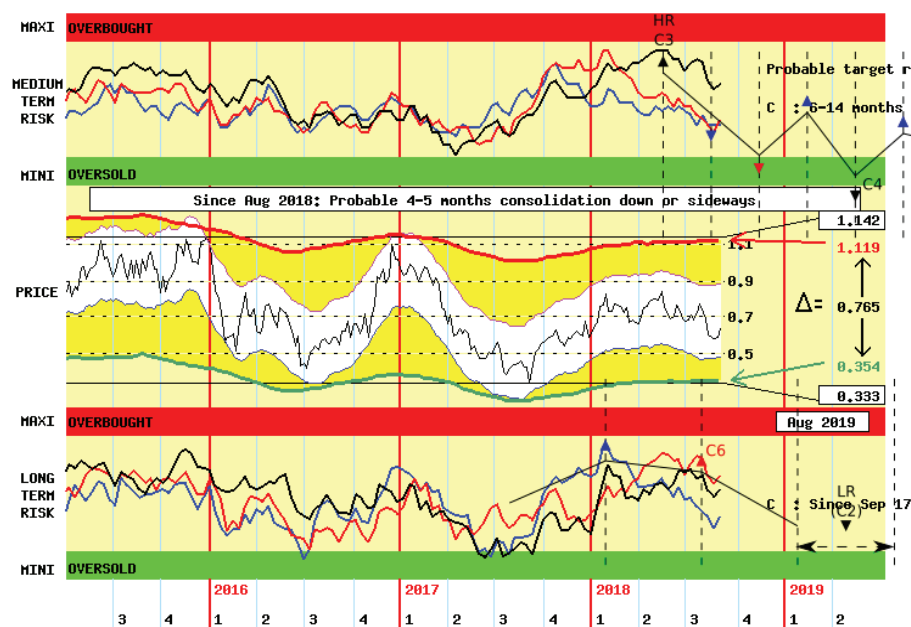


In general, we see little upside potential left on both US10Y and US3Y tenures, if any, and we expect them to start correcting down soon, probably towards Spring next year. This is an important trend reversal to the downside for US Treasury yields, while the FED is still raising rates, and it should continue to flatten the yield curve. That said, on this 10Y-3Y spread, most of the downside potential is probably behind us (I Impulsive targets to the downside; right-hand scale). It is rather the market timing perspective, which is

interesting here: both oscillator series (lower and upper rectangles) and our automatic messaging are suggesting that the US10Y-US3Y continues to flatten until December. **This, in our view, implies that, until December, the FED sticks with its current tightening course, and that the steepening risk until then is limited.**

US 3 years minus US 3 months Benchmark Bond Yields

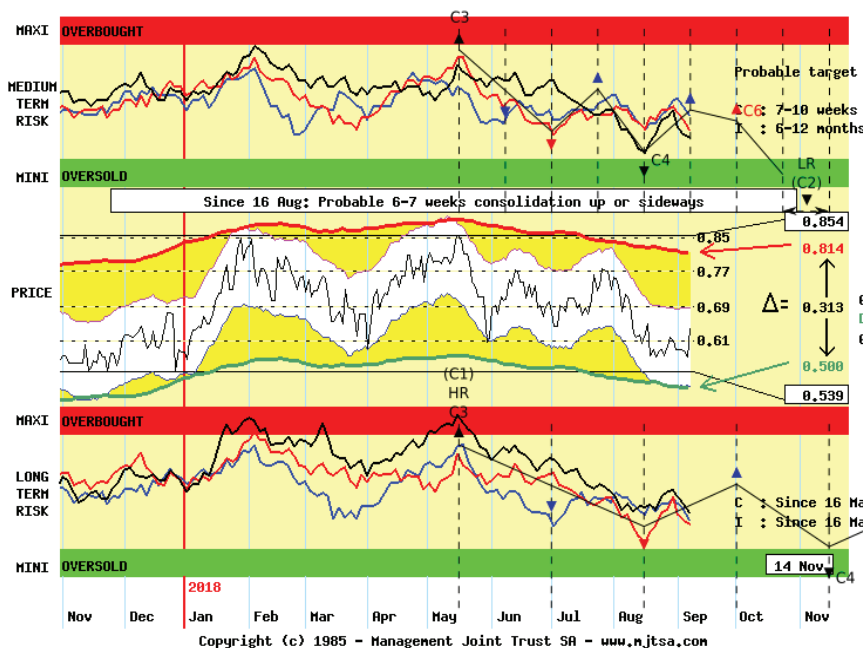
Weekly graph over the perspective next 2 to 4 quarters



The Shorter term end of the curve is in our view more interesting. Indeed, **the 3 Years minus the 3 Months Treasury spread is much more reactive to reflation/deceleration dynamics than the US10Y minus 3Y one.** For example, it shot up late last year as an increase in US Treasury issuance met with a pick-up in US Inflation and Growth expectations. The move was particularly strong as the spread steepened by 50 basis points and this despite the headwind of a 50 basis points increase in the US 3M yield (rising Fed Funds Rate).

The spread eventually saw a first top in January, just prior to the Equity market correction, and then another one in May. It has since been reversing down. **Both our oscillator series (lower and upper rectangles) are now suggesting that it could accelerate down lower, probably into Spring next year at least.** On the target front (right-hand scale), our C Corrective targets to the upside were recently achieved, and **the I Impulsive targets to the downside we can now calculate are pointing towards inversion, possibly also by Spring next year.** This is 60 basis points below current levels (1.3 to 1.7 times our historical volatility measure "Delta", here at 76.7 bps, subtracted from the late 2016 highs at 1.142, i.e. downside targets for the Spread between 0.15% and minus 0.15%). **We believe it reflects a significant deceleration in inflation dynamics and a potentially widespread flight to the Safety of US Treasuries.**

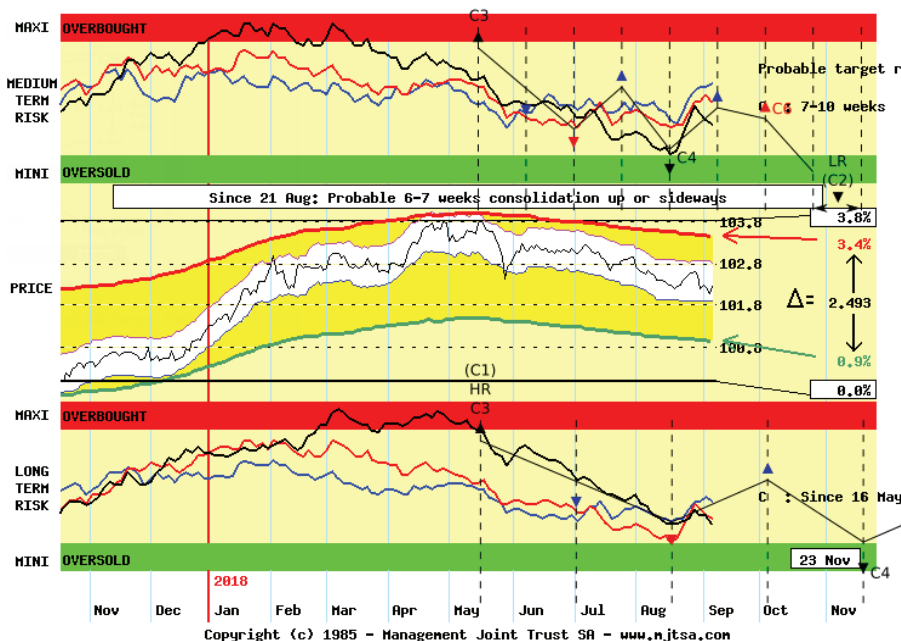
US 3 years minus US 3 months Benchmark Bond Yield Daily graph or the perspective over the next 2 to 3 months



The Daily graph of the US3Y-US3M spread is in our view very telling. Indeed, since January, it has been a great proxy for the risk-ON / risk-OFF cross asset sentiment: it shot up with inflation expectations and equity markets in January, corrected down with equities into late March, followed their strong relief rally until mid May (marginal new highs), corrected down with the Italian political Crisis, saw another relief rally early June, before it retested lower late June as the Chinese devaluation started to accelerate,

bounced in July with Emerging markets and cyclical assets, and followed their renewed sell-off into mid August. **It is currently attempting to bounce again** and according to both our oscillator series (lower and upper rectangles) **could hold up until late September, before it resumes lower into October and then towards mid November.** Our downside targets (right-hand scale) suggest that once it breaks below 0.6%, the spread could then move lower towards the 0.4 – 0.3% range. **This would probably reflect a strong risk-OFF shift, possibly between late September and November, and imply strong flows to the Safety of the very liquid 2 to 5Y US Treasury market.**

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

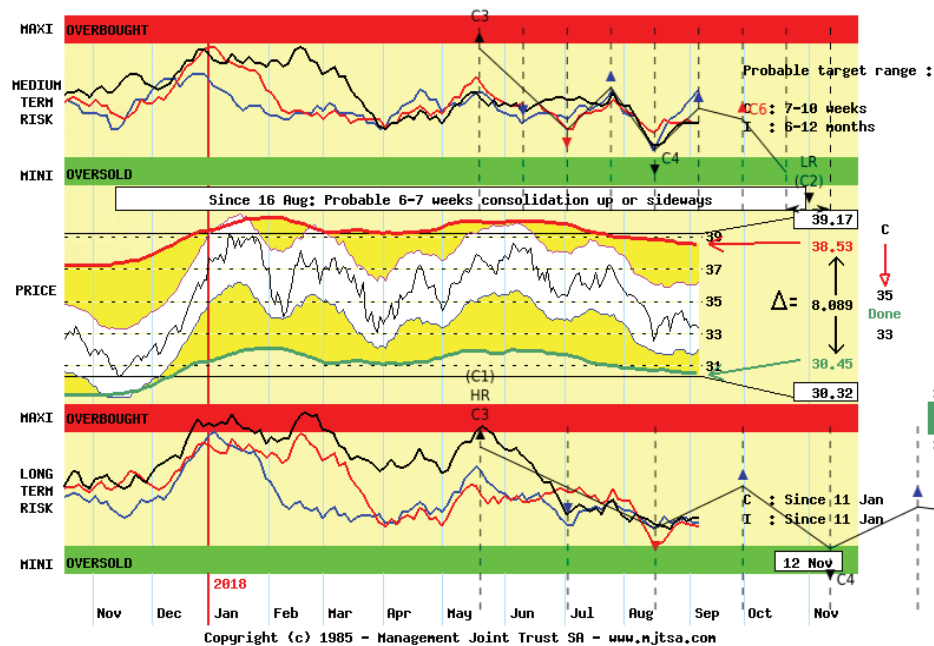


Not surprisingly, changes in inflation expectations, which we measure here using the TIP to Treasuries break-even ratio, are telling a similar story. Indeed, on both our oscillator series (lower and upper rectangles), they are attempting to bounce from the intermediate bottoms we identify mid August. **The rebound is quite weak, yet could hold up until late September, before the TIP/Treasury ratio resumes lower into mid/late November.** Here also, if we break through our C Corrective targets to the downside

(right-hand scale), the ratio could see a rapid sell-off.

XME - SPDR S&P Metals & Mining ETF

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

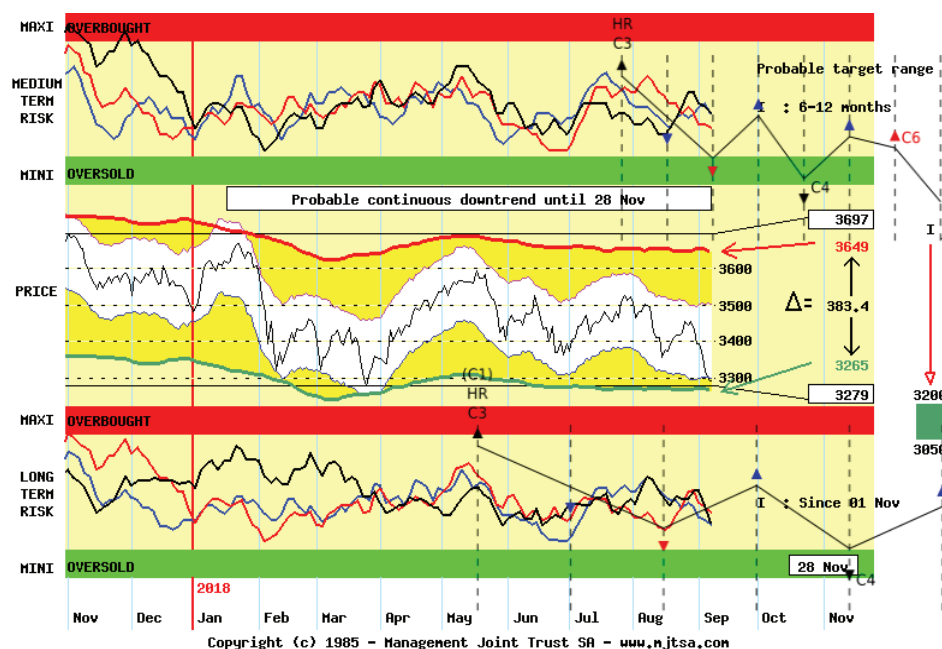


Searching for “Analogues” (other asset which currently show similar profiles), we can find quite a few. For example, our oscillator sequences on the US Diversified Mining sector are very similar (lower and upper rectangles). Also here, we expect the sector to hold up (if even) during September, before it moves down again between late September and mid November. Prices have found support on our C Corrective targets to the downside (right-hand scale), yet once these break, our I

Impulsive potential to the downside is compelling, probably between minus 13% and 25% over the coming months.

DJ Euro Stoxx 50

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



European Equity markets show a similar pattern, yet even weaker. Indeed, last week, the EuroStoxx 50 broke below its August lows. Going forward, a slight bounce may materialize over the next couple of weeks (medium term oscillators; upper rectangle), yet, on both our oscillator series (lower and upper rectangles), we then expect the EuroStoxx 50 to probably sell-off again, from late September at the latest, into mid/late November. Our I impulsive targets to the downside (right-hand scale)

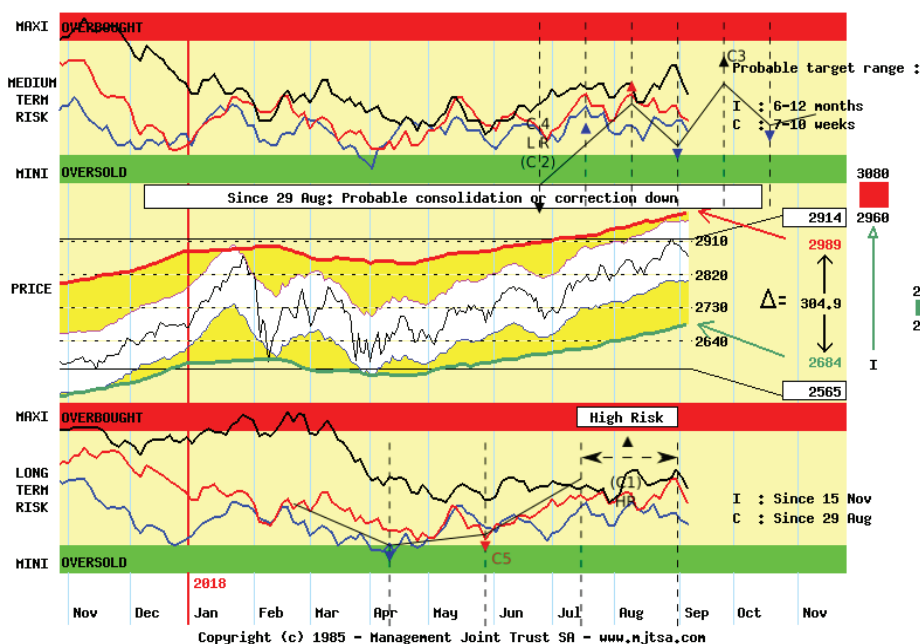
would suggest between 3 and 8% of downside potential into November.

Initial remarks:

Both the examples above (US Diversified Mining and the EuroStoxx50) are interesting as they seem to be caught cross-currents between stronger US equity markets and Emerging markets, which have sold off aggressively over the last 6 months. Indeed, US Diversified Mining is a US sector with a strong sensitivity to Chinese demand, while Europe is a developed market with increasing Sovereign risks on its Southern and Eastern borders. We believe most developed markets ex the US show similar “median” features. Their current price patterns are also quite similar to the US3Y-US3M Treasury spread mentioned throughout this article. They may follow its potential breakdown into late Fall.

S&P 500 Index

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



We now review the two ends of the spectrum.

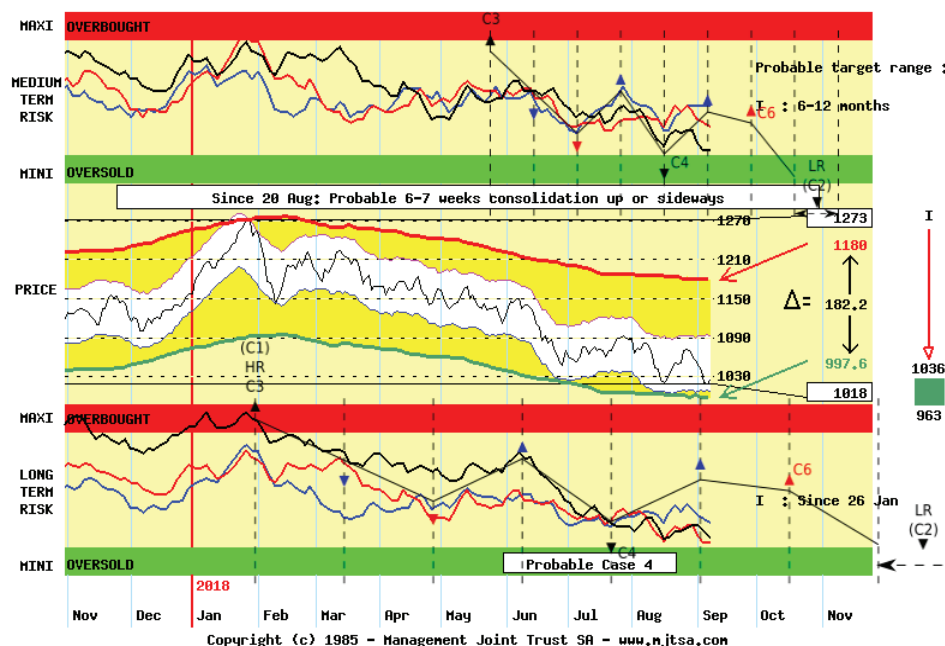
We will start with the S&P500 Index.

For now, it is still uptrending with a risk/reward which is rather neutral (3 to 7% Impulsive upside potential, vs 4 to 7% C Corrective downside potential). Yet, our long term oscillators have now reached a "High Risk" zone (lower rectangle) and such situations usually trigger 2 to 3 months of downside correction at least. On our medium term oscillators (upper rectangle), the uptrend may still push up slightly higher into late September. Yet, the time

frame seems too short to consider a strong upside melt-up. Hence, **we are now turning very prudent on the S&P500. It may hold up until late September, but will probably join other markets to the downside from October into mid/late November. The first support levels are probably somewhere below 2'700.**

MSCI Emerging Markets Index

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

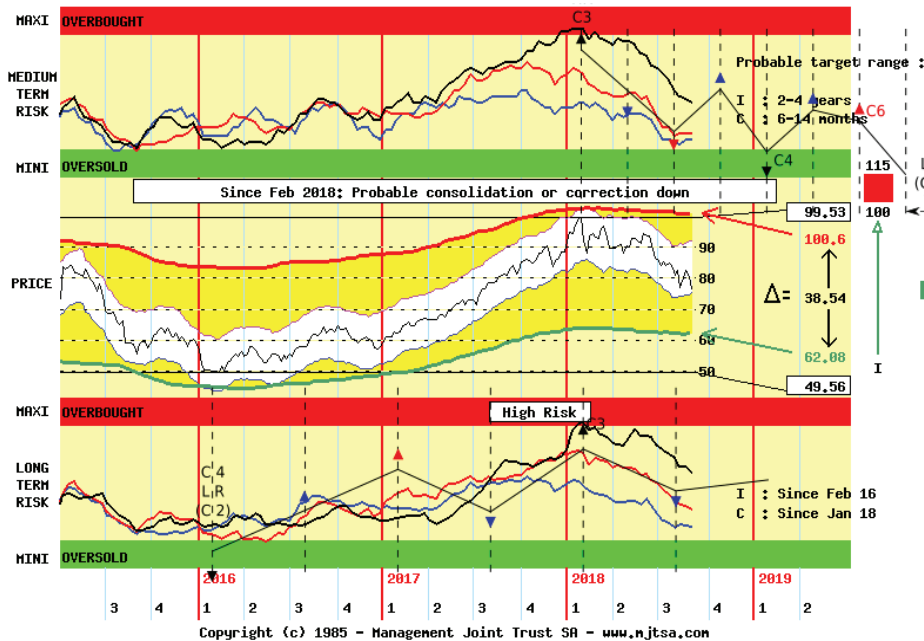


On the other hand, the sell-off in Emerging Markets is looking more and more like a liquidation (minus 20% since January). Indeed, the July and late August bounces were rapidly retraced, and going forward, on both our oscillators series (lower and upper rectangles), we expect **that the succession of weak bounces and rapid liquidations probably continues towards November/December at least. Shorter term, a new rebound is possible on our medium term oscillators (upper rectangle), yet we don't expect it**

to last much longer than a couple of weeks. On the target front, our I Impulsive targets to the downside (right-hand scale) show up to 7% of further downside potential. Our Weekly graph (not shown here) may be suggesting much more into next Spring, especially if prices start moving below 940. Given the arguments above, **we remain very prudent on Emerging Markets. We expect them to resume lower again at some point between now and late September, potentially towards November in first instance.**

MSCI China

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

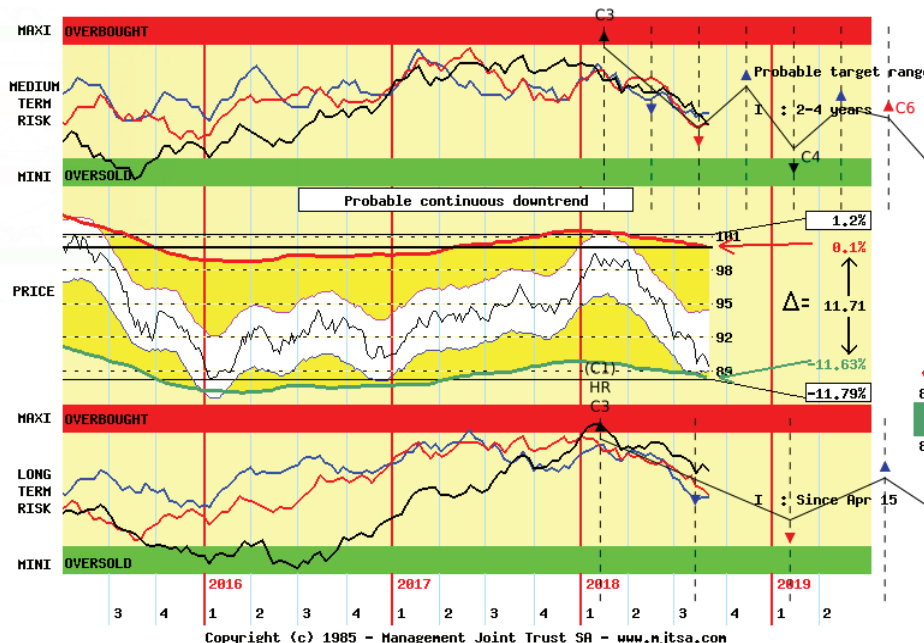


China accounts for more than 30 % of the MSCI Emerging Markets Index. Since June and the acceleration of the Yuan's devaluation, it has been weighing on the index, underperforming it by more than 10 %. Apart from Turkey, Russia, South Africa or Argentina, which are much smaller (even when combined), it is the main driver in the current Emerging Markets rout. Since January, the MSCI China Index has lost almost 25 % of its value. On our long term oscillators (lower rectangle), the uptrend sequence from early

2016 was effectively completed in early Q1 this year. The « High Risk » top, which was then identified, usually triggers at 6 to 12 months of consolidation to the downside, more if the downtrend turns impulsive (then 2 years of downtrend at least). In the current sell-off, the 6 months mark is already behind us, and we now expect China to correct down until early next year at least. Once/if prices break down below our C Corrective targets to the downside into impulsive territory (below 69 ; right-hand scale), the downtrend should then extend lower into late 2019/2020. Shorter term, our medium term oscillators (upper rectangle) could justify a slight bounce until late Q3 / early Q4, and then the downtrend resumes into year-end and early 2019 in first instance.

