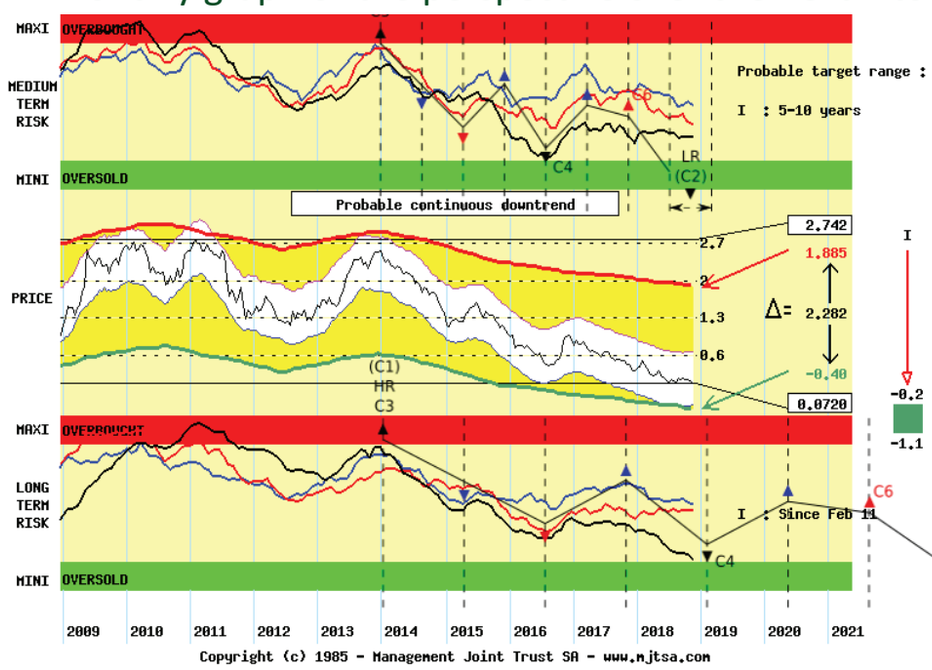
38 / MJT - TIMING AND TACTICAL INSIGHT

The Yield curve is still flattening, the scope is limited, yet it may still extend lower into mid Q1

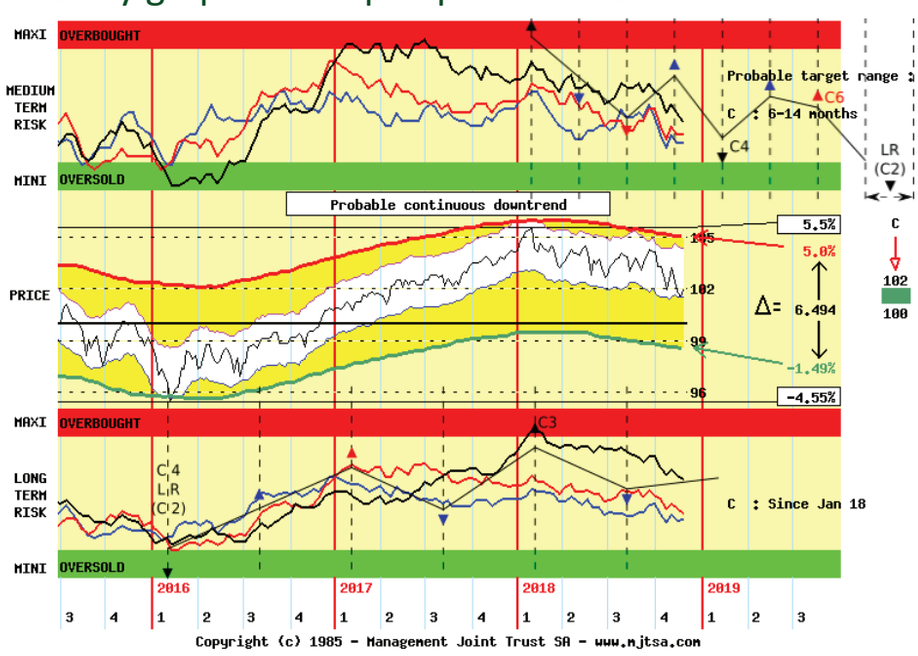
Since the risk asset correction began in early October, yield curve spreads have been contracting again. This flattening accelerated last week as the hopes about the US – China Trade Truce started to dissipate. Indeed, as mentioned in the last few issues of The Capital Observer, for now, the short end of the curve is still being driven up by the FED, while on the other hand, the long end has started to roll-over, being pushed down by Flight to Safety flows as risk assets correct. In this article, we review yields and yield curve spreads across the US and European curves, and assess the scope for further flattening potential going forward, as well as its incidence on the performance of various equity profiles such as Growth, Value or Defensives.

