THE CAPITAL OBSERVER

Emerging Markets and Cross Assets Special Report, September 2018

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THE CAPITAL OBSERVER

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

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3/ Executive Summary

04/ **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 makes matters worst for the Rest of the World.

09/ **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.

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

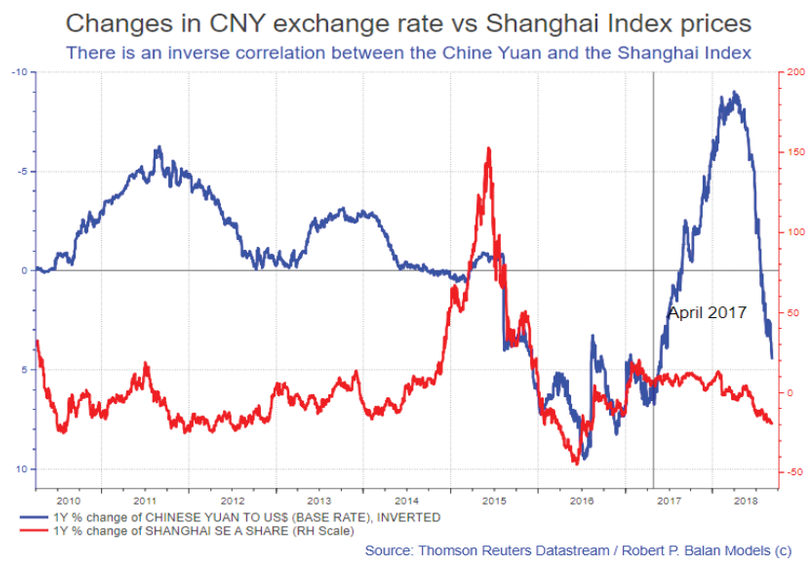
Emerging Market economies are in serious trouble. Increased US borrowing, which is helping power the US economy and its stock market for now, is hurting many other countries' currencies. Current EM problems can indeed merge into a much larger global debt crisis, just like the subprime crisis became a 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."

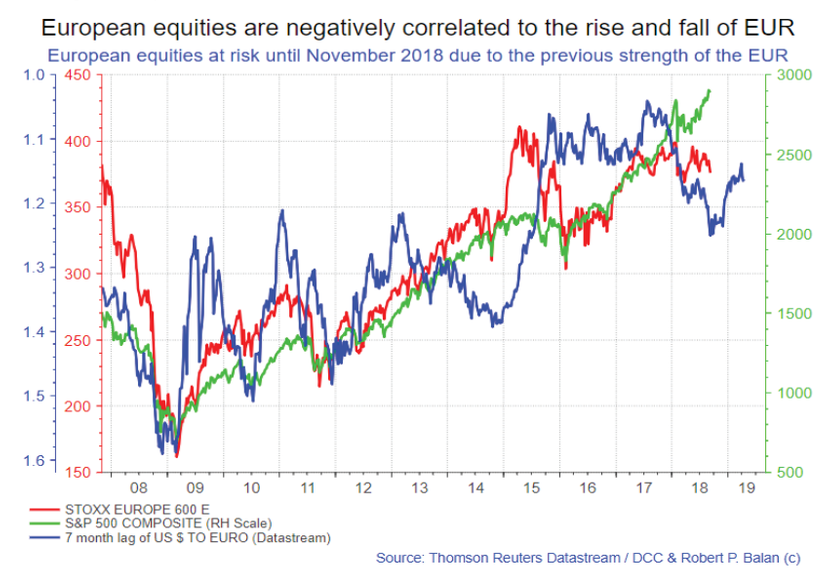
And, indeed, we hark back to the title of this article: the brewing EM crisis is a handiwork of the US Dollar; it will get worse, before it gets any better because the US Dollar rampage is not close to winding down. And worse, it looks like the Trump administration has weaponized the US currency. It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



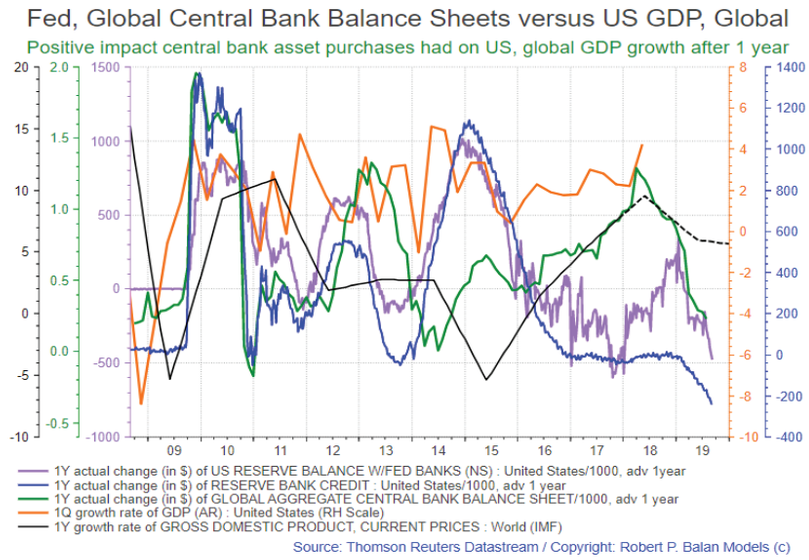
News is plentiful about other Emerging Market (EM) currencies falling against the US dollar. China's yuan has declined by almost 10% against the dollar since February. The Indian rupee just also just hit a record-low against the dollar, though the pace cannot be compared to the Argentine peso or the Turkish lira. Many other EM currencies have been doing poorly in recent months.

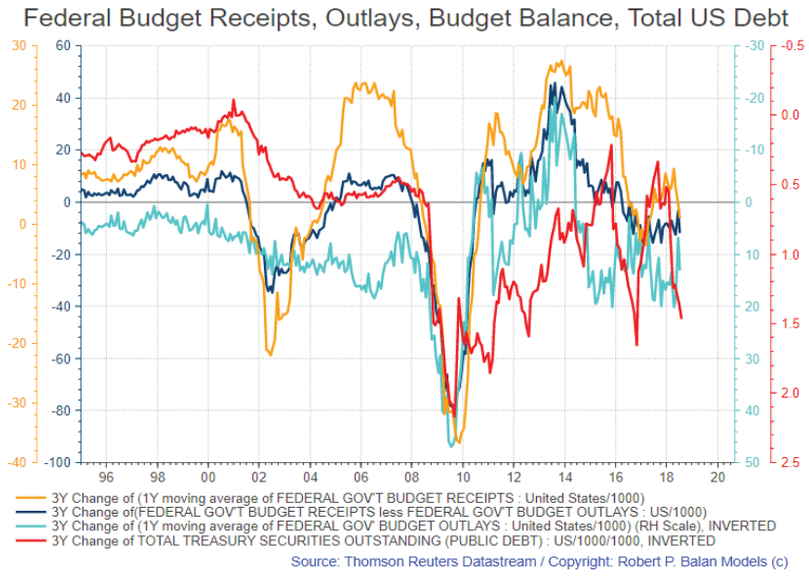
Europe's equity markets are not doing very well either, a victim of currency valuation – its own. European equity markets fell the pain from a strong EUR two quarters after the fact (*see 2nd chart on this page*).

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 that 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.

