THE CAPITAL OBSERVER

November 2018

the technical analyst
AWARDS 2018
WINNER

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

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"Midterm election/market history may be comforting, but it is nowhere nearly consistent enough to ease our other macro concerns."

Nick Colas at DataTrek

The market may underestimate *the impact of the midterms, the FT editorial board writes. With Democrats leading the House, Trump will probably find an outlet for his domestic frustrations in aggression in the form of new trade barriers and confrontations. "This is the reality to which investors must now adjust." It doesn't help that the U.S. economy's fundamentals are starting to slow.*

Financial Times

4/ Executive Summary

12 / **The midterm results are in, and it's a gridlock -- what does it mean for the financial markets?** - The U.S. midterm elections played out much as expected. We have gridlock, but that may not necessarily be seen as a negative outcome by the markets. The US economy, though currently decelerating, should do all right next year with government control divided between Democrats and Republicans. Divided governments have generally been decent for markets. The Democrats will almost certainly challenge and try to distract the president over his past and current business dealings, tax returns or possible Russian implication. There will be greater difficulty for many aspects of President Trump's agenda, but we do not see the midterms as hobbling Trump as a lame duck by any means. The US Senate remains solidly Republican- more so than before the midterms. A GOP-dominated Senate makes it easier for Trump to confirm appointees and efforts toward deregulation should continue. However, we expect trade policy risk to persist: trade is one of the levers for which the president does not need Congress, so we could see a doubling-down on trade policies. We also see significant upside for infrastructure during Trump's second half tenure. The combination of factors summed up above suggests that after the current soft patch, the US economy should continue to grow from mid/late Q1 2019, but may well decelerate in 2020 as the benefits of the distributed lagged capital inflows and fiscal stimulus moderate in the face of rising Fed policy rates. Finally as some risks remain for financial assets they should be coming from the EM world and Chinese growth deceleration not so from the US side.

15 / **Timing and Tactical Insight - Equities rally post election, and the Dollar remains strong post the FED – How long before the defensive shift resumes ? -** Following their strong rally pre and post mid-term elections, equity market started to retrace again on the Fed's hawkish note last Thursday. We believe that these developments will continue to influence equity markets over the coming weeks. First, the election results seem rather positive for equity. Investors expect them to result in a more constructive dialog between Mr Trump and the Democrats, and possibly reign in some of Mr Trump's more aggressive policies. This consensus approach is reassuring for equity markets going forward, for US equity markets at least. On the other hand, the FED's persistent hawkishness should continue to pressure risk assets around the world, and support further USD strength into Q1 next year. These market conditions could resemble the ones that prevailed from May into August this year, when Europe and Emerging markets were correcting, while the US continued its upside path. Yet, this time around, Contagion may be quicker to come by as since early October, US equity markets have probably lost much of their upside momentum. Our timing suggests that by late November / early December, Global equity markets could enter a new leg down, probably towards early next year (early/mid Q1). During this period, the Dollar and defensive trades will probably continue to outperform.

23 / **Trump, the Federal Reserve and interest rates after the midterm elections: no pause for the Fed; the housing market will become progressively grimmer** - President Trump's comments critical of the Federal Reserve are unlikely to change the Fed's reaction function. The Fed will likely raise rates in December and two more times in 2019. This would put the policy rate on the tighter side of neutral, and tighter policy next year is one reason why we expect a much slower growth at a later stage ie going into 2020. The midterm election gridlocked results should largely keep the Fed on its gradual rate hike/balance sheet reduction path rather than going further or faster in raising rates. Unlike the 2016 U.S. election, the fixed income sector was not dealt surprises this time around. The bond focus shifts right back to the domestic fundamental setting-namely, growth prospects, inflation expectations, and any attendant monetary policy "surprises" from the Fed, if any. For the long term yields, one could argue that a good portion of the rise in yields has already occurred because the market's pricing mechanism has already discounted recent improved economic growth, a moderate increase in inflation and increased Treasury supply owing to Trump's deficit spending. With further policy tightening, the yield curve should continue to flatten, especially so because the 10yr yield may plateau on and actually decline early next year. The recent steepening of the yield curve was caused by an uptick in the term premium due to concerns about the rapid wage growth in the past two months. But is appears to us that the Fed only sees the sunny side, but in reality it is raining on the other side of the street. There is one data series that is looking ominously grim-- the housing market. Housing IS the business cycle – economist Edward E. Leamer famously declared in 2007. The Fed is ignoring these metrics but we believe that the housing market will continue to spiral lower over the next 8 months at least. By the end of 2019, there will be a reckoning, as a slowdown being flagged by the housing market now gets even worse. We could then have a sharp growth recession in H1 2020.

26 / **Timing and Tactical Insight - A hawkish FED, yet limited alternatives other than Treasuries when risk assets correct -** While inflation expectations have probably started to reverse down, real rates have recently continued to rise. The balance will determine the future path of nominal treasury yields in the US. Our analysis of US 10Y yields is confirming that a top may be near (i.e. that the balance is shifting). From late November, it suggests a 60 to 100 basis points retracement on US 10Y yields, probably over the next 6 to 12 months. The yield curve is also helpful to time this reversal point. Indeed, while expectations for further FED rate hikes are still strong, the spread between long term yields and the Federal Funds Rate has provided reliable signals for risk-ON / risk-OFF phases since the beginning of the year. Following a slight bounce, our analysis suggests that by late November, the US Yield curve could start to flatten again, probably towards next February. Developments in Bund yields, Corporate and Sovereign Credit spreads as well as for the banking sector vs the market seem to confirm this timing sequence.

5/ Executive Summary

33 / **Commodities outperformance over equities: it has started, it is pausing and will likely accelerate again mid Q1 2019** - At no other time in the history of commodities has the asset class been as weak against equities, as it is today. Over the past 50 years, commodities have never been cheaper relative to equities than they are at present. However, that underperformance is changing quickly to a more positive outlook for resource materials; the ratio between the two assets classes has been stable for more than a year now, and is starting to trend in favour of commodities. Indeed, on the long term picture, the commodity-equity relationship could be setting up a trade of a lifetime, as commodities revert to the mean in the relationship, similar to the one seen in the early 2000s. In 2019, it will be a contest between growth in the US and likely the Rest of the World (and the rising core inflation that it will generate), and a slowdown in China, as represented by that country's TSF. China's domestic currency the CNY has been falling a lot in recent time. That should translate into good manufacturing performance at some point in time, even if the Chinese services sector suffers some slowdown. That will also help the outlook for commodities outperformance over equities stay upbeat during next year. However on the short term horizon (into Q1 2019) we still consider that a strong dollar, decelerating US growth, tightening US policy and negative Chinese dynamic could still challenge commodities and risk assets on absolute level into the start of the new year.

37 / **Timing and Tactical Insight - Expect one last retest down on Commodities, probably towards mid/late Q1 2019 -** While Oil recently topped out in early October, other Commodities (Industrial Metals, Gold, Softs and Grains) have been suffering since the Spring, mainly from USD strength and a deceleration in China. We believe these factors should continue to influence the wider Commodity space probably towards mid/late Q1 next year. Oil should correct down until then, Industrial Metals should continue their correction, and Gold and Agricultural Commodities should retest down once more. Although, we do expect Equities to also resume lower during this period, Commodities are more volatile, and should hence continue to underperform Equities over the next few months. From mid/late Q1, however, Commodities may represent a strong investment case both on an absolute basis and vs equities, probably until Summer next year at least.

46 / **China's growth and trade woes will bring down the Emerging Markets with it; USD-dominated assets should continue outperforming the RoW** - There are a few items of interest in recent Chinese data, and one of them is the country's current account deficit. It may surprise investors drowning in US-China trade tension news that China ran a current account deficit in the nine months of 2018, its first since 1993. Just a decade ago, China's surplus was as high as $420 billion, or 9% of GDP. However, the capital account, which recently rose sharply, suggests to us that this deficit will be short lived. Also, don't expect that blip of current account deficit to mollify Mr. Donald Trump. China's trade surplus (external trade balance), a narrower measure that excludes investment income, remains massive. Insofar as the domestic currency (CNY) is concerned, its devaluation by Beijing is a mixed blessing. For us, devaluing the CNY is not a secret weapon for China to get on top of the trade issues-- Beijing has to do it to kickstart a flagging economy. On the negative side, the sharp decline in the exchange rate of the CNY against the US Dollar has negatively impacted the inflow of Foreign Direct Investments (FDIs) – FDI inflows slowed sharply in H2 2018. On the GDP front, GDP still declined to 6.5% in Q3 2018 (latest data on hand). China's GDP growth woes however are not caused by an errant currency policy. We can also say that the trade skirmish with the United States has probably reduced some growth, but the primary source of decline in activity has been the lack of government largesse. It's is not hard to fathom why. Government expenditures in China have virtually collapsed since January 2016. A slowing China cannot be good for many EM markets. Adding to the woes of the EM market sector, which includes China, is the surge in the US Dollar, which promises to become even more forceful.

49 / **Timing and Tactical Insight - Exploring the links between China, Emerging Markets and Commodity Producers -** Over the next few months, into mid/late Q1 at least, we remain prudent on China and other Emerging markets. Indeed, during November, we expect the US Dollar to start to strengthen again vs Emerging Market currencies. This process should first impact Asian Growth Currencies and with a slight lag their equity markets, while the process could then spread to Commodity producing Emerging Markets towards early December. We then expect China and all Emerging markets to remain weak until mid/late Q1. Looking into next year, and beyond Q1, our analysis suggests that Commodity producing Emerging Markets could outperform China and Asia Growth countries for the rest of 2019..

55 / **Splicing the markets - What's happened to defensive currency trades? -** From the end of this month, we expect defensive currency pairs to start to strengthen in line with the further risk asset correction we expect, probably from late November towards February next year. During this period, USD/JPY may reach back below 110, EUR/JPY below 125 and EUR/CHF below 1.10, while EUR/GBP may climb back above 0.90. Shorter term, considering our cross assets scenario, a slight risk-ON bounce may still materialize over the next couple of weeks. It should die out towards the end of this month and defensive Currency pairs should then strengthen for good.

6/ Mapping the markets

Last month we published while equity markets had started to accelerate lower. The early October top hadn't surprised us given that our medium to long term cross asset rotation framework had been sending defensive indications since August. We actually expected Equity markets to top-out by late September, which was pretty much the case. Going into the correction, we hence warned that the sell-off could be just the beginning of a more substantial move to the downside. Our graphs suggested a first leg down into late October and then following a bounce a further retest into November. Going forward, we expect that Equity markets could bounce once more during the second half of November. Yet, by late November / early December, equity markets should start to resume lower again, probably towards February / March. Our downside targets over the next 2 to 3 months are pointing towards levels below 2500 on the S&P500 and towards 2900 on the EuroStoxx 50.

During the October sell-off, the negative newsflow did shift to the US and to the consequences of the FED's tightening policy. The trigger for the next risk-off phase (from late November into mid Q1) will probably move back to China and Emerging markets. Indeed, the weak US Dollar consolidation we expected into early November is now probably behind us, and the US Dollar could start accelerating up again vs most currencies (except for the Yen), at the latest by late November / early December. This US Dollar strength should put renewed pressure on China and Emerging Markets, as well as related trades such as Commodities. We expect these to lead global markets lower again into mid/late Q1, where we would expect an intermediate top on the US Dollar, an intermediate low on Equity markets and an important low on Commodities.

These dynamics are also quite clear when considering the US yield curve. While the short end is driven by the FED, the long end has been quite sensitive in recent months to risk-ON / risk-OFF considerations. Hence, when risk assets correct, the yield curve usually flattens. We expect a new period of flattening to start from late November, probably extending into mid Q1. This in our view provides additional confirmation that the risk asset correction could resume down soon. Overall, Flight to Safety should intensify from early December from Emerging Markets to the US, from Equities to Bonds, from Cyclical and Growth sectors to Defensives, from Credit to Treasuries and AAA-A Bonds, from Emerging and Southern European Sovereigns to Treasuries and the Bund. These flows should gradually contribute to the roll-over we expect on long term Treasury yields.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	
Main Equities	US S&P500	The bounce since late October is currently retracing, yet US Equities may bounce again into the 2nd half of November. Following that, we expect a new leg down, possibly into mid Q1.	From late November / early December, we expect a new leg down on US Equity markets, it could find support towards February/March. Thereafter, a rally could materialize into the Spring.
	Europe EuroStoxx50	The bounce since late October is currently retracing, yet European Equities may bounce again during the 2nd half of November. Following that, we expect a new leg down, possibly into mid Q1.	From late November / early December, we expect a new leg down on European Equity markets, it could find support towards February/March. Thereafter a rally could materialize into the Spring.
	EMs MSCIEM USD	EMs should resume down between now and late November, probably towards February/March	Emerging markets may find support towards mid/late Q1, and initiate a bounce into the Spring
Treasuries	US10Y Bond prices	Treasuries are starting to stabilize, we expect them to start correcting up from late November into mid Q1 as risk-OFF considerations trigger Flight to Safety flows.	10Y Yields could still theoretically retrace 60 to 100 bps until late next year. From late Q1, however, they may bounce a bit as risk assets start to rebound.
	Germany 10Y Bund prices	Bund Futures are starting to stabilize, we expect them to start correcting up from late November into mid Q1 as risk-OFF considerations trigger Flight to Safety flows.	10Y Bund Yields could theoretically move back into negative territory again, probably during 2019. From late Q1, however, they may bounce a bit as risk assets start to rebound.

Legend:	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight

Main Equities

World markets
p 15, 16, 19, 50, 51-54

Equities have topped out as we expected towards end September. The first leg down found support towards late October and then bounced just prior and in the direct aftermath of the US mid-term election. The current downside retest could last into mid November, before another bounce materializes during the 2nd half of November. Following that, from late November/early December, we expect equity markets to start a second leg down, probably towards mid Q1. A Spring rally may then materialize, before equity market resume lower in H2 2019.

Main Regional picks
p 15, 16, 19

Over the next 3 months, the US should continue to benefit from positive inflows as the negative newsflow migrates back to Europe and Emerging Markets and the US Dollar remains strong. From mid/late Q1, this situation may reverse temporarily as the US Dollar retraces into the Spring.

Emerging markets
p 51-54

Emerging markets should resume lower until mid Q1. Over the next couple of weeks, a slight bounce may materialize once again, yet, by late November/ early December, Emerging Markets should resume down in force probably following China's lead, as well as suffering from renewed strength in the US Dollar.

Volatility

Volatility is going nowhere but UP, at least until mid/late Q1. Rising short term interest rates and falling markets is a deadly cocktail for volatility. It may retrace slightly during the 2nd half of November and then accelerate up gain towards year-end.

Government Bonds

US & European Benchmarks
p 27-29

US 10Y yields are topping out, probably between now and late November. Theoretically, we expect them to retrace between 60 to 100 basis points over the next 6 to 12 months. European long term yields topped in January and have since been trending lower. They bounced during the Summer and have now started to resume their downtrend. From late November, we expect them to start accelerating down towards mid Q1. Ten Years Bund yields should revisit negative territory in 2019.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	The ratio topped out late September as expected and despite the bond rout. The ratio should continue to correct down from late November into mid Q1.	During 2019, the environment should continue to turn more defensive. Yet, the ratio could bounce during the Spring along with equities.
	Europe	The ratio topped out late September as expected and despite the bond rout. The ratio should continue to correct down from late November into mid Q1.	During 2019, the environment should continue to turn more defensive. Yet, the ratio could bounce during the Spring along with equities.
Duration		US and European yield curve spreads should resume down once again (flattening) from late November into mid Q1.	From mid/late Q1, Yield curves could start to steepen. Duration may suffer momentarily, yet should then stabilize as the shorter end of the curves is gradually repriced lower.
Credit		Credit spreads should resume higher from the 2nd half of November, probably towards mid Q1 next year.	Credit spreads could retrace a bit during next Spring, yet the Credit Cycle has probably turned down and we expect to see much higher Credit Spreads during H2 2019.
TIPs/Treasuries		TIPs vs Treasuries should resume lower during the 2nd half of November, probably towards mid Q1 next year.	TIPs vs Treasury ratio could bounce into the Spring, yet it then probably continues lower until end 2019.
Oil		Oil could bounce a bit during the 2nd half of November, it then retraces lower, towards early/mid Q1.	Oil could stabilize towards mid Q1 (low 60s/ high 50s USD/barrel on Brent) and start to bounce into the Spring.
Industrial metals		Following a slight bounce, Industrial metals should resume lower from end November into mid Q1 next year.	From mid/late Q1, Industrial metals could see a bounce during the Spring
Gold		Gold could hold-up during the 2nd half of November, before it resumes lower towards mid Q1.	From mid/late Q1, Gold may start to bounce into the Spring.

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

Equity to Bond Ratios

US & Eurozone Markets
p 30

In the US and Europe, government bond yields could start to retrace soon, while Equities already started their decent in early October. The ratio could bounce slightly during the 2nd half of November, yet then resumes lower from late November on risk-off considerations, probably towards mid Q1 in first instance. Following that, the ratio may bounce again into the Spring along with Equities, yet then resumes lower once more during H2 2019.

Fixed Income Dynamics

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

We expect Yield curves in the US and Europe to continue to flatten. More precisely, following their steepening bounce during September and early October, yields curve spreads should soon start to reverse down again. They should retest their Summer lows as Flight to Safety flows gradually find their way to the US Treasury market. 2019 could then see the beginning of a stronger steepening trend.

Credit
p 31, 32

The Credit cycle has turned. Emerging Sovereign spreads as well as European Sovereign spreads, along with Corporate Spreads in the US have been widening since Q1. They did retrace a bit during the Summer, but are now resuming higher. From late November, we expect this uptrend phase to start accelerating higher probably towards mid Q1 in first instance. Next Spring could see some consolidation, yet we expect Credit Spreads to continue to widen throughout 2019.

Rate Differentials

US rate differential vs other regions is quite extended, yet should continue higher, probably until mid/late Q1 next year at least.

Tips
p 22

TIPs remain under pressure for now probably until Q1 next year as real rates continue to rise given the FED's persistent tightening drive. Yet, their downside risk is probably limited from here on. On the other hand, the TIP vs Treasuries breakeven ratio has started to retrace, reflecting a downward revision in inflation expectations. We believe it could accelerate lower over the next few months. Declining long term inflation expectations will probably outweigh rising real yields from late November, leading nominal yields to start to correct.

Commodities

Oil
p 37, 38

Oil topped out as expected early October and has since been retracing quite aggressively. Following a slight bounce during the 2nd half of November, we expect this retracement to continue towards early next year. Brent will probably reach back down towards the low 60s / high 50s, while WTI could reach down towards the mid/low 50s USD/barrel. From mid Q1, Oil could bounce again and initiate a rally which could last into midyear. Perhaps, will it attempt to make new highs (a low conviction for now).

Industrial metals
p 39-41

As expected, Industrial metals are currently resuming their downtrend and should continue to sell-off along with Chinese equities. This downtrend may see a slight bounce during the 2nd half of November, yet should resume lower again from late November / early December, probably towards mid/late Q1. Following a potential bounce during the Spring, Industrial Metals then resume lower once gain in H2 2019.

Gold & PMs
p 41-44

Gold has followed European currencies in their correction up since August vs the US dollar. In October, it performed slightly better than them on risk-off considerations stemming from the US. Yet, going forward, we expect an environment closer to the one that prevailed during May to August this year, with an accelerating US Dollar and declining Emerging Markets. Gold should suffer again, probably towards mid Q1. We tentatively believe it will hold its support around 1'150 – 1'130 USD/oz. If these levels were to break expect a liquidation below 1'000 USD/oz (not our preferred scenario, yet one to be considered).

Agriculture
p 44, 45

Agricultural Commodities are typical late cycle commodities. They usually outperform other more cyclical commodities such as Oil or Industrial Metals in a cycle downturn. On an absolute, we believe their downtrend is close to exhaustion, yet they may still retest down once more with other commodities towards mid Q1.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	A slight bounce may materialize during the 2nd half of November, yet we remain bullish on the Dollar over the next 2 months, target 1.10-1.09.	EUR/USD remains under downside pressure until at least mid/late Q1, it could then bounce into the Spring.
	GBP	A slight bounce may materialize during the 2nd half of November, yet we remain bullish on the Dollar over the next 2 months, target below 1.25.	GBP/USD remains under downside pressure until at least mid/late Q1, it could then bounce into the Spring.
	JPY	USD/JPY may still retest up during November, yet then starts to correct down towards the 111 - 108 range.	As we move into Q1, USD/JPY continues to consolidate and may break below 108 towards mid/late Q1 before bouncing into the Spring.
	CHF	Following a bit of retracment during the 2nd half of November, USD/CHF then moves up to the 1.02 - 1.05 range	USD/CHF probably continues up towards mid/late Q1, it then retraces a bit into the Spring.
EUR vs	GBP	EUR/GBP continues to retrace until late November and then bounces back until year end.	EUR/GBP probably continues higher towards mid/late Q1 and above 0.90.
	JPY	EUR/JPY resumes lower between now and late November, probably towards year-end and 125.	EUR/JPY continues to fall until mid/late Q1 and into the 125 - 121 range. It may then bounce during the Spring.
	CHF	EUR/CHF resumes lower between now and late November, probably towards year-end and the 1.10.	EUR/CHF continues to fall until mid/late Q1 and into the 1.09 - 1.07 range. It may then bounce during the Spring.
GBP vs	JPY	GBP/JPY resumes lower between now and late November, probably towards year-end and 140.	GBP/JPY continues to fall until mid/late Q1 and into the 139 - 135 range. It may then bounce during the Spring.
	CHF	GBP/CHF resumes lower between now and late November, probably towards year-end and 1.24.	GBP/CHF continues to fall until mid/late Q1 and into the 1.24 - 1.20 range. It may then bounce during the Spring.

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

US Dollar
p 17, 18

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, following its high level consolidation since mid August, the Dollar Index should start to resume higher between now and late November. It then accelerates up into mid/end Q1.

Euro
p 17, 18

Following its weak bounce since mid August, EUR/USD should start to resume lower between now and late November. It then accelerates down towards mid/late Q1 and probably tests long term support in the 1.10 – 1.09 range. Vs CHF, EUR clearly reversed down this Spring. Following its bounce since September, it should also start to reverse down again between now and late November, before it accelerates lower to test long term support in the 1.09 – 1.07. EUR/GBP has been retracing quite aggressively since August. We expect it to find support towards the 0.86 – 0.84 range by late November. It then rebounds into year-end and probably moves back up above 0.90 by mid/late Q1. Obviously successful conclusion (or not) of Brexit negotiations are going to have a strong impact on the pair and its volatility.

Yen
p 55

USD/JPY could continue to retest up during November, potentially reaching marginal new highs. Yet, longer term, we believe that it is reaching the end of its reflationary rebound started in mid 2016. From late November, we would expectit to start retracing down towards the 111 – 108 range on risk-off considerations, and despite a strong US Dollar vs other currencies. Following that, it may break temporarily below 108 by mid/late Q1, yet could then see a bounce during next Spring. Vs the Euro and Sterling, the Yen should start to strengthen again between now and late November, and could then accelerate up towards year-end and into mid/late Q1.

Sterling
p 56

The fate of Sterling is hanging onto the current Brexit negotiations, to their successful conclusion and to the details of this deal. Recently, GBP/USD and EUR/GBP have been quite volatile given the succession of contradictory news flow items. For now, Cable (GBP/USD) remains in a downtrend, and we expect it to start to resume lower again between now and late November. It could dip into the 1.27 – 1.22 range by mid/late Q1. Vs CHF or the Yen, Sterling should also start to resume down between now and late November, probably also towards mid/late Q1.

Oil & Commodities currencies

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) have bounced since September vs USD and especially vs EUR. This rebound could continue until early December. Following that, we expect our Commodity portfolio to start weakening again until mid/late Q1.

Asian currencies
p 49

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) shows a similar profile as the Commodity currencies portfolio above, yet with less volatility (i.e. it is more defensive on a relative basis). We also expect it to start to resume lower, yet perhaps slightly earlier than the Commodity portfolio above. Hence, between now and late November, we expect our Asian Growth Currency to start to resume lower vs USD probably until mid/late Q1.

Equities Markets Segmentation

Core Sector Weightings			Next 2 months					3 to 6 months ahead				
US Sectors - S&P500			**For now, we have kept all sector except for Defensive ones on neutral gear as we still expect a rebound on equities during the 2nd half of November. Following that, from late November, we would under-weight all these into mid Q1.**					**A very defensive allocation, from early December into mid Q1.**				
Sectors	Proxy ETF symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Technology	XLK	21%										
Healthcare	XLV	15%										
Financials	XLF	14%										
Discretionary	XLY	10%										
Communication	XLC	10%										
Industrials	XLI	10%										
Staples	XLP	7%										
Energy	XLE	6%										

European Sectors - Europe Stoxx 600			Next 2 months: **We expect a further rebound during the 2nd half of November, we have since neutralized all sectors except for Defensive ones. Following that, from late November, we will downgrade Banks, Industrials and Energy.**					3 to 6 months ahead: **A very defensive allocation, from early December into mid Q1.**				
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 20-22, 38, 39

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

Indeed, we have kept a rather neutral allocation for now both in the US and Europe as we expect a further equity bounce during the 2nd half of November, and do not want to turn too defensive too early. That said, from late November / early December, we will under-weigh all Cyclical and Growth sectors and favor Defensive sectors, probably towards mid Q1 at least. In Europe, from December, we will keep Personal & Household Goods as well as Insurance on neutral as their profile can be rather Defensive.

Countries allocation

Core Countries Weightings: All World Country Index Currency hedged			Next 2 months: **Until late November, we will remain Overweight the US and neutralize the rest, given the slight rebound we expect on Equities during the 2nd half of November**					3 to 6 months ahead: **From early December into Q1, we will overweigh the US and Switzerland, which we feel are defensive, will neutralize the rest, except for China, which we will downgrade.**				
Countries	Index symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
US	S&P 500	52%										
Canada	TSX	3%										
Europe	SXXP	21%										
-UK	FTSE	6%										
-France	CAC40	3%										
-Germany	DAX	3%										
-Switzerland	SMI	3%										
Japan	N225	8%										
China	MSCICN	3%										

Main Country Allocation
p 15, 16, 19, 50-54

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

We expect one last bounce on equities during the second half of November. We have hence neutralized most country allocations except for the US, which we feel remains strong vs the Rest of the World in USD terms.

From late November / early December, we will overweigh Switzerland as a further defensive play and underweigh China (and Emerging Markets) given the negative dynamics we expect (rising US Dollar). We will keep the UK, the EuroZone and Japan on neutral for now as they may hold up in local currency terms given the stronger US Dollar. We will keep these allocations until mid Q1.

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

Core factors and Themes

Core Factor/Themes Weightings	**Next 2 months**					**3 to 6 months ahead**				
General Comment	**Our Factors and Themes Allocation continues to avoid high beta risk, despite the rebound we expect during the 2nd half of November.**					**From late November, early December, we will confirm this view and turn more defensive into mid Q1.**				
Themes	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Nasdaq 100 (vs S&P500)										
DJ Industrial (vs S&P500)										
Russell 2000 (vs S&P500)										
Wilshire REITs (vs S&P500)										
US Value (vs US Growth)										
Southern EuroZone (vs Stoxx EZ 600)										
EuroZone Small Cap (vs Stoxx EZ 600)										
Japanese Small Cap (vs N225)										
GDX - Goldmines										
XME - Diversified Mining										

Core factors and Themes

During the rest of November, we will continue to avoid high beta plays without turning outright defensive, given the further rebound we expect during the 2nd half of November.

From late November, early December, we will overweigh REITs vs the S&P500 and Japanese small caps vs the Nikkei 225, which we feel could be interesting defensive plays.

12 / The midterm results are in, and it's a gridlock -- what does it mean for the financial markets?

The U.S. midterm elections played out much as expected, with Democrats picked more than enough seats needed to retake the majority in the House of Representatives and Republicans easily defending their majority in the Senate. **We have gridlock, but that may not necessarily be seen as a negative outcome by the markets**. The US economy, though currently decelerating, should do all right next year with government control divided between Democrats and Republicans. Divided governments have generally been decent for markets. **The basic reason for this is simple**: when one party proposes drastic or foolish measures, the other party can obstruct them. The United States prospers most when excesses are curbed, and, if the numbers from the past 50 years are any indication, divided government is what curbs them (*passages taken from the writings of the late economist William A. Niskanen*).

Now that the Democrats control Congress, will they try to impeach President Trump?

The Democrats will almost certainly challenge and try to distract the president over his past and current business dealings, tax returns and the Constitution's Emoluments Clause (which prohibits US officials from personally benefitting from office). However, though the House may have enough votes to impeach, the Senate is very unlikely to convict. That would create a scenario similar to that of President Bill Clinton's in 1998. In other words, any concerns that Trump will not remain in office until his term expires is highly unfounded.

Some key take-aways from the midterm election results:

There will be greater difficulty for many aspects of President Trump's agenda, but we do not see the midterms as hobbling Trump as a lame duck by any means. While Democratic control of the House implies greater political and perhaps legal difficulties for Trump, the election result came short of a so-called "blue wave" that would have rejected the president wholeheartedly, as the Republicans gained ground in the Senate. Because of these factors and the fact that Trump is far from a lame duck, we expect him to continue to pursue his platform vigorously.

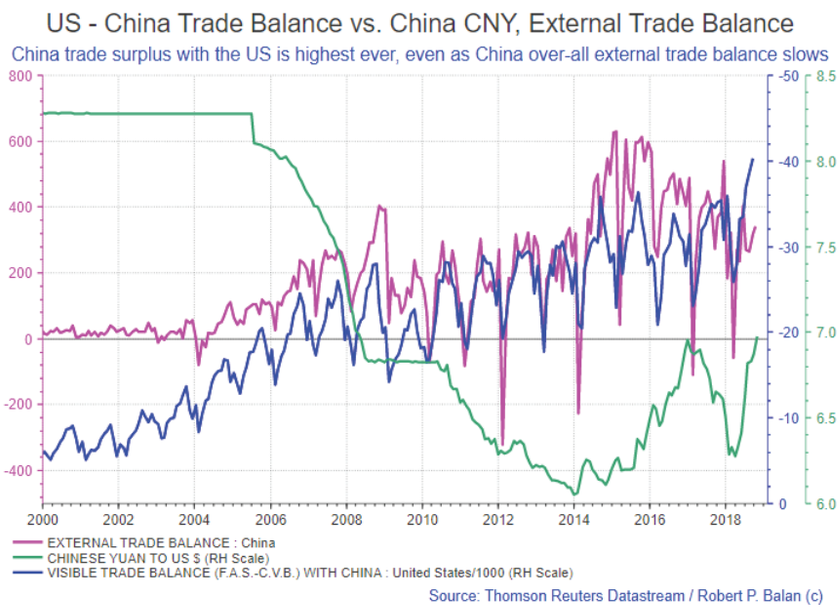
The US Senate remains solidly Republican - more so than before the midterms. A GOP-dominated Senate makes it easier for Trump to confirm appointees. Expect a Cabinet shuffle to take place soon, (Sessions was already the first Cabinet official to go), and a more Republican-leaning judiciary. The Senate is virtually the "personnel department" of the US government, as it is responsible for confirming all high-level appointments by the president. The new Senate will be able to continue confirming Trump nominees -- and the process going forward will likely be less of a nail-biter and contentious than the recent confirmation of Supreme Court Justice Brett Kavanaugh. We expect presidential nominees should be more easily confirmed during the second half of Trump's administration.

Because the Republican Senate majority is bigger, efforts toward deregulation should continue. At a minimum, a reversal of deregulation is unlikely, in our view. We believe these factors should still support business optimism and support growth.

Immigration is an area that has become ripe for compromise, and maybe the odds for a comprehensive immigration bill have become better after the elections. Post-election, immigration has ceased to be a political rapier. Nobody thinks the current law is ideal, and nobody thinks current law is being enforced. Both parties have made points and marks with this issue – maybe it is time for some rationality to become part of the discussions.

Will the trade skirmish with China continue?

Expect trade policy risk to persist: trade is one of the levers for which the president does not need Congress, so we could see a doubling-down on trade policies. Moreover, both Democrats and Republicans are believed to support a tougher stance on Chinese trade and intellectual property practices. As a result, the president may enjoy bipartisan support as he pushes for Beijing to reduce the bilateral deficit. There is less middle ground for practical trade policies than has been the case historically. Partisan Democrats traditionally have been the



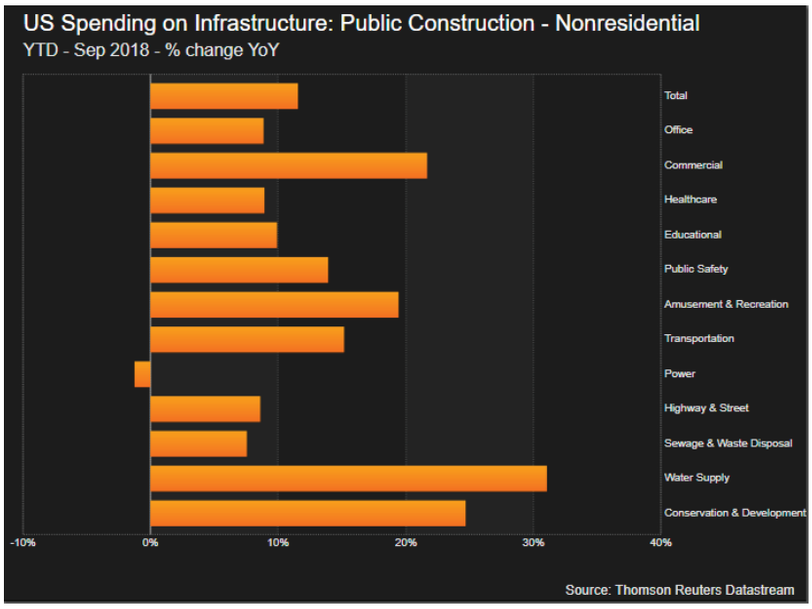
more protectionist party while Trump Republicans are extremely hawkish with regard to everything relating to China. There is convergence of interests of both parties with regards to confronting China on trade issues, especially at a time that China's surplus trade balance versus the US is at an all-time high (*see chart on previous page*).