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



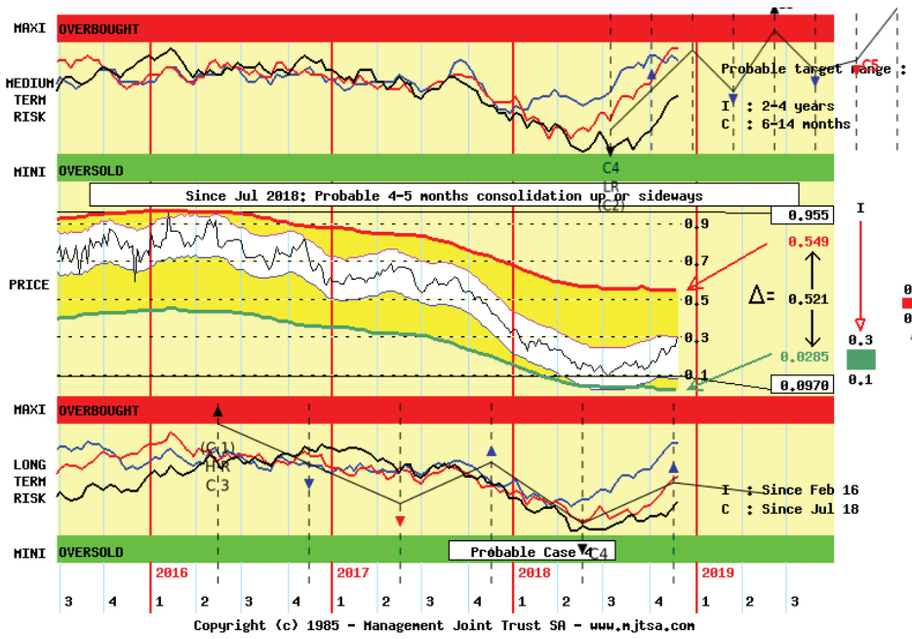
According to this long term graph of the US 10 Years – 2 Years Interest Rate Swap yield curve spread, the US yield curve is on the verge of inverting. Our I Impulsive targets to the downside (right-hand scale) would even suggest that the spread may still have plenty of scope to dip into negative territory (target range between -20 and -110 basis points). That said, the timing is getting tight, the spread has been flattening for almost ten years and both our oscillator series (lower and upper rectangles) are now suggesting that our downtrend models should soon be coming to an end. **So yes, we do expect some inversion over the next couple of months, and the yield curve spread may then dip into negative territory. Yet, this move could be short lived as the curve should start to stabilize during the first half of 2019 and then probably even steepen at some point during 2019**. This would probably imply a strong downward revision in the prospects for short term rates next year, and probably also, at some point, renewed upside pressure on long term rates, perhaps a bit of both. We attempt to understand how over the following pages.

Flight to Safety portfolio simulation
Weekly graph or the perspective over the next 2 to 4 quarters



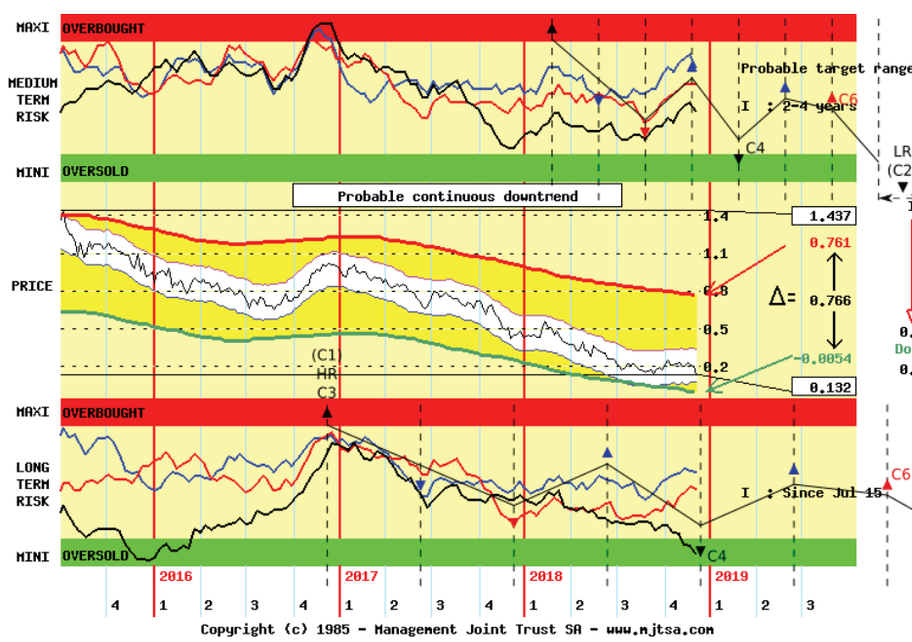
Yet, before we go into the various yield curve spreads, **we first want to simulate what we believe is driving the long end of the yield curve to correct, namely Flight to Safety flows**. This portfolio benchmarks an equal weighted selection of Sovereign and Corporate Credit Instruments as well as Equities vs 10 years US and European Treasuries. The resultant pretty much matches the path of global risk assets since the beginning of the year. According to our long term oscillators (lower rectangle), the 2016-2017 reflationary Bull market probably ended in January this year. Our medium term oscillators (lower rectangle) are now pointing to **further weakness over the next couple of months (until mid Q1), and then to the possibility of a bounce into the Spring, possibly holding up into the Summer**. For now, the downtrend is still in its early stages as it has held above our C Corrective targets to the downside (right-hand scale). Bottom line, **we expect the current deleveraging spree to continue probably towards late January / February, where risk asset should find support, before a strong move up materializes into late Q2 at least.**

