# THE CAPITAL OBSERVER

JUNE / 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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July 2007 R Prince, then CEO of Citigroup:

*"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing,"* he said in an interview with the FT in Japan.

Now in May 2018, we have another insightful banker James Gorman CEO of Morgan Stanley

"*Honestly, I think that's ridiculous,*" Gorman said early today in a TV interview. *"I don't think we're facing an existential threat at all." The bank boss is dismissing billionaire investor George Soros's warning earlier this week that the EU "is in an existential crisis." Soros also offered this heads-up Tuesday: "We may be heading for another major financial crisis."*

# 4/ Executive Summary

12 / **Systemic monetary Liquidity: A Top-Down Look To Understand Where We Came From, Where We're Going -** At The Capital Observer, we look at the liquidity being issued or being absorbed back by global central banks, the Federal Reserve and the US Treasury (real monetary balances flows), and model the manner those systemic liquidity flows impact asset prices. Usually, a change in the systemic liquidity flows which is being provided by the large global central banks today will show its maximum impact 11 to 12 months in asset prices thereafter. Although the Federal Reserve has stopped providing Monetary Base liquidity via its balance sheet, the European Central Bank and the Bank of Japan are still providing global systemic liquidity and will likely do so until late in the year. Nonetheless, we now also understand that this resource is winding down, and in fact, after a favourable uplift into July and August, the flows start to die down, and that will have adverse results on the prices of financial assets going into Q4 2018.
The next few months are still good time for risk assets but an exit strategy/defensive strategy should be prepared- we may be looking at this period with fond memories during the more negative 2019-2020 period. Take advantage of the run up into Q3 when the tax exemptions are at their maximum. But do not overstay- take profits. It is not the time for passive buy and hold strategies on risk assets anymore.

16 / **Timing and Tactical Insight - Into the last stages of the Equity Bull market** - As we have been forecasting for the last couple of years, we expected an important top to materialize on equity markets between earlier this year and this Summer. It should be followed by a downside correction that could last between 12 to 18 months and amount to minus 20 to 35% of performance on the S&P500 for example. Our current analysis suggests that this important top will probably materialize between late July and early August. Anyhow, the remaining upside potential on most markets is limited. Europe and Emerging markets look particularly weak, while the Nasdaq may continue to outperform slightly longer, yet looks extended. Small caps and Japan should benefit from the stronger US Dollar we expect, at least over the next few months.

23 / **U.S. Dollar: Forget Monetary Policy Divergence; Firming U.S. Capital Account Will Support A Rally Until Q3 2018 at least**- Since last February, the US Dollar rallied significantly against the EU and the rest of the DM. Most notably, the US dollar has been strongest on a broad trade-weighted basis and against Emerging Market (EM) currencies (especially against the Brazilian Real), and against some currencies from Eastern Europe. The DXY made tremendous gains as DM currencies fell sharply on the greenback's reversal of fortunes. Almost all the macro factors remain in favor of the US currency, especially those that matter in FX currency valuation. Against the EUR, the dollar's most stalwart rival, GDP growth spreads now lean favourably towards the U.S. With regards to the spread of the 2yr bond and 2yr bund it's almost no contest – the spread is massively in the U.S. dollar's favour. We also suggest that the US dollar's continuing strength is, and will be, coming from the steady improvement of the US Capital Account Balance. Changes in the US capital account normally show up in the valuation changes of the US currency 5 to 6 quarters later. The sharp improvement in the domestic capital account since Q3 of 2016 will therefore likely to result in further rise of the US dollar during H1 this year and perhaps early Summer, a small decline from Q3 to Q4, and then we see a rising US currency during the first half of 2019. That will likely hammer EM equities and other risk assets as well.

28 / **Timing and Tactical Insight - The US Dollar is torn between residual late cycle inflation pressures in the US and an early deceleration tail-wind from Europe -** The US Dollar is balanced between two factors of influence. On the one hand, rising late cycle inflationary expectations in the US are putting pressure on the FED to continue hiking, which may in time flatten the yield curve and ultimately weaken the US Dollar as at some point the FED may need to signal a pause. On the other hand, the re-coupling theme in Europe has lost momentum, the Economic Surprise Index has turned down since mid Q1, and the Italian Political crisis further exacerbates this reversal. We believe that until mid Summer, the US should manage to hold up its positive momentum, while Europe continues to decelerate. This should be positive for the US Dollar until then. Coming this Fall, the US may start to face its own deceleration (rapidly flattening yield curve), while the political situation in Europe may have stabilized somewhat. A rebound in EUR/USD is then possible towards year-end. Our view for 2019, is that the business cycle will have probably turned, that inflation expectations will have subsided, and that any further political/economic instability in Europe, or elsewhere, will be very positive for the US Dollar and other defensive currencies (JPY, CHF) on Flight to safety concerns.

36 / **The yield curve universe is changing** - In the late 1980s to late-2000s, the tendency was for the yield curve to steepen during bond (price) rallies and to flatten during (price) selloffs. Put simply, there was a NEGATIVE correlation between the 10yr yield and the slope of the 2y/10y yield curve. Described another way, when the 10yr yield starts falling, it won't be long before the yield curve steepens. It was a very useful market construct because at that time, changes in the 10yr yield tend to be ahead of the inflection points of the yield curve by about 1 to 2 months. Unfortunately, those easy, profitable trades disappeared once Quantitative Easing (QE) started in November 25, 2008, as the massive infusion of systemic liquidity and new monetary policy tools unleashed by the Federal Reserve sent the yield curve and bond yield comovements into a different direction. The relationship had turned POSITIVE. But the comovement between the yield curve and the 10-yr yield is turning NEGATIVE again! It follows the changes that are happening to the effect of the global central bank stimulus via purchases of asset prices. From inception of QE, the effect of those huge bank reserves, transmitted via the portfolio balance

channel and the signalling channel, did push up house and equity prices, and also lowered the path of short-term rates and reduced longer-term yields. But as from June 2014 onwards, further addition to the bank reserves drove long bond yields higher, and vice versa; reducing the bank reserves triggered declines in yields – not exactly what the global central banks expected to see. From June 2014, the markets started to believe that more stimulus results in higher inflation down the road. Hence, after the global aggregates peaked in March 2017, global inflation expectations fell sharply. That same phenomenon is also driving the US yield curve. The general market thinks inflation will be a huge problem down the road (overly rich 10yr yield). On the other hand, the bond market yawns and flattens the curve by having a negative term premium on the 10-year yield. We believe that the bond market gets it right.

41/ **Timing and Tactical Insight - Yield curve flattening should accelerate in H2 2018** - In the US, the Yield curve should start to flatten again quite aggressively from mid-year / early Summer and towards year-end. By then, it may even be approaching inversion. Indeed, while we expect short term rate hikes to continue, at least into September, and probably into December, long term US yields will probably top-out during the Summer and start to retrace down. In the EuroZone, the Yield curve is driven by long term Bund yields. These may have already topped out in Q1 this year , and following a slight bounce into July, should continue lower towards year-end, thereby also flattening the yield curve in the EuroZone. These negative developments on the yield front are hitting the Financials sectors on both sides of the Atlantic, and these may have also probably already topped out for this cycle. The European banking sector does look particularly weak from this Summer into year-end, suggesting that a new European Sovereign crisis may be just starting.

46 / **Geopolitics faded out and oil fundamentals are back in the forefront, but the June 22 OPEC meeting could throw a Crude Oil curve ball -** In last month's Capital Observer (May 2018), we noted that geopolitics and fundamentals were colliding in the oil price discovery process, and we asked rhetorically – which one will win? At that time, oil fundamentals had already become less price-friendly and it was just the slow simmer in adverse geopolitical events that was keeping sentiments of oil speculators still bullish. Then came the talk of OPEC potentially raising oil production by as much as 1 million bpd after global oil inventories have gone back to their five-year averages. Oil prices promptly collapsed, hastened along by a series of US inventory builds and a surge in US oil production. Nonetheless, the fact that two founding members of OPEC are rocking the OPEC boat suggests that the June 22 meeting will be contentious. It suggests that a good portion of the cartel could line up against any move to increase production. It could set the stage for a heated meeting in Vienna and OPEC watchers are already suggesting it might be one of the worst OPEC meetings since 2011. We expect OPEC to reject any proposal to lift output soon, and the cartel will likely opt to let the agreement run as originally crafted. This will likely provide another up wave to Crude Oil's bull run before a more challenging H2 as deteriorating fundamentals bite back.

49 / **Timing and Tactical Insight - As the business cycle matures, we expect one last push up for Oil into the Summer** - Following their short term correction since mid May, Oil and the Energy sector may be getting ready for a last period of outperformance. We expect it to materialise from mid June into early / mid July. Brent Oil should break back above 80 USD/barrel, and could even push higher (high 80s?) on a spike (which would be a typical late cycle phenomenon). Following that, we expect Oil and Energy to start correcting down, possibly towards year-end, and early 2019 at least. The Energy sector may be particularly hard hit as we would also expect the US and European yield curves to start flattening again. This phenomenon is usually a drag on value and cyclical sectors (of which Energy).

53 / **Splicing the markets - Differentiation in Emerging markets – Asia should hold its ground -** Our view, is that any bounce in Emerging markets over the next few weeks should be considered as an opportunity to exit these trades, or at least reduce them on a relative basis. That said, while Asian Emerging markets could hold up rather decently until the Fall, and probably year-end, the urgency to reduce Latin American and Eastern Europe is probably much greater.

# 6/ Mapping the markets

Over the last two of years, we have been of the view that the strong uptrend on equities, which started in early/mid 2016 would probably meet an important top at some point between the Spring and the Summer of 2018. We still expect this projection to materialize along with the 12 to 18 months correction on risk assets that could follow. The sharp sell-offs, we have recently seen on some Emerging Markets as well as in Southern and Eastern Europe are probably the first shocks to appear and should be taken as early warning signs. The topping process will probably extend into mid Summer. Shorter term, and in the aftermath of the Italian Political crisis, equity markets have managed to stabilize. We would expect them to continue to do so during June and start to resume their uptrends for a last leg up towards mid July, perhaps early August. Stronger markets such the S&P500, the Nasdaq, the Nikkei, the FTSE, the CAC40 or the DAX will probably continue to make new highs for this cycle (all time highs for most), while others will attempt to rebound.

More generally, our assessment of the current cross asset environment would confirm that a topping process on Equity markets may be nigh. Indeed, we believe that we are late in the business cycle (which probably bottomed 2.5 years ago in late 2015 / early 2016) and that the rallies since last Summer on commodities and US long term yields are typical of such a late stage environment. Long term yields outside of the US have probably topped out already in Q1, US yields will probably follow during the Summer, along with Oil and then Copper towards late Summer. In the meantime, the FED remains committed to its tightening spree. In addition to the rate hike expected today, one at least, perhaps two more rate hikes are still planned for this year. With the reversal we expect on US long term yields, flattening of the US yield curve is inevitable. It will probably lead to inversion towards early next year, and will accompany the deceleration of the US economy we expect from late Summer.

As for the Dollar, it is balanced between late cycle residual inflationary pressures in the US (which are fading) and economic deceleration elsewhere, in Europe especially. The US should manage to hold up its positive momentum into mid Summer, while Europe continues to decelerate. This should be positive for the US Dollar until then (targets between 1.14 and 1.10 EUR/USD towards August following the current bounce, which probably dies out between now and late June). Coming this Fall, the US may face its own deceleration and the Euro could then stabilize and may rebound into year-end. Our longer term view is that by early next year, the business cycle will have probably turned, that inflation expectations will have subsided, and that any further political/economic instability in Europe, or elsewhere, will be very positive for the US Dollar on Flight to Safety concerns. In the meantime, from this Fall, the deceleration theme will gradually gain traction. It will favor all defensive assets such as the Yen, Gold, Defensive Equity sectors, Bond proxies or Treasuries.

## Main Equities & Government Bonds

| Main Asset Allocation Drivers | | Next 2 months | 3 to 6 months ahead |
|---|---|---|---|
| Main Equities | US<br>S&P500 | We are still positive of US equity markets possibly until early Summer, when we expect an important top between July and early August. | From mid Summer, the S&P500 could top out for this cycle. The Bear market that follows could last 12 to 18 months. We would start reducing risk in Q3. |
| | Europe<br>EuroStoxx50 | Stronger European markets (France, Germany, UK) may follow US markets up into July, perhaps August, while others will attempt to rebound | As in the US, European Equities should also top out for this cycle during the Summer and start reversing down into the Fall |
| | EMs<br>MSCIEM USD | EMs attempt to bounce late June, but a strong USD keeps them under pressure. Asia holds up while Latam and Eastern Europe underperfom | From late Summer, EMs may find some relief as the USD retraces a bit, yet global deceleration should keep them under pressure. |
| Treasuries | US10Y<br>Bond prices | US Treasuries should bottom out between July and early August, US10Y yield should reach above 3.1%, possibly into the mid 3s %. | From mid Summer, US Treasuries will start to reverse up. Start accumulating as US 10Y Yields may retrace down by 70 to 100 bps into 2019. |
| | Germany 10Y<br>Bund prices | Bund Futures may retrace some of their recent gains, yet we do not expect a widespread sell-off. Accumulate on Dips. | From mid Summer, Bund Futures should resume their uptrend, probably towards year-end at least. |

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

### *Main Equities*

**World markets**
p 16 - 20

Equity markets have probably started their last leg up for this cycle. We expect it to last into the Summer (into early/ mid Q3) and most majors markets could make new highs. Following that, from August, we expect them to start reversing down and gradually enter a Bear market which could last between 12 and 18 months.

**Main Regional picks**
p 16 - 20

The USD could remain strong, probably into mid July / August. Recently, US markets have been leading, yet as the Italian Political crisis dissipates, larger "Core" markets in Europe (France, Germany, UK), as well as Japan, may start to catch up.

**Emerging markets**
p 21, 53-54

We remain prudent on Emerging markets for now given our rather Bullish forecast on the US Dollar from mid/late June into July.

**Volatility**

Volatility continues to move lower, probably towards mid Summer. Following its spike in February this year, it is now back in its H2 2017 record low range.

## *Government Bonds*

**US & European Benchmarks**
p 29, 41, 44

US 10Y yields could see one last move up into July, perhaps August (above %3.1 and possibly towards the mid 3s %). Following their recent sell-off, European long term yields should bounce into July, but will probably not retest their February highs.

# Equity to Bond Ratios, Fixed Income Dynamics & Commodities

| Main Asset Allocation Drivers | | Next 2 months | 3 to 6 months ahead |
|---|---|---|---|
| Equity / Bonds | US | Equities should extend higher, while Treasuries make a last sell-off. The ratio continues to rise into mid Summer. | From mid Summer, Equities and Treasury Yields top out for this cycle, the ratio starts to reverse down, possibly towards year-end. |
| | Europe | Bund Futures continue to consolidates into early Summer, while the stronger European markets conitue to push higher towards mid Summer. | European markets top-out mid Summer, while the Bund gathers steam again. The ratio starts to consolidate down towards year-end at least. |
| Duration | | European long term yield may rebound/retest into early Summer, while US yields make new highs towards mid Summer | Long term Yields and Yield Curves on both sides of the Atlantic start to correct down from mid Summer. The trend acclerates as H2 2018 progresses. |
| Credit | | US High Yields make a last move up into July, while Credit and Sovereign spreads elsewhere resume lower from mid year. | From early Summer, Credits also starts to top out in the US as the business cycle starts to turn and gradually deteriorates towards year-end. |
| TIPs/Treasuries | | The uptrend on TIPs vs Treasuries is still alive as residual inflation expectations continue to rise into the Summer. | The TIPs/Treasury ratio gradually loses momentum towards the Fall, as inflationary pressures subside. |
| Oil | | Oil may still accelerate up towards July (above 85$/barrel on Brent), when it tops out for this cycle | Following a last accleration into early Summer, Oil gradually rolls over as the business cycle starts to top out and risk assets start to correct. |
| Industrial metals | | Industrial Metals continue up to new highs during the Summer. Copper could reach above 8'000$/t. | Along with other Commodities, Yields and Equity markets, Industrial metals should gradually top out for this cycle towards late Summer. |
| Gold | | Gold may still attempt a slight bounce during June, but corrects down in July and early August as the USD strengthens | From late Summer, Gold benefits from a retracement in the USD, then gradually gains momentum as Financial Conditions start to deteriorate. |

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

## *Equity to Bond Ratios*

**US & Eurozone Markets**

Equities and Yields resume their uptrend in the US until mid/late July, perhaps August. In Europe, the stronger "Core" markets are following up, while Bonds retrace some of their recent strength (receding Italian political crisis over the next few weeks at least). The Summer should see Equity and Yields, and the ratios gradually reverse down, as Equities and US yields top-out, and European yields resume lower.

## *Fixed Income Dynamics*

**Duration**
p 42, 44

Yield Curve spreads in the US and Europe should hold up until mid-year, before the yield curves start flattening again quite rapidly into year-end / early 2019, i.e. the FED rate hikes will crush any attempts for the US curve to steepen, while in Europe, long term yields may have already started to turn down. We would wait until US yield have topped out this Summer to enter long duration trade.

**Credit**
p 30

US Corporate Credit spreads may bottom out this Summer along with the top we expect on other risk assets. Sovereign and Credit spreads elsewhere could retrace down, but will probably not make new lows, i.e. they've already turned up for this cycle. We expect strong credit deterioration towards late 2018 and 2019.

**Rate Differentials**
p 29

The progression of the Rate differentials remains in favor of the US (vs Europe, Japan or the UK) probably until the late Summer and even into the Fall.

**Tips**
p 28, 29

Inflation breakevens (TIPs/Treasuries ratio) remain strong and could continue to rise, towards late Summer, even the Fall. That said, we expect TIPs yields and Treasuries yields to start reversing down from early/mid Summer. Hence real yields may start to fall more rapidly than nominal yields. This would explain why TIPs continue to outperform Treasuries until later this year.

## *Commodities*

**Oil**
p 49, 50

Oil attempts a last push up into the 80s USD/barrel (Brent) between mid June and mid July and then probably tops out for this cycle.

**Industrial metals**

Industrial metals should follow Oil higher and resume up towards the Summer. They may extend slightly further than Oil into late Summer. Copper could reach above 8'000 USD/t (LME) by then.

**Gold & PMs**

From mid / end June, Gold could resume lower towards late July/August as the US Dollar enters a second leg up and risk assets attempt one last rally. From the Fall and towards year-end, Gold should then start to move up again vs all currencies and most assets, as financial conditions start to deteriorate

**Agriculture**

Agricultural Commodities are typical late cycle commodities. They are more defensive than Energy or Industrial Metals and should perform well in the current environment. On average, we expect them to move up 10% until mid Summer, and probably another 10% until year-end.

# Foreign Exchange

| | | Next 2 months | 3 to 6 months ahead |
|---|---|---|---|
| USD vs | EUR | EUR/USD could continue to bounce until mid/late June (1.20 - 1.22 range), it then resumes down again until mid August (1.14 - 1.10 range) | From August, EUR/USD ma start to stabilize and could bounce into the Fall |
| | GBP | GBP/USD could continue to bounce until mid/late June (above 1.35), it then resumes lower until late July, beware of any negative price action below 1.34. | From late July, GBP/USD may start to stabilize and could bounce into the Fall |
| | JPY | Towards mid/late June, USD/JPY manages to push above 111. It may reach above 115 by August. | From late Summer, USD/JPY gradually loses momentum and starts reversing back down. The move gradually accelerates into the Fall. |
| | CHF | From mid/late June, USD/CHF resumes its uptrend and by August pushes back above parity and possibly slightly higher | From late August , the Dollar loses mometum and could start to retrace down into the Fall. |
| EUR vs | GBP | EUR/GBP could rebound into late June and then retraces this move into August. | From late Summer, EUR/GBP should resume its uptrend towards 2019 on risk-OFF considerations. Indeed, longer term, the EUR still seems more defensive than GBP. |
| | JPY | EUR/JPY could continue to rebound into mid/late June towards the 131 - 133 range, yet may retrace some of its June gains towards mid July | EUR/JPY may still attempt to move higher until late Summer, yet reverses down during the Fall on risk-off considerations |
| | CHF | EUR/CHF could continue its weak rebound into mid/late June possibly towards 1.17, yet may retrace some of its June gains towards mid July | EUR/CHF may still attempt to retest its May highs until late Summer (1.20), yet reverses down during the Fall on risk-off considerations |
| GBP vs | JPY | GBP/JPY could continue to rebound into mid/late June towards the 149 - 150 range, yet may retrace some of its June gains towards mid/late July | GBP/JPY may still attempt to move higher until late Summer, yet reverses down during the Fall on risk-off considerations |
| | CHF | GBP/CHF could continue to rebound into mid/late June above 1.33, yet may retrace some of its June gains towards mid/late July | GBP/CHF may still attempt to move higher until late Summer, yet reverses down during the Fall on risk-off considerations |

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

**US Dollar**
p 31- 33

We believe the US Dollar has turned up for this cycle and that it will gradually strengthen in successive stages towards mid/late 2019. Shorter term, we expect its current retracement to continue another week or so (mid/late June), before it resumes up into mid July, perhaps August. Following that, the US Dollar could retrace down into the the Fall, potentially towards year-end, as the deceleration theme also starts to hit the US. It re-accelerates up again in 2019 on Flight to Safety concerns.

**Euro**
p 31, 32, 34

The upside momentum on EUR/USD that prevailed throughout 2017 has stalled. Indeed, we believe that the recoupling story (European Growth catching up with the rest of the world) is fading. Indeed, since mid Q1 2018, the Economic surprise index has steadily deteriorated, while the recent Italian Political crisis highlights the persistent structural imbalances in the EuroZone. We expect that the current rebound on the EUR/USD could die out between mid and late June (1.20 – 1.22 range) and that during the first half of July, perhaps until August, EUR/USD could sell-off towards the 1.14 – 1.10 range. Following that, it rebounds back up towards the high teens during the Fall, as the US starts to face its own economic deceleration. In 2019, EUR/USD weakens further as economic, financial and political problems accumulate. Vs CHF, the upside momentum seems to have been broken. EUR/CHF may still attempt to retest its highs during the Summer, but should start reversing lower during the Fall on risk-OFF considerations. EUR/GBP may continue its recent bounce until late June, but probably retests down towards its April lows towards August. Following that its regains strength into year-end and 2019 as Sterling is probably more sensitive than the Euro to any upcoming cyclical downturn.

**Yen**
p 33

The rebound on USD/JPY has been strong and we expect it to continue towards mid July at least. It will first need to move above its recent highs around 111, possibly opening the door towards levels above 115 by mid Summer. Following that as financial/economic conditions start to deteriorate during the Fall we will expect that, at some point, the Yen regains its risk-OFF profile and starts to reverse its Q2/Q3 uptrend, and probably more into 2019. Vs the Euro and Sterling, the Yen could remain quite weak until late Summer, before it regains strength during the Fall and into 2019 on Flight to safety concerns.

**Sterling**
p 32

Cable (GBP/USD) is following similar dynamic than EUR/USD. Its current rebound should die out between mid and late June (possibly towards 1.35), before the pair resumes lower into mid/late July. Any further negative price action below 1.34 is quite alarming as it could open the door to much lower levels below 1.30. As with the Euro, from mid Summer, GBP may start to bounce vs USD probably into the Fall, before it resumes lower in 2019.

**Oil & Commodities currencies**

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB and ZAR) topped out in early February against the Dollar and have been consolidating down since. We expect this nascent downtrend to continue into August in first instance. Thereafter, following a slight bounce during late Summer, early Fall, Commodity currencies should weaken substantially vs the US Dollar from late 2018 and well into 2019. Against the Euro, Commodities currencies should also weaken into mid Summer and then again towards year-end and 2019.

**Asian currencies**

Following its slight bounce since late May (which could end between now and late June), our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) should continue to resume lower vs the USD towards August. Following that it may rebound towards year-end before it corrects down again in 2019. On the other hand, Asia Growth currencies are more defensive than the Euro, and in Euro terms, they should continue to head up into August. Following some retracement vs the Euro during the Fall, they should, similarly to US Dollar, continue to move higher vs the Euro from year-end into late 2019.

# Equities Markets Segmentation

| Core Sector Weightings | | | Next 2 months | | | | | 3 to 6 months ahead | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| US Sectors - S&P500 | | | **We will remain Underweight Defensive and Overweight Technology and Energy for now, probably until July, perhaps into August.** | | | | | **From July/August, we expect Equity, Commodities and Yields to start topping out for the cycle. Our sector allocation will hence turn defensive to reflect this view.** | | | | |
| Sectors | Proxy ETF symbols | Benchmark-weights | Strong Under-weight | Under-weight | Neutral | Over-weight | Strong Over-weight | Strong Under-weight | Under-weight | Neutral | Over-weight | Strong Over-weight |
| Technology | XLK | 26% | | | | | | | | | | |
| Financials | XLF | 15% | | | | | | | | | | |
| HealthCare | XLV | 14% | | | | | | | | | | |
| Discretionary | XLY | 12% | | | | | | | | | | |
| Industrials | XLI | 10% | | | | | | | | | | |
| Staples | XLP | 8% | | | | | | | | | | |
| Energy | XLE | 6% | | | | | | | | | | |

| European Sectors - Europe Stoxx 600 | | | Next 2 months: **We will remain Underweight Defensive and Overweight Energy for now, probably until July, perhaps into August.** | | | | | 3 to 6 months ahead: **From July/August, we expect Equity, Commodities and Yields to start topping out for the cycle. Our sector allocation will hence turn defensive to reflect this view.** | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Sectors | Index symbols | Benchmark-weights | Strong Under-weight | Under-weight | Neutral | Over-weight | Strong Over-weight | Strong Under-weight | Under-weight | Neutral | Over-weight | Strong Over-weight |
| Banks | SX7P | 13% | | | | | | | | | | |
| Industrials | SXNP | 12% | | | | | | | | | | |
| HealthCare | SXDP | 11% | | | | | | | | | | |
| Pers. & HH Goods | SXQP | 9% | | | | | | | | | | |
| Food & Beverage | SX3P | 7% | | | | | | | | | | |
| Insurance | SXIP | 6% | | | | | | | | | | |
| Energy | SXEP | 6% | | | | | | | | | | |

**Main Sectors Allocation**

p 16, 17, 18, 43, 45, 50, 51, 52

Our scenario on equities is still positive until early, perhaps mid Summer (July/August). This move up is potentially the last one to the upside before equity markets top out for this cycle and start to reverse down towards year-end and 2019. Hence, **our sector allocation is quite neutral as the visibility is quite short coming into an important turning point. We will hence remain underweight Defensive sectors for now and overweight Technology and Energy, which should perform well in the current late cycle environment.**

Then, from July/August, we expect Equity, Commodities and Yields to top out for the cycle. Our sector allocation will gradually turn very defensive during the Summer.

# Countries allocation

| Core Countries Weightings | | | Next 2 months: **We will Overweight most main markets vs the RoW until July for now. The US and China given their strong momentum. Europe and Japan should profit from a strong USD.** | | | | | 3 to 6 months ahead: **From mid Summer, Underweight Europe and Commodity producers. Overweight the US. Neutral on China on possible further CB easing.** | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| All World Country Index Currency hedged | | | | | | | | | | | | |
| Sectors | Index symbols | Benchmark-weights | Strong Under-weight | Under-weight | Neutral | Over-weight | Strong Over-weight | Strong Under-weight | Under-weight | Neutral | Over-weight | Strong Over-weight |
| US | S&P 500 | 52% | | | | | | | | | | |
| Canada | TSX | 3% | | | | | | | | | | |
| Europe | SXXP | 21% | | | | | | | | | | |
| -UK | FTSE | 6% | | | | | | | | | | |
| -France | CAC40 | 3% | | | | | | | | | | |
| -Germany | DAX | 3% | | | | | | | | | | |
| -Switzerland | SMI | 3% | | | | | | | | | | |
| Japan | N225 | 8% | | | | | | | | | | |
| China | MSCICN | 3% | | | | | | | | | | |

**Main Country allocation**
p 34, 35, 53-54

During the month of June, we expect the current rebound on EUR/USD to die out . The Dollar should then strengthen towards mid July, perhaps early August, before it corrects down towards early Q4, and finally resumes up towards year-end and into 2019. **The momentum is strong on US markets and compared to the All Country World Index (which is also denominated in USD) we expect US markets to continue to outperform towards mid Summer.** In the meantime, the stronger European markets should benefit from the retracement we expect early Summer on EUR/USD (and the Nikkei 225 from a further rally in USD/JPY). We would however avoid Southern Europe and Eastern Europe and **concentrate on European "Core" markets such as France, Germany and the UK**. We will also avoid Switzerland, which remains very defensive in terms of sector allocation. We would probably avoid Emerging Markets, which except for China (the MSCI China index featured here is very skewed towards Chinese "Big Growth" technology companies, the so called "BATs", which should perform well late in the cycle), could also suffer from further USD strength, from late June into mid July at least.

From mid Summer, we believe that equity markets in general may make an important top and that these could start to correct down towards 2019. We also expect that by then, EUR/USD could start to stabilize as the deceleration story begins to also impact the US. Our allocation will hence turn quite defensive, favoring the US and Switzerland and avoiding Europe as a whole, given the negative impact that a rebound in EUR and GBP during the Fall could have on European markets.

# Core factors and Themes

| **Core Factor/Themes Weightings** | **Next 2 months** | | | | | **3 to 6 months ahead** | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| General Comment | **Until mid Summer, we will Overweight all Themes positively correlated to the USD (and vis-versa), and Underweight Defensives** | | | | | **From mid Summer onwards, we would favour defensive profiles as we expect equity markets to top out, and move away from cyclical themes** | | | | |
| Themes | Strong Under-weight | Under-weight | Neutral | Over-weight | Strong Over-weight | Strong Under-weight | Under-weight | Neutral | Over-weight | Strong Over-weight |
| Nasdaq 100 (vs S&P500) | | | | | | | | | | |
| DJ Industrial (vs S&P500) | | | | | | | | | | |
| Russell 2000 (vs S&P500) | | | | | | | | | | |
| Wilshire REITs (vs S&P500) | | | | | | | | | | |
| US Value (vs US Growth) | | | | | | | | | | |
| Southern EuroZone (vs Stoxx EZ 600) | | | | | | | | | | |
| EuroZone Small Cap (vs Stoxx EZ 600) | | | | | | | | | | |
| Japanese Small Cap (vs N225) | | | | | | | | | | |
| Goldmines | | | | | | | | | | |
| Diversified Mining | | | | | | | | | | |

**Core factors and Themes**
p 21, 22

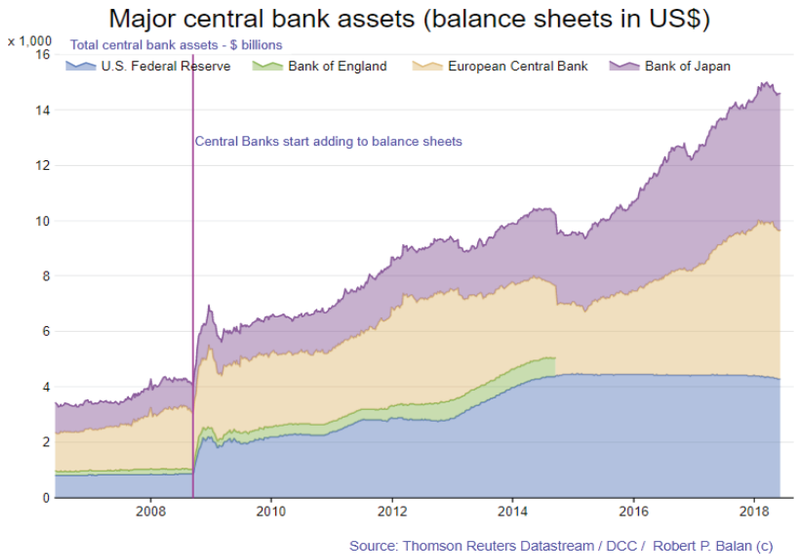
Our scenario on equities is still positive until the early/mid Summer, yet we believe this further leg up is probably the last one before an important top is made on risk assets **towards mid July/August. We will hence remain underweight all defensive themes until the**n (in the table above: REITS and Goldmines) **and continue to favor pro-cyclical ones** (e.g. Diversified Mining). We have also neutralized the Nasdaq vs the S&P500, which could still outperform slightly longer, yet for which the risk/reward vs the S&P500 is starting to look quite extended.

Given that we expect the US Dollar to push slightly higher into mid July, perhaps early August, **we will also underweight all themes negatively correlated to USD strength** such as US Big Caps (DJ Industrial), European and Japanese Small Caps, and areas that may be related to any further Euro weakness (Southern Europe).

Looking into late Summer and the Fall, our Themes & Factors allocation will turn much more defensive as we expect most Equity markets to be topping out for this cycle.

# 12 / Systemic Monetary Liquidity: A Top-Down Look To Understand Where We Came From, Where We're Going

**At The Capital Observer, we look at the liquidity being issued or being absorbed back by global central banks, the Federal Reserve and the US Treasury (real monetary balances flows), and model the manner those systemic liquidity flows impact asset prices**. Our experience in working with systemic liquidity flows stretches back almost 20 years, showing us valuable perspectives in how the interaction of liquidity coming from various sources provide nuances that may sometimes appear counter-intuitive relative to conventional wisdom accepted in the financial markets.



