4/ Executive Summary

12 / **The US Dollar has likely bottomed, as the EUR falters and as capital inflows to the US rise on favorable fiscal and monetary developments -** The reason for the EUR's strength last year: foreign investors bought large amounts of EUR bonds (EUR 1.27 trillion) as a result the European Central Bank's (ECB) Quantitative Easing, and those purchases were mostly unhedged. Another contributor to this move was U.S. investors in exchange-traded funds (ETFs) which shifted from hedged to unhedged European equity exposures. The strength and intensity of this EUR upmove caught many investors and analysts unaware, for good reason-- the European Central Bank (ECB) was continuing both its negative policy rate and quantitative easing programs in earnest at that time. A sharp EUR appreciation at that time was unexpected – the market consensus in Q1 2017 was for a decline in EUR in the near-term. The move higher accelerated when the «fear of missing out» (FOMO) on any further EUR appreciation overcame investors' natural aversion to «timing» currency hedges. However, the EUR's upside momentum (and the US Dollar slide) may be coming to an end or may have even ended-- the greenback's trough may have been made during early February this year-- a USD bottoming process (and EUR peak distribution dynamic) may be going on. Euro bulls have been too optimistic for too long and far too much. It has been reported that open interest on euro futures has increased 36% yoy, while a composite net long position has reached a massive 340,000 futures contracts (as of the end of January)-- an all-time record even if adjusted for higher open interest. Should political developments disappoint in Italy, the EUR bulls could start heading for the exit. That would invigorate a bid for US dollars which is slowly firming and gaining momentum, as fundamentals (which are mainly USD-bullish, longer term) slowly reassert. This is what we are detailing this month.

17 / **Timing and Tactical Insight - The Dollar is Oversold, what kind of counter-trend/reversal can we expect** - Against most currency pairs, the US Dollar currently seems Oversold. On some, it may have bottomed mid February, on others, a further short term retest may materialise until mid March. Following that, we would expect a further bounce into April. Longer term, although quite oversold, the US Dollar may see a further period of retracement and downside re-tests during mid/late Q2. Considering this risk, it may still be a bit too early to enter USD directional trades. We would however consider to take profit on US Dollar bearish bets on any weakness over the next 2 weeks, and possibly put in some asymmetric bets to profit from the rebound.

22 / **The Fed will be the primary determinant of equity markets in 2018, as The Donald choses Main Street over Wall Street; the Fed will stay its tightening regime, or worse -** Mr. Jerome Powell, the new Federal Reserve Chair, and the new FOMC (which will be dominated by new appointees of Mr. Donald Trump) will be the primary determinant of the trajectory of the US stock markets (and global equities, by implication) over the course of the year. The theme that underpins all of these is how Mr. Powell and the new FOMC will view growth going forward. More alarmingly, Mr. Powell stressed that the stock markets are not the economy, and the Fed's focus was the real economy. This was in continuation with Mr Dudley's speech delivered on Dec.1, 2014 when he said «Let me be clear, there is no Fed equity market put. To put it another way, we do not care about the level of equity prices, or bond yields or credit spreads per se. Instead, we focus on how financial market conditions influence the transmission of monetary policy to the real economy. At times, a large decline in equity prices will not be problematic for achieving our goals." Both Messrs. Powell and Dudley have just shot down the notion of a «Fed Put» in the markets. We know now that their focus lies elsewhere, and that the priority is not really to support asset prices but to make sure that financial conditions are optimal for the economy. Sometimes, the Fed over-focuses on inflation, and since inflation lags behind growth and activity, the timing of their reaction-function to this data can sometimes be awkward (to say the least). The Fed will not allow unfettered actual inflation, and the committee will likely overreact to tamp down any inflationary surge. The Fed will «fight inflation» with interest rate increases, even if they are inconvenient to market investors. President Trump will accept possible «normalization» of stock and bond (lower) valuations, if the economy performs well, and jobs (votes) are created. It is choosing Main Street at the expense of Wall Street. This will be one of the key risk for equity markets in 2018.

26/ **Timing and Tactical Insight - An unconvincing bounce on many equity markets may lead to further downside retests into end Q1 / early Q2** - The early February correction on equities created important intermediate tops on many of our long term graphs. The rebound that followed is still underway, yet appears quite weak. We would hence probably expect a further period of downside retesting on equity markets, which could start between now and mid March and last until early, perhaps late April. Relative trends to the downside on Defensive sectors and Goldmines vs the S&P500 seem exhausted for now. These may bounce over the next few weeks, which would confirm that a risk-off period is underway. More generally, equity markets could be approaching the end of their 9 years "Bull" market. We expect them to extend higher one last time from mid Q2 into mid-year, perhaps the Summer, but at this stage, the longer risk/reward on equities seems stretched.