However, expect a scuffle over NAFTA 2.0 (the United States-Mexico-Canada Agreement, or USMCA), as Democrats will want to leave their imprint, which could also mean the president may again threaten withdrawal, going to the brink once more. But we expect NAFTA 2.0 to pass eventually because many state economies are highly integrated with both Canada and Mexico, and a failure would affect major constituencies on both political parties.

Huge upside for infrastructure spending

There is a huge upside for infrastructure during Trump's second half tenure. Democrats want to show they can govern and will likely focus on areas of agreement, including infrastructure, criminal justice reform and drug pricing. Democrats have always said they support infrastructure projects. There are now fewer deficit hawks among Senate Republicans (some of them lost in the election) to oppose infrastructure spending.

We believe that if the works are targeted to specific regions and projects, there would be convergence between Trump and the Democrats on infrastructure spending. There is a real possibility that the Trump administration may reach across the aisle and strike a deal with House Democrats for a significant infrastructure spending package. Highways & Streets, sewerage and power infrastructures have been neglected in the US, and have been low priority recipeints of government funding in recent years (*see 1st chart on this page*). **That could provide significant support to raw materials prices and the stock of materials producers.**



Chances for an infrastructure deal will depend on how Democrats propose to pay for it: If it includes rolling back tax cuts, it would be dead-on-arrival in the Senate. If infrastructure spending can be financed through some other ways, a deal will have very good chances of passing.

Investment implications in the election's aftermath

Both the president and Democrats seem to agree on greater regulation and taxation of technology companies, so further underperformance in the tech sector, which has been richly valued relative to other sectors, is a distinct possibility, during the next two years.

The president and Democrats also agree on regulation of drug pricing. However, any sell-off or underperformance in pharma and biotech stocks due to imposition of new regulations, should be temporary. Senate Republicans are very unlikely to agree to any bill that would regulate drug pricing.

Democratic control of the House almost guarantees that there will be no repeal of the Affordable Care Act (aka, Obamacare), which should ensure more clarity and stability in regulation and pricing for insurers and hospitals and the health care sector overall.

Both Mr. Trump and the Democrats have advocated an increase in the federal minimum wage. While we think it would be difficult to get through the Senate, if it were to pass, it would create pressure on US retailers and restaurants. Several states have already increased minimum wages, as have some major employers like Amazon. Therefore, the effects are more likely to be firm-specific than general, and will be temporary.

Looking forward to 2019 and 2020, expect less extravagant federal spending growth – except possibly for infrastructure spending. Major tax cuts are unlikely. But deregulation should continue in those areas where Congressional approval is not needed. This direction will be good for the US economy.

Mr. Trump and the US Dollar

President has famously said at the outset of his tenure that he wants lower exchange rate values for the US Dollar, in line with his desire at that time to encourage US exports. This desire was of course thwarted by the Federal Reserve's policy tightening regime, which boosted interest rates and consequently the US Dollar's exchange rate valuation. Trump's desire for a cheaper USD was also sunk by his tax rate cuts for corporates and the US middle class. Foreign capital flooded in, and domestic capital repatriation improved the US capital account tremendously. Capital account

inflows morph into Foreign Direct Investments (FDIs) after a short lag, and US FDIs correspondingly promote stronger US Dollars. (*see 1st chart on this page*)

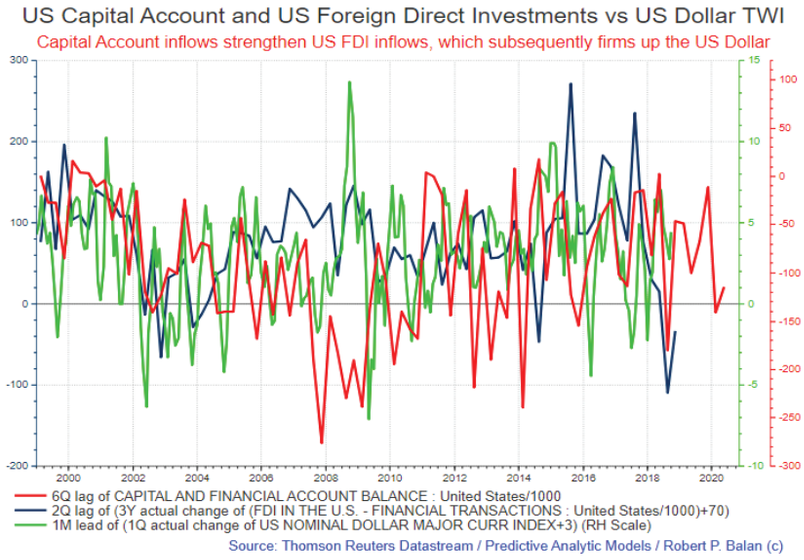
The US Dollar looks set to strengthen until late 2019, so there are strong headwinds for Trump's desire for a weaker domestic currency. There is a silver lining to all this -- a strong currency which has the potential to become even stronger, tends to attract significant amounts of FDIs. Therefore, The Donald may yet be successful in his desire to attract manufacturing companies to settle in the US. A strong US Dollar, which promises to become even stronger, should be the wherewithal for that to happen.

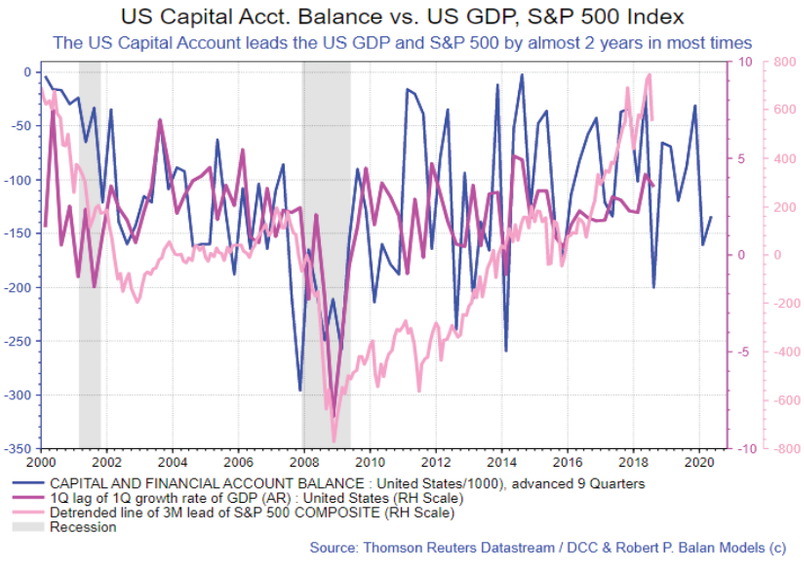
Conclusion

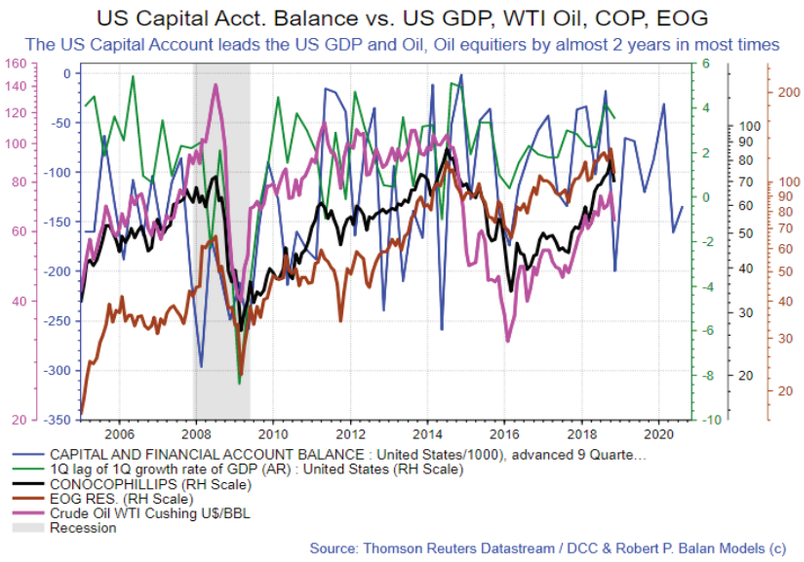
The prevailing view is that gridlock is a positive from the US political side for financial assets, and the potential lack of disruptive initiatives should enable macroeconomics to play out in full. And the macro conditions which are still currently wobbly on the short term should prove a bit more favorable from mid to late Q1 as current, capital inflows provide wherewithal for continued support for growth and rebound of risk assets. (*see 2nd chart on this page*)

If Trump and the Democrats do broker an infrastructure spending deal in 2019, we believe there is still time to bet on the outperformance of risk assets more broadly, and focus on attractive beta-producing momentum opportunities. **Commodities and commodity producers (including oil companies) should perform well under this environment** (*see 3rd chart on this page*).

The combination of factors summed up above suggests that after the current soft patch, the US economy should continue to grow from mid/ late Q1 2019, but may well decelerate in 2020 as the benefits of the distributed lagged capital inflows and fiscal stimulus moderate in the face of rising Fed policy rates. Moreover, deficit spending should slow, as the Democrats will try to push back against Trump initiatives that could enhance his reelection. However, there is silver lining provided by this situation as it lowers the chances of a boom/ bust scenario further down the line (by reducing the risk of another fiscal stimulus that could boost inflation, which is already at the Fed's target, by lowering unemployment further and requiring the Fed to move faster).





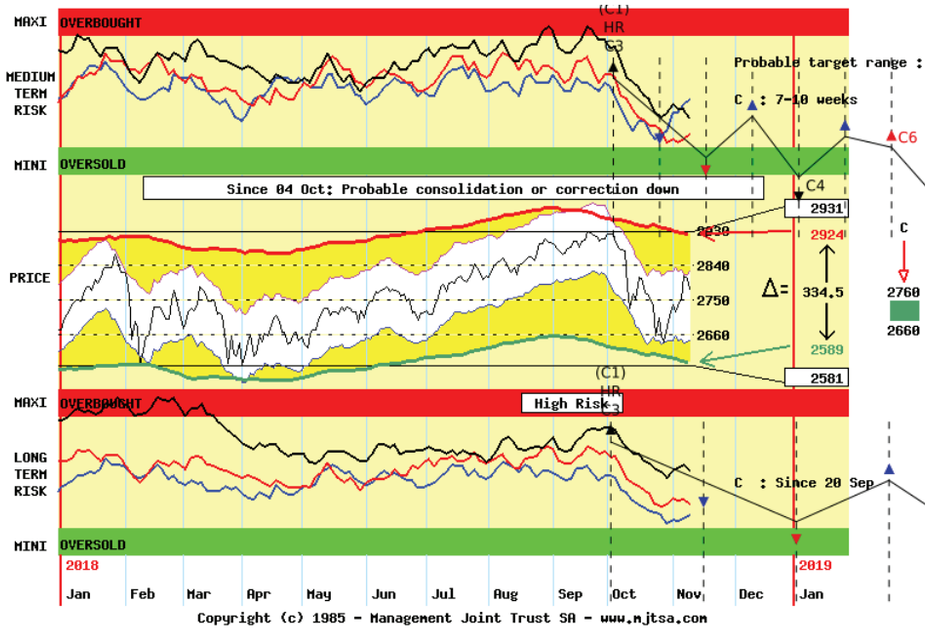


15 / MJT - TIMING AND TACTICAL INSIGHT

Equities rally post election, and the Dollar remains strong post the FED – How long before the defensive shift resumes ?

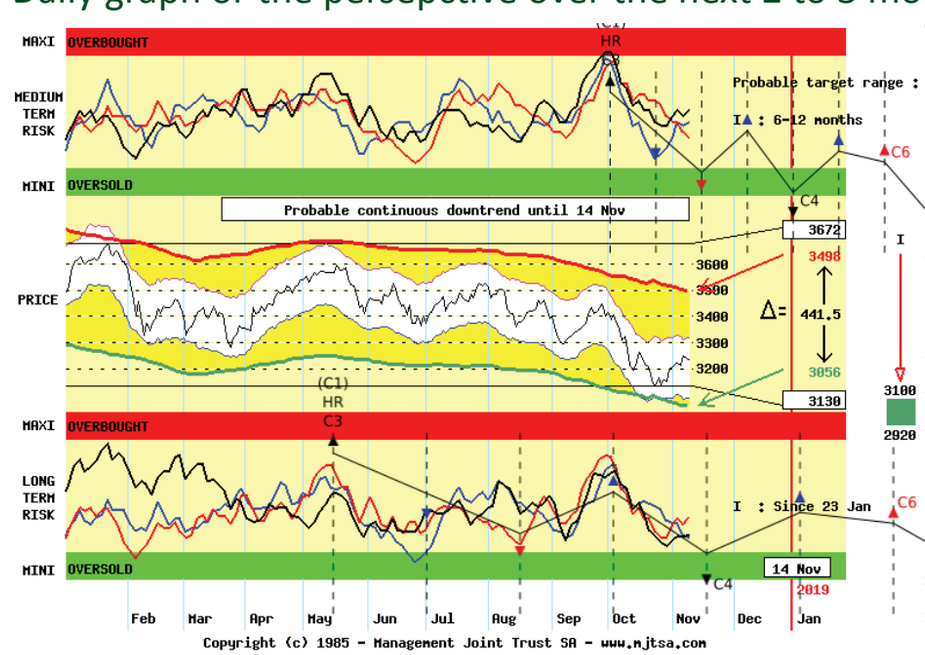
This is a period of indecision and investors are trying to position, hence the strong up and down moves we have seen recently on equities and forex. While the Gridlock election results hold the promise of mitigating some of Mr Trump's more aggressive initiatives, the FED remains hawkish. In this article we consider the main equity indexes and the US Dollar in light of these developments, and wonder how long before the defensive shift, which started early October, potentially resumes.

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



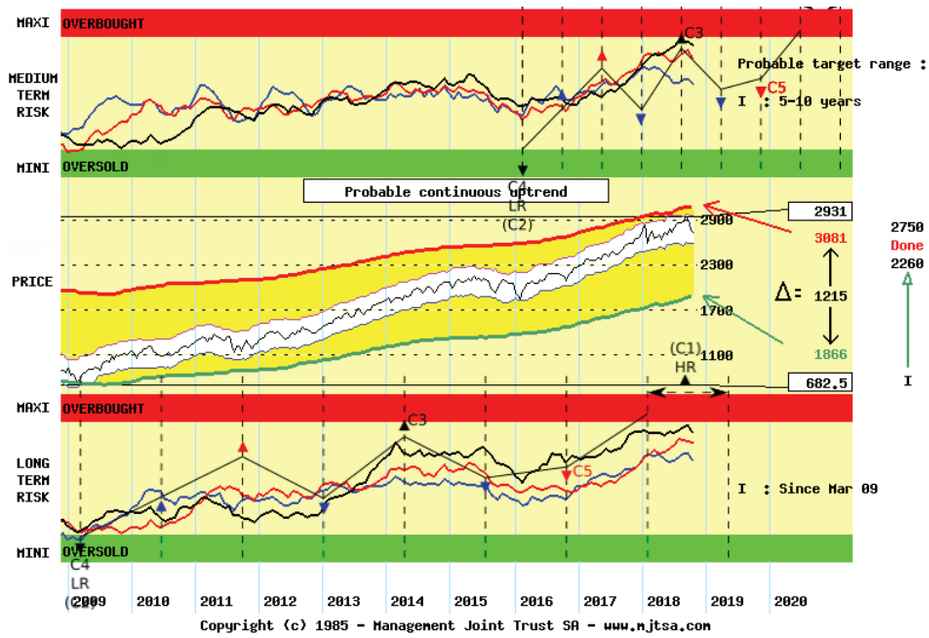
The correction down from late September found a strong support point late October. The S&P500 then started to rebound, a move which accelerated up further last week following the mid-term election results. Despite its velocity, we would still consider this bounce as a counter-trend move. It may continue probably towards the end of this month, before the downtrend resumes until early next year in first instance. Indeed, this is what both our oscillator series are suggesting (lower and upper rectangles). We expect **the S&P500 to retrace a bit until mid November and then to bounce again towards late November / early December. Following that, the trend should then resume lower into early next year, and then potentially into February / March.** On the target front, the sell-off broke below our C Corrective targets to the downside (below 2'660; right-hand scale). This theoretically opens the door to **much lower downside targets once the second leg down we expect materializes, probably towards 2'500 – 2360** (or 1.3 to 1.7 times our historical volatility measure "Delta"- here at 334.5, middle rectangle; right-hand side- subtracted from the 2'931 top).

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



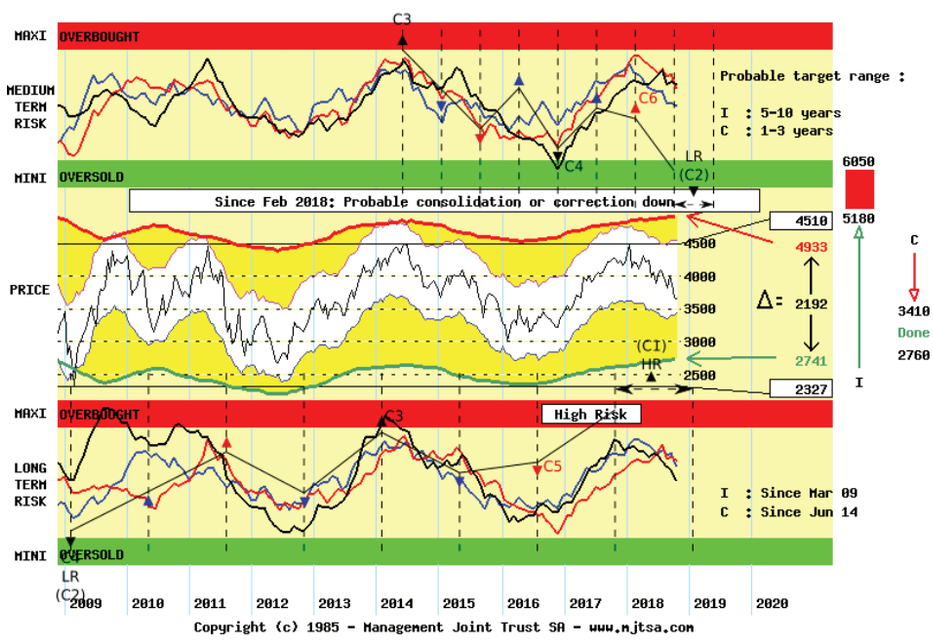
The EuroStoxx 50 also started to bounce late October, yet less so than the S&P500. Both our oscillator series (lower and upper rectangles) are now suggesting that it could retrace a bit until mid November before it bounces again into late November and possibly December. In such situations, where our long term oscillators (lower rectangles) are reaching a worthwhile low, while our medium term oscillators (upper rectangle) are expected to bounce short term, yet resume lower thereafter, we would usually trust our medium term oscillators (upper rectangle). We hence believe that **by late November / early December, the EuroStoxx 50 could start resume lower towards year-end and then possibly again towards February / March.** This is in line with what we expect above on the S&P500. As for our targets, **our I Impulsive targets to the downside (right-hand scale) are still quite important, towards the 3'100 – 2'920 range over the next few months, possibly 10% below current levels.**

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



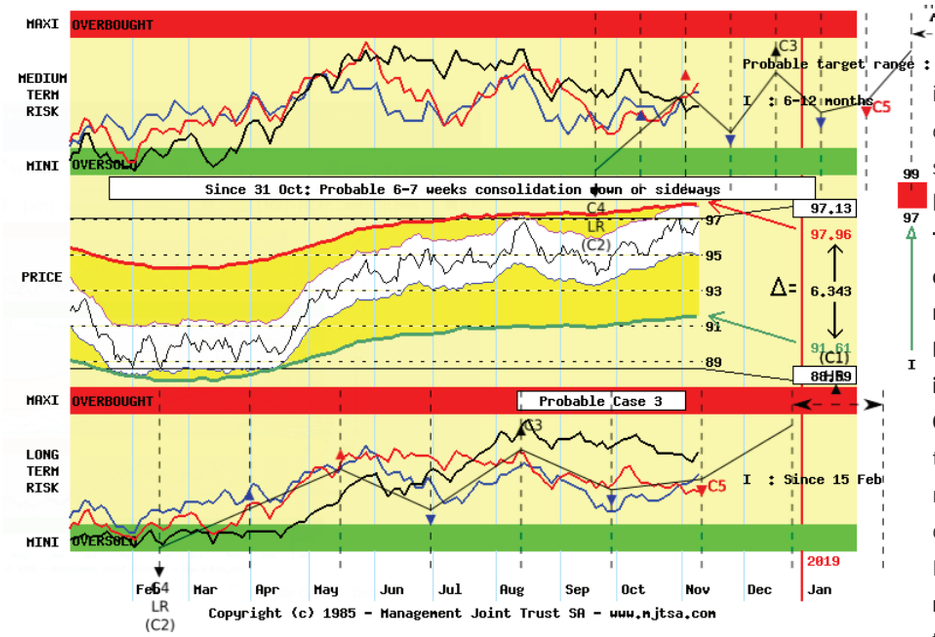
Longer term, the S&P500 Index has now reached a High Risk situation (lower rectangle). This usually implies that **the S&P500 Index is now at risk of entering a multiple months correction to the downside**. On our medium term oscillators (upper rectangle), we show the sequence we feel is the clearest. It confirms that an important top (intermediate or final?) was made a few weeks ago, and that **the S&P500 should at least correct down into Q1 2019**. On the target front, our I Impulsive targets to the upside (right-hand scale) have been achieved, while the C Corrective targets to the downside indicate a level of risk towards the 2'325 – 1'960 range (0.5 to 0.8 times our historical volatility measure "Delta" - here at 1'215; middle rectangle, right-hand side – subtracted from the recent tops). **This is still circa 20 to 30% lower than today. Theoretically, this downside potential could materialize over the next 12 to 18 months.**

EuroStoxx 50 in USD
Bi-monthly graph or the perspectives over the next 1 to 2 years



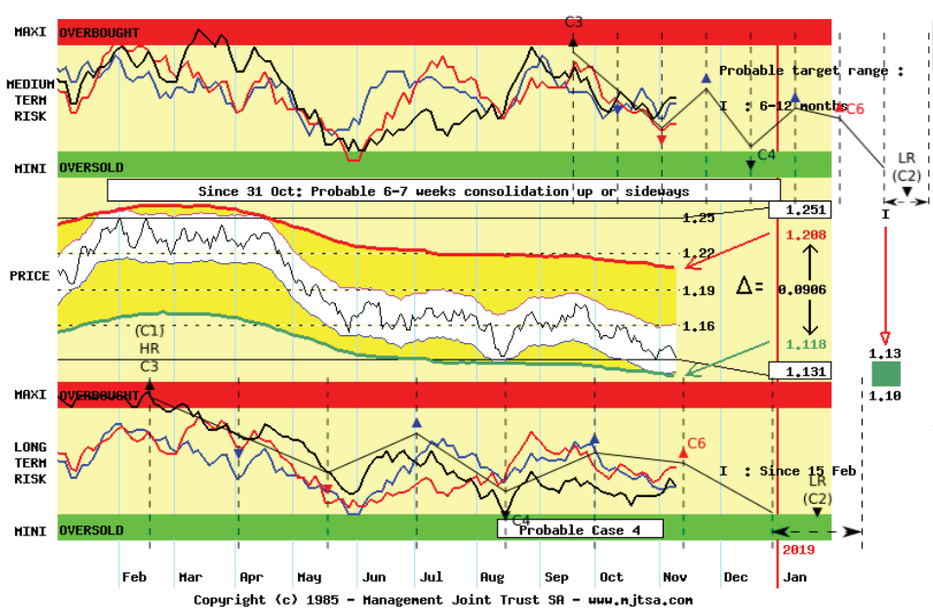
A telling graph in terms of its range-bound price action, and its cyclicality. Indeed, over the last 10 year, the EuroStoxx50 has seen little progression in US Dollar terms. Repeatedly, it has bumped into upside resistance around the 4'500 USD level, and every time was battered back towards the lower end of its range around 3'000. These back and forth movements, which are less visible in EUR terms (as the EUR has weakened), correspond to the cyclical swings of the EuroZone economy. Both our oscillator series (lower and upper rectangle) are suggesting that **the EuroStoxx50 in USD is currently mean reverting again and that it could reach back into the 3'410 -2'760 range over the next 12 to 18 months.** The EuroStoxx currently stands at circa 3'650 in USD terms.

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



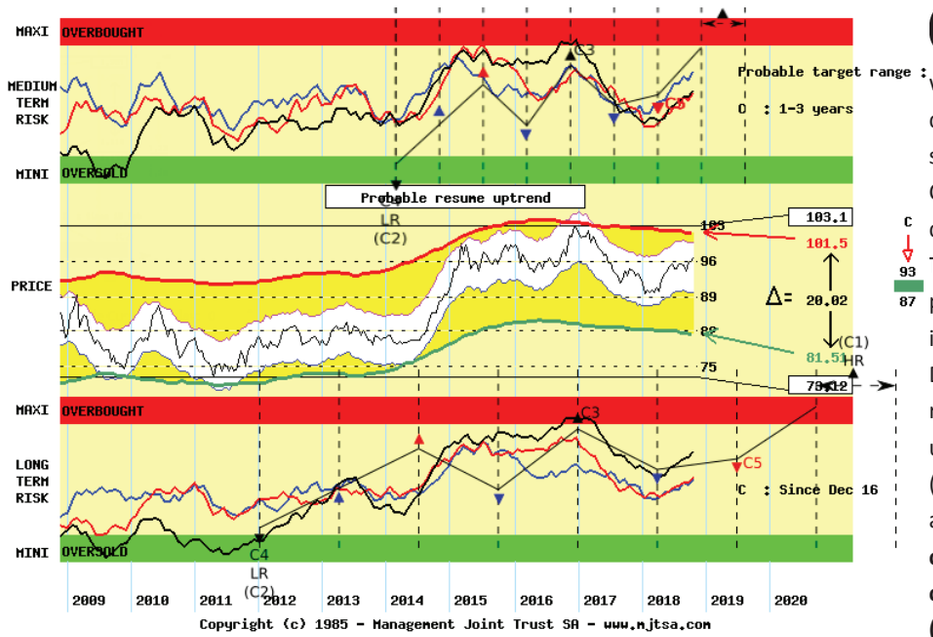
The Dollar Index's ascent since Q1, found an intermediate top mid August on our long term oscillator series (lower rectangle) and has since been consolidating. **This sideways move is coming to an end towards mid November and the Dollar should then resume its uptrend towards Q1 2019**. Our medium term oscillators (upper rectangle) suggest similar dynamics, probably from late November. Hence, **over the next few weeks, we expect the Dollar Index to confirm its move higher, first into mid December, and then again into February/March. In terms of price, our I Impulsive targets to the upside are suggesting that the Dollar Index could approach the symbolic 100 mark** (right-hand scale).

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



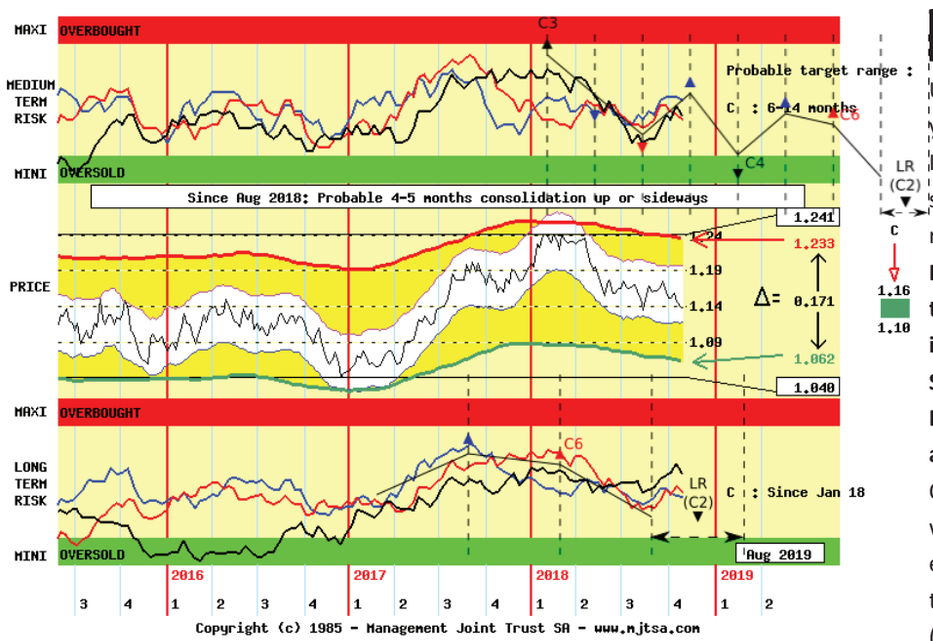
Last month, we expected EUR/USD to initiate a short bounce towards late October, early November, and then to resume lower towards December and then Q1. This is still the case on our long term oscillators (lower rectangle). Our medium term oscillators (upper rectangle) would indicate that a slight bounce may still happen over the next couple of weeks, before **the trend resumes down in full from late November**. Our I Impulsive targets to the downside are suggesting that **EUR/USD could reach down towards the lower end of the 1.13 – 1.10 range over the next few months**. Such developments would reflect the continuous hawkishness of the FED, while political stand-offs continue to threaten the EuroZone.

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



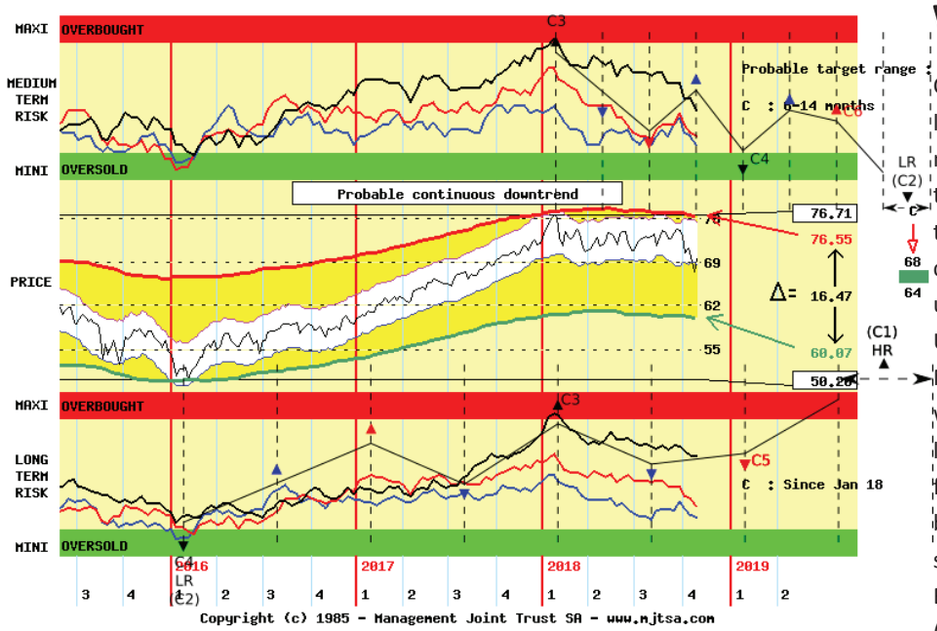
Considering the long term graph of US Dollar Index, we can note that the correction down during 2017 found support this Spring within our C Corrective targets to the downside (right-hand scale). This would imply that the previous 2011-2016 uptrend is still in place, and that the Dollar Index is now probably resuming this long term uptrend. Both oscillator series (lower and upper rectangles), are suggesting that **the current move up will probably continue towards early Spring (upper rectangle). Following that, we expect a few months of consolidation and then potentially another move up into 2020** (lower rectangle). For now, we remain bullish on the Dollar Index with a 1 to 2 years time horizon.

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



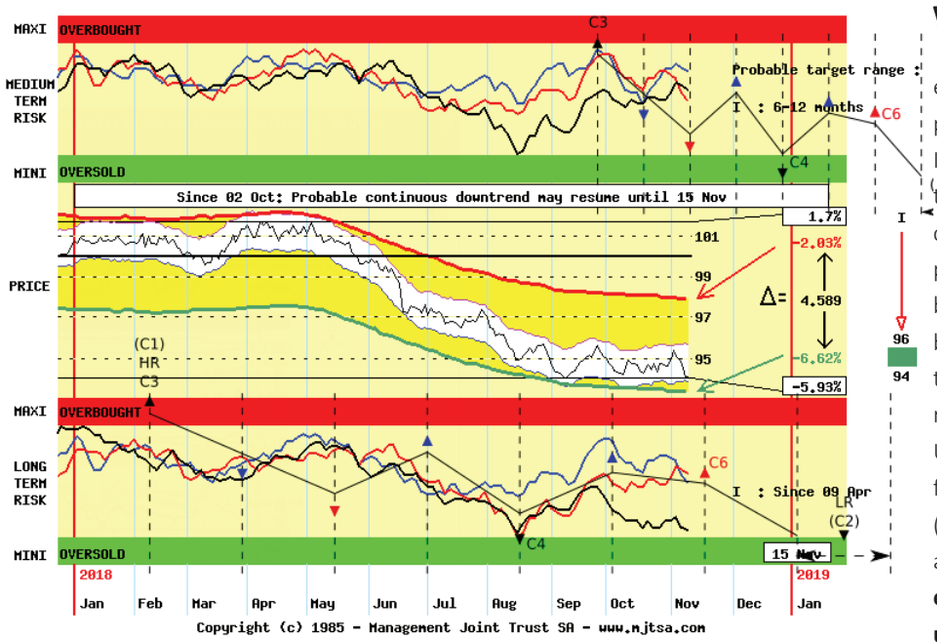
Inversely, the retracement down we expected on EUR/USD during Q2 and Q3 this year is probably far from over. Indeed, on both oscillator series (lower and upper rectangles), **we now expect EUR/USD to continue lower towards mid Q1 2018 in first instance. Then, following a Spring bounce, we expect EUR/USD to weaken once again towards late next year**. Over the next few months, we will probably test the lower end of our C Corrective targets to the downside towards 1.10 (right-hand scale). A break below this level would provide a final confirmation that the long term downtrend on EUR/USD has now resumed. The next level of downside targets are pointing towards parity.