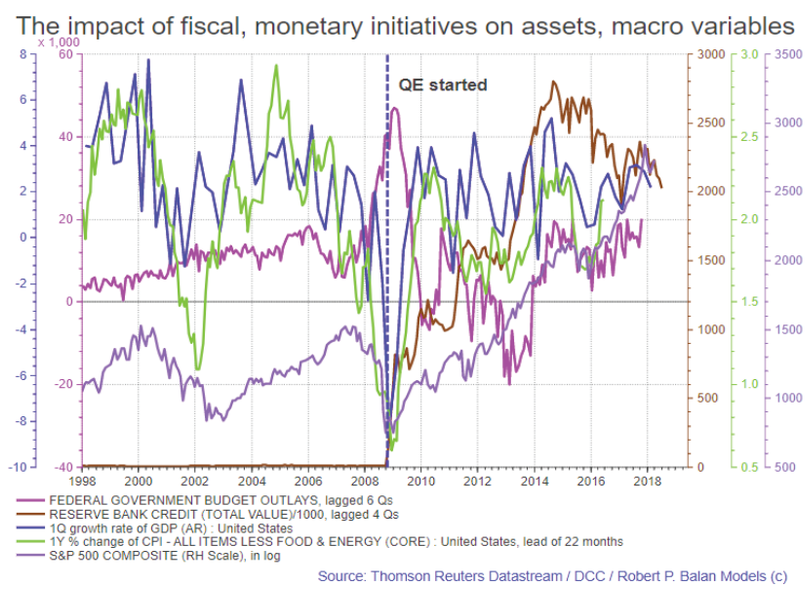

**This is where it starts:**

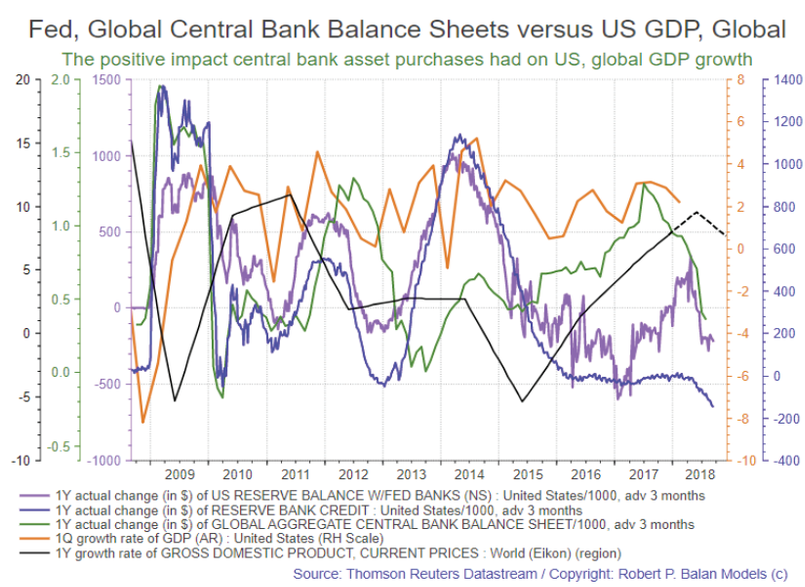
**The grand-daddy of systemic liquidity is, of course, the aggregate stimulus provided by the leading global central banks (the Federal Reserve, European Central Bank, Bank of Japan, People's Bank of China, and Swiss National Bank)**. Their aggregate balance sheets have been feeding economies and financial markets since late 2008 (*see 1st graph on this page*).

After the US Federal Reserve launched its Quantitative Easing programs in November 2008, major global central banks followed suit. The volume of the global bank reserves generated by those large-scale asset procurements were so large that for all intents and purposes those reserves have become the global Monetary Base (MB) of the central banks. **The aggregate global Monetary Base has been credited with pushing up the valuation of equity and other asset markets around the world. We also credit the aggregate global MB for uplifting US and global growth.**

The conventional wisdom being foisted by some academics is that the global monetary stimulus from the central banks' large-scale asset procurement did wonders for financial markets but did little or nothing to

**Systemic liquidity's impact on US GDP growth**



improve domestic economies, or for that matter, world GDP growth. **That is actually a misrepresentation of the positive impact those large-scale asset purchases have on the US and the global economy, which was extensive** (*see graphs on previous page, and 1st graph on this page*).

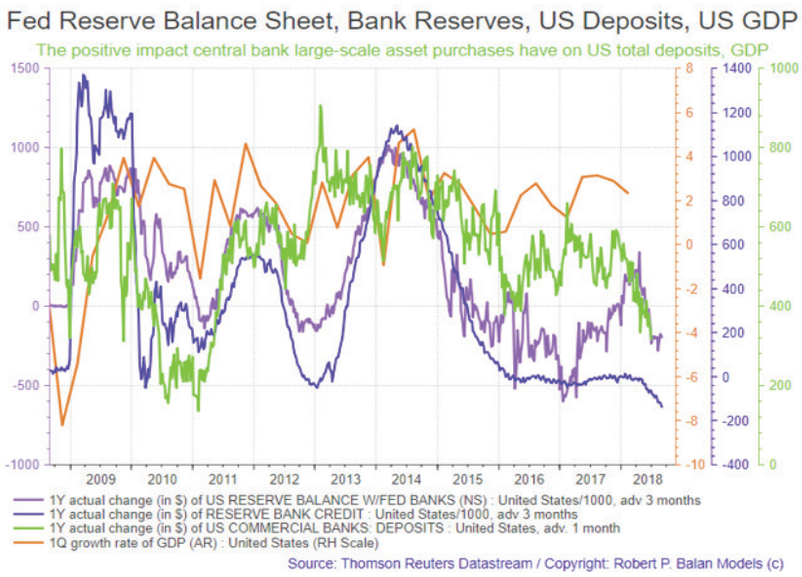
As these central bank balance sheets have subsumed global Monetary Bases, these vectors have become important drivers of economic growth, through linkages with growth in bank loans and investments (*see last graph on previous page*).

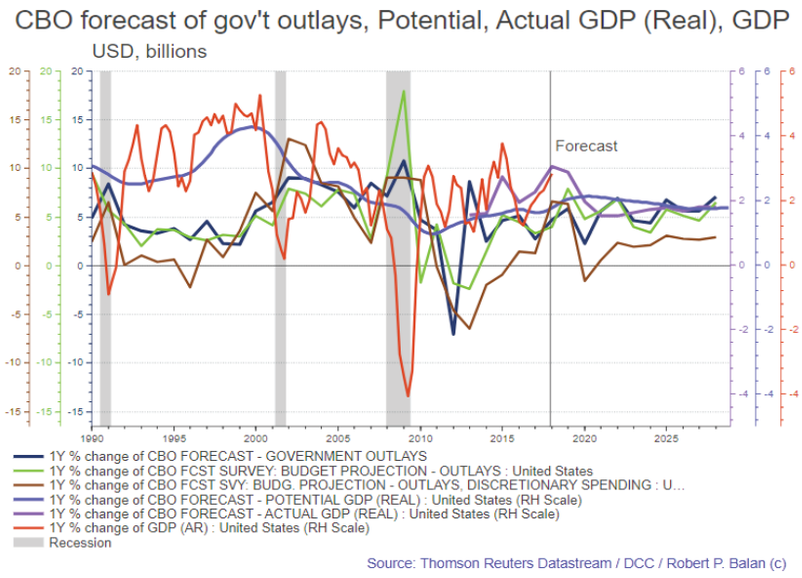
**US GDP growth is very sensitive to the fluctuations of the flows of the Fed's Balance Sheet, Total Bank Reserves at the Fed, and Total US Deposits**. And the growth of bank deposits (loans + investments = deposits, not the other way around), can be largely accounted for by the expansion or contraction of Federal Reserve bank credit. The Fed's balance sheet and aggregate bank reserves at the Fed lead Total US Deposits (loans + investment) by 2 months (*see 1st graph on this page*).

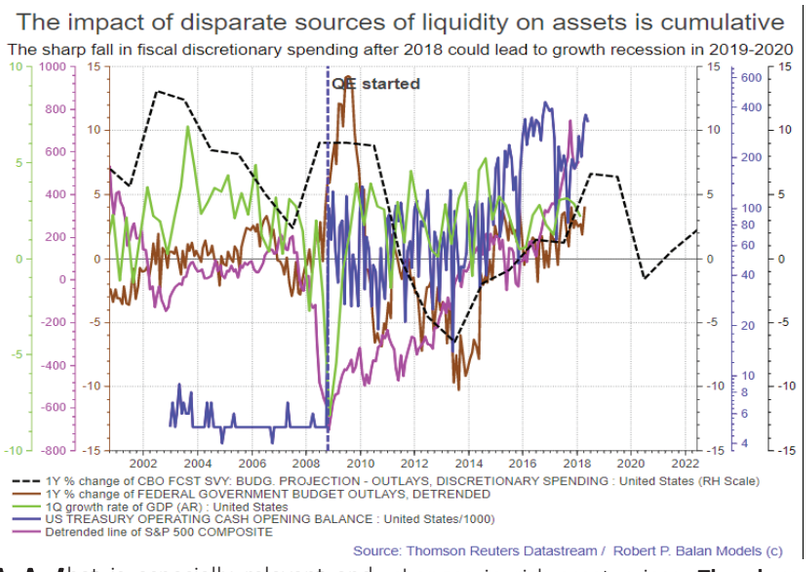
Providing ill portents, deposits have been plunging since November 2017 -- the bill will soon come due. Liquidity flows from these vectors have been leading changes in US growth by a quarter. And the sharp decline in global Monetary Base since March last year does not bode well for continued uptrend in US GDP growth (*see 1st graph on this page*).

**Systemic liquidity from fiscal expenditures:**

**We have been working on this thread for some time, as part of our long-term "scan" of systemic liquidity - the very long-term variety. That's why we were intrigued by the latest forecasts of the US Congressional Budget Office (CBO)**. The CBO laid in detail the dynamics that could lead to a sharp growth slowdown as from late 2018 to 2020. (*see 2nd graph on this page*)




What is especially relevant and telling in our opinion is the sharp decline in fiscal discretionary spending from late 2018 to 2020 (*see last graph on this page*). It resonates with us because the changes in this data lead the changes in GDP and the changes in risk asset prices. **The sharp fall in fiscal discretionary spending after 2018, along with the expiration of tax relief by late 2018, could lead to growth recession in 2019-2020. That could bring down the price of risk assets**.

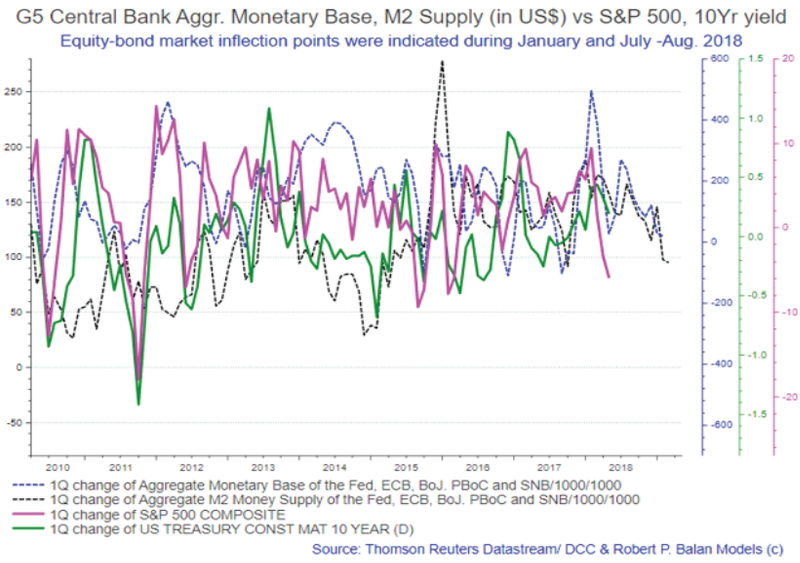
A monetary policy tightening in the entirety of 2018, and fiscal consolidation by late 2018, extending into 2019-2020, are scary prospects, as they would be happening at the same time. The withdrawal of systemic liquidity from those policy actions will have adverse consequences on risk assets. Nonetheless, there is still time to benefit from the recent upwelling of growth worldwide as the spill-over effects would still flow into risk assets over the next 2 quarters.

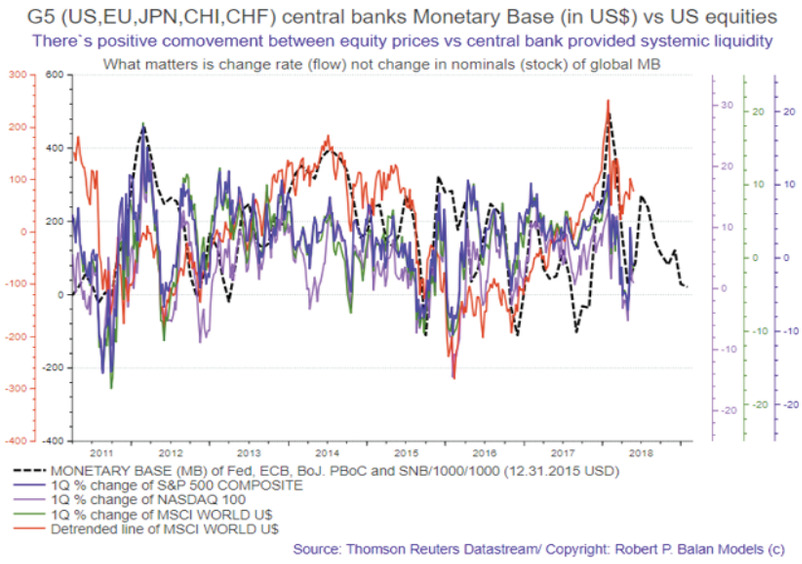
**Systemic liquidity's impact on financial markets:**

After the US Federal Reserve launched its Quantitative Easing programs, major global central banks followed suit. The volume of the global bank reserves generated by those large-scale asset procurements were so large that for all intents and purposes those reserves have become the Monetary Base of the central banks of the US, the EU, Japan, China and the Switzerland. **The aggregate global central bank balance sheet has been credited with pushing up the valuation of equity and other asset markets around the world**.

**The impact of those aggregate global reserves on financial assets was enormous**. During the time global central banks were adding to their balance sheets, financial assets have become beholden to the flow of that global aggregate systemic liquidity. The prices of financial assets have risen as the flow of the aggregate Monetary Base rose, and opposite is also true. This is especially true of the US stock market and US bond markets (*see 1st graph on this page*).

In the 1st graph provided above, for 2018, the flows peaked in January, which coincided with the peak in the S&P 500 Composite, and in the 10-year US Treasury Bond Yield. **There is another peak in the liquidity flow being shown in July – August, this year. We therefore expect financial assets, especially equities, to make significant peaks at that time** (*see 2nd graph on this page*).




**To some extent, that inflow of liquidity is still flowing in, especially from the European Central Bank, the Bank of Japan, and to a more limited extent, the Swiss National Bank.**

There is a long, distributed lag between those liquidity flows and its direct impact on the financial assets, which is usually from 11 to 12 months long. Put another way, the systemic liquidity flows in these aggregates today will show their maximum impact on the prices of asset prices 11 to 12 months from now.

We have added the aggregate M2 money supply of the 5 central banks (in terms of US Dollars) as a control variable and is also lagged 12 months. The global aggregate M2 money supply control variable tends to peak or bottom in concert with the global Monetary Base aggregate. This system of having control variables is a very important part in making sure that we are not looking at spurious correlations. Having two different aggregates in the same monetary set confirming each other's move provides a reasonable check and balance on any conclusions we will make.

**This is how this tool is used in a trading environment:**

As explained in the April 2018 edition of the Capital Observer, in our experience, the most reliable correlations (relatively speaking) can be found between the causality from monetary flows (changes in systemic liquidity) to subsequent changes in asset prices. That's why we rate this tool with high confidence to be used to help for the timing of investment -- from stimuli to peak impact on the price.

In that April 2018 Capital Observer article (April 13, 2018), we showed the impact that systemic liquidity can have on the price structure of many key assets. We provided general descriptions of expected market action over the next few weeks and months based on liquidity developments from the US Treasury and the Federal Reserve. Specifically, we said: "Expect a small recovery, probably for a week - a significant decline follows thereafter. But we should see a cyclic low sometime in late April-early May, followed by a new upside phase of the bull market."

**The US equity markets bottomed in May 3, 2018:**

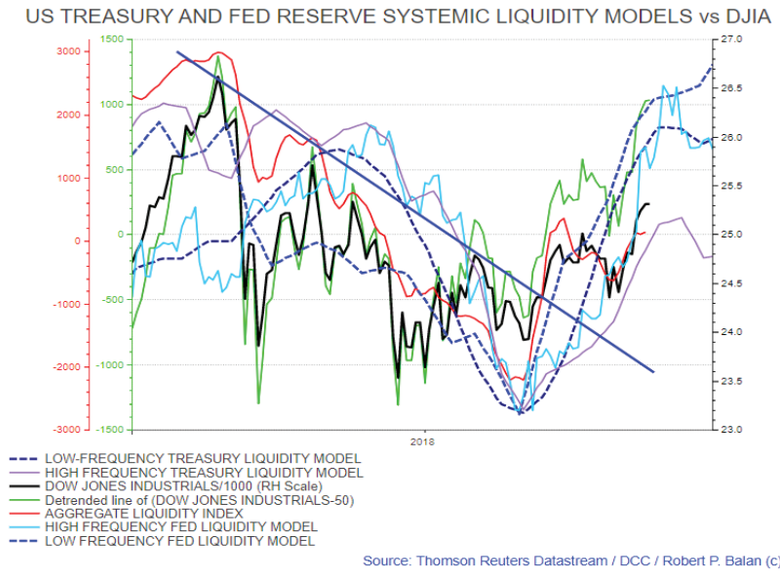
For bond yields, we said: "Expect a further decline for a week – an uptick in yield follows thereafter. But we should see a cyclic high sometime in July, followed by another downtick in yields (*see 1st & 2nd graph on this page*).

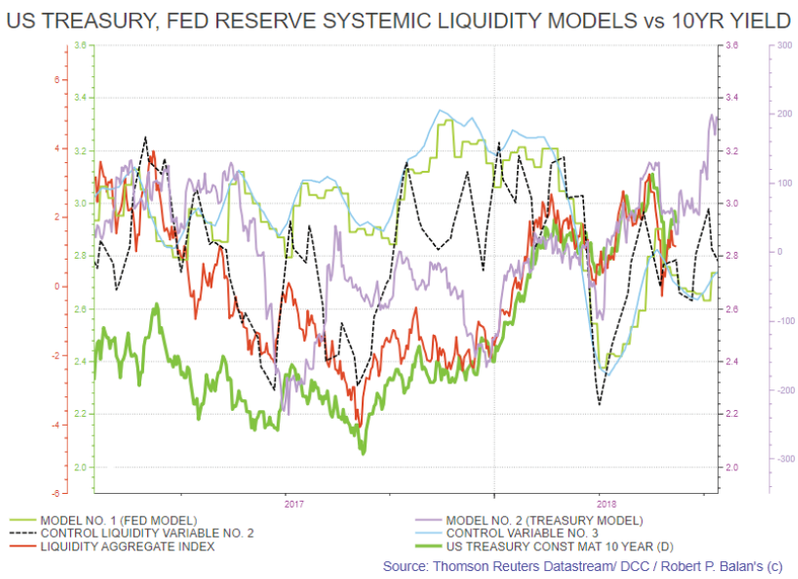
Very often, it is the change rate in the nominal values (flows), not the absolute changes in nominal value (the stock), which makes the most impact. Note, however, that the response of asset prices to the impact of those flows is variable; some assets respond more quickly to the flows; for other assets, the impact of those flows come later.

Nonetheless, despite the variance in response, the individual distributed lag between macro stimulus and the point of maximum impact it has on a specific asset price can be very consistent over long periods. This provides the usefulness of these tools -- the liquidity flows become the leading directional indicator of risk assets.

**Summary:**

So now, we have a general understanding of what has driven the markets in the past. **We also now understand that a change in the systemic liquidity flows which is being provided by the large global central banks today will show its maximum impact 11 to 12 months in asset prices thereafter.**




Although the Federal Reserve has stopped providing Monetary Base liquidity via its balance sheet, the European Central Bank and the Bank of Japan are still providing global systemic liquidity and will likely do so until late in the year.

Nonetheless, we now also understand that this resource is winding down, and in fact, after a favourable uplift into July and August, the flows start to die down, and that will have adverse results on the prices of financial assets going into Q4 2018.

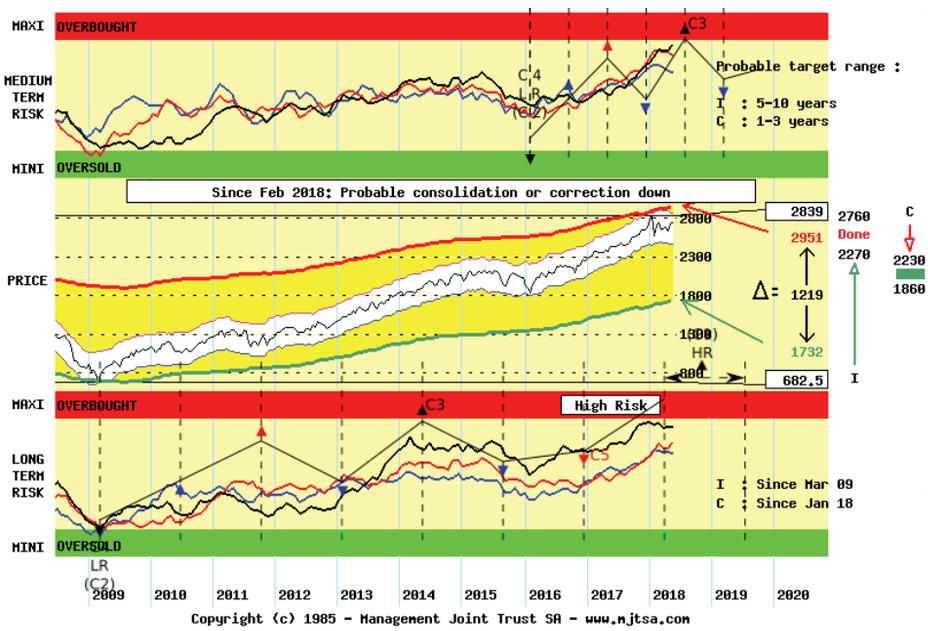
**Nonetheless, the next few months are still good time for risk assets but an exit strategy/defensive strategy should be prepared- we may be looking at this period with fond memories during the more negative 2019-2020 period. Take advantage of the run up into Q3 when the tax exemptions are at their maximum. But do not overstay - take profits. It is not the time for passive buy and hold strategies on risk assets anymore**. We will discuss these issues again as time to exit the risk asset markets approaches. The economy is also at risk if the Fed follows through on its rate hike regime of two, possibly three more, this year. This is a theme that has been thoroughly discussed in previous issues of the Capital Observer, so there's no further need to go into more detail at this time. **But it just shows that the economy and the financial markets are facing a triple whammy after Q3 this year.**

# 16 / MJT - TIMING AND TACTICAL INSIGHT

## Into the last stages of the Equity Bull market

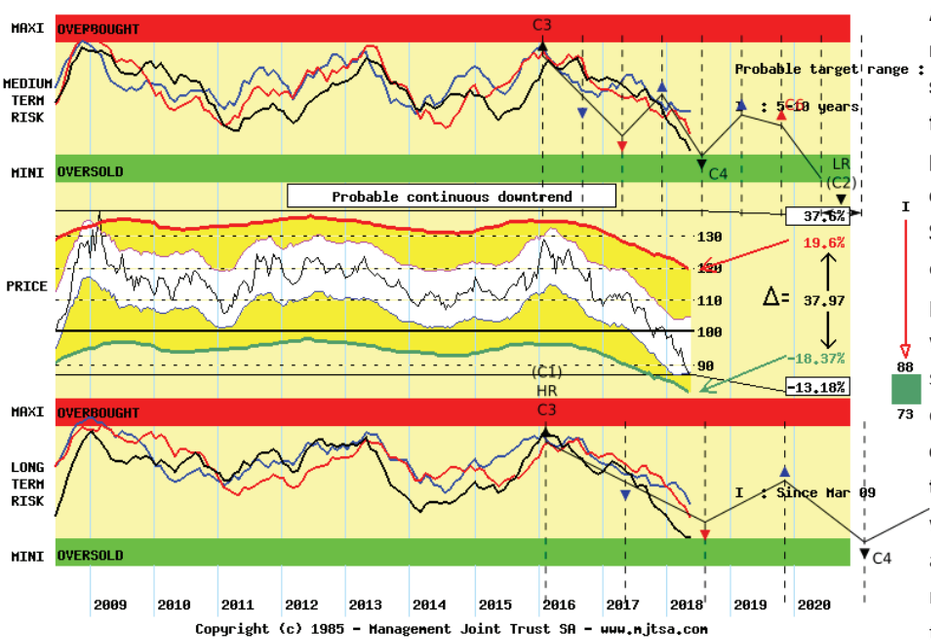
**Our regular readers will know that we are not "perma-bears", and that, in fact, since early 2016, we've being bullish on equity markets. That said, over the last 2 years, we reiterated many times that we expected the current equity bull market to end at some time during the Spring or the Summer of 2018. Today, we have entered this precise time period, and we still expect equity markets to top out and gradually start to reverse lower. In this article, we look at several equity indexes to confirm this view and refine its timing.**

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



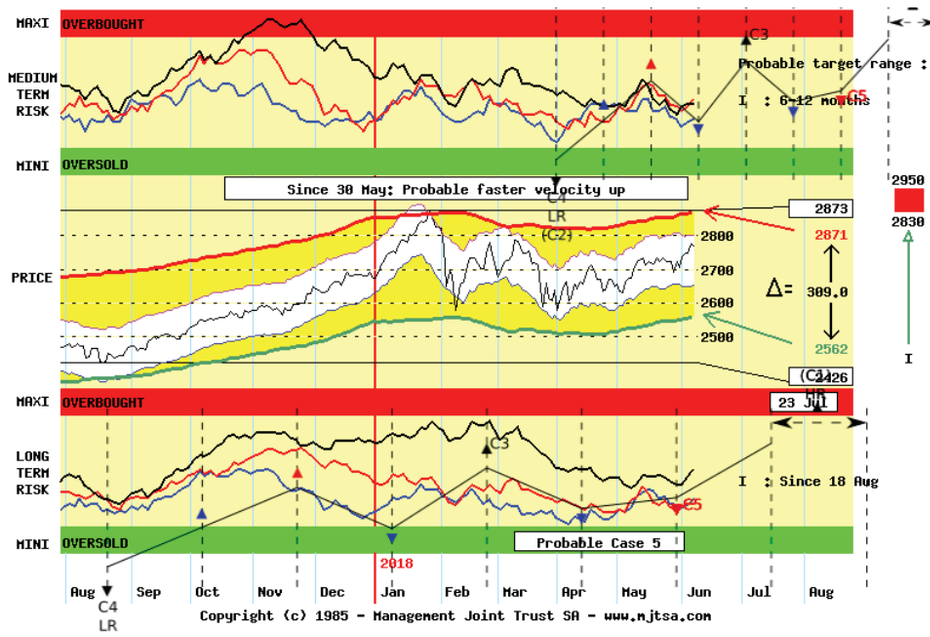

This long term graph of the S&P500 is still in an uptrend. Yet, on our long term oscillator series (lower rectangle), it has reached the end zone of our uptrend model, while our automatic messaging is already signaling a "High Risk" situation. Our medium term oscillators (upper rectangle) offer a bit more precision: **the current uptrend sequence should potentially end during this Summer and then start correcting down into 2019**. Risk/Reward is stretched, the S&P500 has reached, and slightly surpassed, the upper end of our I Impulsive targets to the upside in the high 2'700s, while **the downside C Corrective potential is towards the 2'230 – 1'860 range or 20 to 35% lower than today. We believe that such a correction could materialize over the 12 to 18 months.**

## XLP - Consumer Staples Select Sector SPDR Fund / S&P 500 Index
## Bi-monthly graph or the perspective over the next 1 to 2 years



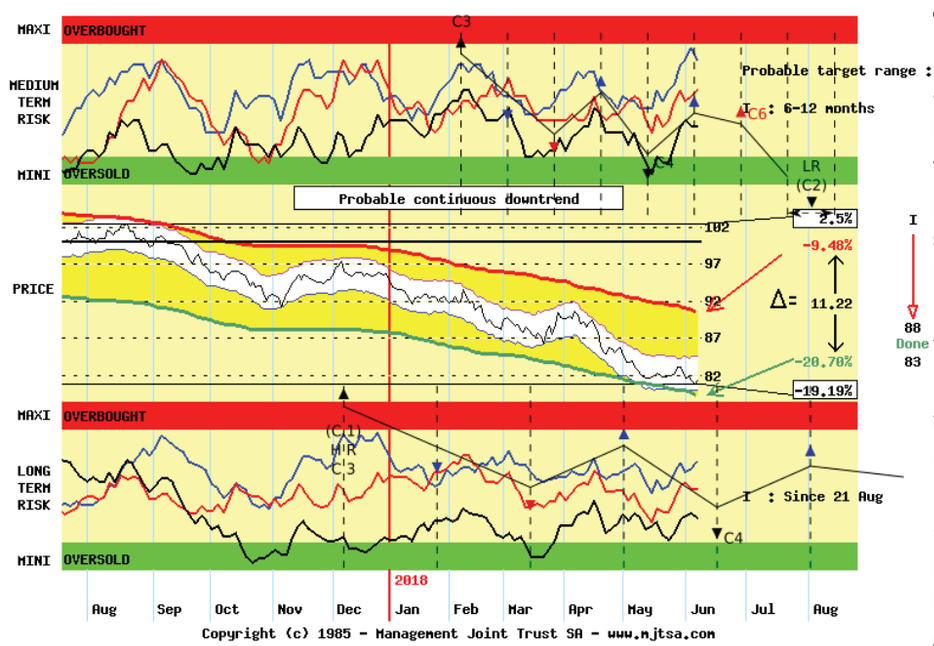

As **equity markets start to correct lower, Defensive profiles should reverse up. This is effectively what we are anticipating on this long term graph of the US Staples sector vs the S&P500 Index**. On both our oscillator series (lower and upper rectangle), the downtrend, which has been quite linear since early 2016, is approaching **an important low, which could materialize sometime this Summer.** Following that, we would expect between 3 and 5 quarters of upside correction, as Staples outperform the S&P500 index during the equity market correction phase we expect. In terms of levels, our I Impulsive targets to the downside (right-hand scale) are still showing some downside risk until the downtrend is exhausted. Hence, it may be worth waiting until this Summer, i.e. until this reversal is effectively confirmed, to enter the trade.

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



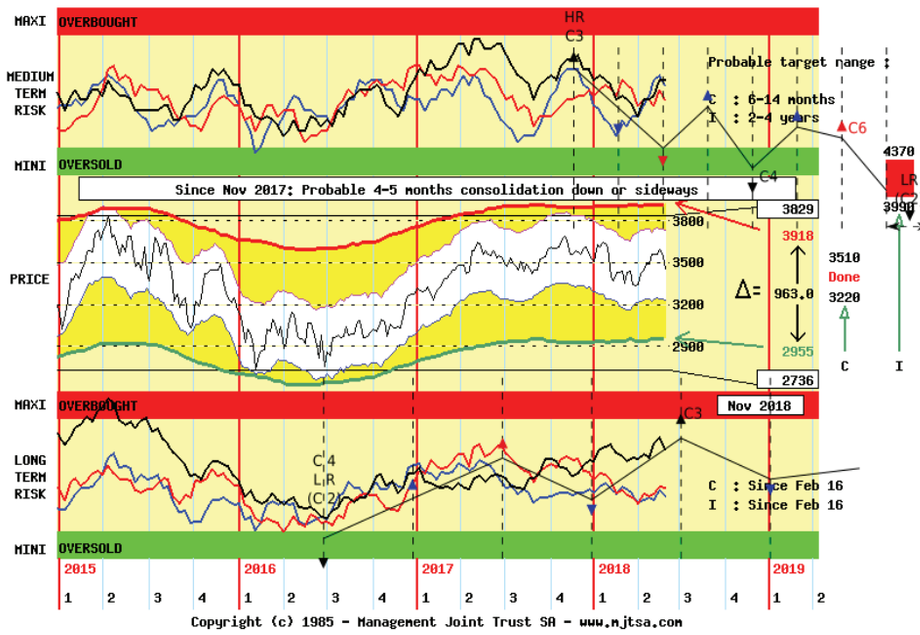

Scoping into the Daily graph, for a more precise analysis over the next few months, we would confirm our automatic messaging, which is calling **for a last acceleration to the upside into mid/late July** (into mid July, potentially mid August according to the model we show on our long term oscillator series; lower rectangle). Our medium term oscillators (upper rectangle), would suggest that the S&P500 first moves up into early July, and then eventually make a last attempt to the upside into late Summer. Our I Impulsive targets to the upside (right-hand scale) indicate **that the current uptrend could top out in the 2'830 – 2'950 and will hence potentially make new all time highs.**

## XLP - Consumer Staples Select Sector SPDR Fund / S&P 500 Index
## Daily graph or the perspective over the next 2 to 3 months



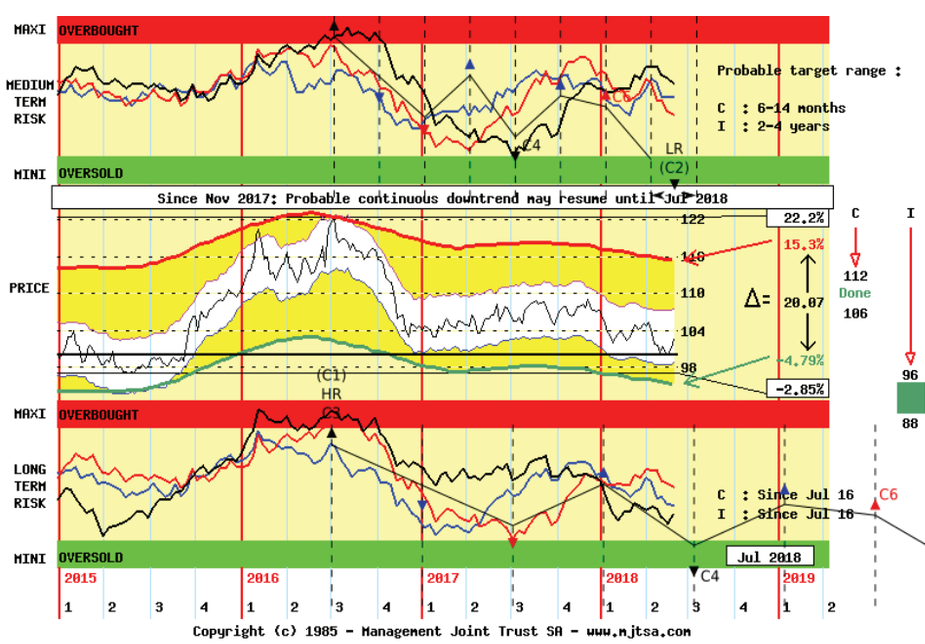

**The downtrend on Staples vs the S&P500 Index already seems quite exhausted on this shorter term time frame. Indeed, our I impulsive targets to the downside (right-hand scale) have been reached**, and the ratio has even moved below these. Timing is tentative has the downtrends on both oscillator series (lower and upper rectangles) are already quite mature. We would probably expect the actual **reversal point to happen at some point between late June and early August.**

## EuroStoxx 50 Index
## Weekly graph or the perspective over the next 2 to 4 quarters



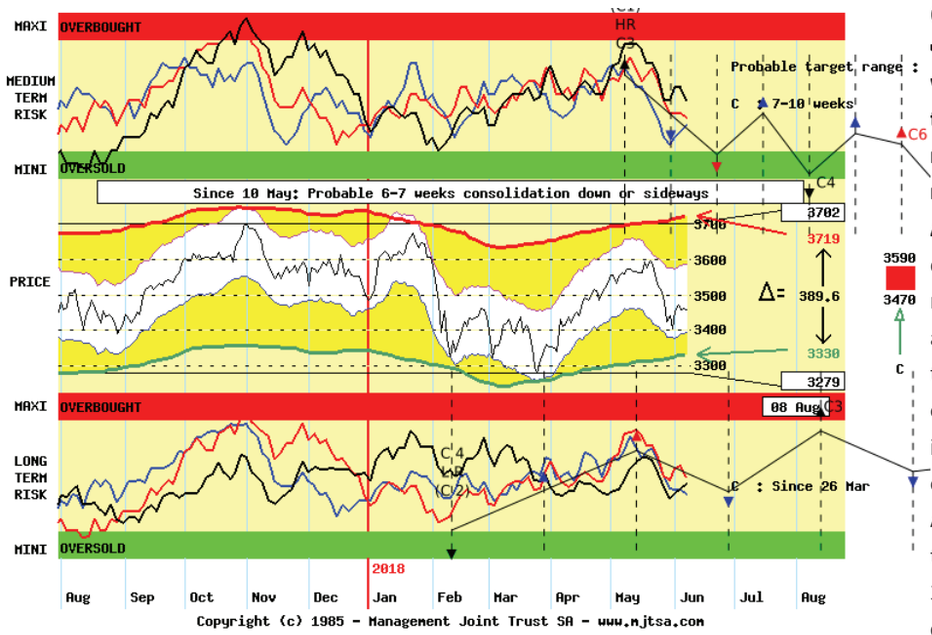

In Europe, the uptrend sequence since early 2016 has been more choppy. Several distinct uptrend sequences are underway and our automatic messaging (lower rectangle) even indicates that a top could materialize as late as November. That said, the sequence we show on our long term oscillators (lower rectangle) seems the clearest. It indicates that the **EuroStoxx 50 should start to move lower during this Summer, possibly until year-end in first instance**. The sequence we show on our medium term oscillators (upper rectangle) would confirm this view with an upside retest into mid Summer and then a sell-off into late Q4 2018. Hence, in terms of targets, our I impulsive targets to the upside between 3'990 – 4'370 (right-hand scale) do seem aggressive for now.