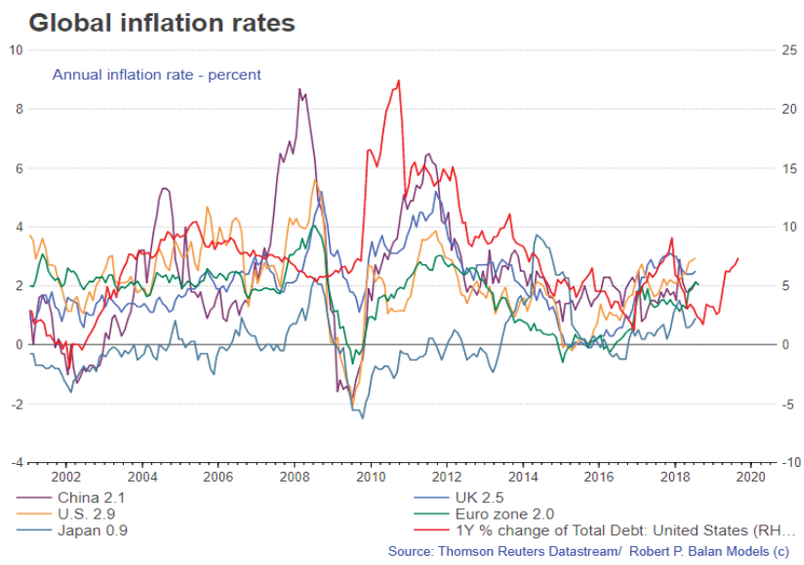
Europe has serious political issues, hindering the possibility of a coordinated fiscal stimulus program that would be acceptable and appropriate to all those who share the same currency but have very different economic and budgetary conditions. Some of the other countries who could have copied the stimulate-to-the-end 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.

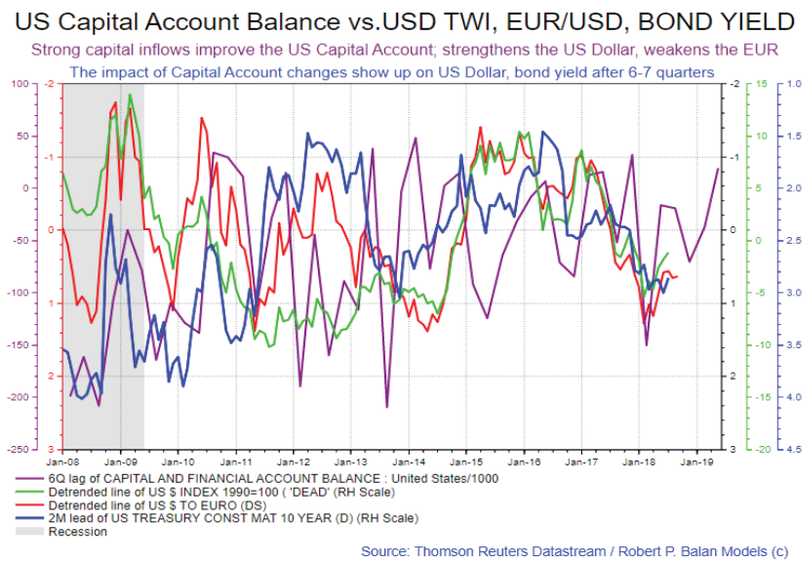
They didn't have the luxury of owning the world's reserve currency, the US dollar. At some point, their public and private borrowing could not continue without getting their currencies hammered.

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 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.**

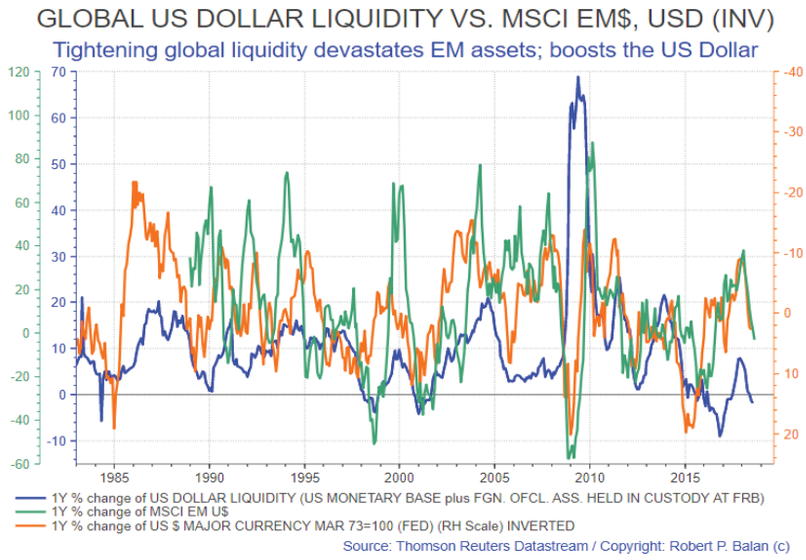
It is true that nobody can blame the US for deciding to run a larger budget deficit. But that is one of the reasons EM currencies are falling. The other factor putting pressure on EM currencies is higher rates from the Fed. Of course, it has been reckless policies by many EM countries that have led to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

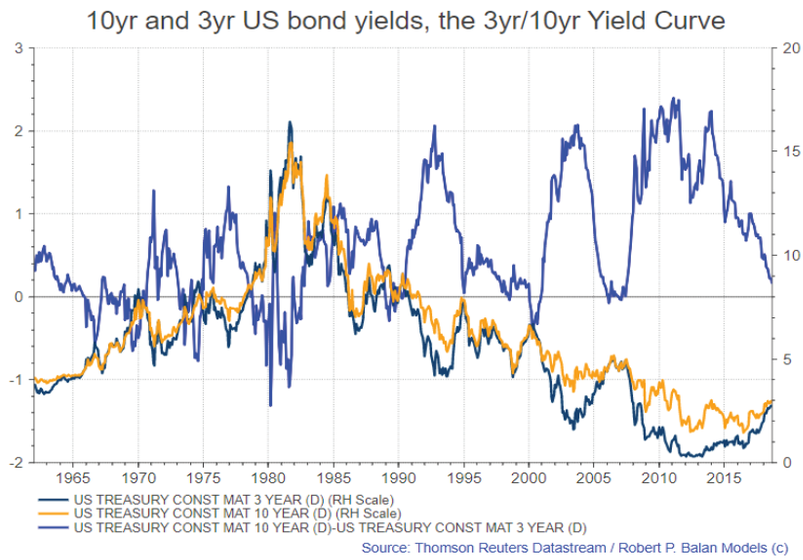
troubles, but let's not fool ourselves – those exactly the same reckless policies are mostly what is powering the US growth. America is running the world's largest current account deficit and the world's largest budget deficit in nominal terms, by far.

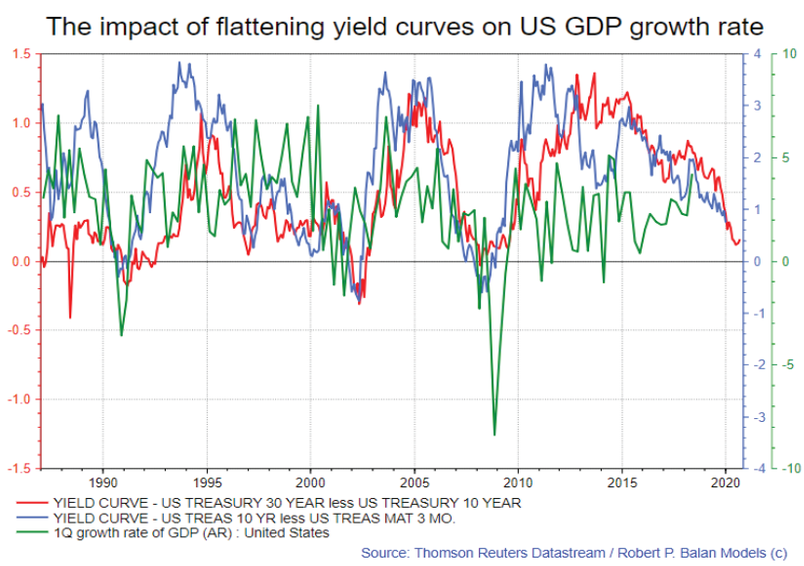
According to the CIA's World Factbook, the US ran a current account deficit of more than $466 billion in 2017, followed by the UK (over $100 billion), India, Canada, Turkey, France, Australia, and then Argentina. Obviously, the only EM countries in the list above, running highest current account deficits, 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.