EM Currencies portfolio vs the US Dollar

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

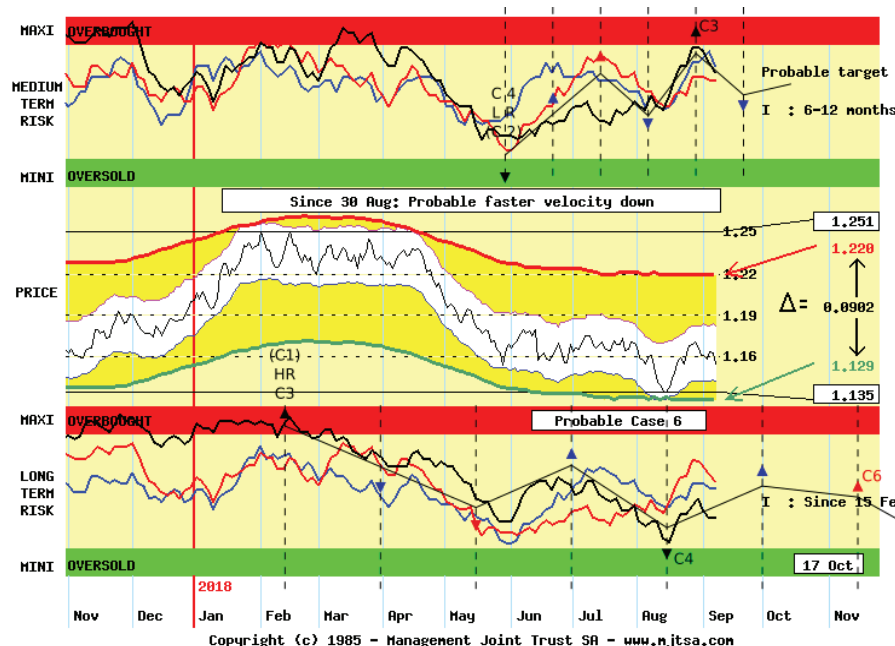


The current Emerging Markets sell-off is also a currency crisis. Indeed, it appears that high levels of Dollar denominated debt in emerging markets, coupled with expansionary monetary and fiscal policies, have recently collided with the FED's more restrictive monetary policies. The ongoing Trade War with China has added more negative pressure. These dynamics have created a negative feedback loops for Emerging Markets and their currencies. We hereby consider a weighted portfolio of the currencies of the Top 8 countries in the MSCI

Emerging Markets Index (China, South Korea, Taiwan, India, Brazil, South Africa, Russia and Mexico). Together, they account for 85% of the index. Similarly to the MSCI China or more generally to Emerging Markets, our oscillators series (lower and upper rectangles) suggest that the sell-off is still ongoing, probably into early 2019 at least. The damage in terms of prices is even greater than on Emerging Markets equities. Indeed, this portfolio has already broken below its C Corrective targets to the downside (not shown here anymore) and is now eyeing 10% more downside potential into next Q1 2019, in addition to the 12% it has already lost since January. The current leg down in Emerging Markets may be only half way through.

EUR/USD

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

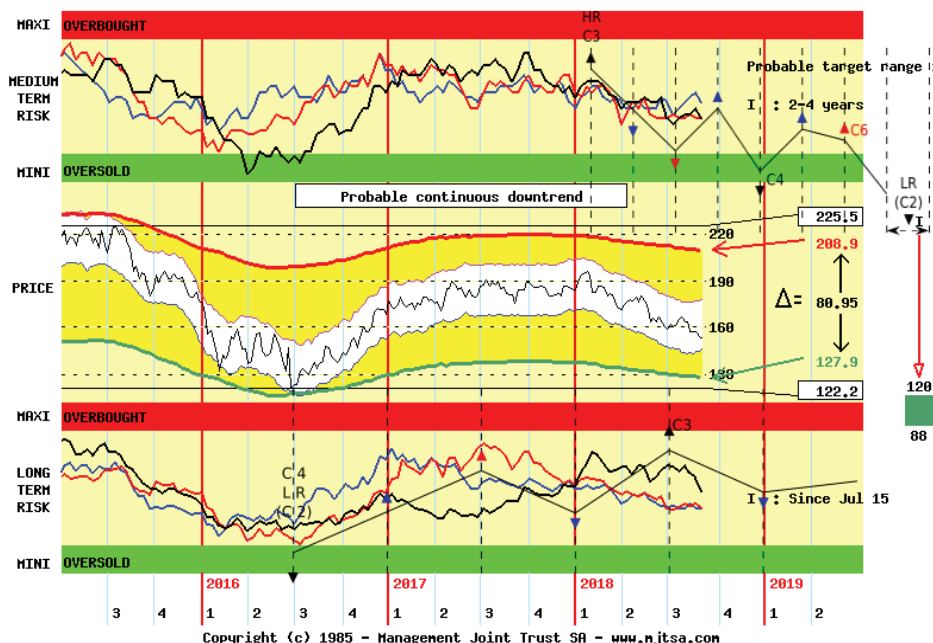


We now turn to EUR/USD, for a view of the US Dollar against the Majors. Here also, the Euro's retracement vs the US Dollar is looking more and more like a liquidation: its bounce since mid August is already retracing, our medium oscillators (upper rectangle) are already overbought again, and our long term oscillators (lower rectangle) suggest further downside pressure from late September, at the latest, and into November, at the least. Our Impulsive targets to the downside (right-hand scale) are also pointing lower, towards the 1.13 to 1.10 range over the next couple of months. These weak EUR/USD perspectives seem to match the weaker ones we expect on the EuroStoxx 50 mentioned

above, and could imply that Europe may be first in line to suffer from any contagion from the ongoing crisis in Emerging Markets.

Europe Stoxx 600 – Banking sector

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



The European banking sector probably crystallizes these fears. For example, and in addition to ongoing problems in the European banking sector, Spanish banks have an EUR 80 billion exposure to Turkey, French Banks EUR 35 billion or Italian bank almost EUR 19 billion. A default of Turkey for example could be a nasty trigger for a more widespread European banking crisis, which would probably spill over into the wider economy. Our Weekly graph of the European banking sector is now back in a downtrend, our Impulsive targets to the downside are scary (25 to 45% below current levels), and both oscillators series (lower and upper rectangles) suggest that from late Q3, the trend may continue

lower again until at least year-end. Our view is that contagion leads to further contagion, and that if the debt default dominoes start to fall, the feedback loops will be negative for other Emerging Markets, for Developed markets and eventually for the US.

Concluding remarks

US Growth and Inflation perspectives remain strong, yet since May, the uptrend on US Treasury yields has stalled. This is quite peculiar, especially on the short end of the US yield curve, as until quite recently 2 to 5Y tenures were rising faster than Fed Fund rates. Indeed, since May, following a strong push up from late last year, the short term end of the US yield curve (3Y minus 3M) has started to flatten. We believe this initially reflects increasing Flight to Safety to the US Treasury market as investors start to exit Emerging Markets. In a way, this may spell the first stages of Contagion. Today, many risk assets show a similar profile as the flattening US3Y minus 3M spread, and in particular European markets. Our models suggests that these, along with the spread, could resume lower again, probably from late September at the latest and into November. US markets may then follow as their uptrends now seem exhausted. Going forward, following a bounce towards year-end, we expect further weakness on these assets into the Spring. Depending on the damage done, deleveraging may then spread to most asset classes and geographies.

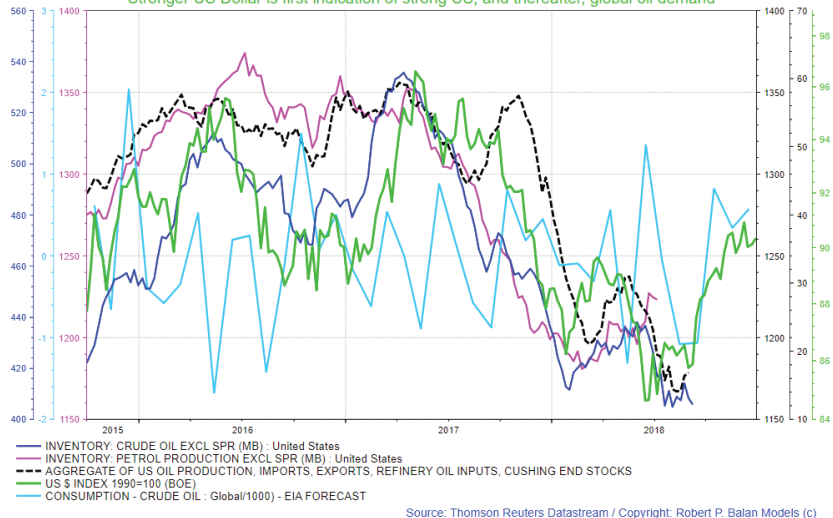
24 / The signalling effect of oil inventories suggests further support for crude oil and E&P into late summer early autumn

The American Petroleum Institute and Energy Information Administration data on crude oil inventories in the United States weekly reports last week were deemed by media and pundits as supportive of the price of crude oil. The API said that stocks rose by only 38,000 barrels for the week ending on August 24 while the EIA reported a 2.6 million barrel decline in inventories. The API reported small increases in product stocks as of August 24 as gasoline and heating oil rose by 21,000 and 982,000 barrels respectively. In terms of products, the EIA report was considered more bullish by the media with declines of 1.6 million barrels in gasoline stocks and 800,000 barrels of distillate inventories.

U.S. crude oil production is at the 11 million barrel per day level, deemed high by pundits, but the lack of sufficient pipeline networks in regions like the Permian basin and other areas has prevented stocks from exploding. At the same time, demand for gasoline and distillate products because of buoyant economic conditions has supported the price of the energy commodity, and refineries work overtime to keep pace with demand. Energy prices generally rose after those reports.

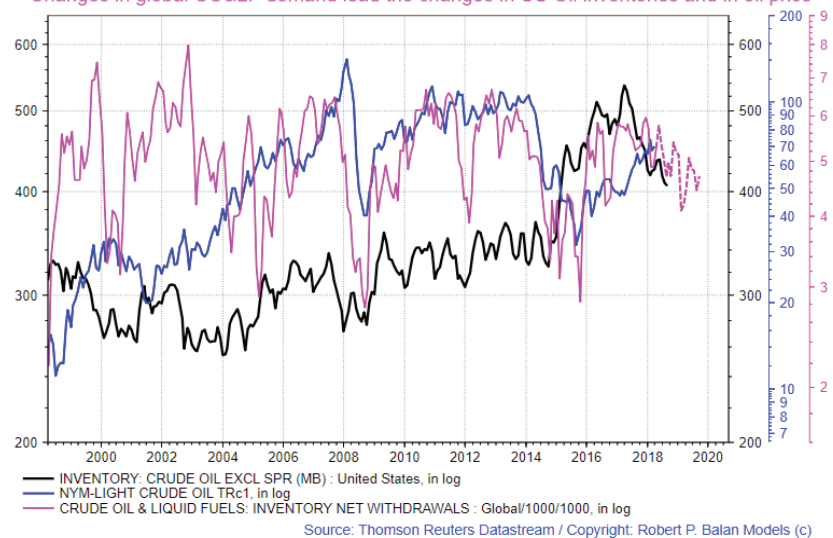
This narrative has conflated the demand for gasoline and distillate products with the lower inventories AND the corresponding rise in crude oil prices. What this bullish narrative did not, and cannot, explain is the fact that the reports also said petroleum inventory has been at the highest since November 2017 (red line in the 1st chart on this page). The pundits have been very selective in picking the rational of their bullish argument (see 1st graph on this page). The primary thrust of their arguments is that lower crude and product inventories (the inverse of higher supplies) should not negatively impact the oil price discovery process. However, why wouldn't higher petroleum inventories have the

US petroleum inventories' deep links to USD, oil imports, exports, global demand
Oil and petroleum inventories build (after a lag) as global oil demand and consumption expands
Stronger US Dollar is first indication of strong US, and thereafter, global oil demand



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

Global CO&LF inventory withdrawals, US oil inventories, Crude oil price
Changes in global CO&LF demand lead the changes in US oil inventories and in oil price



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

opposite impact? Why is this data being ignored as an important element in setting the price of oil?

It pays to go through the data which impact US oil inventories. The US Dollar plays an important role in the draws and builds; moreover, the US Dollar's lead is spectacular. The EIA's consumption forecast is not bad at all. Total petroleum inventories lag the Oil inventories by about 8 weeks (we don't know why -- perhaps reporting issues). Therefore, you can use the Oil inventories to forecast total petroleum inventories (which is unusual). After about a week or so from now, you will have a curious situation where US oil inventories will be rising, and total petroleum inventories will be falling (see 1st graph on this page).

The oil trading universe considers lower inventories (in crude and products) as one prerequisite for rising prices. And builds in inventories are to be shunned, as these are considered harbingers of lower oil prices. But are these suppositions correct?

You should not fear the build in petroleum and oil inventories. The build of inventories is a natural consequence of improving demand for oil crude oil and products. It is inventories being stockpiled in anticipation of near-term consumption. Crude oil cannot be a just-in-time inventory material -- you need some lead time before it is available for consumption. So that is what happens -- demand and consumption increase; inventories

build in anticipation of the bonanza. We can actually show that inventories build at the heels of higher demand and consumption (see 2nd chart on previous page). **Note also that crude oil prices have a general tendency to follow changes in CO&LF demand trends.**

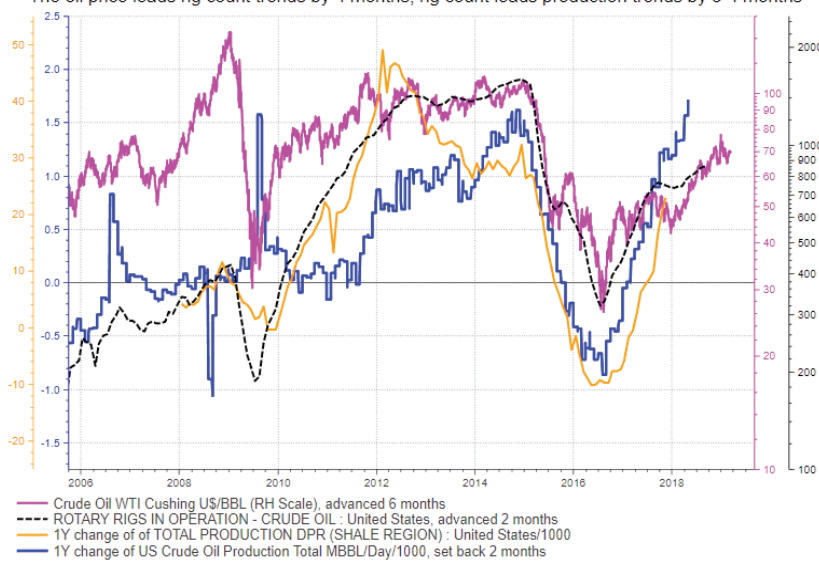
Think about it (think like a businessman): who would stockpile inventories (in anything) if there is no existing (and improving) demand or consumption trends? Inventories are not residuals of supply less consumption. Supply from production is a function of oil rigs; and the oil rig count is in turn a function of the oil price. Higher oil price begets a higher oil rig count after 6 months, and more oil rigs in turn produces more oil 2 months after the change in oil rig count. Look at it this way, changes in oil production substantially lag behind changes in inventories. There cannot be a link direct between changes in inventories and production, except on lagged, cumulative basis (see 1st graph on this page).

That oil inventories are residuals of supply less consumption is a common misconception of economists which fails Econ 101. No right-thinking business person will order crude oil (in large quantities) if there is no demand for it (with the exception of the arbitrageurs).

The build in inventories is healthy sign. **Moreover, the builds lag actual demand and consumption trends and therefore are not really part of the oil discovery process.** They may affect sentiment, but its impact disappears after a day or two. In fact, that is what actually happened two weeks ago when petroleum inventory soared, and oil prices fell by more than 2%. However, the memory of one of the largest builds in petroleum inventories seen in several months was quickly forgotten after two days, as the impact of rising global oil consumption seeped into market data and oil prices started the run that we are seeing at present

Temporal Order: Oil Price, US Rig Count, US Shale & US Total Production

The oil price leads rig count trends by 4 months; rig count leads production trends by 3-4 months



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

GASOLINE, OIL DEMAND TRACKERS vs WTI Spread (CL1-CL3), CLC1



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

(see 2nd chart on this page). **The message: do not fear inventories; they can also be signs of good times.**

Since we understand that inventories lag so far behind consumption and demand data that it is difficult to accept them as prime movers of oil. What can we use it for (to justify all the trouble that we go into understanding its genesis), and how does it really impact the price discovery process for oil prices and E&P equities?

The simple answer: oil inventories is the hard (but lagged) data for oil consumption. We know that inventories as temporally displaced consumption. We know the average lag between the two variables. We then set out to prove if the two variables have similar mathematical identities, so we

can use them both to arrive at a future trajectory of oil prices.

The first step: if we push the inventory data ahead, we can synch the two variables. If they match (and they do) then we know that inventories are real representation of consumption.

Consumption (and expectations of demand; e.g., forward demand) is what really drives oil and E&P prices. We explained earlier that this forward demand can (and does) promote inventory holding, which in turn can help raise price levels. There is a looped (feed-backed) relationship between inventories and oil price because rising oil prices also encourages inventory building. Technically expressed: stocks will increase if forward prices exceed

current spot prices by enough to cover storage. Moreover, strong demand for crude in the future relative to contemporaneous demand can also sustain high prices or cause prices to rise even if current inventories are plentiful.

Put simply, the propensity to build inventories, and thus the energy sector's capacity to satisfy unexpected demand, is set in large part by expectation of future demand and the current price (term) structure of crude oil.

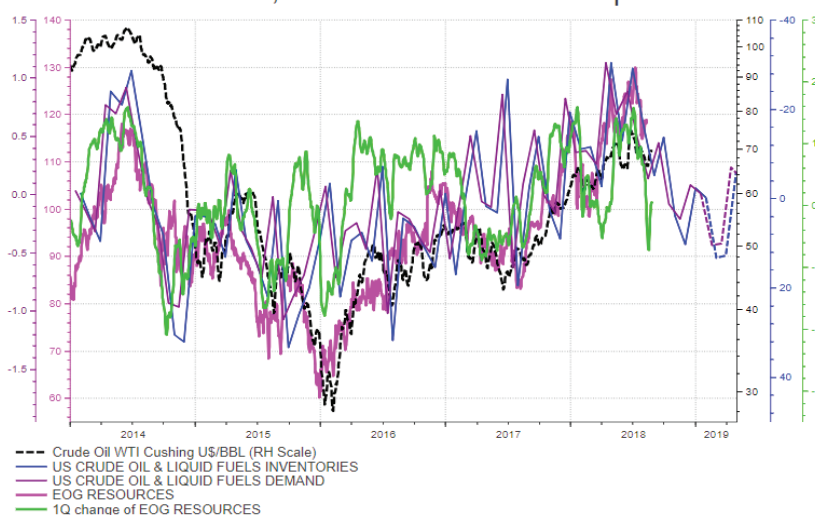
Finally, we then take the final step. We extend the two synched variables by Vector Autoregression (VAR); if the results show that the projected results are still consistent with each other, then we know we have a valid forecast construct in our hands. And that is what happens in this case (see 1st graph on this page):

Oil prices and E&Ps, according to this construct, will be rising until this autumn, then fall precipitously into late Q4 2018. This is entirely consistent with the implications of the oil demand tracker model vs WTI Oil prices. Two different approaches, two different modelling works, one unified conclusion. It cannot get better than that. Better still, we have shown that utilized properly, oil inventories can be useful despite their significant time lag to actual demand.

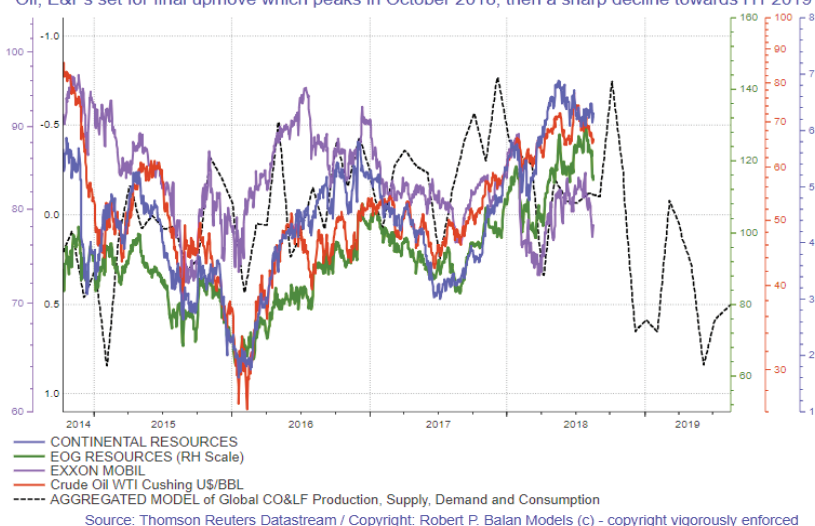
What happens when we put all the elements that typically go into conventional oil price trajectory analysis? Taking the aggregate of global CO&LF production, supply, demand and consumption yields results which are then extended by VAR analysis. **The results are hardly surprising -- they bear very high resemblance to the structure that was produced by the demand cum inventory process.** (See 2nd chart on this page)

Not surprisingly, the route taken by oil prices and E&P equity prices resemble the liquidity flow changes of the global central banks' balance sheets (see 3rd chart above). This is

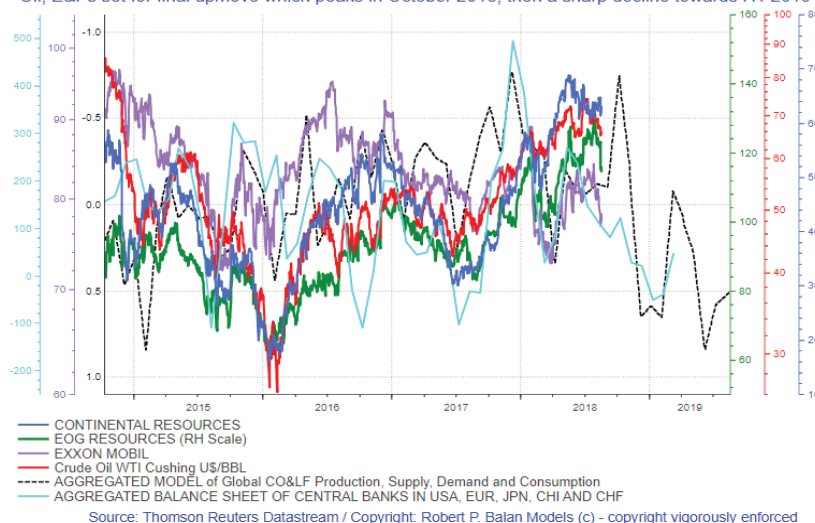
US oil inventories, demand models vs WTI price vs EOG



Aggregate model of global CO&LF production, supply, demand and consumption Oil, E&Ps set for final upmove which peaks in October 2018, then a sharp decline towards H1 2019



Aggregate model of global CO&LF production, supply, demand and consumption Oil, E&Ps set for final upmove which peaks in October 2018, then a sharp decline towards H1 2019



the macro equivalent of the impact the Fed's and Treasury's liquidity flows have on equities, and indeed commodities, on a day-to-day, week-to-week, basis. That is also the reason why crude oil demand forecasts, properly done, are indicative of where economic growth will likely go, as we discussed before in earlier editions of

Capital Observer. This makes sense, as economic growth is, by first principles, the driver of equity and commodity prices. To us, this lends credibility to the route for oil prices and E&P equities projected by the aggregated value of CO&LF production, supply, demand and consumption (see 3rd graph above).

Summary:

There is no single factor which will explain oil prices. The oil market is an economic system where changes in one element almost always affect all the other elements. Unfortunately, the system has no starting or ending point. Rather, it is better described as a circle or an ellipsoid.

There would seem to be no reason for crude prices to rise in a world where crude is plentiful; under normal conditions, the supply of crude can almost be a given if there are no geopolitical events which prevent producers to ship or transport it. The capacity to turn crude into products is, however, limited -- by definition -- and by comparison to the relative ease in producing oil supplies.