## Food & Beverage Sector- Dow Jones STOXX 600 / Dow Jones Europe STOXX 600 Index
## Weekly graph or the perspective over the next 2 to 4 quarters



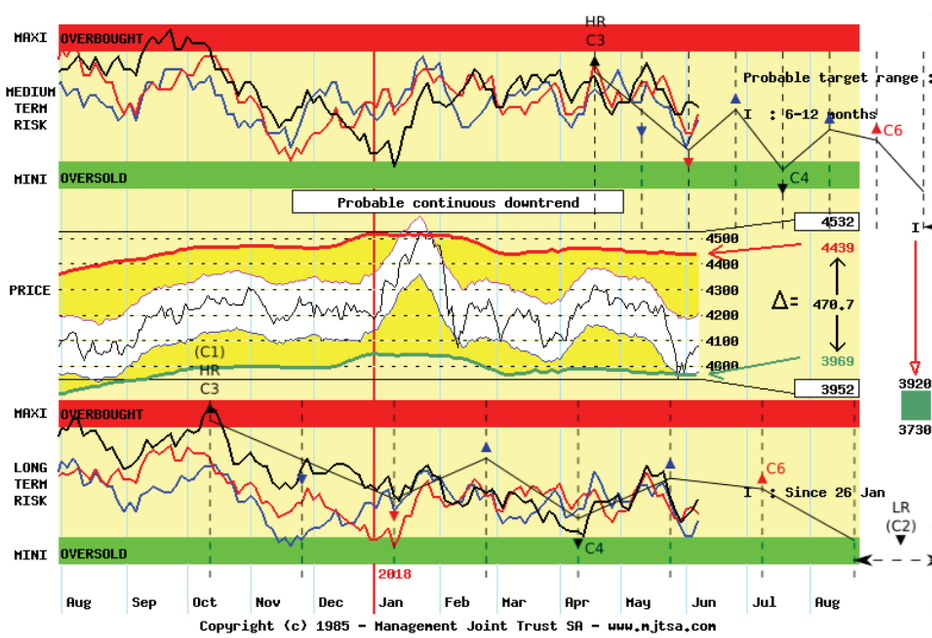

We hereby also consider defensive profiles in Europe vs their reference index by choosing to **compare the European Food & Beverage sector with the Dow Jones Europe Stoxx 600 Index**. On both oscillator series (lower and upper rectangles), **this ratio should be bottoming out at some point this Summer and could start reversing up into early 2019 in first instance**. Our I Impulsive targets to the downside (right-hand scale) indicate that it may be worth waiting for these lows to be confirmed before acting, as they could still be some downside potential left for this ratio over the next couple of months.

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



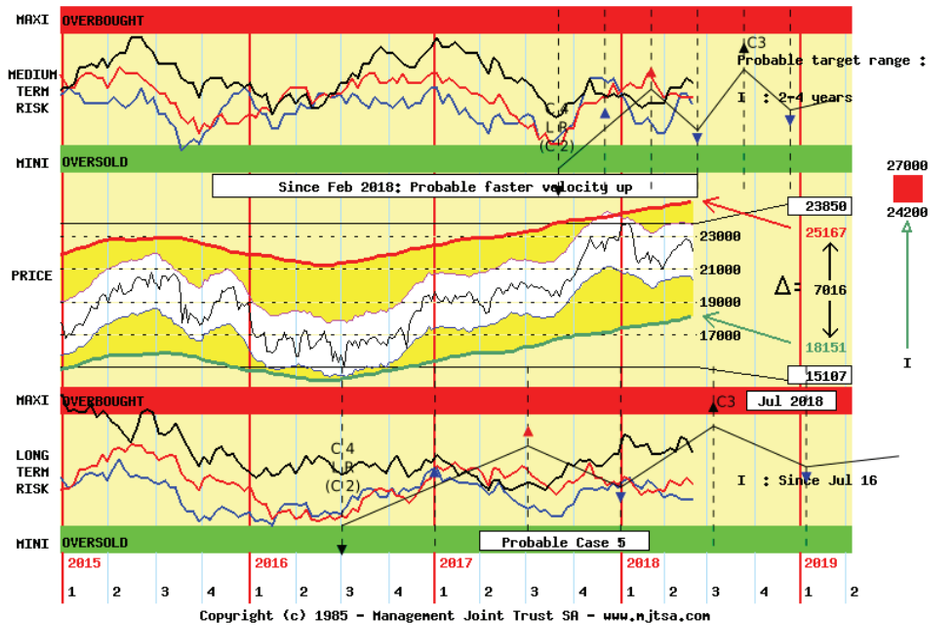

**Shorter term and continuing to focus on Europe, we would expect that the EuroStoxx 50 finds support towards mid/late June and attempts a move up into mid July/early August**. Indeed, while our medium term oscillators (upper rectangle) are suggesting only a short bounce until mid July, the sequence on our long term oscillators (lower rectangle) is more aggressive, probably extending up into early August. A move above our C Corrective targets to the upside (above 3'590; right-hand scale) would confirm this more bullish view. Yet, until then, these levels around 3'600 will probably provide strong resistance to any upside move.

## EuroStoxx 50 in USD
## Daily graph or the perspective over the next 2 to 3 months



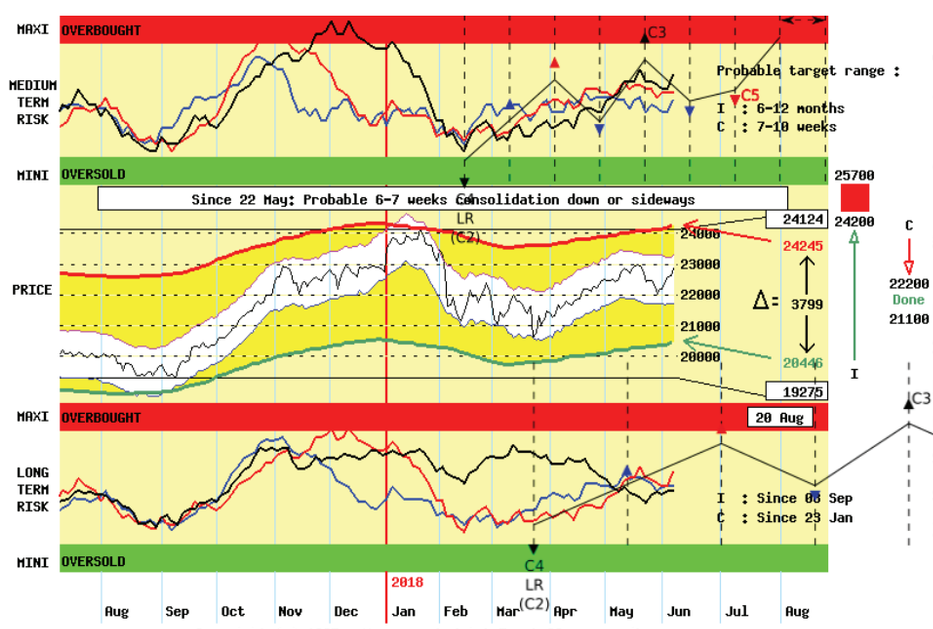

This graph would confirm that any bounce for the EuroStoxx 50 over the next couple of months will probably be nominal, i.e. mostly due to further Euro weakness. Indeed, we show here the EuroStoxx 50 denominated in US Dollars. The sequences on both oscillators series (lower and upper rectangles) would suggest **that any rebound for the EuroStoxx 50 in USD should remain quite limited in time and scope and that in general the recent downtrend started in January should continue lower. I Impulsive targets to the downside /(right-hand scale) would suggest 5 to 10% of downside potential for the EuroStoxx 50 in US Dollars over the next few months.**

## Nikkei 225 Index
## Weekly graph or the perspective over the next 2 to 4 quarters



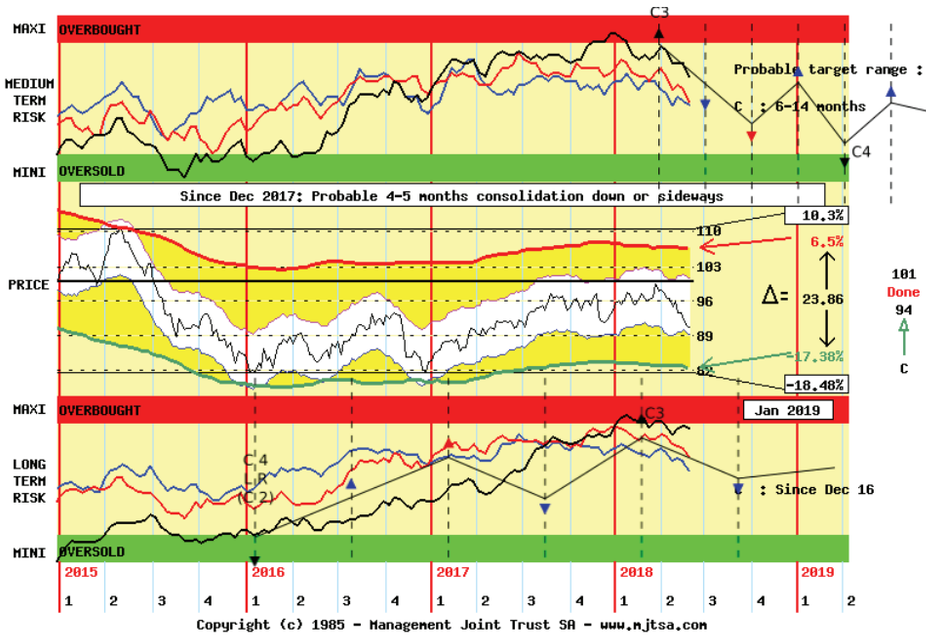

In Japan, several uptrend sequences are also underway on the Nikkei 225 Index. Both our oscillators series (lower and upper rectangles) suggest that these should top-out sometimes between early Q3 (lower rectangle) and late Q3 (upper rectangle). We would expect the correction to the downside that follows to last into year-end /early next year in first instance. According to our I impulsive targets to the upside (right-hand scale) and considering our scenario,which is still bullish, over the next couple of months, **we may see new highs in the 24'200 – 27'000 range during the Summer**. Over the next couple of months, the Nikkei 225 should also be supported by the further rise we expect in the US Dollar.

## Nikkei 225 Index
## Daily graph or the perspective over the next 2 to 3 months



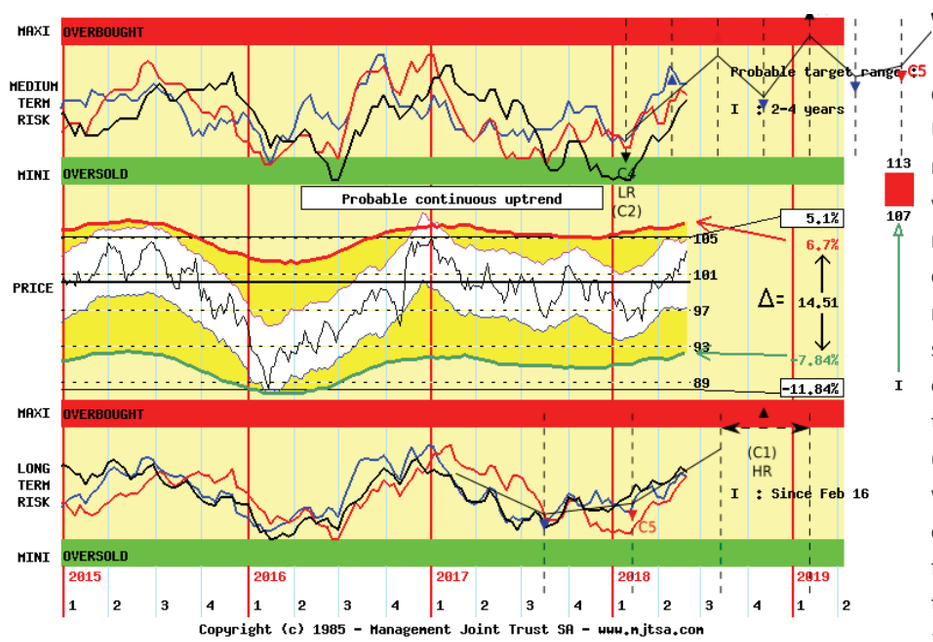

Shorter term, the Nikkei 225, seems to be uptrending again on both oscillator series, possibly into early July on our long term oscillator series (lower rectangles) and into August on our medium term oscillator series (upper rectangles). **Hence, between now and mid Summer, the Nikkei 225, will probably manage to make new highs towards its I impulsive targets range (right-hand scale) between 24'200 and 25'700.** In the meantime, we identify two important support points that would ideally need to hold, the first one towards 22'000, or the recent low made end May, and also corresponding to the upper end of our C Corrective targets to the downside (right-hand scale), the other towards 21'000, or the late March lows and corresponding to the lower end of our C Corrective targets down.

## MSCI Emerging Markets / S&P 500
## Weekly graph or the perspective over the next 2 to 4 quarters



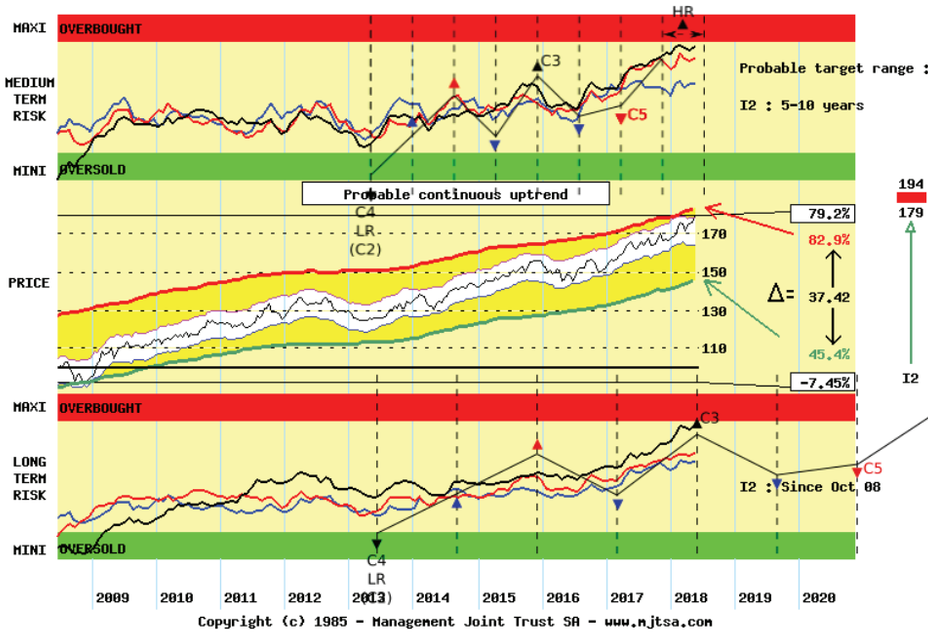

As we will review in more detail in another article in this issue of The Capital Observer, we expect the **US Dollar to resume its recent uptrend until mid Summer in first instance. This US Dollar strength should continue to weigh on Emerging Markets, especially vs the S&P500 Index**, which, as we have seen above, could also remain quite strong until mid Summer. Indeed, following two years of a weak correction up (the ratio never made it above our C Corrective targets to the upside; right-hand scale), **The ratio of Emerging Markets vs the S&P500 has probably topped out for this cycle**. On both oscillator series (lower and upper rectangles), we expect them to continue to underperform first into mid/late Summer, then again towards early 2019.

## Russell 2000 index / S&P 500
## Weekly graph or the perspective over the next 2 to 4 quarters



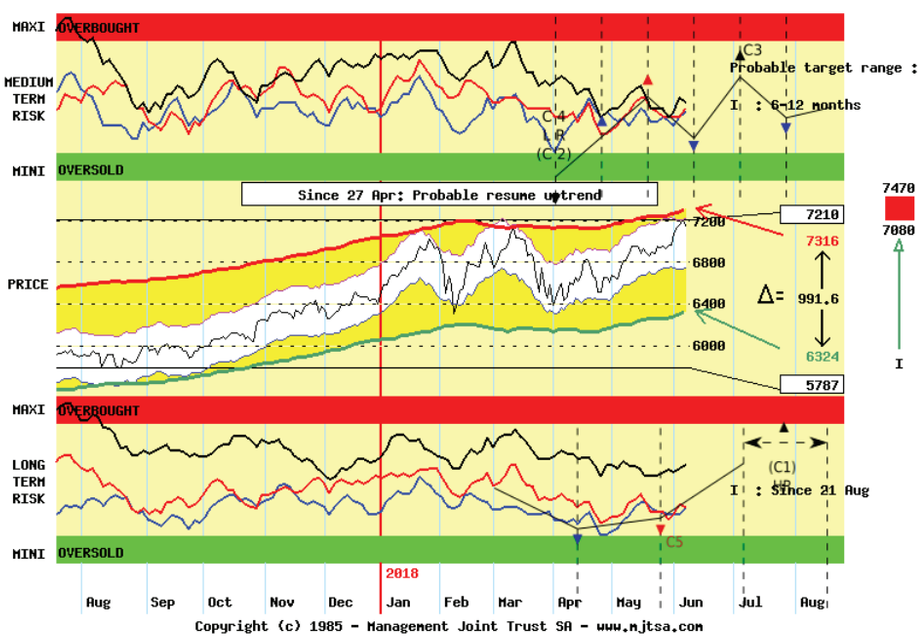

We look at the other extreme of the US Dollar correlation spectrum. Indeed, US Small Caps are usually very much domestic companies, with limited exposure to foreign earnings. They tend to outperform the rest of the market when the US Dollar strengthens. This has been the case over the last few months. Both our oscillator series (lower and upper rectangles) would suggest that this trend continues until mid Summer in first instance, and then again towards year-end and early 2019. **Our I Impulsive targets to the upside (right-hand scale) would suggest a strong outperformance potential for the Russell 2000 vs the S&P500 Index over the next few quarters (between 5 and 10%).**

## Nasdaq 100 Index / S&P500 Index
## Bi-monthly graph or the perspective over the next 1 to 2 years




We now consider a rather contrarian call in comparing the Nasdaq 100 Index vs the S&P500. What we are monitoring here is the outperformance of Growth stocks since 2009 and especially of the Big Growth Internet stocks since early 2017. Over the last 18 months indeed, every time the market has corrected, Big Growth stocks have outperformed. This trend is particularly pronounced at the moment as uptrends in Emerging Markets and Europe are starting to deteriorate and investors seek protection in these Big Growth plays, which they perceive as offering good long term prospects, while being relatively immune to any downturn in the business cycle. That said, on both oscillators series (lower and upper rectangles), the Nasdaq 100 is reaching important tops vs the S&P500, while its outperformance potential has now reached the range of our I2 Impulsive 2 extended long term targets (right-hand scale). **Hence, prospects may be good for these Big Growth stocks, but their valuations are also extended. If our scenario of a markets downturn materializes over the next 12 to 18 months, we expect Big Growth stocks to rediscover some of their High Beta features and to underperform. Such underperformance obviously happened massively following the Internet Bubble, but also to a lesser extent during 2008 financial crisis.**

## Nasdaq 100 Index
## Daily graph or the perspective for the next 2 to 3 months




Looking at shorter term prospects for the Nasdaq 100, we can note that both our oscillator series (lower and upper rectangles) are **still uptrending, probably towards July, perhaps even into early August (as with the S&P500). The risk/reward is however rather stretched.** Indeed, the Nasdaq 100 is already in the range of our I Impulsive targets to the upside (right-hand scale), could still extend towards the higher end of this range (7'470 or an additional 3 to 4%), but probably not much higher.

### Concluding remarks

**As we have been forecasting for the last couple of years, we expected an important top to materialize on equity markets between earlier this year and this Summer. It should be followed by a downside correction that could last between 12 to 18 months and amount to minus 20 to 35% of performance on the S&P500 for example. Our current analysis suggests that this important top will probably materialize between late July and early August. Anyhow, the remaining upside potential on most markets is limited. Europe and Emerging markets look particularly weak, while the Nasdaq may continue to outperform slightly longer, yet looks extended. Small caps and Japan should benefit from the stronger US Dollar we expect, at least over the next few months.**

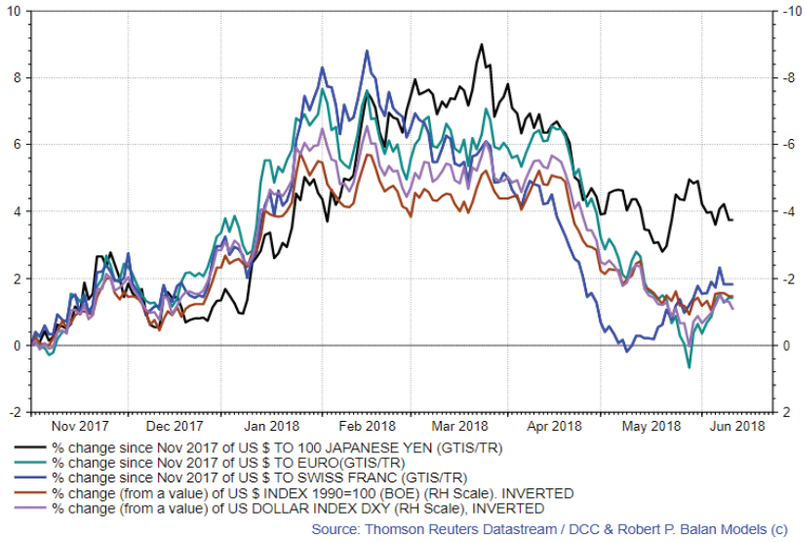
# 23 / U.S. Dollar: Forget Monetary Policy Divergence; Firming U.S. Capital Account Will Support A Rally Until Q3 2018 at least

Since April last year, the US Dollar TWI has been weak against a bevy of Developed Market (DM) currencies. It has been weakest against the euro at that time, but also had significant losses versus the Swiss Franc and JPY. It was no wonder therefore that DXY (The USD vs DM currencies) fell much further then the USD TWI did. However, since last February, the US Dollar rallied significantly against the EU and the rest of the DM. Most notably, the US dollar has been strongest on a broad trade-weighted basis and against Emerging Market (EM) currencies (especially against the Brazilian Real), and against some currencies from Eastern Europe. **The DXY made tremendous gains as DM currencies fell sharply on the greenback's reversal of fortunes (***see 1st graph on this page).*

**As early as January this year, we laid out the reasons why the US Dollar will bottom, and subsequently rally, during Q1 2018 (see "The US Dollar will be boosted by capital inflows in 2018 and should rise again – that could push the economy, markets over the tipping point", Capital Observer, January 2018).** We identified the broad reasons why the US currency should finally very soon get a reprieve:

> *Given all these factors, the recent appreciation of the EUR, which was based on perceived ECB policy tightening, was likely based on false premises. The EUR's perceived advantages should wilt under closer scrutiny, further out. Second, the response by investors to the incentives partly created by the combination of monetary and fiscal policy will soon determine the near-term course of the US Dollar and its counterparts. This is an aspect where the US is ahead of G5 countries, by a mile.*
>
> *The US Dollar could bounce in Q1, re-test down in Q2 and then accelerate up in H2 2018.*

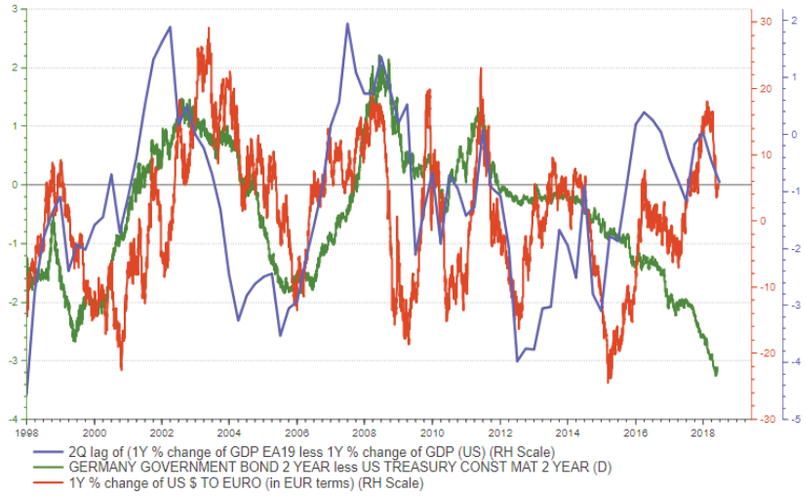
Comparative Performance of US Dollar, G4 currencies since 1 Nov 2017




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

EU-US DIFFERENCES IN GDP GROWTH RATES AND 2YR BOND YIELDS

GDP growth spread as well as the 2yr spread now favors the USD , hence EUR falls




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

Many investors ascribe the new strength of the US currency to the divergence in official monetary policies between the US and the Rest of the World (RoW). Specifically, investors point to the Fed's stance of tightening monetary policy for the rest of the year, possibly in three more tranches, as the FOMC's Summary of Economic Projections (SEP) dot plots last December indicated. This contrasts with a still easier monetary policy expected from the ECB, which may only cease its Quantitative Easing programs only at the end of the year.

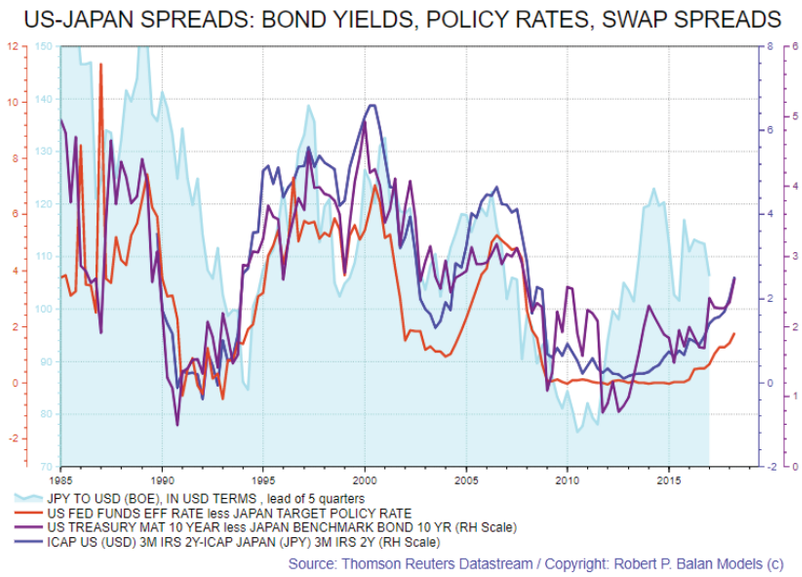
The Bank of Japan has been talking off and on about modifying its QE programs as well, with the intention of tightening policy somewhat. But with no real, consistent progress in its inflation targets, the BoJ is clearly a central bank that is adrift, policy-wise. We do not expect any significant shift by the BoJ to a tightening stance very soon.

**The US dollar is now winning the FX "beauty contest"**

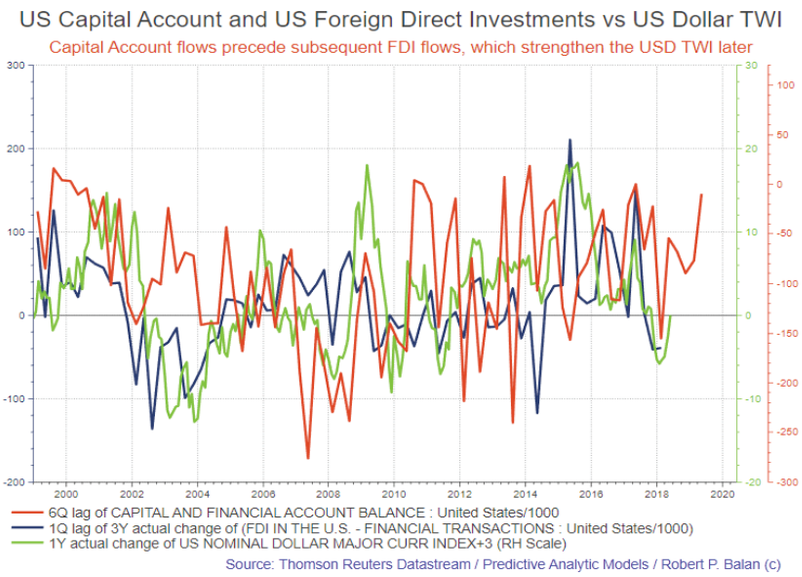
**Almost all the macro factors remain in favor of the US currency, especially those that matter in FX currency valuation. Against the EUR, the dollar's most stalwart rival, GDP growth spreads now lean favourably towards the U.S. With regards to the spread of the 2yr bond and 2yr bund (instruments closest to the official policy rates), it's almost no contest – the spread is massively in the U.S. dollar's favour** (*see 2nd graph above*)

**The very recent EUR bounce against the US Dollar has been triggered by a relief that no Italexit is likely to happen soon. But the EUR rebound is unlikely to last very long.**

**In a US-Japan comparison, the US currency is also ahead. The variance in monetary policy rates is now significantly in favour** of the US Dollar. That goes true as well for long-term bond rates and short-term market rates. These developments have helped strengthen the Dollar versus the Yen, although the Yen has firmed up in recent weeks (*see 1st chart on this page*).




Given all these, it is a wonder why almost all FX analysts (us NOT included) expected the US Dollar to resume its decline from April last year, almost in a straight line. We have compiled the reasons for the pessimism of analysts for the future trajectory of the US Dollar, and the primary underlying reasons can be traced to the analysts' dislike for President Donald Trump and his economic and trade policies. Not very sound rationales in the cold-blooded arena of Foreign Exchange, where personal sentiments can quickly turn into land-mines. This is a world that works off macro numbers; the currency which has the most plusses, wins.




**The Fed will almost certainly decide to raise policy rates by 25 basis points during the FOMC meeting this week. However counter-intuitive it may seem, the US Dollar may actually fall for a short time after policy rates are notched higher**. That has been true for most of the times that the FOMC have raised rates, and it could be happen again this time around. We do not have any explanation for this well-known market history, but it does underline the fact that it is not only spreads in interest rates that drive the valuation of the US Dollar (or any global currency for that matter). **Nonetheless, the divergence of the direction of policies between the US Fed and other major central banks, will be a major linchpin in bullish arguments looking for further US dollar strength down the road. But that is not the sole argument for our enthusiasm for the US currency. Extra support is coming from elsewhere.**

## Improving US capital account balance supports Dollar strength

**We suggest instead that the US dollar's continuing strength is, and will be, coming from the steady improvement of the US Capital Account Balance.** The capital account balance reflects net change in ownership of national assets and is one of the components of a country's Balance of Payments ledger, the other being the Current Account Balance. A surplus (or improvement) in the capital account balance means money is flowing into the country, the inbound flows represent non-resident borrowings or purchases of assets. A deficit (or deterioration) in the capital account means resident capital is flowing out of the country, in the pursuit of ownership of foreign assets. These statements are simplification of relatively intricate balance sheet operations, but they describe the flows well (*see 2nd graph above*).

Although a higher interest rate relative to those of other major central banks tends to attract funds via the capital account, which acts to raise the value of the domestic currency (USD in this case), rate differentials may not be the primary impetus for the recent

improvement of the capital account balance. For instance, anecdotal evidence of US real estate assets being attractive to external investors (the US property market is booming) have been highlighted in recent quarters. Foreigners are snapping up US residential and office building properties in increasing quantities, requiring more US Dollar denominated funds. Foreigners are also eyeing to buy ownership of smaller US technology companies (especially desired by the Chinese).