US 30 years - US 10 years Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



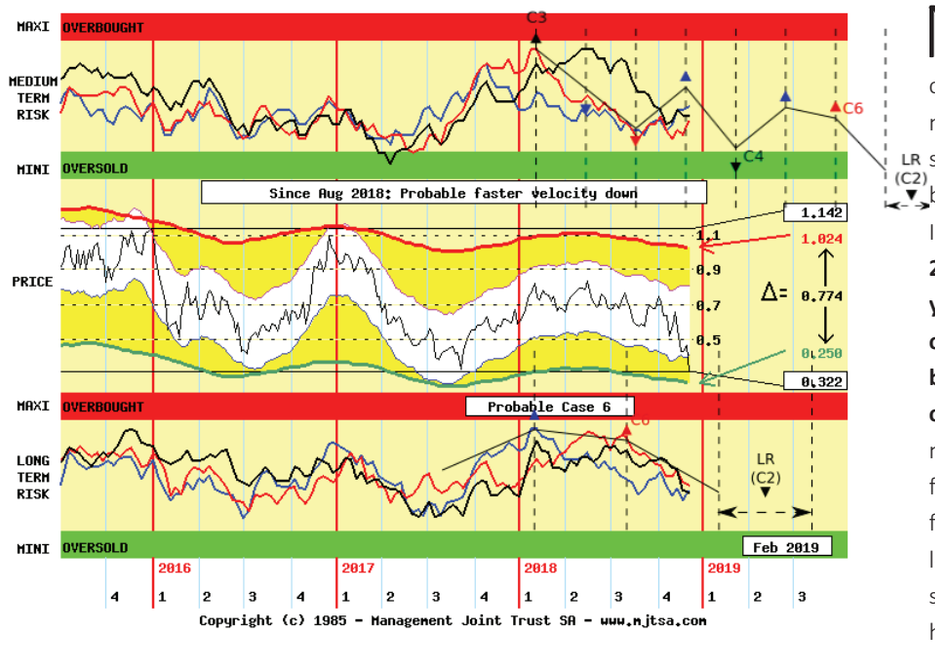
Interestingly, the long end of the US yield curve (30years minus 10 years) is already steepening. It started to turn up in July this year and has since been rising steadily. Indeed, 30 years US treasury yields have been accelerating up more rapidly than 10Y yields since the Summer. We believe this reflects the current late cycle environment and related late cycle inflationary pressures. This spread on longer term yields is also less impacted by current developments in the Fed Fund Rate. Indeed, as the US 30 Years is less liquid, it is seeing less impact from the current deleveraging and related Flight to Safety flows. That said, both our oscillators series (lower and upper rectangles) are suggesting **that some retracement could materialize as we move towards year-end and Q1, yet that thereafter, from late Q1, the spread could widen again (i.e. this long term end of the yield curve should steepen again), probably into late next Spring / early Summer. This is something to bear in mind once risk assets manage to find support probably towards mid/late Q1.**

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



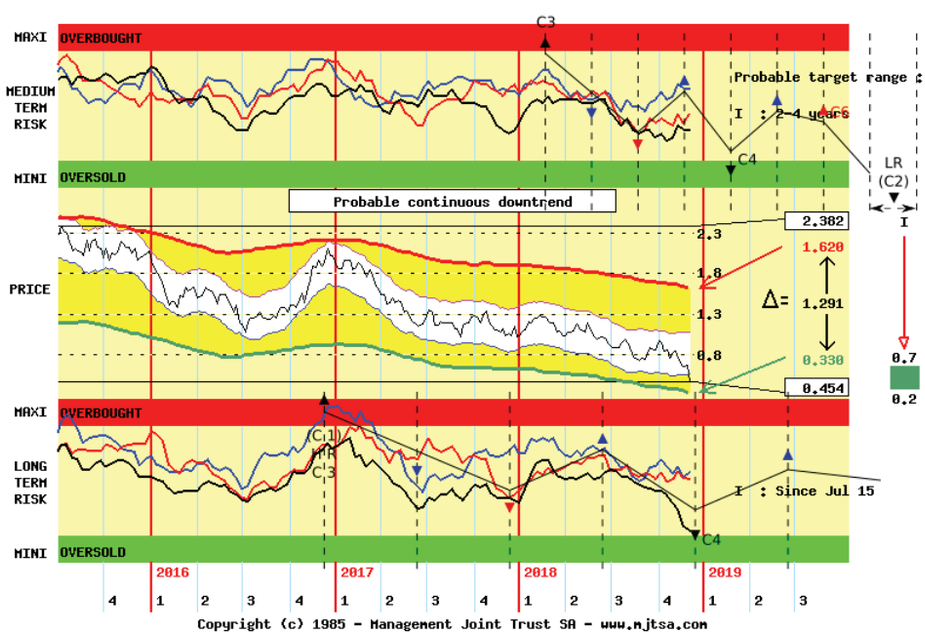
Moving to the middle section of the US curve (10 Years minus 3 Years), we can now start to observe Flight to safety in action. The spread has already come down quite substantially since early 2017, while our long term oscillators (lower rectangle) may be approaching an important low), our medium term oscillators (upper rectangle) would indicate one last flattening move into mid Q1. From a price targets perspective (right-hand scale), **the potential to the downside on the spread is pretty much exhausted, so that we expect a last continuation trade lower, and perhaps, briefly some inversion, before the spread starts to rise again, probably into next Summer.** This schedule going forward pretty matches our conclusion on the first graph in this article (long term bi-monthly graph on the USD 10 years minus the 2 years Interest Rate Swap). **Again, we believe it highlights further deleveraging and Flight to safety flows into mid Q1, before risk assets start to bounce into the Spring and long term yields with them.**