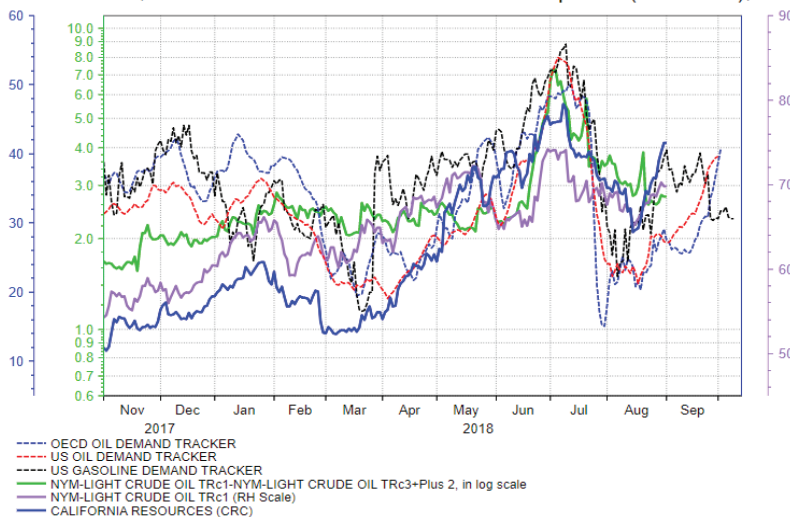
This constraint works with demand to produce most of the high frequency changes in oil prices. When we speak of demand, we speak of demand for products. Consumers do not use crude oil -- they consume oil products. But those relationships are governed by feedbacks, giving rise to the ellipsoid characteristics of the oil price discovery process.

A boost (decline) in crude supply can depress (raise) product prices, just as a drop (rise) in product demand will usually lower (boost) product and crude prices.

At times, crude prices lead product prices. At other times, product prices lead crude prices. Nonetheless, it is clear to us: **changes in spot product prices due to changes in product demand generally leads to changes in oil prices (and E&P equity prices). We came to this conclusion by modelling the relationship between the change in product prices and the change in crude values.** We will articulate this hypothesis in our next oil-related article at the Capital Observer.

The demand trackers, are good forecasters of future oil and E&P prices (see chart below). In fact, some

GASOLINE, OIL DEMAND TRACKERS vs WTI Spread (CL1-CL3), CLc1



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

Positive correlation (and lead) of the US Dollar with US Refiners' equities

A strong US Dollar improves export profits of US major refiners; hence rising USD is positive for refiners



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

E&P equities lag behind the evolution of gasoline and oil prices by 7 trading days (XOM) so that you can use both the demand trackers AND oil prices to forecast changes in those E&P equities. Implication from the data: the possibility for a run up into early autumn before more challenging time.

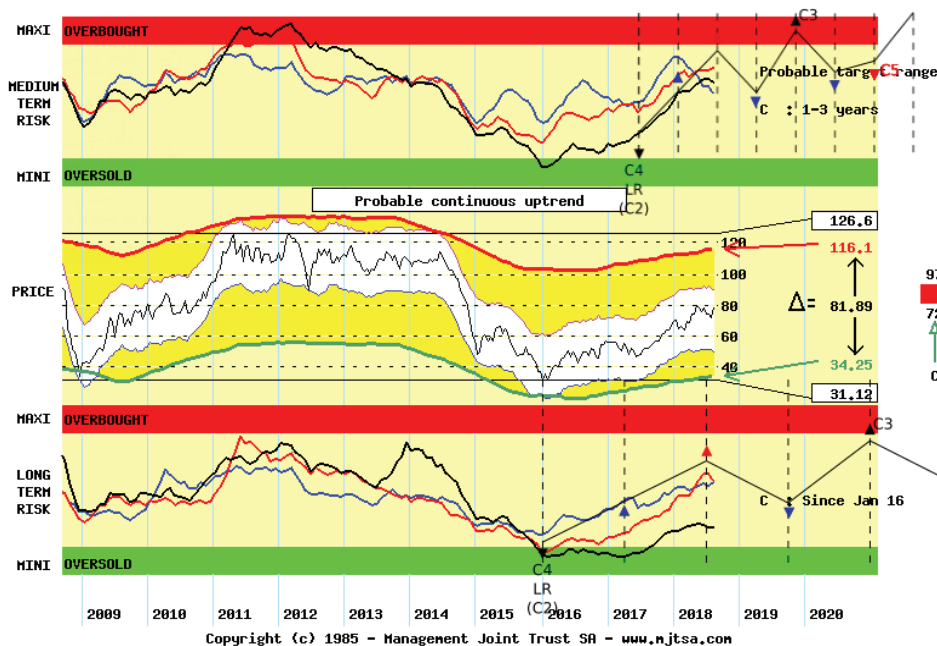
28 / MJT - TIMING AND TACTICAL INSIGHT

Last upside retest for Oil, before it follows other risk assets lower

Over the last few months, the uptrend on Oil has stalled. Brent topped out back in May, while WTI made a new high in early July. While both have been consolidating down since, they are currently attempting to retest these highs. At this stage, it seems rather late in the cycle to consider a strong break-out. In this article, we consider the possibility that an important top on Oil may be just a few weeks away as well as the consequences this would have on the Energy sectors in the US and in Europe.

Brent Oil (USD/barrel)

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

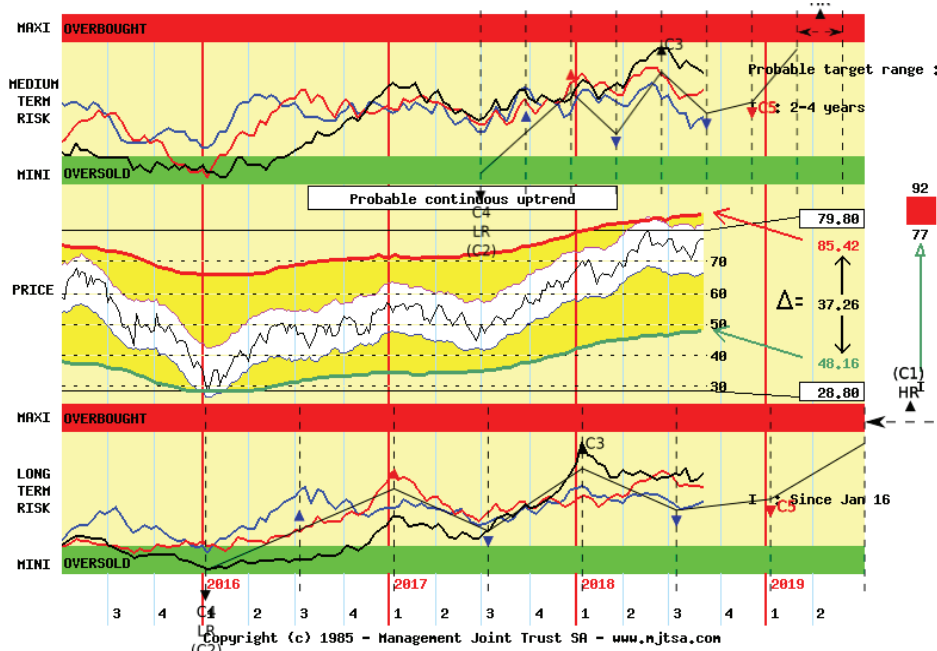


Since early 2016, Oil has been the bell-weather of the reflation trade. It bounced with it in early 2016, then retraced down during H1 2017, and finally, from last Summer, accelerated up again into this Spring. On both our oscillator series (lower and upper rectangles), we expect it to top out soon, initiating a correction that could last between 3 to 5 quarters. During its move up since early 2016, Oil never managed to break above our C Corrective targets to the upside (above 97; right-hand scale). Hence, theoretically, longer term, this uptrend is still in the early and fragile stages (i.e. theoretically the move up since

2016 must still be labeled as an upside correction, not a strong secular uptrend). In such situations, retracements can be quite bloody. They often retrace most of the previous bounce. We would hence recommend to take profit on Oil and Oil trades over the next few weeks as the following months/quarters may provide a strong reality check.

Brent Oil (USD/barrel)

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

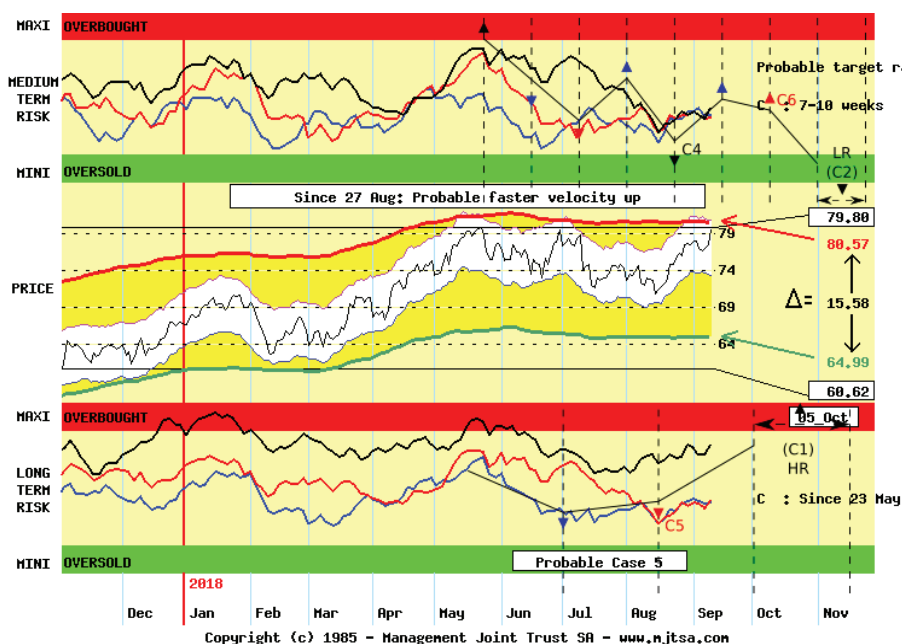


The Weekly graph of Oil is more promising at it shows a strong uptrend since early 2016. Yet on both oscillator series (lower and upper rectangles), it may still top out soon and enter a consolidation phase to the downside that could last until late this year / early next year. Impulsive targets to the upside (right-hand scale) have been achieved in the 77 to 92 USD/barrel range. They may attempt new highs over the next few weeks, yet we believe the time left to fulfill the upper end of this range (towards 92) is too short. We would rather favor a weak upside retest, around 80 USD/barrel and then a correction down into year-

end / early 2019. The C Corrective targets to the downside we can calculate for this correction based on our historical volatility measure "Delta" (here at 37.26 USD/barrel; middle rectangle, right-hand side) are between 61 and 50 USD/barrel (i.e. 0.5 to 0.8 times our "Delta" subtracted from the 79.8 top in May).

Brent Oil (USD/barrel)

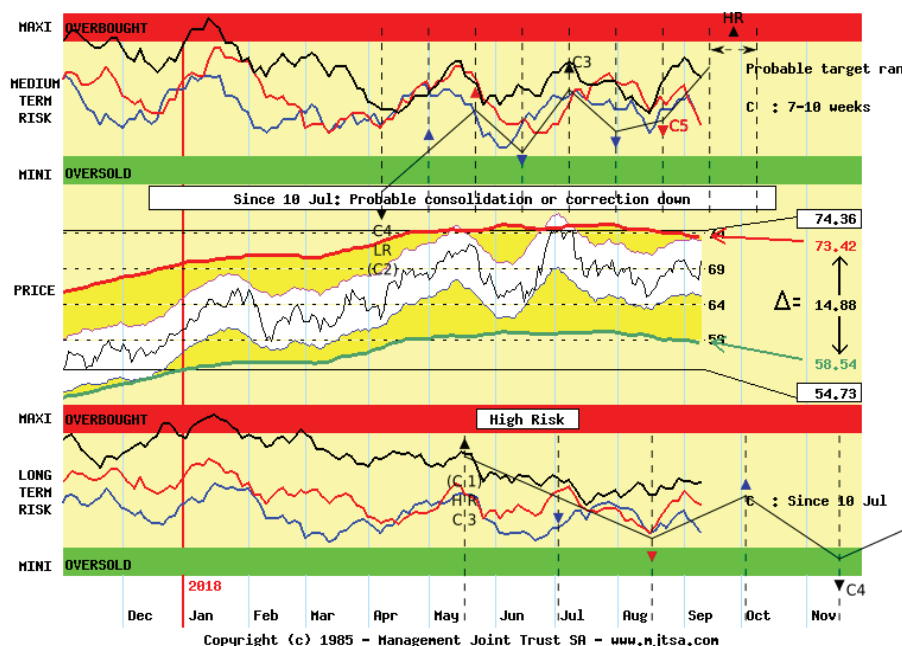
Daily graph or the perspective over the next 2 to 3 months



The Daily graph of Brent is quite similar to many other Daily risk assets graphs in this report: it topped out in May, found support mid August and is now attempting to bounce. To be fair, Brent is slightly stronger than these profiles, as it may make marginal new highs towards late September / early October as shown on our long term oscillators (lower rectangle). On our medium term oscillators (upper rectangle), we show a more conservative path, where the bounce dies out sooner and then gradually rolls over until it starts correcting down more aggressively from early October into November. Combining both, **we expect Brent to push slightly higher over the next couple of weeks before it reverses down into November. In this Autumn sell-off, first levels of support will be found in the high 60s USD/barrel** (C Corrective targets to the downside; right-hand side). **Below these, the next levels of support we can calculate is between 60 and 53 USD/barrel** (1.3 to 1.7 our historical volatility measure "Delta" - here at 15.7 USD/barrel; middle rectangle, right-hand side – subtracted from the 79.8 USD/barrel May high).

WTI Light Crude Oil (Spot)

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

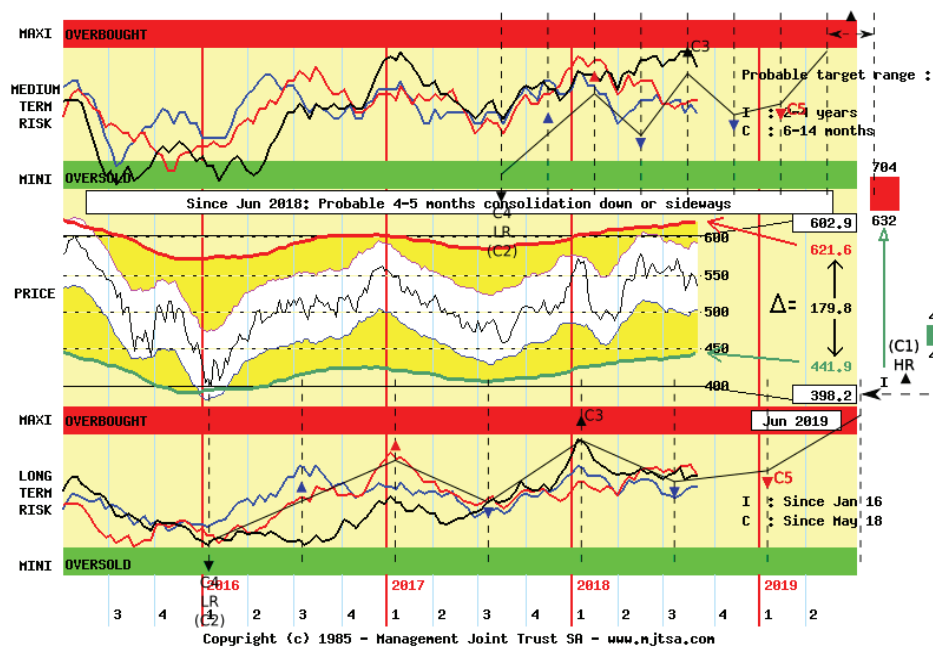


Interestingly, the pattern on WTI Light Crude Oil has been weaker since late July, when it probably topped out for this cycle. Both oscillators series (lower and upper rectangles) are still suggesting that WTI may attempt to retest up over the next couple of weeks, yet given that our trend envelopes are now descending (middle rectangle), we doubt it will manage to achieve new highs. Following that, from late September / early October, we expect it to correct to the downside, probably towards the lower end of our C Corrective targets around 62 in first instance (right-hand scale). Below this level, the next target levels we can calculate (I impulsive targets to the downside) are **towards the 55 to 49 USD/barrel range** (i.e. 1.3 to 1.7 times our historical volatility measure "Delta" - here at 15.01; middle rectangle, right-hand side- subtracted from the graph's highest point at 74.36). Hence, **we expect both Brent and WTI to start rolling over again between now and early October, Brent may make marginal new highs, while WTI probably won't.** This discrepancy is probably due to ongoing political tensions in the Middle East and the Persian Gulf related to the war in Syria and the US sanctions on Iran.

Below this level, the next target levels we can calculate (I impulsive targets to the downside) are **towards the 55 to 49 USD/barrel range** (i.e. 1.3 to 1.7 times our historical volatility measure "Delta" - here at 15.01; middle rectangle, right-hand side- subtracted from the graph's highest point at 74.36). Hence, **we expect both Brent and WTI to start rolling over again between now and early October, Brent may make marginal new highs, while WTI probably won't.** This discrepancy is probably due to ongoing political tensions in the Middle East and the Persian Gulf related to the war in Syria and the US sanctions on Iran.

US Energy sector – S&P

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

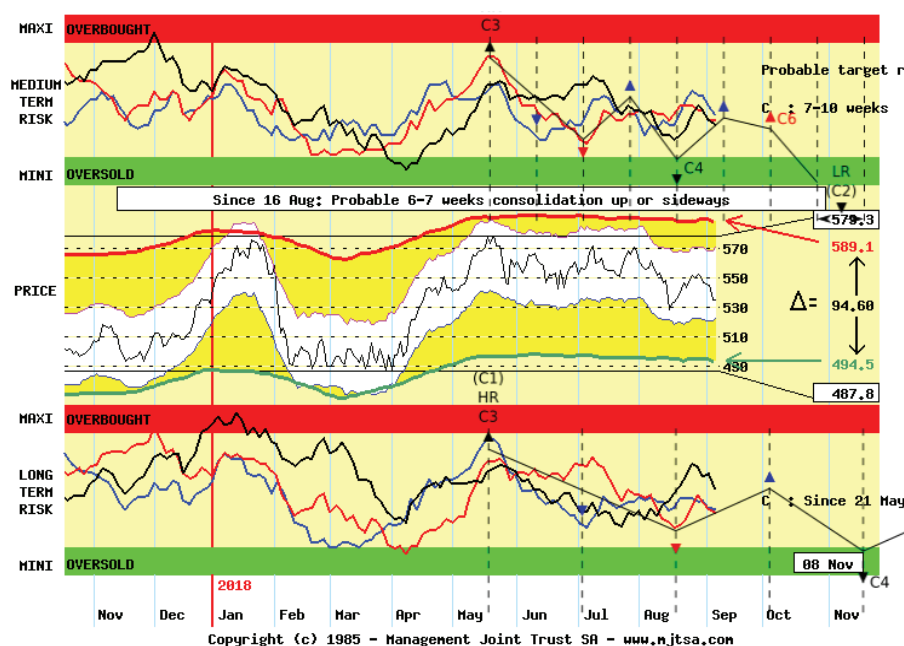


Looking at related sector and first to the US Energy sector, the intermediate tops we are expecting this late Summer may have already been achieved. Indeed, while our long term oscillators (lower rectangle) have been in a high level consolidation since January, the sequence we show on our medium term oscillators (lower rectangle) may have just confirmed an new intermediate top. We now expect the sector to correct down towards early next year at least. The C Corrective targets to the downside we can calculate

(right-hand scale) could lead us back down to the 489 – 435 range, or between 9 and 19% lower than today.

US Energy sector – S&P

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

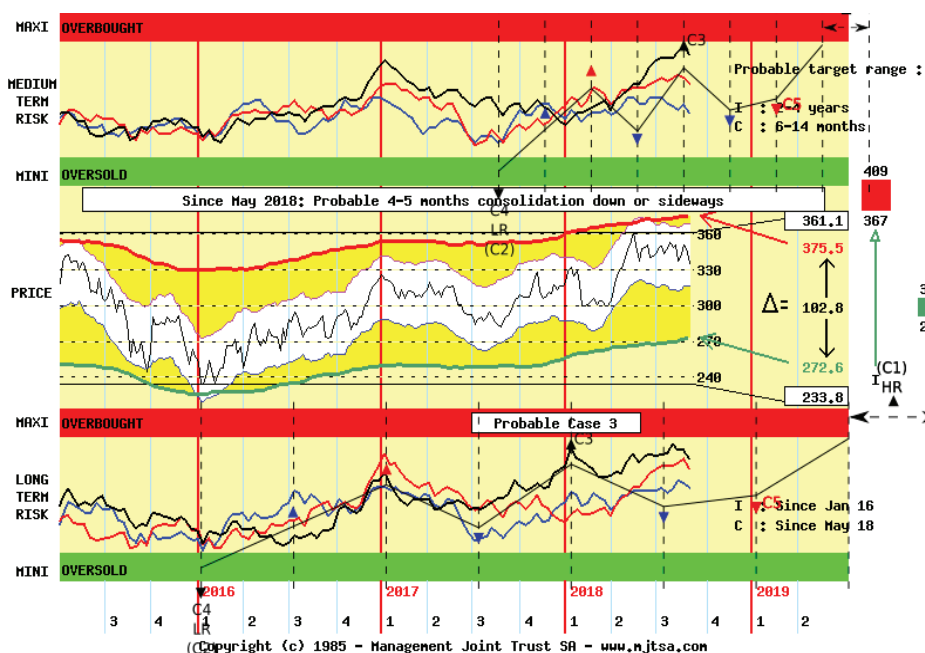


The Daily graph is also more negative that the one on Brent. It is now in a downtrend on both oscillators series (lower and upper rectangles). The bounce since mid August has been weak. It should die out between now and early October, before the sector resumes lower into November. Initially, support will be found in the low 500s (C Corrective targets down; right-hand scale). Below these, the next target levels to the downside we can calculate are between 456 and 418 (or 1.3 to 1.7 times our historical volatility measure "Delta", here

at 94.6- middle rectangle; right hand side – subtracted from the 579.3 may highs). This is 15 to 22% below current levels and pretty much in line with the C Corrective targets to the downside we are expecting on our Weekly graph.

European Energy Sector – Dow Jones Stoxx 600

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

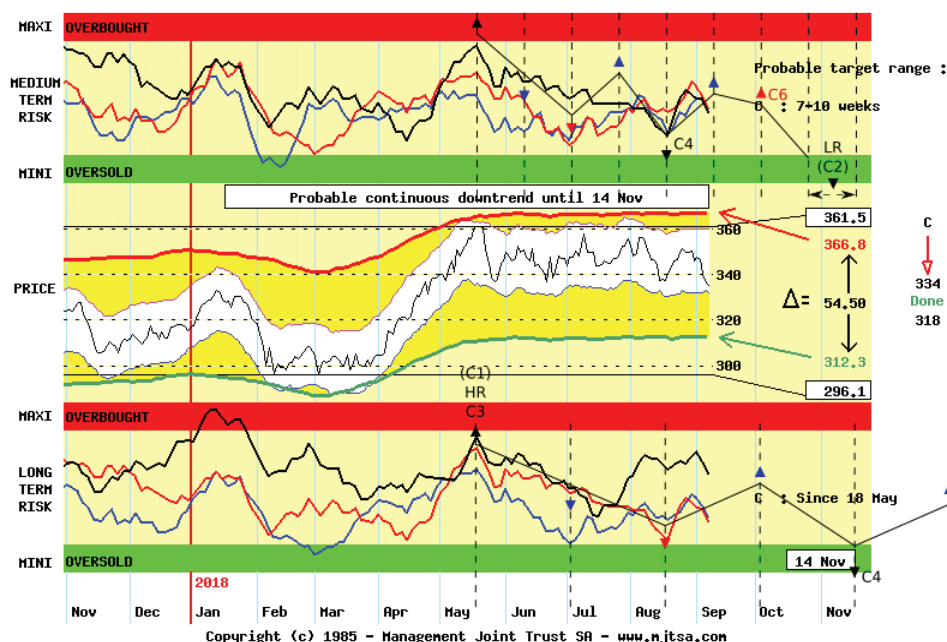


The European Energy sector has been stronger than US one throughout the reflationary recovery. Yet, it has weakened lately, and we believe it is also getting ready to retrace down into early next year at least. Our long term oscillators (lower rectangle) are still theoretically in a consolidation since January despite the higher highs that we made on the sector this Spring. Our medium term oscillators (upper rectangle) have followed this new move up and are now indicating that an new intermediate top may be approaching.

Both oscillator series (lower and upper rectangle) suggest that a correction phase may lie ahead, probably between now and early 2019. Our C Corrective targets to the downside (right-hand) suggest 8 to 17 % of retracement to the downside potential until then.