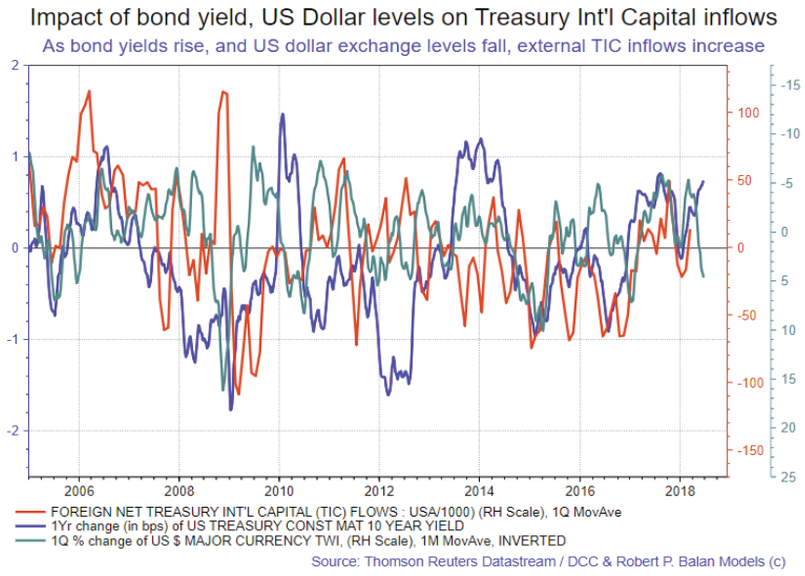
The recent rise in yields of US Treasury and agency bonds, along with the recent weakness of the US Dollar also provide some empirical evidence, via the Treasury International Capital (TIC) flows, that non-resident capital has been moving into the US fixed income markets. It is interesting to note that as bonds become cheaper in price (higher yields), and the US dollar's exchange rate declines, the cross-border TIC volume picks up. Conversely, higher bond prices (lower yields) and firmer US Dollar exchange rate tend to slow down the inflows (*see 1st graph on this page*).

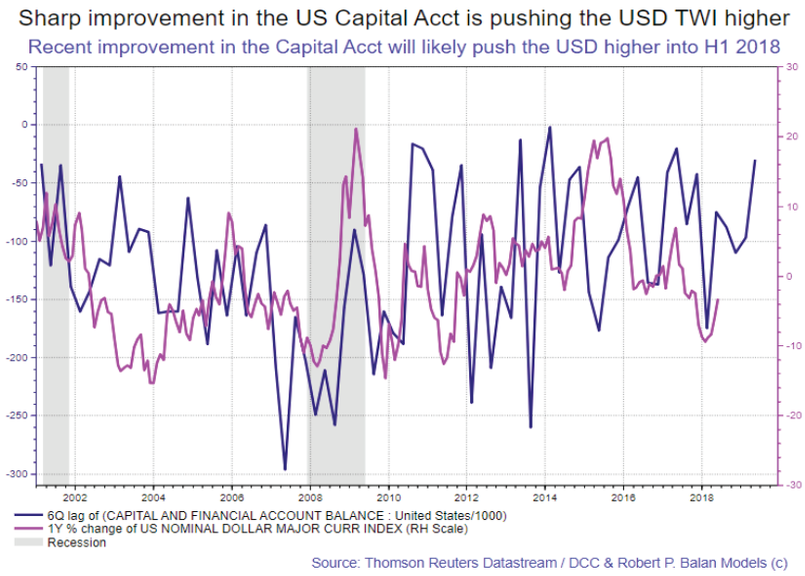
This bit of information is useful to us, as we see it as evidence that non-resident investors have been buying US assets on price dips. That was true in the fixed income market, but we can only speculate if it was also true in the equity markets.

The latest TIC data shows that inflows remain strong. There was $61,838 million worth of Treasury International Capital flowing into the United States in March, 2018. That compares to the $23,323 million worth of external capital flowing to the U.S. in December 2017.

**Changes in the US capital account balance lead USD changes by 5 to 6 quarters**

Changes in the US capital account normally show up in the valuation changes of the US currency 5 to 6 quarters later. Capital accounts improve when non-resident (external) capital inflows increase or resident (domestic) capital outflows slow. **The sharp improvement in the domestic capital account since Q3 of 2016 will therefore likely to result in further rise of the US dollar during H1 this year and perhaps early Summer, a small decline from Q3 to Q4, and then we see a rising US currency during the first half of 2019** (*see 2nd chart on this page*).



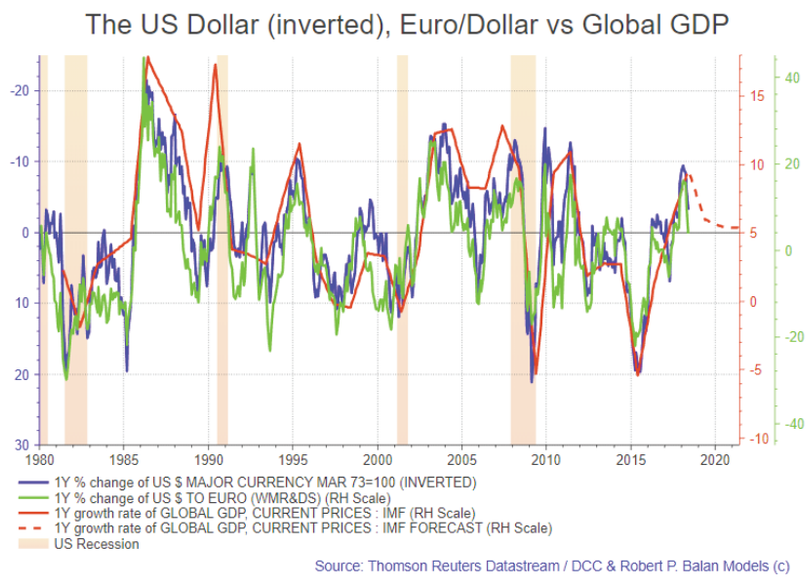
**Putting all the elements together**

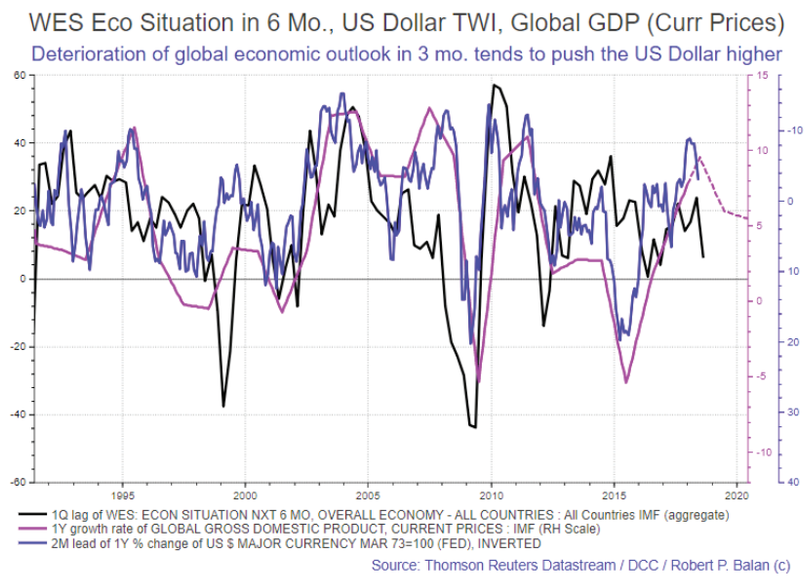
Interpretation of the balance of payment ledger could be nuanced, so it is critical to obtain evidence that the putative relationship between changes in the capital account and changes in the US dollar that we claim are indeed valid and operational at this time. We have taken the following steps:

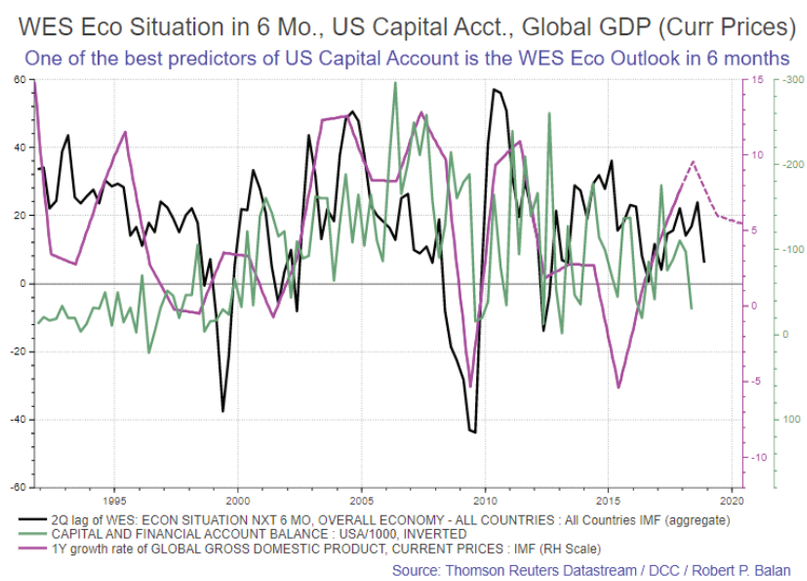
**First**, we showed the correlations between global growth, the US dollar and the EUR/USD. The relationship is positive between the euro and global GDP, and negative between the US dollar and global growth. In more direct terms, the US dollar firms up when global growth wanes, and the EUR strengthens when global growth picks up (*see 1st graph on next page*). **In effect, we want to show that there is a negative link between the US Dollar and global growth (and vice versa). And indeed, we see that in the graph.**

**Second,** we selected a survey-based leading indicator for global growth that has a long success history. We chose the IFO Institute's WES economic situation in 6 months to provide the near-term outlook. The chart below shows how changes in global GDP and changes in the US Dollar match with the twists and turns of the WES economic outlook in 6 months. And there are reasonably good matches between the changes in the variables – **3 months after a deterioration of the global economic outlook, the US Dollar strengthens** (*see 2nd graph on this page*).

**Third**, we determined whether or not the WES survey has predictive property relating to future developments of the US current account balance, and if changes in the US current account balance can be explained by broad changes in global growth. The answer is affirmative on both counts (*see 3rd graph on this page*): **the WES outlook correlates well with the US capital account, and the US capital in turn, provides a high-frequency summary of the evolving global GDP.**



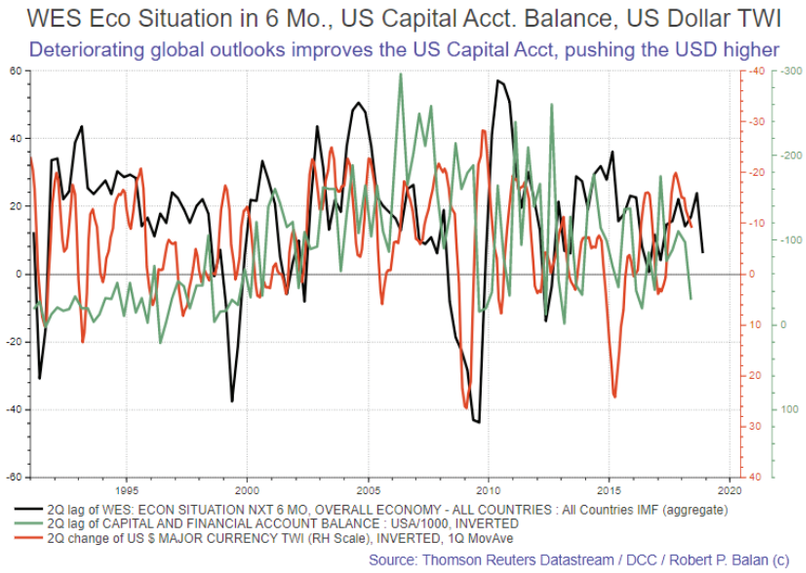



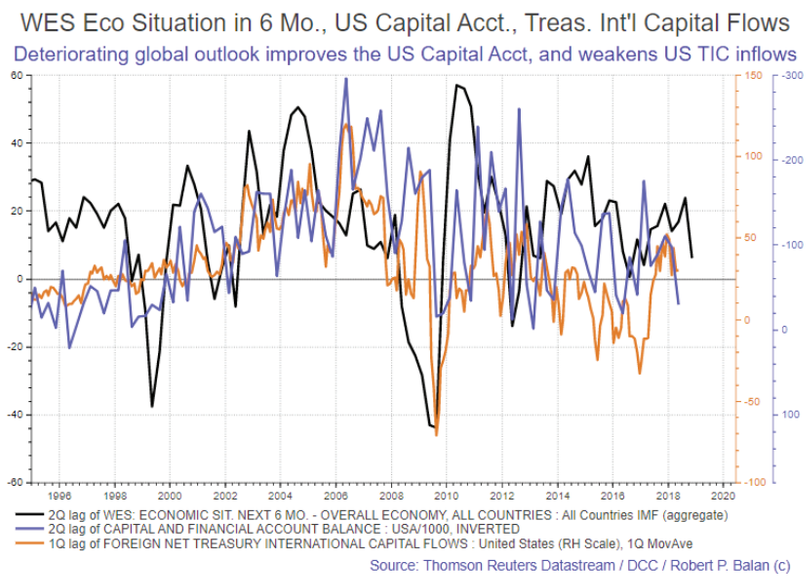
**Finally, we wanted evidence that the WES outlook and the US capital account balance can project a 6-month path for the US Dollar with some reasonably good outcomes. We are satisfied that both variables deliver what we require** (*see 1st chart on this page*).

**To square the circle**, we also decided to see if the Treasury TIC flows may have some correlation with either the US capital account balance or with the WES outlook. TIC flows correlate well with the changes in US capital account balance (as should be expected), but the TIC flow-WES outlook relationship is not as close as we expected, although the relationships is there to see (*see 2nd chart on this page*).

**Summary and conclusions:**

**The sharp improvement in the domestic capital account since Q3 of 2016 will therefore likely to result in further rise of the US dollar during H1 this year and perhaps early Summer, a small decline from Q3 to Q4, and then we see a rising US currency during the first half of 2019. That will likely hammer EM equities and other risk assets as well.**



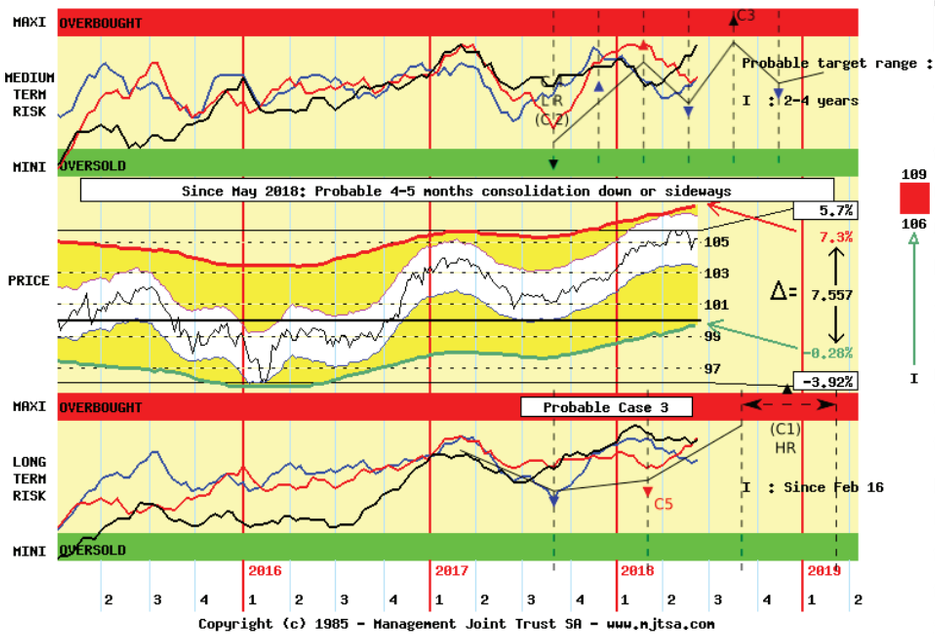



# 28 / MJT - TIMING AND TACTICAL INSIGHT

## The US Dollar is torn between residual late cycle inflation pressures in the US and an early deceleration tail-wind from Europe

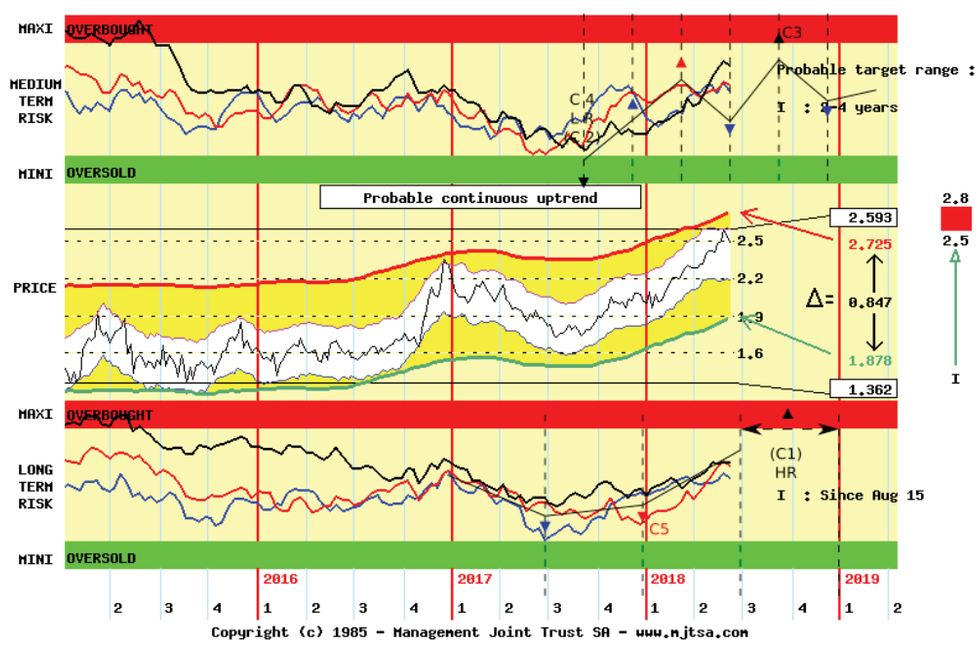
**Memories of the recent December / January inflation scare on the US Dollar are still vivid, yet gradually fading. Indeed, since mid Q1, the European Surprise Index has gone from bad to worse culminating with the climax of the recent Italian political crisis. For the rest of the year, we expect late cycle inflationary pressures on the US (Dollar negative) to continue a while longer, while the deceleration in Europe's economic and financial conditions may gradually gain momentum (Dollar positive). Both factors of influence may take turns at being the strongest. In this article, we will try to assess the timing of their relative influence on the US Dollar.**

## 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



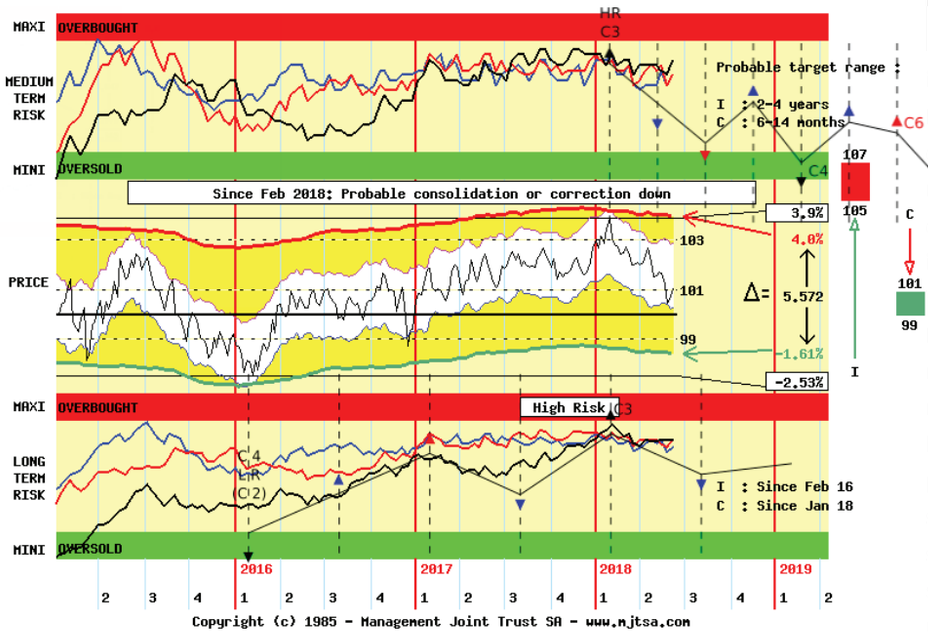

**Inflationary pressures against the Dollar culminated between last December and January as interrogations over the change of leadership at the FED met rising inflation expectations**. This quote from late January summarizes the dynamics: "Late-cycle inflation does little for the Dollar since it's priced in most of the Federal Reserve cycle … Meanwhile, the Euro recoupling with inflation expectations is a sign that market is responding to eventual policy normalization." (Toronto-Dominion Bank). According to both our oscillators series (lower and upper rectangles), inflation expectations (TIP/IEF: or the propensity for investors to switch from Treasuries into inflation protected instruments) should continue higher until mid Summer on our medium term oscillators (upper rectangle), and potentially until year-end on our long term oscillators (lower rectangle). That said, since mid Q1, the second element of the equation, the "EuroZone" recoupling story, has taken a hit (deterioration in the EuroZone economic surprise Index / the recent Italian political crisis). This second theme has dominated the EUR/USD sentiment lately.

## US 10 years - Germany 10 years Benchmark Bond Yields
## Weekly graph or the perspective over the next 2 to 4 quarters



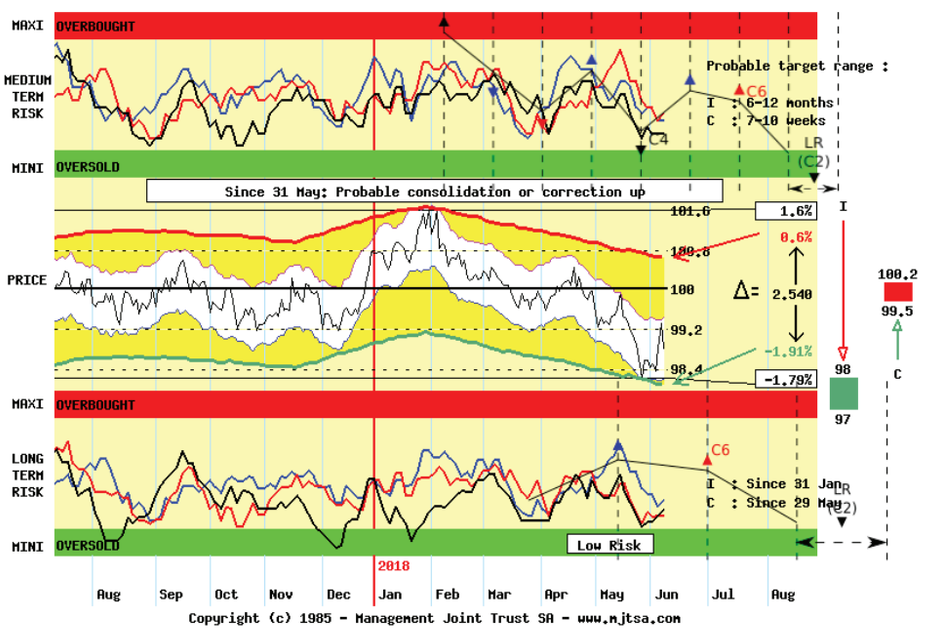

Except for the slight pause it saw in late 2017 / early 2018 (which was concomitant with the January USD sell-off and the strong acceleration up in US inflation expectations), the interest differential of the US vs the EuroZone has been rising again since the Summer of 2017. Its influence on the US Dollar has probably been positive since then (although weak at the beginning). We expect this trend to continue over the coming quarters. **Indeed, while our medium term oscillators (upper rectangle) are suggesting that the differential could top towards late Summer, our long term oscillators (lower rectangle) extend up towards year-end. These projections are very similar to the ones on the TIP/IEF graph above, which highlights the fact that their contradictory influences on the USD will be won at the margin, i.e. residual inflationary pressures in the US vs the deceleration of economic perspectives in the EuroZone.**

## TIP - iShares TIPS Bond ETF / iShares Germany REXX Gov. Bond Index 5.5-10.5yr ETF (currency hedged ratio)
## Weekly graph or the perspective over the next 2 to 4 quarters



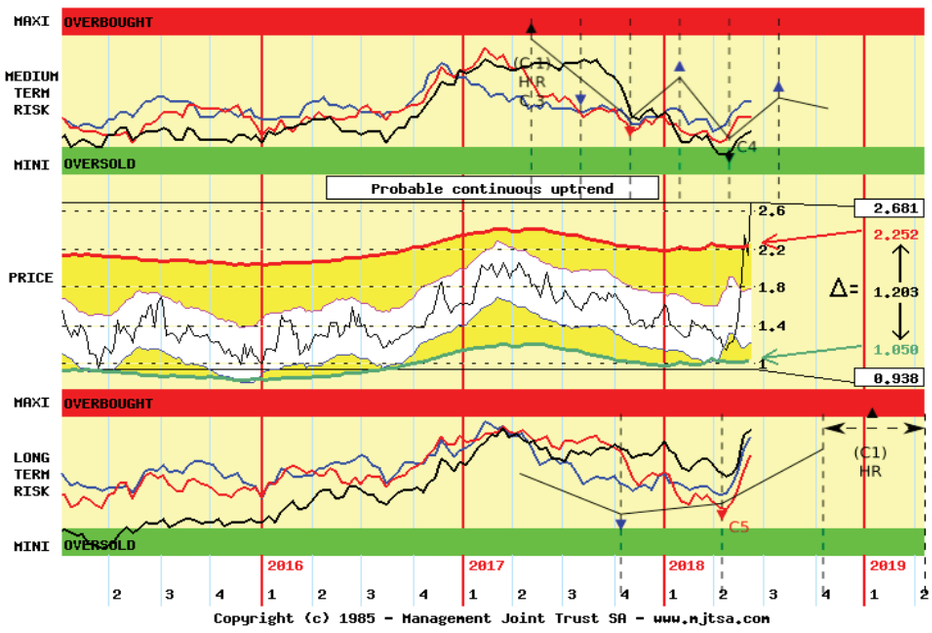

**In order to understand the relative strength of these two influence factors (rising US Inflation expectations vs the deceleration in the EuroZone re-coupling theme), we've compared both extremes in the ratios above, i.e. US Tips vs German Government Bonds, and hedged the resulting ratio for currency movements. The parallels between this ratio and periods of EUR/USD strength since early 2016 are clear to see.** On our long term oscillator series, the ratio completed its uptrend sequence started early 2016 in Q1 2018 (lower rectangle). On our medium term oscillators (upper rectangle), we project the possible path ahead considering that the ratio may have started a new downtrend sequence. **In first instance, this analysis would imply, that the EUR/USD continues lower into mid Summer, before it bounces into the Fall.**

## TIP - iShares TIPS Bond ETF / iShares Germany REXX Gov. Bond Index 5.5-10.5yr ETF (currency hedged ratio)
## Daily graph or the perspective over the next 2 to 3 months



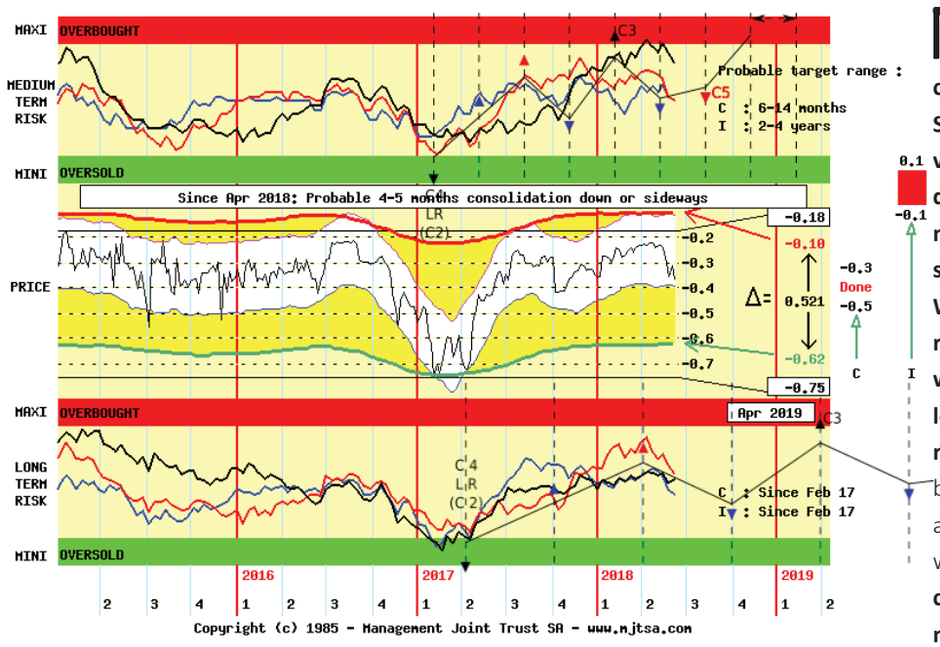

**Scoping down to the Daily graph, we can notice the negative dynamics in this ratio since the EUR/USD topped out late January / early February.** While our long term oscillators (lower rectangle) were very much Oversold late May ("Low Risk" message), the sequences we show on both oscillators series (lower and upper rectangles) would suggest that **the current bounce may last until late June / early July, before the ratio resumes lower into mid/late August**. This forecast may give us a hint as to what to expect on EUR/USD. It is also very similar to the one featuring the European Banking sector on page 45 of this document.

## Italy 10 years - Germany 10 years Benchmark Yields
## Weekly graph or the perspective over the next 2 to 4 quarters



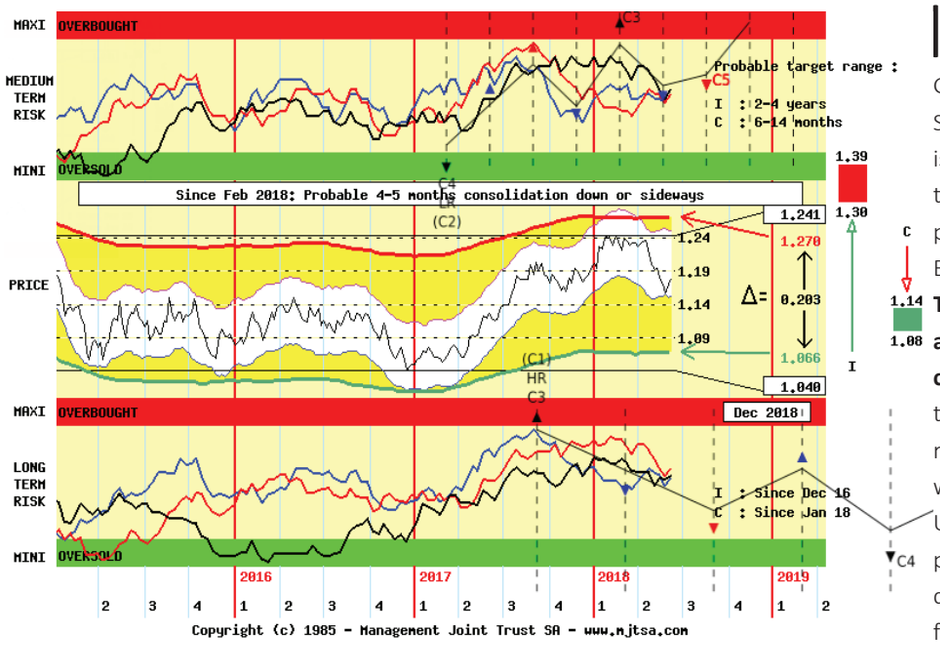

We now focus on recent events. Indeed, while the European Surprise Index has been deteriorating since mid Q1, the real negative catalyst on the EuroZone is the Italian Political crisis. As we can see on this Weekly graph of the spread between Italian and German 10 years Government Bond Yields, the impact has been substantial. Although such violent moves are difficult to analyze graphically, our medium term oscillators (upper rectangle) would suggest that the current rebound may last into early/mid Summer (August?) in first instance. On our long term oscillators (lower rectangle), we have positioned the sequence in a resume uptrend situation. Indeed, **following the recent spike, this Sovereign spread is now back to levels not seen since 2013, probably signalling a reversal of the trend to the upside. According to these projections the spread could now continue higher, at least into late 2018 / early 2019.**

## Germany 10 years - France 10 years Benchmark Bond Yields
## Weekly graph or the perspective over the next 2 to 4 quarters



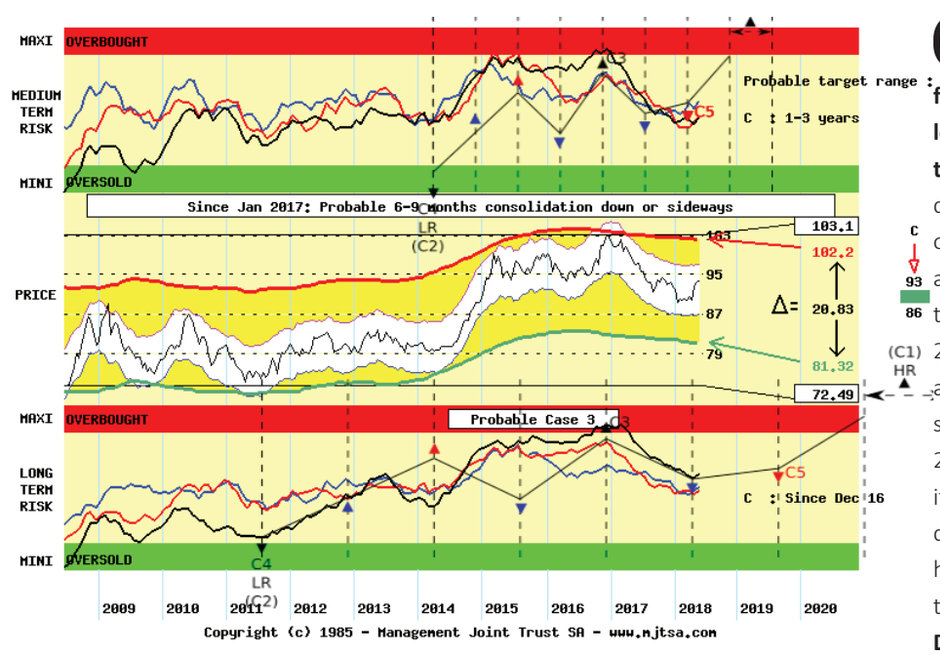

**Not wanting to focus solely on Italy, we are also considering the graph of the Sovereign spread of France vs Germany. We believe it delivers a more general/tamed picture of the Sovereign spread situation in Europe. We've reversed it for cosmetic reason (Germany – France) as we believe it shows the recent loss of momentum in the EuroZone re-coupling theme**. On both oscillators series (lower and upper rectangles), we would expect **this spread to continue to widen (downtrend move on this graph) until mid/late Summer. Thereafter, it could make a new attempt to contract (uptrend on this graph) towards year-end and early 2019. The crucial question will be if this inverted spread can achieve higher highs towards year-end, or if the peak of the EuroZone re-coupling story is already behind us with the tops which were reached a couple of months ago (our preferred scenario at this stage).**

