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A DC&C publication,
featuring MJT timing methodology

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Diapason Commodities & Currencies

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DIAPASON COMMODITIES AND CURRENCIES MACRO ANALYSIS

A Monthly Macro and Asset Review

Featuring MJT Timing Methodology

CONTENTS

The positive reaction of US equities, driven by banks and cyclicals, and the US Dollar to US Presidential elect Trump's shock victory at the expense of Treasuries, reflects increased market expectations of a reflationary US policy stance (increased infrastructure, tax reforms and reduced regulations) over the medium-term. However, key posts for Trump's administration have not yet been announced and the medium-term policy outlook is clouded, so the initially favourable US market response to latest developments may prove premature. Felix Martin

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Post Trump's election, the financial markets may not deliver what investors expect – look for another disappointment in linear thinking.

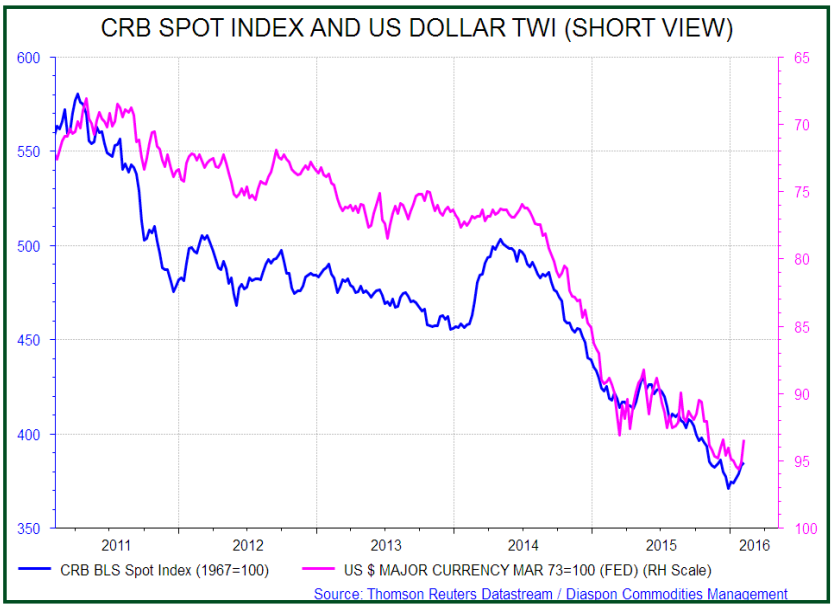
Many analysts characterize the sharp appreciation of risk asset prices after the election of Mr. Donald Trump as "reflation" – in the two weeks after Trump's election, US stocks went on a tear, the S&P 500, the Nasdaq Composite, the Dow Industrials and the Russell 2000 index simultaneously hitting new record highs last month. The Financial Times noted that an event like this had not happened since New Year's Eve of 1999, as the tech bubble was about to reach its apex. **The imagery is such that Mr. Trump's election clicked on a switch which ignited a humongous rally in the equity markets and the US Dollar, and sharply de-rated the bond market. That characterization is very far from the truth – the reality was that the reflation process started much earlier.** In fact, by mid-February this year, we started a countdown for a cyclical trough in hard assets, after the US Dollar weakened, and the CRB Index correspondingly rose by almost 4% ("Elements of a turn-around in commodities: are commodities bottoming out?", February 13, 2016). In that report, we noted that:

"*The world was still obsessed with the prospect of Chinese weakness, Fed tightening, collapsing commodity prices and super-low oil prices, all of which might -- or so the thinking goes -- tip us into a deflationary downward spiral, with adverse consequences on asset prices. When a narrative such as this becomes so widespread, it's easy to miss important clues that espouses the contrary opinion . . . One of such clues was the sharp appreciation of the CRB Index from the November 2015 low. Since late November, the index was up almost 4% - after tumbling more than one-third of its index value from its early 2011 high. As the chart below shows, the plunge in recent years is similar - if not greater - in magnitude to other plunges, all of which were followed by significant reversals to the upside. Maybe the great commodity sell-off is slowing down and could soon come to an end? As the chart below shows, commodities have a strong tendency to move inversely to the US Dollar Trade Weighted Index.*"

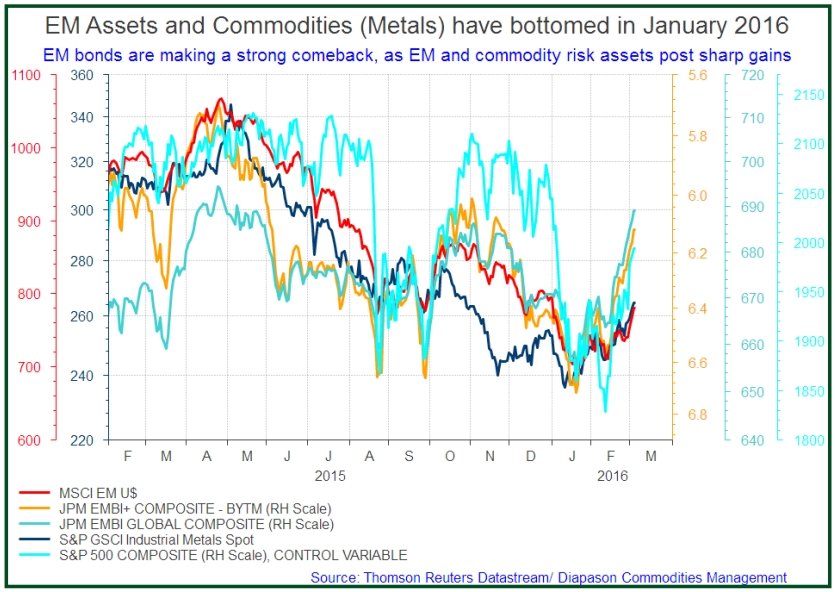
"*Might it be the case that the US Dollar is beginning a topping out process as well, complementing a commodity recovery? Our scenario is that there could still be a short-term strength left in the US Dollar – hence, we are prepared to see a further short-term weakness in commodities as well. But we believe that for various reasons the Fed is unlikely to raise rates aggressively over the course of the year. The FOMC itself pencilled in at least four instances of tightening, but the market now expects two more over the next two years. With the greatly reduced prospect of higher short-term rates (and less than previously expected Fed tightening), the dollar has been losing some of its appeal . . . The down moves in crude oil, copper, cocoa and other raw material markets at the end of 2015 are likely to give way to large recovery rallies in the weeks and months ahead.*"

February 2016 marked the bottom of spot commodity prices, and hard assets went on a mini-tear since then -- so much so that by early March, we were getting concerned that the unwinding of short commodity trades was getting a little out of hand. This is what we reported at that time ("Green shoots are sprouting across all risk assets, but prices have risen too quickly", March 7, 2016):

"*We also said that when these one-way short trades unwound, it would be the short squeeze of historic proportions. Some green shoots started sprouting when the commodity space recovered from an early January*



nasty sell-off. The proximate cause was a sharp US Dollar decline, in line with a new market calculus that the Fed may not be in a position to raise rates this year due to the turmoil in the global financial markets. EM bond yields also peaked, EM equities and base metal prices started to move higher. It also helped that US equity markets rose strongly from a very sharp sell during that period (see the chart below)."