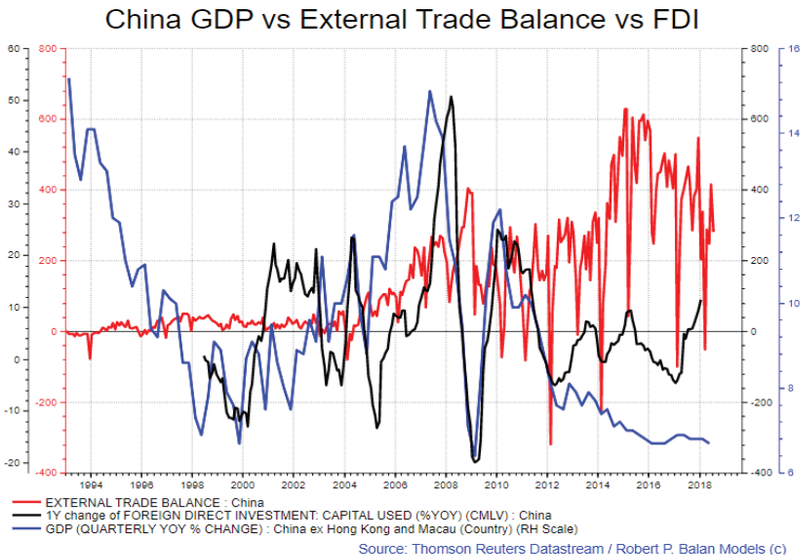




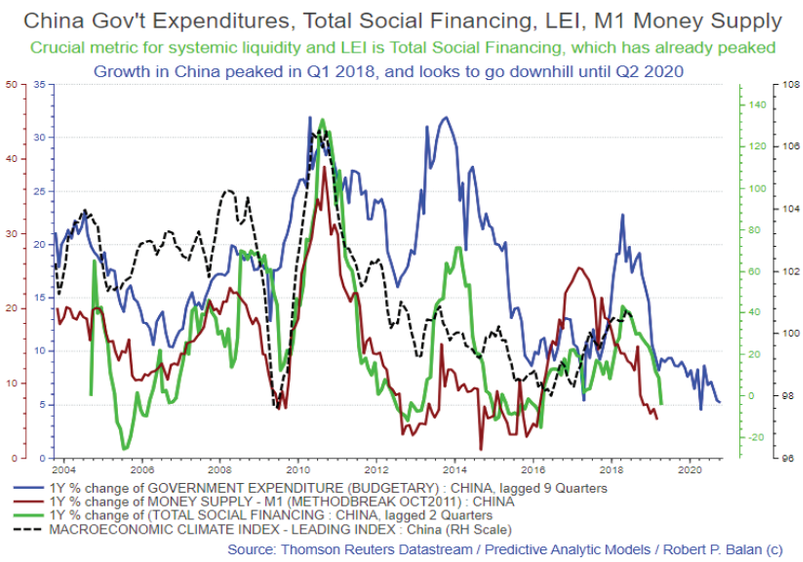


In any case, it seems clear that what has been a great year for the US economy and especially the US stock market, has been at least partially to blame for the woes of the rest of the world who have been trying to apply the same recipe Mr Trump has been applying, successfully. We have written extensively, 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.

Unsurprisingly, the latest news is not encouraging for China. China actually posted a current account deficit of about $28 billion in the first half of the current year, for the first time in 20 years. We don't know how things will proceed in the coming months and quarters for sure, but in case China is not able to return to a current account surplus, we doubt the yuan will be spared the pressures that have started to crush other currencies. The recent rapid devaluation of the yuan, whether deliberately engineered by China or not, is not a good move for the Middle Kingdom.

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 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.

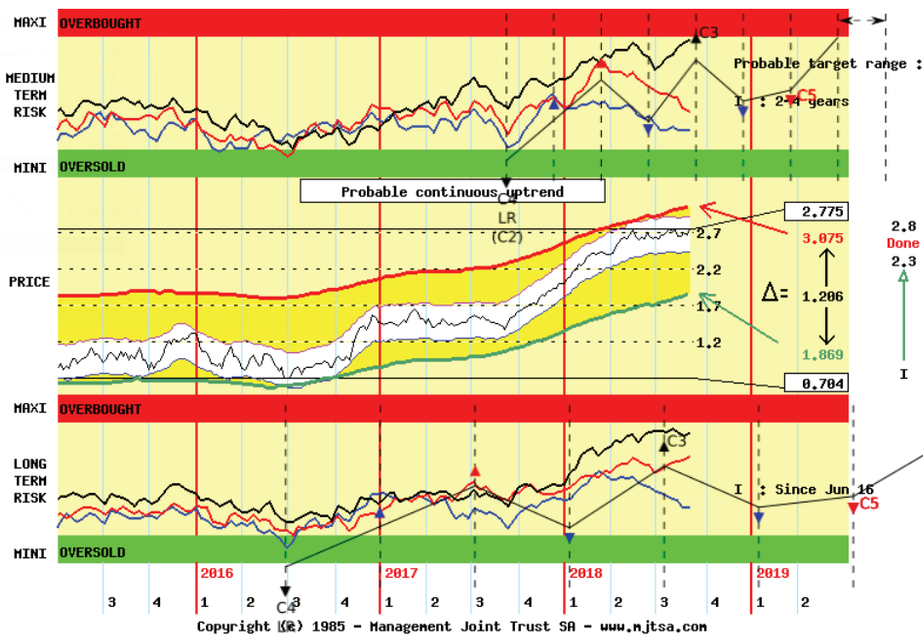
Back in 2007, almost nobody thought what started as the subprime crisis could turn into a global debt crisis. Almost nobody fears what is now an Emerging Market crisis - which is in reality a debt crisis in the making for those countries - could turn into a much bigger global debt crisis again. But the 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.

09 / MJT - TIMING AND TACTICAL INSIGHT

Flight to Safety is accelerating

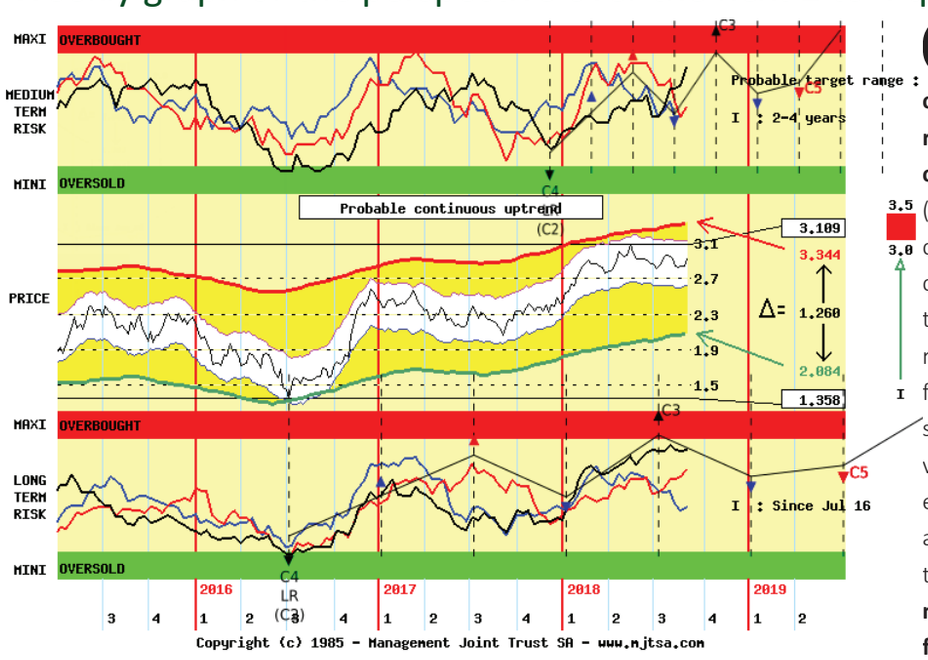
Since May, the rise in US Treasury yields has stalled. This is rather surprising given strong US GDP growth, a tight labour market, a Fed, which seems committed to several more rate hikes, and further increases in the supply of US Treasury Bonds. Consolidation or Distribution? In this article, we consider 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