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



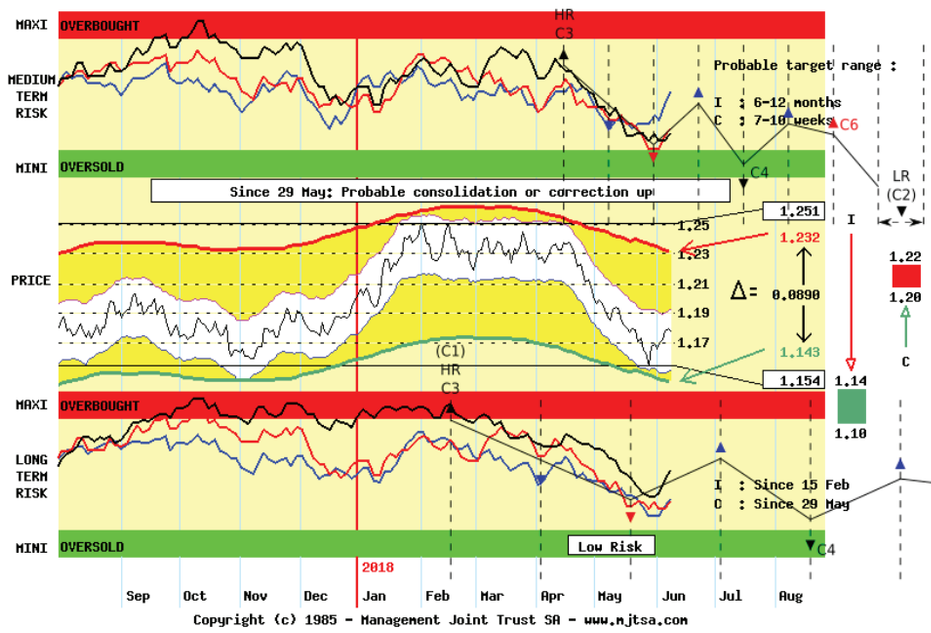

It may not come as much of a surprise that the Weekly Germany to France inverted Sovereign spread graph above is very similar in term of rhythm to EUR/USD. They basically proxy the same story, i.e. the EuroZone recoupling theme. **This graph needs thorough analysis as its outcome is not clear cut yet.** On our medium term oscillators (upper rectangle), we show a scenario, which is still positive for EUR/USD until early next year. The pair entered a correction to the downside in February, recently found support, could bounce for few weeks, before it retests down into August without making new lows. EUR/USD then accelerates up towards year-end and possibly new highs. **On our long term oscillators (lower rectangle), we show a more negative scenario for EUR/USD, which we believe is a better match for our more defensive cross assets views over the next few quarters. The sequence would imply that the current bounce is relatively short lived, and that EUR/USD resumes lower towards lower lows in the 1.14 - 1.08 range into mid/late Summer (C Corrective targets to the downside; right-hand scale). It then bounces into year-end without making new highs, before it resume much lower in 2019. For now this is out of consensus, yet our favored scenario.**

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



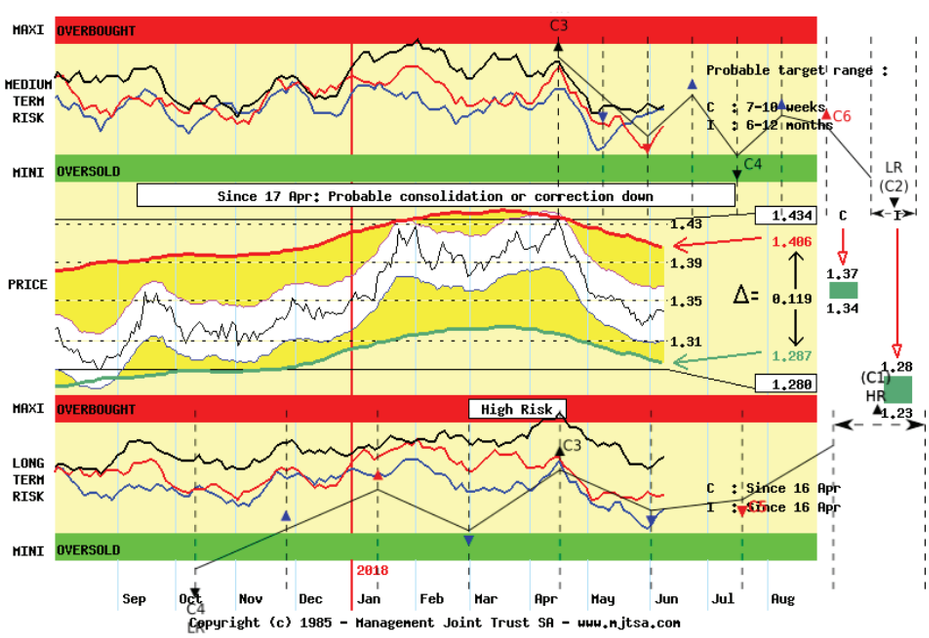

**Our more defensive view on EUR/USD going forward corroborates our long term positive bias on the Dollar.** Over the last few quarters, we have been voicing our support for the Dollar advocating that the correction to the downside since late 2016 was just a counter-trend, and that the Dollar would find support at some point in H1 2018 above the lower end of its C Corrective targets to the downside (here at 86; right-hand scale). We still believe this is correct and that **the US Dollar is now in the process of resuming up towards 2019** on our medium term oscillators (upper rectangle), and **even potentially towards late 2020/2021** on our long term oscillators (lower rectangle).

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



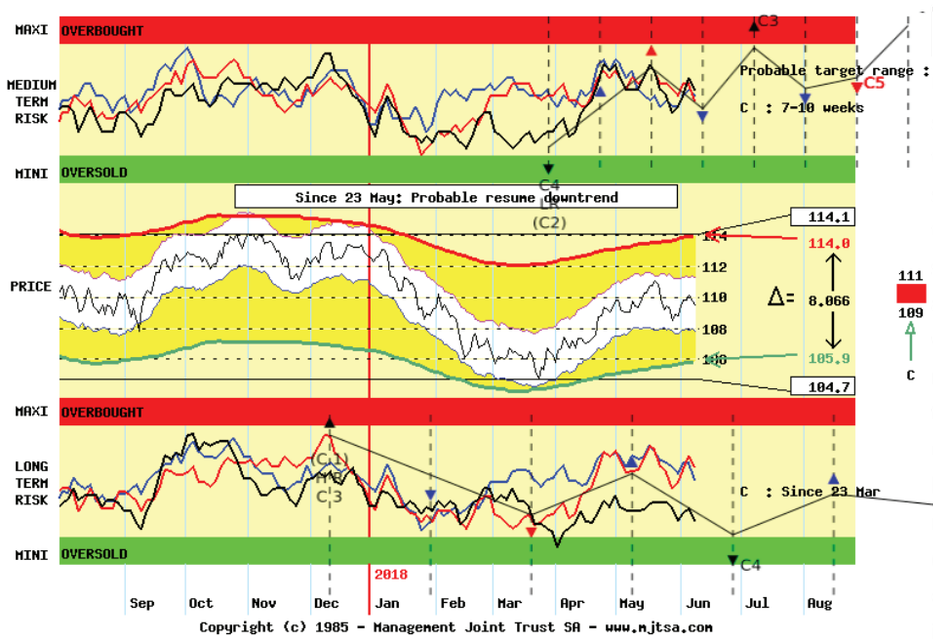

We now turn to the Daily graph of EUR/USD to consider the perspective over the next few months. The picture seems to indicate that the current downtrend is not over yet, and that it could make new lows in the 1.14 – 1.10 range towards mid Summer (I Impulsive targets to the downside; right-hand scale). The sequence we show on our long term oscillators (lower rectangle) starts with the highs in February and recently reached an intermediate low. **The sell-off into late May lasted a few days longer than we expected due to the Italian crisis, yet EUR/USD is now rebounding on a "Low Risk" situation. This rebound could last into early July and reach the 1.20 – 122 range (C Corrective targets to the upside; right-hand scale), before it resumes lower into mid/late August. The sequence on our medium oscillators (upper rectangle) implies a short rebound towards late June and then new lows into mid July. These negative dynamics, which would see a bounce into late June/early July, before a new sell-off towards mid July/August will remain valid as long a EUR/USD doesn't break above its C Corrective targets to the upside (i.e. above 1.22).**

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



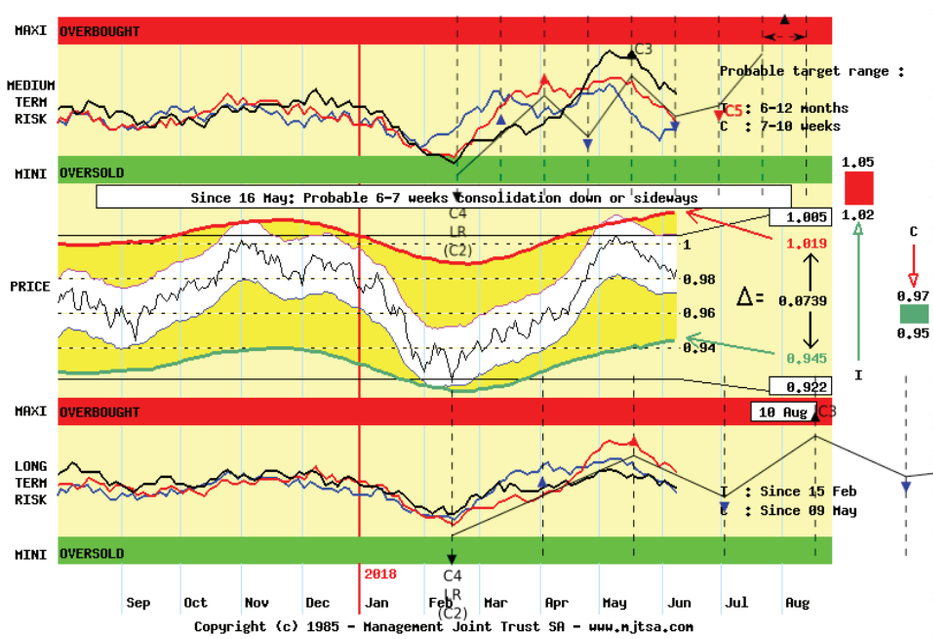

**Cable (GBP/USD) is also at important crossroads.** Indeed, the sell-off since mid April has made it below the support of our C Corrective targets to the downside (below 1.34; right-hand scale). This break-down theoretically opens the door to much lower levels, towards our I Impulsive targets to the downside in the 1.28 – 1.23 range. Cable may hence have started to turn down for this cycle. Indeed, **in order to maintain its long term upside momentum, Cable will now need to hold at current levels, probably until mid/late July. It will then find support to move higher again into the Fall** (the sequence on our long term oscillators; lower rectangle). **Any negative divergence from this rather constructive scenario, will probably trigger a continuation of the initial downtrend started in April**. This is the sequence we show on our medium term oscillators (upper rectangle): Cable bounces until late June, then resumes lower below 1.34 again towards mid July, and then following a bounce, lower again into late August/ September. **The more time we spend below 1.34 over the next couple of months, the more likely this more negative scenario will become.**

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



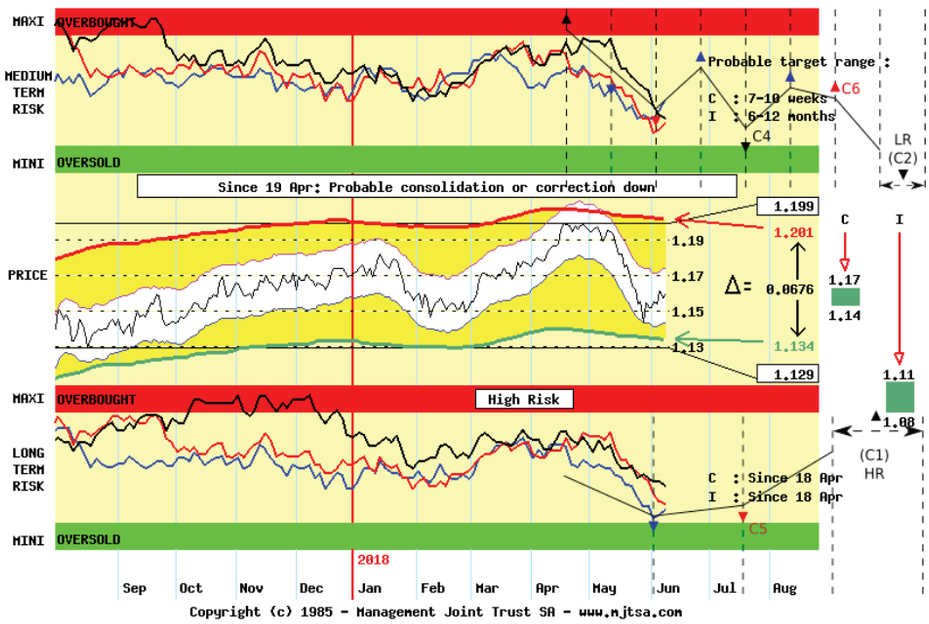

Following a promising first move up since late March, USD/JPY is trying to find new support to move higher into the Summer. On both oscillator series (lower and upper rectangles), **these support points should come between now and late June. Following that, we would expect USD/JPY to move up first into July, then towards August**. In its recent upside attempt, USD/JPY did briefly move above our C Corrective targets to the upside (right-hand scale). In order to confirm our positive scenario into the Summer, USD/JPY will need to break above these again, and **start accelerating up, probably towards its Impulsive targets up, which we can calculate in the 1.15 - 1.18 range**, i.e. 1.3 to 1.7 times our historical volatility measure "Delta", here at 8.066 (middle rectangle; right-hand side) added to the graph low at 104.7.

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



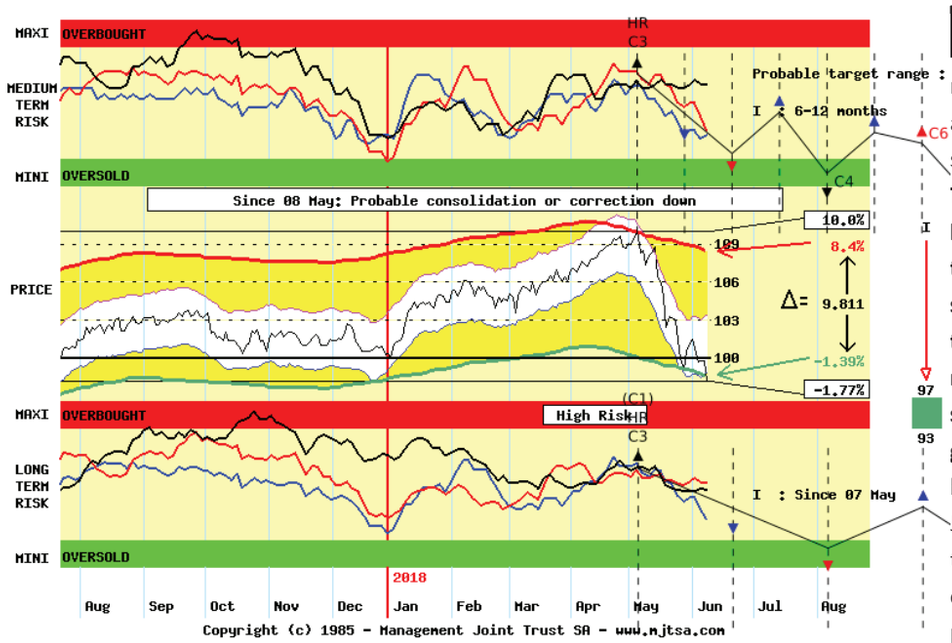

Vs Swiss Franc, the Dollar has seen one of its strongest reactions since February. **The pair reached an intermediate top early/mid May and according to both our oscillator series (lower and upper rectangles) should start resuming higher again between now and end June. We then expect it to move up above parity again (I Impulsive targets to the upside; right-hand scale) probably towards late July / early August**. Alternatively, a move back below 95 would be very negative for the long term prospects on USD/CHF (C Corrective targets to the downside; right-hand scale), yet for now this is not our preferred scenario.

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



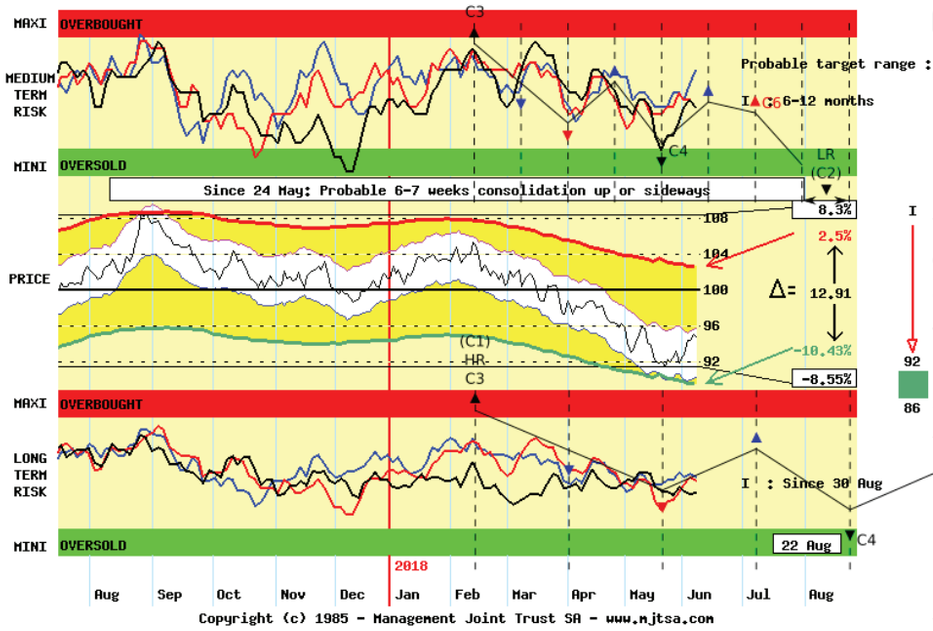

The dynamics on EUR/CHF are similar to the ones on Cable (GBP/USD) analysed above. Both pairs had resisted quite well despite the increased volatility on equities since February, and both made new highs in April. The Italian Political crisis may have reversed this situation for both pairs. Indeed, **Swiss Franc is usually risk-off vs the Euro, and over the last 18 months, the European re-coupling story has allowed EUR/CHF to move up quite substantially (risk-on). We wonder if this situation has now reversed. Indeed, our C Corrective targets to the downside (right-hand scale) were recently taken out (break below 1.14), which opened the door to much lower levels towards our I impulsive targets to the downside in the 1.11 -1.08 range.** On our medium term oscillators (upper rectangle), we picture this negative scenario, where **following a bounce into end June, EUR/CHF resumes lower first into mid/end July, then into the Fall.** To justify the more positive scenario on our long term oscillators (lower rectangle), EUR/CHF will need to hold above 1.14 until mid/late July, before it finds new support to move up into the Fall. This positive scenario may be starting to look quite wishful.

## FTSE MIB (Italy) / Dow Jones EuroStoxx 600
## Daily graph or the perspective over the next 2 to 3 months



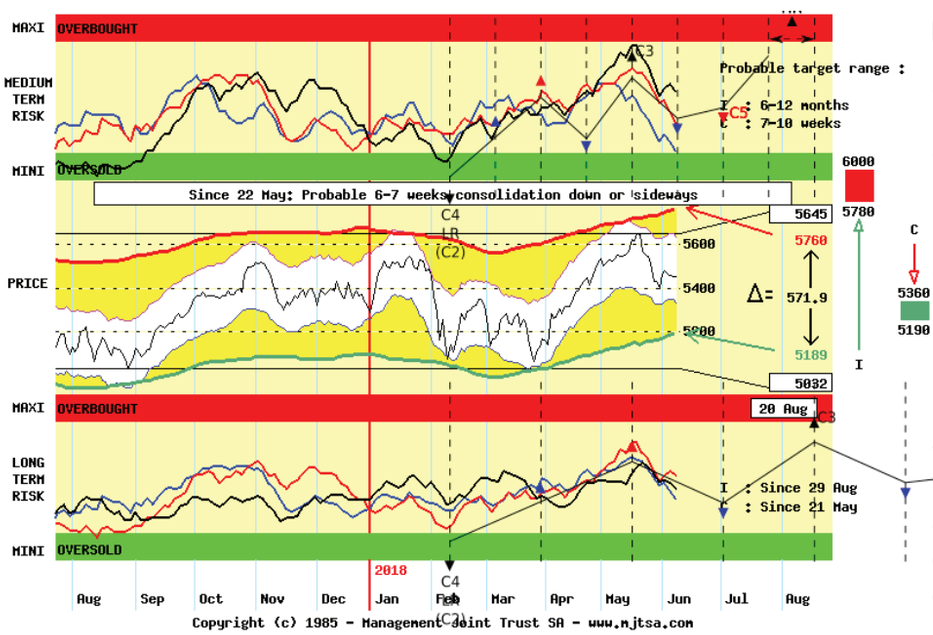

Indeed, to a certain extent, EUR/CHF represents risk-on/risk-off dynamics in Europe, and the recent sell-off in Italy is starting to look rather serious. **This graph compares the Italian Mib Index to the EuroStoxx 600. On both oscillator series (lower and upper rectangles), the ratio has clearly reversed, and its downtrend seems set to continue into August at least** (following a slight bounce from mid June to early July). Our I impulsive targets to the downside (right-hand scale) calculate that Italy could underperform the EuroZone by a further 5 to 6% by then.

## WIG Index (Poland) / Dow Jones Europe Stoxx 600 (currency hedged ratio)
## Daily graph or the perspective over the next 2 to 3 months




Other parts of Europe are also suffering. Indeed, since September and especially since February, Poland has been underperforming the rest of Europe, possibly on the back a stronger Dollar, but also due to new political tensions with Brussels. **Poland is just another example of how various parts of Europe (the South, the East) are gradually destabilizing the European re-coupling story.** On both our oscillator series (lower and upper rectangle), we would expect that **from late June / early July, Poland resumes its underperformance vs Europe, probably into mid/late August**. Our I impulsive targets to the downside (right-hands scale) would suggest up to a further minus 10% of underperformance.

## CAC40 Index
## Daily graph or the perspective over the next 2 to 3 months



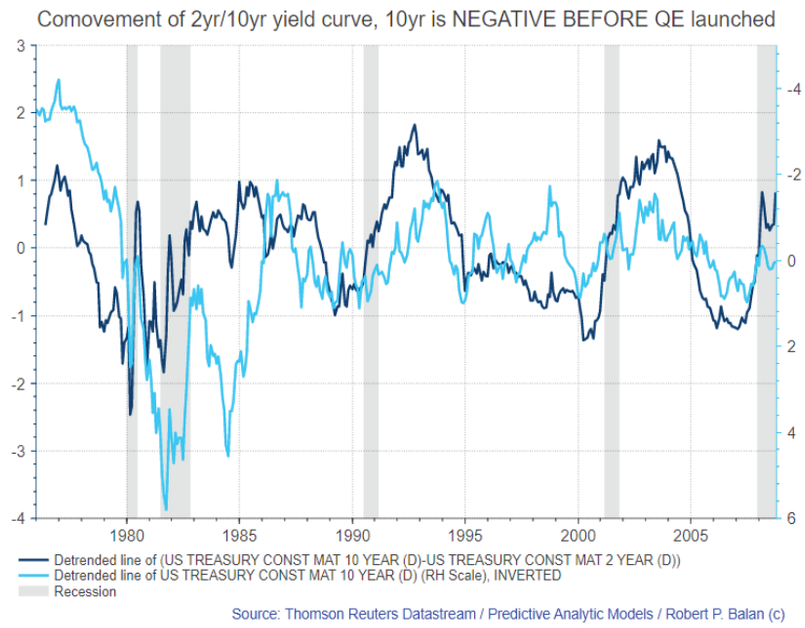

On the other side of the spectrum, the CAC40 has been one of the strong performers in the EuroZone. On an absolute basis, it made new highs for the year in May, and its retracement down since then has been relatively tamed. According to both our oscillators series (lower and upper rectangles), we would probably expect it to find support between now and late June, and then **move up towards August and new highs in the 5'780 – 6'000 range (I Impulsive targets to the upside; right-hand scale). This is in sharp contrast with what we are expecting for Italy or Poland, and in our view, it highlights a certain flight/concentration to the Core of the EuroZone**. Indeed, while problems on the "Fringe" may be destabilizing the Euro, the "Core" (e.g. Cac40) is profiting from its weakness. Such differentiation may not last for long. Either the "Fringe" needs to stabilize soon, or the "Core" will suffer from contagion.

### Concluding remarks

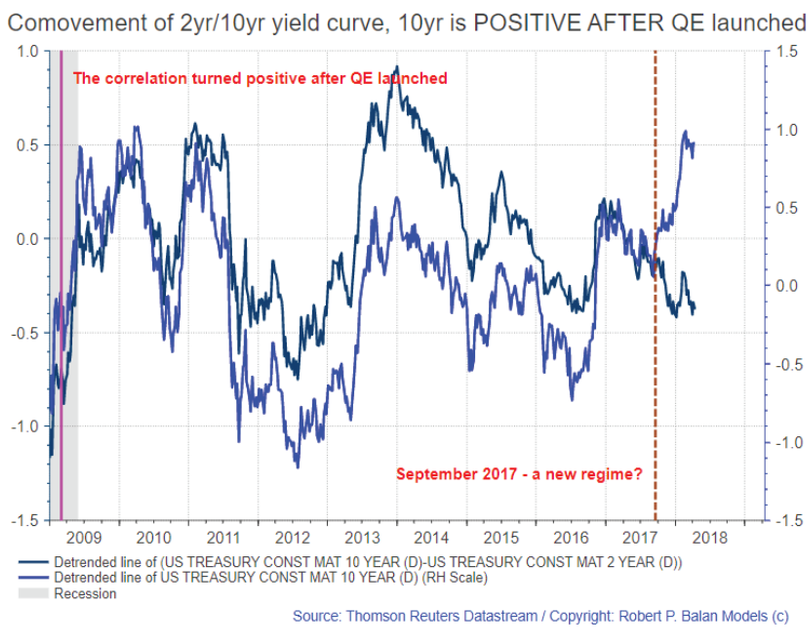
**The US Dollar is balanced between two factors of influence. On the one hand, rising late cycle inflationary expectations in the US are putting pressure on the FED to continue hiking, which may in time flatten the yield curve and ultimately weaken the US Dollar as at some point the FED may need to signal a pause. On the other hand, the re-coupling theme in Europe has lost momentum, the Economic Surprise Index has turned down since mid Q1, and the Italian Political crisis further exacerbates this reversal. We believe that until mid Summer, the US should manage to hold up its positive momentum, while Europe continues to decelerate. This should be positive for the US Dollar until then. Coming this Fall, the US may start to face its own deceleration (rapidly flattening yield curve), while the political situation in Europe may have stabilized somewhat. A rebound in EUR/USD is then possible towards year-end. Our view for 2019, is that the business cycle will have probably turned, that inflation expectations will have subsided, and that any further political/economic instability in Europe, or elsewhere, will be very positive for the US Dollar and other defensive currencies (JPY, CHF) on Flight to safety concerns.**

# 36 / The yield curve universe is changing – shifting inflation expectations is prime mover for those changes

**In the late 1980s to late-2000s, the yield curve had the tendency to steepen during bond (price) rallies and to flatten during (price) selloffs**. Put simply, there was a NEGATIVE correlation between the 10yr yield and the slope of the 2y/10y yield curve. Described another way, when the 10yr yield starts falling, it won't be long before the yield curve steepens. It was a very useful market construct because at that time, changes in the 10yr yield tend to be ahead of the inflection points of the yield curve by about 1 to 2 months. The graph below shows this tendency.




The 10-year yield is on the right-hand axis and showed as inverted scale. The 2yr/10yr spread is on the left-hand axis. **Another interesting feature of this negative relationship: not long after a major, simultaneous inflection of a steepening yield curve and a falling 10-year yield, a growth recession is not far behind**. That was seen in the run-up to the double recessions of 1980 and 1981, in 1990, in 2001, and just before the 2007 recession that ushered in the Great Financial Crisis (GFC) (*see 1st graph on this page*).




**Another feature of the pre-QE negative relationship was that once it starts to change direction, it tends to move towards the same direction with some persistence**. The negative correlation between the long term rate and the yield curve tends to feed the inverse movements due to the following: (1) when the curve was steep, steepening trades (selling 10-year notes and buying duration-weighted 2-year notes, both repo-financed) tended to have positive carry, were easy to maintain and were therefore very popular, and (2) on the other hand, when the curve was flat, the opposite tended to be true and the opposite trade was executed. Other factors may have determined the inflection points of both the long-term bond yield and the yield curve, but once the negative relationship got going, the movements tended to be fed by those lucrative trades.

**Unfortunately, those easy, profitable trades disappeared once Quantitative Easing (QE) started in November 25, 2008, as the massive infusion of systemic liquidity and new monetary policy tools unleashed by the Federal Reserve sent the yield curve and bond yield comovements into a different direction. The relationship had turned POSITIVE.**

**Since November 2008, the curve has tended to flatten during bond price rallies (falling yields) and steepen during price selloffs (rising yields)** - it was the complete opposite of what was seen pre-QE. True to the new form, when bond yields started to rise sharply after bottoming in July 2016, the yield curve dutifully steepened (*see 2nd chart above*).

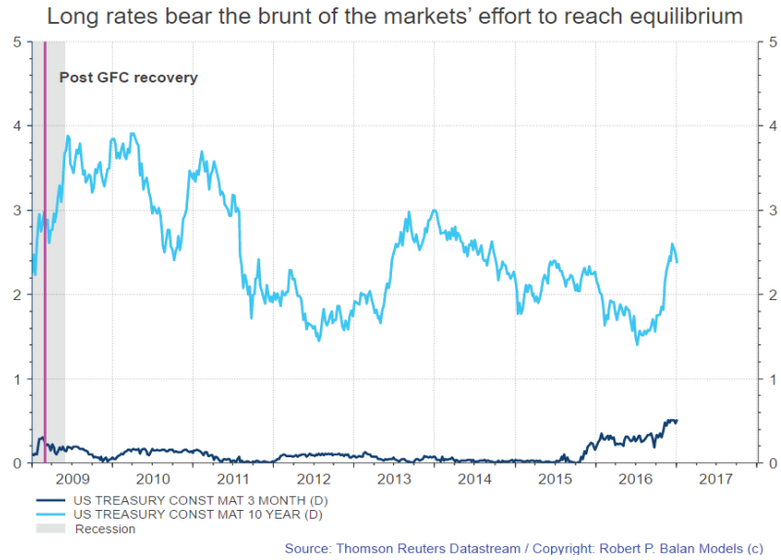
## Why did the relationship change after QE started?

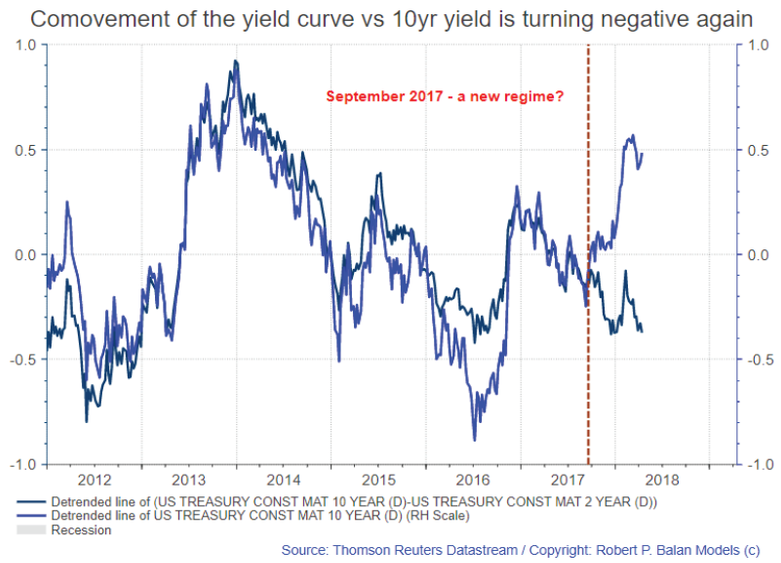
Carry dynamics was not sufficient to explain the phenomenon, and in fact the new, positive comovement between the long-term yield and the curve runs counter to what carry dynamics would normally bring in such circumstances. That the phenomenon appeared exactly after Quantitative Easing series started, suggest that the policy to constrain the policy rate (and thereby, the short-end) had much to do in flipping the relationship. The humongous amount of liquidity floating inside the financial system likely reinforced the new regime.

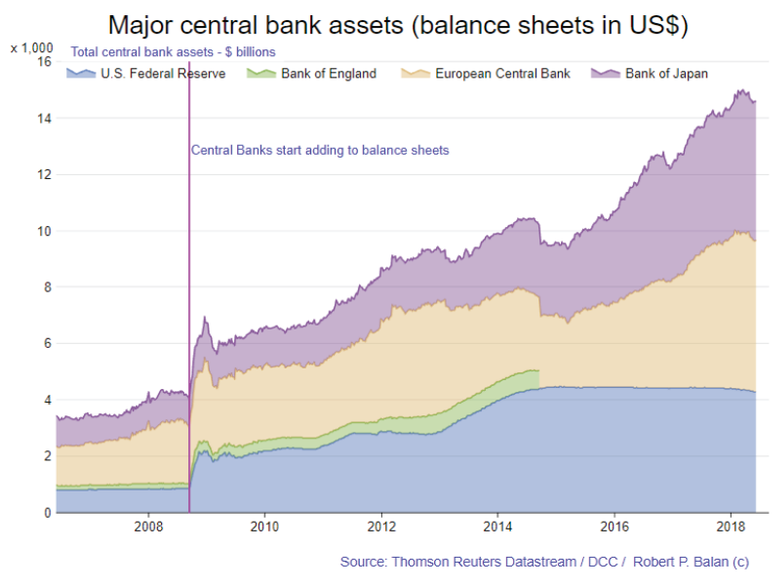
**Since the implementation of the QE programs, the short rate (the overnight rate as proxy) had been anchored**. It was not the anchoring that made the difference - there were other times in the past when the overnight rate was anchored as well, and the relationship did not flip. It was the market's perception that, for the very reason that QE was full-blown, the Fed had very limited room to move very far from zero-bound. That differentiated from the other times when the policy rate was anchored but was pinned at significantly higher levels.