"The big question is this: will this last? The world's markets are rallying nicely as the U.S. enjoys improving data and China looks set to implement stimulus to forestall further growth deterioration. But INFLATION remains the ultimate test and goal. The world's central banks are trying everything, even negative interest rates, to battle disinflation (and promote a little bit of inflation), but while the investment markets don't seem to think anything is working, economic data suggests that we're on the cusp of inflation beginning, at least in the US. "

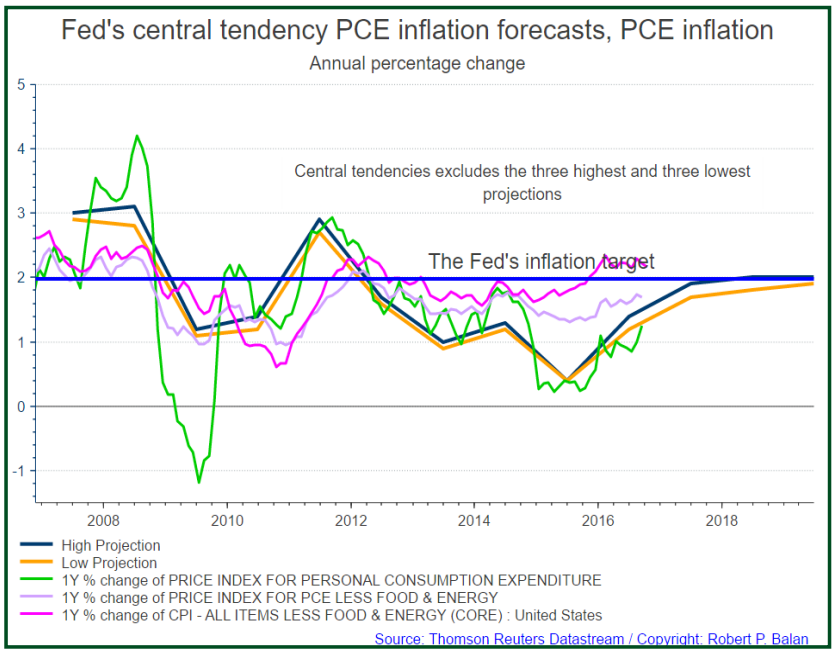
"We believe that positive jobs and wages data are a sign that inflation — the current gold standard for economic recovery — may be right around the corner. The Fed's latest Beige Book indicated that wage pressures are escalating, which of *course a prerequisite for inflation to catch a foothold. The primary cause for disinflation – falling energy prices – might disappear soon. Oil prices might be on the path to recovery as investors have been rewarding major oil giants for cutting their capital expenditures plans for this year, which will help limit oil output, requisite to higher prices. With stable oil prices, rising cost of services will be instrumental in pushing CPI inflation in the US."*

"The broad underpinnings of the January CPI data confirm that the reality of higher inflation will remain a game-maker in our near-future. The notion that deflation is THE existential threat, and that the powers-that-be are helpless to combat it, may become a critical miscalculation of the market. We believe that inflation is headed higher, whether investors expect it or not. Inflation has been trending below the Federal Reserve's target of 2.0% for the past four years, a fact that has conditioned our minds to expect low and slow growth -- low inflation had suggested weak demand growth and had raised fears of actual decline in prices, or deflation. For us, this is wrong-headed – this condition will not persist for long."

Back to the present. It is clear that the seeds of the current rally were planted earlier in the year, and the markets were already betting on reflation long before Trump's victory added further fuel. Granting that this reflation process started earlier, will the markets continue to maintain the momentum that we have seen in the past few weeks? Will it be a long-duration final leg to the equity bull market, or the start of a short-lived, speculative "melt-up" like the one seen in 2000, followed by a multi-quarter correction in all risk assets? To answer these questions, we may have to accept that the startling reversal of market sentiment after Mr. Trump's election may not be a frivolous, one-off phenomenon. As we have documented above, the reasons for the ongoing rally in risk assets are deep-seated and the message being sent by the current price action should be taken seriously. **But there are cross-currents investors should be wary of. Here are the reasons why:**

The new president will be working with a backdrop of a unified Republican control of both Houses of Congress, which means that gridlock is over, and there would be a distinct shift to fiscal policy orchestrated by Congress, after eight years of dominance by monetary policy conducted by the Fed. The market seems to like the prospects of that change – hence the exuberance of risk assets during the past few weeks. So, until the shift to fiscal policy fails to take place, or there is unmistakeable evidence that it failed to spark growth, the best strategic stance is to expect that markets will hold on to that assumption, and will continue to boost positive bets that reflation trades are the way to go forward. Indeed, there is compelling evidence that during a great financial crisis (GFC), fiscal policy solutions are more efficacious than monetary policy actions. This was illustrated by the evolution of economic activity during the GFC of 2007-2008.

The consequent sell-off of bonds and massive inflow into equity funds was breath-taking, and likely reflects the genuine belief of investors that inflationary growth policies will be in place soon, and that those policies will be implemented quickly. That is all good, if these assumptions will come to pass. This is actually the weakest assumption adopted by the



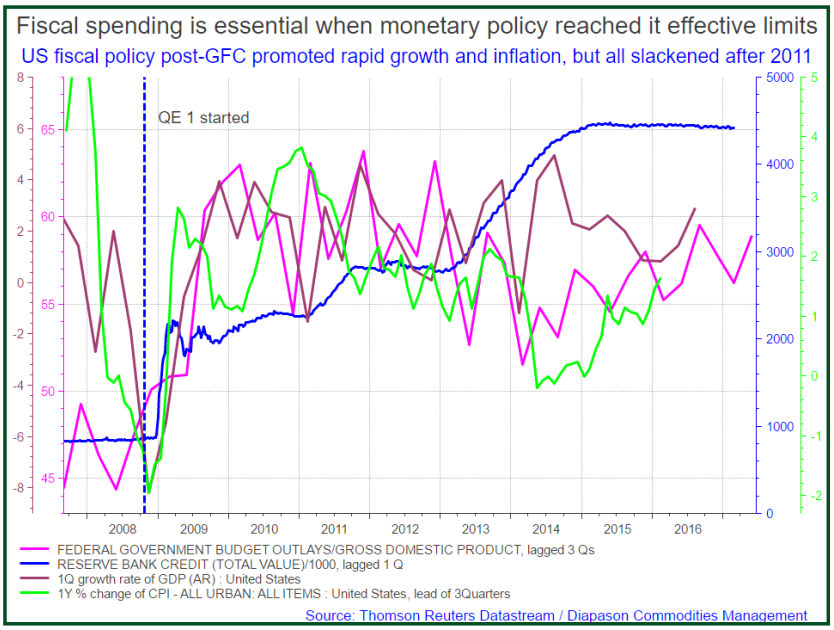
market. The fact that the presidency and Congress being controlled by the same political party does not guarantee trouble-free adoption and implementation of Mr. Trump's campaign promises regarding building of infrastructure. On closer analysis, Mr Trump's plans seem to rest largely on a proposal to give tax breaks to companies for infrastructure investment – the government does not implement the projects and the spending itself. That may be the vulnerable point in the strategy. The way we see it, expenditures emanating from infrastructure projects over the near-term, as defined by Mr. Trump's campaign narratives, are no slam dunks. But most investors believe that those projects will come to pass soon, so we will keep an open mind, until we see evidence suggesting otherwise.

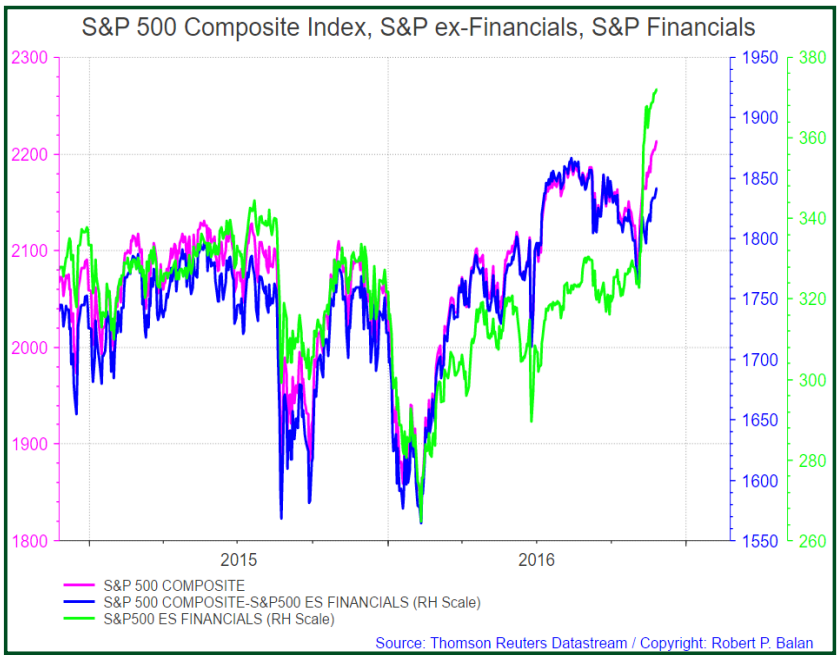
The banking sector performed extremely well during the frenetic weeks after Mr. Trump's election – but they have already been doing well since summer (see graph next page). Bank equities are very sensitive to changes in interest rates. They also benefit from a steeper yield curve, and therefore had already started to outperform as from late summer, after many years of abominable performance. The sharp steepening of the yield curve after the election was key – it ignited the equity prices of the financial sector on the prospects of the banks' higher net investment margins (NIMs) and on the somewhat puzzling market view that the administration of Mr. Trump will deregulate the sector. This is the weakest argument for the equity rally, and we see that in the composition of the rally drivers. If financials are excluded, the S&P 500 Index will be still below its recent highs, a red flag which warns that the current rally may not be as broad-based – or as long-lasting -- as investors thought.