European Energy Sector – Dow Jones Stoxx 600

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

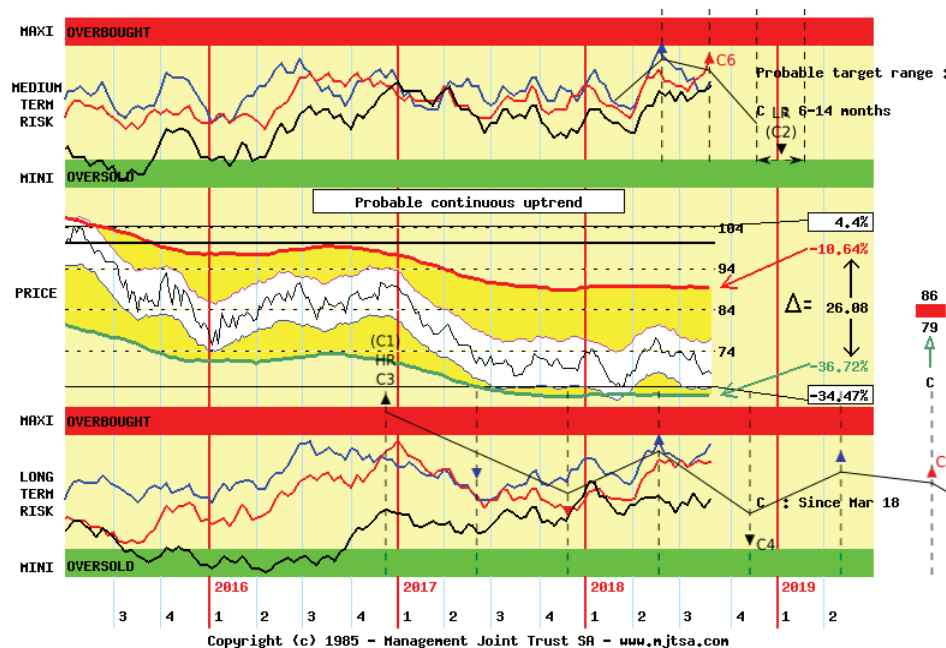


Following its impressive rally during April and early May, the European Energy sector has been consolidating since at high levels. We believe it may be getting ready to sell-off. Both our oscillators series on this Daily graph (lower and upper rectangles) suggest that the bottom mid August was probably an intermediate low, and that the European Energy sector will probably start to resume lower at some point between now and early October, probably until mid/late November. Downside targets for this move indicate a

first support point towards our C Corrective targets to the downside around 310 or circa 7% below current levels. If these levels break, which according to the projections we show on our oscillators is likely, the Impulsive targets to the downside we can calculate are into the 291 – 269 range, 13 to 20% below current levels (i.e. 1.3 to 1.7 times our historical volatility measure "Delta" here at 54.5- middle rectangle, right-hand side – subtracted from the graph's high at 361.5).

US Energy sector – S&P vs the S&P500 Index

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

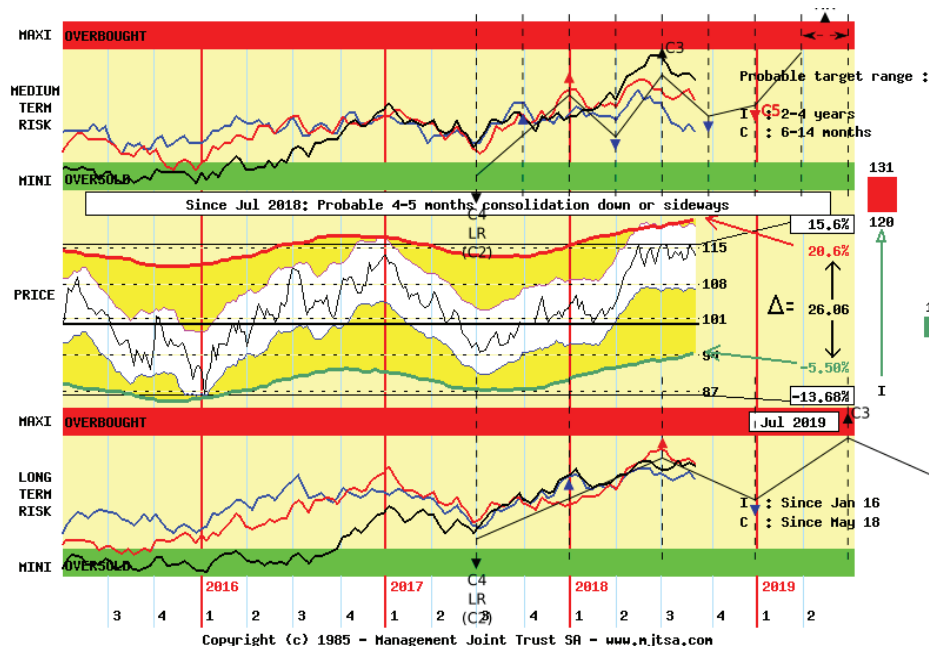


Despite the strong rise in Oil prices since early 2016, the US Energy sector has consistently under-performed the S&P500 Index. This deceiving relative performance is most likely attributed to the Value characteristic of the sector in an environment where the US Yield curve was mostly flattening. Indeed, this flattening did advantage Growth sectors such as Technology or Consumer Discretionary, while the US Energy sector was lagging behind. Going forward, both our oscillator series (lower and upper rectangles) suggest further under-performance probably until December / year-end. This projection is again quite similar to our forecast on the longer end of the US Yield curve

(10Y-3Y spread). From early next year, the sector may start to bounce vs the market and could outperform by circa 10 to 20% according to our C Corrective targets to the upside (right-hand scale), yet it probably continues to under-perform until then.

European Energy Sector – Dow Jones Stoxx 600 vs the Europe Stoxx 600 Index

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



In Europe, Value to Growth dynamics are less pronounced. In addition, over the last two years, shorter term interest rates have had less of a negative impact on cyclical sectors, as they have remained constantly in negative territory. Since 2016, the European Energy sector has hence out-performed the market, despite strong retracements during the correction phases of the reflation trade (e.g. H1 2017). Going forward, both oscillator series (lower and upper rectangles) suggest that the European Energy sector has probably reached an important intermediate top during this Summer, and than it should now enter a correction phase to the downside that could last into year-end. The C Corrective targets to

the downside we are projecting (right-hand scale) suggest that until year-end, the European Energy sector may under-perform the market by circa 10 to 20% before it starts out-performing again next year.

Concluding remarks

On our long term Bi-Monthly and Weekly graphs, Oil has probably reached an important intermediate top. The correction to the downside that follows should last at least into early next year, and potentially into the second half of 2019. The downside potential may be as low as the mid/high 50s USD/barrel on Brent, and the low 50s on WTI. We also expect Energy sectors in the US and Europe to enter a correction phase to the downside. The risk is probably between minus 10 and 20%. We also believe that these sector should under-perform their respective markets, at least into December, possibly year-end. Shorter term, until end September / early October, Oil may attempt a last upside retest. It may make new marginal highs on Brent (mid eastern political risk), yet probably won't on WTI. October and November should then see both benchmarks move lower into mid/late November in first instance.

33 / China's CNY, and Gold: linked at the hip, and hobbled by the US Dollar's ascendancy, China's growth implosion

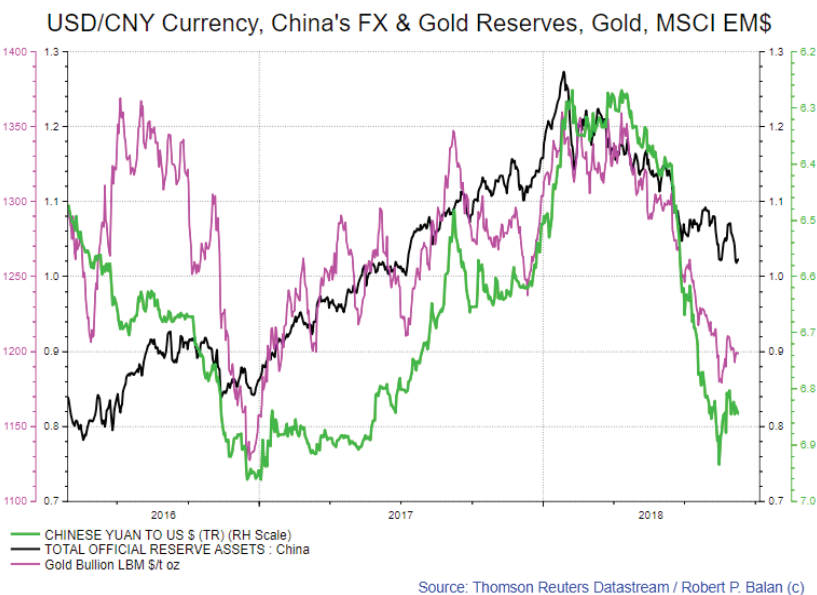
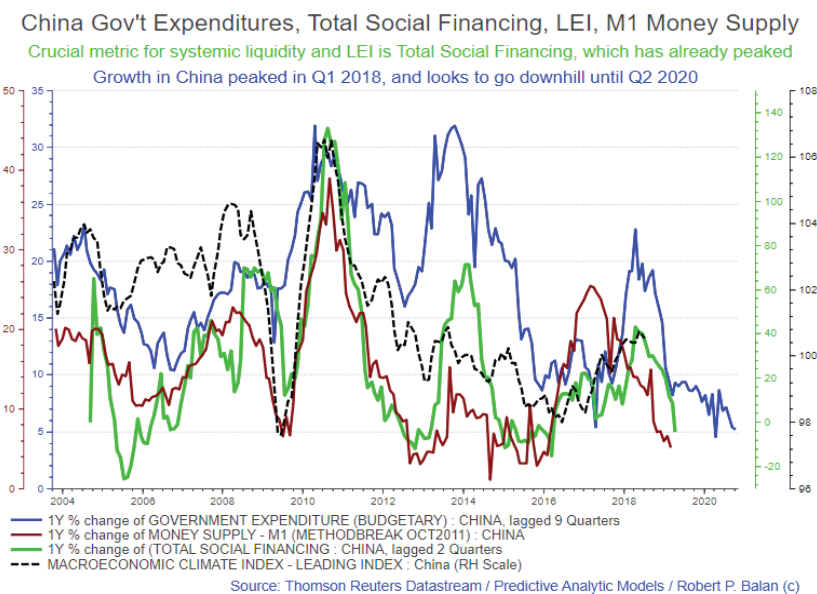
As Emerging Markets equities (proxy: MSCI EM\$) entered into a negative spiral again last week, gold analysts, almost to every man or woman, feared that the yellow metal would sell off once again in response. The gold price held firm, however, but nonetheless leaving analysts to ponder the yellow metal's immediate future.

Gold's future is generally tied to the trend of the US Dollar, but for practical purposes, gold is currently tied at the hip with the Chinese CNY (see 1st chart on this page). And the CNY is hostage to the escalating trade war between the Trump government and Chinese President Xi Jinping.

But even before the tit-for-tat escalation of tariff rhetoric between the US and China, gold has already been weakened by the severe underperformance of EM assets due to the resurgence of the US Dollar and by weakness in China and Emerging Markets economy (see 2nd chart on the right).

Much of that weakness is reflected in EM currencies, and the price of gold suffered alongside them. We discussed the weakness of the Chinese economy in another article in this month's Capital Observer which has led to some weakness in CNY, which should extend further as China's economy will likely spiral lower over the next few quarters.

A month ago, the People's Bank of China intervened to try and stabilize the yuan after the currency experienced several weeks of sustained weakness. **The CNY stabilized after the People's Bank increased its reserve requirement ratio on some foreign exchange forwards in an attempt at supporting the local currency. This had the effect of stopping, at least temporarily, the yuan's bleeding and has allowed the currency to build some support.**

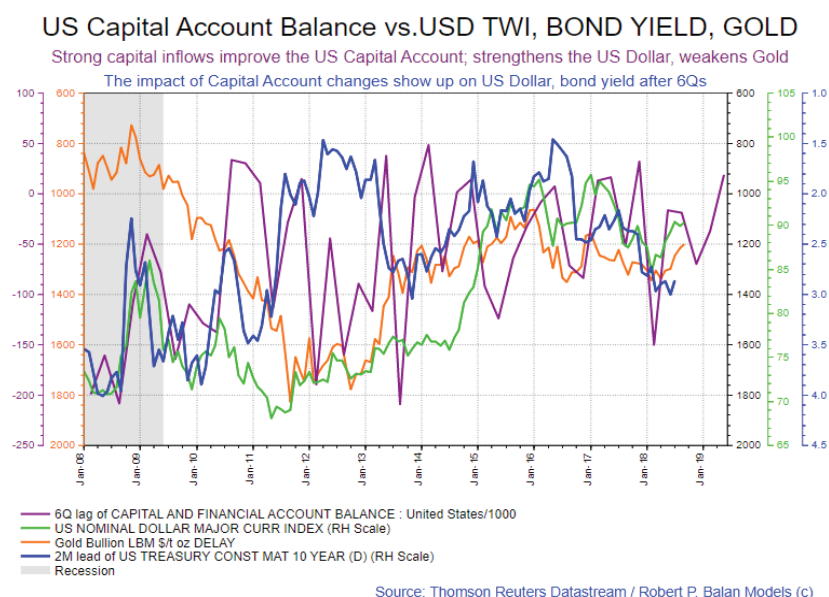
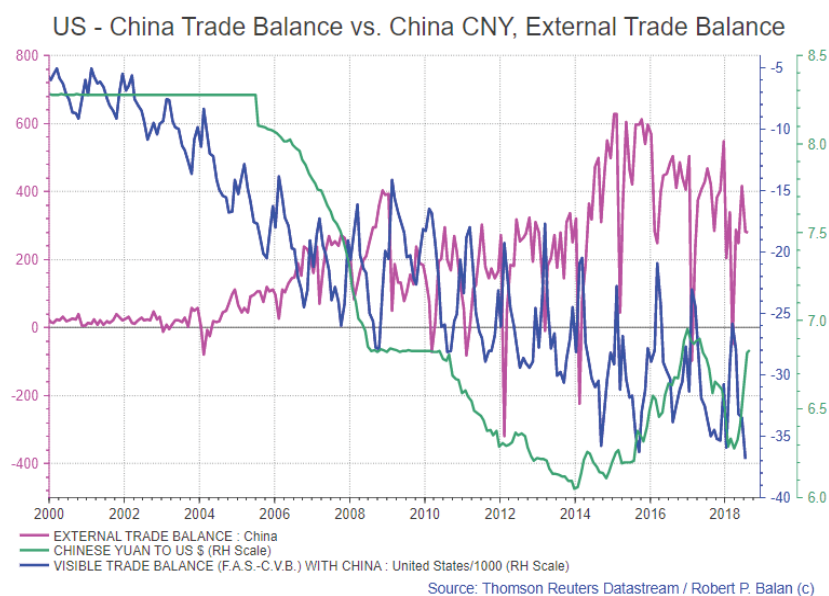


Some analysts also say that China can start backing the CNY with gold, which would basically stop the rot of the domestic currency. According to China watchers, China has a lot more gold than the 1,842 tons the government officially admits to holding in its reserves. Beijing has been diversifying away the US Dollar for the last three decades and may have accumulated “more than 20,000 tons of gold”, according to some China watchers. Should China decide to back the yuan currency with its gold reserves, it could also significantly undermine the dollar’s hegemony, according to some analysis.

Nonetheless, the immediate prospects of gold are tied up with the published intentions of the Trump administration to impose further 25% tariff on \$200bln or 40% of China’s exports to the U.S. at any time. With the U.S.’s trade deficit with China hitting a new record high in July (see 1st chart on this page), there seems little doubt that The Donald will proceed with those tariffs; it is unlikely that Mr. Trump will blink first. All that remains to be determined is how they will implement them and how will China respond?

New tariffs on Chinese exports to the US can be calibrated different ways, with several degrees of nuances. The worst-case scenario is that the new US tariffs are implemented all at once and immediately, which would prompt the most negative response from China. China may again choose to continue to devalue the CNY on a sustained basis. Consequently, Gold could continue to decline further.

Alternatively, the tariffs could be implemented in stages. For example, they could roll out tariffs on \$50bln of Chinese exports per month over four months. This would delay the impact to U.S. consumers and businesses and therefore, would reduce their potentially negative impact on the US November mid-term elections.



The trade war and its effect on the USD/CNY exchange rate remain the immediate determinant of Gold prices in dollar terms. Until either the trade war ends or the dollar falls, either of its own accord or due to a Fed reversal in policy, CNY is likely to go lower, followed in its wake by the gold price.

In the medium term, the outlook for gold is tied with the outlook for the US currency until credit risk factors and/or the debt crisis starts to spread. With the US Dollar expected to appreciate to Q1 2019 due to the lagged impact of capital flows (see 2nd graph on this page), there seems to be little benefit in investing in gold.

We therefore expect gold to briefly shine over the next two to three weeks, but could thereafter resume

the downtrend until Q1 2019, when presumably (according to our models) the US Dollar bull trend pauses. That would be a period more apropos to investments in the precious metals sectors and in the Miners’ equities.

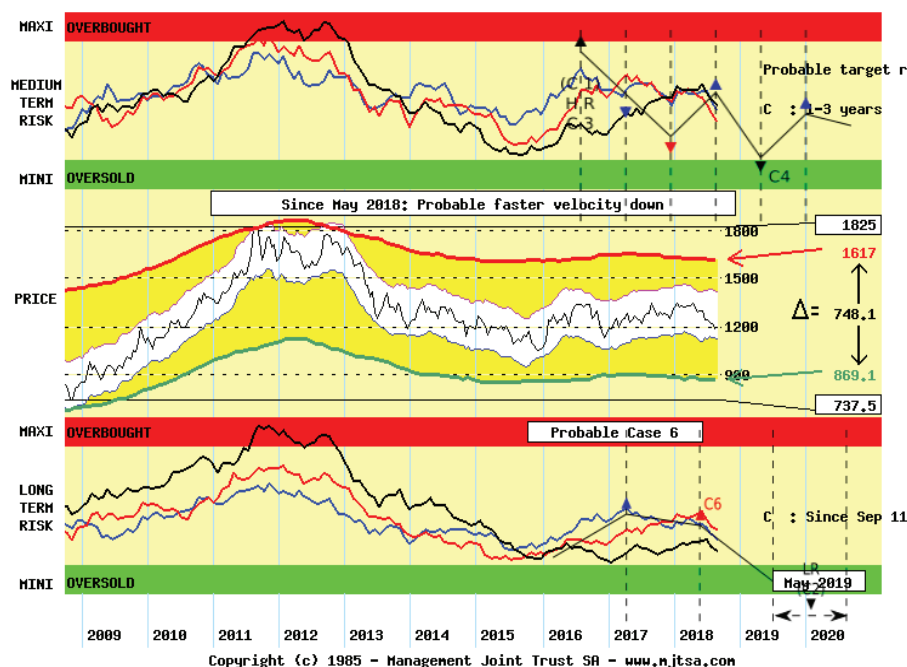
35 / MJT - TIMING AND TACTICAL INSIGHT

Gold is still stuck between a rock and a hard place

Our last three The Capital Observer publications highlighted the negative path for Gold we expected during the Summer claiming that it was first in line to suffer from the strong US Dollar rally we then expected. Our projections also pointed to September as a possible period when Gold could bounce as the US Dollar started to retrace. For now, the consolidation down since mid August on the US Dollar is looking rather weak, and the Greenback now appears that it may continue to push higher, possibly into early next year. In this article, we consider Gold in light of this strong Dollar scenario and will try to assess when/if Gold can break out of this negative correlation as the cross asset environment gradually turns more defensive.

Gold spot (USD/oz)

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

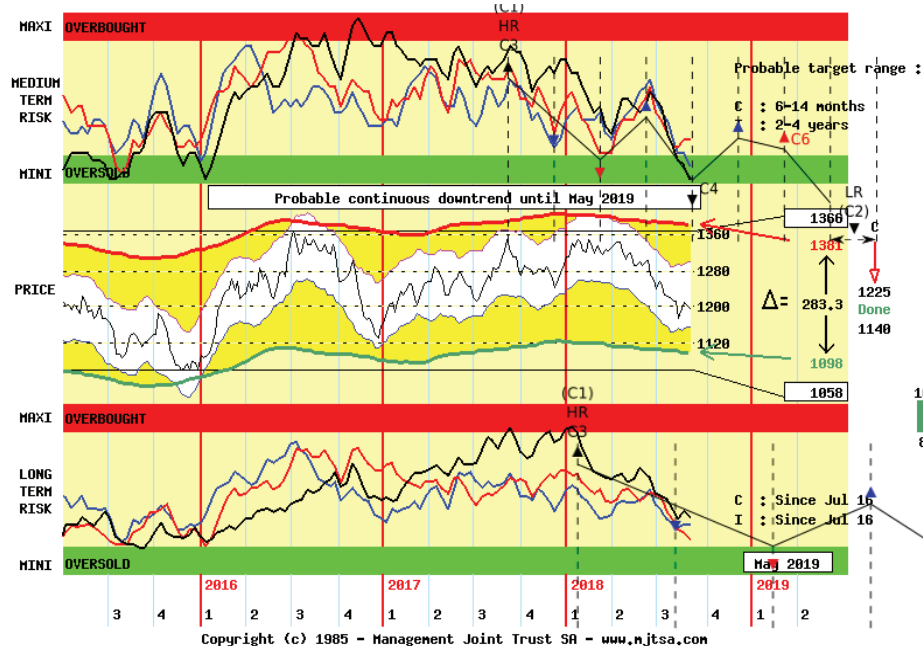


On this long term graph of Gold, the bounce since late 2015 is looking rather weak. Indeed, on both oscillator series (lower and upper rectangles), the sequences we show are projecting a negative path for Gold at least into Spring next year. Since it started to correct down in late 2012, Gold has found support many times below the lower end of our C Corrective targets to the downside (1'230; right-hand side). Each time, up to now, it has managed to bounce back. Yet, according to our methodology, once price move below the C Corrective targets to the downside, it theoretically opens the door to much lower levels i.e. to our I Impulsive targets to the downside, which, at the

moment, would calculate to levels well below 1'000 USD/oz. Hence, over the next few months, we can only hope that Gold manages to climb back up once more above our 1'230 support. **At best, the situation on Gold looks quite uncomfortable at the moment.** This is rather counter-intuitive given the defensive shift we expect on risk assets over the next couple of quarters.