Also, at those other times, the Fed had no similar constraints and could easily move away from the anchored level, even forcefully if they must. The QE, and the entire rationale for doing it in the first place, effectively pinned the short-end close to the zero-bound. The high levels of reserves provided the fuel for the unanchored element (the long-end- the sole, unpinned variable) to manifest the potential energy inherent in the system. **It did so, with a vengeance**. ***The long-term yield had become the de facto policy rate*** *(see 1st chart on this page)*.

Nonetheless, we can't become complacent because it looks like new trouble is brewing on the yield curve front. Have a second look at the zoomed version of the graph (*see 2nd chart on this page*) that was shown earlier – **the comovement between the yield curve and the 10-yr yield is turning NEGATIVE again!**




The change taking place in the US yield curve are also taking place at a global macro setting. This time, we are talking about really grand scale – as in the aggregate QE proceeds of the five largest, stimulus-addicted central banks of the world – the Fed, the European Central Bank, the Bank of Japan, the People's Bank of China, and the Swiss National Bank (*see last graph above*).

## By June 2014, stimulus had no more effect on global rates

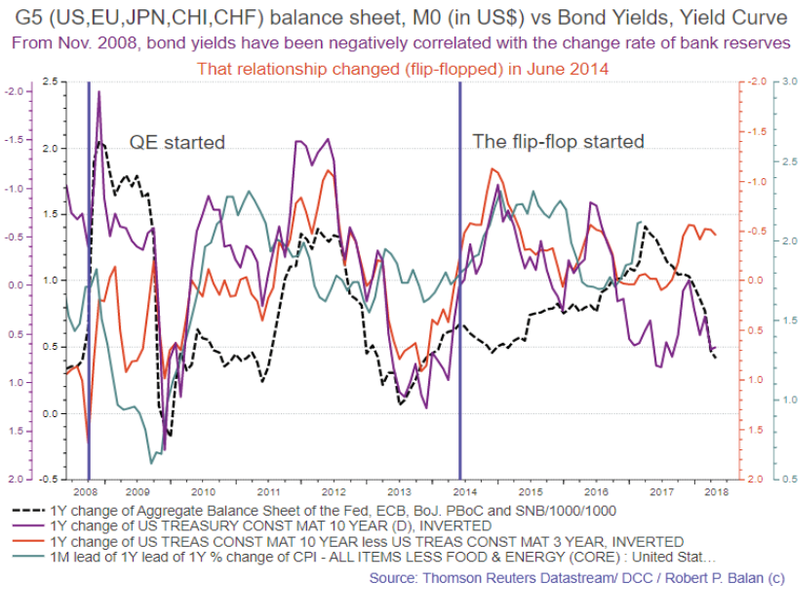
Much has been written about the impact of the asset purchases of the central banks on a broad range of financial assets (specifically, the equity markets). The transactions were essentially just plain asset swaps - the Fed took in short-dated securities from the banks (many with no market price at that time), and gave them back Treasury Notes averaging 5yr-7yr duration. That converted the banks' illiquid holdings into bank reserves. Arguably, the effect of those huge bank reserves, transmitted via the portfolio balance channel and the signalling channel, did push up house and equity prices, and also lowered the path of short-term rates and reduced longer-term yields.

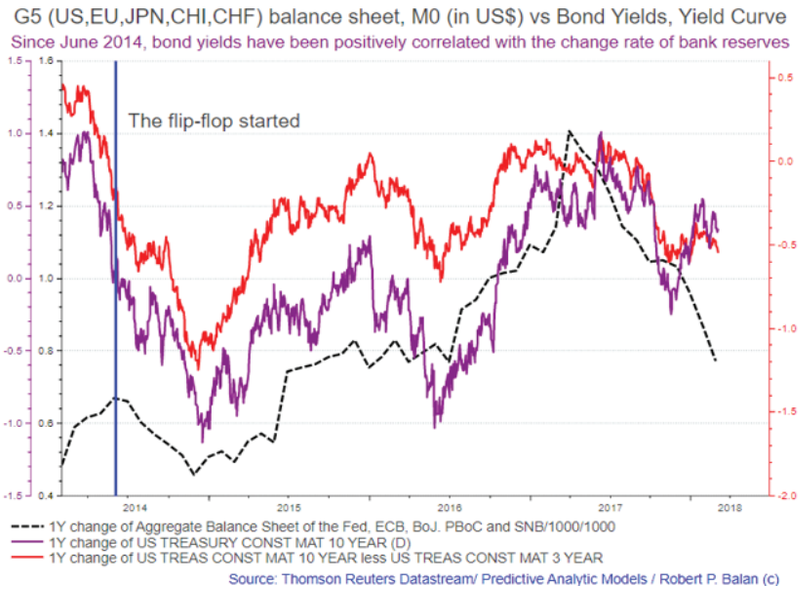
***But, and this is crucial, the depressive effect on rates stayed in place only from November 2008 (when the Fed started QE) until June 2014, even if the equity and housing markets still continued to benefit from the central banks' largesse.***

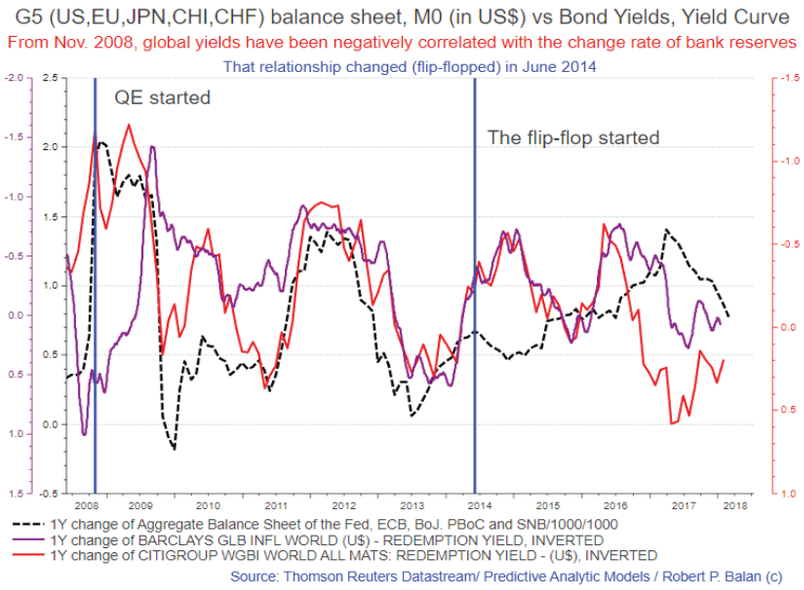
We still have to find out what special event happened in June 2014 to bring the effect of the mountain of global reserves on rates to a shuddering halt, then reverse the process. At this time, all we know is that as from June 2014 onwards, further addition to the bank reserves drove long bond yields higher, and vice versa; reducing the bank reserves triggered declines in yields – not exactly what the global central banks expected to see (*see the 1st & 2nd graphs on this page*).

## The phenomenon is global

Now, we have to dispel the idea that this phenomenon is local to the United States, because if it were, then we should not see the same effect in global long rates. But we do see it in the global yields versus the aggregated balance sheet: reduction of stock and falling flows in the global balance sheet were followed by falling yields (*see Last graph on this page and first on next page*):



## Global Inflation at work (or not)

**We have no idea if there was a specific event that triggered the flip-flop. But since the changes in rates synchronized with the changes in the central banks` aggregated balance sheets, we suspect that the evolution of GLOBAL INFLATION (actual and expected)** may have been the culprit. If you include an inflation-linked instrument in the graph above (Barclays Global Inflation Bond Index, showing its Redemption Yield), it does correlate well with the changes in the aggregated global balance sheet. To test this hypothesis further, we added a measure of expected inflation using the Citi G10 Surprise Inflation Index as proxy. We replicated the procedure used above to find the comovements - the results confirmed our fears. Global inflation expectations were driving the show (*see 2nd & 3rd graphs on this page*).

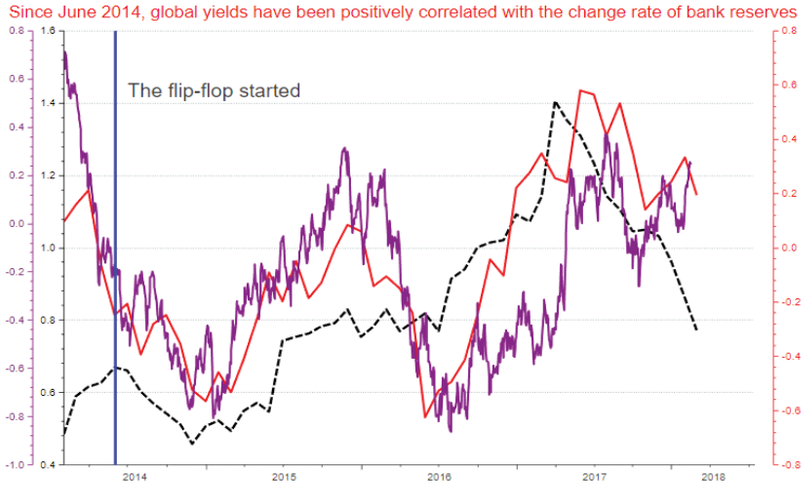
## After June 2014, the central banks overstayed their welcome

**It is clear that global inflation expectations have been driving a large portion of the movements in global yields (as it should be), especially after June 2014. After that, rising amounts of global reserves drove both inflation expectations and global bond yields higher. The inverse was, of course, is also true. After June 2014, reduction of global reserves was followed by lower inflation expectations and falling global bond yields.**

Simply put, the central banks have overstayed their welcome. No wonder, the serial Stimulators have shifted their objective from keeping yields lower (and equity and house prices higher) to pushing up inflation to (or in the case of Japan, above) their inflation targets.

G5 (US,EU,JPN,CHI,CHF) balance sheet, M0 (in US$) vs Bond Yields, Yield Curve

Since June 2014, global yields have been positively correlated with the change rate of bank reserves

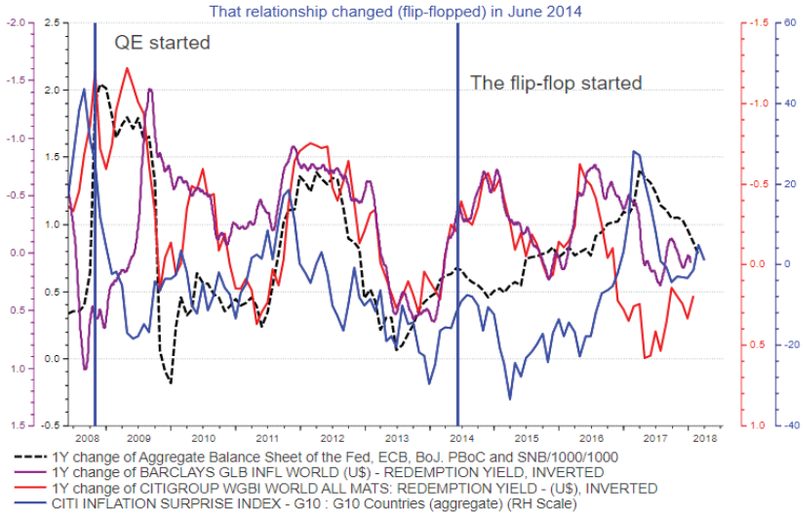



Source: Thomson Reuters Datastream/ Predictive Analytic Models / Robert P. Balan (c)

G5 (US,EU,JPN,CHI,CHF) balance sheet, M0 (in US$) vs Bond Yields, Yield Curve

From Nov. 2008, global yields have been negatively correlated with the change rate of bank reserves

That relationship changed (flip-flopped) in June 2014




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

G5 (US,EU,JPN,CHI,CHF) balance sheet, M0 (in US$) vs Bond Yields, Yield Curve

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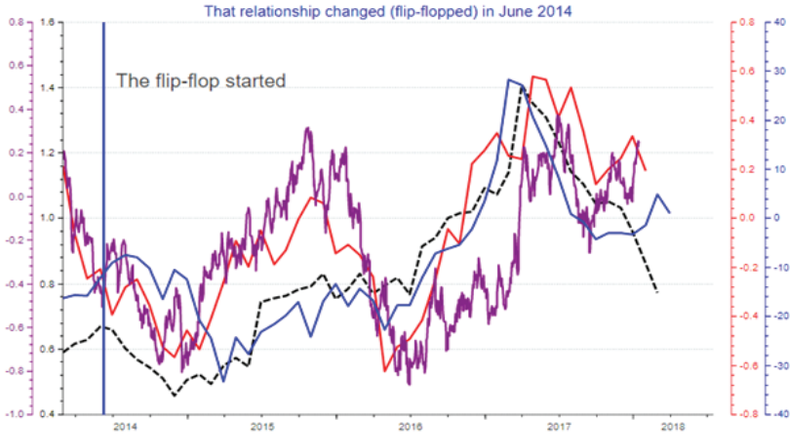



Source: Thomson Reuters Datastream/ Predictive Analytic Models / Robert P. Balan (c)

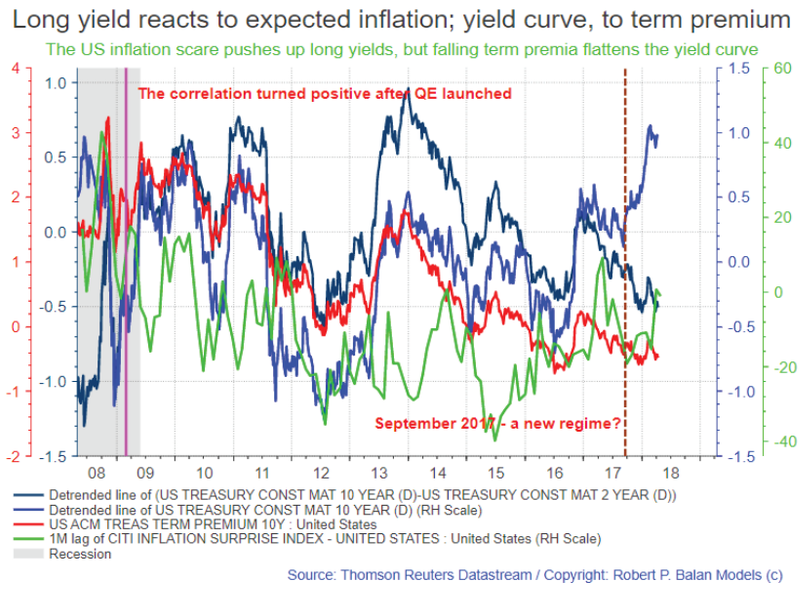
## We can now make some notes and a few conclusions:

- The market, as from June 2014,started to believe that more stimulus results in higher inflation down the road. Hence, after the global aggregates peaked in March 2017, global inflation expectations fell sharply. (*see the Citi Inflation Surprise Index - G10 in the graphs on the previous page*)
- The nominal amount (stock) and change rate (flow) of the aggregate global central bank balance sheet have been falling sharply for a few quarters now, since March 2017.
- With those reductions well in place, actual global inflation is expected by the market to fall further, following the sharp declines in global inflation expectations since March 2017.
- Despite their rebound since mid 2017, Global bond yields did top-out in March 2017 with the reduction in the flow of the global balance sheet and global inflation expectations: global yields lag the two variables by one quarter. (*see the Barclays and Citi Group World redemption yields indexes in the graphs on the previous page*)
- With recent declines in the balance sheet flow, global bond yields should resume their fall (based on this metric).
- **There is no empirical evidence which supports the market fear that reduction of the global balance sheet will cause global interest rates to rise.**

## The new US yield curve-10yr yield conundrum

But what is the linkage between the global picture and the new, negative divergence (since September 2017) between the US yield curve and the Treasury long bond yield?

It turned out that inflation expectations were the culprit there as well, but the thrust of the argument is towards the opposite direction – the market believes that US inflation will be rising sharply in the near-term at least. Hence, the long bond has been driven higher out of proportion to the delta of the near-term inflation expectations (*see 1st graph on this page*). In other words, the long-end is now certifiably too rich.




**The general market has been very sanguine insofar as inflation is concerned. On the other hand, the bond market has been more circumspect, and in fact downright dovish with regards to US inflationary pressures. Proof? The 10-year Treasury Term Premium has been falling in step-ladder basis – and the yield curve has basically kept pace with it on the way down. The 10yr term premium has even turned negative.**

The bond term premium is the excess yield that investors require to commit to holding a long-term bond instead of a series of shorter-term bonds. It is a significant component of bond yields, and it changes over time. In the example we showed in the above graph, the term premium on the 10-year Treasury note depends crucially on financial market expectations about the course of shorter-term U.S. interest rates over the next ten years. It can be additive to, or subtractive of, the bond yield. Note that, along with expectations on the path of short-term rates, the term premium also takes in the fluctuations in long-term bond yields due to changes in market expectations about long-run inflation.

## The general market worries about inflation; the bond market does not

**In the current case of the negative divergence between the 10yr yield and the yield curve, it is obvious that the bond market is not so worried about the implications of long-run inflation on the valuations of long-term bonds. And the evidence is a negative term premium in the composition of the long-term bond yield.**

**So, the general market thinks inflation will be a huge problem down the road (overly rich 10yr yield). On the other hand, the bond market yawns and flattens the curve by having a negative term premium on the 10-year yield. Another point to consider is that global inflation expectations are heading lower (actual inflation follows to the downside after a short lag) – global bond yields should be declining further out.**

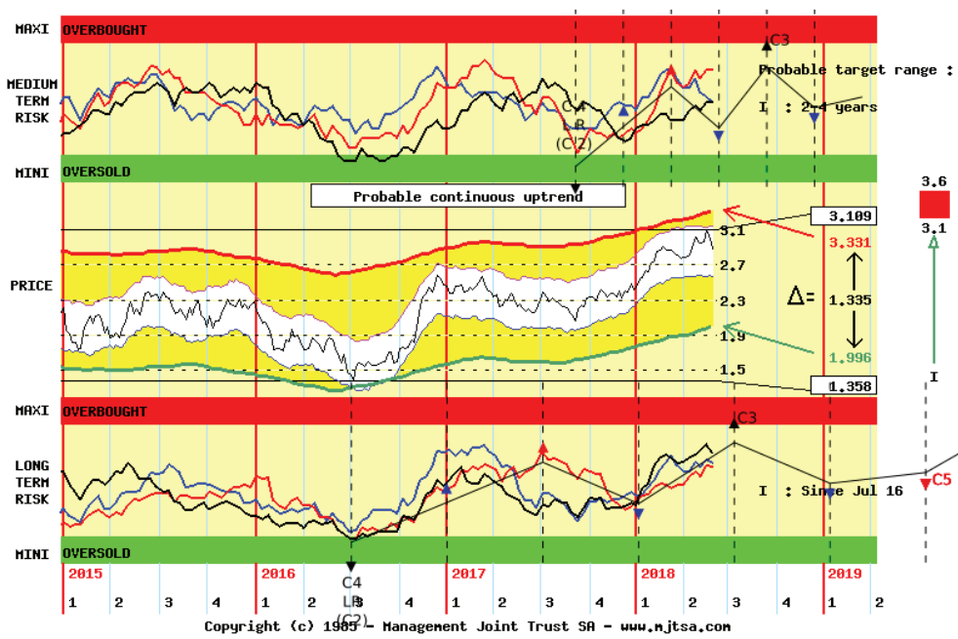
**We side with the bond market, which you can rely time and time again to get it right.**

# 41 / MJT - TIMING AND TACTICAL INSIGHT

## Yield curve flattening should accelerate in H2 2018

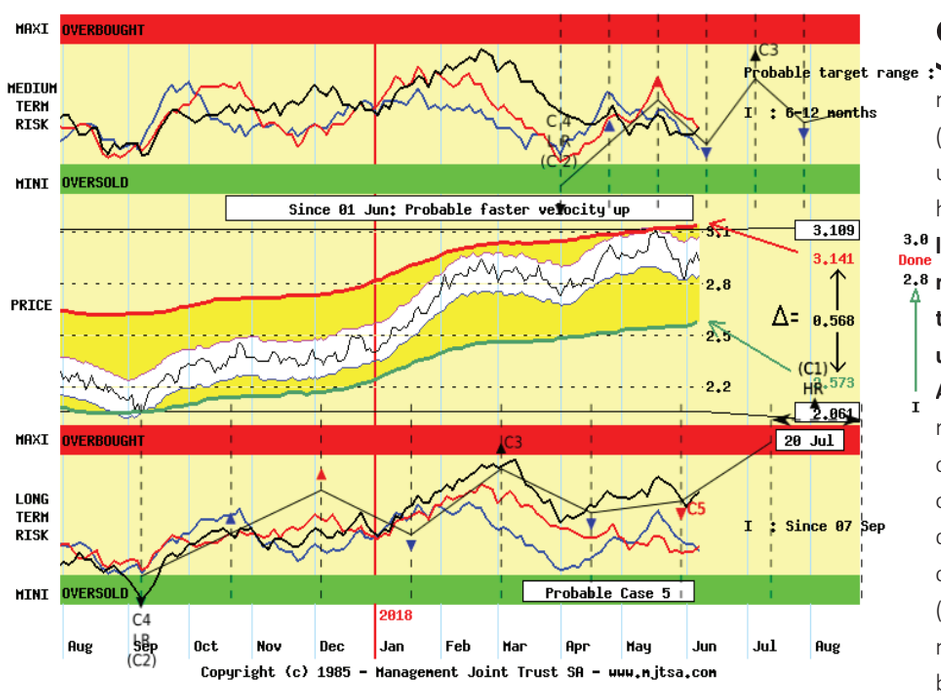
**The FED will most probably raise its short-term benchmark interest rate by another 25 basis points this week (95% probability). Further rises are also anticipated in September (circa 80% probability) and even in December (close to 50% probability). For now, despite these regular hikes, developments in the US yield curve have been rather neutral since last Summer. Long term rates have followed short term ones up and the whole curve has shifted higher. Will they be able to continue to keep up? Probably not in our view as we expect them to top out sometime this Summer.**

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



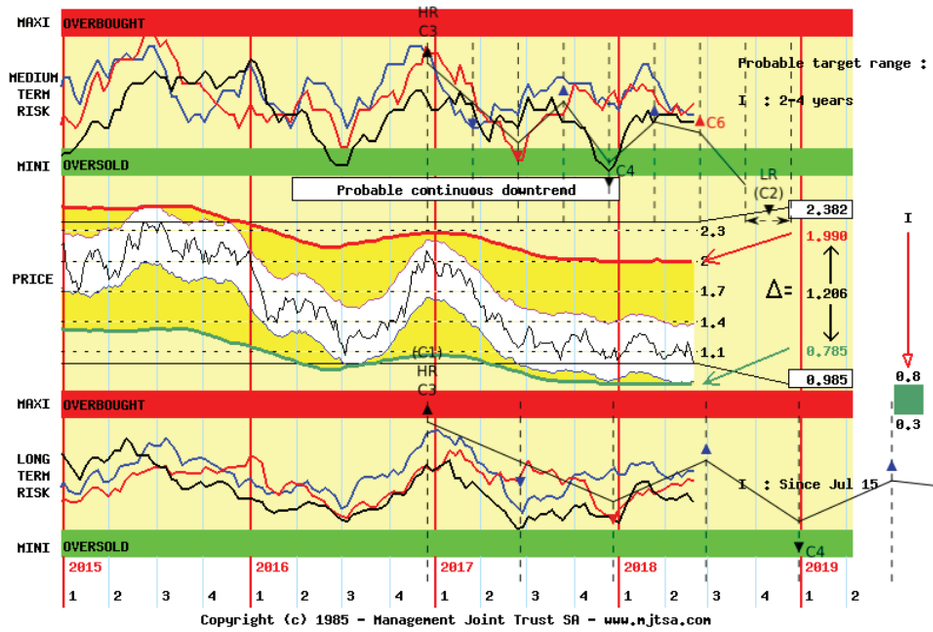

On both oscillator series (lower and upper rectangles), **US 10 year benchmark yields should reach an important intermediate top over the next 2 to 3 months**, towards July on our long term oscillators (lower rectangle), or towards late Q3 on our medium term oscillators (upper rectangle). Our I Impulsive targets to the upside (right-hand scale) still suggest **some potential, probably back above 3.1% and eventually reaching into the mid 3s %. Following that, the US 10 Year benchmark yield could correct down into early 2019 in first instance. The scope of this correction to the downside could amount to between 0.5 and 0.8 times our historical volatility measure "Delta" (here at 133.5 basis points, middle rectangle; right-hand scale) or between 67 and 107 basis points.**

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



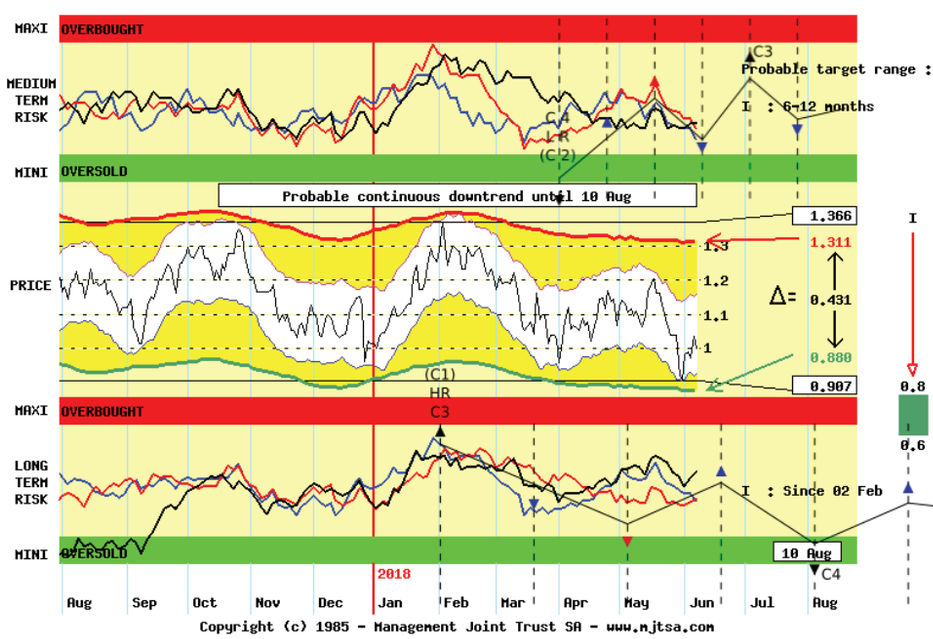

Shorter term, the Daily graph would confirm this view. The move is already quite extended (i.e. our I Impulsive targets to the upside have been reached; right-hand scale), yet **both our oscillator series (lower and upper rectangles) would suggest a further continuation of the uptrend until at least July, probably into August**. In general, the uptrend remains in place as as long as we can hold above the lower end of our C Corrective targets to the downside. This support levels currently calculates at 2.65% (0.8 times our historical volatility measure "Delta", here at 56.8 basis points, subtracted from the graph's highest point, 3.109%).

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



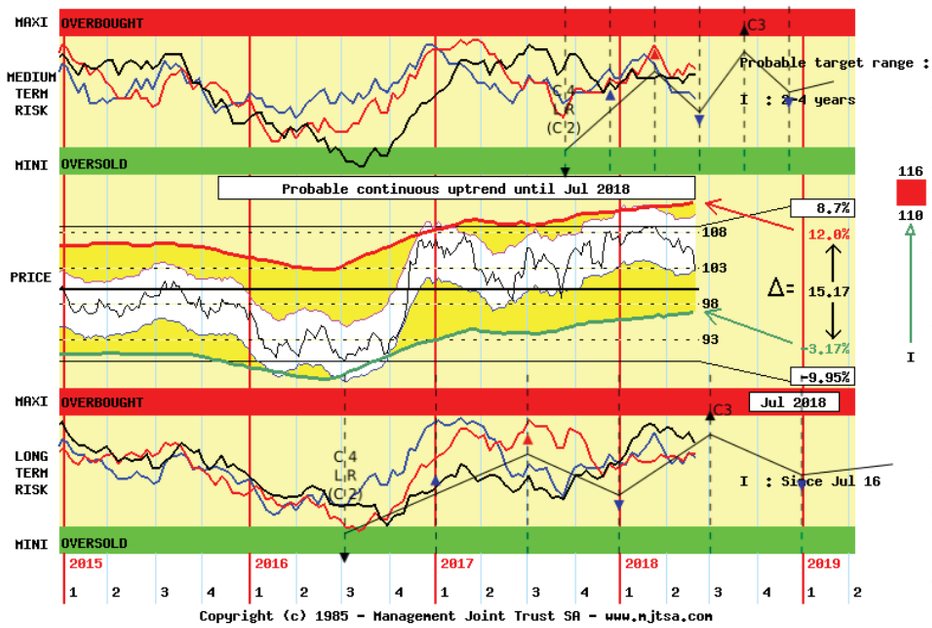

With the path of short term rate hikes pretty much set until September ( at least another 50 basis points), the **10Y-3M yield curve spread will help us assess when the progression of long term rates should start to fall behind. According to both our oscillators series (lower and upper rectangles), this should probably start to happen sooner than later, Indeed, the sequences we show suggest that the 10Y-3M yield curve spread should start to resume its downtrend by mid-year / early Summer, and that the move then extends lower probably into year-end. According to our I Impulsive targets to the downside (right-hand scale), the spread could contract down to 0.3% over the couple of quarters. The US yield curve may hence be approaching inversion again by year-end**. Such flattening probably confirms that long term yields will have topped out along the way.