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



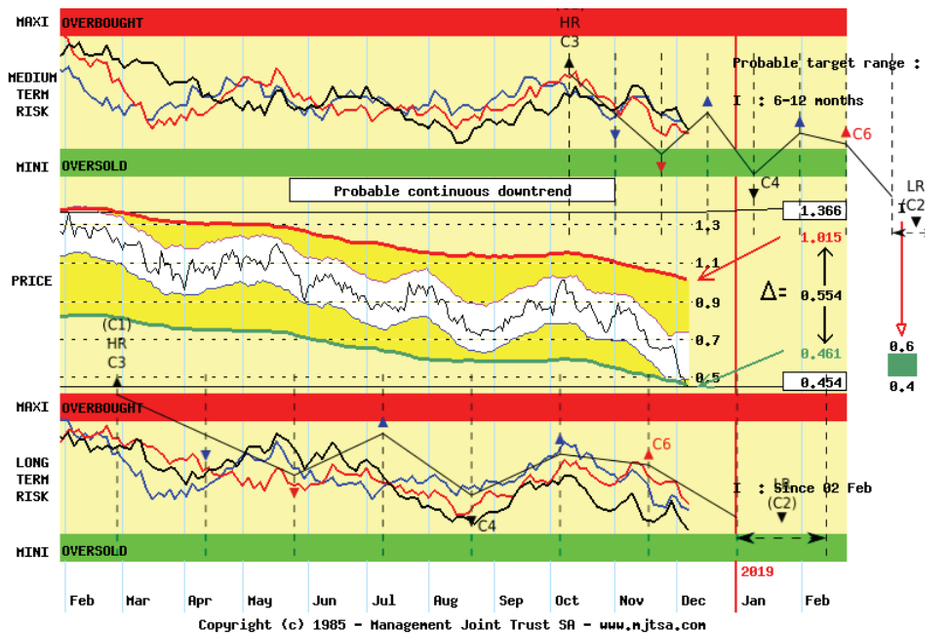
Now looking at the short term end of the US yield curve, namely to the 3 years minus 3 months treasury yields spread, Flight to Safety then becomes much more apparent. Indeed, we can note that **the 2 to 5 years section of the US yield curve is the most liquid one, and that it is probably be the main recipient of flows out of risk assets**. We can also notice, that this spread has followed all reflationary/dis-inflationary periods over the last three years, and especially since the beginning of this year has been been very well synchronized with the path of risk assets (as we already pointed out in our early September issue of The Capital Observer). **Going forward, we are expecting further downside pressure on the spread on both our oscillator series (lower and upper rectangles), probably into mid/late Q1, and then, as with other spreads mentioned above, we expect a bounce into the Spring, probably towards mid year, and perhaps the Summer. On the price targets front, we are currently making new lows. Over the next few months, the spread may contract by another 20-30 basis points, or to not far from zero.**