There are other, structural, reasons not to get carried away at this point. Mr. Trump's election does not erase the impact of the economic and market malaise over the last eight years under President Barack Obama. If it is known in 2008 that growth would be anaemic, debt would soar, government regulation would increase dramatically, taxes would increase, and a new universal medical entitlement would be heaped upon the backs of the American taxpayers/consumers, we wonder if investors would have piled heavily into equities, as they did. Yet all stocks went on to triple in valuations. Granting that stocks started from fairly low multiples, the equity market went on to the current, extremely high multiples. Of course, the prime mover was related to the fact that the Fed took trillions of dollars of safe securities out of the market, forcing investors (through the "Portfolio Balance Channel") into risky securities. The proceeds of the bank asset sales were impounded by the Fed and has become a tool for tweaking monetary policy (see graph US banks reserve balance with the Fed).

By reverse analogy, now that the Fed is actually telegraphing that they will take away the punch bowl sometime soon, might stocks decline over the medium-term even if the business climate will be more benevolent under Mr. Trump? That is not a stretch – and, given the current lofty valuation levels, that's not terribly unlikely.

The selloff in global bond markets surprised us even much less. What we did not expect was the violence of the initial reaction to a reversal of the bond market paradigm. In July 12, 2016, we published an advisory report





which projected that the Brexit vote on June 27 was a crucial turning point in the bond market phase change ("Global Macro Outlook: Austerity Is Out, Fiscal Spending is In – The Bond Bull Market Peak Forms", July 12, 2106). We said then:

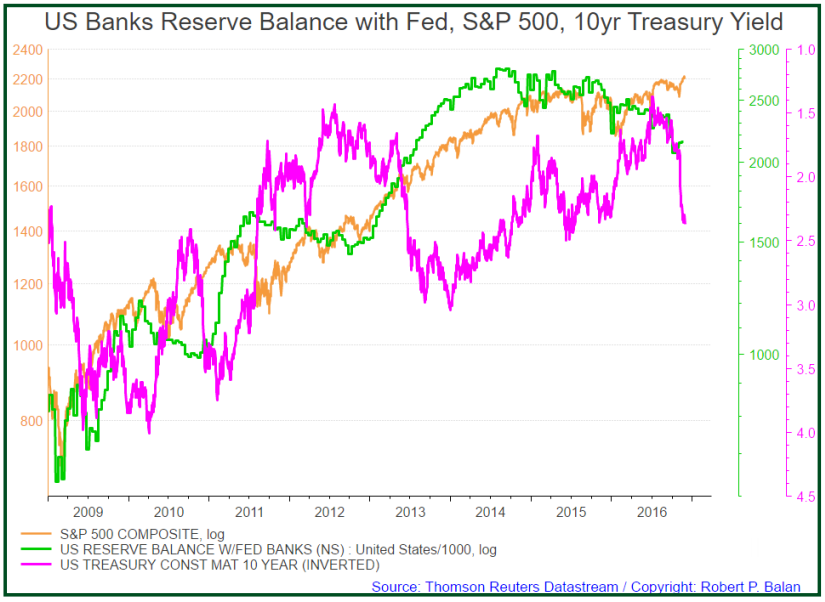
"The Brexit vote was pivotal, and has reinforced our sense that the tide in the bond market is turning. Ironically, while global bond yields fell sharply in the wake of the polling results, the longer-term outcome is likely to be higher inflation and, ultimately, higher nominal yields. If policymakers around the world embrace reflationary policies in a bid to quell growing populism, inflation will rise; if they don't, the resulting surge in anti-globalization sentiment will damage the supply side of the economy."

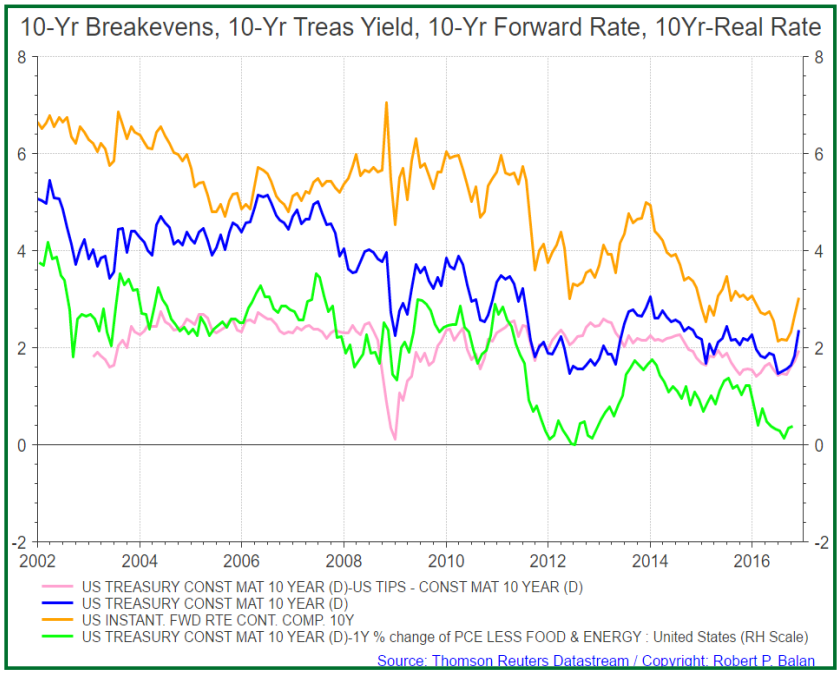
"We believe that policymakers will lean towards the former option, if only to protect their collective behinds. This is good news for risk assets. To be clear, calling for the end of the 35-year old global bond bull market is not the same as calling for a new bear market. The global economy continues to suffer from significant spare capacity, and this is likely to limit the ability of most central banks to engage in a full-blown tightening cycle."

"This includes the Fed, which runs the risk of pushing up the dollar to punitive levels if it starts to raise rates too aggressively. Nevertheless, with yields in most markets now below estimates of fair value, our inclination is to get a bit more bearish on bonds over the next quarters. The world is starting to embark on a new fiscal policy wave. In fact, fiscal policy was shifting in a more expansionary direction even before the Brexit vote. The Liberal government in Canada was elected partly on a promise to increase infrastructure spending. Hillary Clinton and Donald Trump have both pledged to boost government spending, with the latter also touting sizable tax cuts."

The Great Bond Readjustment post-Trump election was followed by a sharp rally in inflation breakevens. As we have been saying for a long time, fixed-income assets were, as of three weeks ago, horribly mispriced and that investors should only hold bonds if they must have to hold bonds. And, if they have to, should only hold TIPS given how cheap they were (and still are). Because of their sharp outperformance in the weeks post-Trump's election, 10-year TIPS are now only about 40-50bps cheap compared to nominal bonds (as opposed to 110 in late June), and so breakevens have become less cheap. They are not anymore relatively as cheap as they were, but they are still absolutely less expensive compared to bonds, as real rates have risen. Current 10-year real rates at circa 0.37% -- not the stuff to salivate about, and that is the highest yield since August this year.