Gold spot (USD/oz)

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

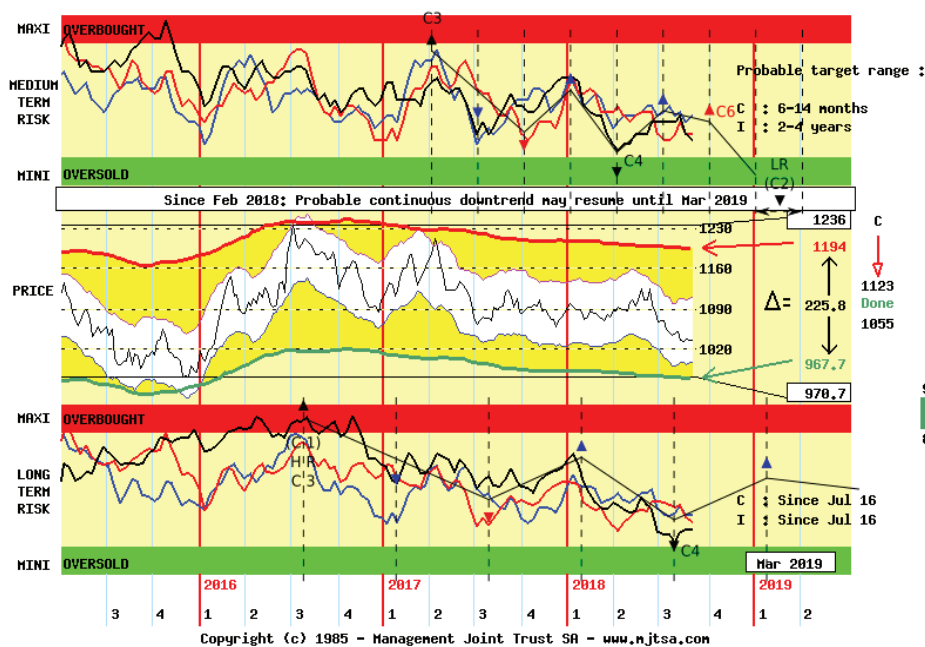


Turning to the Weekly graph, our medium term oscillators (upper rectangle) may have reached an intermediate low mid August and could bounce into the Fall. For now, Gold has also held above the lower end of our C Corrective targets to the downside, above 1'140 (right-hand scale). This is rather reassuring. **That said, Gold's price action since February has been quite synchronized with the ones of most currencies vs the US Dollar, and we are currently considering that their downtrend may continue into early next year.** This is the scenario we show on our long term oscillator series (lower rectangle), where the current bounce dies our quite rapidly and Gold continues to liquidate. Any price

action below 1'140 would probably confirm these negative dynamics, and could justify our I Impulsive price targets below 1'000 USD/oz. **Hence, we are treating the recent low on Gold (and the subsequent bounce since mid August) with extreme caution as we fear it may not hold.**

Gold Spot in EUR (EUR/oz)

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

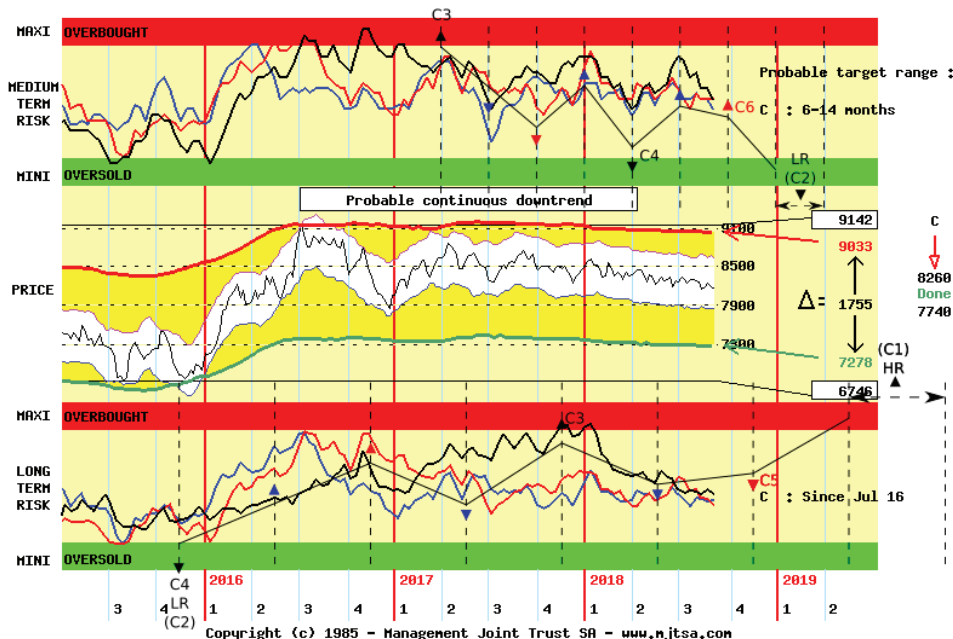


Looking at Gold in EUR doesn't really brighten the picture. Our long term oscillators (lower rectangle) have reached an intermediate low and may be getting ready to bounce into Q1 2019, yet our medium term oscillators (upper rectangle) rather suggest a continuation of the downtrend until then. Gold in EUR is now also below our C Corrective targets to the downside (right-hand scale). We hence cannot exclude that Gold in EUR reaches down into our I Impulsive targets to the downside in the 942 – 852 range. Again an

uncomfortable situation, which for now should discourage any bottom fishing.

Gold Spot in Yuan (Yuans/oz)

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

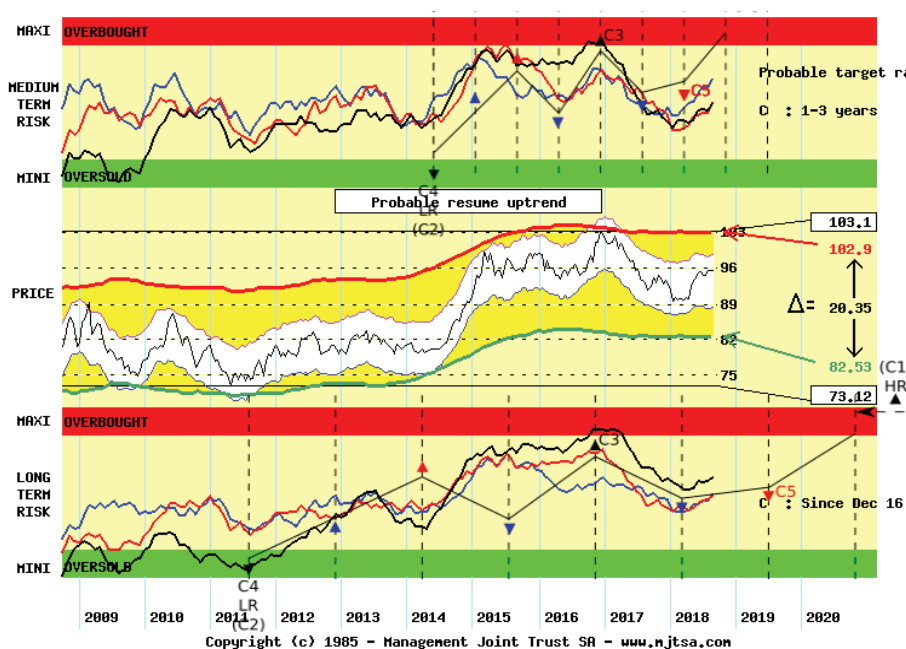


Since this Spring, it has been widely noticed that Gold has followed the USD/ Yuan exchange rate down quite closely. In this graph, we hence consider Gold in Chinese Yuan to assess their relative strength. Even against the Yuan, the Bullish case is not straightforward. While our long term oscillators (lower rectangle) may be pointing to a support point towards November this year, the sequence we show on our medium term oscillators (upper rectangle) is still descending towards early next year. Gold is also approach-

ing the support of our C Corrective targets to the downside (right-hand scale), yet given current developments, it is difficult to assess if these levels will hold. Indeed, Gold is following the same descending path that the Yuan vs the US Dollar, yet its volatility seems slightly higher to the downside, for now at least.

Dollar Index

Bi-monthly graph or the perspective over the next 2 to 4 quarters

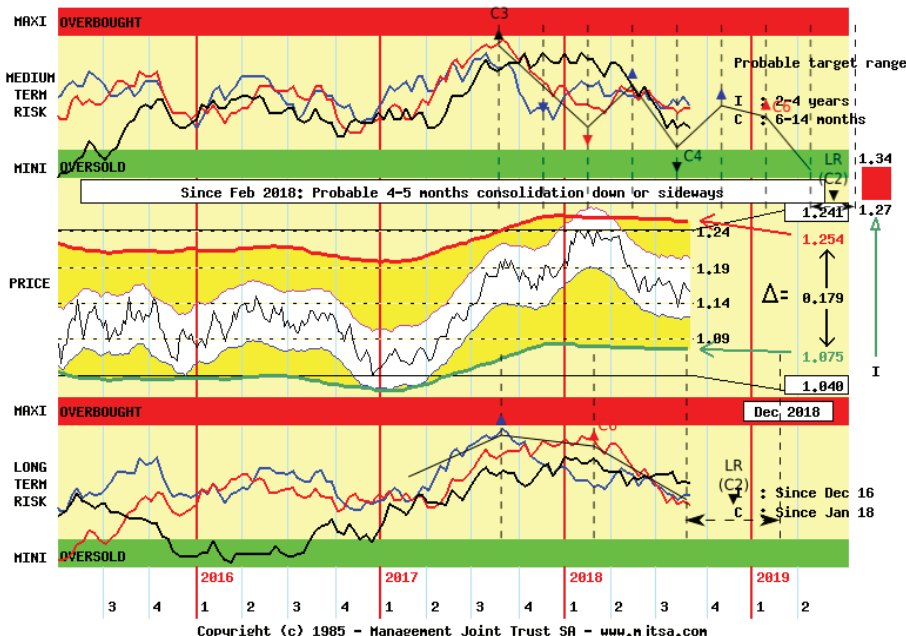


We now turn to the US Dollar, which has been the main negative factor for Gold since it bottomed last February. On this long term bi-monthly graph of the Dollar Index, **the correction down during 2017 found support this Spring within our C Corrective targets to the downside** (right-hand scale). On both oscillator series (lower and upper rectangles), **it is now resuming up probably towards next Spring (upper rectangle) and eventually much further into 2020 (lower rectangle)**. The fact that we never made it below our C

Corrective targets to the downside (i.e. below 87) during the 2017 sell-off, would confirm that the uptrend since 2011 is still in place. **For now, we remain bullish on the Dollar Index into next year.**

EUR/USD

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

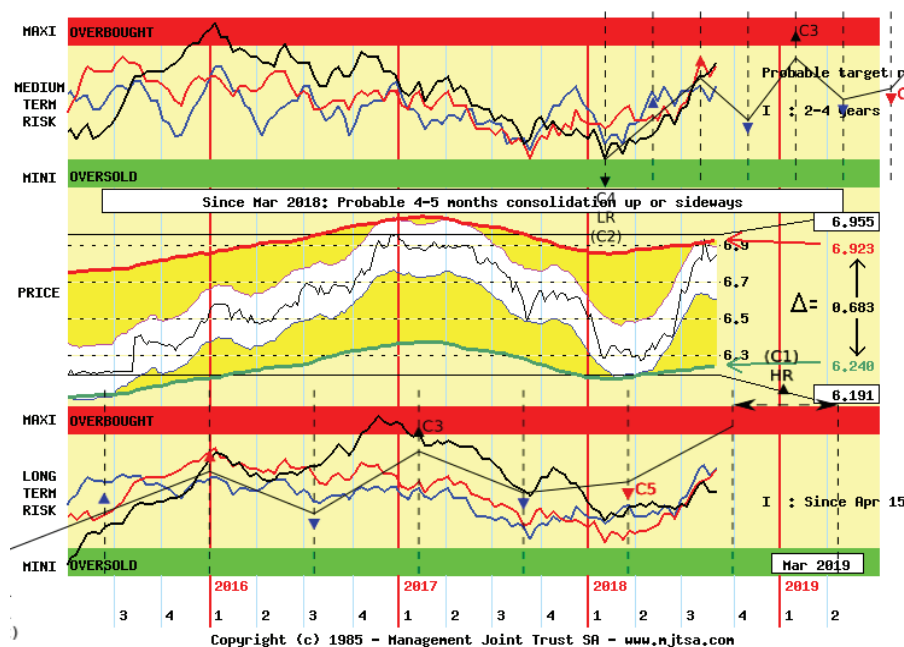


This Weekly graph of EUR/USD zooms into the 2017 US Dollar correction and the corresponding rise in EUR/USD. On this time-frame, the 2017 EUR/USD uptrend may still look impulsive, and could theoretically still justify the I impulsive targets to the upside, above 1.27, that our system is calculating (right-hand scale). Yet, in The Capital Observer issues published in Q1 this year, we had been reluctant to confirm these targets. Rather, we chose to concentrate on the retracement down we expected during Q2 and Q3 this year. This

choice was based on the bi-monthly Dollar Index graph above, which was still holding above its C Corrective targets to the downside (as mentioned in its commentary). **Since February, EUR/USD has seen quite a strong retracement. We now believe that this retracement could continue into early 2019.** Indeed, on our longer term oscillators (lower rectangle), the Q1 2018 oscillator top came in below the Q3 2017 one. This is a sign of weakness, which could justify, that despite its strong price move, the EUR/USD uptrend during 2017 was just a correction. It is now in the process of reversing down. As with Gold in USD, our medium term oscillators (upper rectangle) may have reached an intermediate low mid August. Yet we are not convinced it will hold, and from early Q4, we expect it resumes lower towards Spring next year. **A break below our C Corrective targets to the downside (below 1.10; right-hand scale) would provide a final confirmation that the long term trend on EUR/USD is now heading down again.**

USD/CNY

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

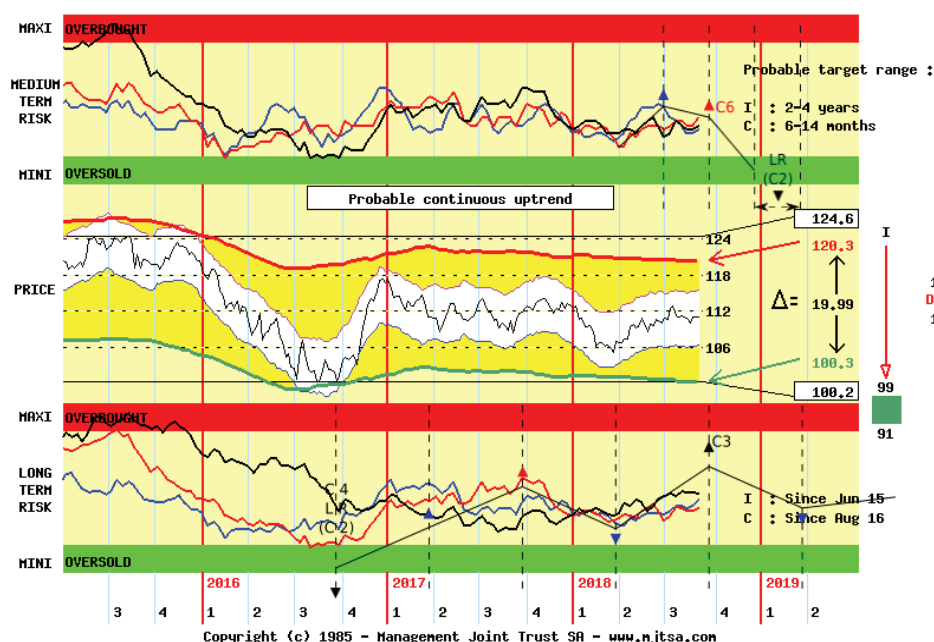


The analysis on USD/CNY is similar to the EUR/USD in reverse, yet also ahead in terms of confirmations. Indeed, since it bottomed between February and April, USD/CNY has shot back up into impulsive territory, and our price targets (right-hand scale) are now projecting that **the pair could reach the 7.1 – 7.4 over the next few quarters**. Our long term oscillator series (lower rectangle) would justify a similar argumentation that on EUR/USD in reverse, i.e. **the uptrend during 2015 and 2016 saw a strong correction down in 2017, yet**

has since resumed up in force. Our medium term oscillators (upper rectangle) would confirm this uptrend, probably into early, perhaps late next year. This is rather scary for Gold if the current positive correlation between the Yuan and Gold continues to hold.

USD/JPY

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

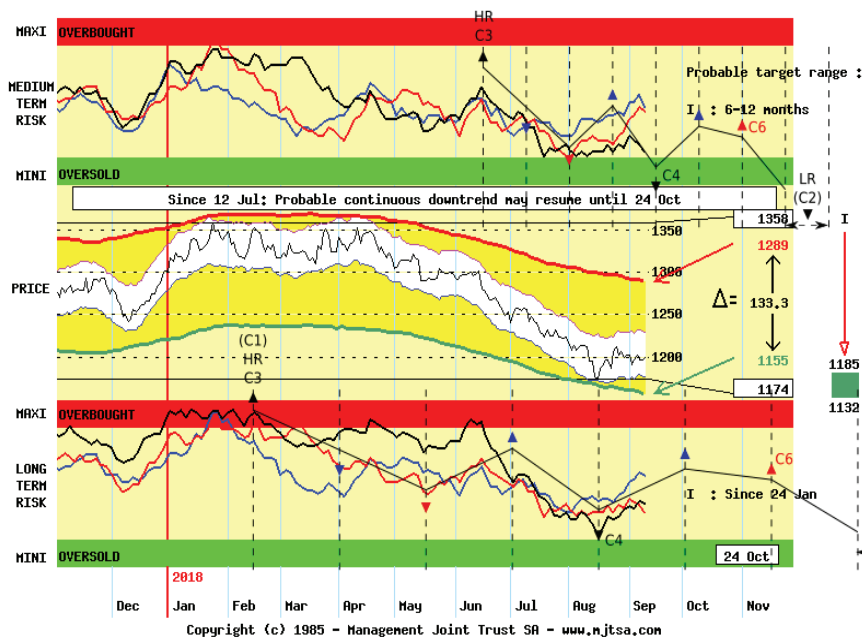


The story-line on USD/JPY is somewhat different as the Yen is historically a very defensive currency. In times of trouble, it tends to strengthen against the US Dollar even if EUR/USD is weakening. At least this is what happened during the 2018 financial crisis. **In 2016, USD/JPY bottomed with interest rates. It has since been correcting up. The move has been rather weak and choppy and we believe it may be coming to an end soon.** This is what we confirm on both our oscillator series (lower and upper rectangles). **Following**

that, over the next few months, we expect the long term downtrend on USD/JPY to resume. Our Impulsive targets to the downside between 99 and 91 (right-hand scale) are quite aggressive. **This is good news for Gold as traditionally it was very much correlated with the Yen. Yet, since this Spring, the Yen has proven much more resilient vs the US Dollar than Gold, and they may take several months to resynchronize.**

Gold Spot (USD/oz)

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

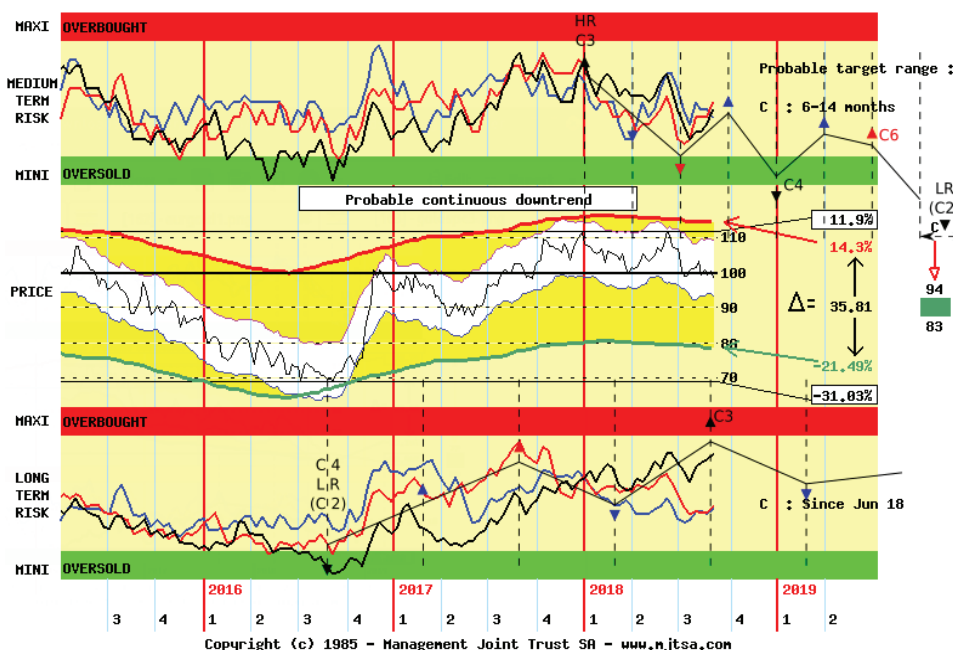


We now focus on the shorter term trend of Gold with its Daily graph. The sell-off since April reached an intermediate low in August. Gold has since been rebounding. As with EUR/USD, the rebound is rather unconvincing for now. Both oscillator series (lower and upper rectangles) suggest that **Gold may hold into the end of September, perhaps early October, but that it then resumes its downtrend towards new lows (right-hand scale) into November or even year-end.** Hence, for now, we believe it is still too early to consider it

as a worthwhile defensive play. Indeed, it is still very much correlated with Emerging markets, the Yuan or the Euro and along with them should continue to suffer against the Dollar.

Copper Spot (LME, USD/ton) vs Gold Spot (USD/oz)

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

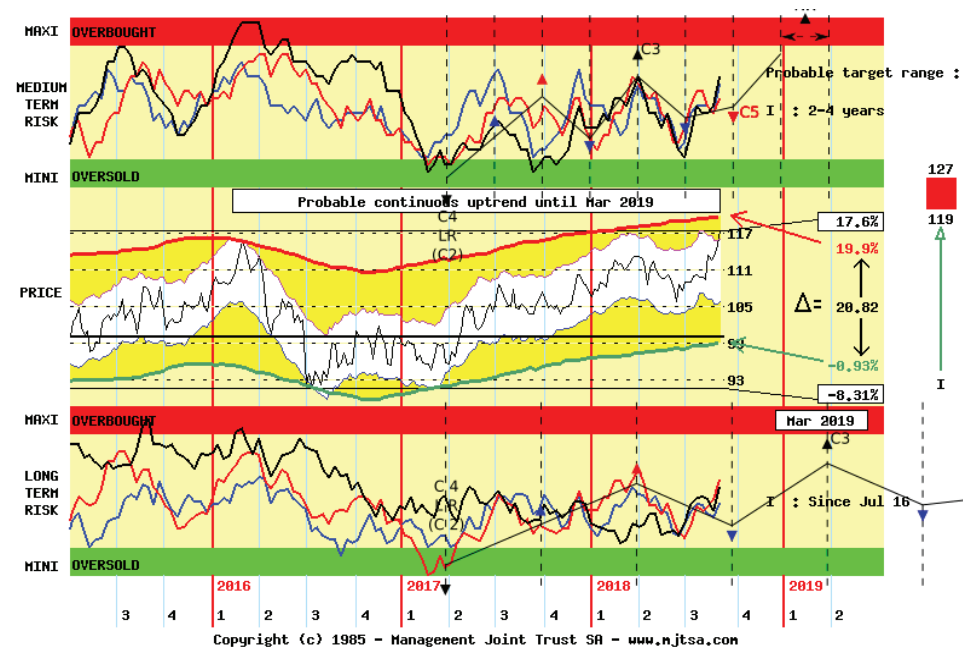


On the other hand, **Gold has started to reverse up vs other metals. We believe this spells the end of the reflation trade as Gold is usually considered as one of the most defensive commodities.** The Copper to Gold ratio we show here topped out in June, and on both oscillator series (lower and upper rectangles), we now believe that the ratio is getting ready to resume lower, probably into year-end / early 2019. According to our C Corrective targets to the downside (right-hand scale), the next support levels for the

Copper vs Gold ratio may be as much as 17% lower. This projection synchronizes quite well with the continued sell-off we expect on China and related assets in this issue of The Capital Observer.

Gold Spot (USD/oz) vs Silver Spot (USD/oz)

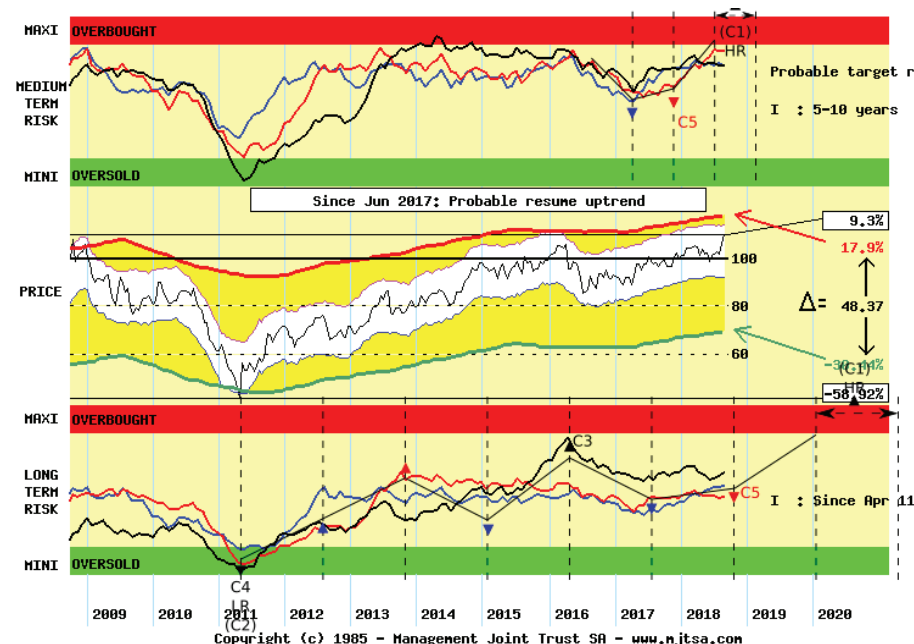
Weekly graph or the perspective over the next 2 to 4 quarters



Against Silver, Gold has been in a strong uptrend since early 2017. Historically, Silver is stronger than Gold during the early stages of the business cycle, while both are moving up, and then suffers dramatically against it during risk-off periods. We believe such a period lies ahead of us. Both our oscillator series (lower and upper rectangles) are indicating that the Gold to Silver ratio should continue to accelerate up at least until early next year. Our Impulsive targets to the upside (right-hand scale) are suggesting that Gold could outperform Silver by a further 10% over the coming months.