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



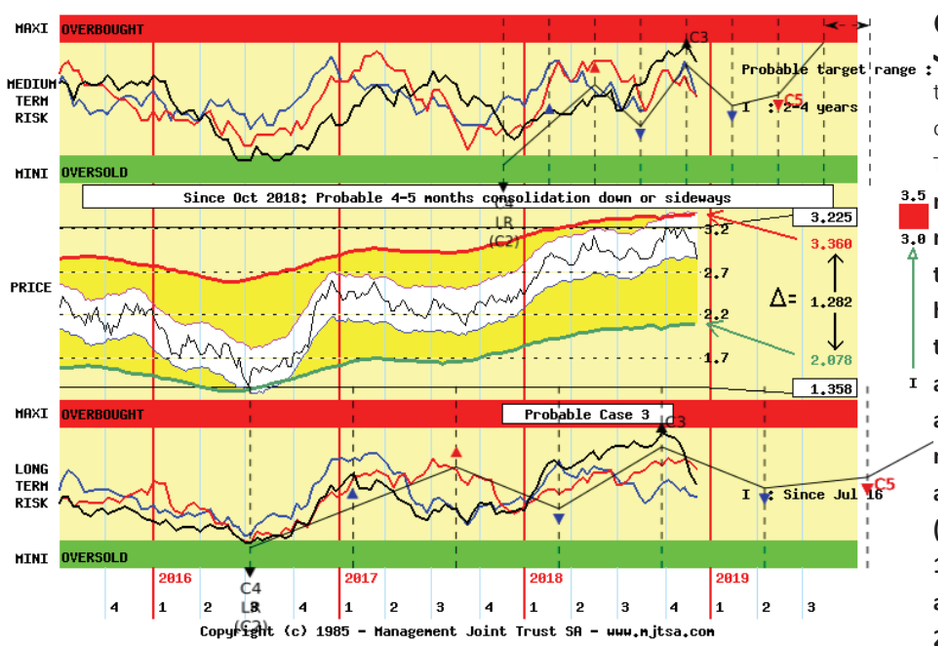
The last retest down we expect into mid Q1 is also quite clear, when comparing the US 10 years spread minus the 3 months. Indeed, while our long term oscillators (lower rectangle) are suggesting a low this month**, our medium term oscillators (upper rectangle) are telling us that the spread could now resume lower, probably until mid/late Q1.** On the price targets front (right-hand scale), our I Impulsive targets tot he downside are pointing to **another 20 to 30 basis points of flattening potential, or the 20 to 30 basis points we expect on the 3Y-3M spread, plus a marginal additional downside move on the 10Y-3Y spread** (as mentioned in both previous graphs).

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



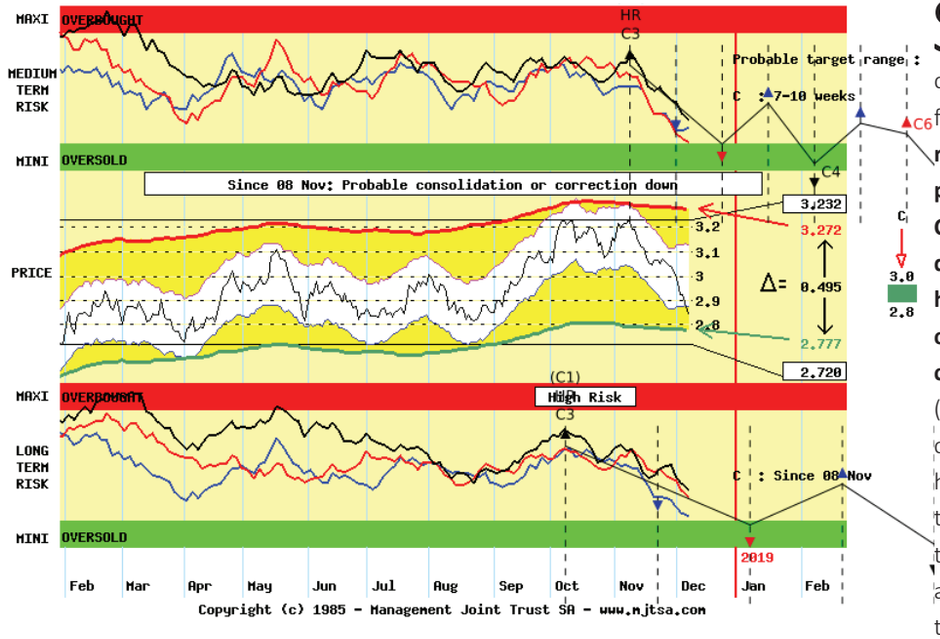
On the Daily graph of the 10 Years minus 3 Months spread, the Flight to safety acceleration is very clear. It started early October, and both our oscillator series (lower and upper rectangles) are now suggesting that it should continue lower, first into early/mid January, and then probably once again into February / March. Our Impulsive targets to the downside have pretty much been achieved (right-hand scale), yet as mentioned above, our Weekly graph is suggesting slightly more downside potential into Q1.