All Country World Index
Weekly graph or the perspective over the next 2 to 4 quarters



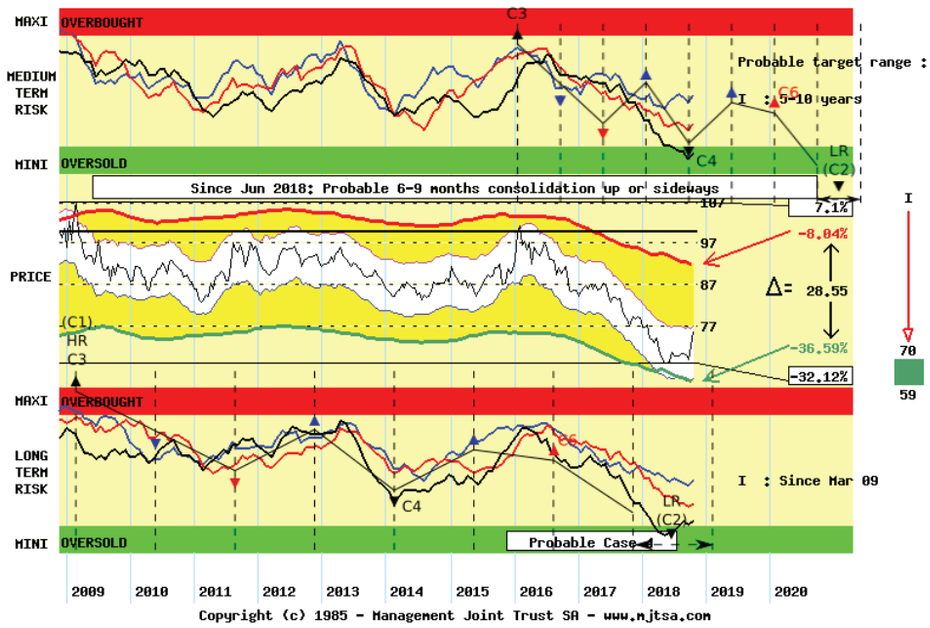
We now look at the Weekly graph of the All Country World Index in US Dollars. It started its downtrend almost a year ago. This highlights the recent relative strength of the US stock market, which continued to make new highs up until recently, while the US Dollar was strengthening. Most other markets have been weaker. They initiated a first leg down into the Spring and, following a weak Summer bounce, have now probably started a second leg lower. Both our oscillator series (lower and upper rectangles) are suggesting that **global equity markets will probably remain under pressure until mid Q1 in first instance**. On the targets front (right-hand scale), we expect the All Country World Index to test the support of our C Corrective targets to the downside between 68 and 64 (right-hand side). We believe these could break, thereby opening the door to much lower targets into late 2019 (upper rectangle). This is our preferred scenario for now. Alternatively, global equity markets could hold at, or slightly below, current levels into the Spring. This would then form a base for them to move higher throughout 2019 (lower rectangle).

All Country World Index vs S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



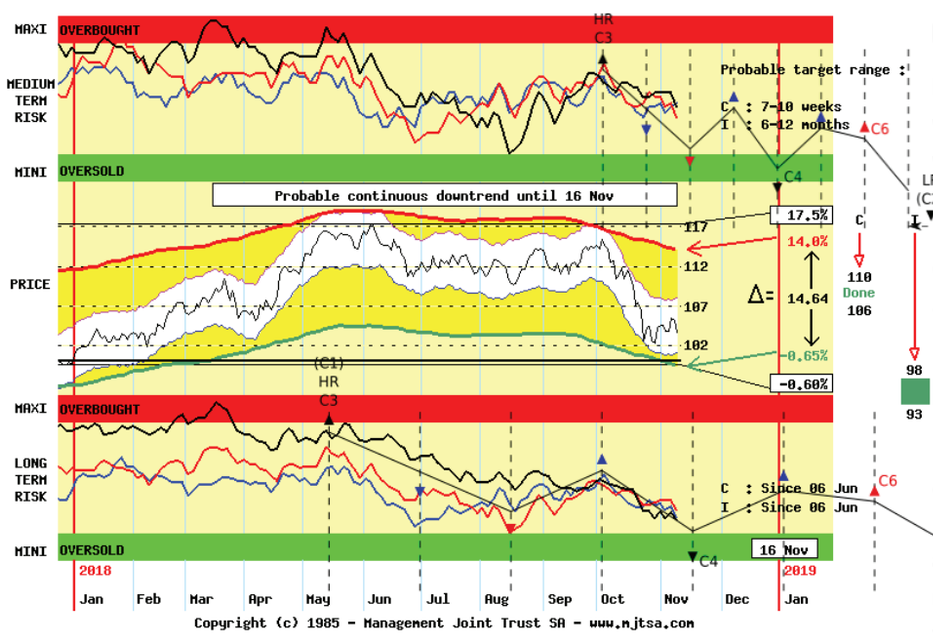
We consider the relative weakness of Global equities vs the US, by comparing the All Country World Index vs the S&P500. The ratio should capture both the currency and relative market performance, which, since the beginning of the year, have been moving in the same direction. Again, this highlights the remarkable relative strength of US markets year to date. Going forward, both oscillator series (lower and upper rectangles) are suggesting that **Global equity markets could start to underperform the US once again soon, probably starting between now and late November, first towards year-end, and then possibly towards February / March.** These projections match our negative scenario on both equity indexes and EUR/USD. We hence anticipate that **the negative news-flow will probably shift back to Europe and Emerging Markets over the next few weeks. This may also revive the "Contagion" debate once again. Yet, the strong momentum on US markets did take a huge hit in October and "the contagion effect" may be easier to come by this time.**

S&P Consumer Staples sector vs the S&P500 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



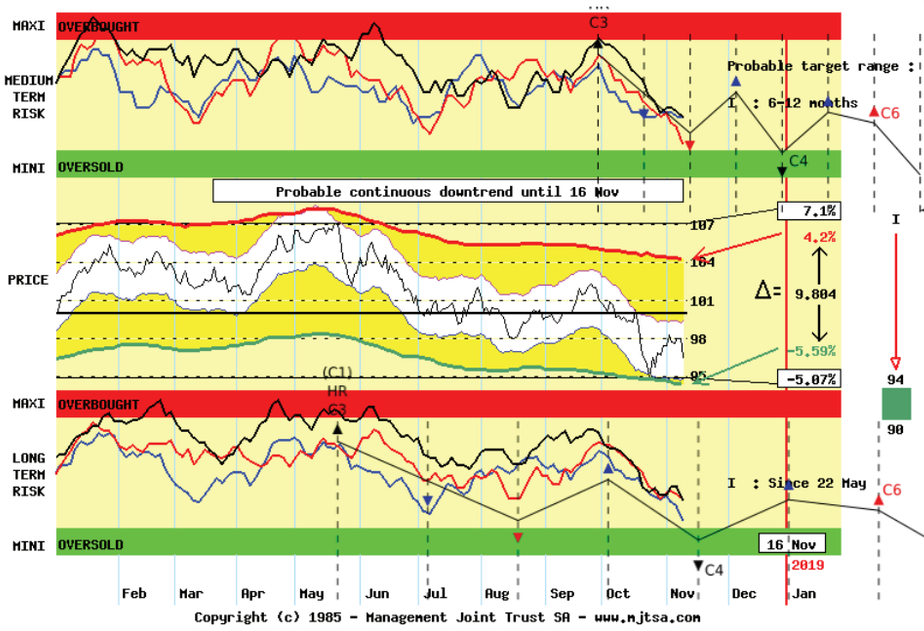
We now turn to sector relative ratios, and first start with the defensive Staples sector vs the S&P500 Index. Usually, Staples start to outperform as equity markets enter the corrective phase of their market cycle (which lasts 1 to 2 years), and while the economy is still growing strongly, i.e. the ratio usually anticipates a downturn well in advance as futures economic perspectives are gradually revised down. According to both our oscillator series (lower and upper rectangles), we may have hit this point in time. Indeed, these are suggesting that **Staples were recently very Oversold vs the market, and that they may have made an important low. We now expect the ratio to continue its recent rebound vs the S&P500 over the next 3 to 5 quarters.**

S&P500 Index vs S&P Consumer Staples sector
Daily graph or the perspective over the next 2 to 3 months



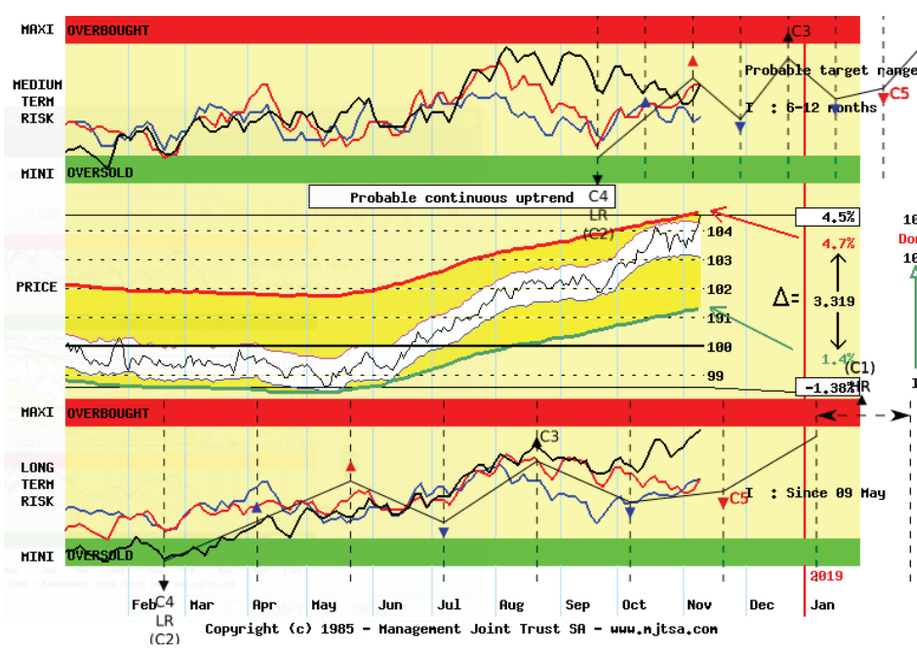
Considering US markets vs the US Staples sector highlights the defensive shift which is currently underway within US equity markets. The ratio topped out in June, did not make new highs in early October and has since been accelerating lower. Will it manage to stabilize and resume its uptrend, or do these development spell the beginning of a more lasting downtrend? Both our oscillators series (lower and upper rectangles) suggest that **a low could be made towards mid November, which should trigger a bounce.** Yet, our medium term oscillators are suggesting **that this bounce could be short lived** (upper rectangle)**, and that by early December, the S&P500 index could start to underperform the Staples sectors once again, first into year-end and then possibly into February/March.** On the target front (right-hand scale), the ratio broke below our C Corrective targets to the downside in late October, opening the door to our I Impulsive targets to the downside. These suggest **that US markets could underperform the Defensive Staples sector by a further 6 to 11% over the next few months.**

Dow Jones Europe STOXX 600 vs the European Food & Beverage sector
Daily graph or the perspective over the next 2 to 3 months



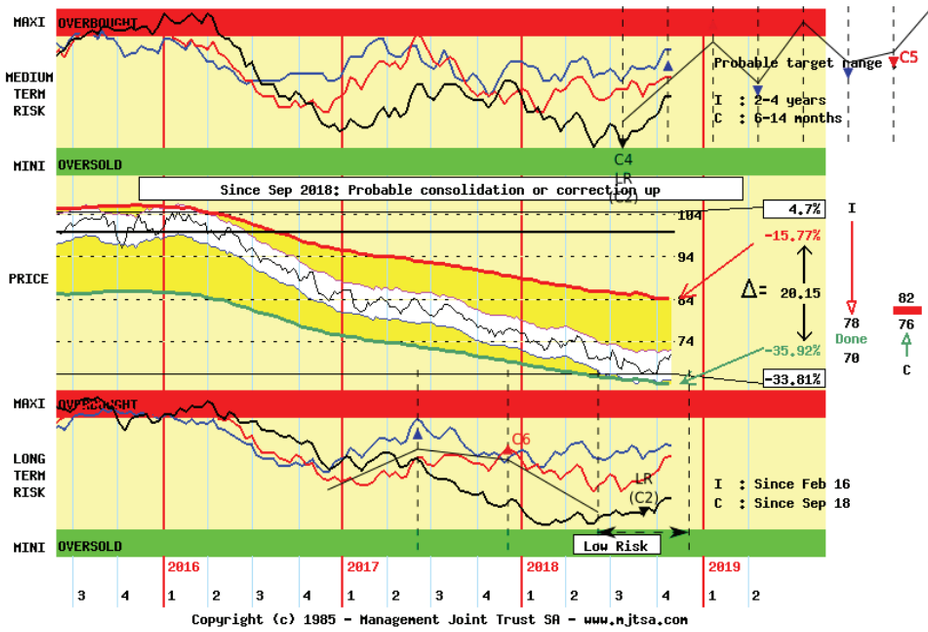
In Europe, both our oscillator series (lower and upper rectangles) suggest that the ratio could also make a low mid November, before a further bounce materializes into late November / early December. Similarly to the US market vs US Staples graph on the previous page, **we expect that from early December, the ratio should resume lower, first into year-end and then possibly into February/March. On the target front, our I Impulsive targets to the downside (right-hand scale) are suggesting that European markets could underperform the European Food & Beverages sectors by a further 8% over the next few months.**

Equal Weighted Portfolio US and European HealthCare vs their respective Market Indexes
Daily graph or the perspective over the next 2 to 3 months



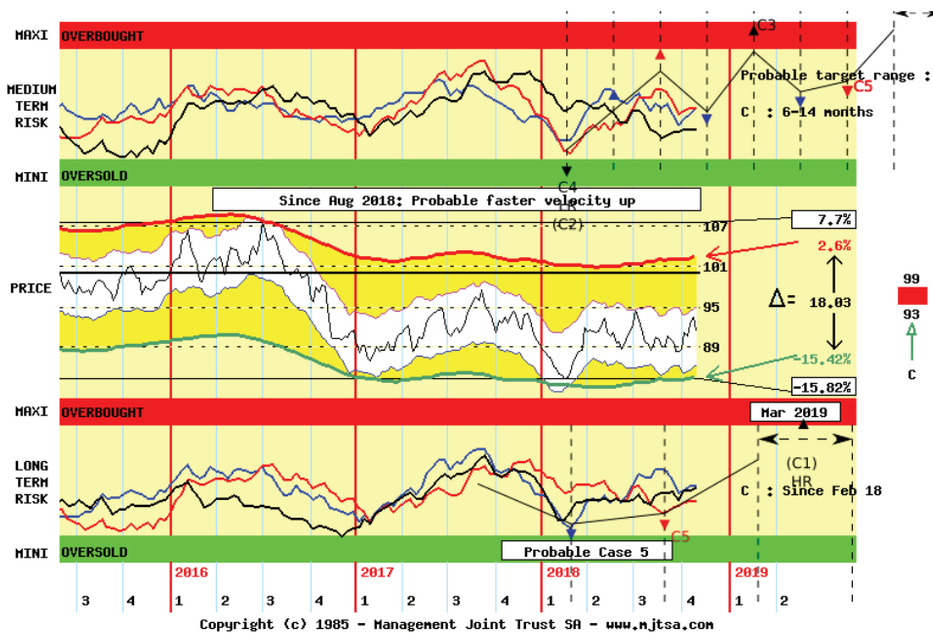
In this graph, we perform an equal weighted simulation of both US and European Healthcare sectors vs their respective indexes. Over the last six months, Healthcare has been an early outperformer in the defensive space. This is probably be due to its profile which is more Growth oriented than other defensive sectors. As a result, on a Daily graph basis, **HealthCare's outperformance potential is slowly getting exhausted vs the market,** and indeed, our I Impulsive targets to the upside have now been reached (right-hand scale). Hence, although both our oscillators series (lower and upper rectangles) are still pointing to further outperformance for HealthCare vs the market from December into Q1 next year, **the pace of this uptrend could slow over the next few months.** At this stage, other more Defensive sectors may provide better protection against a widespread equity market correction. We consider a couple of examples below.

European Telecom sector vs Dow Jones Europe Stoxx 600
Weekly graph or the perspective over the next 2 to 4 quarters



The European Telecom is typically a cash generating defensive sector and it usually outperforms when equity markets are correcting down. Both our oscillator series (lower and upper rectangles), recently reached "Low Risk" positions vs the market, while the relative I Impulsive potential to the downside (right-hand scale) is exhausted. On our medium term oscillators (upper rectangle), we expect **the European Telecom sector to outperform the market first into mid Q1 next year, and then probably again during H2 2019**. Its outperformance potential could be as high as 10 to 15% vs the market (C Corrective targets to the upside; right-hand scale).

European Utilities sector vs Dow Jones Europe Stoxx 600
Weekly graph or the perspective over the next 2 to 4 quarters



Utilities are also a pure defensive play. The sector is also particularly sensitive to any rise and fall in interest rates. It's a Bond proxy. Since early 2016, it has underperformed the market each time long term yields have accelerated up (e.g. H2 2016 or Q4 2017 to mid Q1 2018). Inversely, when long term yields retrace (i.e. as Bund yields have done this year), the sector then outperforms the market. Over the next few months, we expect European long term yields to continue their downtrend, probably from December into mid Q1 2019 (our article on Yields and Yield Curve further down this issue, pages 26 to 32). **This environment should be beneficial for Utilities on a relative basis**, a trend that both our oscillator series are confirming (lower and upper rectangles).

Concluding remarks

Following their strong rally pre and post mid-term elections, equity market started to retrace again on the Fed's hawkish note last Thursday. We believe that these developments will continue to influence equity markets over the coming weeks. First, the election results seem rather positive for equity. Investors expect them to result in a more constructive dialog between Mr Trump and the Democrats, and possibly reign in some of Mr Trump's more aggressive policies. This consensus approach is reassuring for equity markets going forward, for US equity markets at least. On the other hand, the FED's persistent hawkishness should continue to pressure risk assets around the world, and support further USD strength into Q1 next year. These market conditions could resemble the ones that prevailed from May into August this year, when Europe and Emerging markets were correcting, while the US continued its upside path. Yet, this time around, Contagion may be quicker to come by as since early October, US equity markets have probably lost much of their upside momentum. Our timing suggests that by late November / early December, Global equity markets could enter a new leg down, probably towards early next year (early/mid Q1). During this period, the Dollar and defensive trades will probably continue to outperform.

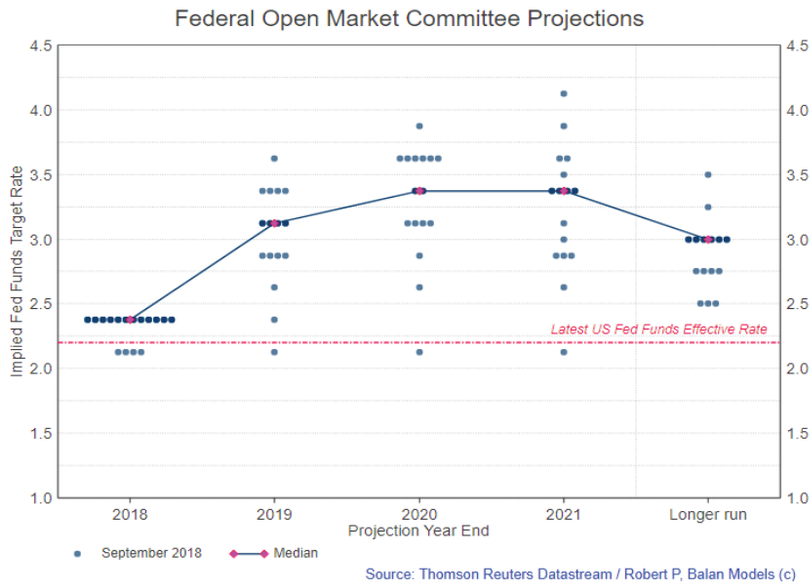
23 / Trump, the Federal Reserve and interest rates after the midterm elections: no pause for the Fed; the housing market will become progressively grimmer

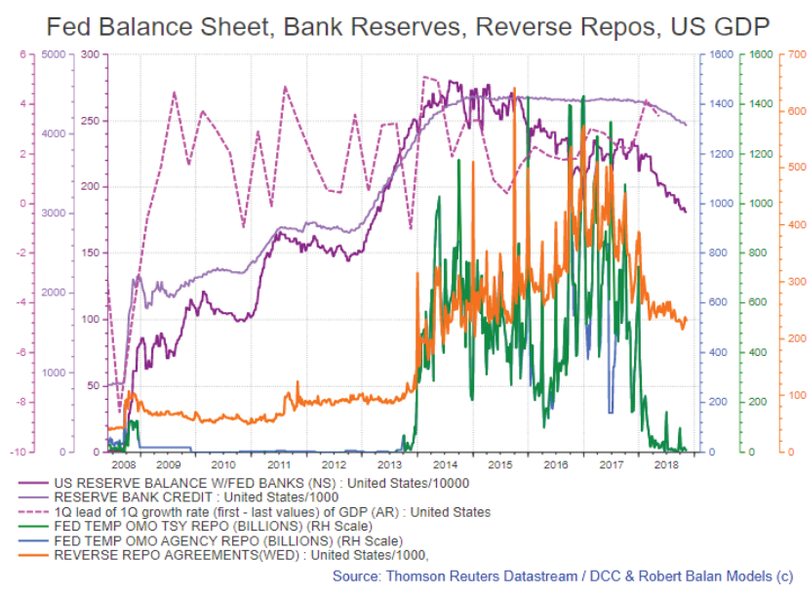
President Trump's comments critical of the Federal Reserve are unlikely to change the Fed's reaction function. The Fed will likely raise rates in December and two more times in 2019. This would put the policy rate on the tighter side of neutral, and tighter policy next year is one reason why we expect a much slower growth at a later stage ie going into 2020.

The midterm election gridlocked results should largely keep the Fed on its gradual rate hike/balance sheet reduction path rather than going further or faster in raising rates. It would have been under pressure to act more forcefully that there been a Republican sweep, since the chances of another round of fiscal stimulus would have been higher.

Unlike the 2016 U.S. election, the fixed income sector was not dealt surprises this time around, so the bond market moved on quickly. The lack of need for safe haven investing quickly brought bond yields higher, resuming the uptrend that was in place before the elections took place.

The bond focus shifts right back to the domestic fundamental setting-namely, growth prospects, inflation expectations, and any attendant monetary policy "surprises" from the Fed, if any. The recent turmoil in equity and bond markets were triggered by Fed chair Jerome Powell's injudicious, off-the-cuff talks about policy becoming more "restrictive." As far as future rate hikes go, an increase at the December FOMC meeting followed by at least two more in 2019 (March and June) seems to be the more probable outcome. So, if you do the math, by mid-2019, the middle of the Federal Funds Rate target could be 3.25%.(*see 1st chart on this page*)





Outlook for U.S bond yields needs to be detailed into two parts: short-term and intermediate to longer-dated yields.

For short-term rates, the Fed will likely continue on its gradual rate hike path, with some balance sheet reduction providing some negative flavor on growth and activity as their "normalization" schedule winds down.

Therefore, one could argue that a good portion of the rise in yields has already occurred because the market's pricing mechanism has already discounted recent improved economic growth, a moderate increase in inflation and increased Treasury supply owing to Trump's deficit spending (*see 2nd chart on this page and 1st chart on the next page*).

With further policy tightening, the yield curve should continue to flatten, especially so because the 10yr yield may plateau on and actually decline early next year. The recent steepening of the yield curve was caused by an uptick in the term premium due to concerns about the rapid wage growth in the past two months (*see 2nd and 3rd charts on this page*).

Developments on the wage front will need to be monitored closely, with any upside surprises potentially putting upward pressure on core inflation, and subsequently, on yields. Taking the midterm election results into consideration, there could be potential boost from fiscal policy in the area of infrastructure, which requires both political parties to work "across the aisle." We assign a fairly high likelihood that this will happen. That could boost wage growth or at least keep the jobs mills rolling.

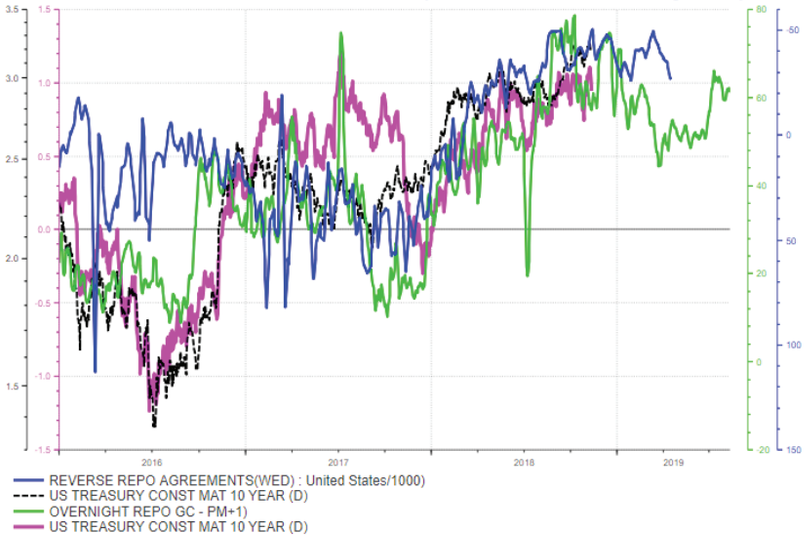
This rising data point in fact is what is vexing to the Federal Reserve Bank. During last week's FOMC Q&Q session, the surging wage growth was pointed out to Mr. Powell, and to the surprise of many in the session hall, he off-handedly mentioned that wage growth, if it continues to grow, may eventually lead to "restrictive policy". That unnerved the risk markets, and over the next three weeks, more than $3 trillion worth of assets went down the drain. That comment from Mr. Powell may have been injudicious but we cannot exactly put him at fault because wage growth had just shown its strongest back-to-back growth in a decade (*see 3rd graph on this page*).

But is appears to us that the Fed only sees the sunny side, but in reality it is raining on the other side of the street. While there were virtually no surprises in last week's FOMC statement -- at least relative to expectations -- stock markets reacted badly immediately after. The hawkish market reaction suggests that the Fed did in fact say something that was unexpected, although parsing the statement shows the central bank was showing a happy face. From the part of the statement describing the economy, the Fed sees:

"...the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has declined. Household spending

Regression of Fed Funds Rate, Reverse & Overnight Repos, 10yr yield

Second Differences of Fed Funds and Money Market Rates lead the long bond yield

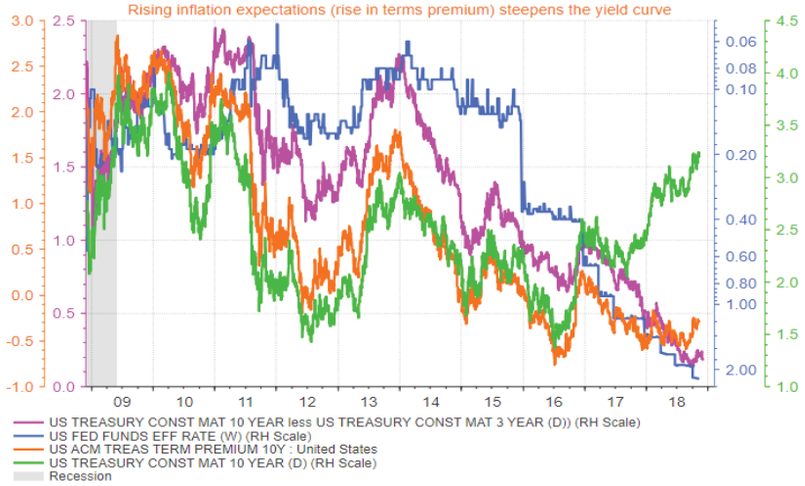


Source: Thomson Reuters Datastream / DCC & Robert P. Balan (c) - copyright vigorously enforced

Inverse correlation bet. FFR vs 3Y/10Y Yield Curve, Bond Term Premium

As long as the Fed continues to tighten, the yield curve's default response is to flatten

Rising inflation expectations (rise in terms premium) steepens the yield curve

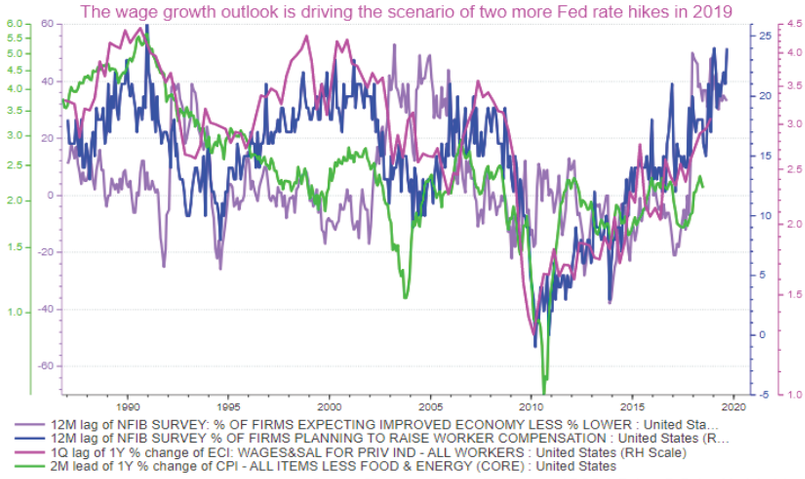


Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

US NFIB growth and wage survey vs ECI raising wages and Core CPI

The future wage outlook provides a case for rising Core PCE luntil 2020

The wage growth outlook is driving the scenario of two more Fed rate hikes in 2019



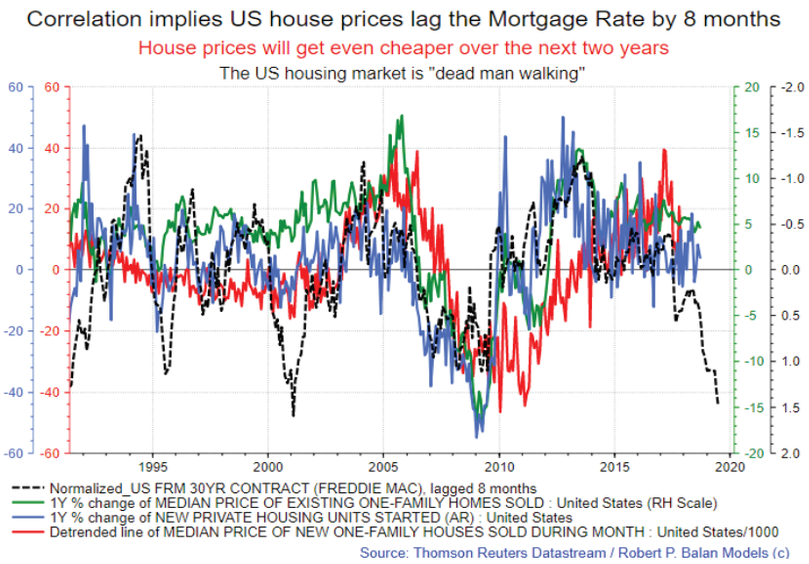
Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier in the year."

The Fed and the FOMC are seeing a Goldilocks scenario. Even the one parameter it mentioned as weakening, business fixed investment, did so from a previously "rapid" pace. So it looks like the US economy looks fine with the Fed, and there is no reason to deviate from their tightening regime.

There is one data series that is looking ominously grim -- the housing market. Housing IS the business cycle – economist Edward E. Leamer famously declared in 2007. His research showed that of the components of GDP, residential investment offers by far the best early warning sign of an oncoming recession. Since World War II we have had eight recessions preceded by substantial problems in housing and consumer durables. We have done our research and came out with a simple model which replicates some of Mr. Leamer's findings. We used the US mortgage rate as proxy for all the sub-data which negatively impact the housing market, and came out with a reasonably good forward-looking indicator (*see 1st chart on this page*).

The Fed is ignoring these metrics but we believe that the housing market will continue to spiral lower over the next 8 months at least (the implied lead of the mortgage rate over house prices). That tallies well with our thesis that the Fed will continue with the tightening regime, even as the housing market gets progressively worse. By the end of 2019, there will be a reckoning, as a slowdown being flagged by the housing market now gets even worse. We could have a growth recession in H1 2020.

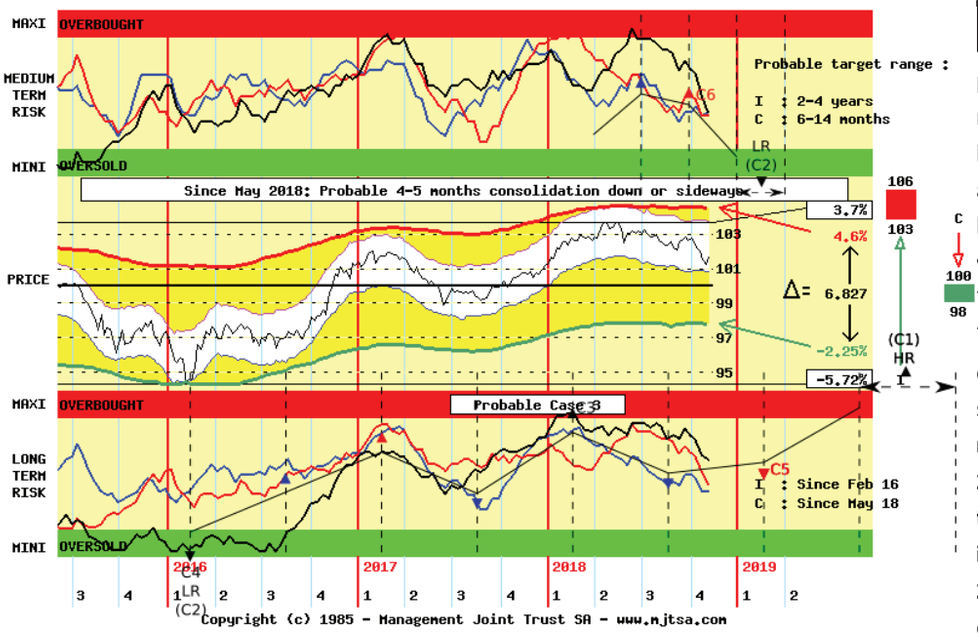


26 / MJT - TIMING AND TACTICAL INSIGHT

A hawkish FED, yet limited alternatives other than Treasuries when risk assets correct

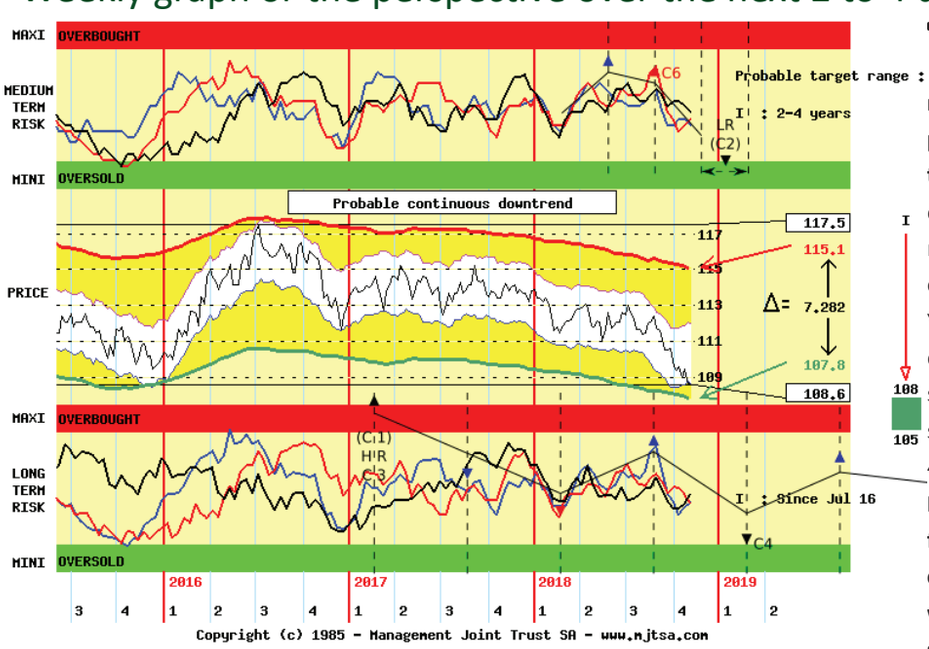
In September, we wrote about Flight to Safety and attempted to monitor its dynamics using the US yield curve. Our projections at the time were that the yield curve could steepen a bit until late September (risk-ON), before we expected it to flatten again until late October, early November (risk-OFF). These projections were slightly off in term of timing (the yield curve steepened until early October, flattened aggressively thereafter, then started to rebound late October), yet they allowed us to basically avoid being caught in the strong risk assets correction that materialized during the first 3 weeks of October. In this article, we review these yield and yield curve dynamics as well as the various sources of Flight to safety flows, in preparation for the next risk-OFF phase we expect, probably from late November / early December into early next year.