Gold Spot (USD/oz) vs Silver Spot (USD/oz)

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



Our longer term bi-monthly graphs confirm this view. Following a sell-off during the early stages of the last recovery while both metals were moving up (2009 – 2011), the Gold to Silver ratio then resumed its uptrend until 2016. Then, following a slight dip during the early stages of the 2016 deflationary recovery, the ratio continued to move up. Both our oscillator series (lower and upper rectangles) indicate that the ratio should now continue higher into early next year at least (upper rectangle) and potentially until end 2019 (lower rectangle). If we are correct in forecasting a strong risk asset correction over the next few quarters, the ratio seems to indicate that it may take well into 2019 before a recovery actually materializes.

Concluding remarks

The rebound on Gold since mid August is rather weak and bottom fishing it against its recent downtrend still seems quite uncomfortable. This is the case in US Dollar terms, but also in EUR or even CNY terms, as Gold is negatively correlated to the US Dollar, yet with a stronger volatility than these currencies. Going forward, we expect the US Dollar to remain strong, probably into Q1 2019 at least. This will put additional pressure on Gold, and in the current context, a capitulation below 1'000 USD/oz cannot be excluded. We would hence stay away from it for now, this despite the defensive cross asset shift we expect. It's a question of timing within the downtrend cycle. Gold is currently getting stronger vs Copper, which suggests the end of the deflation trade, yet it is also accelerating up vs Silver, which usually happens when both precious metals are declining. In 2008 for example, Gold and Silver started to react up very late in the year, following the Lehman crisis and only once the TARP rescue program was put in place. Gold and Silver then accelerated up during the first years of QE, Silver more than Gold, and the Gold to Silver ratio declined. Our graphs suggest that this is unlikely to happen at least until next year. The fact is that Gold is a monetary phenomenon, it reacts to the cure (monetary easing), rather than the crisis itself. With the FED and potentially the ECB still on the tightening path, Gold should remain under pressure for now. This will continue to be the case until these Central Banks start to flinch. Given our negative scenario on risk assets over the next few quarters, this is not implausible, yet it may take a few more months/quarters to actually materialize.

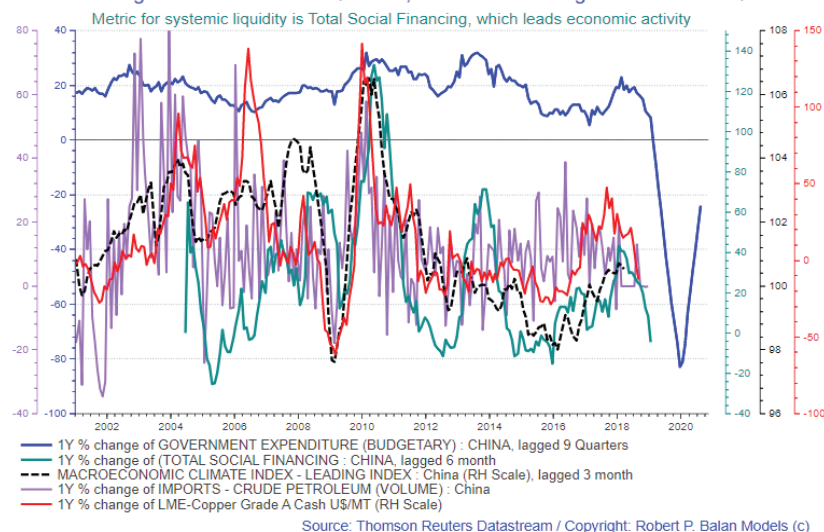
41 / Base metals face headwinds from China's slowing growth, firm US Dollar trend

It was common to see headlines like “Copper rises on strong Chinese growth and China’s industrial profits rise the most in four years on commodity prices”? It is easy to show that there is a mutually supportive cycle of Chinese strong growth fuels rising commodity prices, and rising prices fuels strong China growth. But since early Q2 2018, there has been a softening in commodity prices and the former explanation has dominated (e.g., “Chinese demand concerns hit metals and related stocks”). The recent Chinese slowdown in oil imports has been instrumental in undercutting oil and base metal prices (see first two charts on this page).

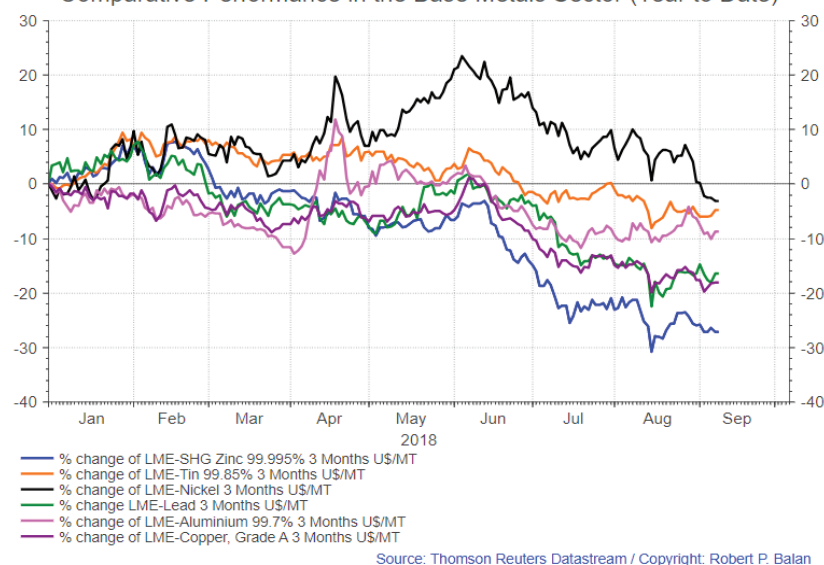
The voracious devourer of raw materials, and relentless growth machine that was China during the last two decades is finally and now truly showing signs of distress – something that even the most stalwart pundits touting China’s prowess now accept. Ironically, it is not the failure of the country’s long-term, export-led growth model that is to blame -- it has been increasing its exports imbalance with the US three months running, which could trigger another round of recriminations from the Trump administration, and layers of additional tariffs levied on US-bound Chinese exports. This of course can further add to China’s angst.

The culprit is slowing domestic consumption. The trade spat with the US has darkened consumer sentiments, and the sharp decline in the value of the CNY has curbed significant part of imports for goods and luxuries. Retail sales this year have grown at their slowest pace in more than a decade. Wages in the private sector are growing at their slowest pace since the global financial crisis. The stock market has fallen by one-fifth, a victim of deteriorating sentiment and the sharp decline in the value of the domestic currency.

China Gov't Expend., Total Social Financing, China oil imports, Copper
There was growth in China until Q1 2018, but then looks to go downhill until Q1 2020

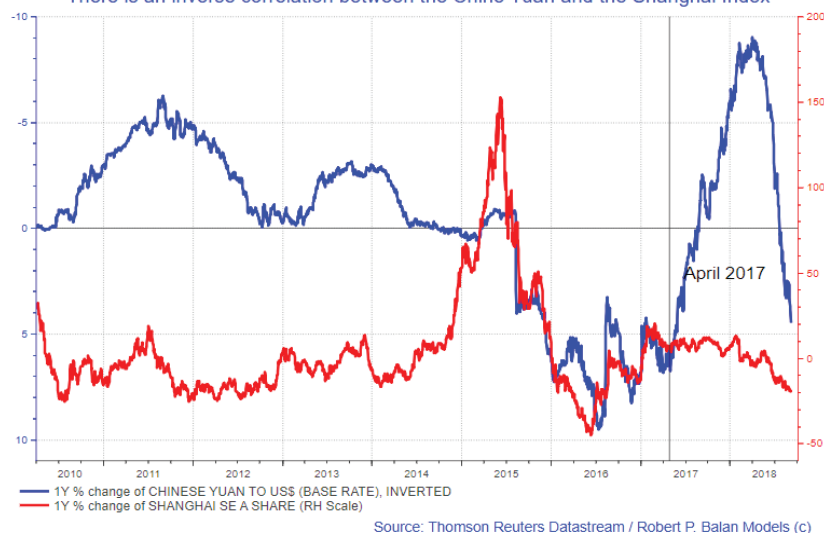


Comparative Performance in the Base Metals Sector (Year to Date)



Changes in CNY exchange rate vs Shanghai Index prices

There is an inverse correlation between the Chine Yuan and the Shanghai Index



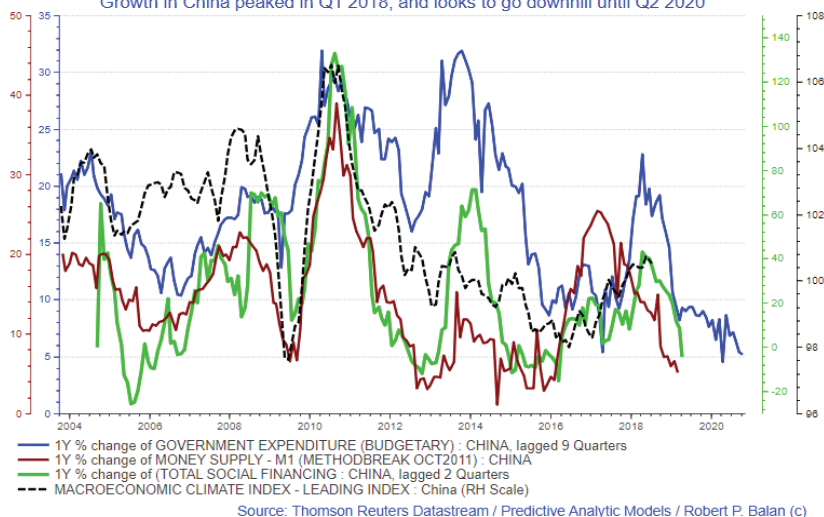
Most of China's current woes are self-inflicted. Government expenditures in China have virtually collapsed since January 2016. And like everywhere else, if the government does not spend, economic activity slows down in proportionate degree. And the government tightening in China had been severe. The heady rise of the central government expenditures from January 2015 to January 2016 has been essentially erased over the past two years (see 1st graph on this page).

The key illustration of the link between fiscal spending and growth in China can be seen in the graph above. This is key element in this illustration: the impact of fiscal and budgetary expenditures is being transmitted to the real economy via the Total Social Financing (TSF) expenditures. This leading indicator has already peaked, has declined sharply, and is about to fall further. These have been the consequence of the (TSF) slowdown: (1) As a consequence, China's Leading Economic Indicator (LEI) will also declining faster soon, and (2) the fall in M1 Money Supply dropped precipitously from January, this year, and no bottom in sight, so far, while the (TSF) keeps on falling (see 2nd graph on this page).

TSF is a very reliable indicator of future economic activity in China and is therefore an excellent tool in forecasting the future direction of commodity prices. Where commodity prices go, the metals and mining sector will follow. The impact of the TSF is pretty much "baked in the cake" and so its negative trend should be a headwind for commodities and metal prices well into H1 2020. The TSF as a harbinger of Chinese activity, and therefore of future price of resource materials, has been discussed in great detail at this current and past issues of the Capital Observer.

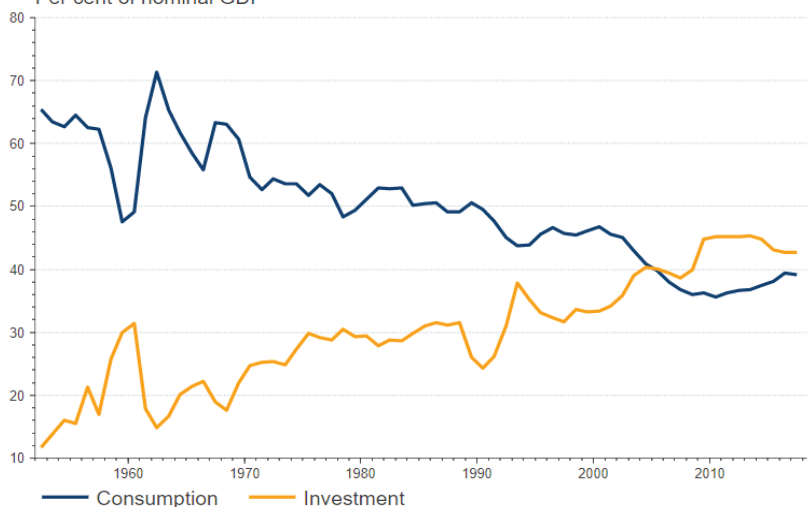
Nonetheless, it is not an unmitigated disaster for commodities and base metals. China has been moving heaven and earth to refocus the economy from export-led growth to

China Gov't Expenditures, Total Social Financing, LEI, M1 Money Supply
Crucial metric for systemic liquidity and LEI is Total Social Financing, which has already peaked
Growth in China peaked in Q1 2018, and looks to go downhill until Q2 2020



China nominal consumption and investment

Per cent of nominal GDP



domestic consumption. It also did a lot to curtail corporate debt and excesses in it "shadow banking" industry – part of the reasons for the slowdown in monetary (liquidity) growth. There is growing international resistance to China's mercantilist trading approach. Unfettered creation of systemic liquidity also fuelled massive and often inefficient or wasteful investment in the country's industrial sector. Therefore, steering the economy toward meeting domestic consumption and a more rational investment program are logical steps in the maturation of the domestic economy (see 2nd graph on this page).

The current woes are therefore temporary, and even if China economy has been slowing, it has decelerated from nominally higher

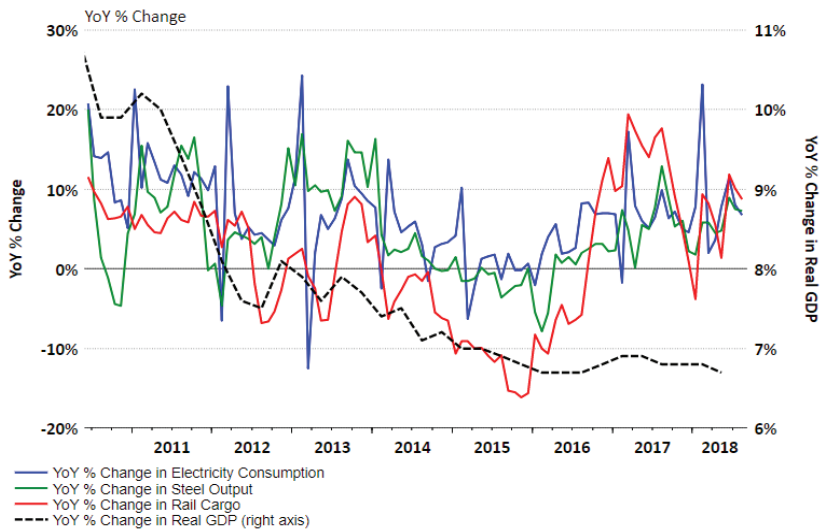
levels that it has been five years ago. There is still nominally significant propensity to consume raw materials, produce electric power, and goods are still moving. These data comprise what has been called the "Li Keqiang Index," three indicators reportedly preferred by the current premier of China as better indicator than the official numbers of GDP, which almost everyone acknowledges as unreliable and overstated (see 1st graph on next page).

Base metals and the rest of the commodity universe (which include a wide swath of the Emerging Markets) also face stiff headwinds from the resurgence of the US Dollar, which we expect to be ascendant until Q1 2019. There are multitude of reasons

for a new USD upsurge, and primary are the stated objective of the US Federal Reserve to keep raising rates unit they are deemed “normal”, and the lagged impact of a massive inflow of repatriated and foreign capital. This has caused favourable changes in the US Capital Account, which in the final analysis, is the real macro data which ultimately determines the course of US interest rates and the domestic currency (US Dollar), *see 2nd chart on this page*. We have extensively discussed these correlations in the current and past issues of the Capital Observer.

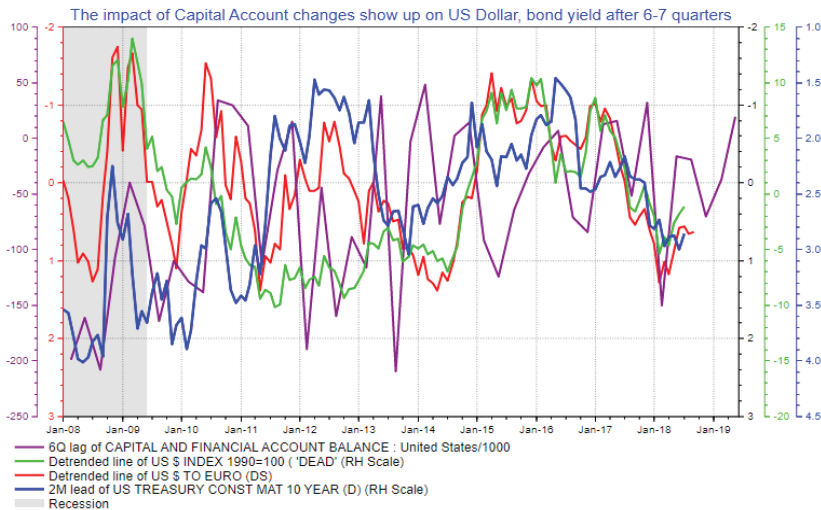
But all of these will come to pass, and even if we expect base metals and commodities to mark time over the next few quarters, a new upwards cycle in global and US growth probably awaits in the later part of 2020. That could initiate a widely expected new cycle of boom times for resource materials.

China: Electricity Consumption, Steel Output, Rail Cargo, GDP



US Capital Account Balance vs.USD TWI, EUR/USD, BOND YIELD

Strong capital inflows improve the US Capital Account; strengthens the US Dollar, weakens the EUR



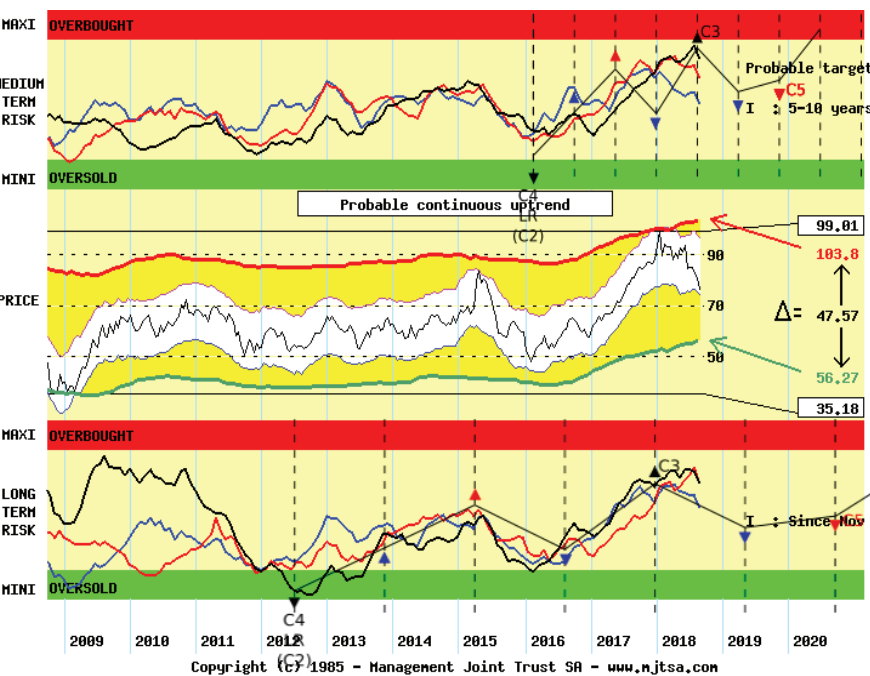
44 / MJT - TIMING AND TACTICAL INSIGHT

A Chinese hard landing is an increasing probability

When an economy increasingly leverages to meet growth targets, at some point it will hit a rock. This may currently be happening to the Chinese economy. Since January, Chinese stock markets are down circa 25%. Can they really stabilize or will be the current liquidation continue? What happens to related trades such as Industrial Metals?

MSCI China

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

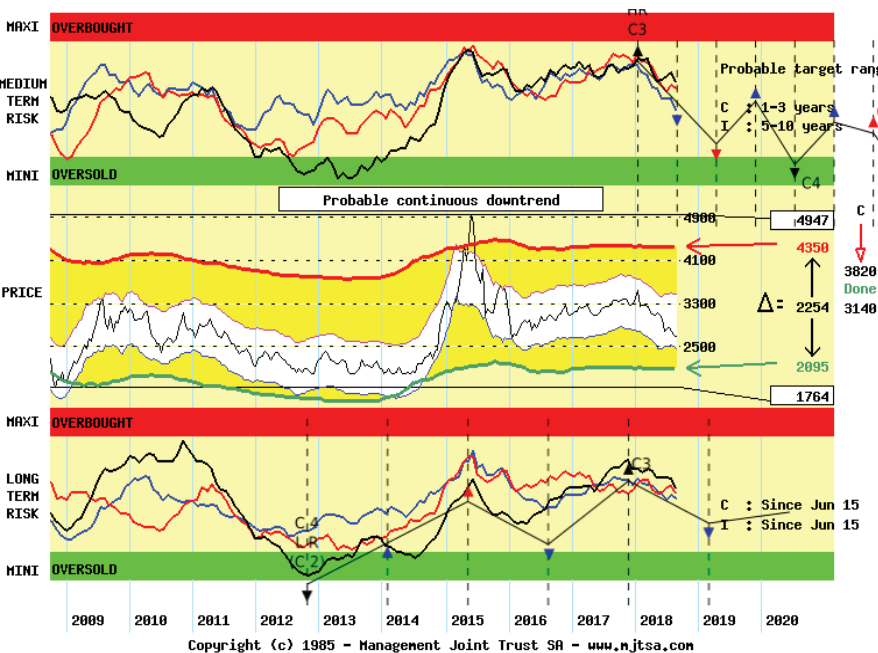


During the 2016 -2017 reflationary boom, the MSCI China Index doubled in price. This uptrend first started with a rebalancing of Commodity markets in 2016, and then accelerate up further with Growth themes such as the so called BATs stocks (Baidu, Alibaba, Tencent). Since January, the trend has started to reverse, and the correction down since then, at circa minus 25%, is quite substantial. Is there a bottom fishing opportunity here or will the sell-off continue? The sequences we show on both our oscillators series (lower and upper rectangles) suggest that **we are rather late in the cycle, and that important tops were probably made between early this year in H1 2018.** Our I Impulsive targets had been

reached (right-hand scale), yet the **C Corrective targets to the downside we can calculate indicate that initial support may be as low as the 61 level** (0.8 times our historical volatility measure “Delta” – here at 47.57; middle rectangle, right-hand side – subtracted from the highest point of the graph, here at 99.01), **which is another 20% lower than today.** Our belief is that it is currently much too early to venture back into the Chinese market.

Shanghai Composite Index

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

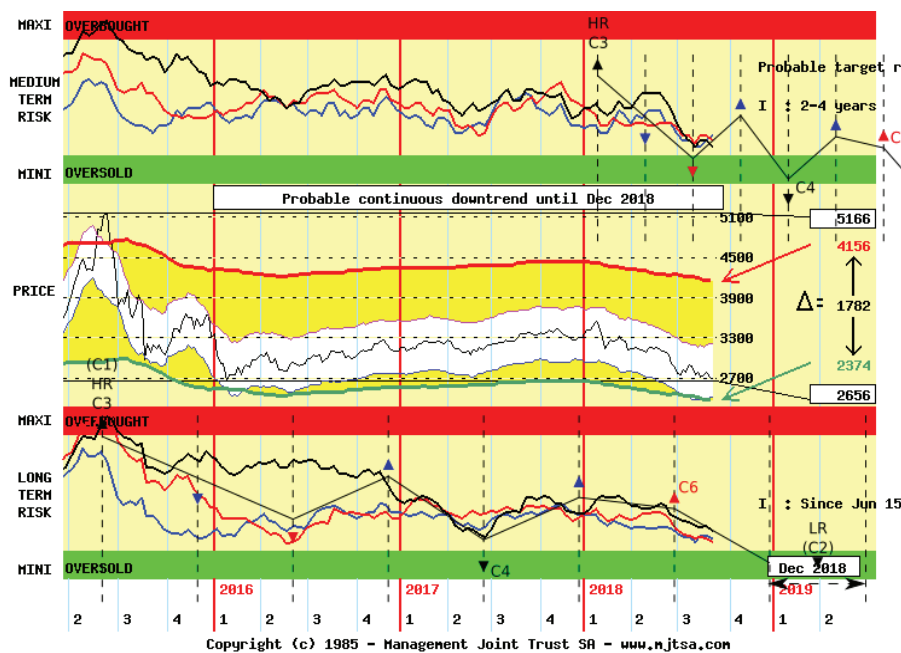


The configuration on China’s domestic markets in much more alarming. The 2016 – 2017 reflationary bounce still looks rather weak in comparison to the 2015 Bubble and subsequent Burst. We believe the trend is now resuming lower and that it has broken back down again below the support of our C Corrective targets to the downside (below 30140; right hand scale). Our I Impulsive targets to the downside now suggest that **it could reach below the 2’000 mark over the couple of years, probably even substantially below that.** Both our oscillator series (lower and upper rectangles) suggest that **the current sell-off could first last into Spring next year. Then following a bounce, it probably continues**

lower into 2020.