Breakevens did rise sharply in the aftermath of the election reflecting the Trump Effect, but they were already rising steadily before the election – even when everyone thought Hillary Clinton was a shoo-in. And breakevens were not just rising in the US, but globally. **The rise in global inflation markets is easy to explain without resorting to the Trump Effect -- the prior collapse of energy prices is starting to fall out of the year-over-year figures, taking in higher oil prices from January this year, as we expected as early as March. However, we do NOT believe that breakevens can continue sustain inroads to higher levels until the global financial policy structure, one that has favoured savings over investments, undergoes a radical change.** The imbalance of excess savings and a dearth in investments, created and nurtured by global central banks' and fiscal





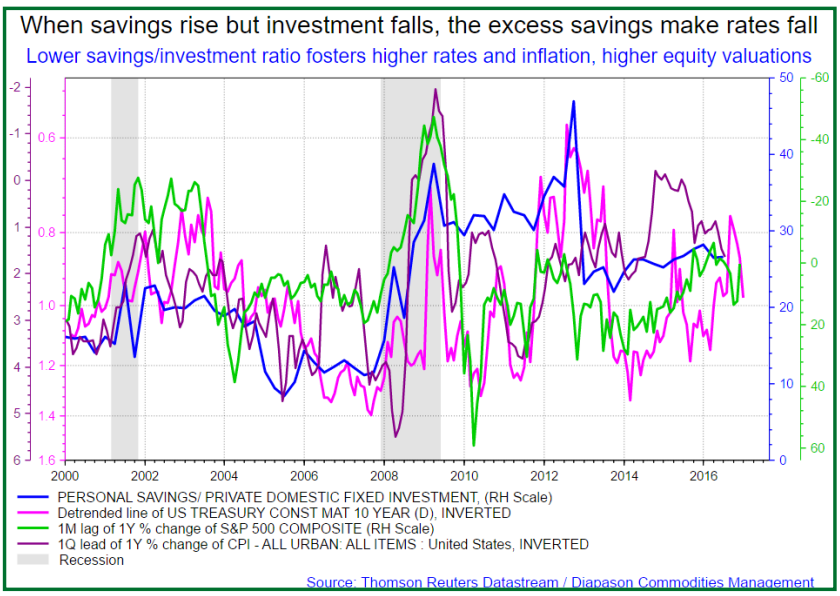
authorities' policies over the last couple of decades – especially in the last eight years – are being unwound and conditions are thereafter expected to return to normal. But it will take some time. Those imbalances had fostered a final phase in the bond bull market in the past several quarters by depressing yields and a comovement of restraining equity prices. We suspect that removing that imbalance between savings and investments, or mitigating their ratio, will bring about the opposite. Higher rates and inflation and better equity valuations are the obvious outcomes of a lower ratio between savings and investments (see graph When saving rise but investment falls).

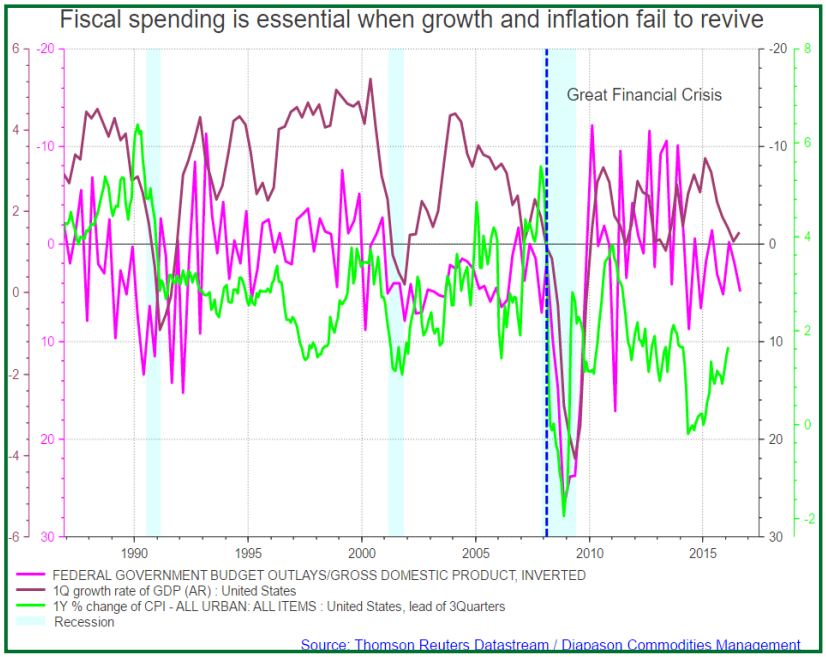
The evidence is in that the paradigm has changed – fiscal austerity is out; fiscal deficit spending is back. Put another way, there is only so much that the central banks can do at this point. To break the economic logjam that the global economy is in right now, a new paradigm (fiscal spending), and another set of players (the global governments) have to enter the arena. However, the change in the stage backdrop and the change in the set of actors will not deliver those expected results right away. The switch to a new fiscal paradigm is not a quick process, and it will involve cobbling together several conceptual building blocks, before the transformation is completed:

- The natural state of capitalism is ever-increasing output. Whether prices happen to rise or fall along the way depends on the choice of monetary regime. This is a political decision, not an economic one.
- Regimes based on the gold standard tend to have a deflationary bias, whereas regimes based on fiat money tend to have an inflationary one.
- In every society, there are more debtors than creditors. Unexpected inflation hurts the latter, while benefiting the former.
- By focusing on growth, global central banks tend to foster inflation. The efforts by policymakers to avert deflation through QE, ZIRP, and now NIRP (Negative Interest Rate Policy) is evidence that the underlying inflationary bias in the global monetary system remains in place.
- A politician who ignores the demands of the public tend to be not elected. Therefore, democratically elected government officials tend to be populists, if not by choice, then by expediency.
- After the June 23 Brexit results, politicians have been given a warning shot. They now have no choice but to react. They have to placate the irate masses. Therefore, ideology is out, realism is in. Populism is in -- any other polity is out.

- And there is only one way to do it. The meme of austerity, which is keeping global growth in doldrums, is out -- fiscal spending to generate growth is in (see chart above).
- The seeds of widespread global spending have been, or are being, sowed. It may take a while, but as seen from the US example after the Great Financial Crisis, with fiscal (deficit) spending, growth and inflation should follow.

While the transition to a new paradigm is taking place, other factors which always impact asset prices, will continue to dictate the short-term evolution of asset prices, a new paradigm or not. One such factor is

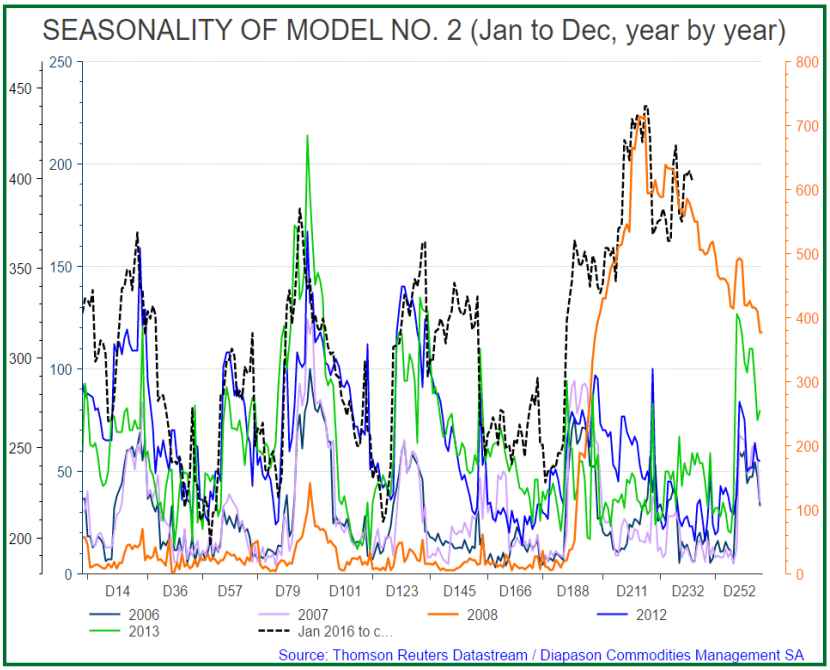




systemic liquidity provided by the Federal Reserve and the US Treasury.

Asset prices are impacted by various liquidity sources in different ways. And asset prices may also have slightly different reactions to the same source of liquidity. This variability manifests as lags and leads of these asset prices to the impact of that same source of liquidity. Each asset class has its own set of liquidity vectors, and their own underlying idiosyncratic response to the various forms of liquidity.

We modelled the impact of those various forms of liquidity on asset prices. As an example, we feature what we called Model No. 2 (the "Treasury Model"). The model extrapolates the impact of liquidity entering the financial system today, to a point in the near-future. The model values have distinct seasonal tendencies, as displayed in the chart below. And they are very consistent every year, to a point that even without extrapolations, it is easy to project the high and low points the model values will likely take in the future. Except in September this year. **The increase in liquidity did not peak by mid-September month as usual, but went on and peaked less than two weeks before the November 8 presidential elections at significantly higher nominal levels.** We can only speculate as to the reasons for this massive infusion of liquidity leading to the US presidential election; we are not here to add to the post-election clangour, but to try and understand the consequence of this event. There will be repercussions on asset classes down the road. The graph Seasonality of model 2 will show the seasonal regularities as discussed.



It is also clear that since the peak, that surfeit of liquidity is being clawed back. We may have the guide on how excessive liquidity will eventually disappear. The same thing happened in September 2008; liquidity this year went on to peak at the same calendar period. The 2008 surfeit subsequently went back to normal levels by January the following year. We believe this year's peculiar liquidity hump will eventually disappear in the same manner.