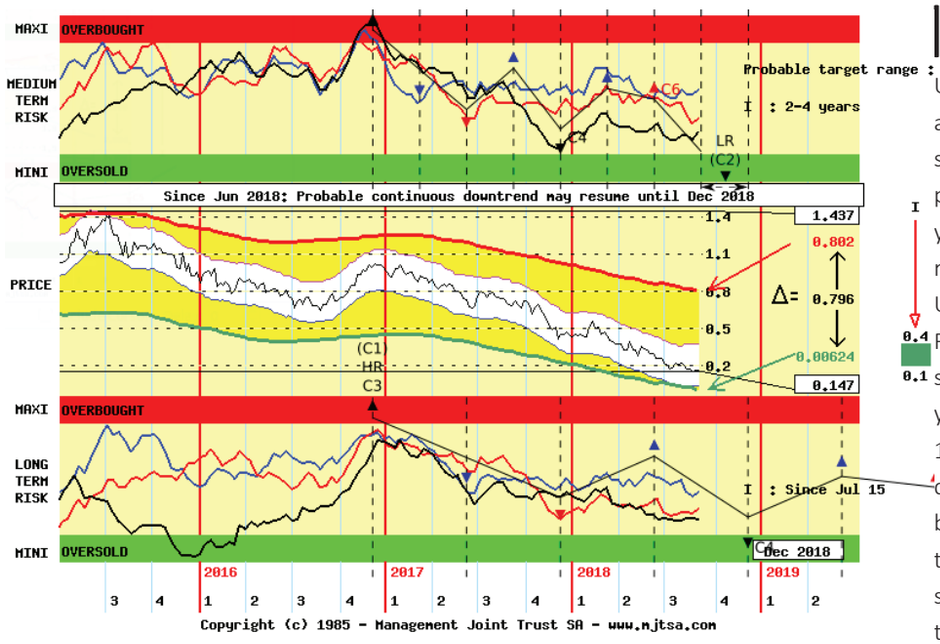
US 3 years Treasury yields have pretty much stalled since mid Q2, this despite an acceleration in Treasury issuance on the 2 to 5 years tenures (+ 1 billion USD a month on each on the 2Y, 3Y and 5Y issues). Indeed, while our I Impulsive targets to the upside between 2.3 and 2.8% have been achieved (right-hand 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



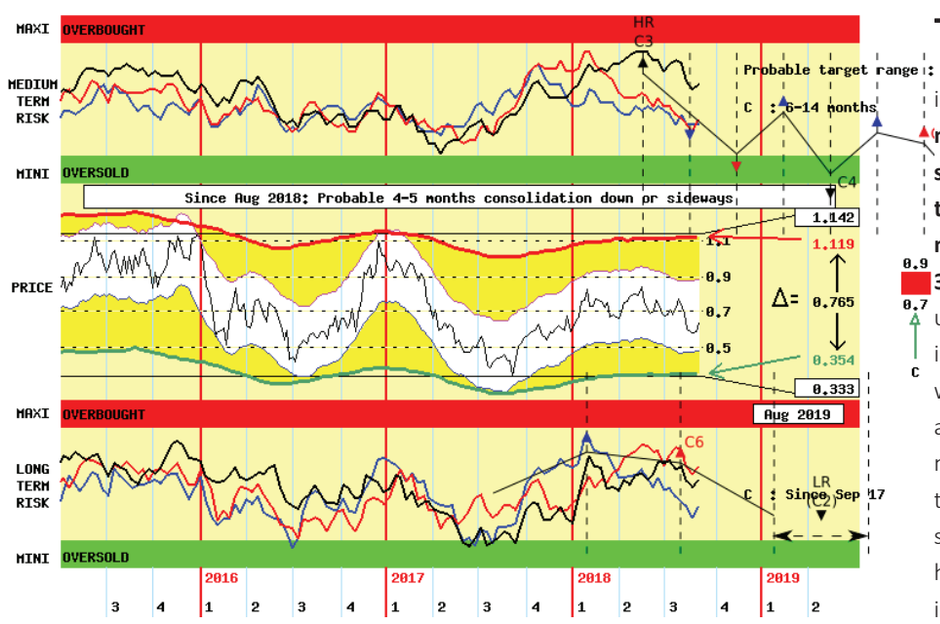
On US10Y Treasuries yields, the sequences we show on both oscillator series (lower and upper rectangles) could also be topping out soon. Our long term oscillators (lower rectangle) may have already done so this Summer, while our medium term oscillators (upper rectangle) would suggest a last upside retest 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



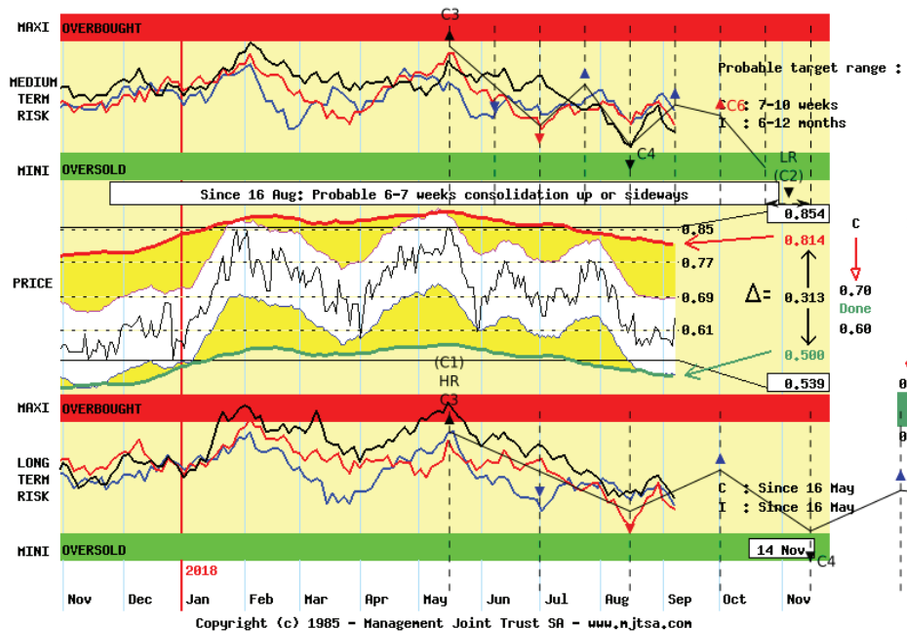
In general, we see little upside potential left on both US10Y and US3Y tenures, if any, and we expect them to start correcting down soon, probably towards Spring next year. This is an important trend reversal to the downside for US Treasury yields, while the FED is still raising rates, and it should 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