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



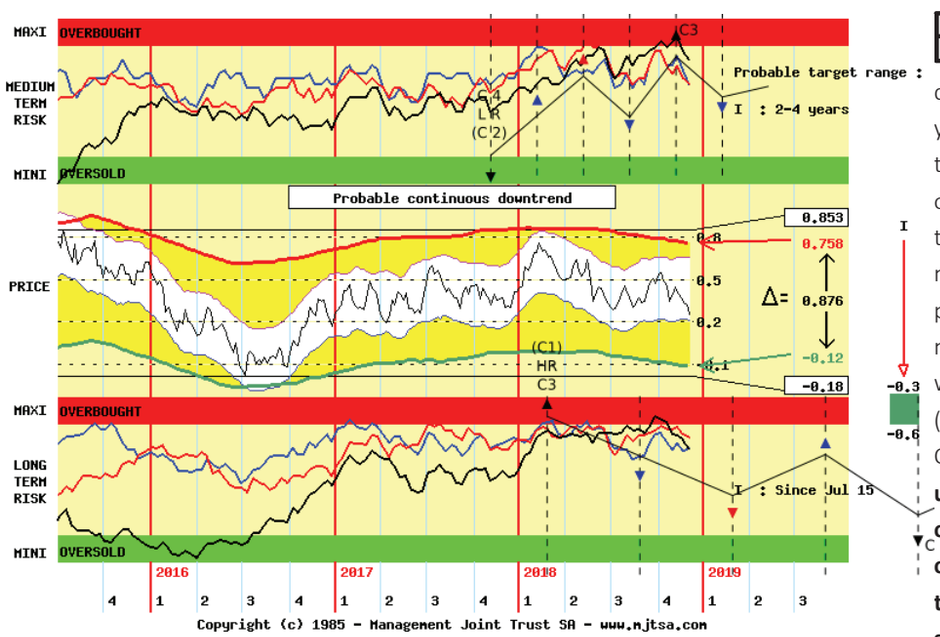
So how to these developments on the yield curve translate into the price action of the US 10 Years benchmark Treasury yield. **Well, considering that the Fed Funds rate-rates could still rise by another 25 basis points (one last hike in December), yet, that the 3 months has probably already anticipated this move, and that the 10 Years minus 3 months curve could flatten by a further 20 to 30 basis points (as we assessed above), the 10 Years Treasury yield would also need to fall by another 20 to 30 basis points to match these projections**. This is pretty much the scenario we have been pointing to over the least few issues of The Capital Observer. Indeed, both our oscillator series have recently confirmed important intermediate top (lower and upper rectangles), and we now expect the US 10 Year Treasury yield to correct down into mid/late Q1. On the price targets front, our C Corrective targets to the downside (not shown yet) would calculate towards the 2.6% – 2.2% range (0.5 to 0.8 our historical volatility measure "Delta", here at 1.282%- middle rectangle, right hand side – subtracted from the recent tops at 3.225%). **According to our calculations, the upper end of this range could be reached over the next couple of months. It would probably imply additional flows towards Treasury and hence, a continuation of the deleveraging process on risk assets.**

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



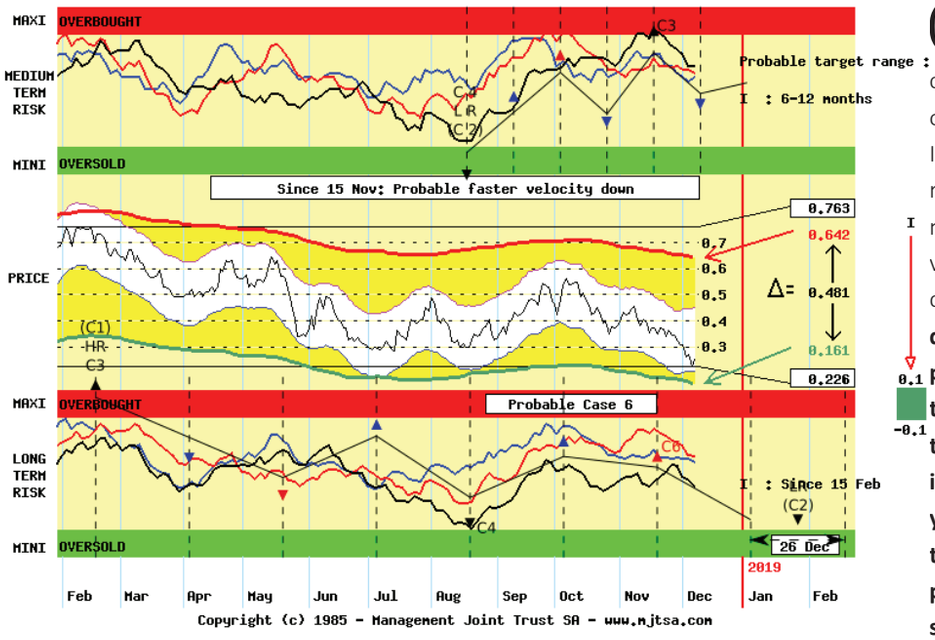
Shorter term, the Daily graph has been correcting down sharply over the last few weeks. **10 Year yields are rapidly approaching the support of the lower end of our C Corrective targets to the downside around 2.8% (right-hand scale). If these do break, our next level of targets would calculate in the 2.59 – 2.39%** (1.3 to 1.7 times or historical volatility measure "delta", here at 0.495% - middle rectangle; right-hand side – subtracted from the graph's top at 3.232%). This is pretty much towards the higher end of our Weekly corrective targets above. In terms of timing, we show slightly different sequences on our long term and medium term oscillator series (lower and upper rectangles). Indeed, the US10 Years yield shows two significant tops (one in early October, one in early November) from which to start our downtrend sequences. **By and large, we expect a first move down into year-end, probably early January, and then a further move lower into February / March.**

German 10 Years Bund Yield
Weekly graph or the perspective over the next 2 to 4 quarters