These are the consequences of this evolution of liquidity levels, in our opinion:

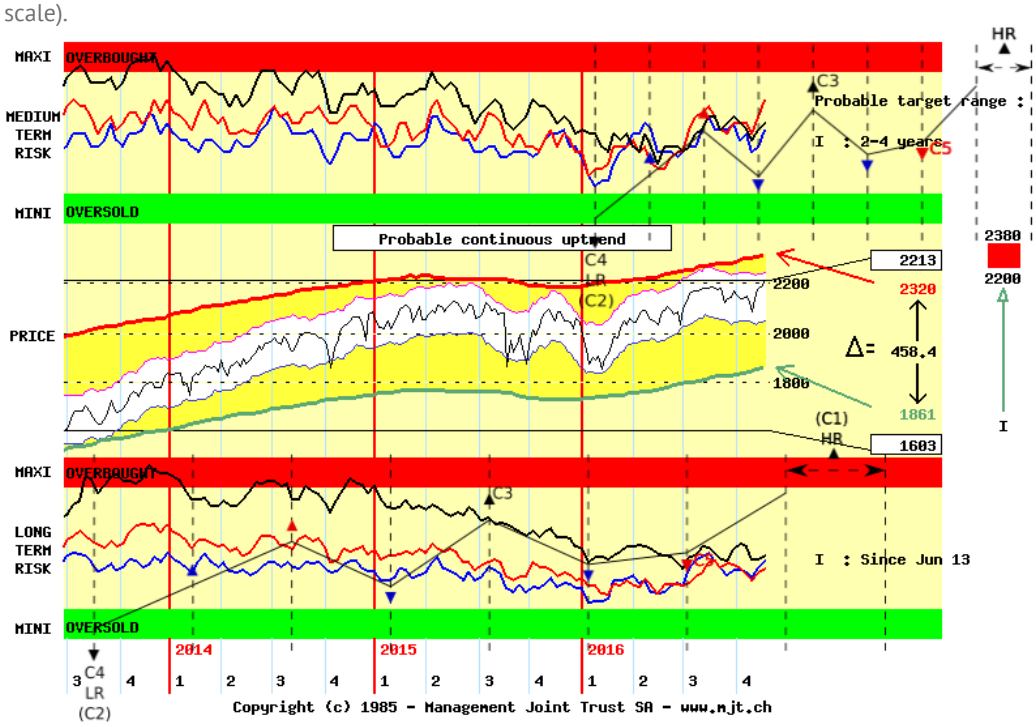
- **Liquidity tightening over the next few weeks will eventually hit the stock market, after a lag. We expect the impact to start manifesting sometime in late January - early February, and the stock market will likely spiral lower over the next quarter or so.**
- The short-term liquidity cross -currents from other sources may weaken the US Dollar over the next few weeks, but by January, we could the US currency resuming the rally it started a few weeks ago.
- The US Dollar movements will likely coincide with a fall in yields in the short term (until early January) but we should see yield rising again thereafter, putting further positive spin on the US currency.

These are generalizations of what we expect asset prices to do due to changes in levels of liquidity over the near-term. Farther in the report, we will focus on specific asset classes and apply bespoke

Timing US equity markets into 2017 (multi time frame analysis):

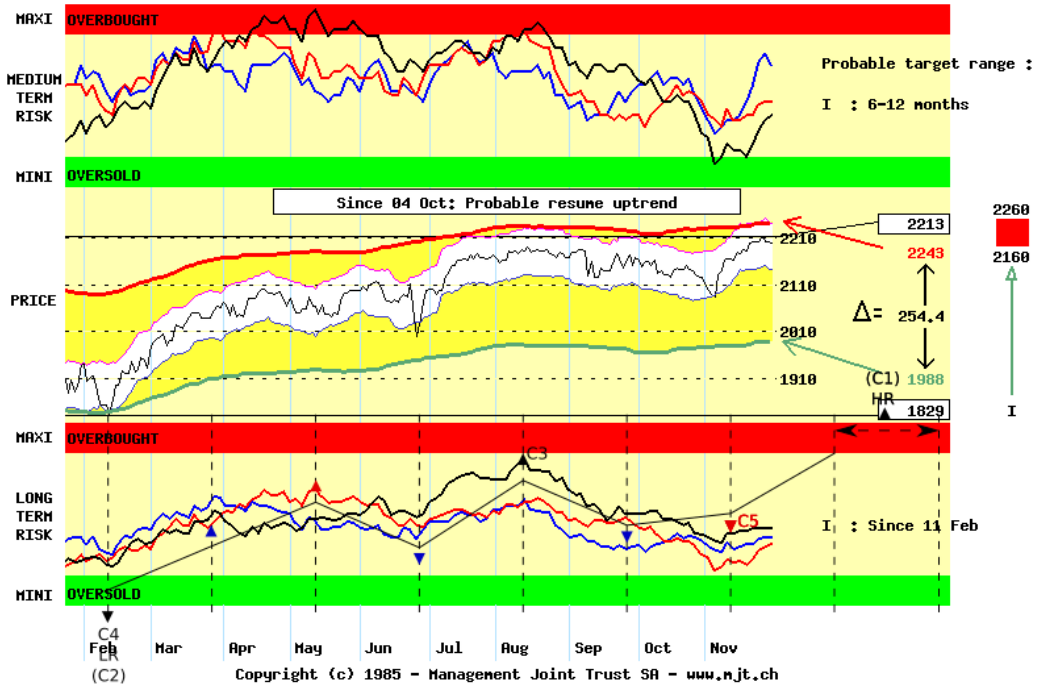
S&P500 Index (Weekly graph or the perspective over the next 2 to 4 quarters):

The sequences of two ascending lows (Case 5) made early this year and on Brexit on our long term oscillators (bottom rectangle) are leading us into a High Risk zone in early 2017. The sequence on our medium term oscillators (upper rectangle) would imply that the actual top extends into February followed by 2 to 3 months of consolidation. Further upside is then envisaged from late 2Q2017 to end 2017, yet for now, possible price objectives into the 2'300s (right hand scale).



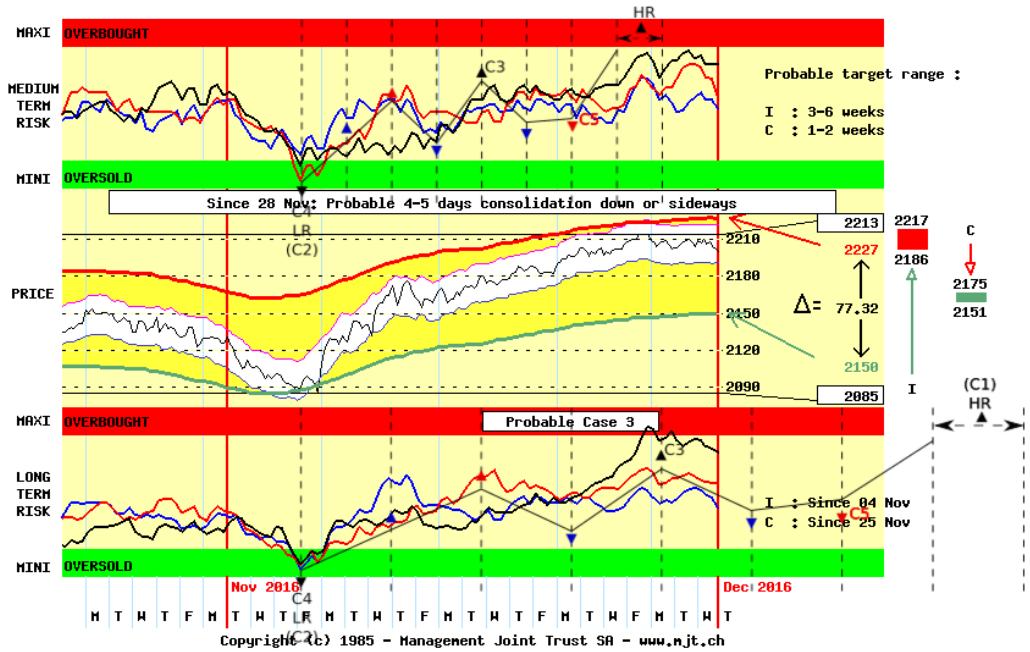
S&P500 Index (Daily graph or the perspective over the next 2 to 3 months):

Following its consolidation down from mid August (Case 3), the S&P500 is back in an acceleration up (Case 5) on our longer term oscillators (lower rectangle). The Target zone for the next top (High Risk zone) extends between late



S&P500 Index (Hourly graph or the perspective over the next 2 to 3 weeks):

The rally since the 9th of November has reached its impulsive targets on the upside (right hand scale) and our long term oscillators (lower rectangle) have recently confirmed an intermediate top (Case 3). Our medium term oscillators (upper rectangle) are now also Overbought. They are entering a High Risk zone. Over the next week to 10 days, as shown by our model, we would now expect a consolidation down which could retrace towards our envelope (towards 2150 - 2175), before a new uptrend materializes until year end.