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



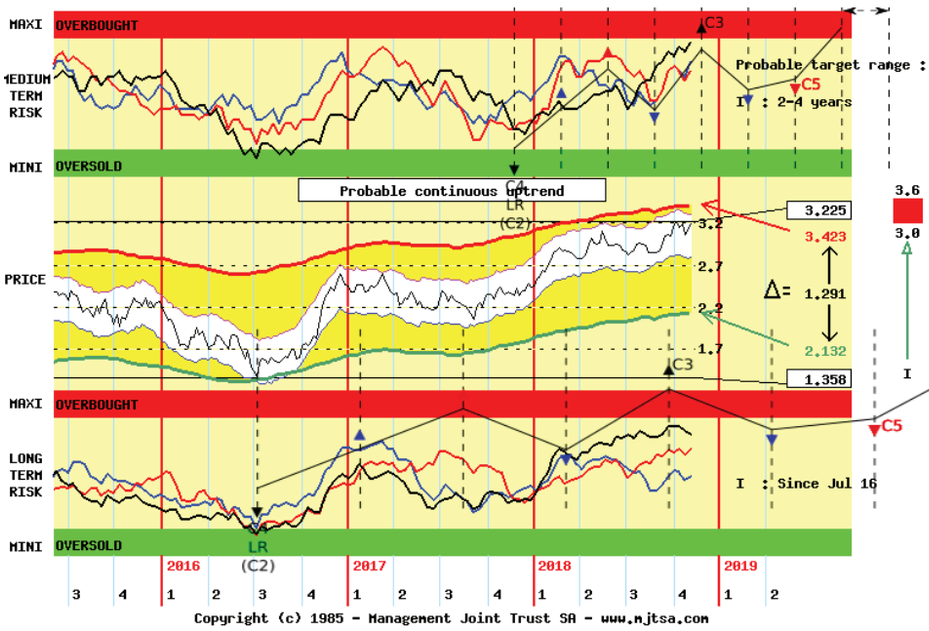
Inflation is a late cycle phenomenon. Yet, much of this "tail" inflation may be already priced in. Indeed, when considering the markets inflation expectations as captured by the breakeven ratio between US TIPs and Treasuries, we believe that the trend has already started to turn down. Such reversals usually happen when demand from TIPs gradually starts to fall vs demand for Treasuries, when the market considers that enough inflation is already priced into Treasuries. The ratio then moves lower. **This reversal process probably started mid Q2 2018, and according to both our oscillator series (lower and upper rectangles), it should continue towards mid/late Q1 2019 at least.** Hence, going forward, we expect any further rises in real long term yields to be offset by falling inflation expectations. At some point, nominal yields will probably come under pressure as falling inflation expectations overtake the rise in real yields.

TIP - iShares TIPS Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



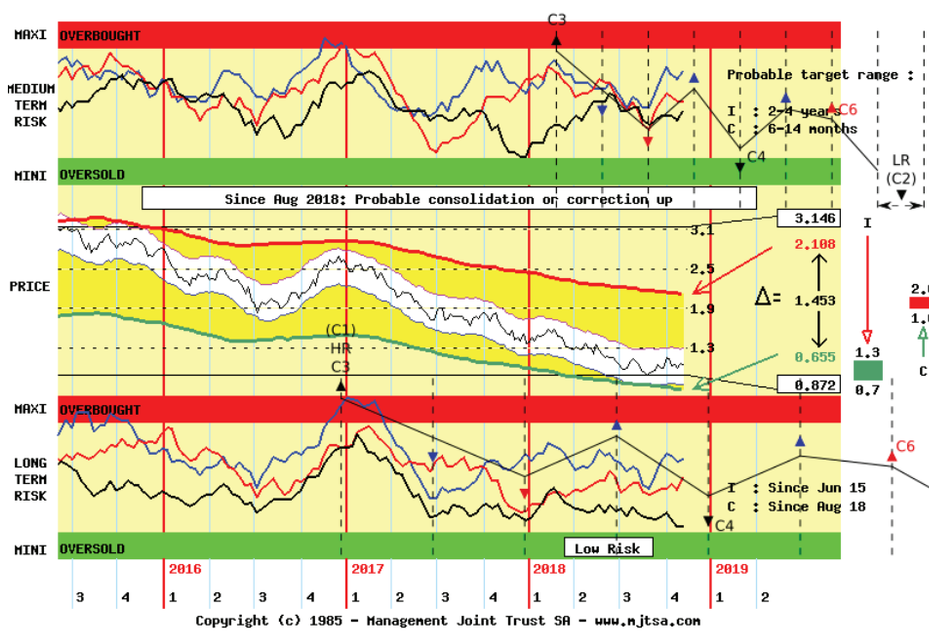
Talking about real yields, we now turn to the analysis of TIPs on a standalone basis (average maturity of 8 years). For now, it does appear that real yields will continue to rise over the next few months (falling TIPs prices). Indeed, both our oscillator series (lower and upper rectangles) are suggesting that their downtrend could continue until early/mid Q1 next year. Yet, the remaining I Impulsive potential to the downside may be quite limited. Our calculations suggests another 0.5% to 3% of risk (right-hand scale), which theoretically equates to circa 10 to 40 basis points of additional upside in real yields. **It will be interesting to monitor if and when falling inflation expectations will start to fully compensate for this rise in order to understand when long term nominal yields may gradually start to reverse down.**

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



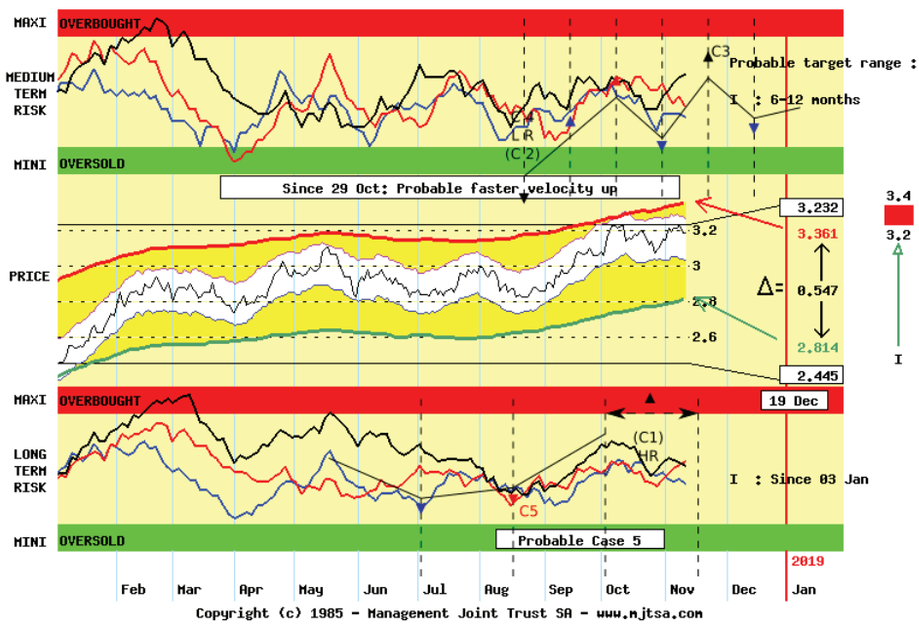
Hence, we now review the Weekly graph of US 10Y treasury yields. Our long term oscillators (lower rectangle) are suggesting that an important intermediate top is due to materialize soon. We would then expect US10Y yields to start to retrace, probably into mid/late Q1 next year in first instance. Both our oscillator series (lower and upper rectangles) are confirming this reversal. On the target front, we are now in the middle of out I Impulsive targets to the upside. Reaching their upper end towards 3.6% is not impossible, but looks aggressive given the short time window we have left. Hence, we believe that the short term upside risk is rather limited compared to the circa 60 to 100 bps retracement potential we can calculate over the next few quarters (minus 0.5 to 0.8 times our historical volatility measure "Delta", here at 1.292; middle rectangle, right-hand side). **To summarize, we believe that the uptrend up since mid 2016 could make an intermediate top soon, that the remaining upside potential is rather small, and that circa 6 to 12 months and 60 to 100 basis points of retracement lie ahead.**

US 30 years Benchmark Bond Yield- US 3 Months benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



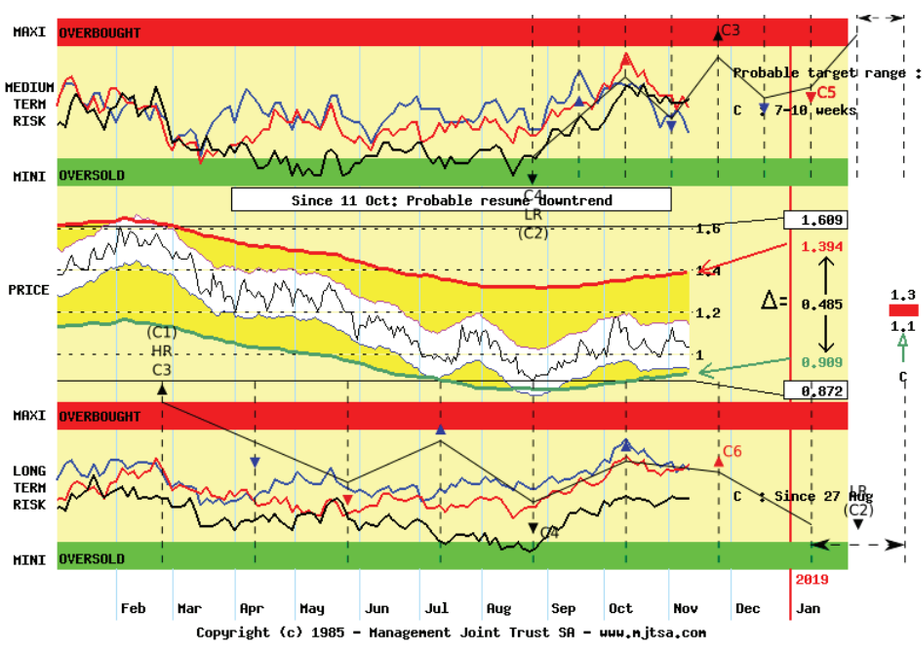
We now switch to the US Yield Curve and first compare its extremes, i.e. we look at the 30 Years minus 3 Months spread. The downtrend over the last 2 years is quite clear, yet it is interesting to note that each bounce/sell-off in the spread corresponds to a concomitant acceleration up/down in long term yields (please compare with the graph above), i.e. their cyclical rhythm is the same although one graph is in an uptrend while the other is in a downtrend. This is quite logical as both graphs are very sensitive to rises and falls in long term yields, while US3M yields have been rising steadily along with the FED's regular rate hike policy. Our long term oscillators (upper rectangle) are suggesting **that the flattening trend since early 2017 is slowly coming to an end. Yet, on our medium term oscillators (upper rectangle), we would still expect one last sell-off into early / mid Q1. Following that, we may then see the beginning of a more substantial steepening counter-trend.** Our I Impulsive targets to the downside (right-hand scale) are still pointing to further downside, possibly towards new lows (0.7% ?).

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



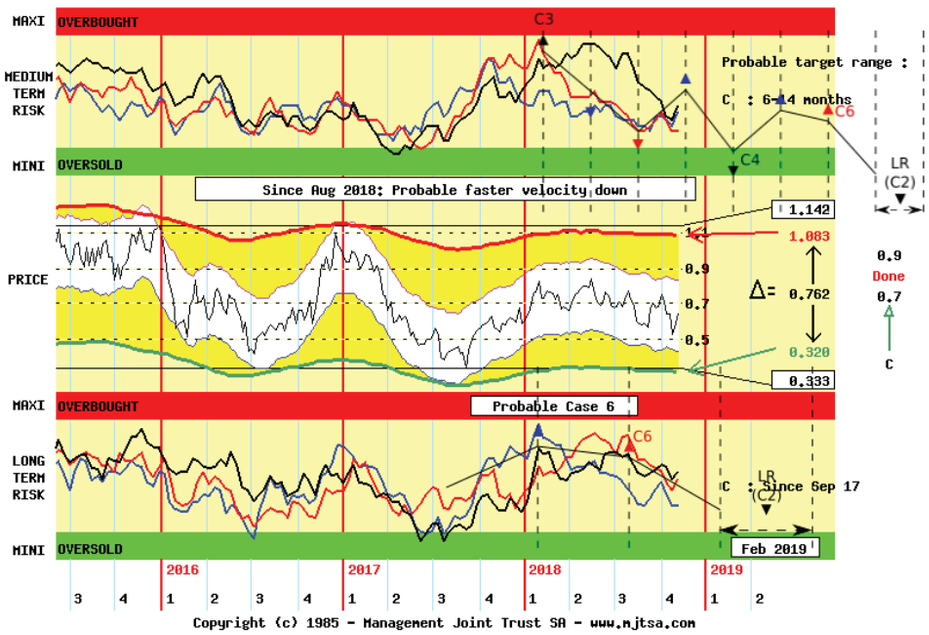
As mentioned above in this article, inflation expectations have probably started to reverse down (consolidating TIP/Treasuries ratio). This is an important headwind for further rises in long term yields. Indeed, our long term oscillators (lower rectangle) have now entered a High Risk zone, a situation that usually triggers 2 to 3 months of consolidation to the downside. Our medium term oscillators (upper rectangle) are still uptrending, yet should probably top out towards the end of November. Combining both projections, **we are expecting a last push to the upside over the next few weeks, possibly reaching marginal new highs (i.e. our I Impulsive targets to the upside; right-hand scale), and then, from end November, the beginning of a reversal with a first move down into February/March next year.**

US 30 years Benchmark Bond Yield - US 3 Months benchmark Bond Yield
Daily graph or the perspective over the next 2 to 3 months



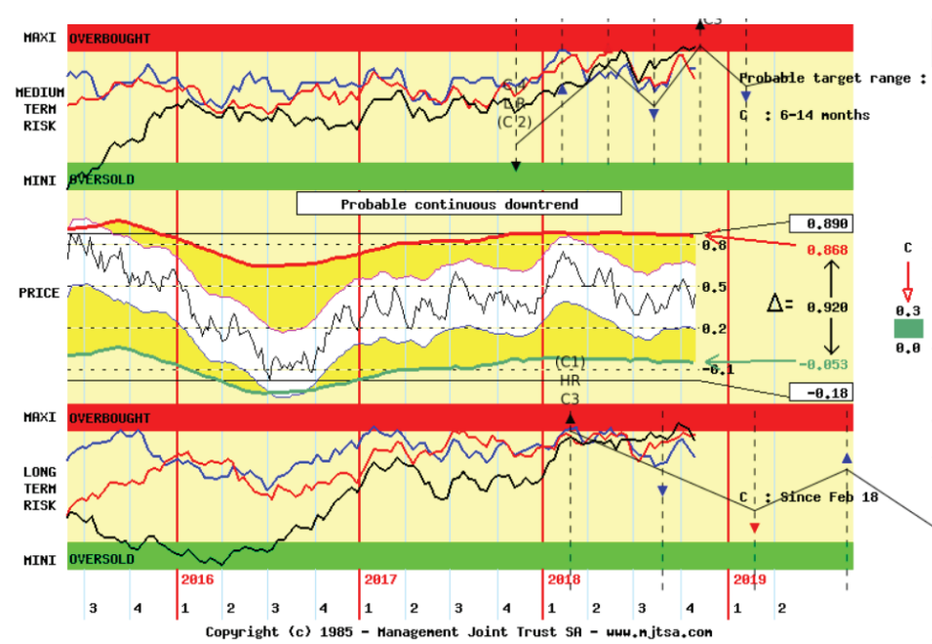
Again, the 30Y minus 3M US treasury spread confirms this timing. Indeed, this spread has been bouncing since late August, reached an intermediate top in early October and could soon rise again towards another top late November. Following that, it probably resumes lower until February/March next year. This is what we show on both oscillator series (lower and upper rectangles). On the target front (right-hand scale), the spread remains below our C Corrective targets to the upside, which confirms that the downtrend since February this year is probably still in place, and that the probability of a further sell-off is still strong.

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



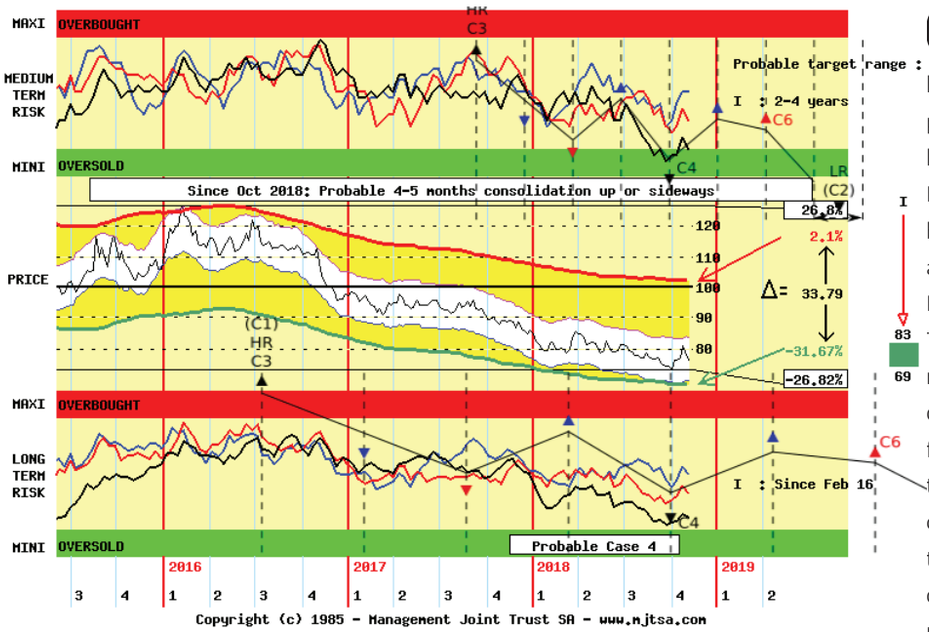
As we pointed out in previous The Capital Observer issues, the long term end (30Y-10Y) and the medium term part (10Y-3Y) of the US yield curve have already flattened quite substantially. The flattening may continue another couple of months, yet the scope of these moves is probably limited (exhausted downside potential). On the other hand, the Shorter end of the US yield curve seems more interesting. **Over the last three years, the 3 Years minus the 3 Months Treasury spread has indeed been very reactive to reflation/deceleration dynamics.** 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 suggesting **that it could continue to accelerate down lower, probably into late Q1 next year at least.** On the target front (right-hand scale), the I Impulsive targets to the downside we can calculate are **pointing towards inversion, possibly by late Q1 next year. This is 60 basis points below current levels** (1.3 to 1.7 times our historical volatility measure "Delta", here at 76.3 bps, subtracted from the late 2016 highs at 1.142, i.e. downside targets for the Spread between plus 0.15% and minus 0.15%)**. If these projections come true, expect a strong deceleration in inflation dynamics and widespread Flight to the Safety towards US Treasuries.**

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



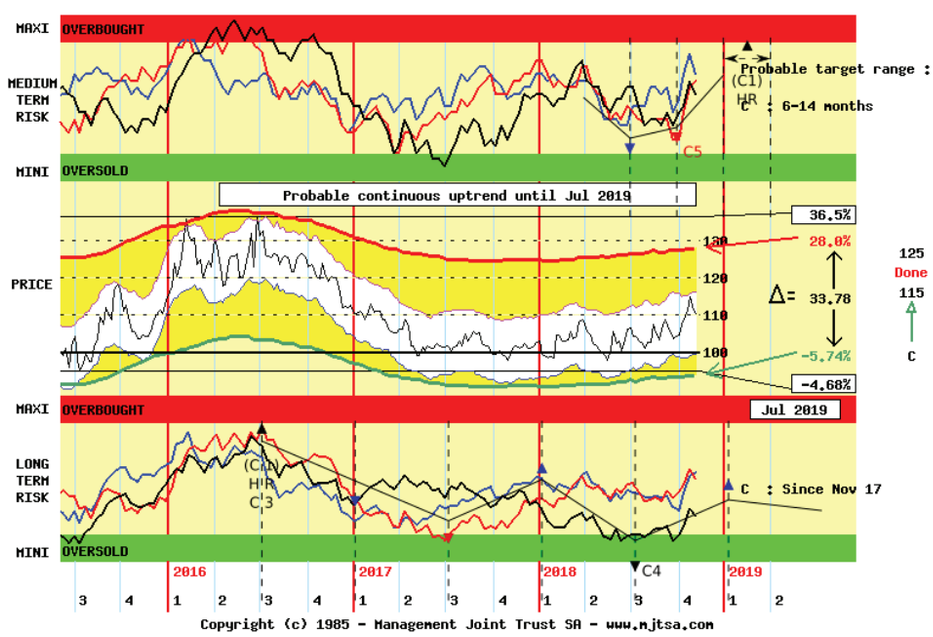
In Europe, we are also expecting some retracement on Bund Yields. They did bounce quite nicely during the Summer, yet from early October, we expected them to start to resume down again. Both our oscillator series (lower and upper rectangles) are suggesting **that they will probably continue lower towards mid Q1 next year at least.** Our C Corrective targets to the downside (right-hand scale) are suggesting that 10Y Bund yields should retrace back down below 0.3% and possibly even retest 0.0% over the next few quarters.

30 Years US Treasury Futures vs the S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



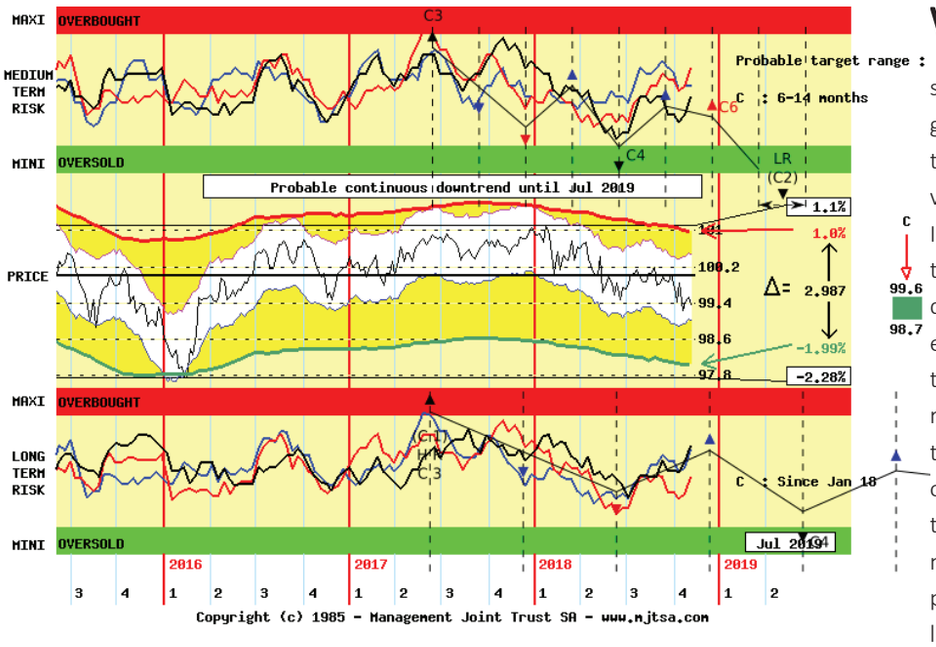
Over the last few graphs, we have described how we believe US and European yields will probably correct down / resume lower from late November into February. We expect this move to be concomitant with a strong risk asset correction and hence with Flight to Safety flows towards Treasuries and Bunds. Over the next few graphs, we will consider where these flows may come from, and first from equities with this relative performance graph of US 30Y Treasury Futures vs the S&P500 Index. On both oscillator series (lower and upper rectangles), **the downtrend of Treasuries vs US equity markets seems exhausted and may have just made an important low. The bounce that follows could last first into mid/late Q1.** On the target front, our I Impulsive targets to the downside have been reached (right-hand scale), while **the C Corrective potential to the upside we can calculate is between 10 and 20% in favor of Bonds over the next couple of quarters** (0.5 to 0.8 time our historical volatility measure "Delta", here at 33.97 – middle rectangle, right-hand side – added from the low of the graph). This is quite substantial.

10 Years Bund Futures vs EuroStoxx 50 Futures
Weekly graph or the perspective over the next 2 to 4 quarters



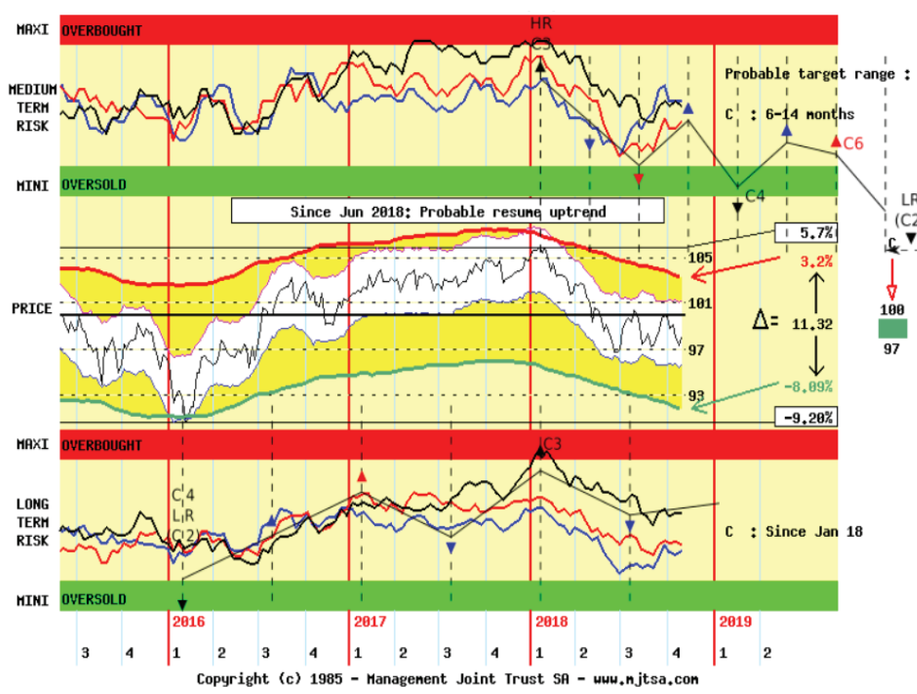
In Europe, the ratio of the Bund Futures vs the EuroStoxx50 Futures has been building a base since last year. Both our oscillators series (lower and upper rectangles) are suggesting that **the Bund could now continue to outperform European equity markets, probably into mid Q1 next year in first instance**. Our C corrective targets to the upside (right-hand scale) are suggesting that over the next few quarters, the ratio could continue to bounce by a further 5 to 15%.

US Investment Grade Corporate Bonds in USD vs USD AAA-A Corporate Issuers
Weekly or the perspective over the next 2 to 4 quarters



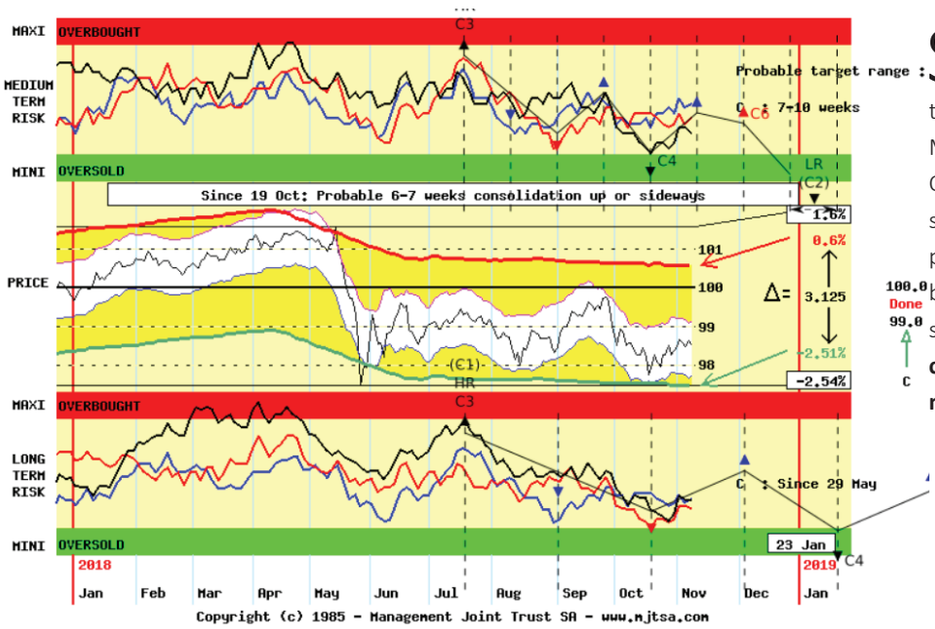
We now look at Credit markets, which we believe have also started to reverse down since the beginning of the year. We first compare the wider US investment grade universe vs Aaa-A rated USD corporate bonds. Indeed, there is a growing concern in the market, that the issuance of lower quality investment grade bonds has exploded over the last few years, and that many of these issues now run the risk of being downgraded to junk once the credit cycle turns. On both our oscillator series (lower and upper rectangles), we expect the ratio to continue lower over the following months, possibly the next few quarters. We believe it will break below the support of our C Corrective targets to the downside (right-hand scale). This would imply strong **Flight to Quality flows from Credit towards Aaa-A bonds and probably help put a cap on the upside progression of longer term US Treasury Yields.**

Emerging Markets Sovereign Debt ETF vs 7-10 Year Treasury Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



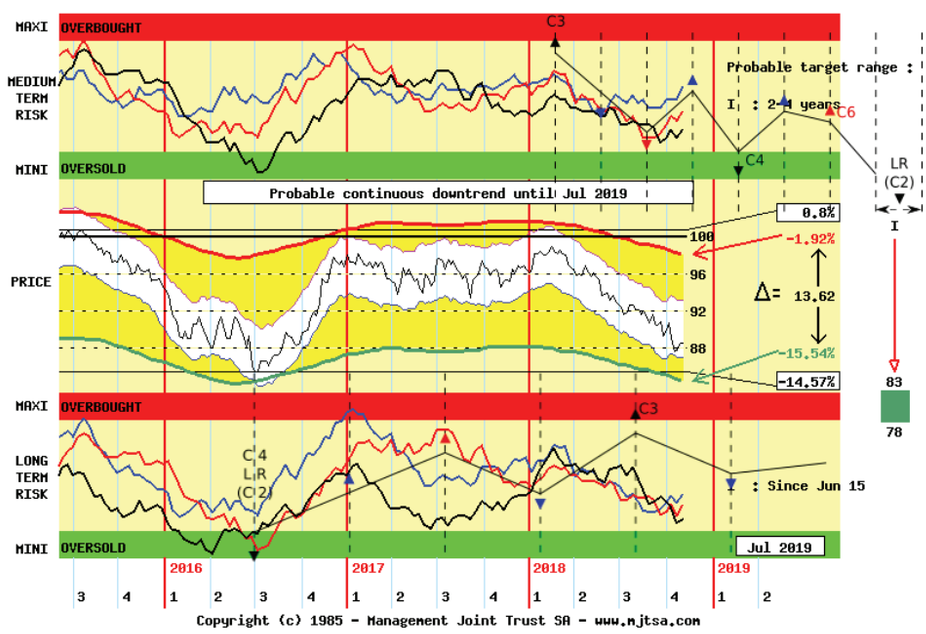
Similarly, when we compare Emerging Markets Sovereign debt to US Treasuries, we can also notice the strong deterioration. It started at the beginning of the year and found support between early and mid Summer. It has since been bouncing. Yet, on both oscillator series (lower and upper rectangles), **we now believe that it could soon start to resume lower, probably from late November towards mid Q1. The ratio is also close to breaking below our C corrective targets to the downside (right-hand scale). This would open the door to much lower targets over the next few quarters. These projections corroborate our general view that the emerging markets troubles since this Spring are probably far from over.**

EuroZone Sovereigns vs Bunds
Daily or the perspective over the next 2 to 3 months



Similarly in the EuroZone, Flight to Safety flows seem to be flowing to the Bund. This trend started with the Italian political crisis in May and saw another sell-off during the early October market turmoil. Both our oscillators series (lower and upper rectangles) are now pointing to a few more weeks of rebound, before EuroZone Sovereign Credits spreads start to widen again. **The ratio should then continue lower, probably towards late January at least.**

Equal Weighted Portfolio US and European Banks vs their respective Market Indexes
Weekly graph or the perspective over the next 2 to 4 quarters



This environment where we expect yields to gradually start to retrace down, the yield curve to flatten once again and Credit to deteriorate, is not favorable to the Financials sectors. Hereby, we present a graph simulation of an equal weighted portfolio of European and US Banks vs their respective market indexes. According to both our oscillator series (lower and upper rectangles), **the downtrend on Banks vs the respective market indexes seems far from over. It should resume lower over the next few weeks, probably towards mid Q1. Then, following a bounce during the Spring, Banks could underperform once again in H2 2019. We expect between 7 and 12% of underperformance for the sector vs the market over the next 12 months** (our I Impulsive targets to the downside; right-hand side).