Shanghai Composite Index

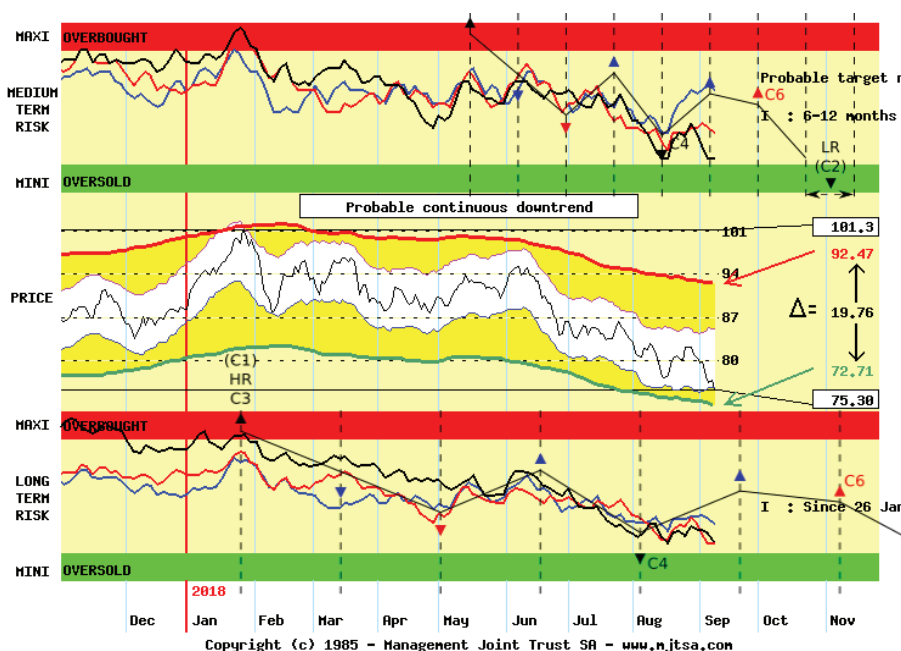
Weekly graph or the perspective over the next 2 to 4 quarters



The Weekly graph is not much more reassuring. Both our oscillators series (lower and upper rectangles) are suggesting that the current sell-off continues until early next year at least. Our Impulsive targets to the downside suggest that prices could reach as low as 2'140 until then (right-hand scale). This is another 20% lower than today and hence the sell-off since January may only be half way through.

MSCI China

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

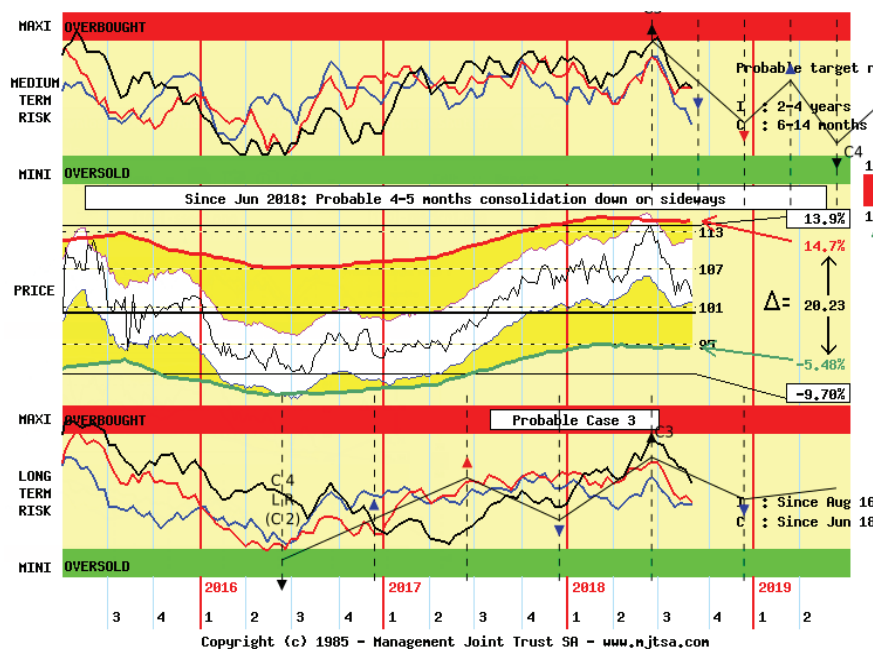


Focusing back on the MSCI China Index, and its shorter term Daily graph, we can notice that the intermediate bottom, which was identified mid August on both our oscillators series (lower and upper rectangles) is having trouble holding. Over the next couple of weeks, it may hold up and bounce again, yet the downtrend is still very much prevalent. We expect it to return in force, probably from late September into November and then probably towards early next year. Our Impulsive targets to the downside (right-hand scale)

would suggest 10% more downside potential for the MSCI China over the next 2 to 3 months.

MSCI China vs MSCI Emerging Markets

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

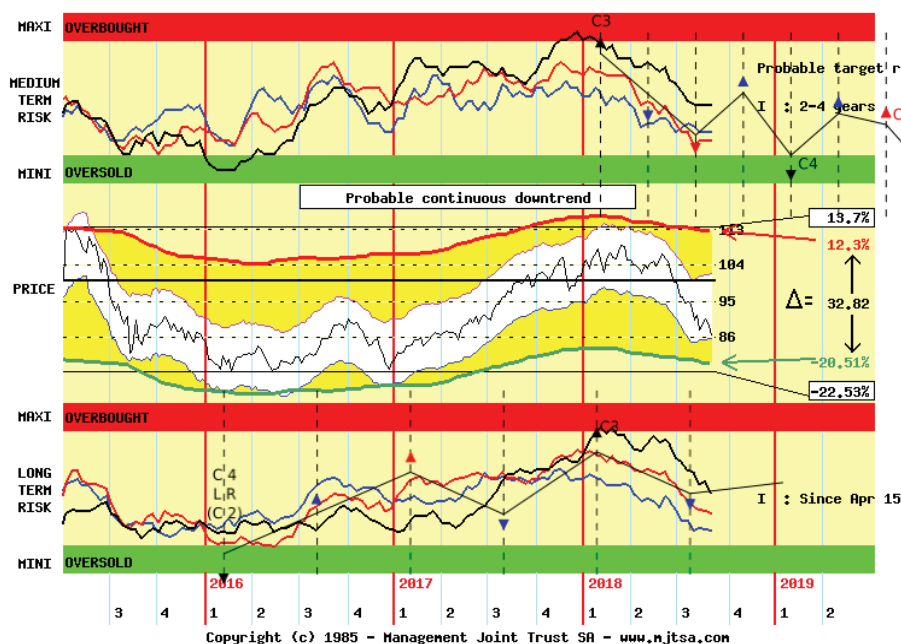


On a relative basis, the MSCI China topped out in June vs other Emerging markets. Up to then, it had been a rather defensive play in the Emerging Markets space. The reversal coincided with the acceleration of the Yuan's devaluation. Since then, **China seems to be leading the way in the current Emerging Markets sell-off.** Both our oscillator series (lower and upper rectangles) suggest that **it will probably continue to underperform until at least year-end, and then perhaps again into the Spring.**

Corrective targets to the downside (right-hand scale) and may find some support 4 to 5% below current levels, yet if these again fail to hold, the next relative performance support levels are 15 to 25% below current levels.

MSCI China vs the MSCI World

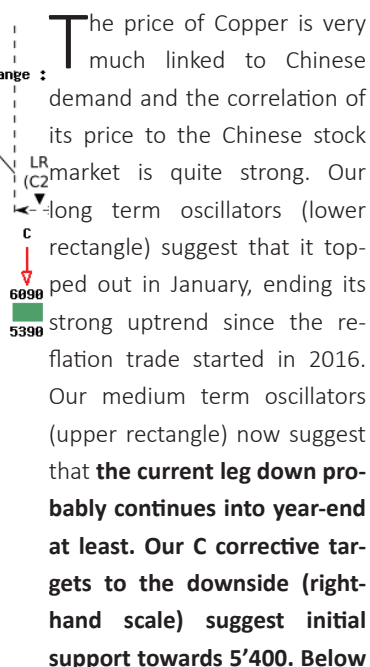
Weekly graph or the perspective over the next 2 to 4 quarters



Against the MSCI World Index, the MSCI China Index is already in **I Impulsive territory to the downside (right-hand scale).** These targets are **pointing to 20 to 30% of further under-performance over the next few quarters.** Both our oscillators series (lower and upper rectangles) suggest than an intermediate low would have theoretically been made mid August. Yet, for now, it hasn't triggered much reaction. **More and more the move down since Q1 is looking like a orderly liquidation. It will probably continue relatively**

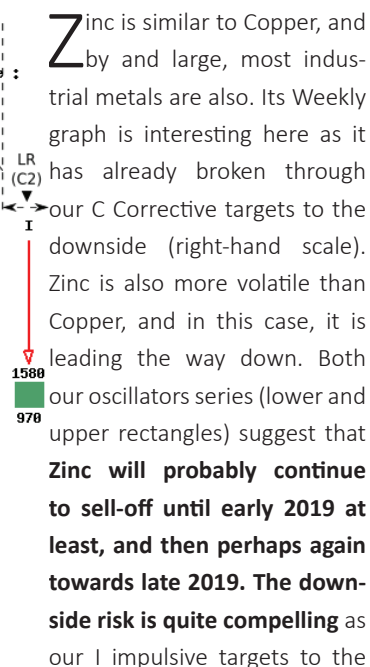
unscathed until early next year.

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



Zinc Spot (LME, USD/ton)

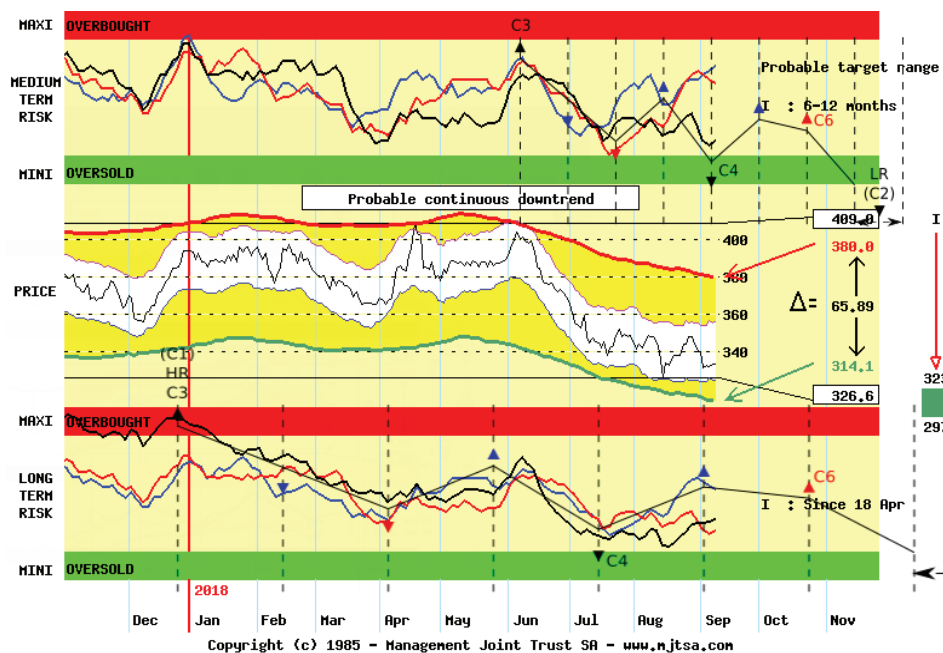
Weekly graph or the perspective over the next 2 to 4 quarters



47

Goldman Sachs Industrial Metals Index

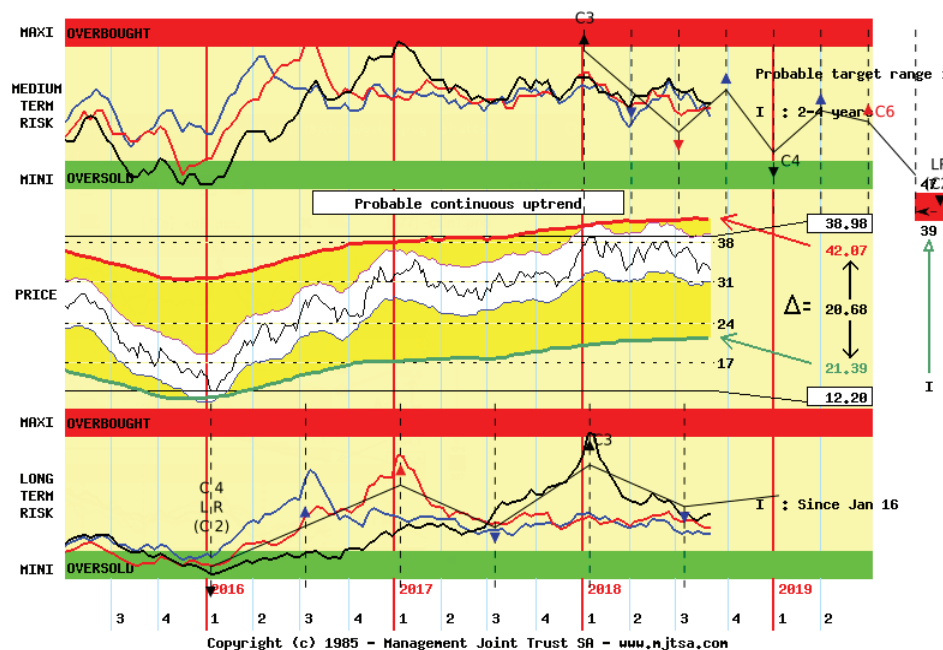
Daily graph or the perspective over the next 2 to 3 months



Shorter term, following their strong June to August sell-off, Industrial metals may be making intermediate lows on our medium term oscillators (upper rectangle). However, **by late September, we expect them to resume lower probably into late November / December.** Our long term oscillators (lower rectangle) would confirm that the trend resumes lower at the latest during October. I Impulsive **targets to the (downside (right-hand) point to a price target zone towards the 323 – 297 range, i.e. a further 10% below current levels over the next couple of months.**

XME - SPDR S&P Metals & Mining ETF

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

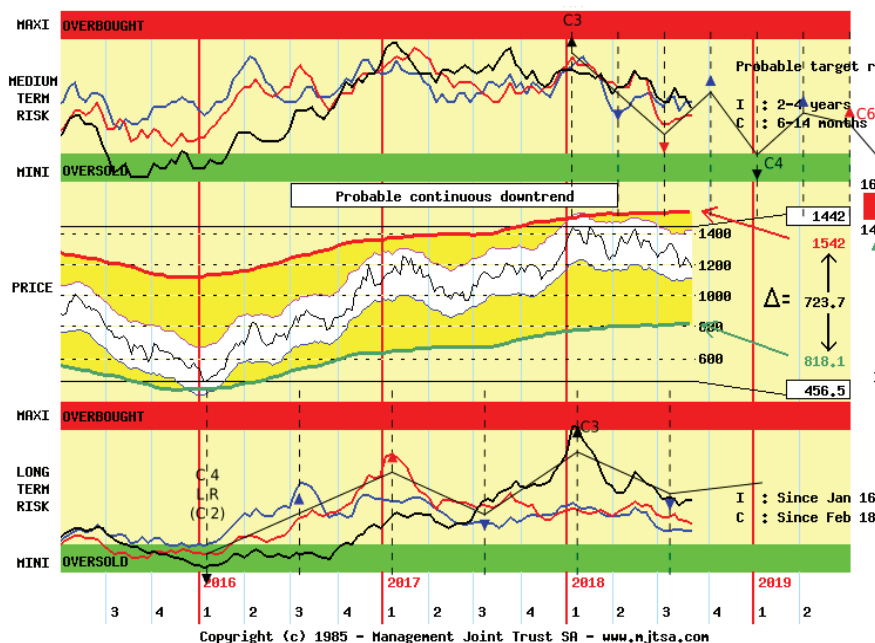


Related sectors in the US are also starting to reverse. The US Diversified Mining sector, for example, topped out in January on our long term oscillators (lower rectangle) and has started to reverse. Our medium term oscillators (upper rectangle) suggest **that it may now continue lower, probably from end Q3 into year-end. Following that, a further downtrend sequence could materialise until end 2019.** Our I impulsive targets to the upside (right-hand scale) have been pretty much achieved. Given the scenario

we are considering, we don't think they will be retested. **The initial C Corrective targets to the downside (right-hand scale) we can calculate would suggest support towards the 28.5 – 22.5 range** (0.5 to 0.8 times our historical volatility measure "Delta" – here at 20.68; middle rectangle, right-hand side- subtracted from the highest point of the graph, here at 38.98). **That is circa 15 to 30% below current levels.** Beyond that, our next level of targets would suggest a full retracement of the 2016-2017 reflatory move.

STEEL – Steel Sector Index (NYSE Arca)

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

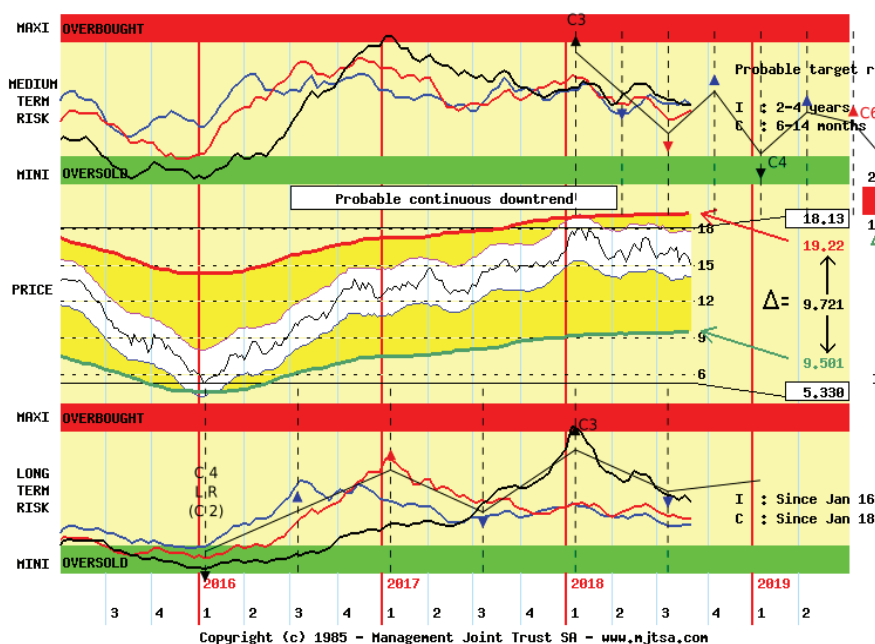


Other related US sectors are slightly more advanced. For example, steel producing companies made a top in January on our long term oscillators (lower rectangle) and have probably topped out for this cycle, while the sequence we show on our medium term oscillators (upper rectangle) is already descending. **We expect it to resume lower from late Q3 into year-end, and then perhaps once again into late 2019. Initial support will be found towards the lower end of our C Corrective targets to the downside (right-hand scale) around 860. This is**

already almost 30% below current levels. Beyond that, if/once these levels are broken, US Steel companies may retrace all of their 2016-2017 inflationary gains.

KOL - Market Vectors Coal ETF

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

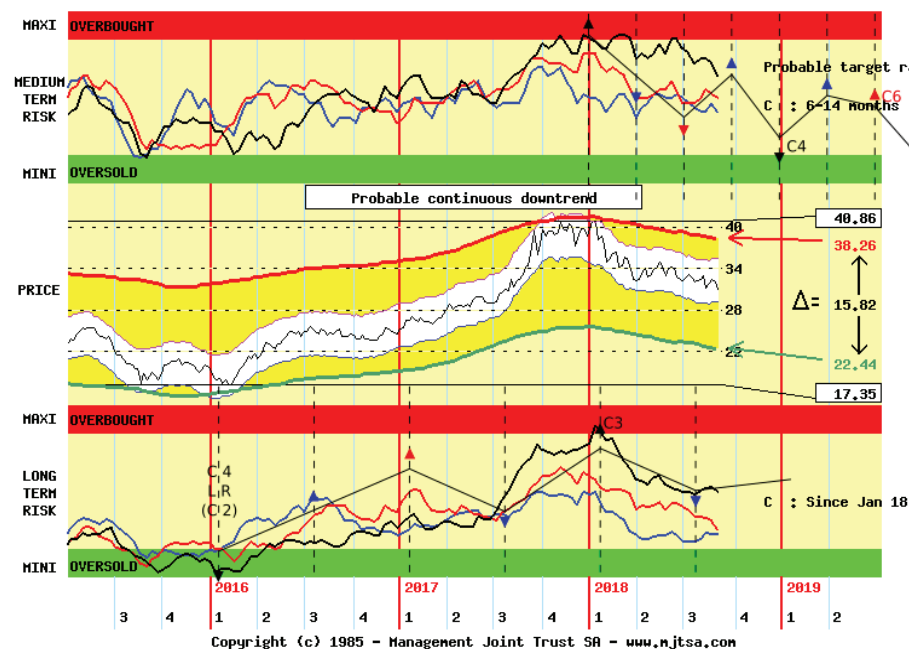


Similarly, Coal producing companies also started to reverse down in January following the top which was made on our long term oscillator series (lower rectangle). On our medium term oscillators (upper rectangle), **we now expect them to move lower until early next year at least, and then potentially again into late 2019. Initial support could be found towards the lower end of our C Corrective targets to the downside around 10 (right-hand scale). That is circa 35% below current levels.** Below that, the next level of tar-

gets we can calculate would probably reverse the whole 2016-2017 inflationary uptrend.

LIT - Global X Lithium ETF

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

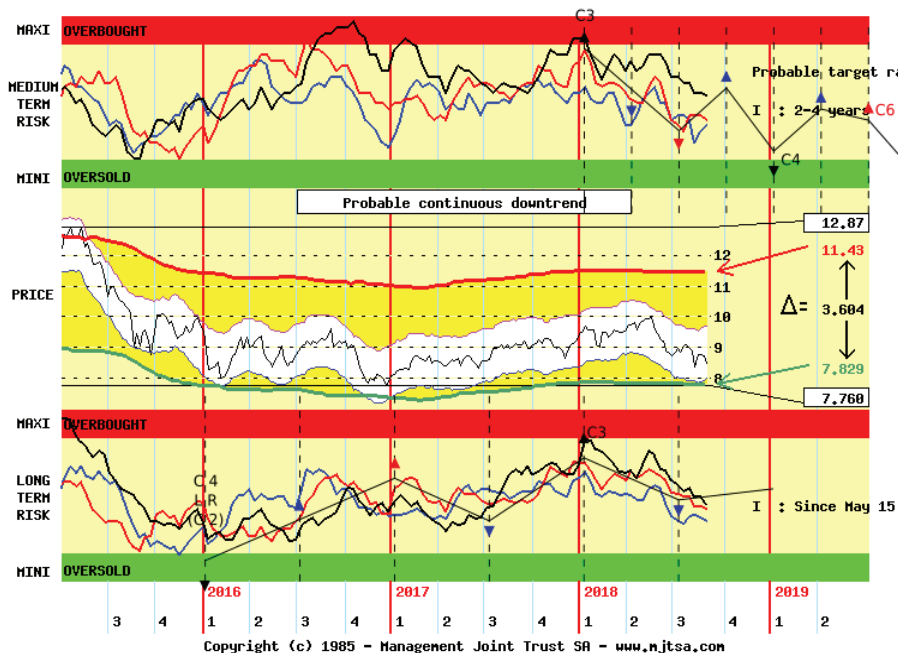


Given the strong growth momentum in the Alternative Energy, Electric Cars and in mobile phones penetration, the Lithium theme had gathered strong upside momentum during the reflation trade. As with other mining products, it topped out in January on our long term oscillators (lower rectangle) and has since been correcting to the downside. Our medium term oscillators (upper rectangle) would suggest that following an intermediate bottom towards early Summer, which hasn't triggered much reaction, the Lithium theme should now resume its downtrend probably towards year-end and then probably once again towards late 2019. Our C Corrective targets to the downside (right-hand scale) have pretty much been fulfilled. If prices break below their lower end,

our I Impulsive targets to the downside would point to a range between 20 and 14. As with other sector we mentioned above, an acceleration of the downtrend over the next couple of months could lead to a full retracement of the 2016-2017 uptrend over the next few quarters. This is rather bad news for this popular investment theme.