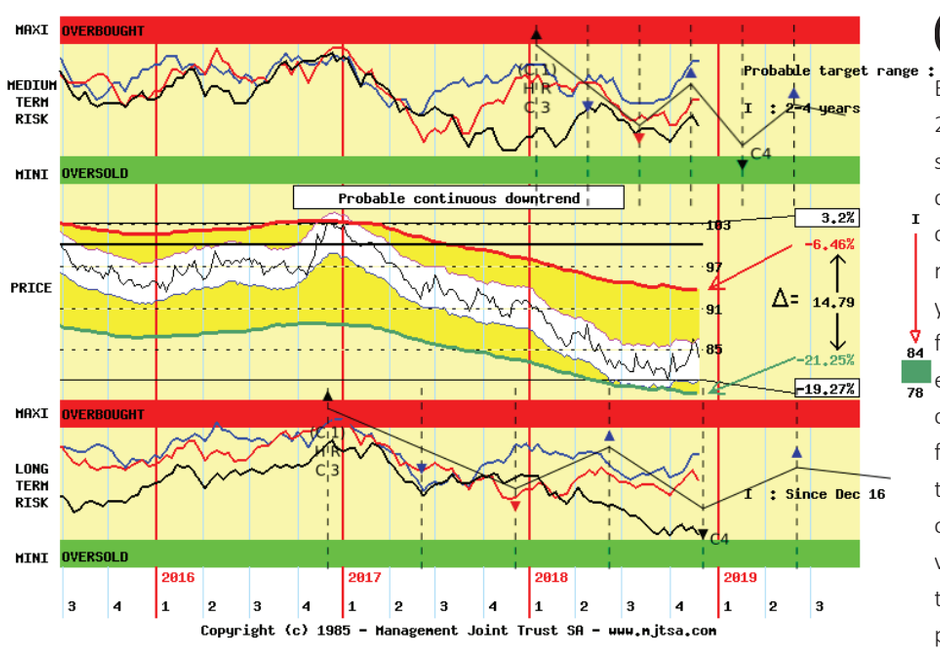
Bund yields offer further confirmation of the move down we expect on long term yields over the next few months. Indeed, while our long term oscillators (lower rectangle) topped out in Q1 this year, our medium term oscillators (upper rectangle), just confirmed a new top in October, with prices which were already descending (a lower top than the Q1 one in October). **This configuration is usually quite negative and is often followed by a rapid sell-off. Our I Impulsive targets to the downside (right-hand scale) are now in impulsive territory and point to a substantial move to the downside, probably back below 0% and possibly towards the -0.3 to -0.6% range. This would be extremely worrying for the fate of risk assets in Europe and the EuroZone.**

German 10 Years Bund Yield
Daily graph or the perspective over the next 2 to 3 months



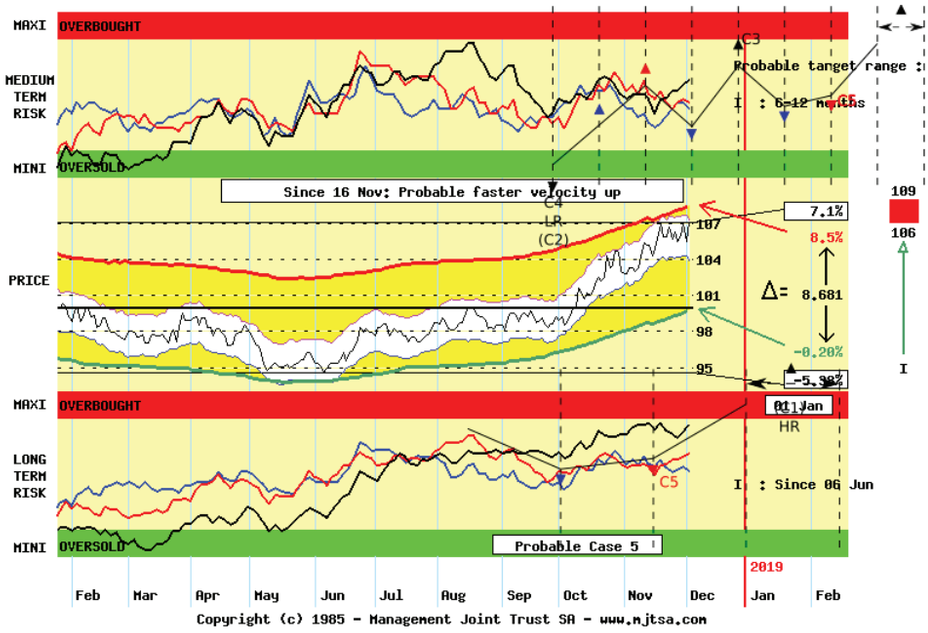
Our daily graph of the German 10 Years Bund Yields confirms our negative prospects on these over the next 2 months. Indeed, on both our oscillator series (lower and upper rectangles) new tops were made early November while prices were already declining. **This again, is usually quite negative and suggests a possible further acceleration to the downside of German long term yields. Our timing suggests, initial support points towards year-end / early January, and then probably further downside pressure into February. I Impulsive target to the downside are indicating that 10 Years Bund yields could dip below 0% by then** (right-hand scale).