Concluding remarks:

While inflation expectations have probably started to reverse down, real rates have recently continued to rise. The balance will determine the future path of nominal treasury yields in the US. Our analysis of US 10Y yields is confirming that a top may be near (i.e. that the balance is shifting). From late November, it suggests a 60 to 100 basis points retracement on US 10Y yields, probably over the next 6 to 12 months. The yield curve is also helpful to time this reversal point. Indeed, while expectations for further FED rate hikes are still strong, the spread between long term yields and the Federal Funds Rate has provided reliable signals for risk-ON / risk-OFF phases since the beginning of the year. Following a slight bounce, our analysis suggests that by late November, the US Yield curve could start to flatten again, probably towards next February. Developments in Bund yields, Corporate and Sovereign Credit spreads as well as for the banking sector vs the market seem to confirm this timing sequence.

33 / Commodities outperformance over equities: it has started, it is pausing and will likely accelerate again mid Q1 2019

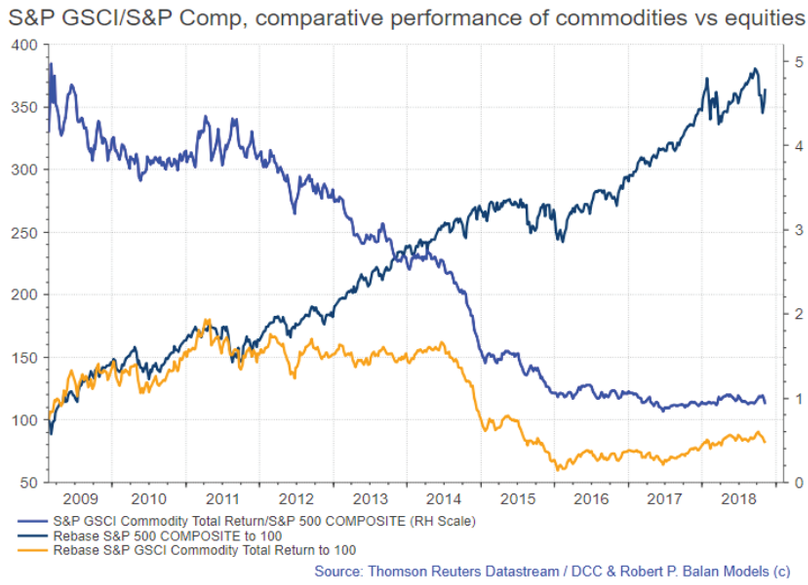
As we first reported during the July 2017 edition of the Capital Observer, **at no other time in the history of commodities has the asset class been as weak against equities, as it is today. Over the past 50 years, commodities have never been cheaper relative to equities than they are at present.** The divergence has reached historic levels in the back of a 246%-plus move on the S&P Index (SPX) since the trough of the Great Financial Crisis in Q1 2009, compared with a 31.2% decline for the Goldman Sachs Commodity Total Return Index over the same period.

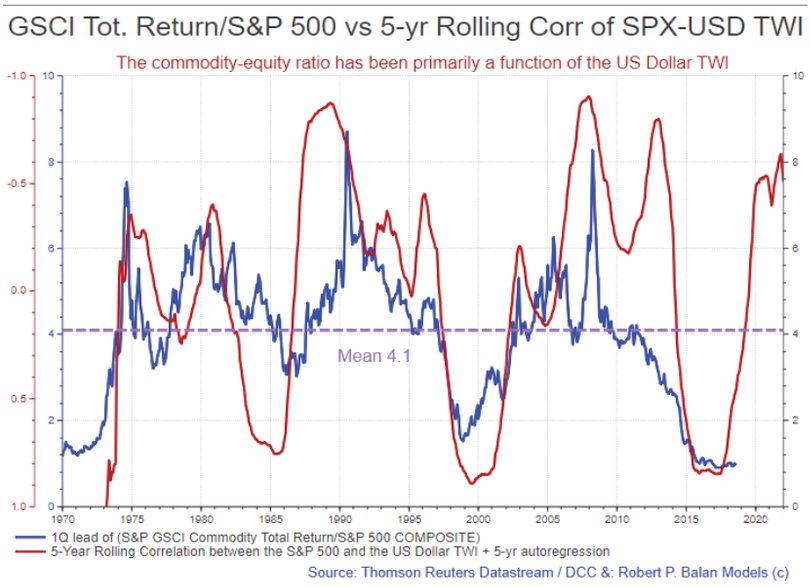
That underperformance is changing quickly to a more positive outlook for resource materials; the ratio between the two assets classes has been stable for more than a year now, and is starting to trend in favour of commodities *(see 1st graph on this page).*

In the May 2018 Capital Observer issue ("*Is it time to allocate funds away from equities to commodities?*"), we published a graph that has elicited a lot of attention and comments (*see 2nd graph on this page*). In the chart, we juxtaposed the rolling correlation between the S&P 500 and the US Dollar TWI, with a 5yr autoregression, which defined and illustrated the highly cyclical performance of commodities as an asset class versus the S&P 500 Index (as proxy for the equities asset class)

Given those identified relationships, and the possible inflection point of a new commodities outperformance, which was highlighted by the model, we said then:

"This is literally a once-in-a-generation opportunity that investors with a long-term view should seriously consider. For perspective, had you invested in a fund tracking the S&P GSCI or an equivalent commodities index in 2000, you would have seen a compound annual growth rate (CAGR) of around 10 percent for the next 10 years, according to Bloomberg data. It's doubtful if you're going to get a clearer or resounding signal that now could be an ideal time to add to your commodities exposure."





Those comments in the May Capital Observer issue were not far-fetched: **indeed, on the long term picture, the commodity-equity relationship could be setting up a trade of a lifetime, as commodities revert to the mean in the relationship, similar to the one seen in the early 2000s**. Today, the relationship remains near the lowest point in recent history, and more analysts are talking about the ratio's reversion to the mean, which is at 4.1 (it is currently at 1.05) taking into stock the somewhat spotty prices available during the late 1960s (see graph below). **The divergence in the commodity-equity relationship remains extreme and has been for so long, that a snap back into more reasonable levels looks inevitable sometime soon** (*see 1st graph on the next page*).

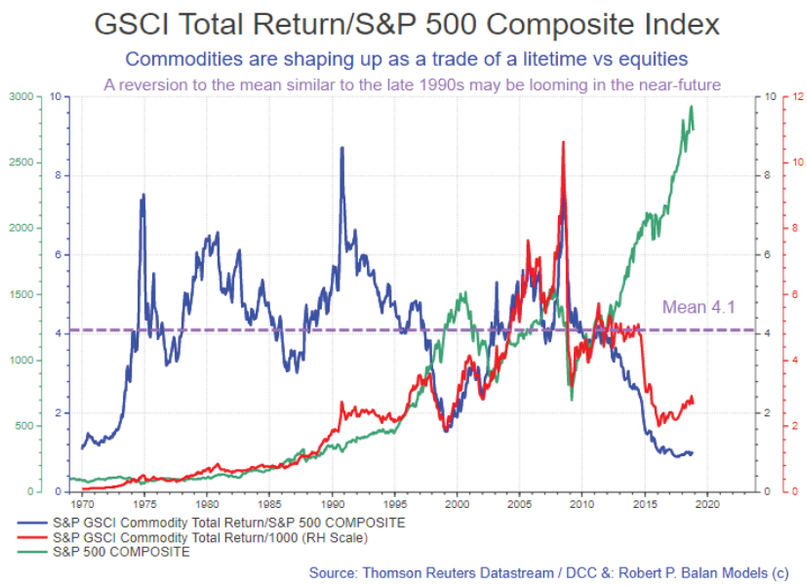
Any movement towards the mean of 4.1 in the equities/commodities ratio should be signalled by a change in the correlation between the two asset classes. Not many have noted that the current recent stock-commodity correlation has been at the

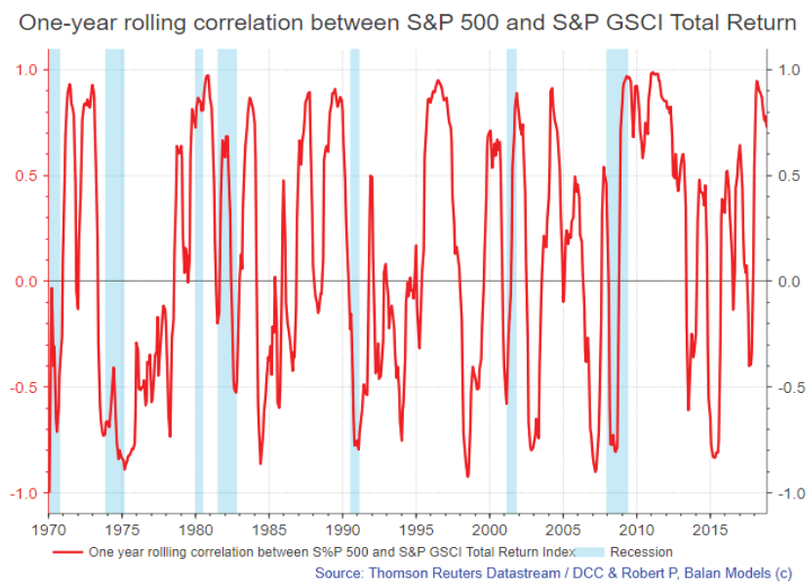
upper end of its historic range – in fact it has just been to just below unity (at 1). As the graph below shows, for the commodity outperformance to take place, the correlation has to move to negative, even close to negative 1 (-1) as in the early 2000s (*see 2nd chart on this page*). **The correlation is now likely moving towards zero, and subsequently, to negative.**

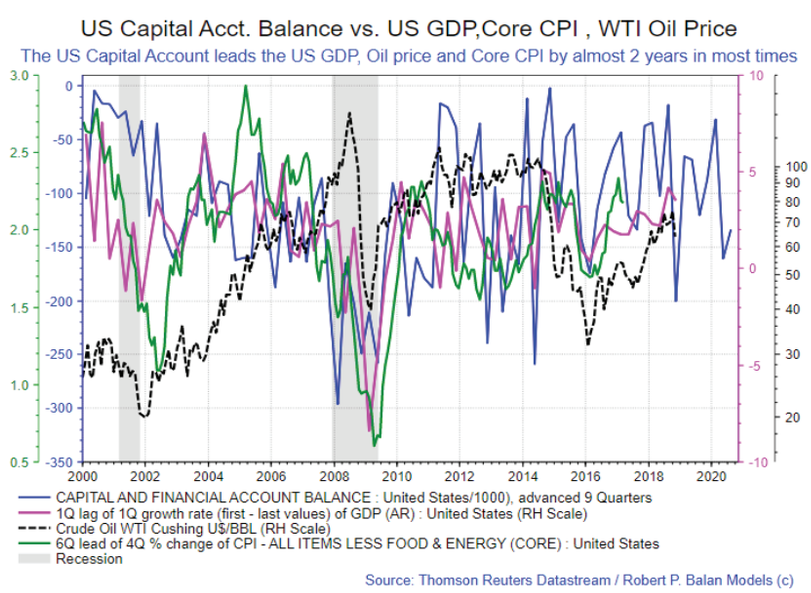
As the graph above shows, flipping from (+1) to (-1) correlation occurs fairly often, which hints at a cyclicality of the relationship between the two asset classes. Proof: since 1970, the stock-commodity correlation has been close to zero, on average. The overall low correlation between commodities and equities has, in fact, been touted as one of the three main benefits of commodity investing (the other two being equity-like returns and a positive correlation with inflation).

Nonetheless, these point estimates conceal wide degrees of variation. For instance, the historical spread of the annual correlation between stocks and commodities has ranged from -0.92 to 0.98 (*see 3rd graph on this page*). The current 1-yr rolling correlation between the two is at 0.78, from the recent 0.97 high, and should not long after, revert to zero, or even make another trip to the area of -0.92. That is when the commodities outperformance will likely occur.

A fall in correlation could be accomplished in three ways: (1) commodities could rally while equities decline (or vice-versa); (2) commodities and equities fall together but equities decline at a faster and larger degree relative to commodities, and (3) commodities and equities rise together, but the former outpacing the latter. If a move to negative correlation continues to progress, as we believe it would, we believe that the more likely case will be (3), where commodities and equities will continue to rally, but with commodities outperforming equities.







For factor (3) to be valid, where commodities outperform equities, there has to be a certain set of macro conditions, primarily presence of economic growth and/or the rise of core inflation.

We would only see those conditions happening from mid Q1 2019, so in a few months as on the short term some risks remain for growth. That is also the projection indicated by our US Capital Account model of foreign and domestic capital flowing into the US.

The last graph on th eprevious page shows the high likelihood of GDP growth in 2019 into early 2020. This follows what could be a significantly low growth reading in Q4 2018-Q1 2019, which has been instrumental in depressing risk assets prices like US equities and oil recently. This should carry on affecting risk assets into Q1 2019 with Chinese, Em and the dollar also playing their part.

The case for rising US Core CPI is straight-forward. We discussed this at great length in the May 2018 issue of Capital Observer: ("*What's Up With Core Inflation? Core CPI Will Rise Over The Next 5 To 6 Quarters: Actionable Ideas*"):

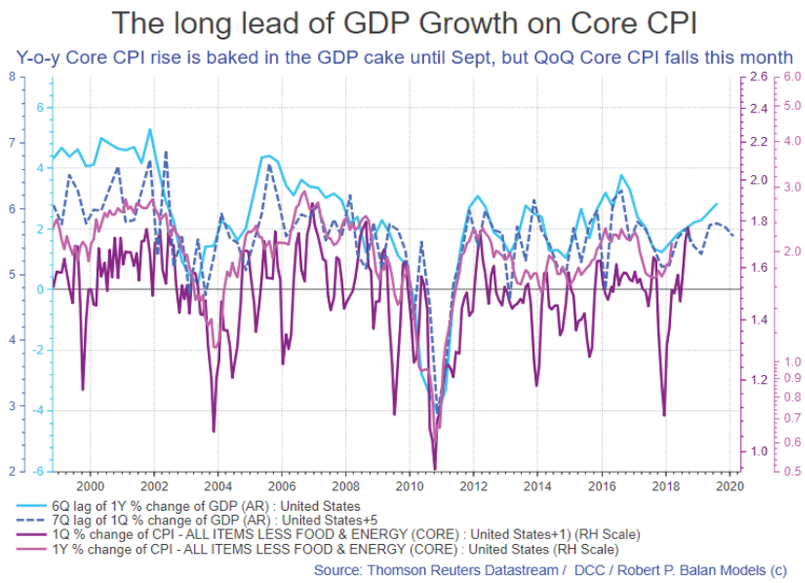
There is a distinct cadence in the relationship between GDP growth, core inflation and the subsequent, and corresponding, reaction function of the Federal Reserve. This is the timeline: GDP change rates lead changes in Core Inflation by 5 to 6 quarters. Core CPI, in turn, leads changes in the Fed Funds Rate (proxy of Fed policy changes) by 2 quarters

Not to be left unsaid, knowledge of those dynamics enables anyone to predict the path (and to some degree, the extent) of core inflation changes 5 to 6 quarters ahead (see 1st and 2nd graphs on this page).

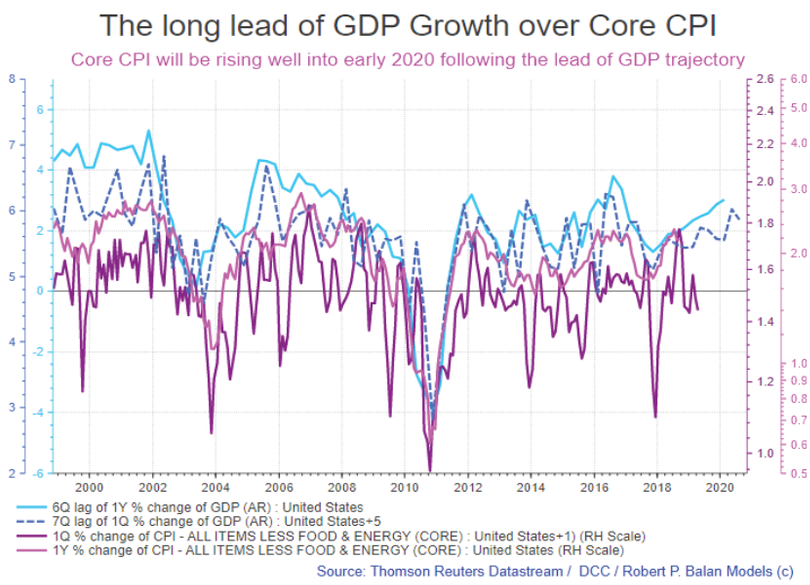
What these graphs suggest is that the year-on-year Core CPI will be rising well beyond September this year, and into Q3 2019, in fact. The quarterly Core CPI however will tend to decline over the next two or three months.

Core CPI should be rising well into early 2020 following the lead of the GDP trajectory. This conclusion tallies very well with the outlook derived from the Capital Account model shown earlier. This is likely, even if GDP growth declines from Q1 2020, as our models (shown earlier) suggest. That possible divergence will be a function of the lagged response of Core CPI changes to changes in GDP growth, going into H1 2019.

Original chart in the May 2018 Capital Observer



This is how that chart in May 2018 looks now



It should be noted that despite the historic low, long-term correlation between these two asset classes, commodity price increases often come on the back of buoyant demand due to booming economic activity, which corresponds to optimal conditions for stock bull markets. That's the condition we could see from mid Q1 2019. However, the expected, persistent rise in core inflation during that period could weigh heavily on equities, and may contribute to the expected underperformance of the equities asset class. Therefore, the sign of the correlation may converge to minus 1 (-1), even as as both equity and commodity prices could increase on positive macroeconomic outlook. That is exactly what happened in the early 2000s.

The evolving relationship of the US Dollar versus these two asset classes will also be a factor in the forthcoming outperformance of commodities against equities. The USD-S&P 500 correlation at this time is heading for minus 1 (-1) by year-

end, while the same variable for USD-commodities is heading for zero (0) by year end (*see 1st graph on this page*).

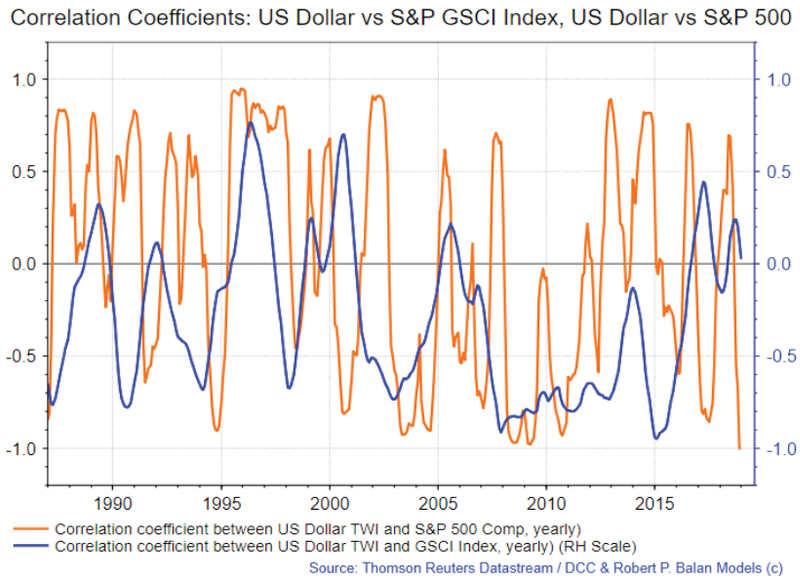
This has plenty of implications during a period when we expect the US Dollar to strengthen significantly due to the distributed, lagged impact of Capital Account inflows. This is also a theme which we have been hammering on at the Capital Observer since Q1 this year –- the surge of capital inflows last year will be a huge factor in the outperformance of the US Dollar this year.

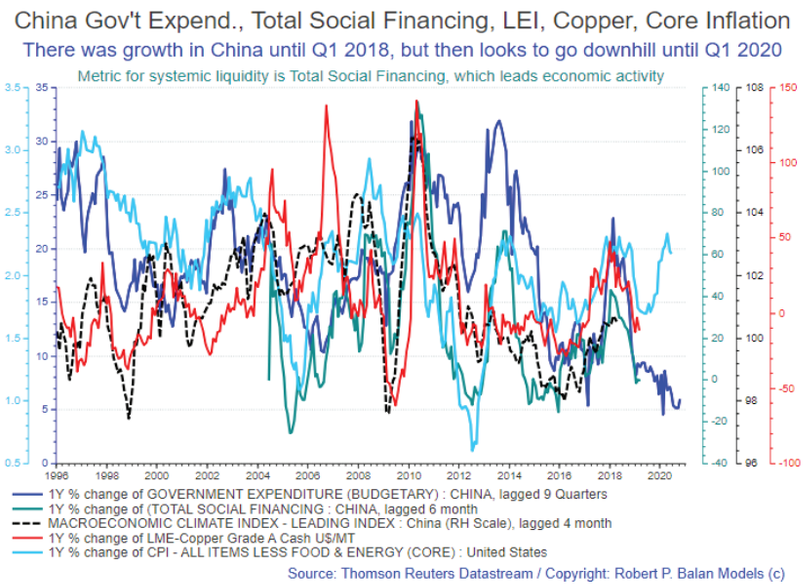
The stars are therefore aligned for a likely outperformance of commodities from mid Q1 next year. However, there is an issue which we needed to resolve in this scenario – the expected slowdown of growth in China. As early as in Q3 last year, we have been detailing at the Capital Observer how China's economic activity would start slowing down in Q1 2018. And it did. We warned then that *"the withdrawal of fiscal policy support by the Chinese central government will severely depress Total Social Financing. We said then that 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 blue line, 2nd graph on this page)."*

The key illustration of the link between fiscal spending and growth in China may also 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 decline soon, as soon as the next few months. (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 above).

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 TSF is a harbinger of Chinese activity, and therefore plays an important role in the future price of resource materials.

Nonetheless, in 2019, it will be a contest between growth in the US and likely the Rest of the World (and the rising core inflation that it will generate), and a slowdown in China, as represented by that country's TSF (see 2nd graph above). China's domestic currency the CNY has been falling a lot in recent time. That should translate into good manufacturing performance in the near-term, even if the Chinese services sector suffers some slowdown. That would keep the outlook for commodities outperformance over equities stay upbeat during next year. **However on the short term horizon (into Q1 2019) we still consider that a strong dollar, decelerating US growth, tightening US policy and negative Chinese dynamic could still challenge commodities and risk asset into Q1 2019.**



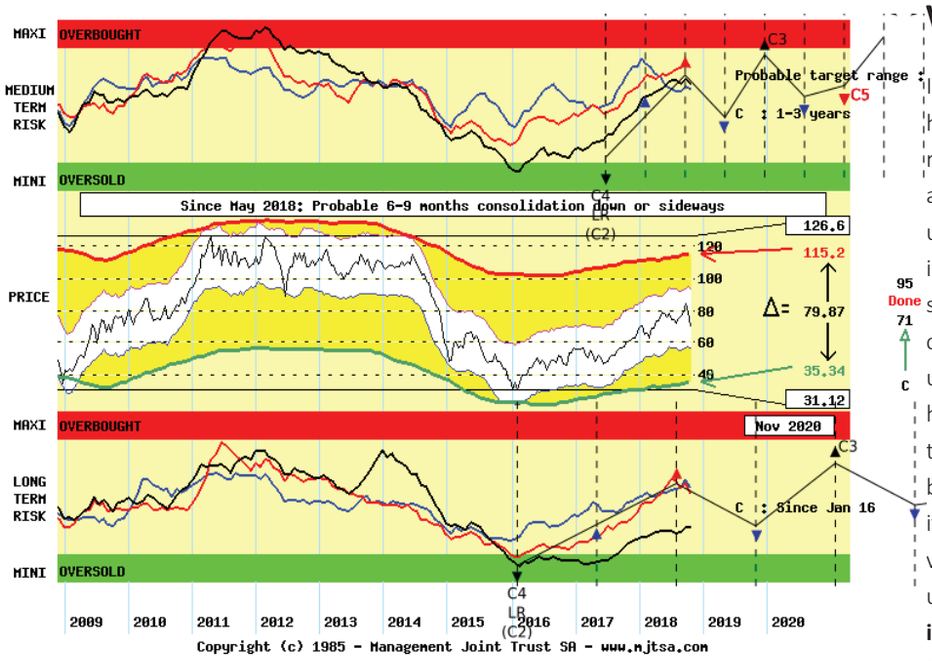


37 / MJT - TIMING AND TACTICAL INSIGHT

Expect one last retest down on Commodities, probably towards mid/late Q1 2019

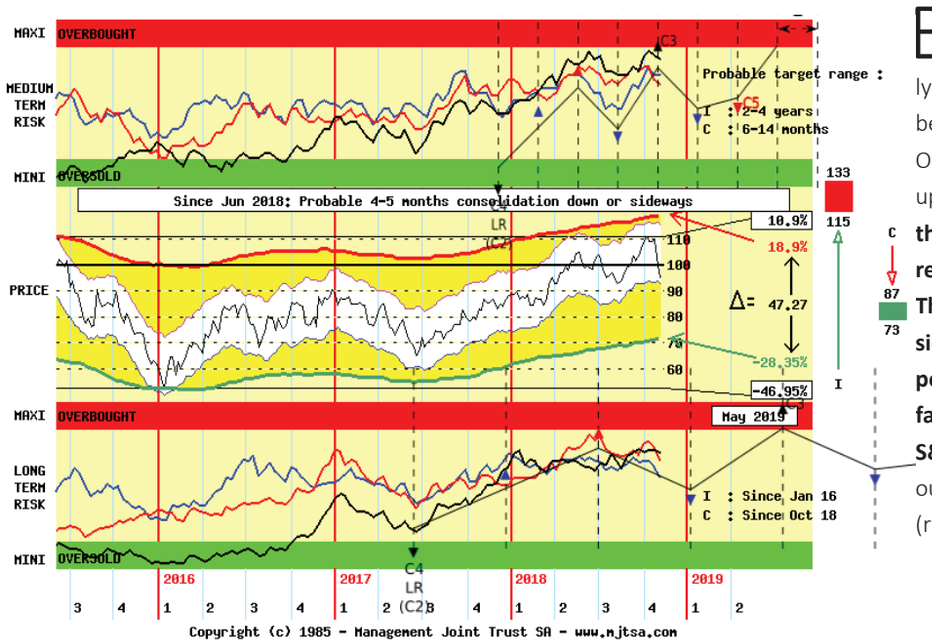
It has been a difficult year for Commodities, except for Oil which managed to extend its 2016-2017 uptrend until early October. Now that Oil has also started to correct down, one may wonder if the Commodity space is resynching to the downside, and how long and deep the current correction could continue. In this article, we review the various Commodity profiles (Energy, Industrial Metals, Gold and Agricultural Commodities), both on a standalone basis and vs Equities.

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



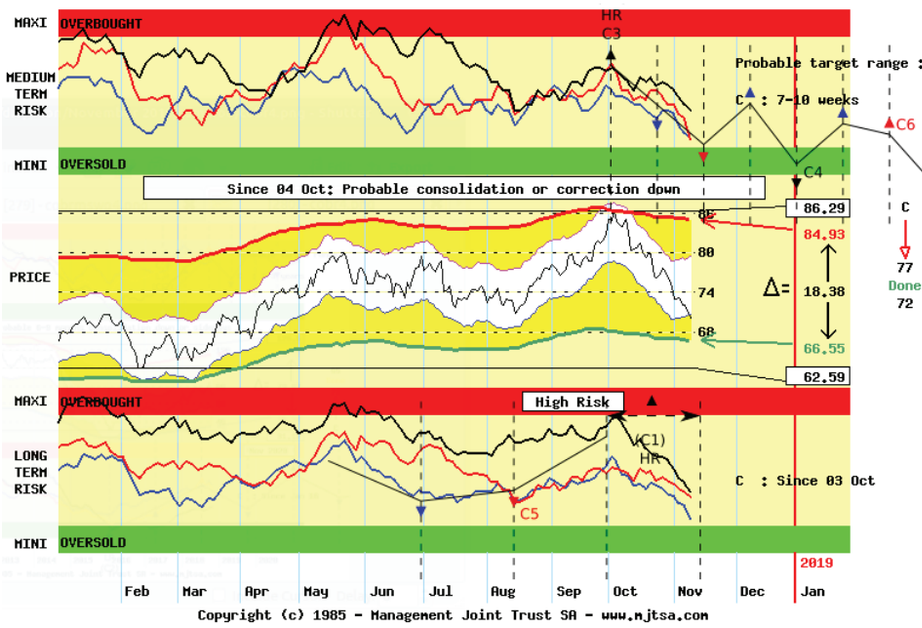
We start this commodity review with the long term graph of Oil. Indeed, Oil is a late cycle performer and has been emblematic of the reflationary re-acceleration that started 2.5 years ago. On both oscillator series (lower and upper rectangles), it recently reached important intermediate tops. These should imply between 3 to 5 quarters of correction to the downside. The move up since 2016 has been impressive. It has fulfilled our C Corrective targets to the upside between 71 and 95 USD/barrel (right hand scale). Yet for now, it has failed to break above these levels to confirm a long term impulsive uptrend. **Hence for now, we are still in the early stages of a potential long term uptrend, and during these early stages, retracements can be quite drastic. We would hence tread with extreme caution on oil over the next 3 to 6 months at least.**

Brent Oil (USD/barrel) vs the MSCI World Index
Weekly graph or the perspective over the next 2 to 4 quarters



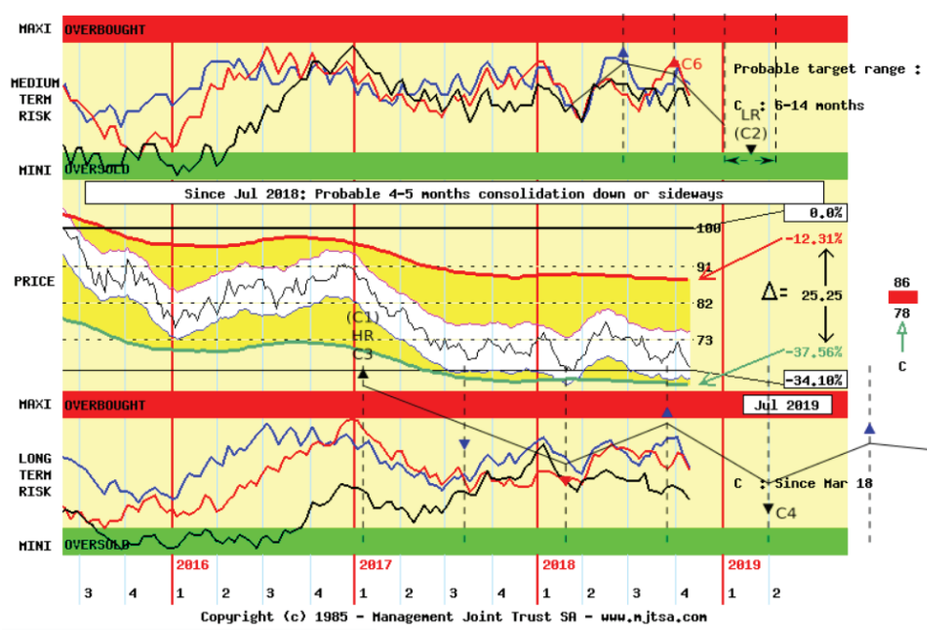
Both Oil and global Equities have been in strong uptrends since early 2016. When comparing both, Oil has been stronger given its higher volatility. On both our oscillator series (lower and upper rectangles), **the ratio of Oil vs the All Country World Index recently reached an important intermediate top. The current correction to the downside could last until early next year and possibly into the Spring. Oil could still fall between another 10 to 20% vs the S&P500 during this period** according to our C Corrective targets to the downside (right-hand scale).

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



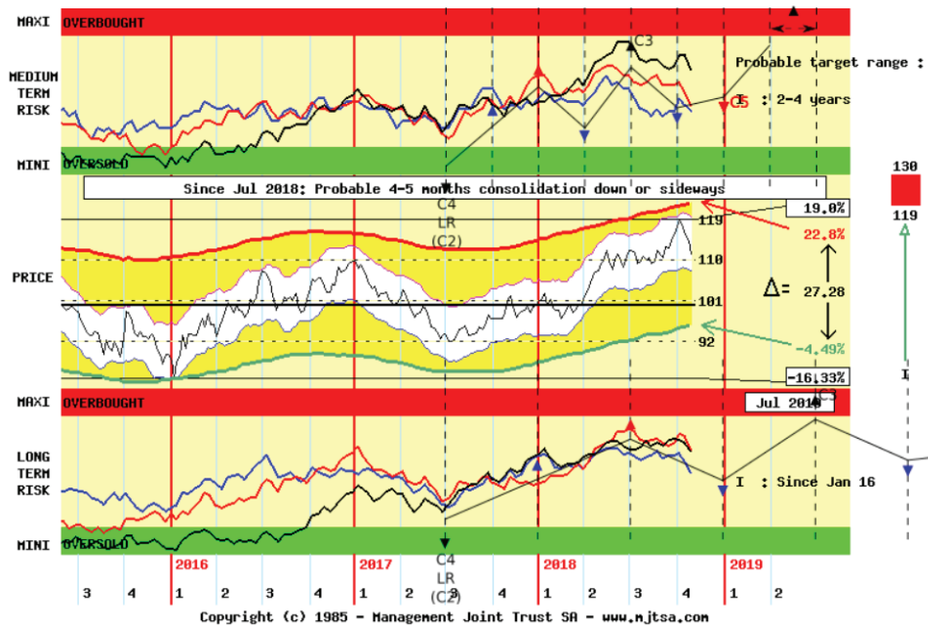
Shorter term, **Oil reached a High Risk situation early October** on both oscillators series (lower and upper rectangles). Such situations usually trigger at least 2 to 3 months of correction to the downside. The sequence we show on our medium term oscillators (upper rectangle) would suggest **a first intermediate low towards mid November and a slight bounce. Following that, Oil could resume lower first towards year-end and then possibly into late Q1**. On the target front, Oil just made it below the support of our C Corrective targets to the downside (right-hand scale). The next level of targets, **our I Impulsive targets to the downside would calculate in the 62 – 55 USD/barrel (right-hand scale). This is another 10 to 20% below current levels**. We would hence suggest to limit investments in the Oil space between late November and early next year.