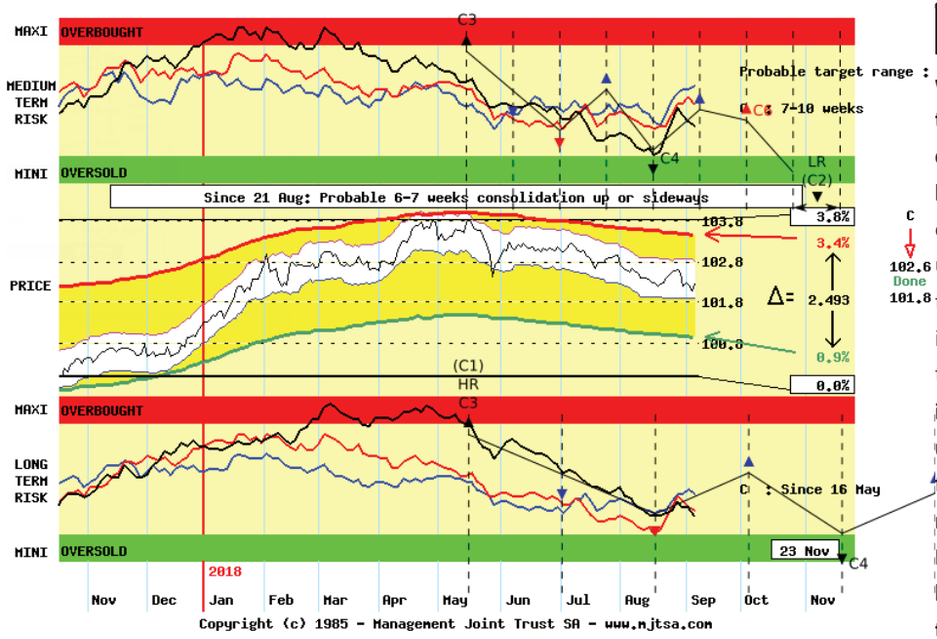
The Shorter term end of the curve is in our view more interesting. Indeed, **the 3 Years minus the 3 Months Treasury spread is much more reactive to reflation/deceleration dynamics than the US10Y minus 3Y one**. For example, it shot up late last year as an increase in US Treasury issuance met with a 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 perpsective over the next 2 to 3 months



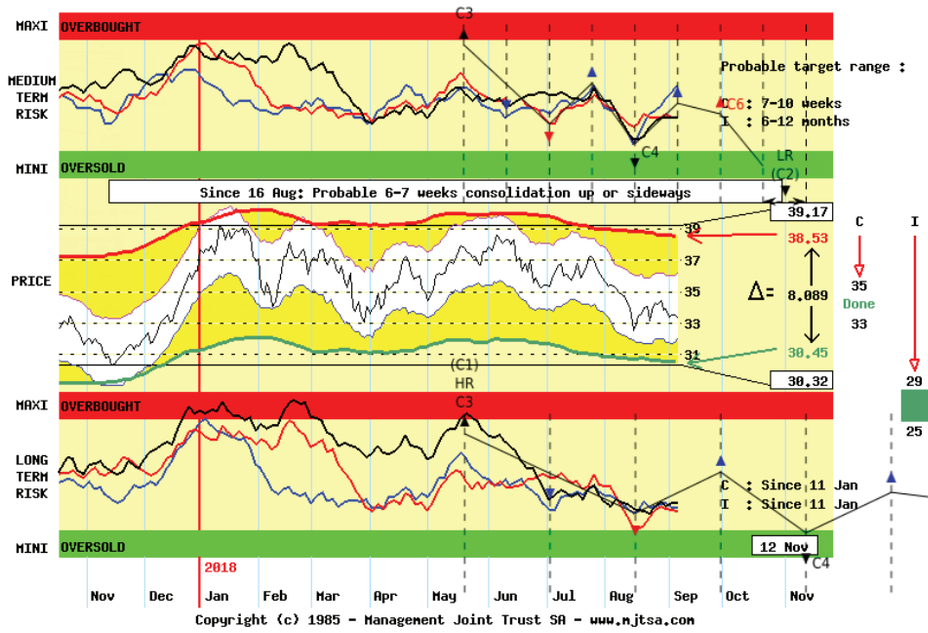
The Daily graph of the US3Y-US3M spread is in our view very telling. Indeed, since January, it has been a great proxy for the risk-ON / risk-OFF cross asset sentiment: it shot up with inflation expectations and equity markets in January, corrected down with equities into late March, followed their strong 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 oscillators 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



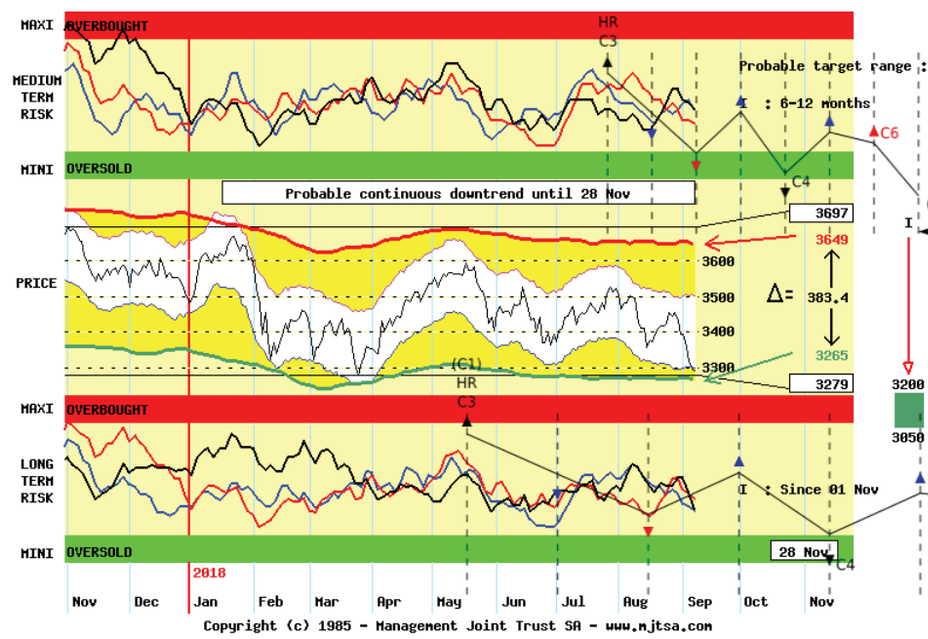
Not surprisingly, changes in inflation expectations, which we measure here using the TIP to Treasuries break-even ratio, are telling a similar story. Indeed, on both our oscillator series (lower and upper rectangles), they are attempting to bounce from the intermediate bottoms we identify mid August. **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

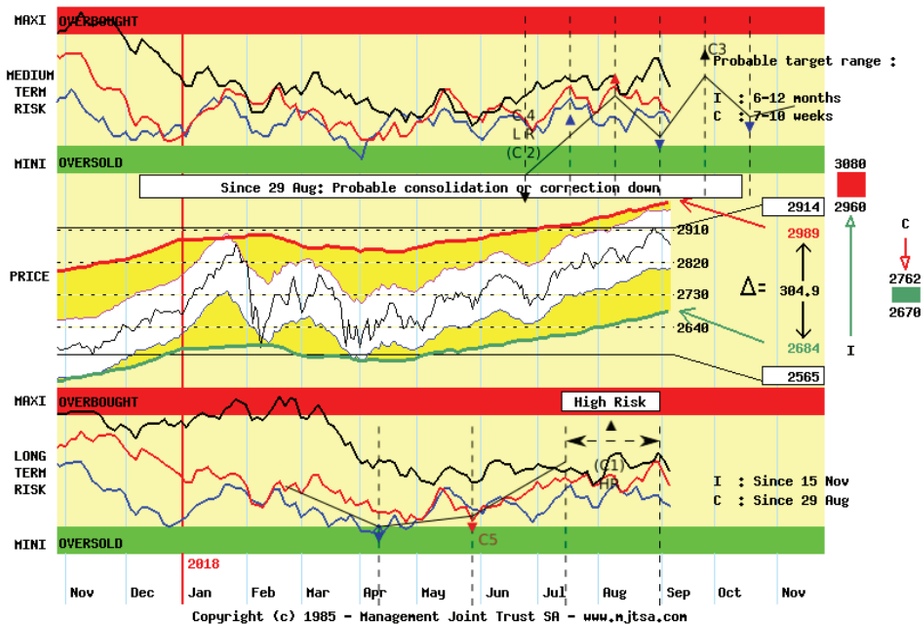


European Equity markets show a similar pattern, yet even weaker. Indeed, last week, the EuroStoxx 50 broke below its August lows. Going forward, a slight bounce may materialize over the next couple of weeks (medium term oscillators; upper rectangle), yet, on both our oscillator series (lower and upper 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:

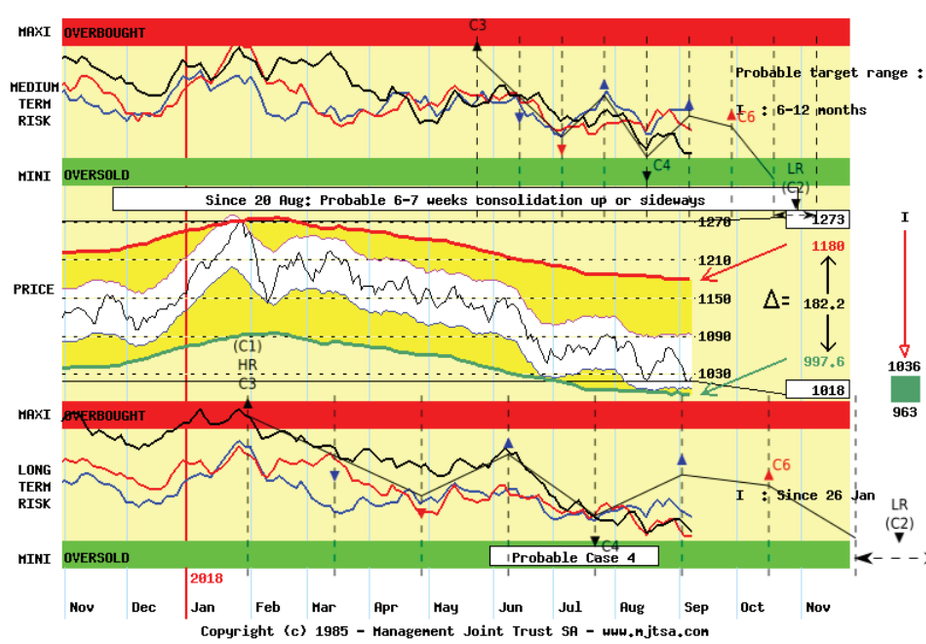
Both the examples above (US Diversified Mining and the EuroStoxx50) are interesting as they seem to be caught cross-currents between stronger US equity markets and Emerging markets, which have sold off aggressively over the last 6 months. Indeed, US Diversified Mining is a US sector with a strong sensitivity 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 the late Fall.

S&P 500 Index
Daily graph or the perspective over the next 2 to 3 months



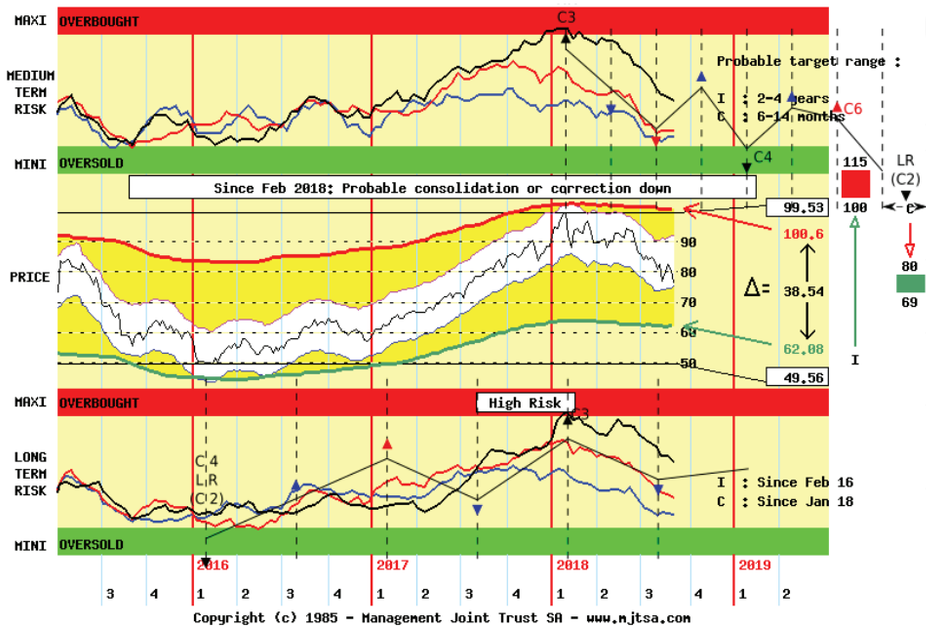
We now review the two ends of the spectrum. We will start with the S&P500 Index. For now, it is still uptrending with a risk/reward which is rather neutral (3 to 7% I Impulsive upside potential, vs 4 to 7% C Corrective downside potential). Yet, our long term oscillators have now reached a "High Risk" 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



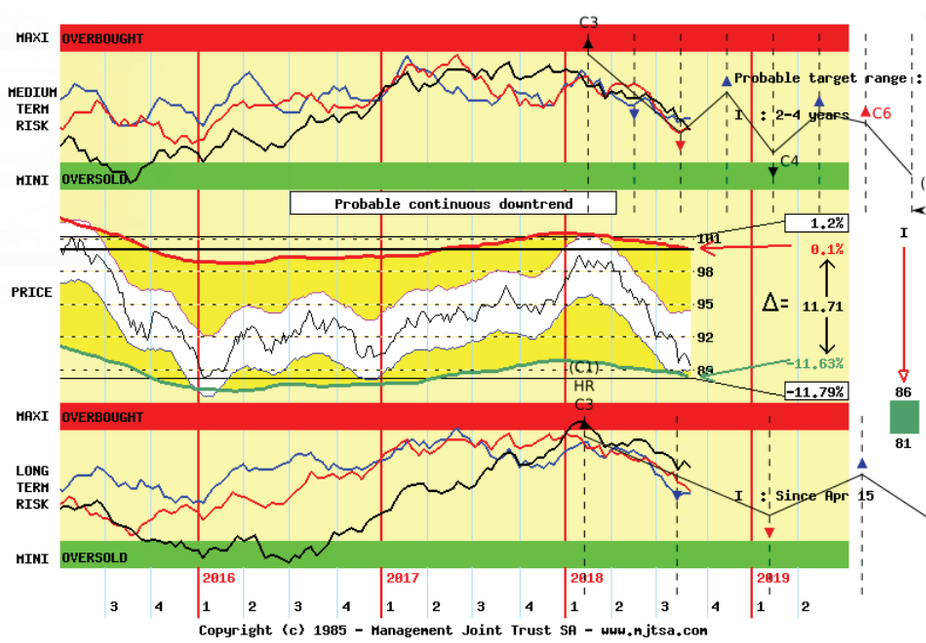
On the other hand, the sell-off in Emerging Markets is looking more and more like a liquidation (minus 20% since January). Indeed, the July and late August bounces were rapidly retraced, and going forward, on both our oscillators series (lower and upper rectangles), we expect **that the succession of 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