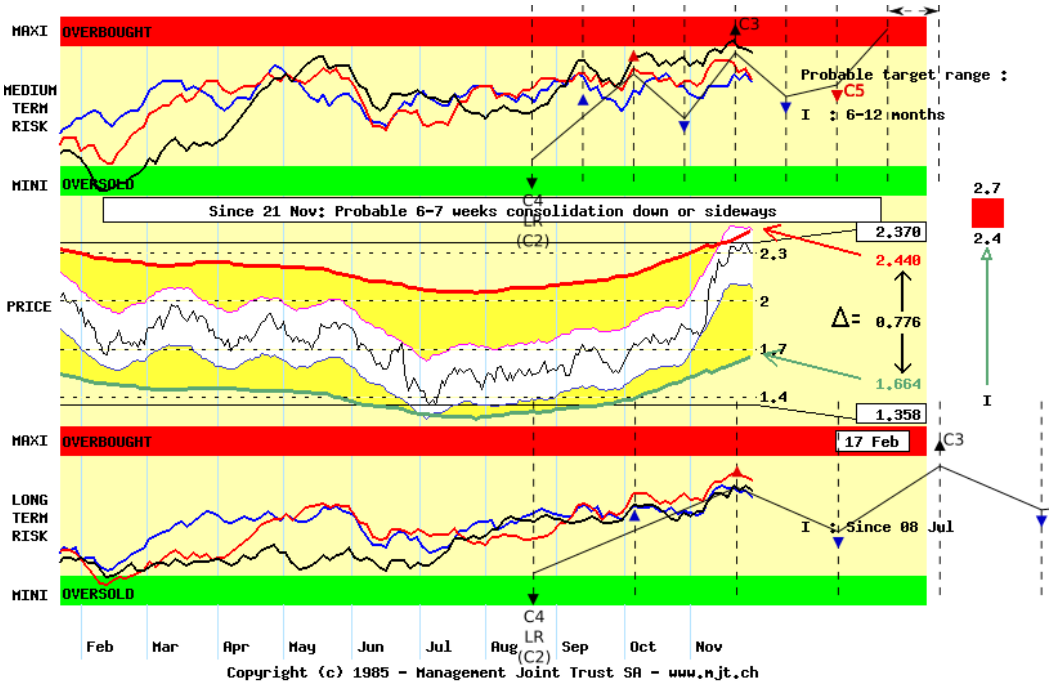


Summary: The current leg up on equities and the S&P500 should extend into late January / early February. In the meantime, we could see some consolidation into December before resuming the uptrend towards year end and the new year. The price potential on the upside is however limited (below 5%).

12 / MJT TIMING INSIGHT
Interest rates and inflation expectations:

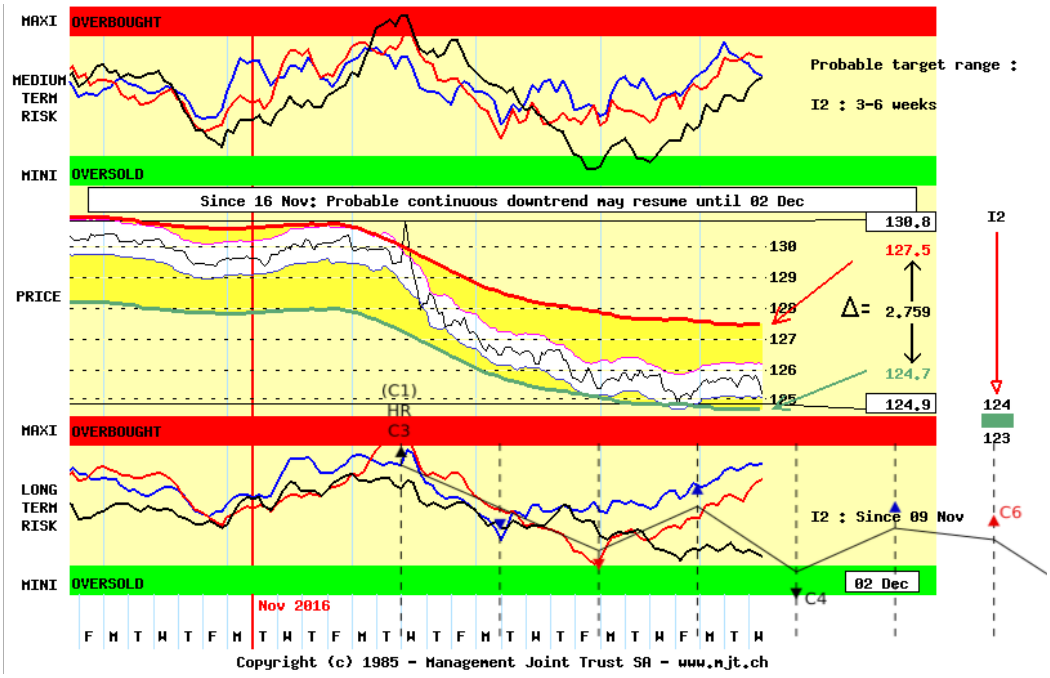
US 10 years Benchmark Bond Yields (Daily chart or the perspective over the next 2 to 3 months):

The recent acceleration on the upside on US interest rates has reached an intermediate top on our long tem oscillators sequence (lower rectangle). Following a consolidation period, which should materialise into December, the uptrend then probably continues into mid February. In this first leg up for interest rates (we expect more upside later in 2017), most of the potential is behind us, as indicated by our price targets (right hand scale). Our medium term oscillators (upper rectangle) give a clue as to how the consolidation could materialise: a first move down into mid December, a higher low in early January and a new leg up towards February.



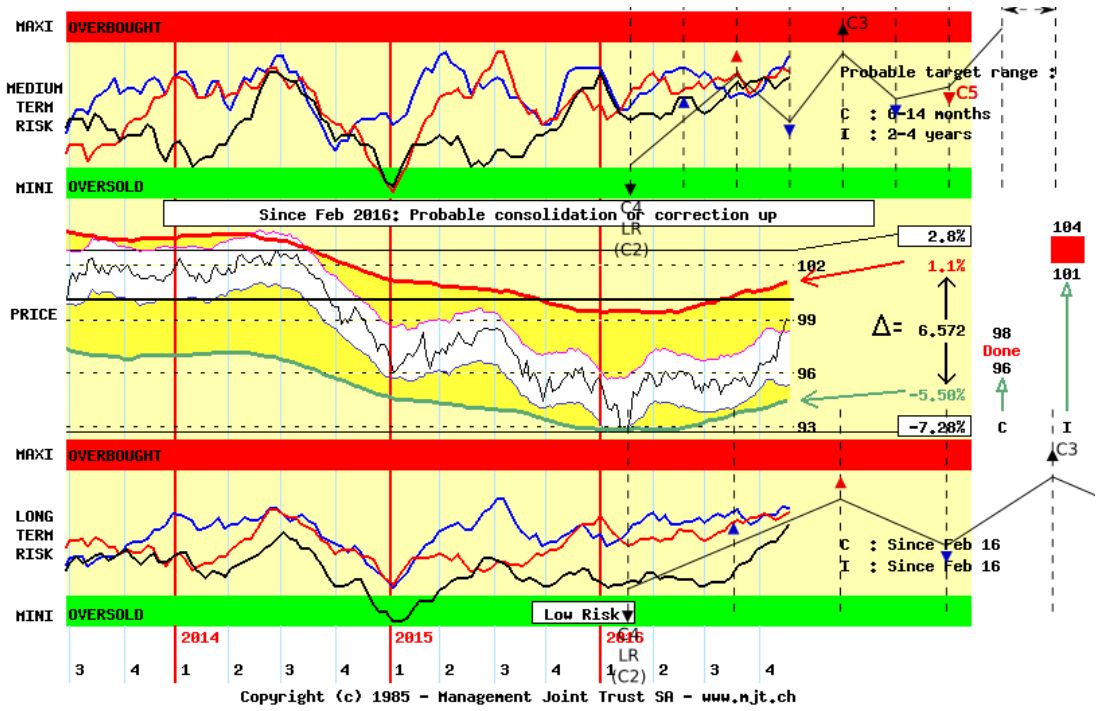
Dec. Treasury Notes 10 years contract (Hourly chart or the perspective over the next 2 to 3 weeks):

The recent government bonds sell-off is close to its Hourly price targets down (right hand scale). It is also approaching an intermediate bottom on our long term oscillators (lower rectangle). From early December, a correction up is expected. It could last a week to 10 days and retrace up towards 127/128 (the upper boundary of our envelope) or circa 30 to 40 bps on the 10Y yields.