## US 10 years - US 3 Months benchmark Bond Yields
## Daily graph or the perspective over the next 2 to 3 months




Shorter term, both our oscillator series on this Daily graph (lower and upper rectangles) confirm that **the flattening should resume probably from late June / early July. In the meantime, a slight bounce may materialize over the next few weeks. Our I Impulsive targets to the downside (right-hand scale) would suggest that the 10Y – 3M spread could reach levels as low as 0.6% by August. If correct, this 40 basis points drop in the spread should confirm that the US 10Y benchmark bond yield will have started to reverse down.**

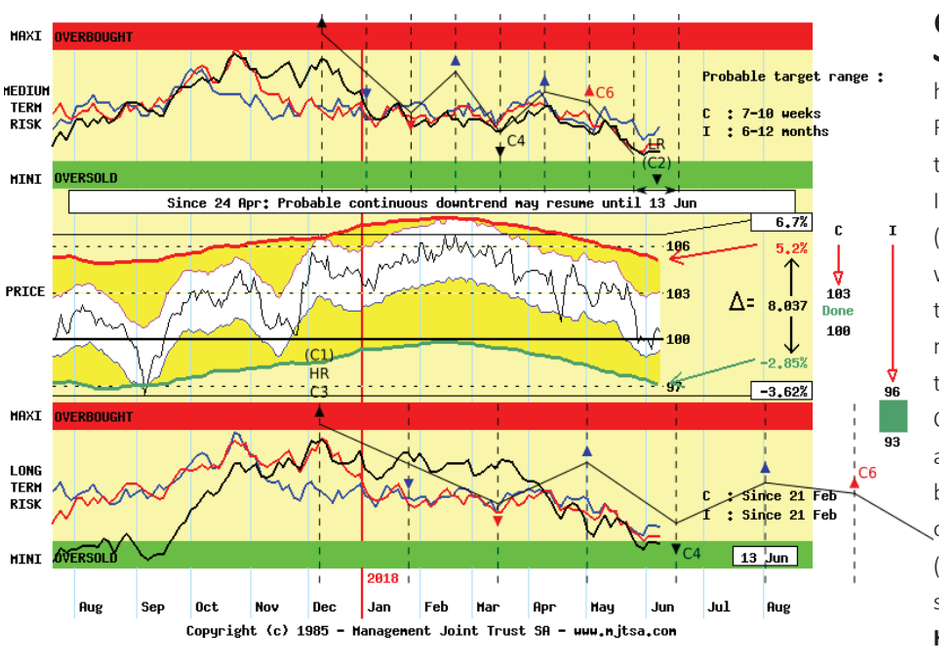
## XLF - Financial Sector SPDR Fund / SPY - SPDR S&P 500
## Weekly graph or the perspective over the next 2 to 4 quarters




The fate of the Financial sector is very much linked to the progression of long term yields and of the yield curve spread. On this relative graph vs the S&P500, Financials may already be signaling that long term yields are in the process of topping out for this cycle. Both our oscillators series (lower and upper rectangles) still suggest **some kind of upside retest during the Summer, yet the extent of the recent sell-off will probably make it very difficult for Financials to achieve new relative highs vs the S&P500.**

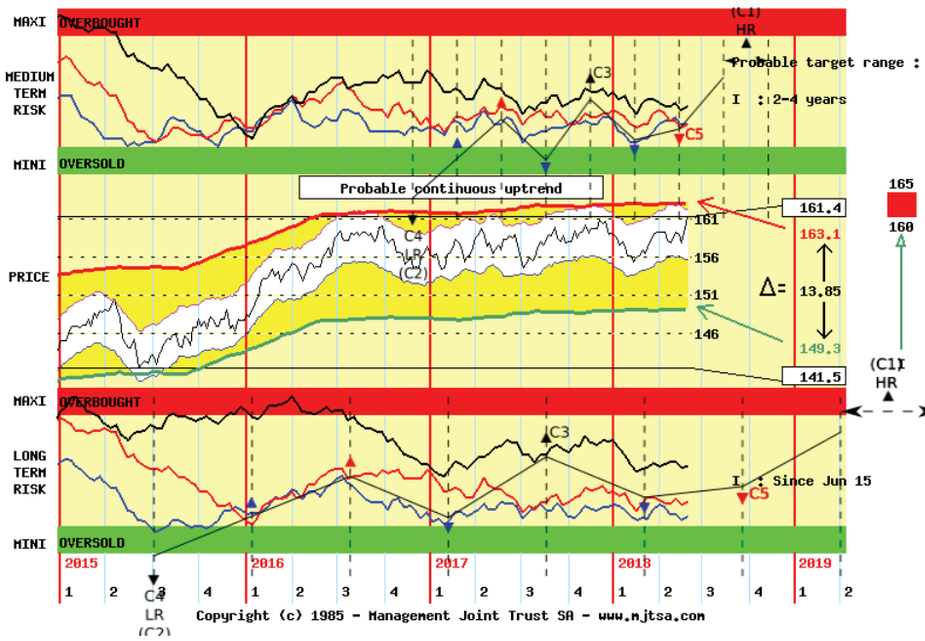
**From mid/late Summer at the latest, we expect US Financials to start to underperform the general US market, probably until year-end at least.**

## XLF - Financial Sector SPDR Fund / SPY - SPDR S&P 500
## Daily graph or the perspective over the next 2 to 3 months



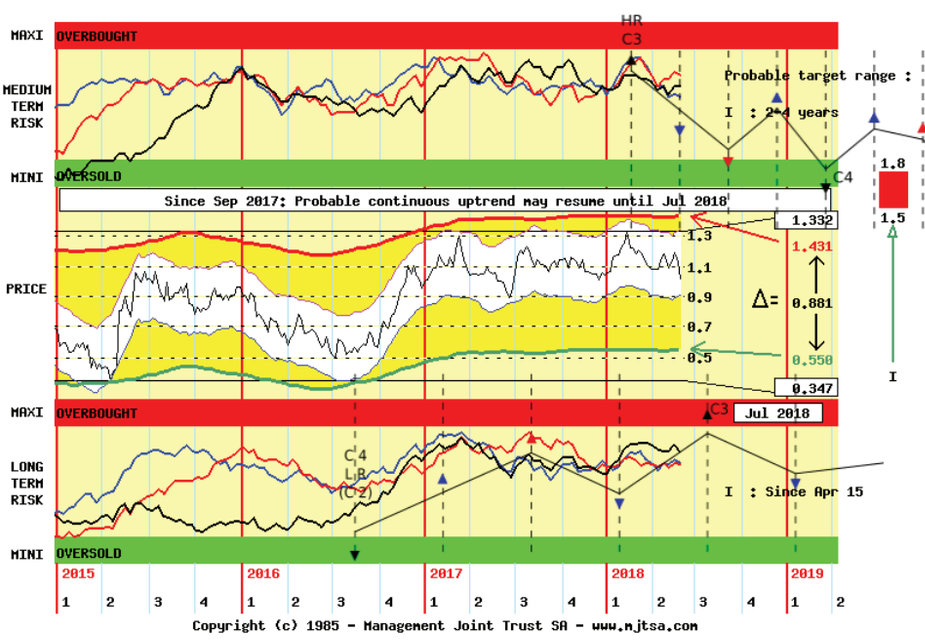

Since December, the upside momentum on Financials had been broken, and since February, these have started to reverse down vs the S&P500 Index. On both oscillator series (lower and upper rectangles), we now expect this downtrend to take a pause. Indeed, from mid June, we expect Financials to start bouncing towards July. Current levels on the ratio are also crucial as we are currently bouncing off the lower end of our C Corrective targets down (right-hand scale). These often serve as worthwhile support. **Hence, over the next week or so, we expect Financials to start bouncing vs the S&P500, probably into mid / late July. This move should accompany the last push up we expect on long term US yields.**

## Bund Futures (Sep)
## Weekly graph or the perspective over the next 2 to 4 quarters



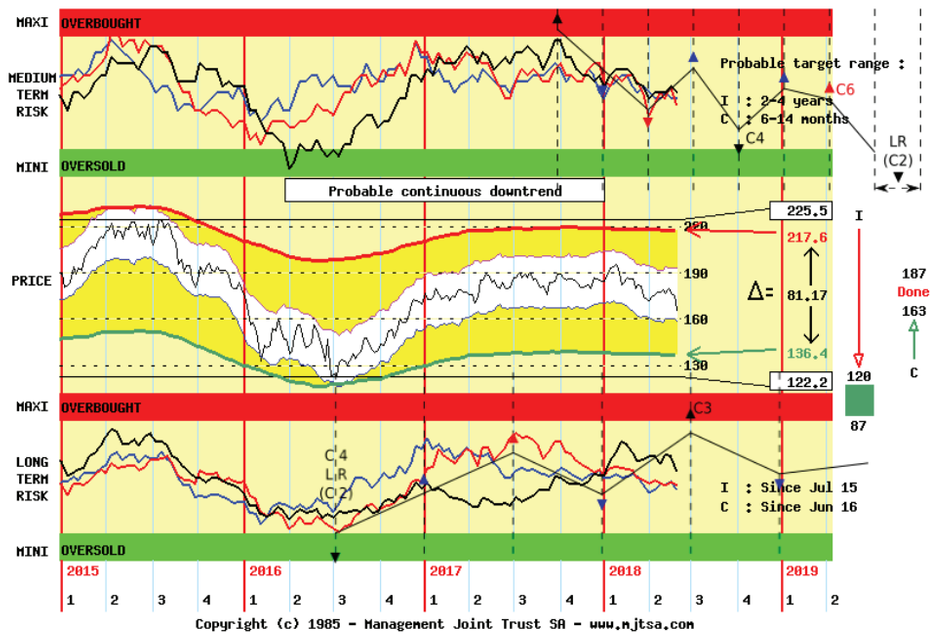

In Europe, the yield curve is driven by its long end given that short term rates are still stuck below zero. The Bund is hence the crucial instrument to watch in order to understand the future path of long term yields and of the yield curve in the EuroZone. **Since mid Q1, the Bund has been resuming up.** It started with the European surprise index which has been deteriorating since mid Q1, and then the recent Italian political crisis did trigger a strong Flight to Safety shift towards the Bund. On both our oscillator series (lower and upper rectangles), **we expect this move up on the Bund to continue, probably towards the Fall on our medium term oscillators (upper rectangle) and then well into 2019 on our long term oscillators (lower rectangle).**

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



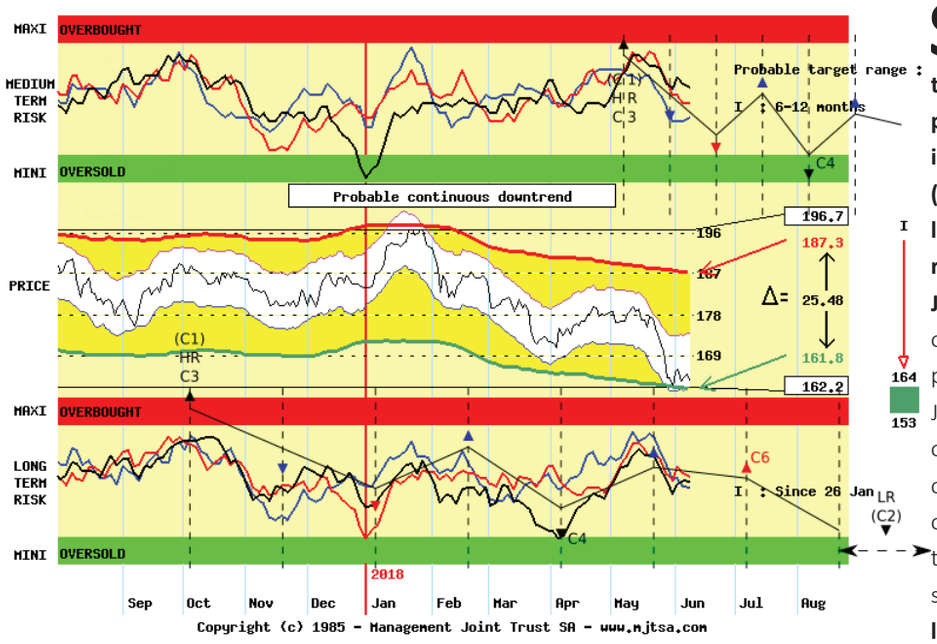

**Similarly the EuroZone yield curve spread may have started to reverse down in mid Q1.** Our long term oscillators (lower rectangle) still suggest one last upside retest for this 10Y-2Y German spread into July. Yet, the sequence we show on our medium term oscillators (upper rectangle) already seems to be down-trending. **We hence expect it to bounce a bit over the next few weeks, but thereafter, the European yield spread should resume lower probably towards end Summer and then again into early 2019. Hence, yields and the yield curve spread in the EuroZone may have already topped out for this cycle during Q1.**

## Bank Sector - Dow Jones STOXX 600
## Weekly graph or the perspective over the next 2 to 4 quarters




Along with German long term yields, the EuroZone yield curve spread has probably topped out already, and started to reverse lower. As in the US, this reversal should have a strong negative impact on the European Financial sector. This is indeed the case, even an absolute basis, as since mid Q1, the European banking sector has been going from bad to worse. Short term, both oscillator series (lower and upper rectangles) would suggest **an upside bounce into mid year, yet thereafter, we expect the European banking sector to resume lower again, probably towards year-end and then into 2019. Our I Impulsive targets to the downside (right-hand scale) would suggest significant risk for European banks, probably towards the 120 to 87 range or 30 to 50% below current levels. If we are correct, problems may be just starting for the European Banking sector.**

## Bank Sector - Dow Jones STOXX 600
## Daily graph or the perspective over the next 2 to 3 months




**Shorter term, looking at the Daily graph of the European banking sector, we would expect it to remain under pressure until August at least, and in first instance. Our long term oscillator series (lower rectangle) would suggest that following a slight bounce during June, European banks resume lower from early July into end August.** On medium term oscillators (upper rectangle) would also point to a slight bounce between mid June and early July and then a new period of weakness into August. Although most of the risk to the downside has been taken out for now (I Impulsive targets down towards the 164 – 153 range; right-hand scale), we could still expect **marginal new lows, some 5 to 7% below current levels on the sector, potentially by August.**

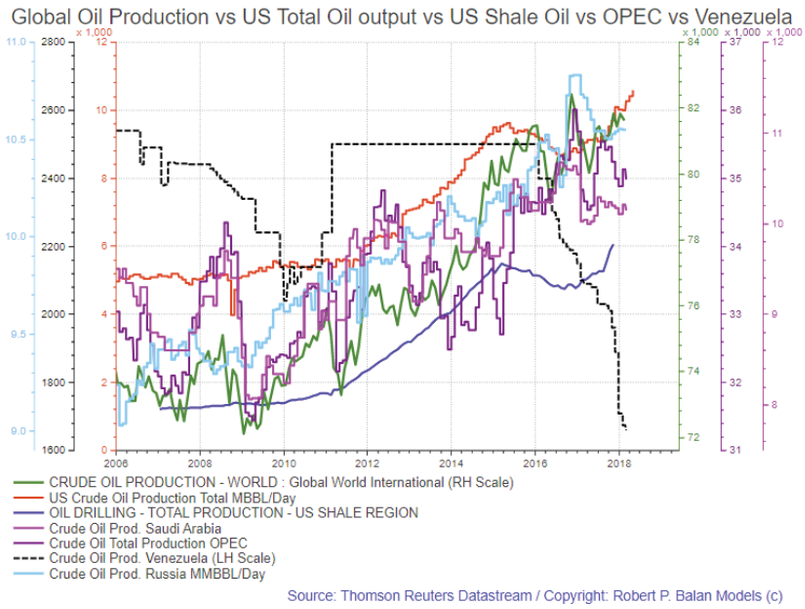
### Concluding remarks

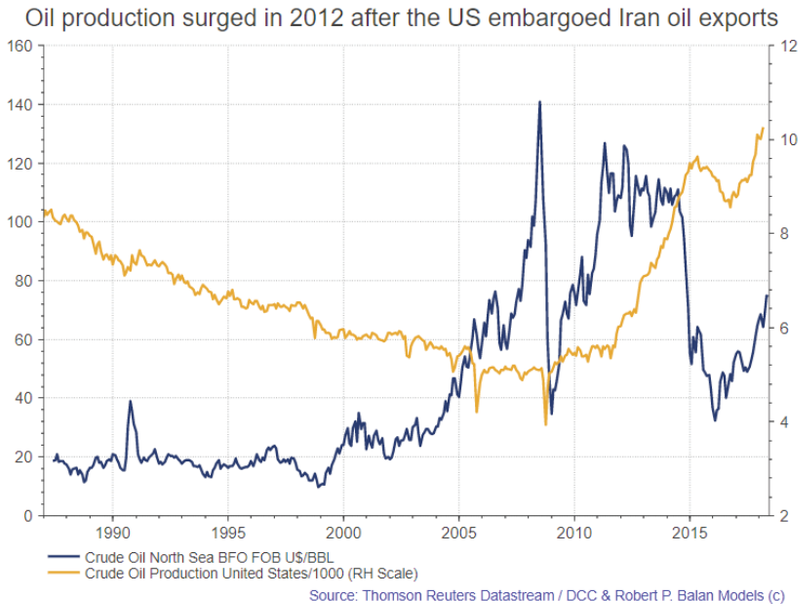
**In the US, the Yield curve should start to flatten again quite aggressively from mid-year / early Summer and towards year-end. By then, it may even be approaching inversion. Indeed, while we expect short term rate hikes to continue, at least into September, and probably into December, long term US yields will probably top-out during the Summer and start to retrace down. In the EuroZone, the Yield curve is driven by long term Bund yields. These may have already topped out in Q1 this year , and following a slight bounce into July, should continue lower towards year-end, thereby also flattening the yield curve in the EuroZone. These negative developments on the yield front are hitting the Financials sectors on both sides of the Atlantic, and these may have also probably already topped out for this cycle. The European banking sector does look particularly weak from this Summer into year-end, suggesting that a new European Sovereign crisis may be just starting.**

# 46 / Geopolitics faded out and oil fundamentals are back in the forefront, but the June 22 OPEC meeting could throw a Crude Oil curve ball

**In last month's Capital Observer (May 2018), we noted that geopolitics and fundamentals were colliding in the oil price discovery process, and we asked rhetorically – which one will win?** At that time, oil fundamentals have already become less price-friendly and it was just the slow simmer in adverse geopolitical events that was keeping sentiments of oil speculators still bullish. Then came the talk of OPEC potentially raising oil production by as much as 1 million bpd after global oil inventories have gone back to their five-year averages. Oil prices promtply collapsed, hastened along by a series of US inventory builds and a surge in US oil production.

At crude oil's lowest point in the sell-off on June 5, WTI oil lost $8.52 (from $72.80 to $64.28/bbl), which matches the Middle East risk premium of $7.00 to $9.00 per bbl. Why is this significant? Because removing that much from WTI oil price means that **the oil discovery process will now rely more on fundamentals than geopolitical events.** The current lower oil price is again open to a new series of Middle East political machininations, but nothing threatening is in the horizon, except for a quicker imposition of US oil embargo on Iranian oil exports. But that too has already been discounted by the market, especially after Saudi Arabia expressed willingness to make good any shortages caused by US action. The only event which one may call "force majeure" is a complete collapse in Venezuela's production. This slow-motion train-wreck has also been discounted by the market, as it is more than made up for by a new surge in US oil production, and higher Russian oil production, which already started ticking higher (*see first chart on this page*).



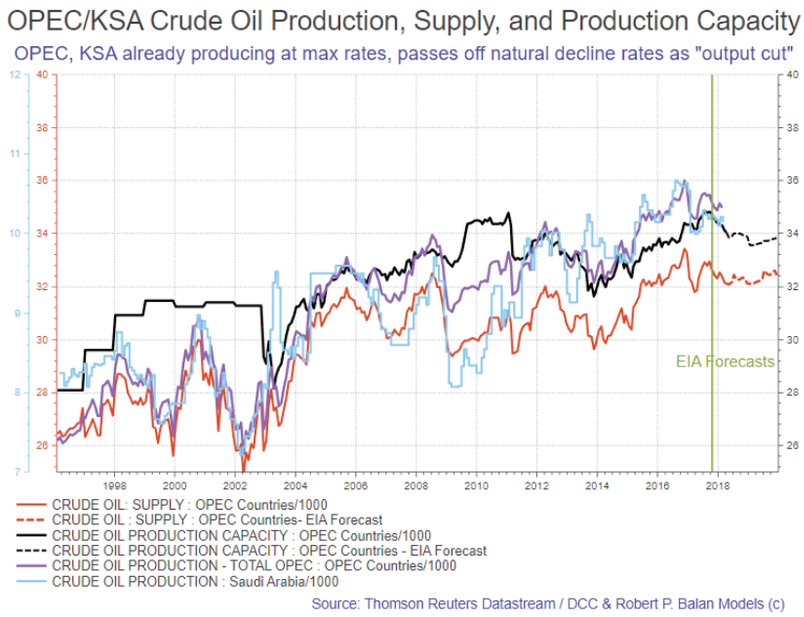

**The most significant wild card facing the market is the June 22 OPEC meeting**. It is shaping up to be a contentious one, after news broke that the U.S. government asked Saudi Arabia to increase oil production before Washington pulled out of the Iran nuclear deal. According to Reuters News, a high level Trump administration official called Saudi Arabia a day before Trump was set to announce the U.S. withdrawal from the Iran nuclear deal, asking for more oil supply to cover for disruptions from Iran. This has incensed Iran, and the apparent willingness of Saudi Arabia to comply with Washington's request has ignited furor from within OPEC.

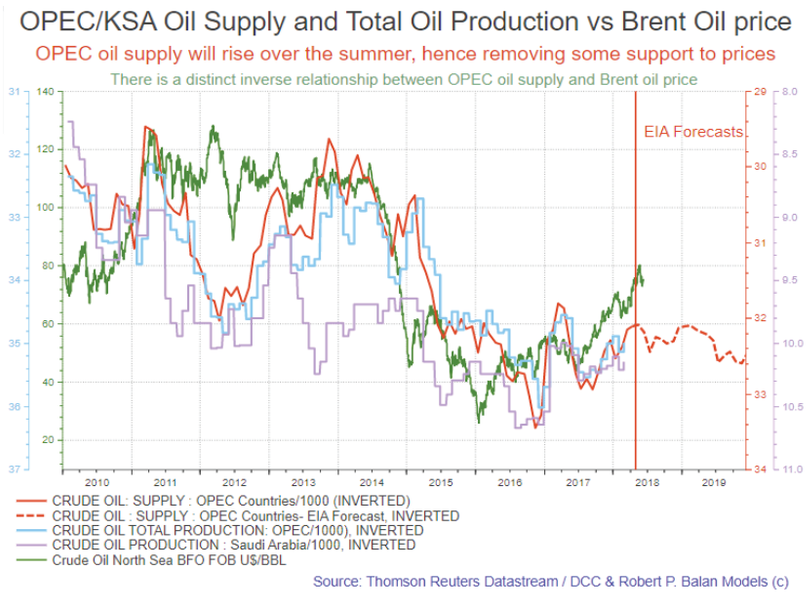
But this is not a special case, and there is no surprise that Saudi Arabia is just too willing to go along with the Trump administration. Anything that can financially hurt Iran, and slows down their capability to produce a nuclear bomb, will always be welcome in the Kingdom. Moreover, there is historical precedent. The last time the U.S. government pressured OPEC into adding supply, it was also over Iran. The Obama administration wanted the cartel to offset disrupted Iranian production, after an international coalition put stringent sanctions on Iran in 2012. Roughly 1 million barrels

per day were knocked offline, and OPEC finally made good the shortfall after oil prices run-up to $125.00, and triggered a severe global growth slowdown which just stopped short of a recession. That US oil production became almost exponential from late 2011 also held oil prices in check, and that helped convince the OPEC to leave Iran to its own devices (*see 2nd chart on previous page*).

Iran, and now, Venezuela wrote to OPEC members, asking them to denounce U.S. sanctions. But the OPEC steering committee rejected Iran's request which will be the likely fate of Venezuela's entreaties as well. Venezuelan oil minister Manuel Quevedo wrote: "I kindly request solidarity and support from our fellow members. The group should discuss the constraining effects of unilateral sanctions imposed by the United States of America, which represent an extraordinary aggression, financially and economically, for our national oil industry's operations and the stability of the market." (Reuters). Nonetheless, the fact that two founding members of OPEC are rocking the OPEC boat suggests that the June 22 meeting will be contentious. It suggests that a good portion of the cartel could line up against any move to increase production. It could set the stage for a heated meeting in Vienna and OPEC watchers are already suggesting it might be one of the worst OPEC meetings since 2011. At that time, Saudi Arabia wanted to increase production to ease triple-digit oil prices following the conflagration in parts of North Africa and the Middle East during the Arab Spring. The Saudis were overruled. And they may yet again be overruled come June 22, if the Saudis propose increased output, which is not yet clear at this time if they intend to do so.

There is a lot of farcical overtones into discussions going into the June 22 meeting, as the OPEC+Russia consortium's pact to limit output is a sham, for lack of better word to describe it. We have seen the power of any hint




to increase production – the price of oil promply tumbling down sharply. Aside from Iran and Venezuela's grip about the US "unilateral" embargo, **there is little incentive to increase production from OPEC. Just about every OPEC member outside of the Gulf is unable to increase production anyway, so it is of little surprise that they are, and will be, opposed to higher production**. Venezuela, Angola, Libya and Nigeria don't have official limits on their output as part of the OPEC deal, so there is little upside for them in supporting production increases from other countries. And they won't. Even the Gulf producers are already at maximum output, and they have gone to calling natural decline rates as "output cut" (*see 1st graph on this page*).

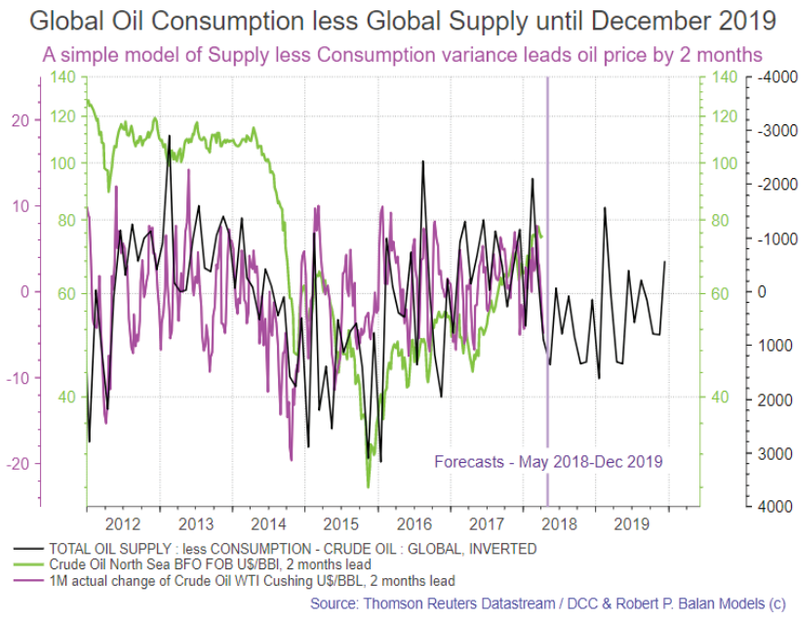
Russia (Rosneft) has already started raising production; and on Saturday (June 9) Russian news agency Interfax reported that Russia's oil production, the world's biggest, had risen to 11.1 million bpd in early June, up from slightly below 11 million bpd for most of May, and well above its target output of under 11 million bpd as part of the deal. OPEC oil supply has also started rising, as extraneous output goes into storage. Effectively, OPEC supply has bottomed in May, coinciding with the top in oil prices. OPEC supply will rise going into summer, and that will remove some of the support for prices**. There is a distinct inverse correlation between OPEC oil supply and price, so going into the June 22 meeting, this might pressure prices further** (*see 2nd graph on this page*).

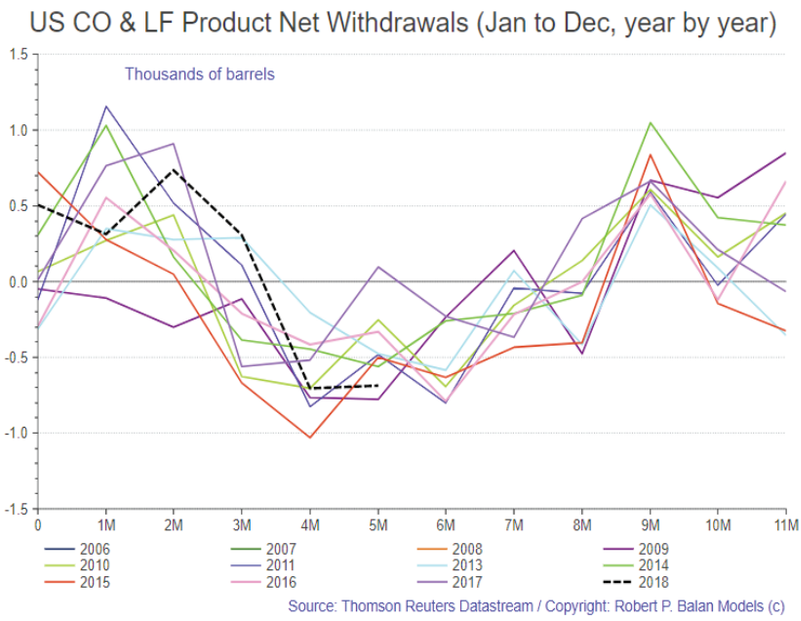
This could also be a significant development as further declines, after a circa $9.00 price declines in just a month, could harden the attitudes of the major producers. **We expect OPEC to reject any proposal to lift output soon, and the cartel will likely opt to let the agreement run as originally crafted.**

**Summary:**

**This will likely provide another upwave to Crude Oil's bull run. A new rally in oil prices should in fact coincide with, and support, a new bull market in equities up to an expected July-August peak**. However, the rally should be tempered by increasing US oil production during H2 2018. Demand is also expected to moderate somewhat, so there could be a test of the previous $72.80 top, but the calls for $80.00/bbl oil are unlikely to materialize. This theme is confirmed by a simple price model using the variance between global oil comsumption and global supply (*see 1st chart on this page*). The model shows that an oil bottom is likely in June followed by a moderate rise in price.

A pick up in H2 2018 is also supported by seasonal tendencies for oil demand and consumption to rise until Q3, this year and most years (*see 2nd graph on this page*). This tells us that the bottom we expected for equities and bond yields by the 3rd week of June, may be the same period when oil prices bottom and go on to retest the previous top.



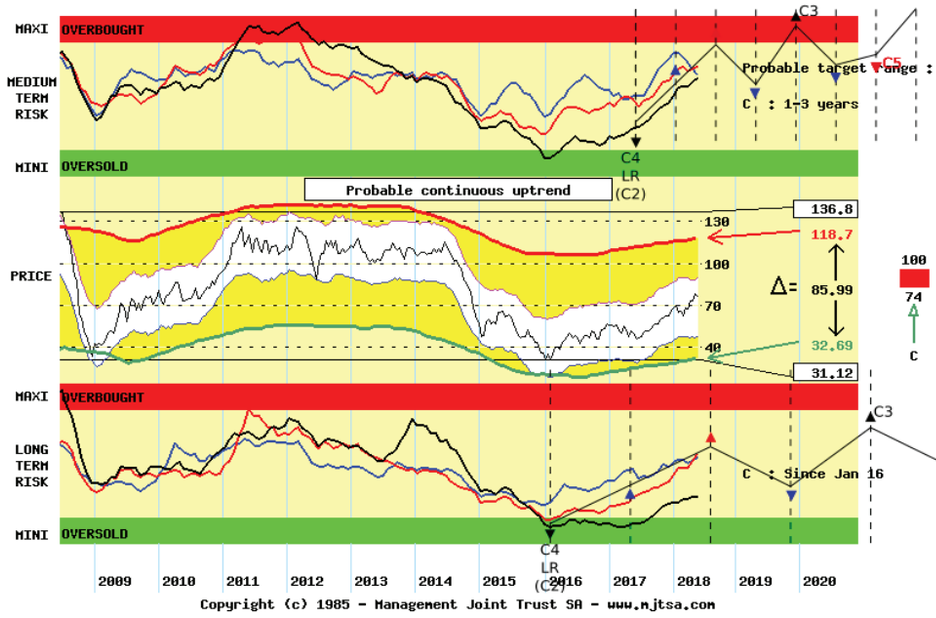



# 49 / MJT - TIMING AND TACTICAL INSIGHT

## As the business cycle matures, we expect one last push up for Oil into the Summer

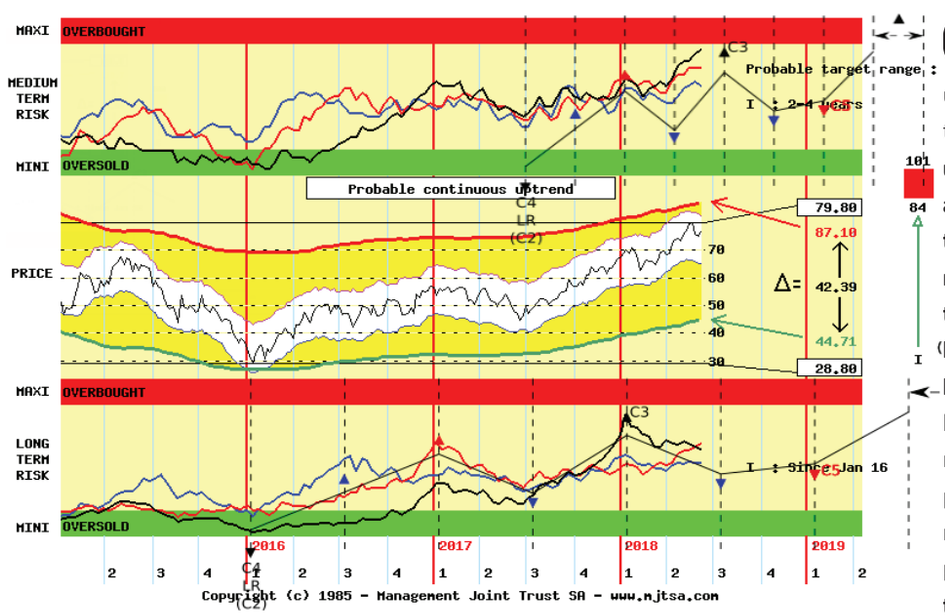
**A month ago, we were forecasting one last move up for Oil, possibly until early, perhaps mid Summer. Shorter term, however, we expected a slight counter-trend move lower, probably from mid May to early June, which we labelled as a last/late "Buy the Dip" opportunity. Over the last few weeks, the first leg down of this articulation has come true, shouldn't we now be preparing for Oil's last leg up.**

## Brent Oil (Spot)
## Bi-monthly graph or the perspective over the next 1 to 2 years



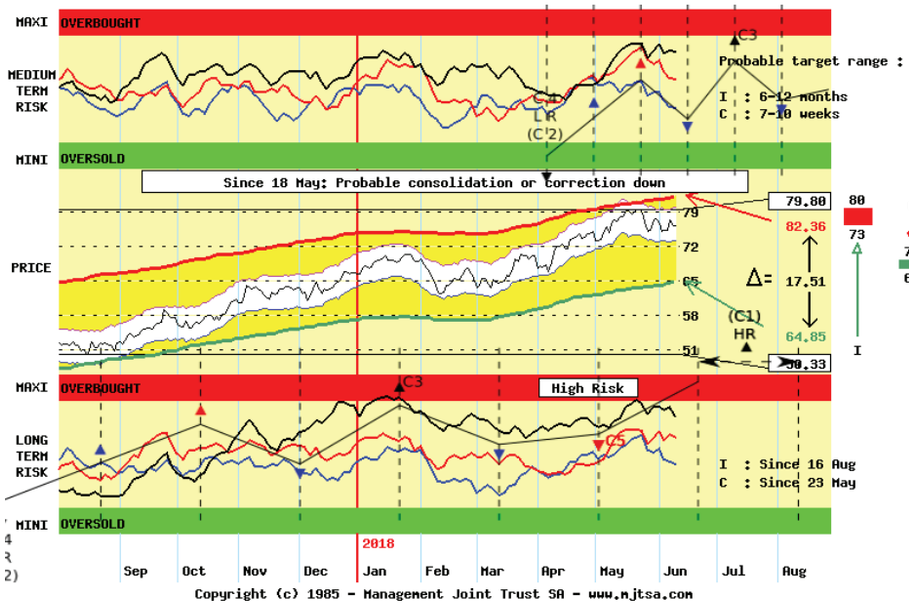

Long term, Oil has already come a long way since it bottomed out in early 2016 slightly below 28 USD/barrel. In fact, it is now back in the range of the 2014 sell-off, having taken out its 2015 highs earlier this year. This break-out event may have opened the door to much higher levels, as above 70 USD/barrel, **there are little historical technical resistances left until Brent reaches the high 90s USD/barrel**. Although our C Corrective targets to the upside (74 -100 range; right-hand scale) may justify such a move, **the time left to achieve it in this economic cycle seems limited**. Indeed, both our oscillator series (lower and upper rectangles) are suggesting that **Oil may top out sometime this Summer and start to correct down towards year-end and 2019.**

## Brent Oil (Spot)
## Weekly graph or the perspective over the next 2 to 4 quarters



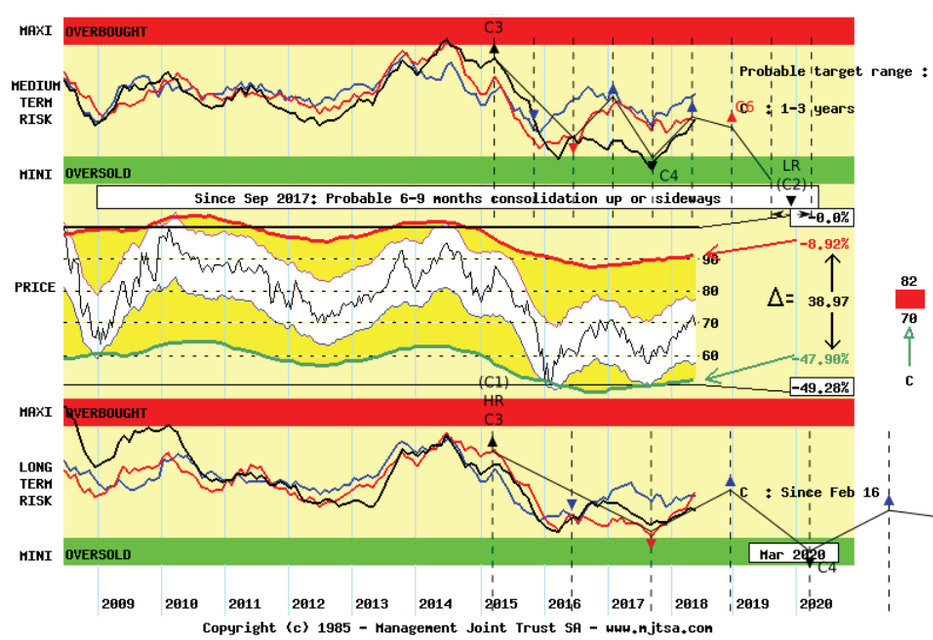

On our Weekly graph, our I Impulsive targets to the upside (right-hand) are indicating that **Brent Oil may reach up above 85 USD/barrel, and possibly even towards the symbolic 100 USD/barrel mark. Here too, however, the time left to achieve this acceleration to the upside seems limited.** Indeed, while our long term oscillators (lower rectangle) may be still supportive towards next year, our medium term oscillators (upper rectangle) are signalling **that a top should materialize as early as July (over the next month or so)**. This is in line with our long term projections on the bi-monthly graph above, and the correction down that follows should last into early 2019 at least (and probably more if you consider our long term graph above).