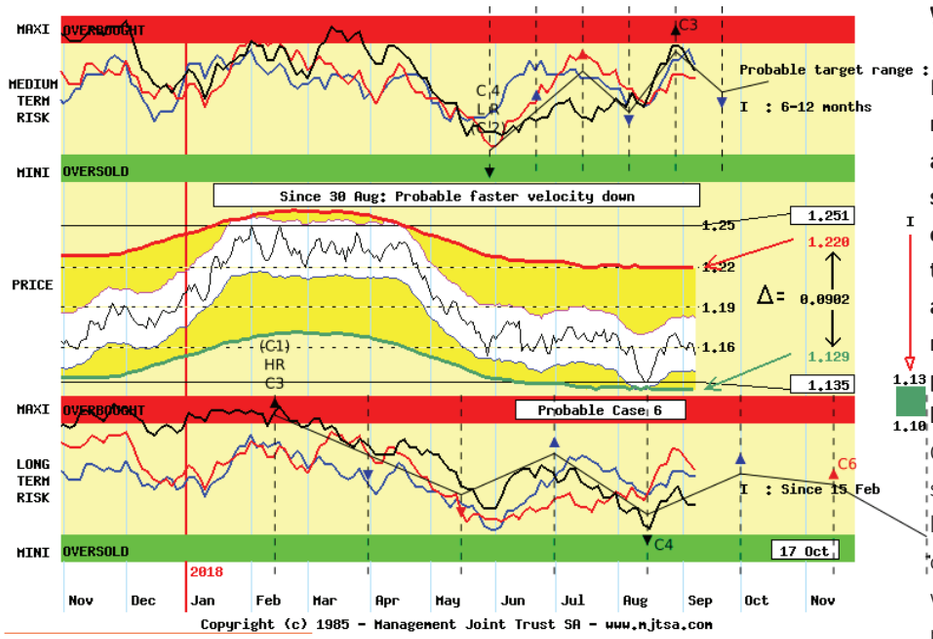
China accounts for more than 30 % of the MSCI Emerging Markets Index. Since June and the acceleration of the Yuan's devaluation, it has been weighing on the index, underperforming it by more than 10 %. Apart from Turkey, Russia, South Africa or Argentina, which are much smaller (even when combined), 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



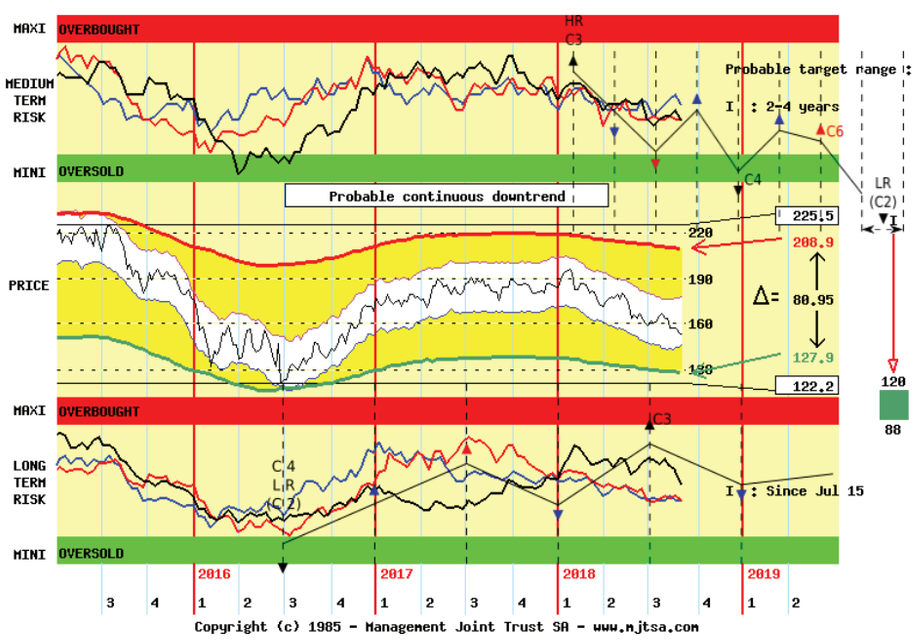
The current Emerging Markets sell-off is also a currency crisis. Indeed, it appears that high levels of Dollar denominated debt in emerging markets, coupled with expansionary monetary and fiscal policies, have recently collided with the FED's more restrictive monetary policies. The ongoing Trade War 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 (Chian, 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 that 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 I 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



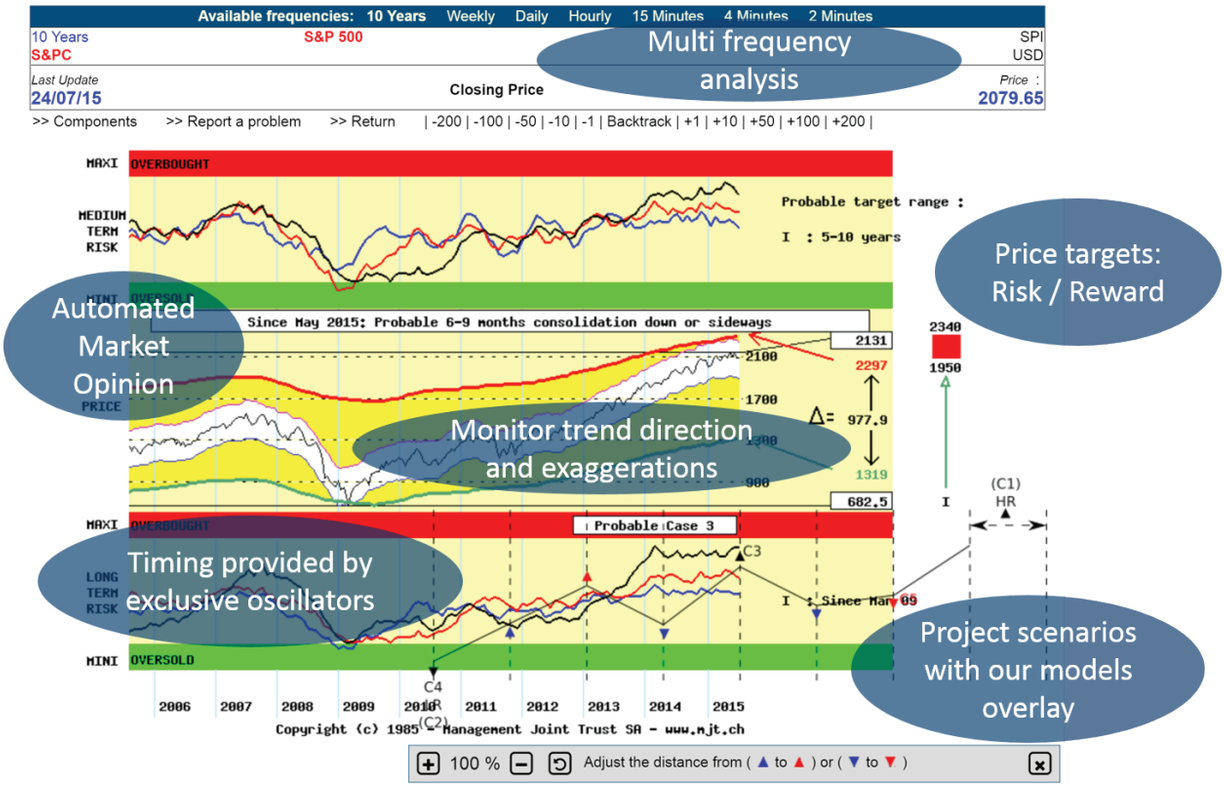
The European banking sector probably crystallizes these fears. For example, and in addition to ongoing problems in the European banking sector, Spanish banks have an EUR 80 billion exposure to Turkey, French Banks EUR 35 billion or Italian bank almost EUR 19 billion. A default of Turkey for example could 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 I 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

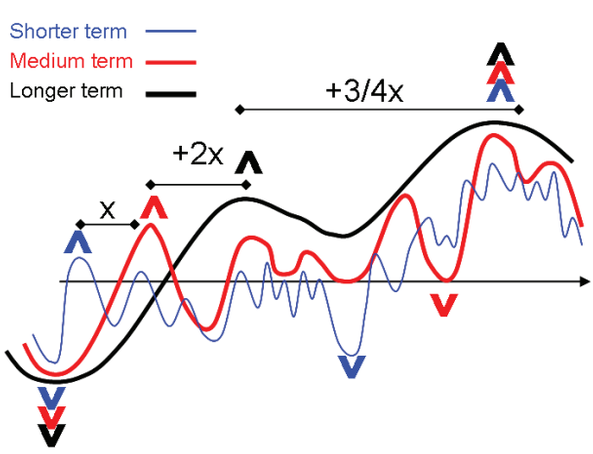
US Growth and Inflation perspectives remain strong, yet since May, the uptrend on US Treasury yields has stalled. This is quite peculiar, especially on the short end of the US yield curve, as until quite recently 2 to 5Y tenures were rising faster than Fed Fund rates. Indeed, since May, following a strong 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.