Value vs Growth - S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



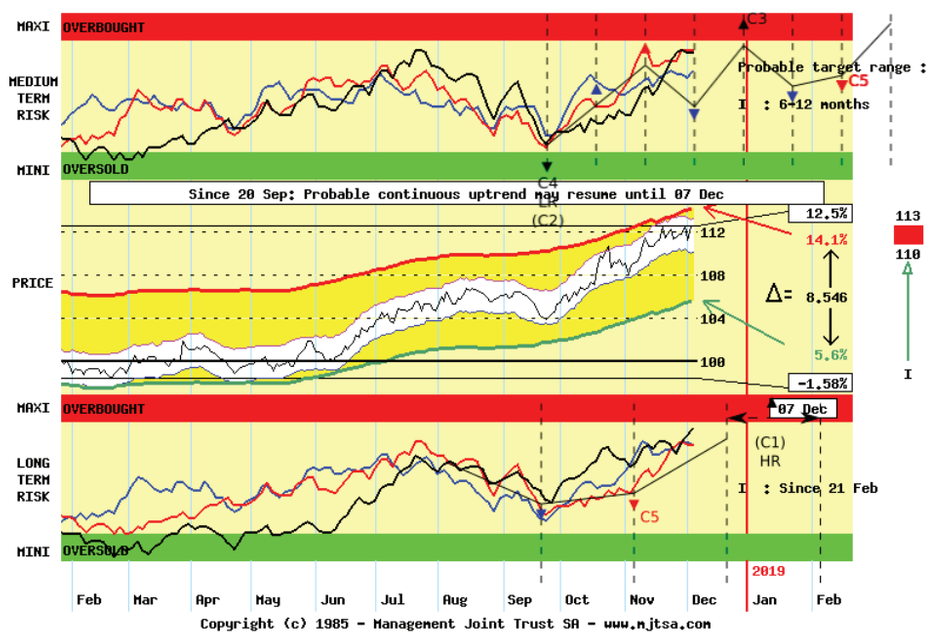
Given these negative prospects on Government Benchmark yields over the next 2 months, and the last flattening spree we expect on the US yield curve into mid Q1, we will now consider the US Value to Growth relationship. Over the last two years, the yield curve has already flattened substantially. Hence, even if we do expect the yield curve to flatten once more, before it starts to reversing up into the Spring (our medium term oscillators; upper rectangle), our view is that most (if not all) of the Growth pick up vs Value is probably already behind us. This is what our long term oscillators are suggesting pointing to an important low on the ratio over the next few weeks (lower rectangle). **Tactically, we believe that over the next couple of months, any Value to Growth arbitrage will probably offer little potential, nor any visibility in terms of risk/reward. Indeed, the current drivers in the market are probably much more Manichean. They are centered around the risk-off / risk-on relationship, and given our scenario, we expect both Growth and Value to underperform the market over the next couple of months.**

US Defensive sectors vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



Naturally we are turning to defensive sectors as we have done several times over the last few months. The portfolio we show includes the main US defensive sectors (cap. weigthed HealthCare, Staples, Utilities and Real Estate) vs the S&P500 Index. Although these have already been outperforming since the Spring, both our oscillator series (lower and upper rectangles) are suggesting that **this outperformance may continue to extend, first into year-end / early January, and then possibly once again into February / March**. Our I impulsive targets to the upside are suggesting limited outperformance potential left (right-hand scale), yet for now we continue to privilege our timing, which is still very much positive on this ratio.

Main European Defensive sectors vs the Europe Stoxx 600 Index
Daily graph or the perspective over the next 2 to 3 months



In Europe, our Defensive portfolio includes Food & Beverage, Utilities and HealthCare, which we have cap. weighted and compared to the Europe Stoxx 600 Index. Similarly to the US Defensives vs the S&P500 above, our timing suggests further outperformance, probably towards year-end and potentially into February. Here also, our I Impulsive targets to the upside have been achieved, yet for now, the uptrend still seems very robust. **We would hence continue to promote a risk averse equity allocation and would for now overweight defensive sectors, both in the US and in Europe.**

Concluding remarks

The US yield has flattened substantially over the last 2 years. Yet, we do expect one last attempt lower, probably into mid Q1. The 10 Years to 3 months treasury spread could still fall by a further 20 to 30 basis points over the next couple of months.This would also imply circa 20 to 30 basis points of additional retracement on the US 10 Years benchmark yield (the 25 bps rate hike in December is probably fully priced into the 3 months). This corresponds to the downside potential we've been forecasting over the last few issues of The Capital Observer. In our view, it can only happen if risk assets continue to drop, while Flight to Safety intensifies over the next couple of months. On the Equity front, we would hence avoid playing either Value nor Growth profiles, and continue to focus on Defensive sectors, which we believe should probably outperform further, first into January, and then possibly into February / March. By then, the correction on risk assets may have reached a worthwhile support, the FED could signal a pause in its rate hiking spree, and risk assets and long term yields could start to bounce into the Spring, thereby contributing to an initial period of steepening throughout the US Yield Curve.