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



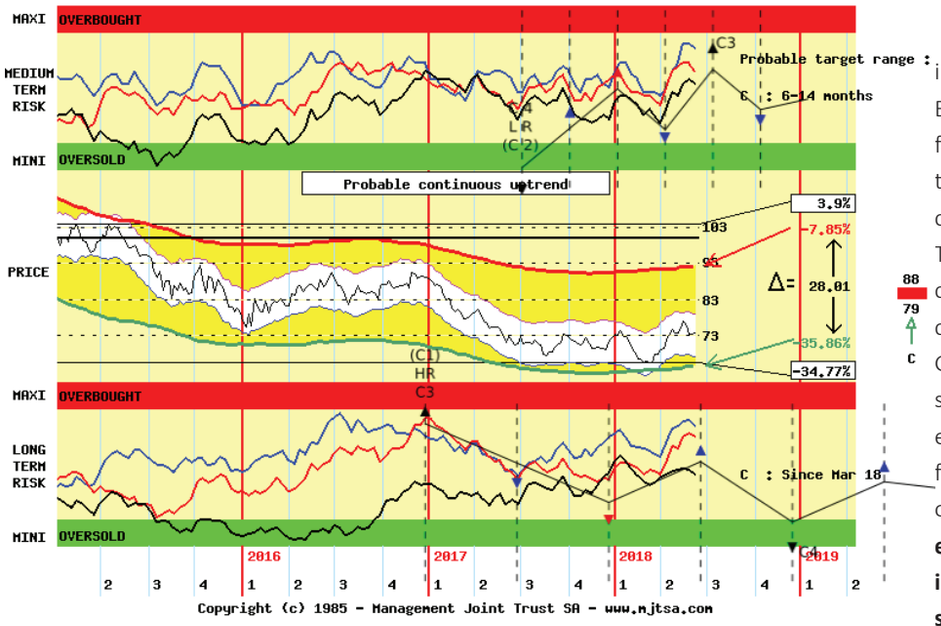

The uptrend on our Daily graph is already well advanced, with a "High Risk" situation, which was detected in May by our automatic messaging system (lower rectangle). That said, it may have come slightly too early, as the sequences we show on both oscillator series (upper and lower rectangles) would rather suggest **a Summer top, towards mid/late July**. Shorter term, our medium term oscillators (upper rectangle) are indicating that a low will be found over the next week or so, which could provide an entry point for this ultimate move higher. **On the price targets front (right-hand scale), our I Impulsive targets to the upside have been achieved between 73 and 80 USD/barrel. Their higher end may be retested and slightly surpassed during the last move up we are considering until July. If we would factor the eventuality of a spike (a typical late cycle event), Brent could theoretically reach up to our I2 Impulsive 2 extended upside targets. These would calculate in a range between the high 80s and the low 90s USD/barrel for Brent.**

## S&P Oil & Gas Exploration & Production / S&P Integrated Oil & Gas
## Bi-monthly graph or the perspective over the next 1 to 2 years



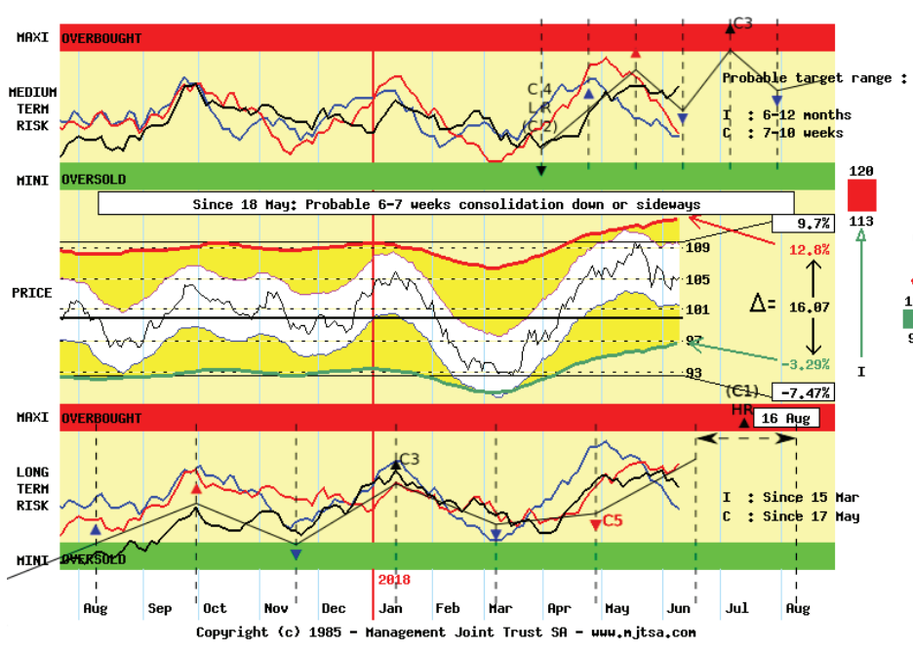

**Beyond the top we expect on Oil this Summer, this long term graph reiterates our defensive bias on the Oil and Energy thereafter.** It compares the S&P Oil & Gas Exploration & Production segment index, which is quite sensitive to progressions in Oil prices, to the more defensive segment of usually large integrated Oil & Gas producers. **In a way, this ratio is a "beta" measure of the Oil sector.** Following the two bounces we have seen since early 2016, both our oscillator series (lower and upper rectangles) would suggest that **the ratio could be topping out again between now and year-end, and that thereafter, the higher "beta" companies of the Oil Industry could remain under pressure until late 2019 / early 2020**. The fact that the move up since 2016 never made it above our C Corrective targets to the upside (right-hand) would confirm our assessment that this move was just a counter-trend reaction, and that a new move lower in the direction of the previous trend (down) is now likely.

## S&P Energy sector / S&P500 Index
## Weekly graph or the perspective over the next 2 to 4 quarters



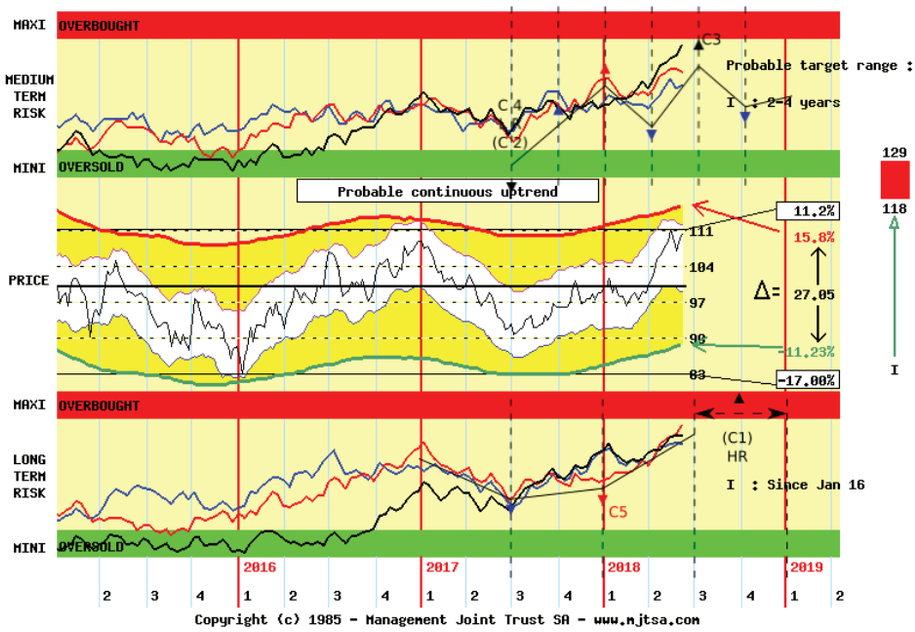

The Energy sector underperformed the S&P500 Index in 2017, as Value sectors, and Energy especially, underperformed Growth trades. Indeed, throughout last year, the yield curve has struggled to steepen. This usually favours long dated cash flow streams vs more cyclical ones (Energy is cyclical). Going forward, the situation should remain the same, as we expect the yield curve to flatten further in H2 2018 (see graph on page 42). **Shorter term, into early Summer, a slight pick up in Energy vs the S&P500 may still be expected on the back of a last move up in Oil prices. Following that**, as shown on both our oscillator series (lower and upper rectangles), **we would expect Energy to underperform again into the Fall and towards year-end.**

## S&P Energy sector / S&P500 Index
## Daily graph or the perspective over the next 2 to 3 months



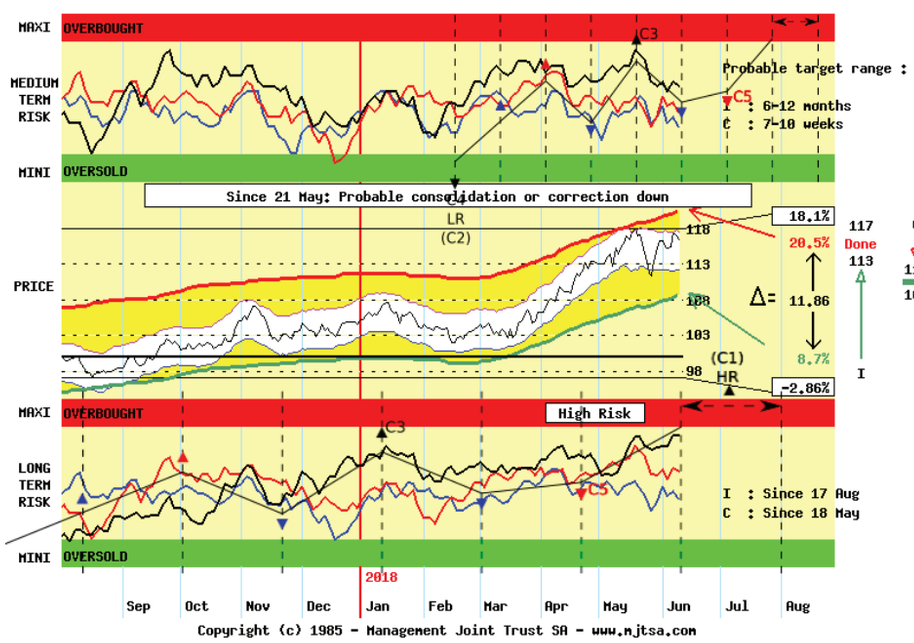

Following a good run over the last few months, both our oscillator series (lower and upper rectangles) suggest that the Energy sector could be topping out vs the S&P500, at some time between late June and early August. This would also corroborate our Daily graph on the US yield curve on page 42 of this document. On the target front (right-hand scale), the ratio could still outperform by another 10 to 15% until then, but as mentioned above, the time window for this move is closing. **We would hence start to turn prudent on the sector vs the S&P500, probably during July**. Note: on an absolute basis (standalone), we would also expect the Energy sector to top out towards early Summer as mentioned in last month's edition of The Capital Observer.

## Energy sector - Dow Jones Europe STOXX 600 / Dow Jones Europe STOXX 600
## Weekly graph or the perspective over the next 2 to 4 quarters




Since mid 2017, the European Energy sector has seen more upside momentum vs the Europe Stoxx 600 than in the US. That said, on both oscillator series (lower and upper rectangles), we expect the Energy Stoxx Europe Index to top out vs the Europe Stoxx 600 Index towards early Q3. In our view, the correction to the downside that follows will probably last into year-end. On the target front (right-hand scale), our I Impulsive targets to the upside would suggest a further 7 to 15% of possible outperformance. Yet again, the time window to achieve these levels is rapidly closing. **We will hence also start to turn prudent on the European Energy sector during July.**

## Energy sector - Dow Jones Europe STOXX 600 / Dow Jones Europe STOXX 600
## Daily graph or the perspective over the next 2 to 3 months




Shorter term, the relative ratio of Energy vs the market in Europe is showing only limited upside potential left (our I Impulsive targets to the upside have been achieved and are labelled "Done"; right-hand scale). That said, on both oscillator series (lower and upper rectangles), **the outperformance of European Energy may still extend slightly higher towards July, perhaps even towards early August. As with other graphs in this article, we would probably let the Energy Nexus attempt one last push up into July. Thereafter, we expect Oil to top out for the next few quarters, and will probably turn neutral on the sector, at best.**

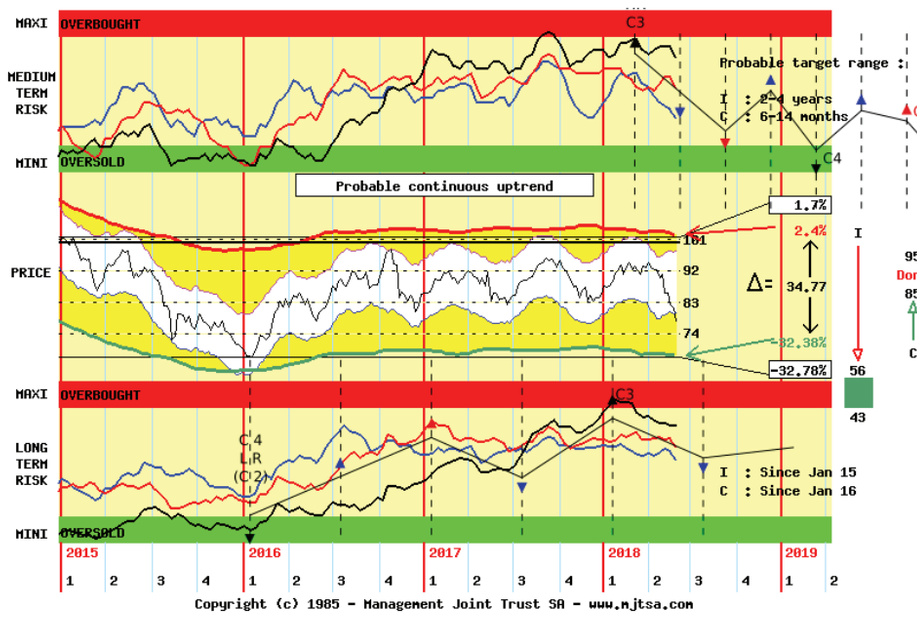
### Concluding remarks

**Following their short term correction since mid May, Oil and the Energy sector may be getting ready for a last period of outperformance. We expect it to materialise from mid June into early / mid July. Brent Oil should break back above 80 USD/barrel, and could even push higher (high 80s?) on a spike (which would be a typical late cycle phenomenon). Following that, we expect Oil and Energy to start correcting down, possibly towards year-end, and early 2019 at least. The Energy sector may be particularly hard hit as we would also expect the US and European yield curves to start flattening again. This phenomenon is usually a drag on value and cyclical sectors (of which Energy).**

# 53 / Splicing the markets – Differentiation in Emerging markets – Asia should hold its ground

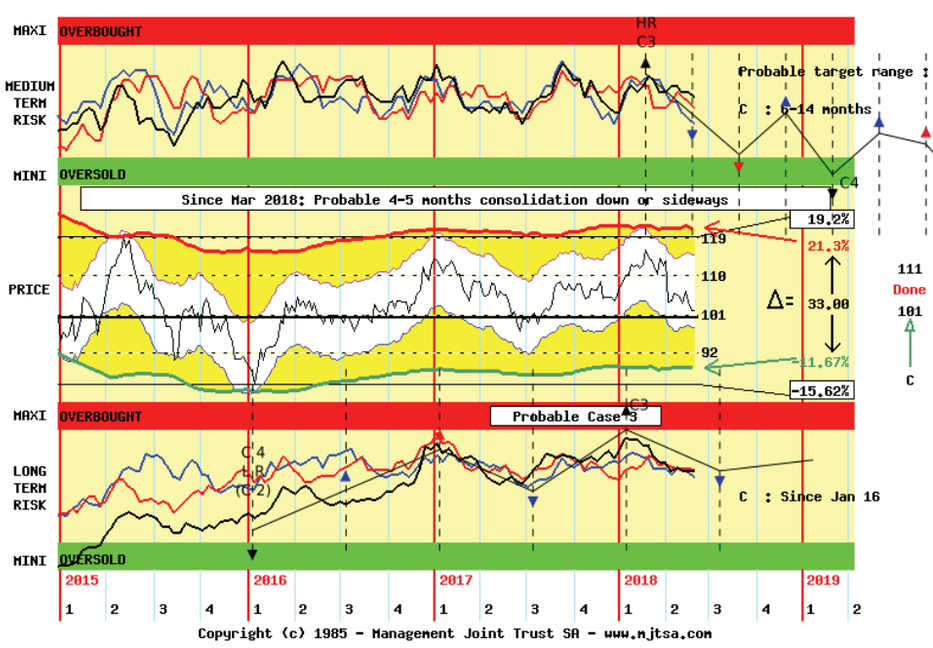
**Emerging markets are currently being hard hit by the recent US Dollar surge. Yet, it appears that in these later stages of the Equity Bull market, not all Emerging markets are made equal. Indeed, while Latin America and Eastern Europe seem particularly weak, Asia may still have the potential to outperform into the Fall.**

## MSCI Emerging Markets Latin America / MSCI World Index
## Weekly graph or the perspective over the 2 to 4 quarters



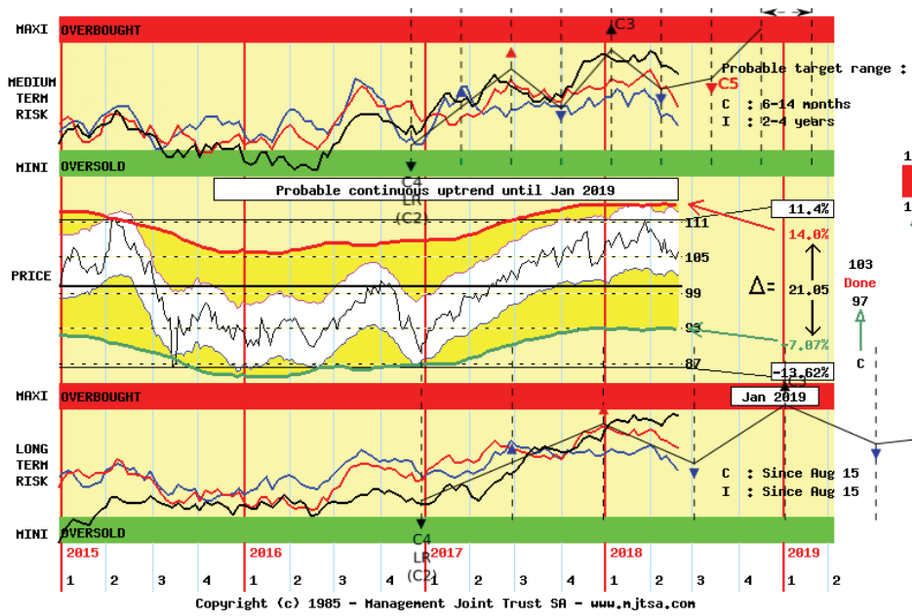

**Vs the MSCI World, the Latin America Emerging markets index has probably topped out for this cycle and is getting ready to underperform again, probably towards late Summer and then into 2019**. Indeed on our long term oscillator series (lower rectangle), the Latin America Emerging market Index made an important top vs the MSCI World. In fact, the whole move up since 2016 can be labelled as just a Correction, i.e. the move on the ratio never made above our C Corrective targets to the upside (right-hand scale). It is now resuming lower into its previous downtrend as shown by the sequence down we project on our medium term oscillators (upper rectangle). **The underperformance potential is important over the next few quarters as suggested by our I Impulsive targets down (right-hand scale). It calculates that Latin America could underperform the MSCI World by 30 to 50% into 2019.**

## MSCI EM Eastern Europe / MSCI World Index
## Weekly graph or the perspective over the next 2 to 4 quarters



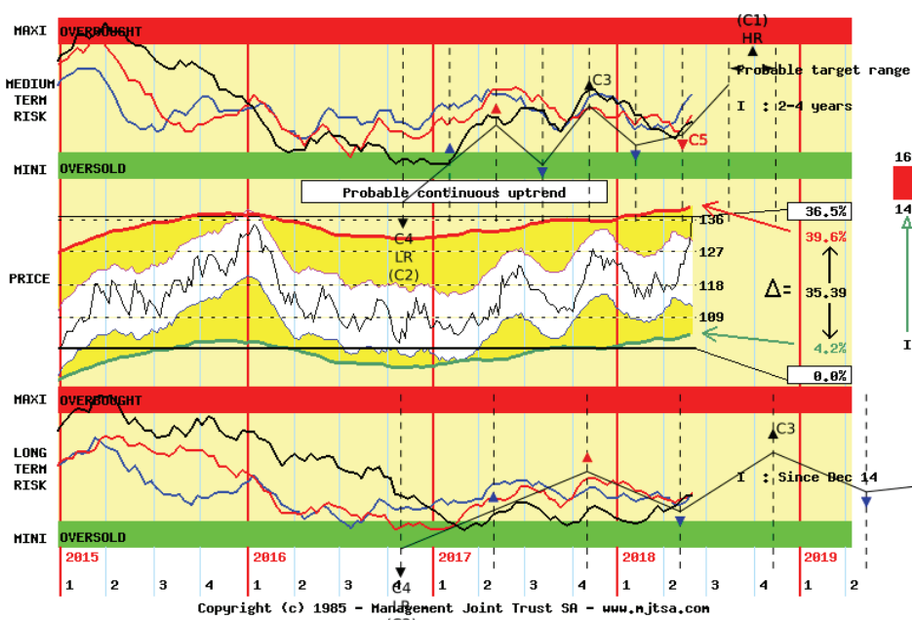

**The ratio of Eastern Europe vs the MSCI World features a similar situation**. Indeed, on our long term oscillators (lower rectangle), the move never really made it above our C Corrective targets to the upside (right-hand scale), i.e. it was just a correction, and recently in Q1 2018, it made an important top. On our medium term oscillators (upper rectangle), **we now expect it to follow a downtrend sequence, first into late Summer and then towards 2019. The I Impulsive targets to the downside we can calculate** given our current volatility measure "Delta" (here at 33%; middle rectangle, right-hand) **would suggest that the underperformance potential towards next year is between 30 and 50%** (or towards a range between minus 1.3 to 1.7 times "Delta" substracted from the recent highs in the ratio which were made in Q1 2018).

## MSCI Emerging Markets Asia / MSCI World Index
## Weekly graph or the perspective over the next 2 to 4 quarters




On the contrary, the Emerging Markets Asia index seems better positioned vs the MSCI World as we move in to the second half of the year. The index is composed for 42% of China, 20% of South Korea, 16% of Taiwan and 11% of India. Although on both oscillator series (lower and upper rectangles), we may have reached an important intermediate top in late Q1 2018, another sequence up, which started in late 2016 may still be underway. **It could lead the ratio higher again into Q4 2018 and potentially even towards year-end. Although our I Impulsive targets to the upside do seem aggressive given our generally prudent bias on Emerging markets (see page 21 of this document), we would probably expect the ratio to attempt a retest of its recent highs between now and year-end. At leasr Emerging Asia does seem to hold up much better than the two other regions featured on the previous page.**

## MSCI Emerging Markets Asia / MSCI Emerging Markets Latin America
## Weekly graph or the perspective over the next 2 to 4 quarters



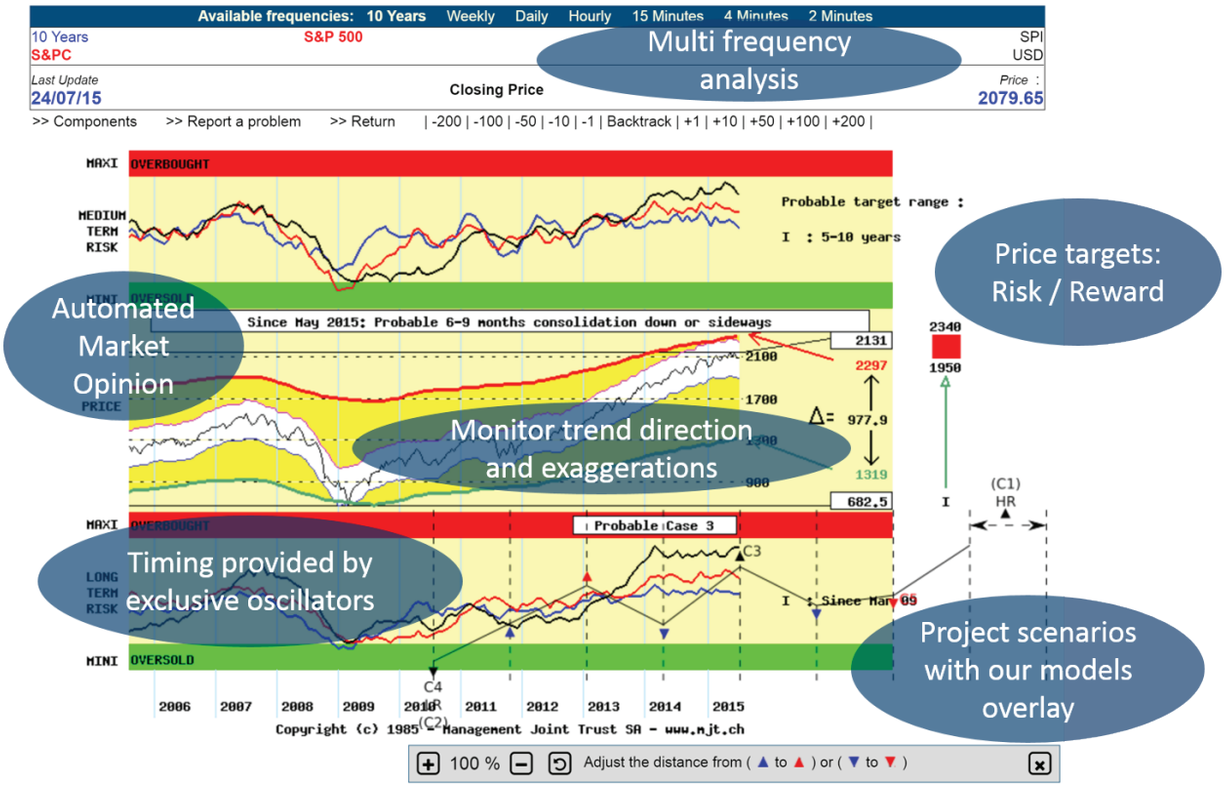

**On this graph, we compare the performance of Emerging Asia over Latin America. Both oscillator series (lower and upper rectangles) are in strong uptrend sequences and we would expect these to top out towards the Fall**. Our I Impulsive targets to the upside (right-hand scale) would suggest an outperformance potential of between 7 to 18% for Asia Emerging Markets vs their Latin American counterparts.

### Concluding remarks

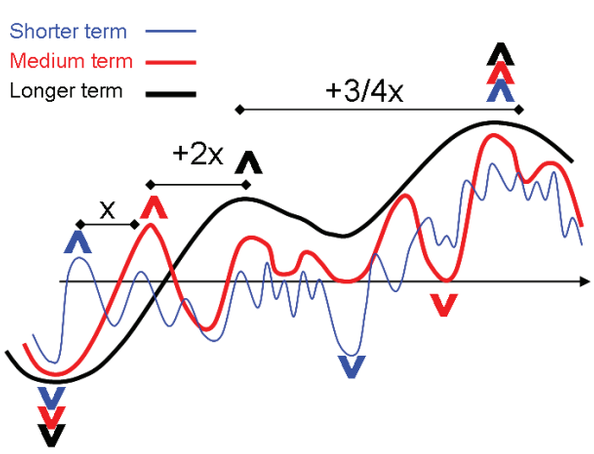
**Our view, is that any bounce in Emerging markets over the next few weeks should be considered as an opportunity to exit these trades, or at least reduce them on a relative basis. That said, while Asian Emerging markets could hold up rather decently until the Fall, and probably year-end, the urgency to reduce Latin American and Eastern Europe is probably much greater.**

# 55/ 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)

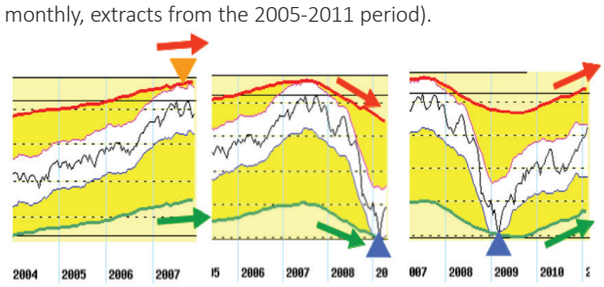



**Timing oscillators:** Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)

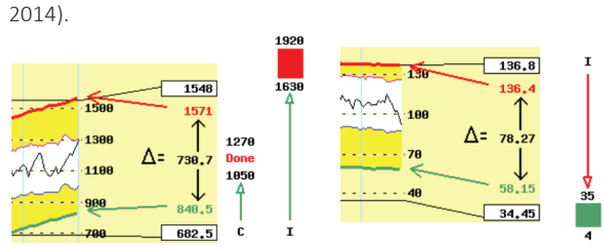




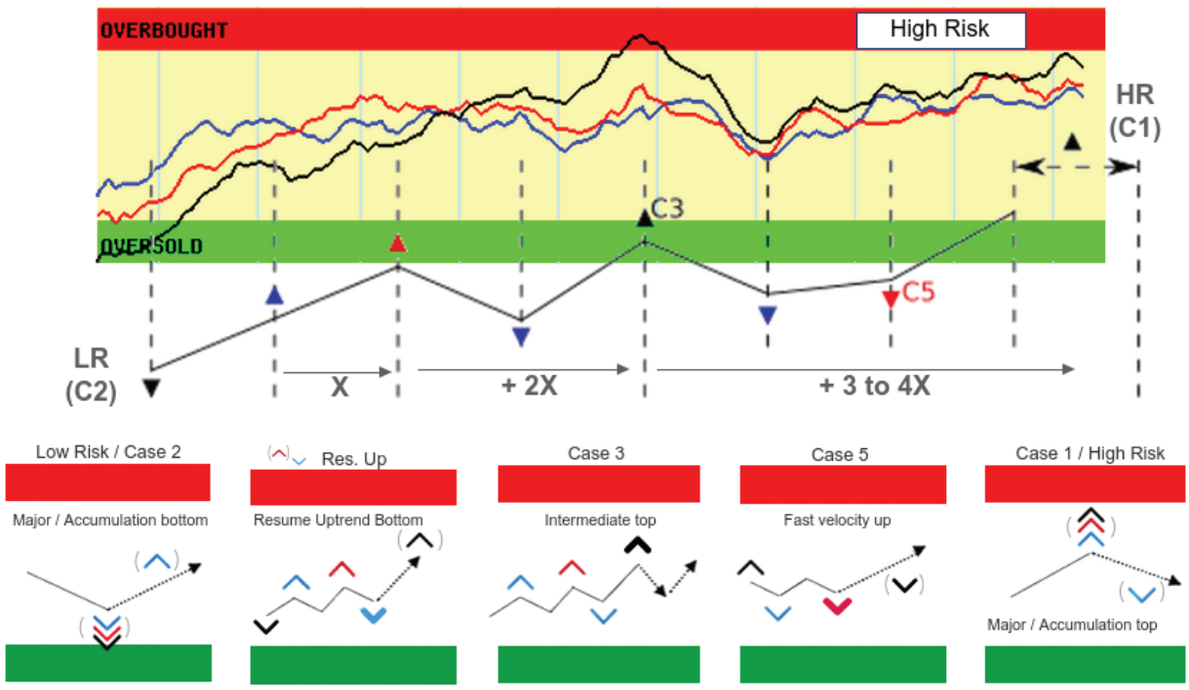

**Trend direction:** the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points ( e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).




**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).



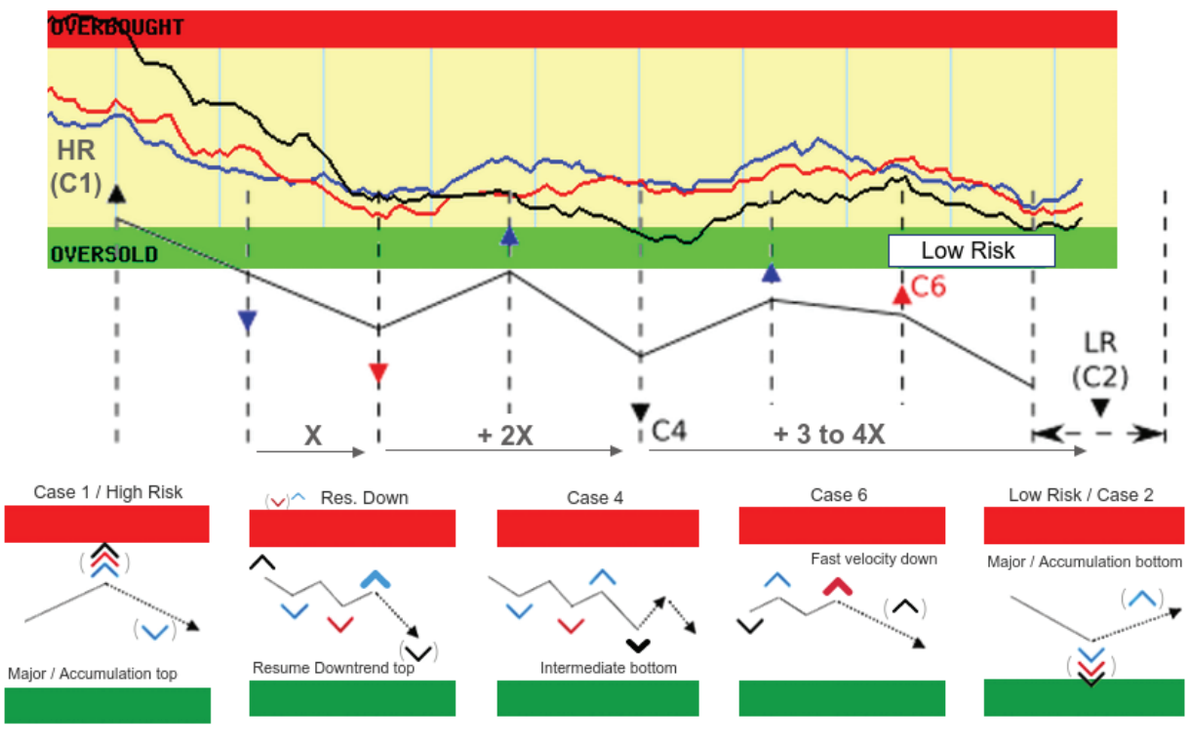
### Ideal Uptrend Model






(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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