16/ METHODOLOGY

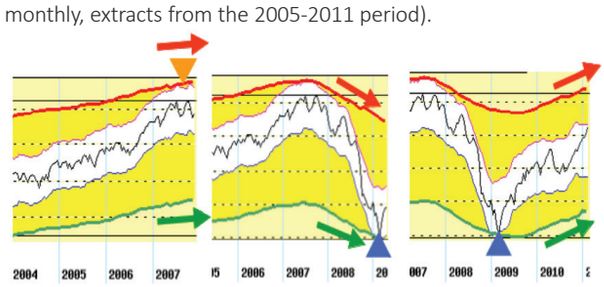
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



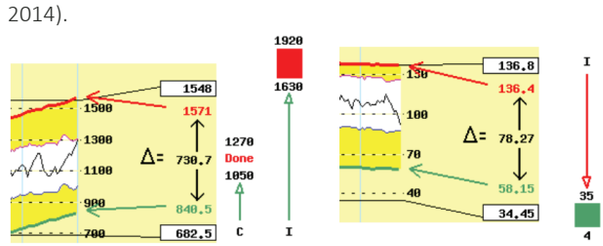
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)



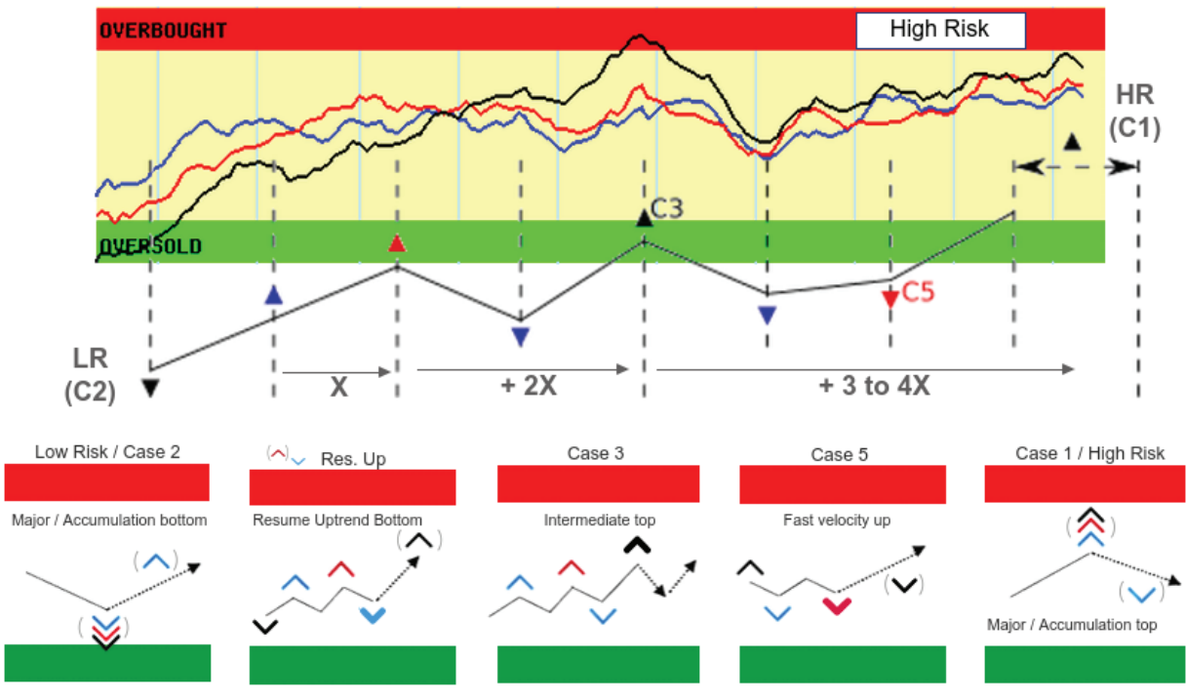
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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

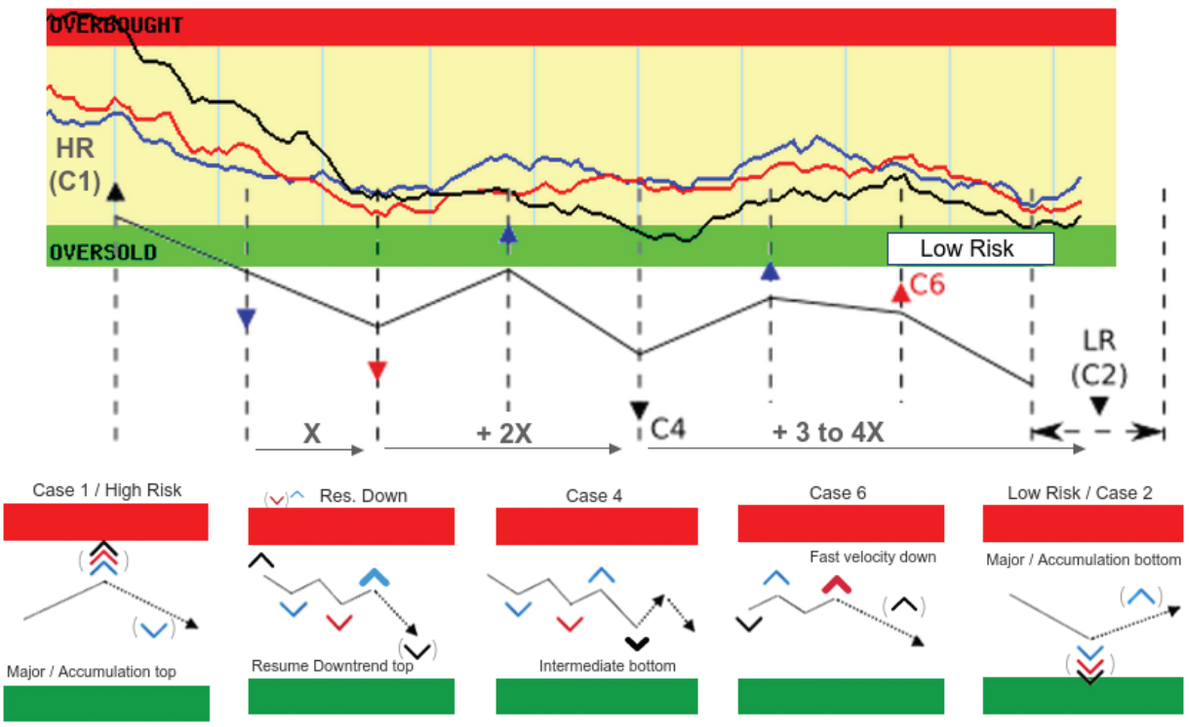


Ideal Uptrend Model



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

Ideal Downtrend Model



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

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