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



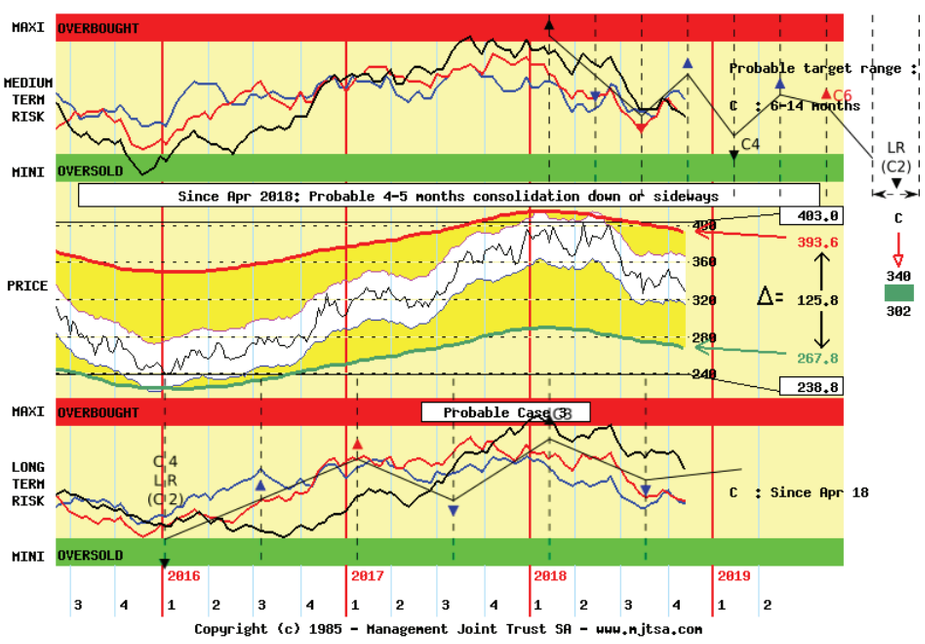
Despite the strong rise in Oil prices since early 2016, the US Energy sector has consistently underperformed the S&P500 Index. This poor relative performance is most likely attributed to the Value characteristic of the sector in an environment where the US Yield curve was mostly flattening. Going forward, both our oscillators series (lower and upper rectangles) are suggesting that the current downtrend may continue towards Q1 next year, probably towards late Q1**. Following that, the sector may start to bounce vs the market during the Spring and could outperform by circa 20 to 30% towards late Summer 2019 according to our C Corrective targets to the upside (right-hand scale).**

European Energy Sector vs the Europe Stoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



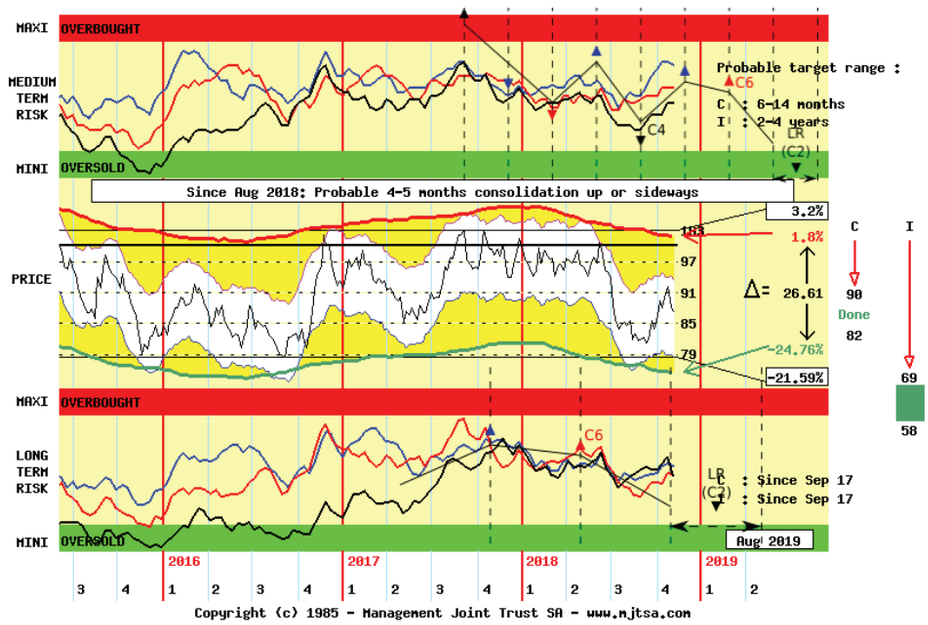
In Europe, the sector has shown a much stronger performance vs the EuroStoxx600 index during the 2016-2017 reflation period. Yet, recently, in early October, it also made an important intermediate top. Both our oscillator series (lower and upper rectangles) are suggesting **that the current correction could last until year-end at least. Following that, from Q1 and into midyear 2019, our I Impulsive targets to the upside (right-hand scale) are suggesting that the sector could outperform the Europe Stoxx 600 by 10 to 20%.**

Goldman Sachs Industrial Metals Index
Weekly graph or the perspective over the next 2 to 4 quarters



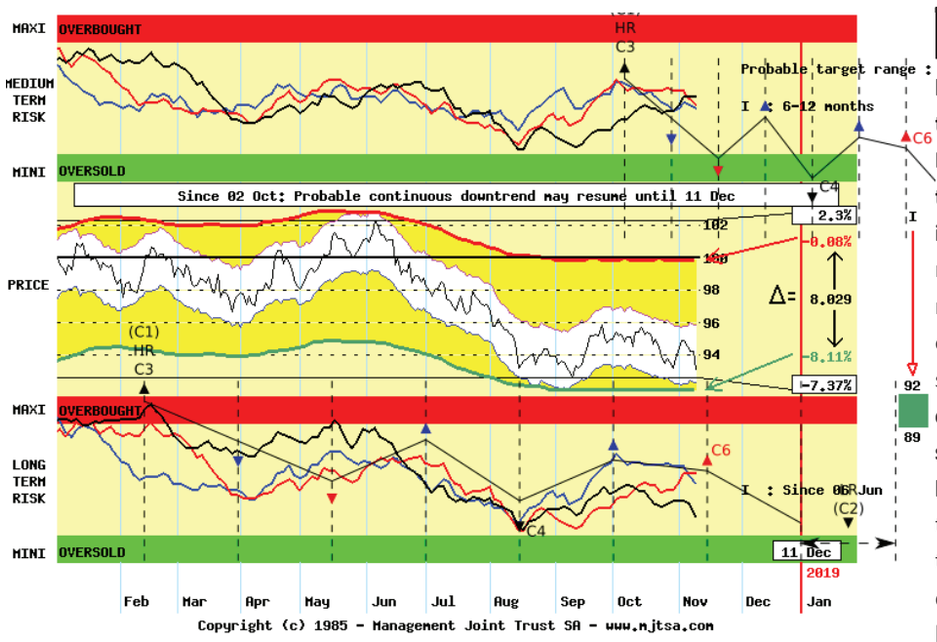
Since the Spring, Industrial metals have also been correcting down. Indeed, these are very much related to China, which for example accounts for circa 70% of the global demand for Copper. Hence, as China decelerates, industrial metals prices are correcting. **For now, we expect them to continue lower** (the sequence we show on our medium term oscillators; upper rectangle), **first into mid Q1 2019, and then following a Spring bounce, probably once again during H2 2019**. On the target front (right-hand scale), **we are currently working through the support of our C Corrective targets to the downside between 340 and 302 (right-hand scale). If these break over the next couple of months, much lower targets could then be envisaged probably towards the 2016 lows by the end of 2019.**

Copper Spot (LME, USD/ton) vs the MSCI World Index
Weekly graph or the perspective over the next 2 to 4 quarters



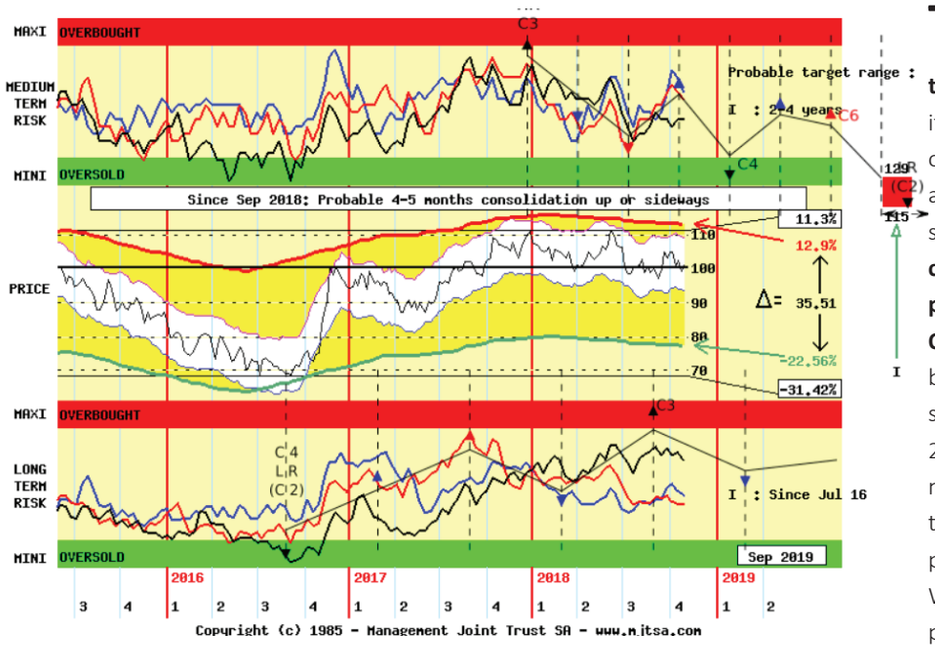
We now compare Copper vs the All Country World Index. For now, the ratio is still in a downtrend, despite its strong bounce over the last couple of months. **We expect it to resume lower soon, probably towards late Q1, early Q2 at least** on both our oscillator series (lower and upper rectangles). This Summer, the support of our C Corrective targets to the downside, did break although briefly (right-hand scale). This has opened the door to **much lower targets (I impulsive targets to the downside) some 20 to 30% lower than today. Given this risk, we would avoid any exposure to industrial metals, until this Spring at least.**

Equal Weighted Portfolio of US Mining and European Natural Resources vs their respective Market Indexes
Daily graph or the perspective over the next 2 to 3 months



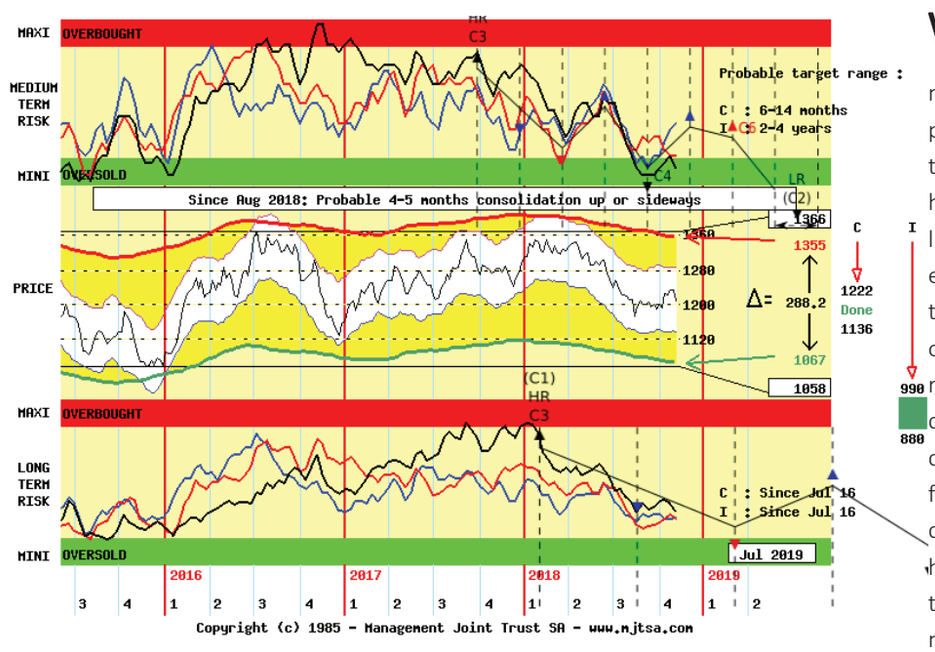
In this graph, we have computed an **equal-weighted balanced portfolio of the US Metals & Mining sector and the European Basic Resources sector vs their respective market indexes**. Both sectors are very much exposed to the industrial metals space. Our long term oscillators (lower rectangle) are suggesting that **the portfolio could resume its downtrend soon, probably towards February next year.** Our medium term oscillators (upper rectangle) could make an intermediate bounce between mid and late November and then move lower again towards January and then possibly towards late Q1. Our I Impulsive targets to the downside (right-hand scale) show another 5% of underperformance for these sectors vs the market. On its Weekly graph (not shown here), the underperformance is more compelling, possibly towards 10 % into Q1 2019. **We would hence avoid any exposure to these sectors until then.**

Copper Spot (LME, USD/ton) vs Gold Spot (USD/oz)
Weekly graph or the perspective over the next 2 to 4 quarters



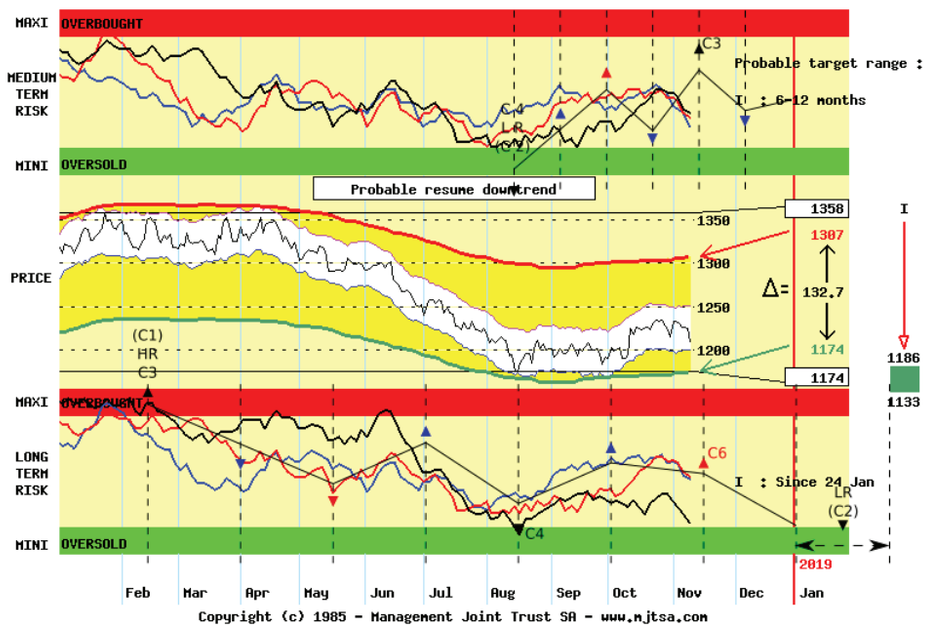
This ratio is emblematic of the 2016-2017 reflation trade. Yet, since June this year, it has been rolling over. Both our oscillator series (lower and upper rectangles) are now suggesting **that the current correction to the downside probably continues until mid Q1 at least**. Following a Spring bounce next year, it could resume lower again during H2 2019 (upper rectangle). For now, our I Impulsive targets to the upside (right-hand) are still pointing to new highs in 2019. We doubt this can actually happen. Rather, **we prefer to focus on our C Corrective targets to the downside, which would currently calculate in the 93.5 – 83.0 range** (0.5 to 0.8 times our historical volatility measure "Delta" – here at 35.51%; middle rectangle, right-hand side – subtracted form the graph's highest point at 111.3%), **or circa 7 to 17% lower than today**. **Hence, over the next few months at least, we expect the ratio to continue its recent correction. Copper and Industrial metals should underperform the more defensive Gold and Precious Metals during this period.**

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



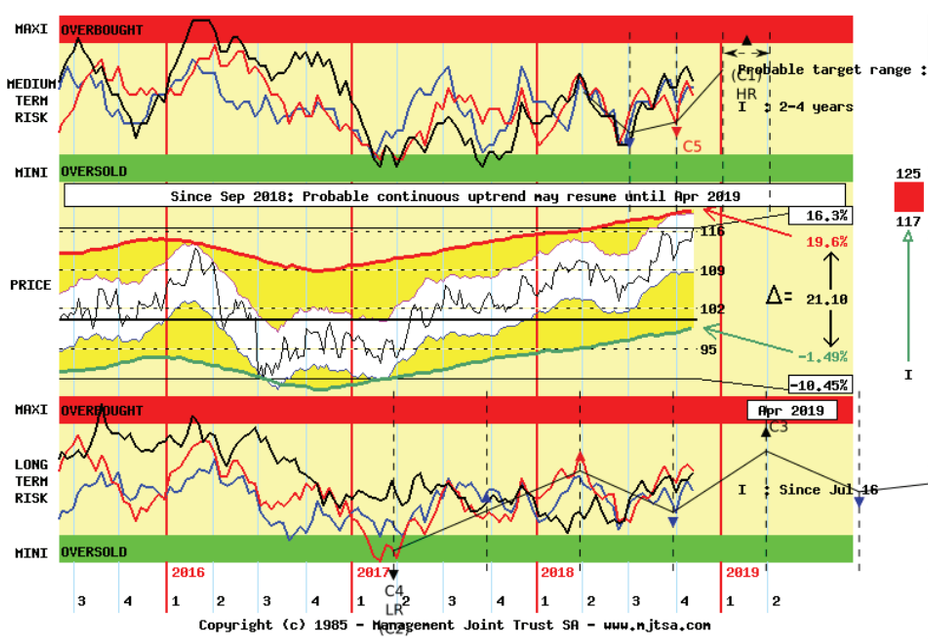
We now turn to Gold on a standalone basis. Our medium term oscillators (upper rectangle) reached an intermediate low mid August and have since seen a weak consolidation to the upside. We now expect them to resume lower towards Q2/mid next year. On our long term oscillators (lower rectangle) we show a slightly different sequence. It is also down-trending, yet basically follows USD/CNY in reverse. Indeed, both the Yuan and Gold have been very correlated vs the US Dollar since the beginning of the year. This second sequence suggests an earlier **low, probably towards mid/late Q1**, which is more in line with the projections on other Commodities in this article. On the target front (right-hand scale), Gold has held for now above the support of the lower end of our C Corrective targets to the downside, above 1'136 (right-hand scale). This is rather reassuring. We would be more worried if at some point over the next few months, it did break through this level as this could imply further downside below the 1'000 mark (a liquidation). **Our preferred scenario for now, is that Gold probably retests below 1'150 over the next few months, but ultimately holds and then gradually resumes up during the rest of 2019. We would however, consider any break below 1'130 as a strong warning signal of further downside risk.**

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



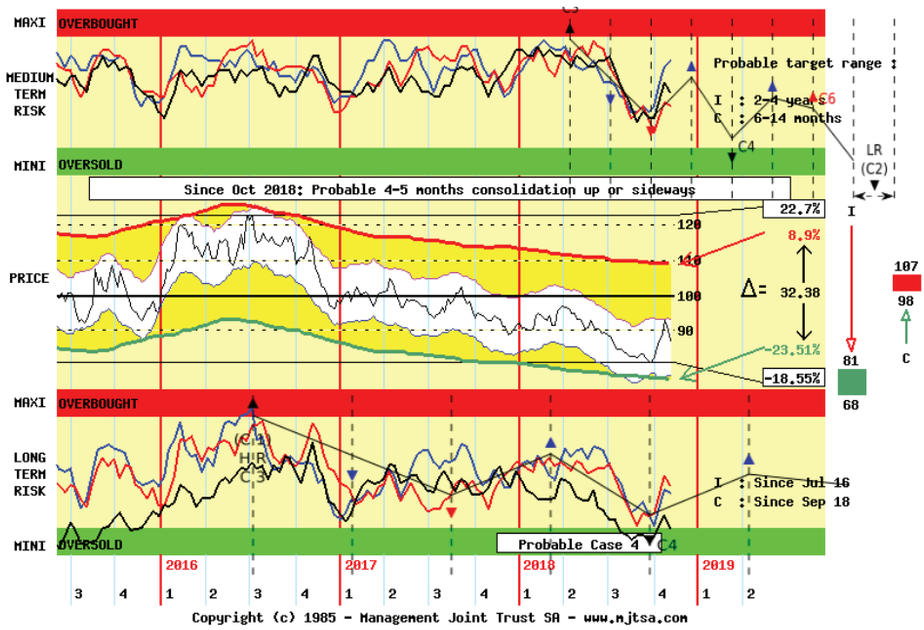
On the Daily graph. Gold is acting very much as EUR/USD. It made a low mid August and has since seen a weak consolidation up. Both our oscillator series (lower and upper rectangles) are now suggesting **that it could resume lower between now and late November, probably towards February. This is in line with our projections on the US Dollar, which highlights the fact the Dollar is still probably the dominant factor affecting Gold prices for now** (rather than its defensive bias). This was also the case during the May to August downtrend period this year (less so during the October sell-off). This usually coincides with negative newsflow in Emerging Markets, rather than in the US. Throughout this issue of The Capital, this is the scenario we are projecting. On the target front, our I Impulsive targets to the downside are suggesting that **Gold could reach back down towards the 1'150s, probably testing its support (mentioned above on the Weekly graph) around 1'130.**

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



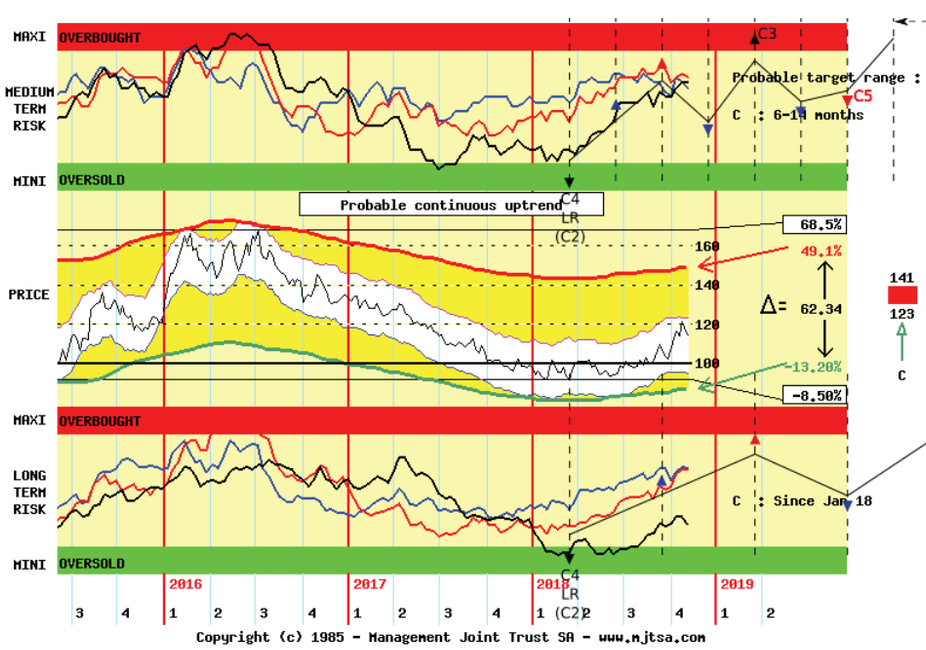
Looking at Gold in EUR doesn't really brighten the picture. As we have argued in previous issues of The Capital Observer, Gold is much more volatile than currencies. Hence, when Gold falls against the US Dollar, it also falls vs other currencies, although slightly less. Our long term oscillators (lower rectangle) may have reached an intermediate low towards late Summer, yet our medium term oscillators (upper rectangle) suggest **a continuation of the downtrend probably into mid/late Q1 next year**. On the target front (right-hand scale), Gold in EUR did break through our C Corrective targets to the downside in September (right-hand scale). Hence, **we cannot exclude that it could reach down into our I Impulsive targets to the downside in the 946 – 857 range. This is more negative than what we are projecting on Gold in US Dollars, but at least it reminds us to remain prudent of Gold until mid/late Q1 at least.**

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



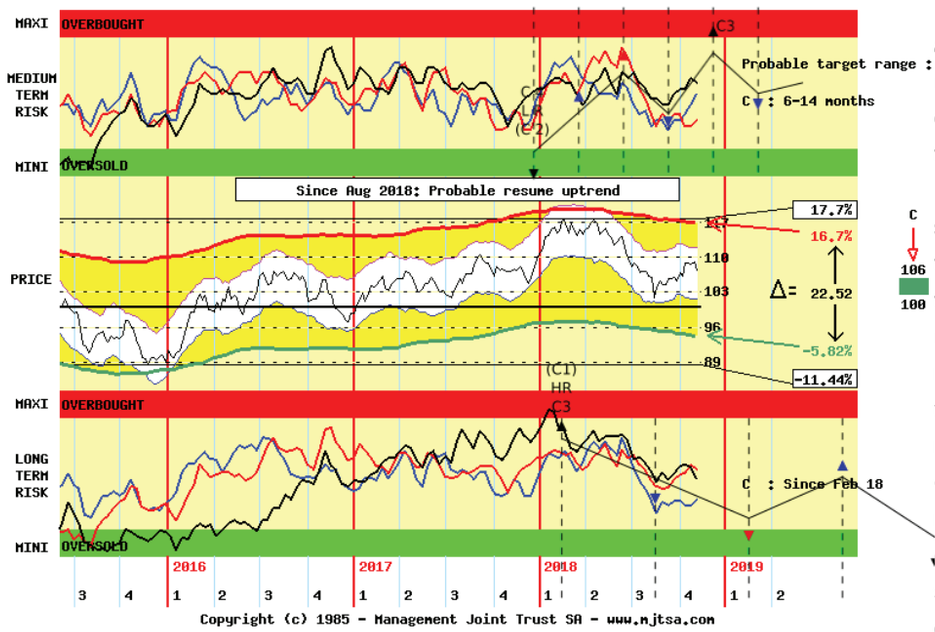
As we have done with other Commodities above, we now compare Gold to the All Country World (equity) Index. On our long term oscillators (lower rectangle), it may have reached an important intermediate low in late September (just prior to the equity market sell-off). Yet, on our medium term oscillators (upper rectangle), **we would still expect one last downside retest into mid/late Q1**. Hence, although Gold is quite Oversold vs Equities, the US Dollar should remain its dominant negative factor, and Gold may underperform equities one last time over the next few months as it already did during the Q1-Q2 Emerging markets sell-off earlier this year. On the target front (right-hand scale), our I Impulsive targets to the downside are still quite compelling. They suggest **that Gold could fall a further 10 to 20% vs Global Equities until mid/late Q1. Following that, it probably rebounds up quite nicely towards mid next year.**

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



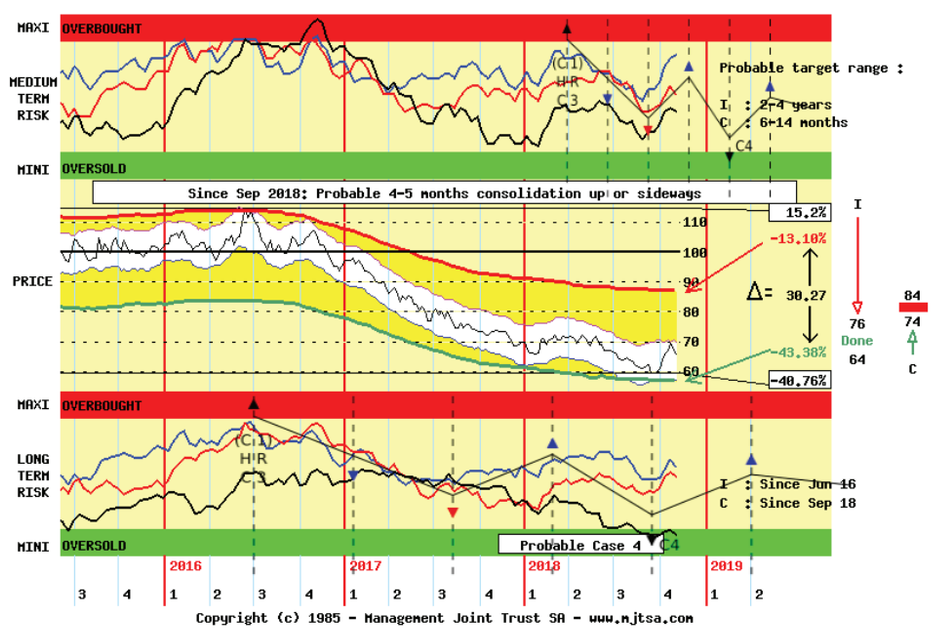
Given the links we make above between Gold, the US Dollar, the Yuan and Emerging markets, it is interesting to compare Gold vs the MSCI China equity index. The resulting profile is quite different to the one of Gold vs Global Equities and it highlights the important risk we expect for Chinese equities over the next few months. Indeed, **since early 2018, Gold has started to trend up vs the MSCI China index and should probably continue to do so towards late Q1 next year** in first instance according to both our oscillator series (lower and upper rectangles). Hence, **Gold may represent an interesting Flight to Safety alternative for Chinese investors if, as we expect, the MSCI China starts to sell-off again.**

Gold Spot (USD/oz) vs 7-10 Year Treasury Bonds
Weekly graph or the perspective over the next 2 to 4 quarters



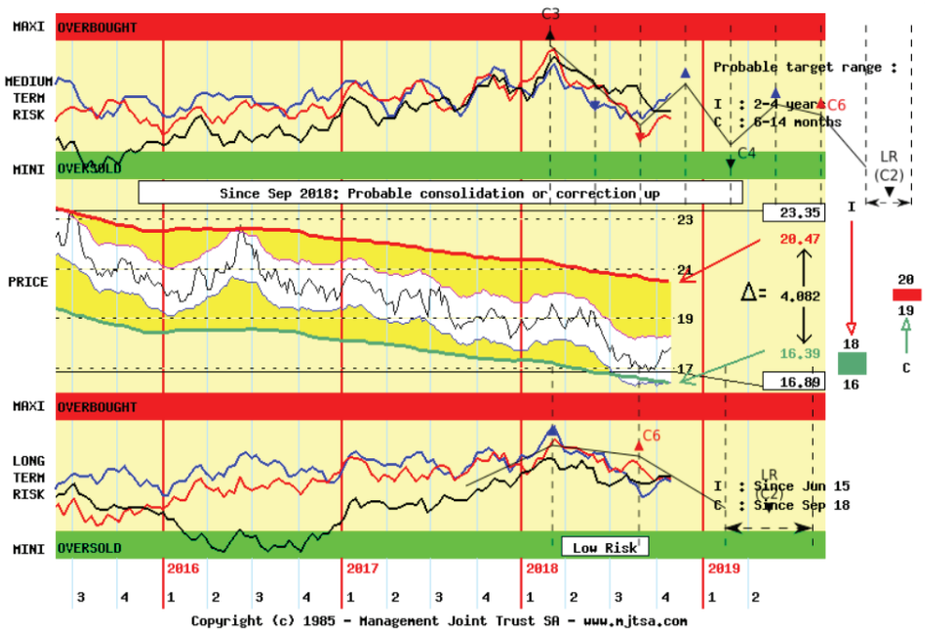
Another comparison, which we believe confirms our negative prospects for Gold over the next few months, is the Gold to US Treasuries ratio. Interestingly, its profile is quite similar to many of the reflation trades, which we have monitored throughout this document. Indeed, Gold outperformed US Treasuries throughout the 2016-2017 reflationary period, and since the beginning of this year, it has started to retrace. While, our long term oscillators (lower rectangle) are suggesting that **the ratio could continue lower towards mid Q1 in first instance**, our medium term oscillators (upper rectangle) are pointing that this move could start over the next few weeks. Given the above, we would consider Gold as a reflationary asset vs US Treasuries, i.e. **Gold for now is more pro-cyclical than Treasuries, and in the current strong US Dollar environment, Treasuries are more defensive than Gold.**

Cap Weighted Portfolio of Agricultural Commodities vs the MSCI World Index
Weekly graph or the perspective over the next 2 to 4 quarters



One last Commodity segment we are considering is this article is Agriculture Commodities. The portfolio we show contains various grains and softs, each equal weighted according to the Reuters Commodity Futures Price Index. Agricultural Commodities are usually more defensive than other Commodities and hence their profile vs the All Country World (equity) Index is closer to Gold than to cyclical Commodities such as Oil or Industrial Metals. **As with Gold vs Equities, our long term oscillators (lower rectangle) probably made an important low late September, yet our medium term oscillators (upper rectangle) are still suggesting a last downside retest, probably into mid Q1 next year.** On the target front (right-hand scale), the downtrend since 2016 seems exhausted. Hence, although we suggest to wait another 2 to 3 months, **Agricultural Commodities may provide an interesting diversifying trade to equities, probably from mid/late Q1 into mid 2019 in first instance.**

PowerShares DB Agriculture Fund
Weekly graph or the perspective over the next 2 to 4 quarters



We finally look at the Powershare Agriculture Fund as a proxy for the path of Agricultural Commodities on an absolute basis Its profile confirms our relative timing vs Equities outlined in the graph above. Indeed, our long term oscillators (lower rectangle) have reached an important intermediate low this Summer ("Low Risk" as mentioned on the graph), and our I Impulsive targets to the downside (right-hand scale) have been achieved (i.e. the downtrend since 2016 is exhausted). Yet, **both our oscillator series (lower and upper rectangles) still suggest one last retest lower, probably into mid/late Q1 next year. Following that, we hence expect that Agricultural Commodities could present an interesting value opportunity, probably from Spring to Summer next year.**

Concluding remarks

While Oil recently topped out in early October, other Commodities (Industrial Metals, Gold, Softs and Grains) have been suffering since the Spring, mainly from USD strength and a deceleration in China. We believe these factors should continue to influence the wider Commodity space probably towards mid/late Q1 next year. Oil should correct down until then, Industrial Metals should continue their correction, and Gold and Agricultural Commodities should retest down once more. Although, we do expect Equities to also resume lower during this period, Commodities are more volatile, and should hence continue to underperform Equities over the next few months. From mid/late Q1, however, Commodities may represent a strong investment case both on an absolute basis and vs equities, probably until Summer next year at least.