Graph 6: TIP - iShares TIPS Bond ETF / IEF - iShares 7-10 Year Treasury Bond ETF (Weekly chart or the perspective over the next 2 to 4 quarters)

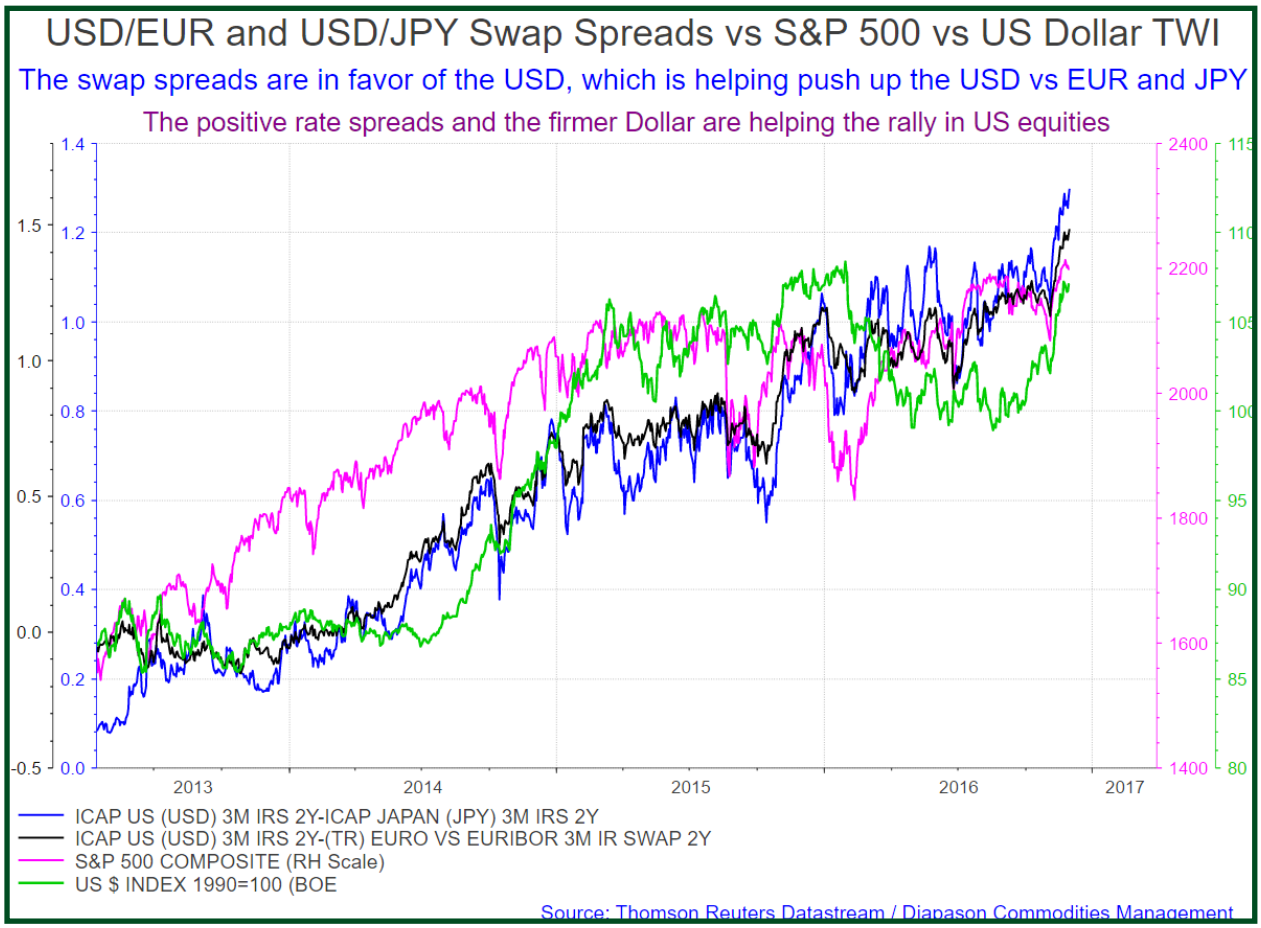
This ratio is a proxy for the purchase of inflation protection by investors. It bottomed out earlier this year with oil, and is now accelerating again on the reflation theme. On our long term oscillator (lower rectangle), we expect it continue until an intermediate top is reached in the middle of 1Q2017. Following several months of consolidation, it should then accelerate again in the second half of 2017.



Summary:

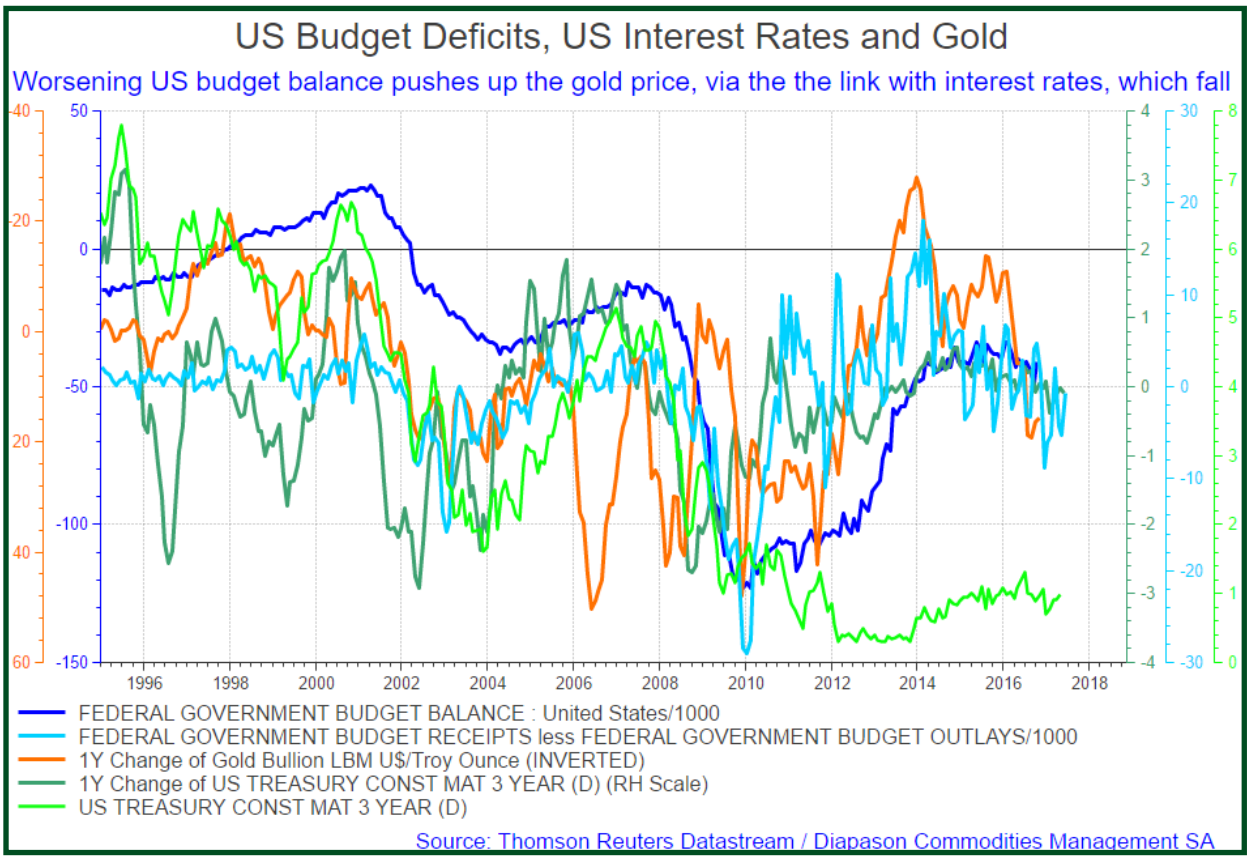
Interest rates and inflation expectations should pursue their first leg up into the middle of the first quarter 2017. Yet, our assessment is that a large portion of the move is behind us and that the pace of their ascent should gradually decelerate. Following that, both should correct down into 2Q2017, before resuming their uptrend in the second half of 2017.