ICLN - iShares S&P Global Clean Energy Index Fund

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



Alternative Energy is a typical Growth theme that has a strong exposure to China. Similarly to other sectors above, it is currently retracing its 2017 upswing. Both oscillator series suggest than an intermediate low was probably made this Summer, yet that for now, prices are continuing to drop. As shown on our medium oscillators, we expect Alternative Energy to continue lower, initially towards early next year and then possibly once again towards late 2019. Our I impulsive targets to the downside (right-hand side) suggest than the sector will probably see new secular lows by then. Unfortunately, this may also be a warning for other Growth oriented sustainability themes.

Concluding remarks :

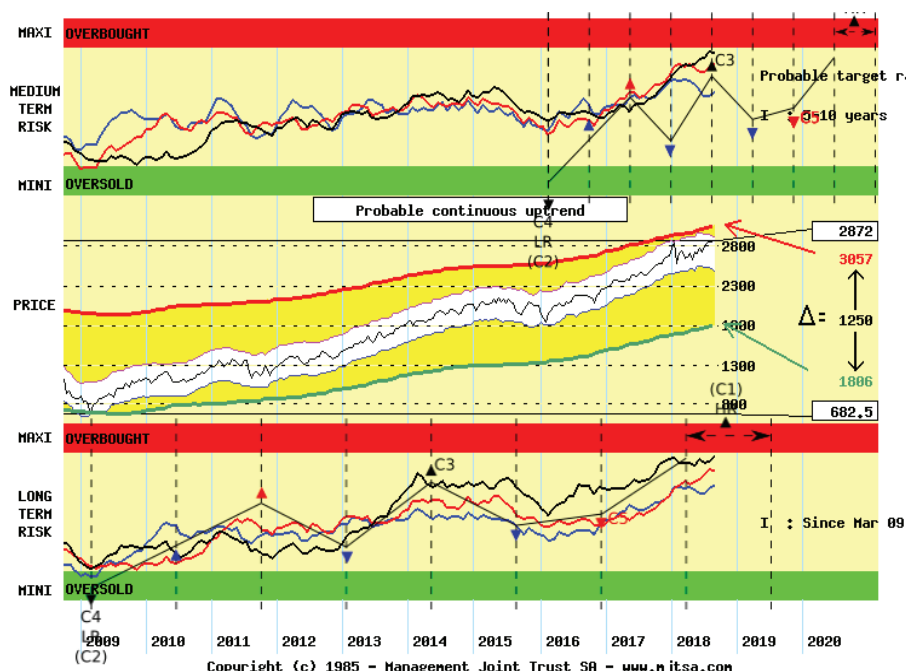
The sell-off in Chinese equity seems far from over. The downtrend is especially clear on the Chinese domestic market where the Shanghai Composite could continue to slide towards the 2'000 mark by early next year, and perhaps even lower, later on in 2019. All attempts to bounce during the Summer were rapidly retraced, and we now expect that from late September at the latest, Chinese equity markets could accelerate down again into November/December. Chinese equities also seem very weak vs both other Emerging Markets and the MSCI World Index, and in general the sell-off in Chinese Equities looks more and more like a panic liquidation. The Chinese equity sell-off is also impacting all related themes. Industrial metals such as Copper or Zinc have started to accelerate lower, the US Diversified Mining, Steel or Coal sectors are gradually reversing down, and growth themes related to basic metals or China, such as Lithium or Alternative Energy, are also selling off. We see little respite for most of these themes until at least early next year, and probably until end 2019, and believe that their downtrends could see further acceleration during these periods. We would hence avoid any investment themes relating to China and Industrial metals over the next few months and probably the next few quarters, i.e. don't try to catch a falling knife.

51 / Splicing the markets – This time is probably not that much different

Our medium to long term cross-asset scenario is turning more defensive, and while we were explaining it over the last few weeks, we were getting more and more of the “this time is different” type of argument. Indeed, as they say, the US is still growing strongly, the Emerging markets crisis seems contained for now, interest rates are still relatively low by historical standards and, most importantly, the FED is acting gradually and seems to be in control. In this context, our downside targets do seem aggressive to these professionals, which given the resilient Bull market we’ve been in since 2009, is probably understandable. In this section, we review and explain the downside targets we currently calculate for the main equity markets.

S&P 500 Index

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



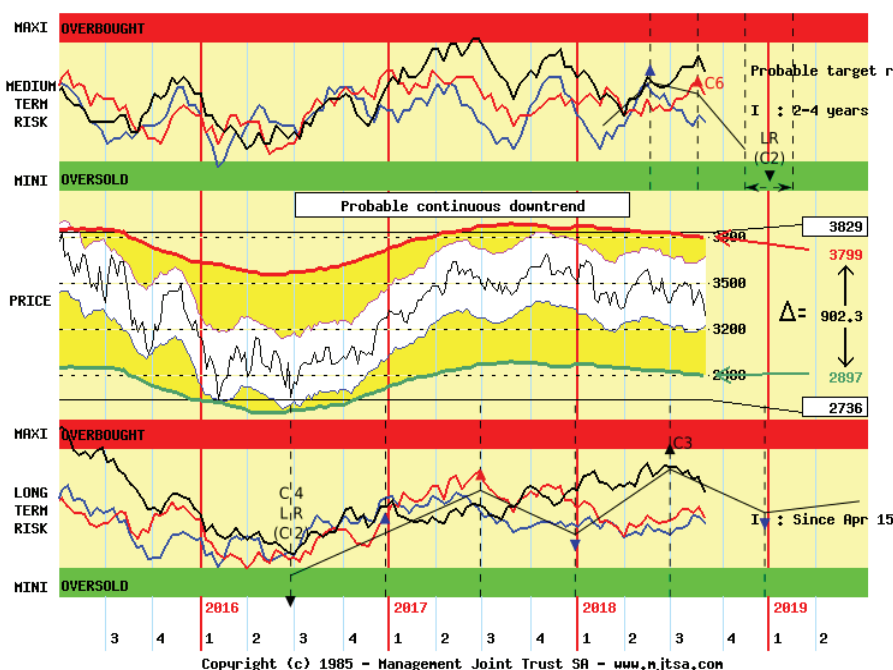
The S&P500 Index is still in an uptrend, yet on both our oscillators series (lower and upper rectangles), it is reaching important tops. Our envelopes (middle rectangle) are touching each other, which is a sign of exaggeration, and our I impulsive targets to the upside have been achieved (right-hand scale).

Taking profit at these levels is rather comfortable in our view, as in general the risk/reward to the upside does seem exhausted. Yet, will the market really start to sell off? We believe so, as the current tops we are expecting on this bi-monthly graph are probably the most important ones since the 2009 recovery. Indeed, our long term oscillators (lower rectangle) are getting to the end of their uptrend model. We call these

situations “High Risk”, and on a bi-monthly graph, they usually trigger 1 to 2 years of a downside correction while achieving our C Corrective targets to the downside. We currently calculate these between 2’247 to 1’872 or 22% to 35% below current levels (0.5 to 0.8 times our historical measure of volatility “Delta” – here at 1’250; middle rectangle, right-hand side – subtracted from the graph’s highest point). When considering market history over longer periods of time, such correction phases are rather standard.

EuroStoxx 50

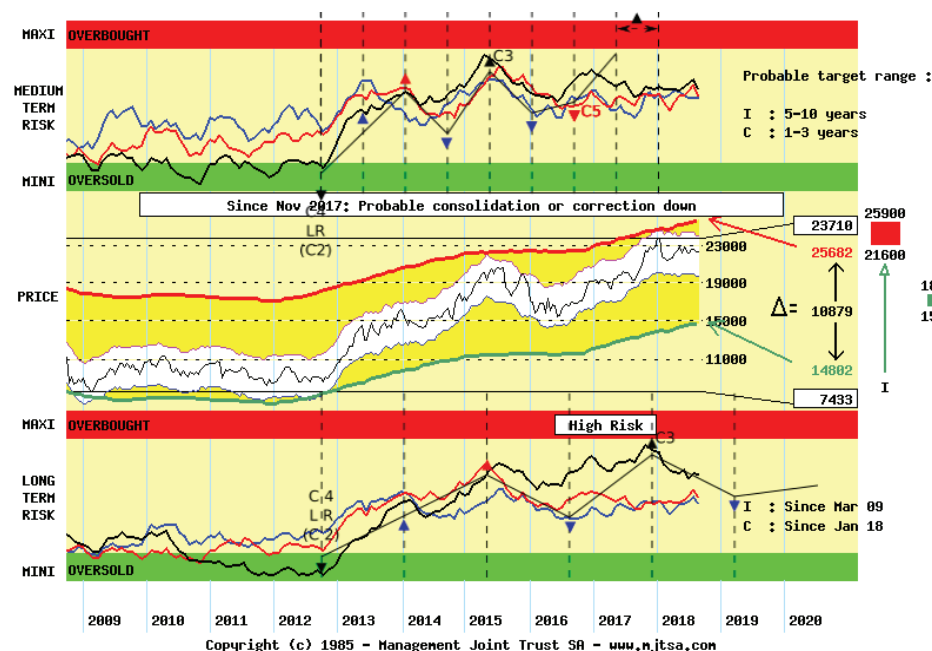
Weekly graph or the perspective over the next 2 to 4 quarters



For the EuroStoxx50, we have chosen the Weekly graph. Indeed, compared to the S&P500, its downtrend seems to have already started, while its price targets to the downside are already impulsive (right-hand scale). Both our oscillators series (lower and upper rectangles) suggest that a first move down will probably materialize into year-end. Following that, the downtrend may then extend into late 2019. Our downside targets until then (mid/late 2019) are suggesting that the EuroStoxx 50 could move down to the 2’660 – 2’290 range (right-hand scale). This would be 20 to 30% below current levels and below its 2016 lows. Since 2009, such corrections have happened before, in 2011 and in 2015.

Nikkei 225

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

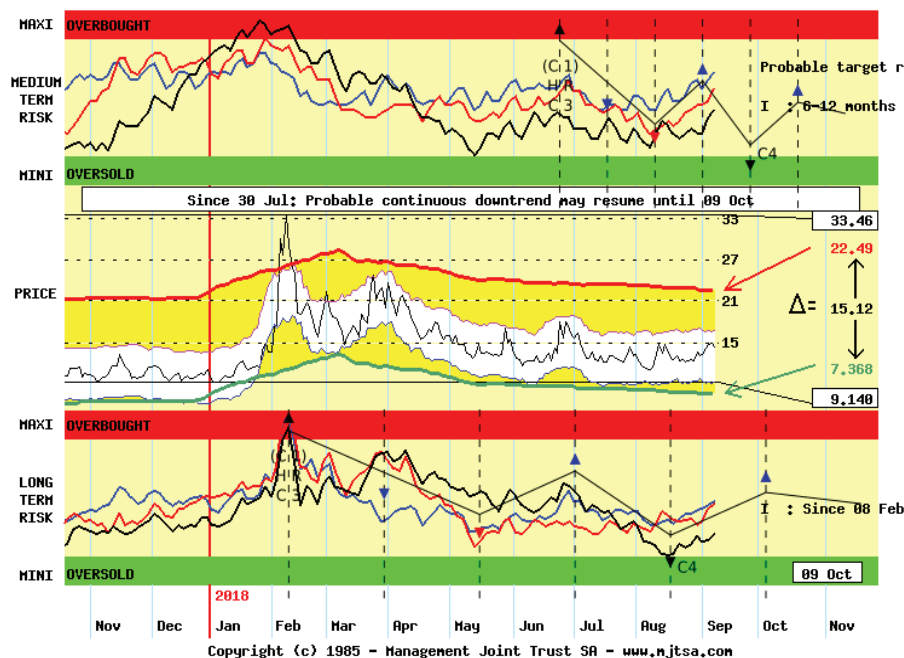


So far, the Japanese market seems relatively immune to contagion from China and other Asian Emerging markets. Indeed, although it topped out in January, it held up rather well during the Summer. That said, both our oscillators series (lower and upper rectangles) are suggesting that important tops have probably been made, and that the **Nikkei 225 could now continue to consolidate into 2019**. While our I Impulsive targets to the upside have been achieved (right-hand scale), our C Corrective targets to the downside are **suggesting initial downside targets in the 18'300 – 15'000 range**. These are circa 20 to 35% below current levels and in line with what we are projecting on the S&P500 and the EuroStoxx 50. For this correction to the downside, Japan may have an additional trigger.

Indeed, if our defensive scenario materializes, the Yen, which is a defensive currency, will probably start to strengthen vs most currencies, and even against the Dollar. During such periods in the past, when the Yen has strengthened, the Nikkei 225 typically underperformed other developed markets (2009 – 2012 or H1 2016).

VIX CBOE Volatility Index

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



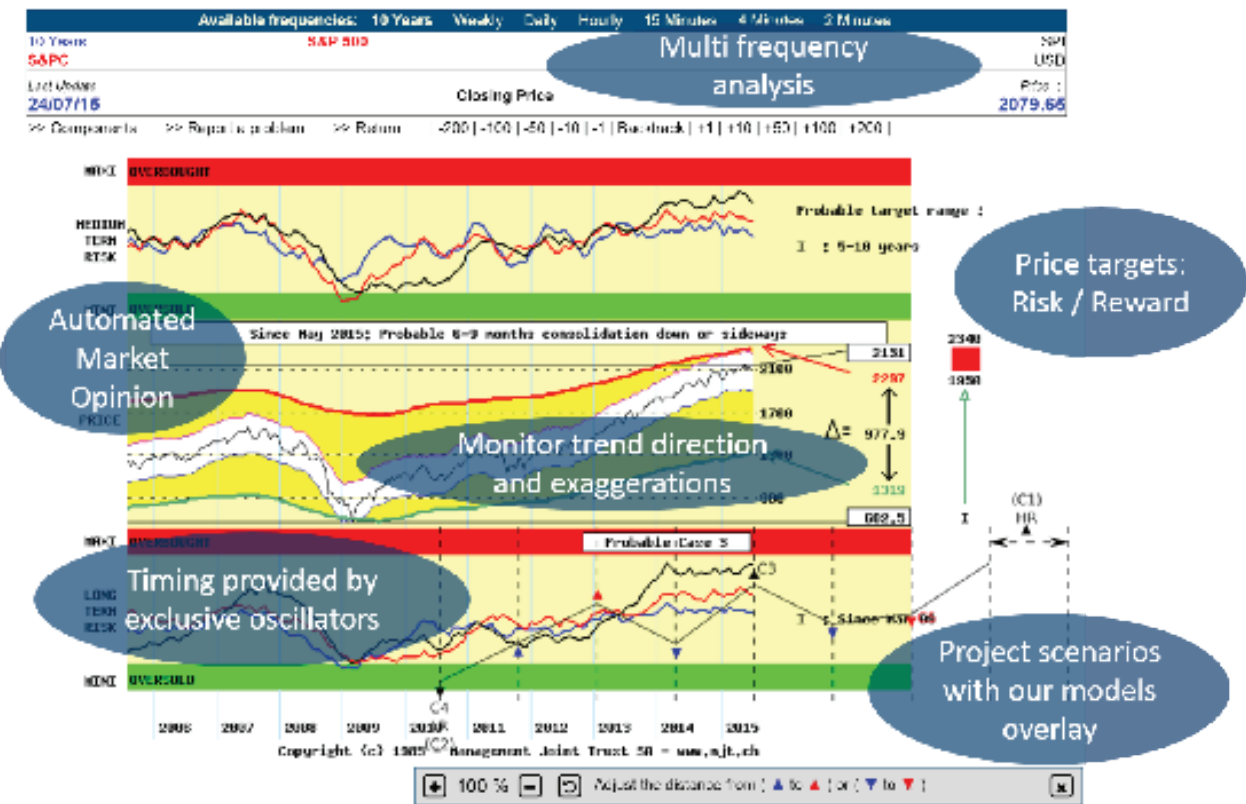
Throughout this document, we have been writing that we expect equity markets to start a new leg down probably between now and late September. The VIX S&P500 Volatility index seems to show these perspectives in reverse. Indeed, on our long term oscillators (lower rectangle), an intermediate bottom was made mid August and the VIX has since been moving higher. On the other hand, our medium oscillators (upper rectangle) suggest that the VIX may retest down once more over the next couple of weeks. Following that, it should also start to resume up. Combining both, we believe that the **VIX could be bottoming out soon, and that during the leg up we expect during October and November, equities markets and risk assets in general could see another leg down**.

Concluding remarks :

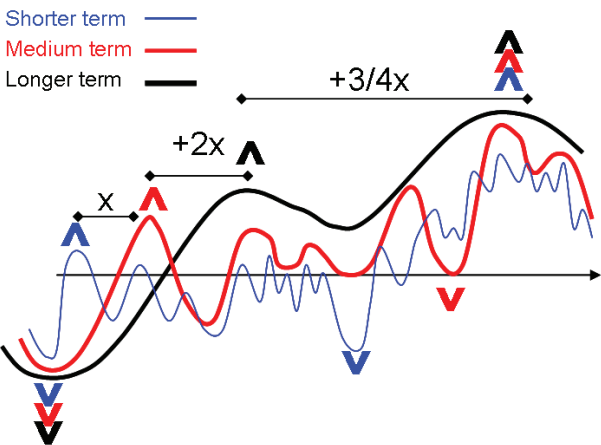
Given the long standing linear Bull market on US equities, a correction that could reach beyond minus 20% would feel like a surprising anomaly. Yet, such corrections have happened in the past and not so long ago in Europe, Emerging Markets or Japan. Financial crisis usually come from left-field and unexpectedly. This time may not be that much different and the current set-up, where, longer term, our oscillators on most markets are reaching important tops, or are already descending, seems quite right for it to happen again.

53/ 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)

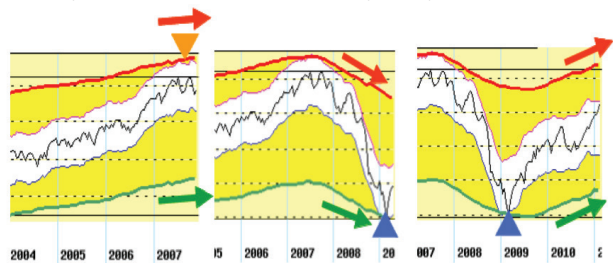


Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)

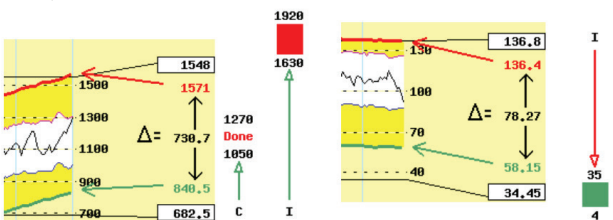


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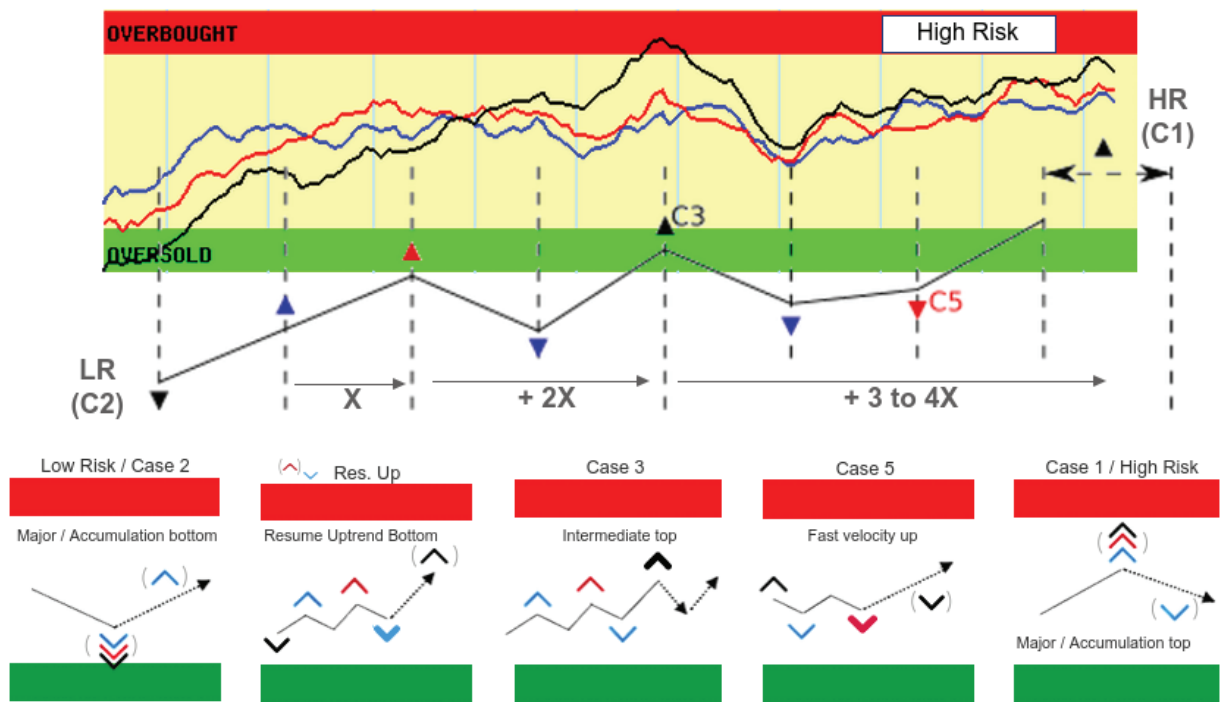
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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).



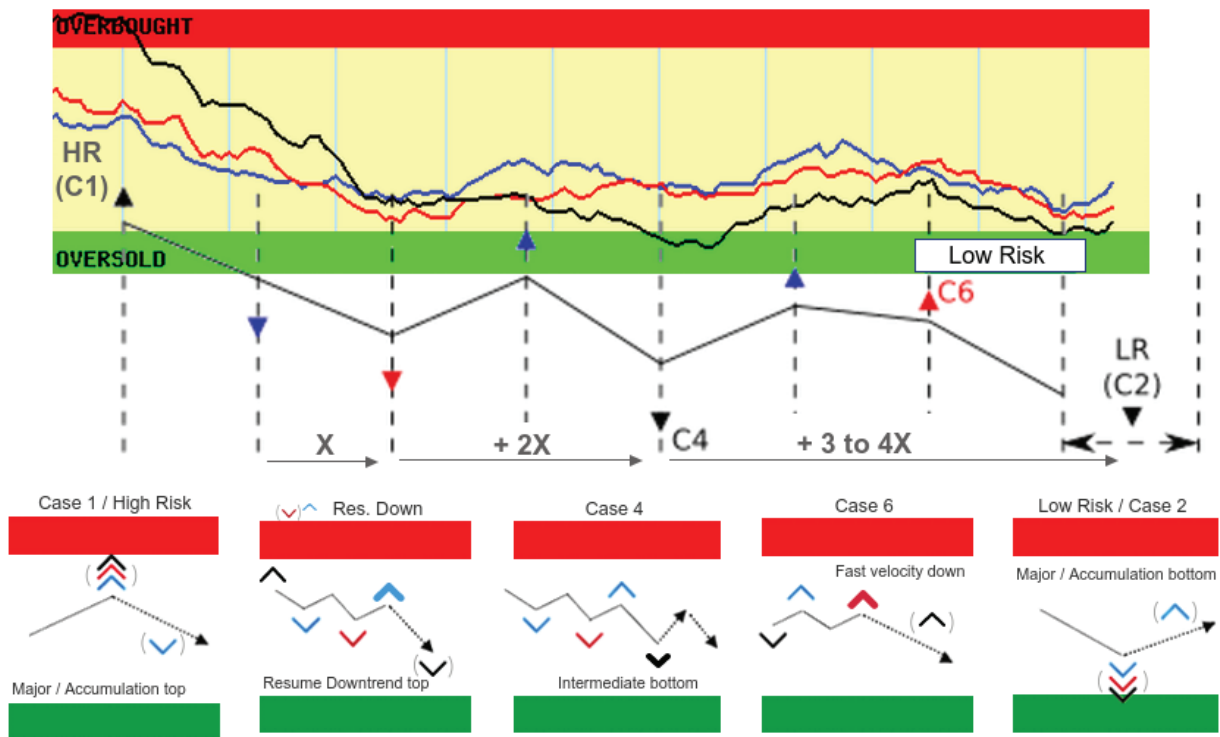
Ideal Uptrend Model



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(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



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(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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