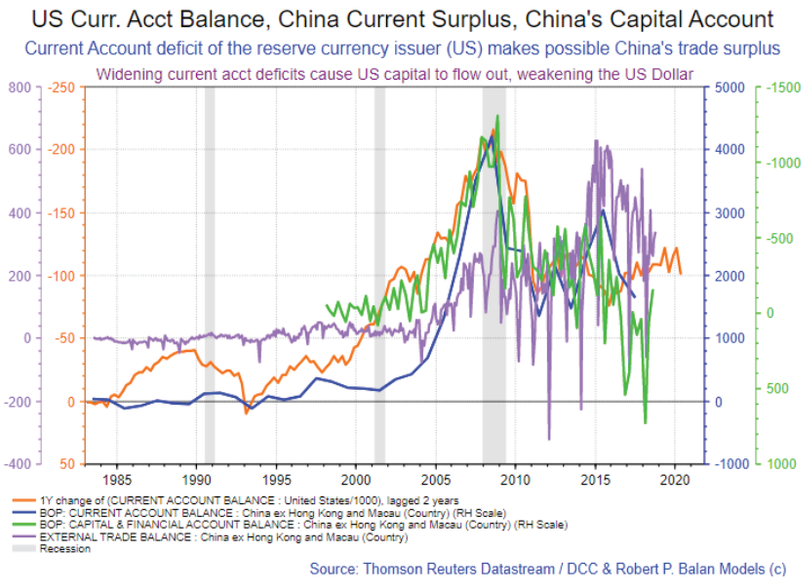
46 / China's growth and trade woes will bring down the Emerging Markets with it; USD-dominated assets should continue outperforming the RoW

There are a few items of interest in recent Chinese data, and one of them is the country's current account deficit. It may surprise investors drowning in US-China trade tension news that China ran a current account deficit in the nine months of 2018, its first since 1993. The $12.8 billion deficit is only about 0.1% of GDP, annualized, it is an important marker of China's success in moving away its economy's reliance from exports to domestic demand. **Just a decade ago, China's surplus was as high as $420 billion, or 9% of GDP** (*see 1st graph on this page*). **However, the capital account, which recently rose sharply, suggests to us that this deficit will be short lived.**

Also, don't expect that blip of current account deficit to mollify Mr. Donald Trump. China's trade surplus (external trade balance), a narrower measure that excludes investment income, remains massive. The trade surplus with the U.S. stands at about $350 billion (a $390 surplus in goods and a $40 billion deficit in services). That trade surplus with the US is likely to become bigger with the recent decline in the exchange rates of the CNY, as we will show in the later part of this article.

In contrast, China is effectively running a 3-4% GDP deficit with the rest of the world, particularly against oil exporters and Asian economies. This is what is galling to Trump administration officials. Their aim is to remove some of the trade imbalance, and for Beijing to shift some of the burden of adjustment on other China's trading partners.

Insofar as the domestic currency (CNY) is concerned, its devaluation by Beijing is a mixed blessing. On the negative side, the sharp decline in the exchange rate of the CNY against the US Dollar has negatively impacted the inflow of Foreign Direct Investments (FDIs) – FDI inflows slowed sharply in H2 2018. The Capital Account balance also fell, suggesting that some domestic capital have left for offshore destinations (*see chart below*).

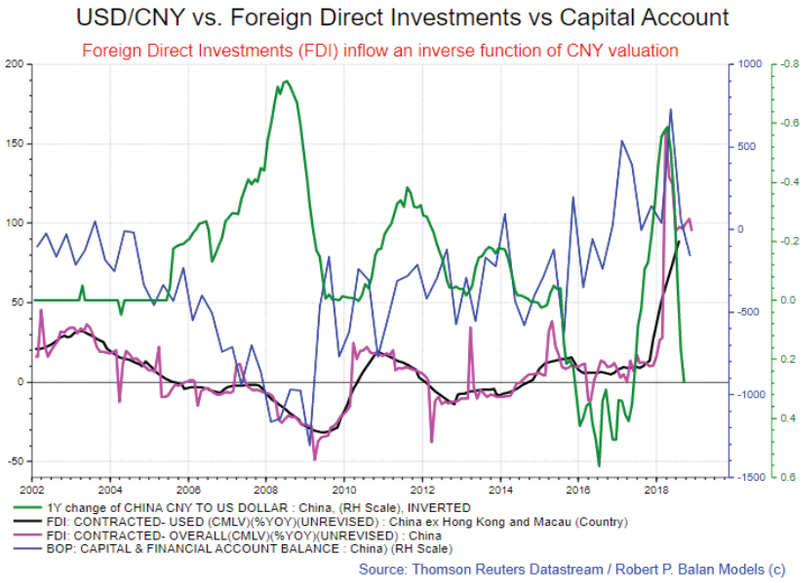


Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

Currency devaluation of the Chinese kind has been tagged by pundits and bloggers as a "secret weapon" in the trade skirmishes. **But for us, we conclude that devaluing the CNY is not a secret weapon for China to get on top of the trade issues -- Bejing has to do it to kickstart a flagging economy**. It was also providential that The Donald provided them the ammunition for a quick devaluation, and not get blamed. That was, and still is, an opportunity for a counterpoint that is too juicy to ignore or waste.

In the 1st graph on the next page, we see that China's External Trade Balance (Trade Surplus, in this case) is inversely correlated with the domestic currency (CNY). In fact, the trade surplus is a function of the level of the CNY -- weaker CNY begets a bigger trade surplus, as China's exporters become more competitive.

Therefore, China's PMIs, for manufacturing and for services, have indeed become more competitive and have actually improved over the



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

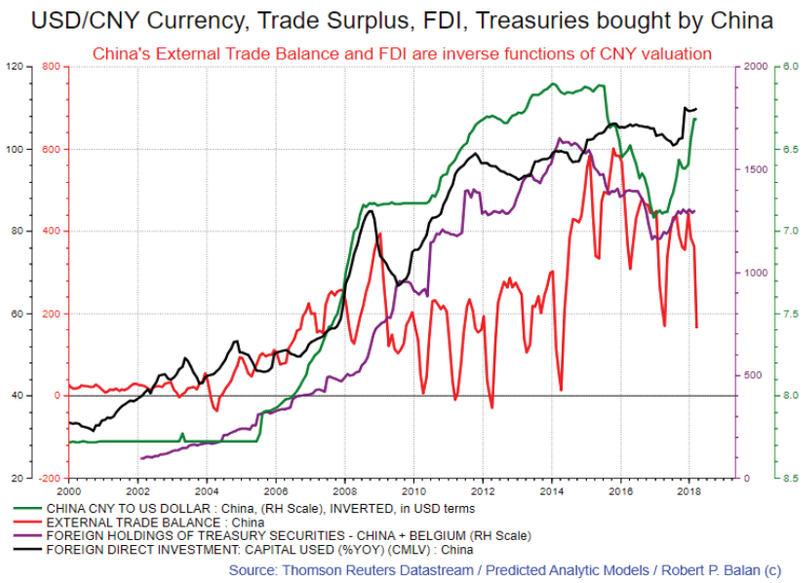
period that the CNY has been falling sharply (*see 2nd chart on this page*). **However, it provided scant help for over-all growth, as GDP still declined to 6.5% in Q3 2018 (latest data on hand).**

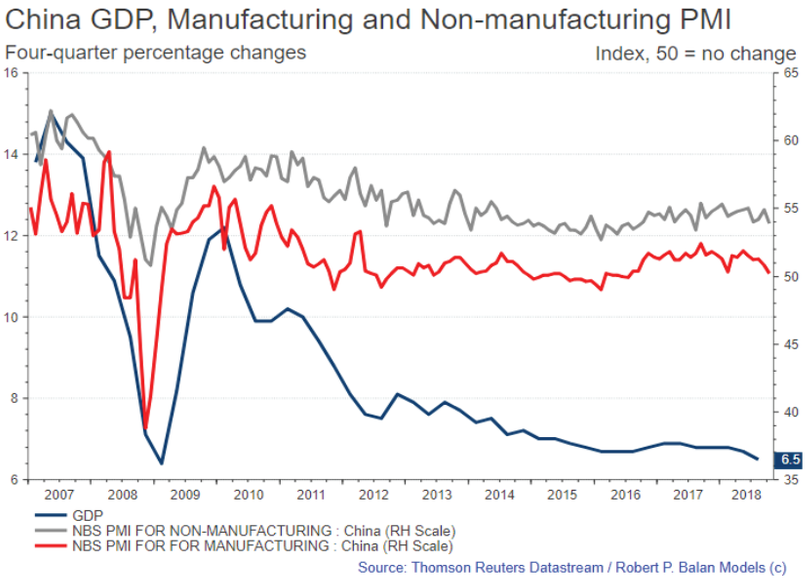
China's GDP growth woes however are not caused by an errant currency policy. We can also say that the trade skirmish with the United States has probably reduced some growth, but the primary source of decline in activity has been the lack of government largesse.

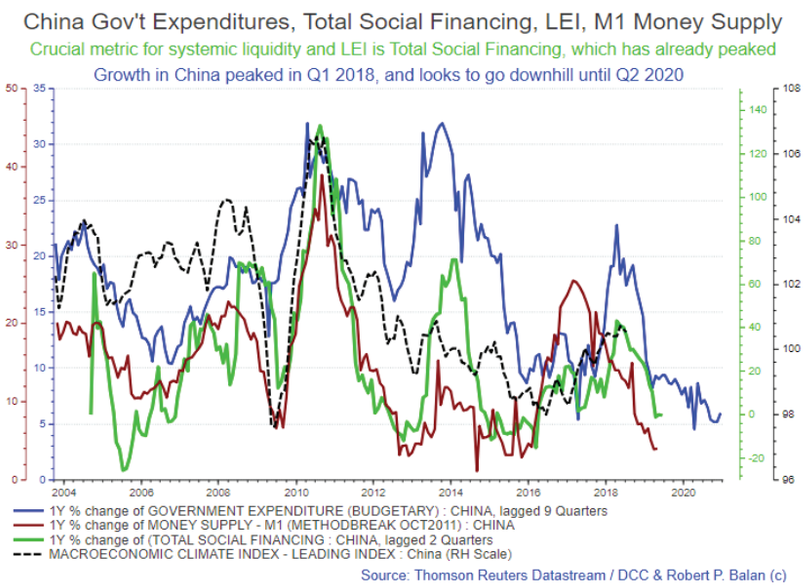
It's is not hard to fathom why. Government expenditures in China have virtually collapsed since January 2016. And like everywhere else, if the government does not spend, economic activity slows down in proportionate degree. And the government tightening in China had been severe. The heady rise of the central government expenditures from January 2015 to January 2016 has been essentially erased over the past two years (see 3rd graph on this page).

The key illustration of the link between fiscal spending and growth in China may also 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 decline soon, as soon as the next few months. (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 graph 3rd 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 TSF as a harbinger of Chinese activity, and therefore of future price of resource materials.



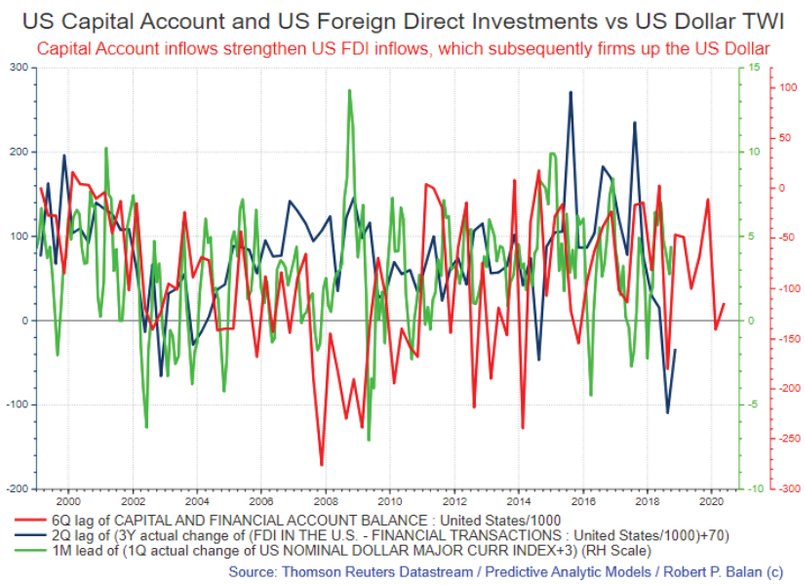




This brings about the link with the rest of the Emerging Markets universe. A slowing China cannot be good for many EM markets

where commodities are the primary resource. Moreover, for the first time in a quarter century, China has become a capital importer, a significant shift in the global pattern of savings and capital flows. Just five years ago, China was plowing $300-$400 billion annually into global markets. China is now competing against many EM markets for inflows of capital.

Adding to the woes of the EM market sector, which includes China, is the surge in the US Dollar, which promises to become even more forceful. The US Dollar's primary motive force comes from US capital account inflows and outflows. The changes in those flows have a distributed lag of up to about 8 quarters before they impact the greenback to the full extent. We are still in a period when the positive effects of those inflows come into full force. At this stage we should see a continuation of the strong period for the US currency (see graph on this page). The implications are clear: US Dollar denominated assets should still be strong.

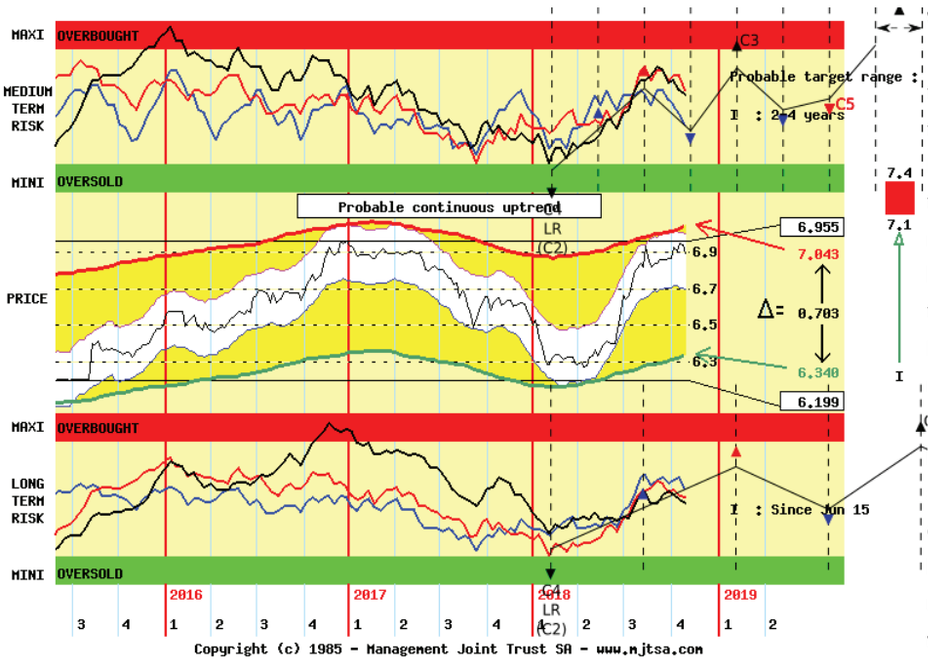


49 / MJT - TIMING AND TACTICAL INSIGHT

Exploring the links between China, Emerging Markets and Commodity Producers

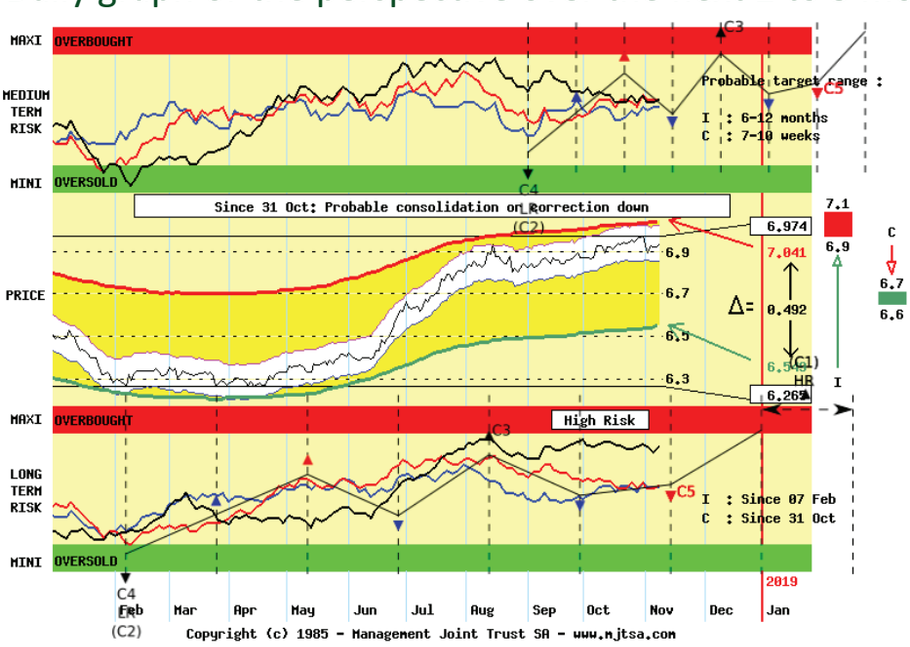
In our early September issue we warned our readers on China and related trades. We expected that by end September, Chinese and Emerging Market equities, Industrials Metals or sectors related to them, could start to resume lower, on an absolute, but probably also on a relative basis, potentially into early 2019. These projections have partly been fulfilled as most of these assets did sell-off quite aggressively during the equity markets correction in October. Yet, on a relative basis, some have shown more resilience. We believe it's now time to review the Chinese and Emerging Markets Investment case in order to gain more clarity.

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



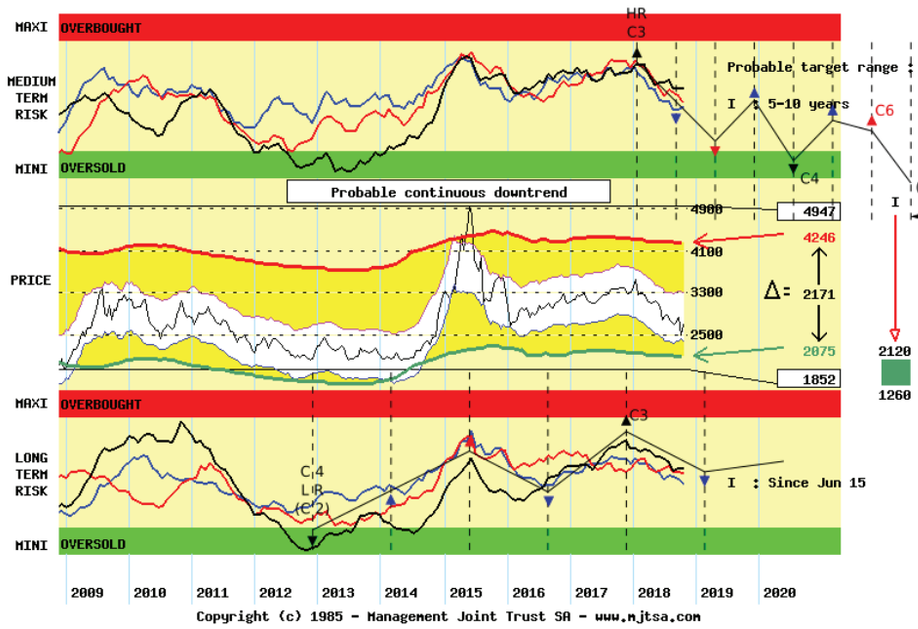
We start this article on China with the Yuan. Indeed, since April, the POBC has been in a quasi quantitative easing mode. It has lowered its Required Reserve Ratio for banks three times already in an attempt to push more liquidity into the market. Recently, it vowed to defend the Yuan around the psychological 7.00 mark vs the US Dollar. Yet, giving the easing measures mentioned above, this commitment does sound somewhat unconvincing. At least, this is what our oscillators series are suggesting. Indeed, **the uptrend on USD/CNY seems well in place, and both our oscillator series (lower and upper rectangles) are pointing to further USD/CNY strength, probably into mid Q1 and then possibly again towards H2 2019. Our I Impulsive targets to the upside (right-hand scale) are projecting that the pair could reach the 7.1 – 7.4 range over the next few quarters**. Since the Spring, such falls in the Yuan vs the US Dollar have usually corresponded to corrections in Chinese equity markets, probably due to capital flight towards other regions. We believe this could happen again if our USD/CNY projections materialize over the next few months.

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



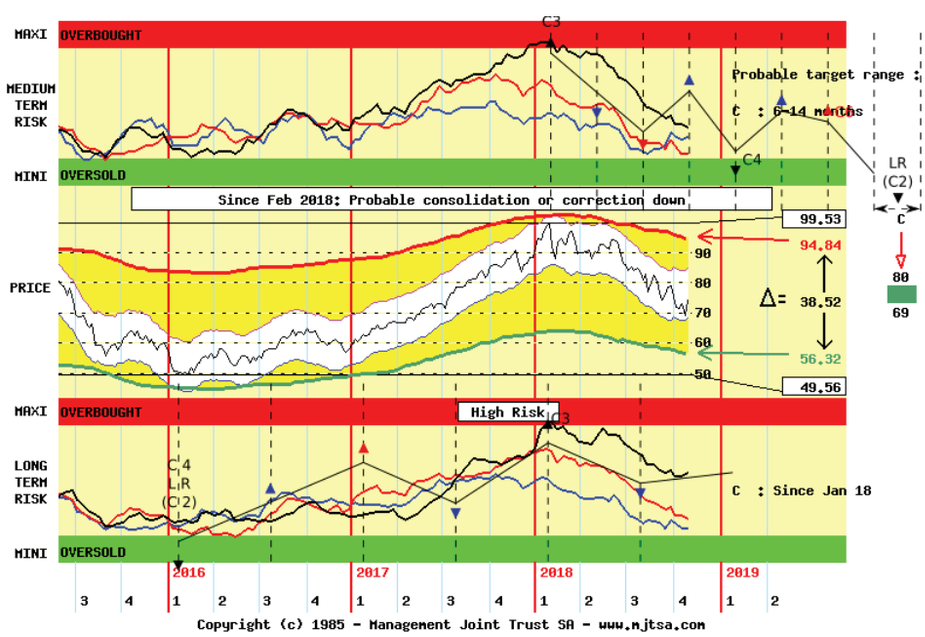
On the Daily graph, USD/CNY has been in a high level consolidation since August on both our oscillator series (lower and upper rectangles). Although, our target to the upside may look somewhat exhausted (right-hand scale), **we would still expect the pair to resume higher between now and late November, probably towards February or March**. This renewed US Dollar strength should once again put pressure on Chinese and Emerging Markets equities and related trades as capital flows will probably seek cover into other regions.

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



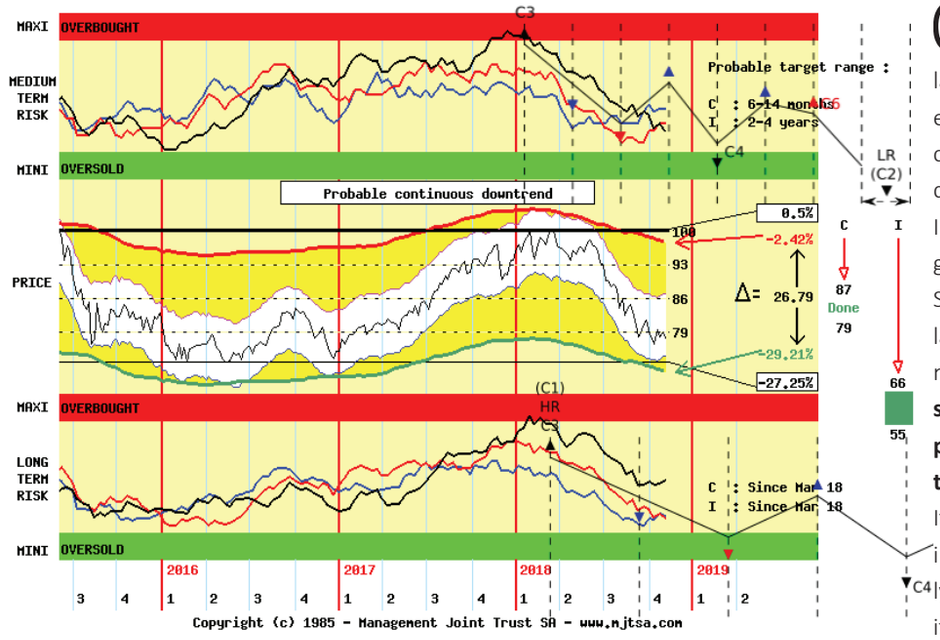
Indeed, the configuration of China's domestic equity market is in our view still quite negative. When considering the 2016-2017 Bull market, it does pale in comparison with the stock market bubble of 2015. Such series of declining tops (2015, early 2018) usually trigger **between 2 to 3 years on correction to the downside** on a bi-monthly graph according to our methodology. This is the sequence we show on our medium term oscillators (upper rectangle). In the meantime, both oscillator series (lower and upper rectangles) are pointing towards a **first move down into Q1 2019, where the Shanghai Composite could mark an intermediate low**. On the target front, our I Impulsive targets to the downside are suggesting that the **Shanghai Composite could reach below the 2'000 mark over the couple of years, and possibly even substantially below that** (right-hand scale).

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



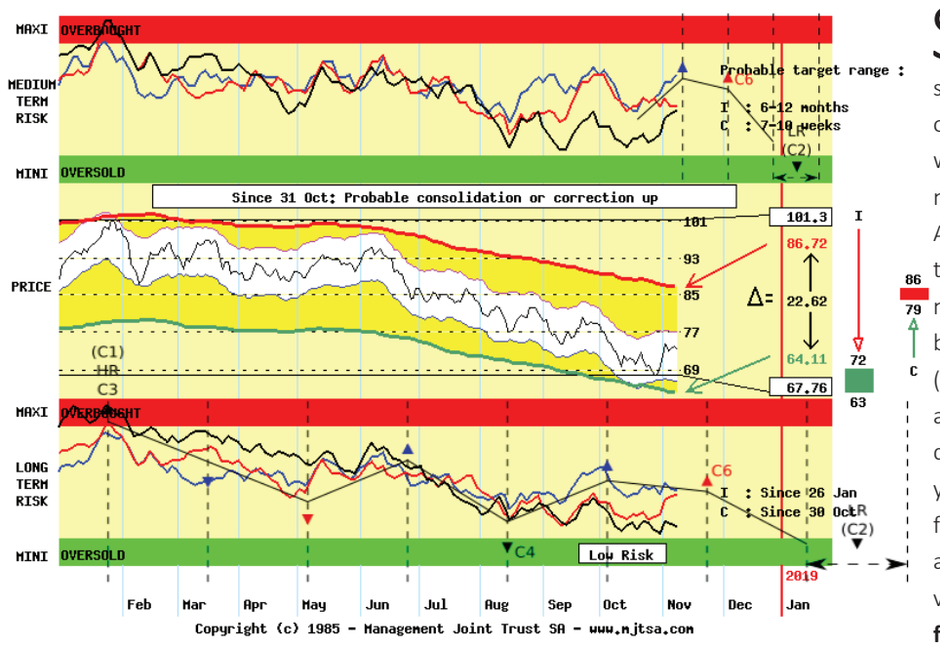
We now focus on the MSCI China index, which includes China's larger international companies and especially the 3 BATs (Baidu, Alibaba and Tecent). The index largely outperformed the Shanghai Composite during the 2016-2017 reflationary period, yet since June this relation has started to reverse. Indeed, since the beginning of the year, the MSCI China Index has lost almost 30% of its value. It is now hitting the support of our C Corrective targets to the downside (right-hand scale). If these were to break, the next level of targets we can calculate would probably be much lower and imply **a full retracement of the 2016/2017 reflationary Bull market. This is what our medium term oscillators (upper rectangle) are suggesting. We expect a further move down into mid Q1, when we expect an intermediate low and a bounce into Q2. Then the downtrend probably resumes again in H2 2019.**

MSCI China Index vs All Country World Index
Weekly graph or the perspectives over the next 2 to 4 quarters



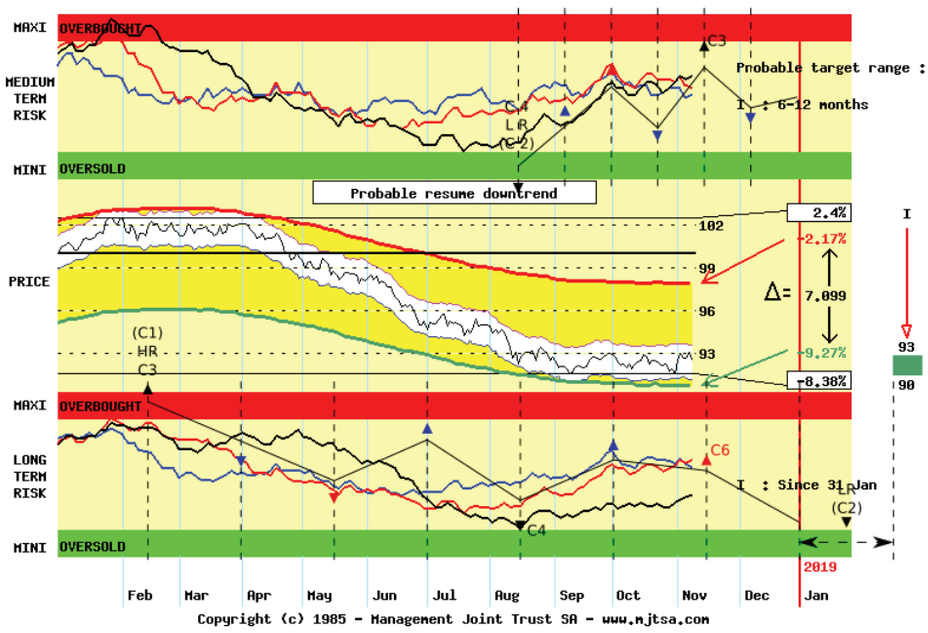
One may argue that China has stabilized over the last couple of months vs other equity markets. This graph compares the MSCI China Index to the All Country World Index. Indeed, China has held ground on a relative basis since September, yet on both oscillator series (lower and upper rectangles), **the downtrend is still well in place and should probably resume lower soon towards mid/late Q1 2019.** It then probably drops again in H2 2019. The ratio recently broke below the support of its C Corrective targets to the downside (right-hand scale). **The I Impulsive downside range we are now targeting suggests another 15% to 30% underperformance for China vs Global equities over the next 6 to 12 months. We would hence remain very prudent on China at least into mid Q1, and probably towards the end of next year.**

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



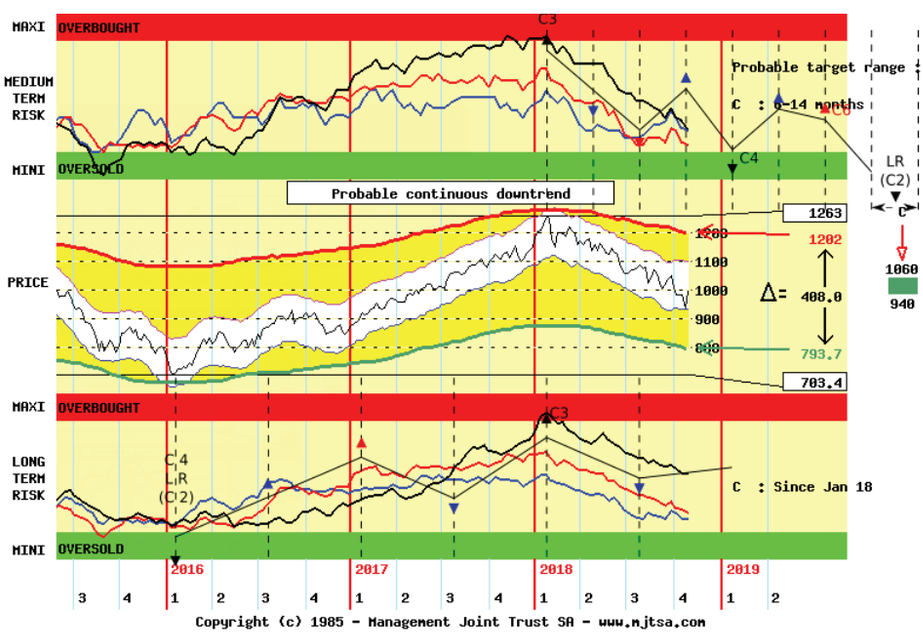
Shorter term, we consider the MSCI China index on a standalone basis. Our long term oscillators (lower rectangles) would suggest that an intermediate low was made mid August. Yet, the bounce since then has been very weak, and new lows were made in October. Both our oscillators series (lower and upper rectangles) are still pointing to further downside potential towards year-end and Q1 2019. New inflexion points to the downside are awaited towards late November. Hence, **over the next few weeks, the MSCI China Index should resume its downtrend, probably towards February next year, perhaps March. Our I impulsive targets to the downside (right-hand scale) are pointing to a further 10 to 12% of downside potential during this period.**

Top 8 Cap. Weighted Emerging Markets Currency vs USD
Daily graph or the perspective over the next 2 to 3 months