The Capital Observer editors team, London / Geneva, March 8th 2018
to view previous issues, please visit our website at: http://www.thecapitalobserver.com

5/ Executive Summary

32 / **Changes in Money Velocity are rising, and that is pushing Core CPI higher; rising interest rates are in turn pushing up changes in MV, and rising CPI pressure rates higher -** We know that inflation expectations have been rising lately, but that Core CPI has been relatively tame so far. So actual inflation was not the issue when the equity market broke down sharply a few weeks ago – but inflation expectation was. So what pushed up inflation expectations in the first place?
The development in MV was totally ignored by the market, but that probably stems from the fact that monetary velocity is not very well understood. Interest rates moves tend to precede movements in money velocity, which is what we would expect from a causal relationship such as this – there is a positive correlation between interest rates, and interest rates are the lead variable in the relationship. And this is where the link between interest rates and MV becomes significant-- changes in money velocity (RoC) cause changes in inflation. Higher interest rates push changes in Money Velocity higher, which in turn, pushes up Core CPI. Then it is easy to see why rising interest rates push up Core CPI after a lag, via the MV transmission link. The relationship between these three variables is very reflexive, as interest rates are affected by inflation, or more properly by the expectations of inflation. And expectations about inflation tend to follow actual, realized inflation. This is where it becomes scary, rising interest rates, and more importantly rising money velocity, create a very unfortunate backdrop of rising inflation. If you combine changes in money velocity with other growth variables, you can easily see why Core CPI will be persistently ascendant in 2018.

34 / **Timing and Tactical Insight - Inflation anticipations may subside until end Q1, yet should rise again in Q2 -** Inflation expectations, Oil, Copper, Gold, long term yields and related sector trades are currently approaching intermediate tops. We expect them to consolidate at high levels probably until early / mid April. Following that, from mid Q2, inflationary/reflationary themes should accelerate up again possibly towards midyear, perhaps the Summer. The sector mix, which we see outperforming during this short pause in inflationary dynamics is quite defensive (high yielding stocks, Gold mines, Utilities), which may imply a rather risk-off bias.

40 / **The long-term price action in the grains sector is about to form a major bottom in Q2 2018 -** The agriculture sub-sector has been one of the most neglected sub-sectors in the commodities asset class, and has just edged out the precious metals sub-sector for the most laggard position since the cyclical trough of commodities in February 11, 2016.
Nonetheless, we believe there are good reasons to revisit the grains sector, as any significant setback from current levels may provide entry levels for long trades positioned for another episodic surge of prices over the next year or so. Over the past decade, grains have exhibited behavior which can be very profitable if timed correctly. Weather developments are also lending a positive spin to the agriculture sector – the dreaded La Nina phenomenon is making an impact on grain prices. As we head into spring season, the current La Nina weather pattern could make the southern portion of the United States experience periods of drought-like conditions. If the 2018 crop year does not turn out to be the sixth consecutive year of bumper production, we could see prices for grains move appreciably higher towards the middle of the year. Demand limits the downside potential for prices while any unexpected weather event could lead to explosive price action on the upside. There has been five consecutive years of bumper crops, but there is no guaranty that we will see the sixth of such bumper crops.

42 / **Timing and Tactical Insight - Agriculture Commodities are typically late cycle reflationary trades; Grains especially have started to react** - Agricultural Commodities have recently broken out of their persistent downtrend. We expect this bounce to gain traction over the next few months and possibly continue higher towards late Summer at least. Indeed, Agricultural Commodities are late stage reflationary assets and at some point during 2018, we would even expect them to take on the lead in the Commodity space (probably once industrial commodities such as Oil and Copper, top-out sometime towards early Summer). Shorter term, Agricultural Commodities may correct a bit towards late Q1 / early Q2. They should then be bought (BUY the Dips). Looking at its individual constituents, the Agricultural sector is quite differentiated. Grains and perhaps Cacao have started to bounce, their price potential is compelling and they look promising for the rest of 2018. Coffee and Sugar, on the other hand, are still down-trending, while Cotton and Lumber, following strong uptrends over the last 2 years, already seem quite exhausted with little upside potential left.

48 / **Splicing the markets - Investment Grade Bonds are stuck between a rock and a hard place -** Until mid 2018 at least, we expect an environment of rising inflation expectations, rising yields and rising risks for risk assets. This is not a friendly environment for Investment Grade Corporate Bonds, which usually thrive when inflation diminishes, and growth and equity markets accelerate up. Indeed, Investment Grade does not address the two main risks in this late cycle environment. High Yield will protect you against short term inflationary pressures, Treasuries will protect you against the deflationary bust that may follow. Investment Grade addresses neither. It's like a siting Duck caught cross current between inflationary and deflationary pressures.

The Capital Observer editors team, London / Geneva, March 8th 2018
to view previous issues, please visit our website at: http://www.thecapitalobserver.com