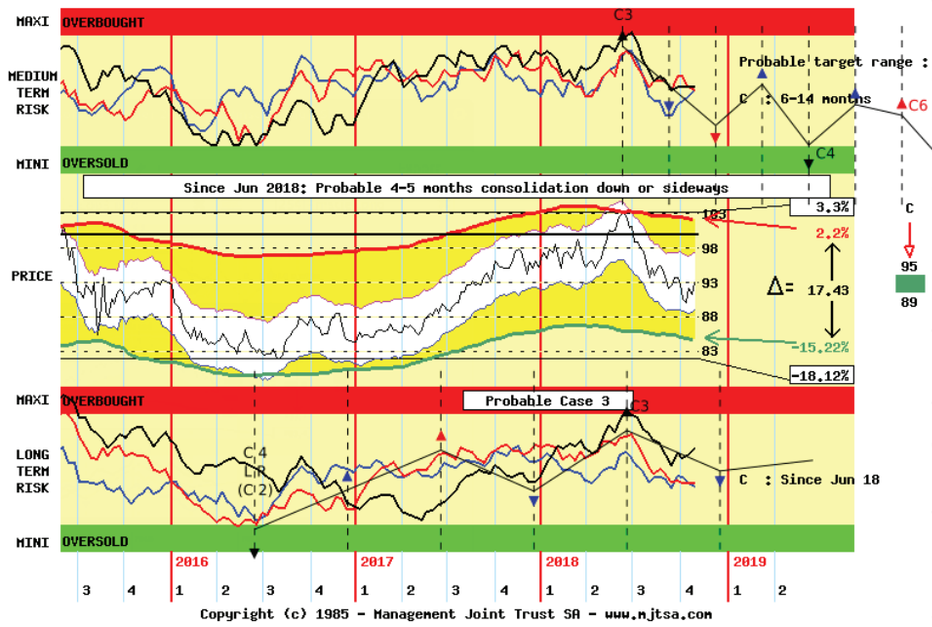
As we mentioned above, an interesting parallel can be made between Yuan and Chinese Equity weakness. This is also true when considering other Emerging markets currencies. Indeed, the Daily graph of Emerging Markets currencies vs the US Dollar does show a similar profile. The portfolio we use here includes the largest 8 emerging market currencies (China, South Korea, Taiwan, India, Brazil, South Africa, Russia and Mexico), cap weighted according to their respective countries' weighting in the MSCI Emerging Markets index. On both our oscillator series (lower and upper rectangles), **we expect this portfolio to resume lower vs the US Dollar, probably from mid November towards January / February 2019**. It is however interesting to note here that this timing is slightly in advance to the one we mention on the MSCI China above (by 1 to 2 weeks). This may be suggesting that **while the US Dollar starts to accelerate up again from mid November, it will start to weigh on China and other Emerging equity markets with a slight lag, probably by late November.**

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



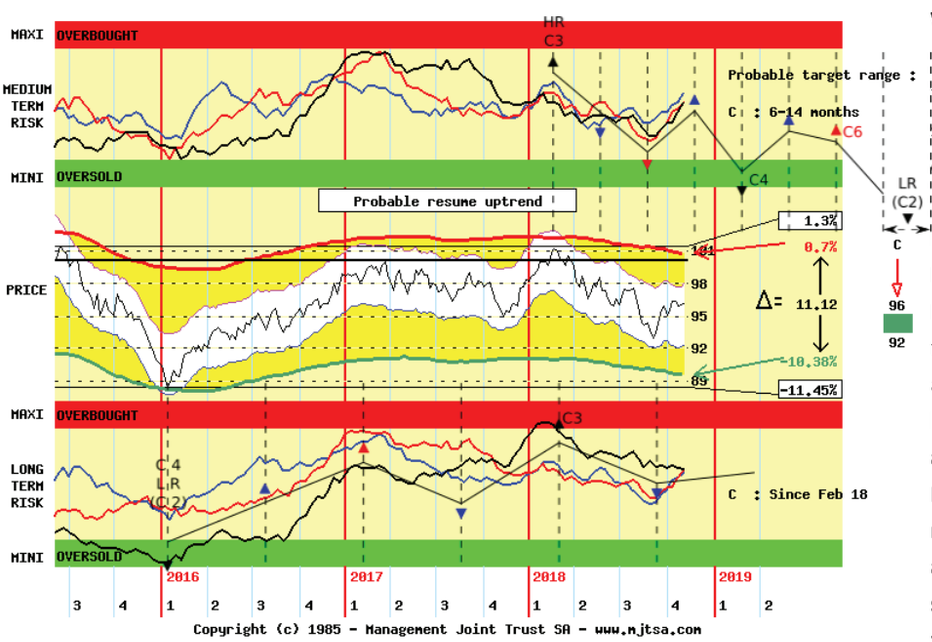
This study would not be complete without showing the resemblance between the wider Emerging Markets index to the MSCI China. Indeed, these show a very similar profile. The index is very much weighted towards China as well as other Asian developing equity markets (China accounts for more than 30% of the index, while together South Korea, Taiwan, India, Thailand, Malaysia and Indonesia account for another circa 40%), yet other Emerging Markets are also linked to China through their important exposure to Commodities and their sensitivity to the US Dollar. As with the MSCI China index, the Emerging Markets index reached a intermediate lows this Summer on both our oscillator series (lower and upper rectangles). Yet, the bounce has been very weak and new lows were made during October. We now expect it to continue lower towards mid Q1 at least, and then following a bounce towards mid next year, we would expect further weakness in H2 2019. Here also, we are currently working through the support of our C Corrective targets to the downside (right-hand scale). Any break below these (below 940), could open the door to additional downside potential, possibly towards a full retracement of the 2016-2017 Bull market. **Given these common negative dynamics, we will continue to avoid hunting for value in Emerging Markets, along with China.**

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



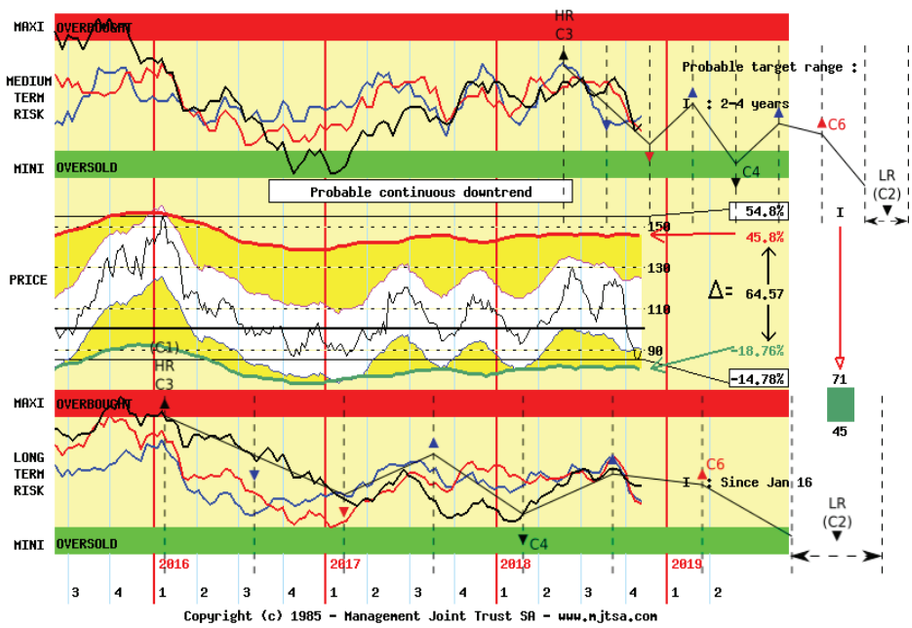
We now attempt to differentiate between the two, i.e. China vs other Emerging markets. Since June and the acceleration in the Yuan's devaluation, China has indeed been underperforming other Emerging Markets. **It is interesting to note that the ratio seems to be lagging the MSCI Emerging Markets index by about 4 to 6 months. This was the case on the lows made in 2016, and again on the tops made this year. Going forward, our oscillators series (lower and upper rectangles) could be indicating that this lag will probably continue**. Indeed, we expect an intermediate low on the ratio towards year-end. Yet, following a slight bounce, China may then continue to underperform other Emerging Markets towards late Q2 next year (as shown on our medium term oscillators; upper rectangle). This is quite worrying as the ratio is currently working through the support of our C Corrective targets to the downside (right-hand scale). If these were to break, the next relative performance support levels are 15 to 25% below current levels. Such developments would probably weigh quite heavily on the whole Emerging markets space, at least well into H1 2019.

EM Currencies – Commodity Producing vs Importing Countries
Weekly graph or the perspective over the next 2 to 4 quarters



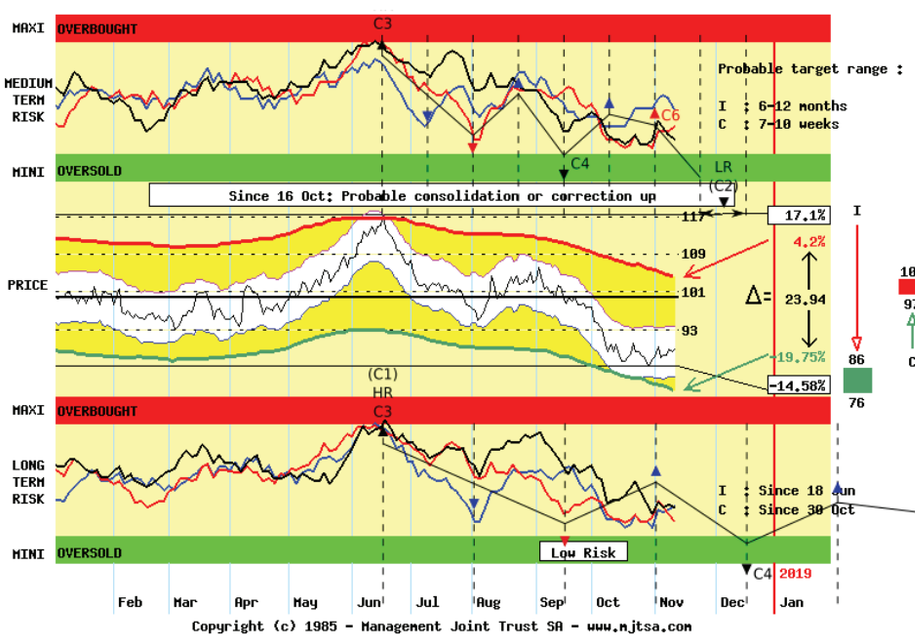
Within the Emerging Markets currency space, it is also interesting to highlight the relative strength between Commodity producing and Importing countries. We have left out the Yuan (and China) for now to focus on other plays, i.e. RUB, BRL, ZAR (Commodity producers) vs INR, MXN, KRW (Commodity importers). The portfolio is equal weighted among all positions (a neutral portfolio). **Commodity producers have seen a decent bounce since September vs Importers. Both our oscillator series (lower and upper rectangles) are now suggesting that they could soon resume lower, probably from the end of this month and towards mid Q1. We then expect them to bounce into the Spring.** Once again here, we are monitoring the support of our C Corrective targets to the downside (right-hand scale), which would probably need to hold, if our bullish case on Commodities, following a last downside retest into Q1 is to have any credence (see our articles on Commodities further up in this issue, pages 37 to 45). Note: interestingly, shorter term, the currencies of Commodity producing countries may hold up a while longer vs the US Dollar, probably until early December, following that, they should catch up to the downside with other Emerging market currencies, probably until mid Q1.

South Korean's KOSDAQ Index vs Brazil's Bovespa in US Dollars
Weekly graph or the perspective over the next 2 to 4 quarters



We now take this comparison to the equity level and compare the South Korean Kosdaq to Brazil's Bovespa (an Asian Growth profile vs a Commodity producer profile). Our oscillator series (lower and upper rectangles) are suggesting that Importers will probably underperform exporters over the next 12 to 18 months. Indeed, while South Korea may bounce slightly vs Brazil from late Q4 2018 into late Q1 2019 (which is in line with our EM currency analysis above), it then probably underperforms throughout the rest of 2019 and into 2020. Our I Impulsive targets to the downside (right-hand scale) for the ratio are much lower than today, some 25% to 50% lower. This suggests than **Asian Growth's underperformance vs Commodity producers may be quite compelling from Spring to end 2019**. Indirectly, it also confirms our view that Commodities may start to bounce again from mid/late Q1 next year.

MSCI China vs a portfolio of Commodity producing countries
Daily graph or the perspective over the next 2 to 3 months



Finally, we compare the China MSCI Index to an equal weighted portfolio of Commodity producing Emerging markets (Brazil, Russia and South Africa). Interestingly, yet not surprisingly, the profile here offers a zoomed version of the graph above. Both oscillator series are suggesting **that China could underperform Commodity producing Emerging markets until mid December, before a bounce is triggered into January / February. Following that, from mid Q1 2019, we expect China (and by extrapolation, Asian Growth equity markets) to start to resume lower against these Commodity producing ones.**

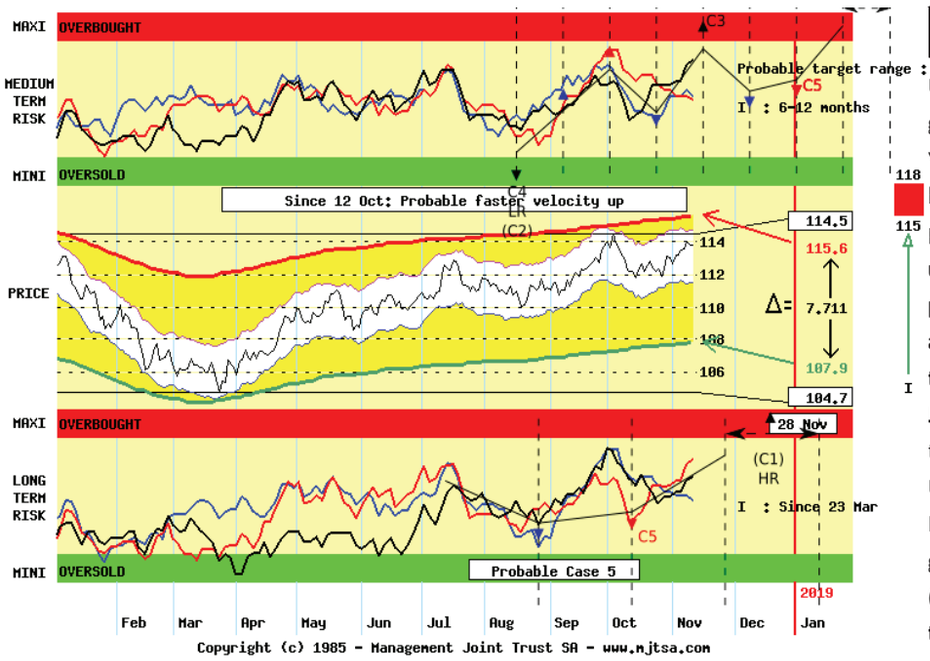
Concluding remarks:

Over the next few months, into mid/late Q1 at least, we remain prudent on China and other Emerging markets. Indeed, during November, we expect the US Dollar to start to strengthen again vs Emerging Market currencies. This process should first impact Asian Growth Currencies and with a slight lag their equity markets, while the process could then spread to Commodity producing Emerging Markets towards early December. We then expect China and all Emerging markets to remain weak until mid/late Q1. Looking into next year, and beyond Q1, our analysis suggests that Commodity producing Emerging Markets could outperform China and Asia Growth countries for the rest of 2019.

55 / Splicing the markets – What's happened to defensive currency

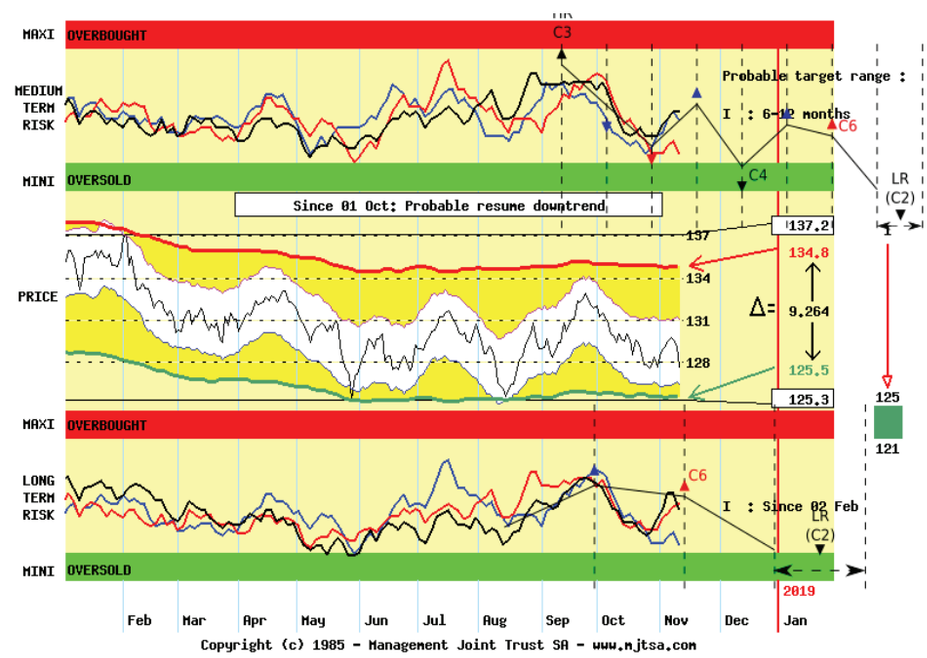
During the October risk asset sell-off, defensive currency pairs and crosses, USD/JPY, EUR/JPY, and EUR/CHF (and inversely EUR/GBP) showed little downside (upside) momentum. This was quite surprising, yet we believe this situation is about to change.

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



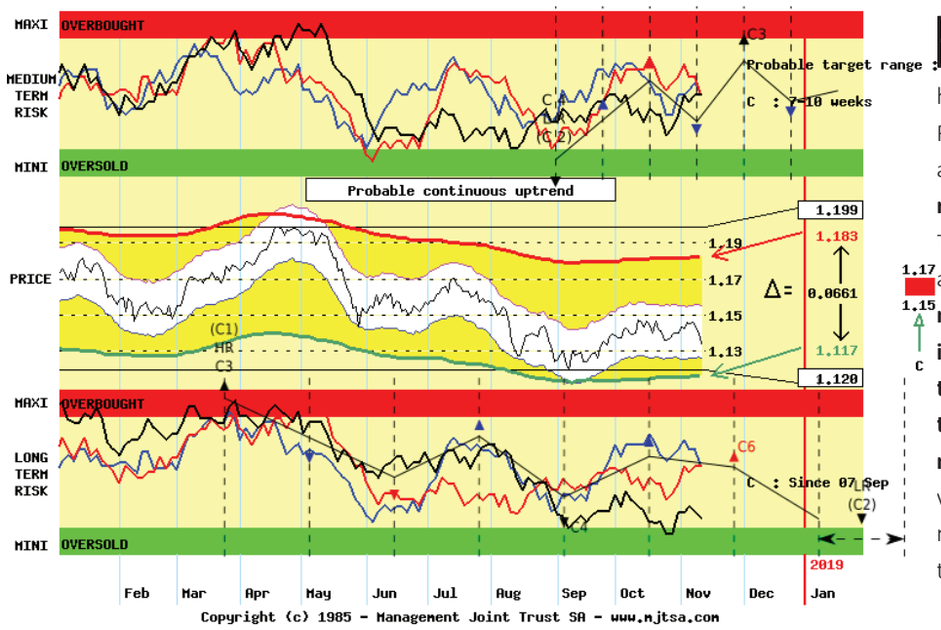
Despite the strong risk asset correction that took place in October, USD/JPY corrected down less than 3 figures. This is rather surprising given the Yen's usual strong defensive bias. What both our oscillator series (lower and upper rectangles) are suggesting is that **the uptrend may continue slightly longer probably towards mid/late November, at the latest early December. Following that, we expect the reversal on USD/JPY to finally start to materialize**. Until then (i.e. over the next couple of weeks), USD/JPY may attempt to retest its highs. It may even push into our I Impulsive targets to the upside between 115 and 118 (right-hand scale). **We would consider this move a last move up before USD/JPY starts to reverse down towards year-end and our C Corrective targets to the downside. We calculate these towards the 111 – 108 range** (or 0.5 to 0.8 times our historical volatility measure "Delta", here at 7.711 – middle rectangle; right-hand side – subtracted from the recent tops).

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



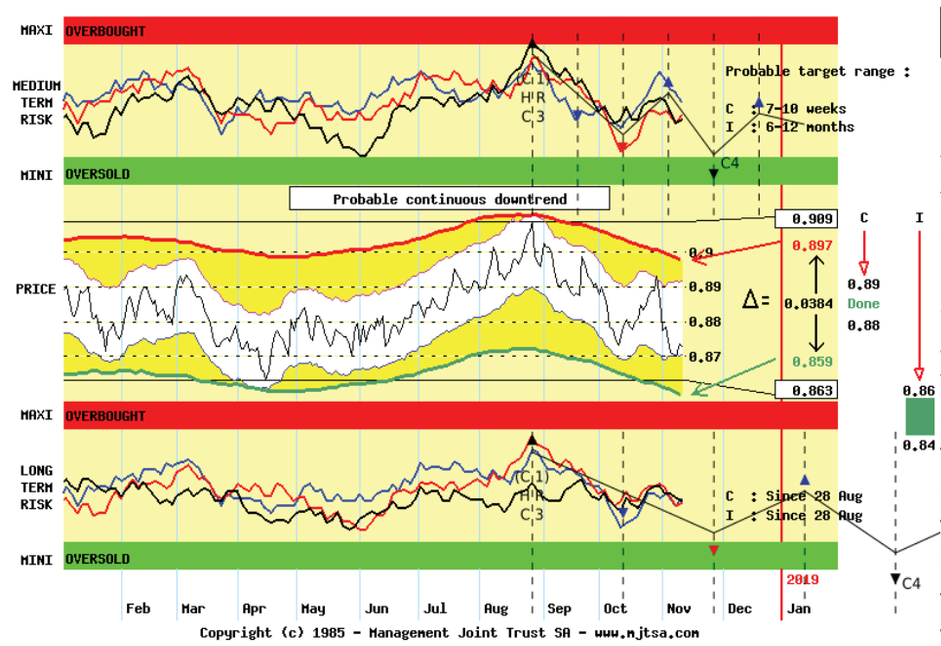
EUR/JPY has also been quite resilient, especially when considering that EUR/USD has been quite weak since mid September. Similarly to **the USD/JPY graph above, both our oscillator series (lower and upper rectangles) are however suggesting that the Yen should start to strengthen again soon, probably from mid/late November. We would then expect EUR/JPY to move down towards year-end and then possibly into February. The I Impulsive targets to the downside we can calculate over the next few months would point to a range between 125 and 121** (or 1.3 to 1.7 times our historical volatility measure "Delta" – here at 9.264; middle rectangle, right-hand side – subtracted from the highest point of the graph at 137.2). This is 3 to 6% lower than today.

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



EUR/CHF is usually quite synchronised with EUR/JPY. It's resilience since early October has also been quite surprising. Has the Swiss Franc lost its defensive bias? We believe not and would probably expect **EUR/CHF to start resuming lower from the end of this month**. This is what both our oscillator series (lower and upper rectangles) are suggesting. **The move lower that follows will probably last into February, and the I Impulsive targets to the downside we can calculate would point to the 1.11 – 1.085 range over the next few months** (or 1.3 to 1.7 times our historical volatility measure "Delta" – here at 0.0661; middle rectangle, right-hand side – subtracted from the graph's highest point at 1.199).

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



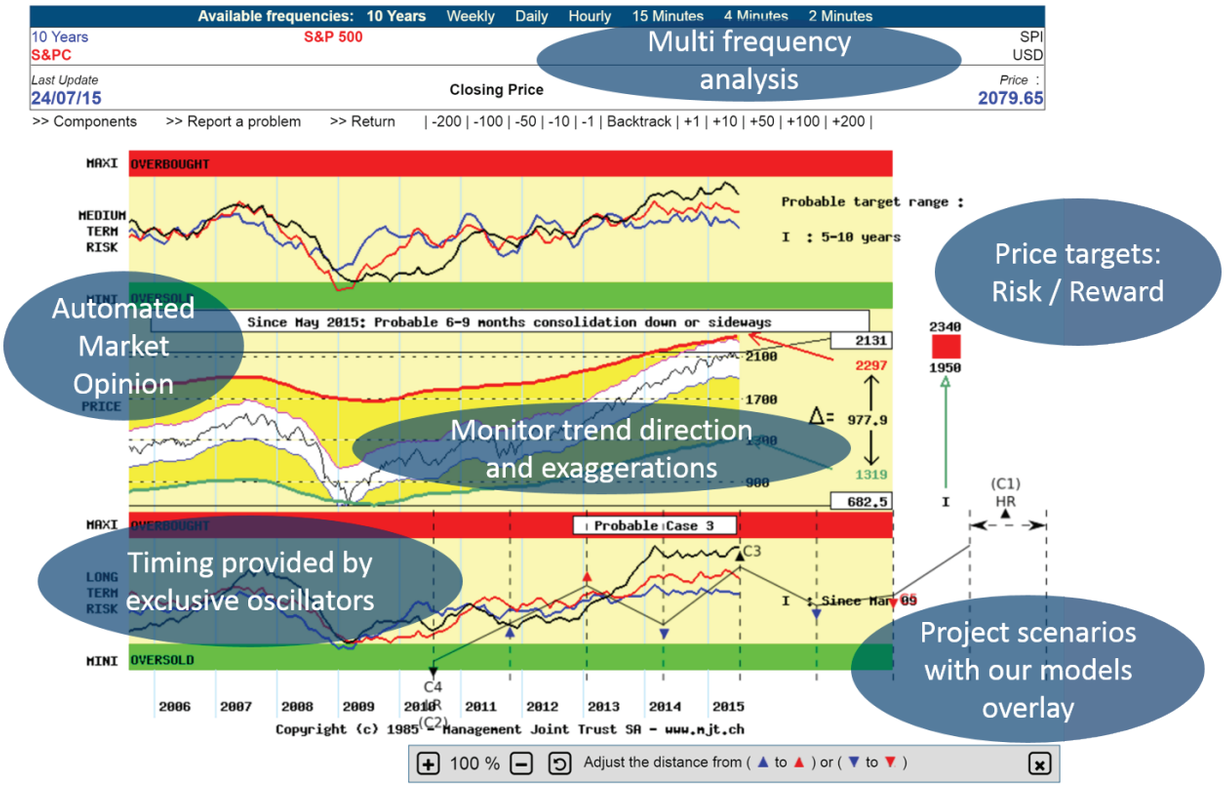
Finally, we consider EUR/GBP, which is usually also quite defensive. Indeed, despite all its problems, the EUR is historically less volatile than GBP and does tend to perform better during in risk-off periods. The final stages of the Brexit negotiations have also added quite a bit of volatility to the pair recently. Going forward, both our oscillator series (lower and upper rectangles) are suggesting a similar timing on EUR/GBP than on the other defensive currency pairs mentioned above. **These indicate that EUR/GBP could find a low towards the end of this month, possibly towards our I Impulsive targets to the upside in the 0.86 – 0.84 range (right-hand scale) before its starts correcting up towards year-end and possibly early next year. We would probably expect it to reach back towards the upper end of its recent range, above 0.90, during this period.**

Concluding remarks :

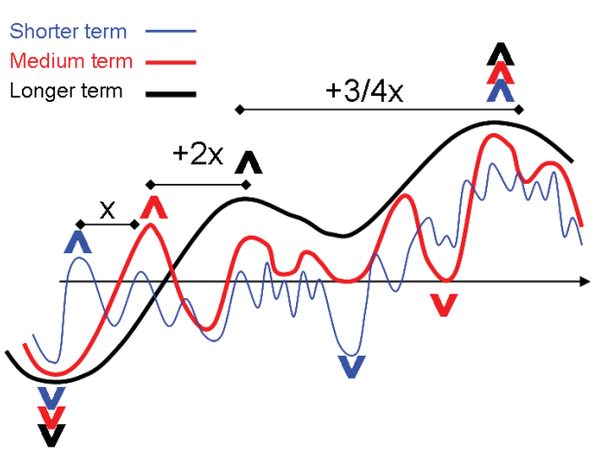
From the end of this month, we expect defensive currency pairs to start to strengthen in line with the further risk asset correction we expect, probably from late November towards February next year. During this period, USD/JPY may reach back below 110, EUR/JPY below 125 and EUR/CHF below 1.10, while EUR/GBP may climb back above 0.90. Shorter term, considering our cross assets scenario, a slight risk-ON bounce may still materialize over the next couple of weeks. It should die out towards the end of this month and defensive currency pairs should then strengthen for good.

57/ METHODOLOGY

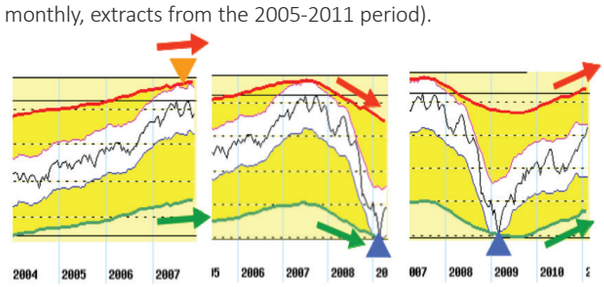
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



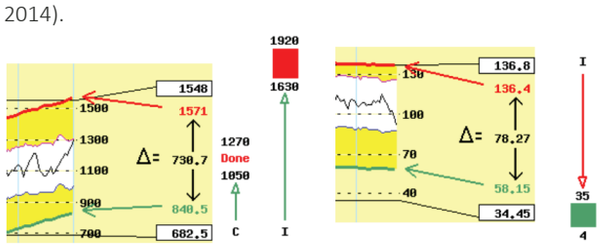
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)



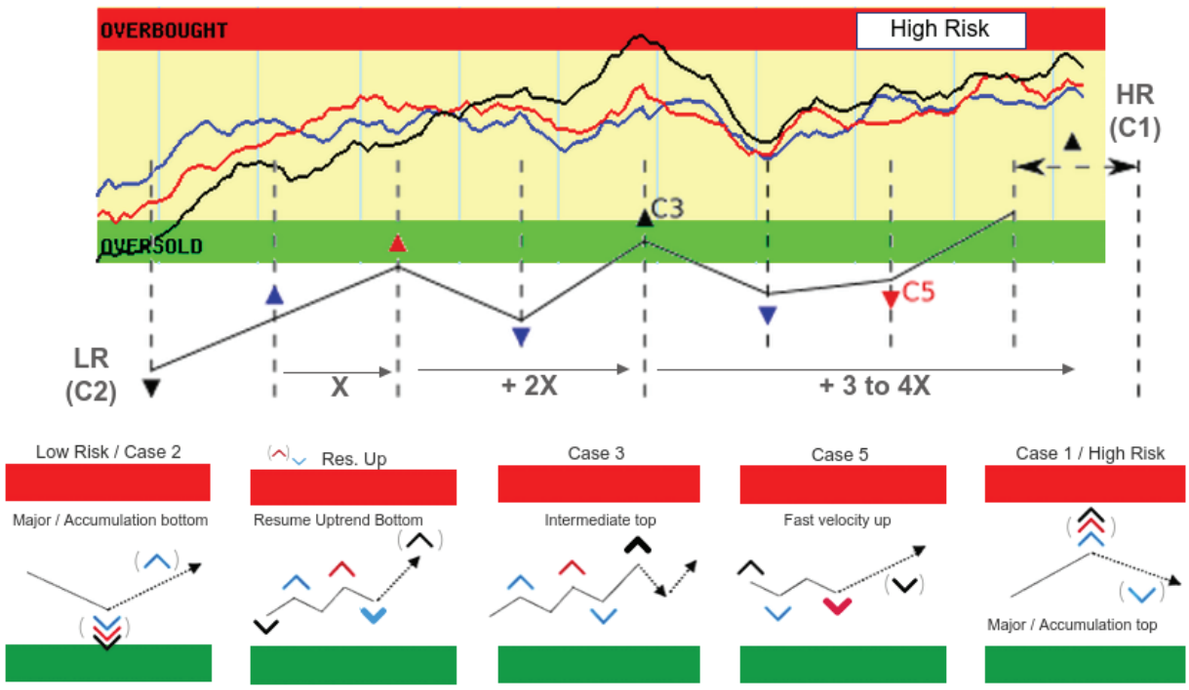
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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).

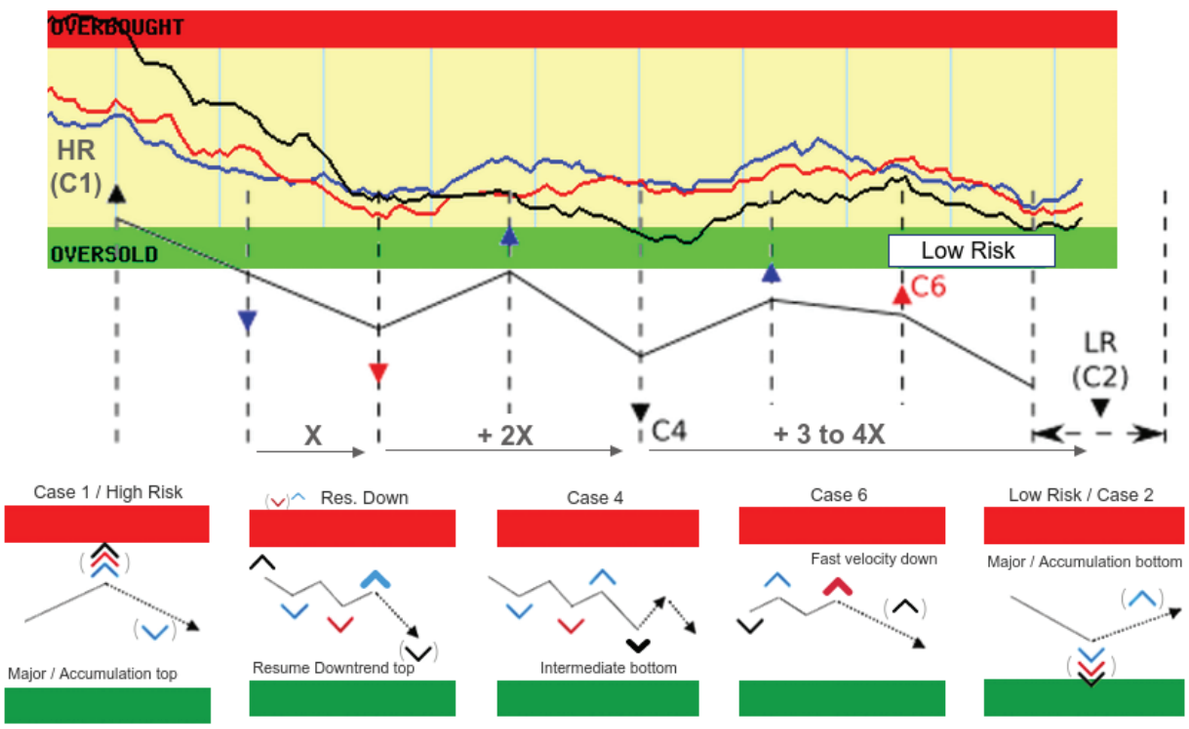


Ideal Uptrend Model



(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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