THE US DOLLAR: Enthusiasm for Trump's planned policies are positive for the USD but implementation may prove more negative.



The US Dollar Trade Weighted Index is threatening to break out to new bull market highs after trading in a reasonably well defined range over the past couple of years. The previous motive force has been the policy divergences between the US and the other major developed economies (e.g., Eurozone, Japan); the election of Mr. Donald Trump who wants to employ significant deficit spending to kick-start the moribund US economy has added to the upside momentum for the US unit. However, unlike the movement of paper assets, long-term changes in the value of currencies often provoke feedback loops that impact the course of currency valuations in unpredictable ways, by virtue of their linkages to growth (via net exports) and to the rise and fall of inflation. So, it is necessary for us to make distinctions between short term and long term drivers, which may not necessarily be complementary.

Our immediate short term concern about the USD: is the threatened breakout sustainable? On some measures the US dollar is starting to look slightly over-valued, over-bought, even over-hyped, so it makes sense that we should expect some degree of consolidation sometime soon. But with the market still focused on a Fed tightening in December, and on bond yields recently bumped higher by investor exuberance post the Trump election, interest rate differentials favour the US currency, as the US cash rate stays bid (see graph USD/EUR & USD/JPY Swap spread). This spread factor support may even may even grow as the Fed restarts its



tightening cycle. Thus from a portfolio perspective it will probably pay to have a long dollar bias in the short-term. Based on this argument, it also pays to stay long on US equities in the short-term.

However, investors who bought the US Dollar on the presumption that Mr. Trump can deliver on his campaign promise of massive infrastructure spending, may want to reassess the long-term implications of that deficit spending policy plan.
Debt and deficit spending are really no big deal (but the lack of correct perspective makes them such contentious subjects) -- they are lagged functions of the economy (and so is the US Dollar)- Those linkages are shown in the graph (Us budget deficits, US Interest rates, USD) which we explain further:

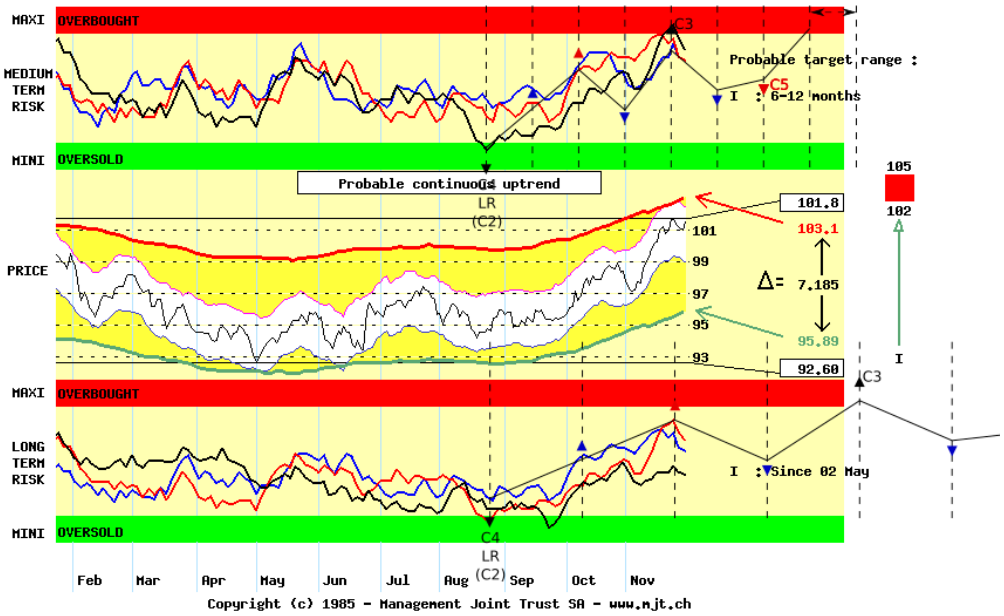
Federal Budget Balance (the delta between Receipts and Expenditures), is positively correlated with US GDP growth (after a lag). It is very easy to explain that correlation - that is, the FDB becomes less negative when GDP growth rises and vice versa. In other words, budget balance is a lagged function of GDP. Apply the math and you will see that government debt is a negative function of GDP. To keep their living standards at the same level, individuals, corporations and the government borrow when GDP slows down. For the government, it is the automatic (spending) stabilizers that keep borrowings high (thereby making debt rise) when GDP slows down (reduction of tax revenues). Those automatic stabilizers are there by law, even if spending for them increases the debt over GDP ratio. The other complication is that GDP growth is also, to a large extent, dependent on government spending, especially during GDP growth recessions. And for a government to do that during a recession, they have to borrow, which further adds to the US aggregate debt. Strongly rising US aggregate debt has provided some of the most spectacular US Dollar bear markets (and the inverse, spectacular gold bull markets).

Given these contradictory vectors, we will characterise the outlook for the US Dollar as positive in the short-term, probably even in the medium-term, though with limited potential but negative further out.

USD medium term positioning, Dollar Index, EUR/USD, USDJPY:

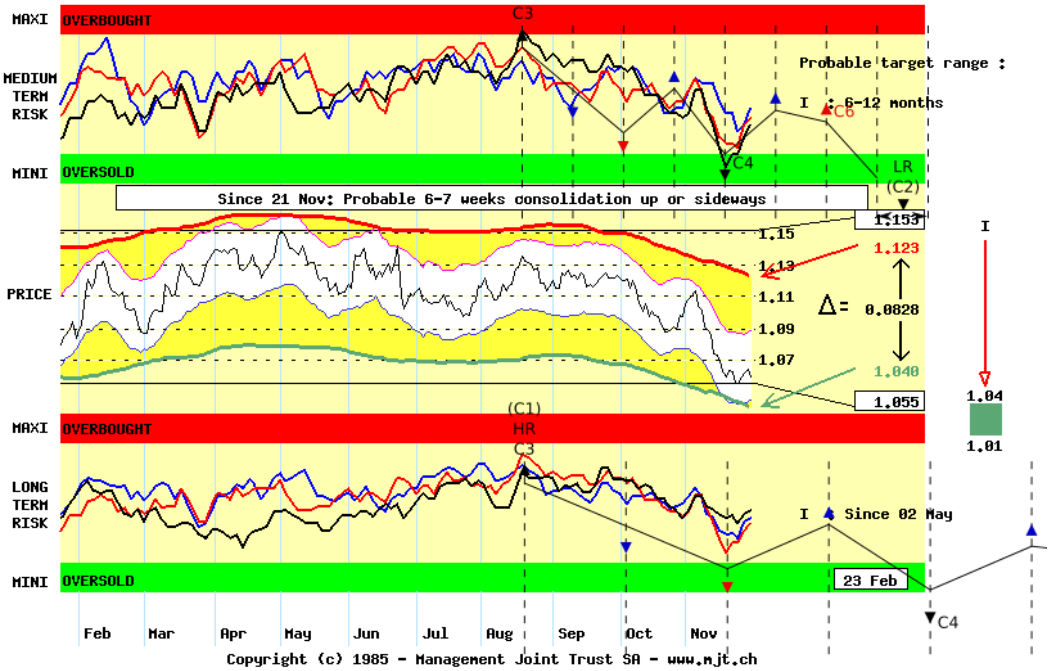
DXY – Dollar Index (Daily Graph or the perspective over the next 2 to 3 months):

The move up since August and the recent acceleration on DXY since the US election has now reached an intermediate top on our long term oscillators (lower rectangle). We would now expect a consolidation which could resemble the model presented on our medium oscillators (upper rectangle): first, a couple weeks on consolidation down into mid December (price targets towards the 99 level on DXY) and then a higher low in January to resume the uptrend to February. The potential on the upside is however (right hand scale:102/105) is limited.



EUR/USD (Daily Graph or the perspective over the next 2 to 3 months):

Inversely, but yet similarly, following its recent sell-off, EUR/USD is forming an intermediate bottom on both our oscillator sequences (lower and upper rectangles). The upper boundary of our downside price targets has almost been reached at 1.04(right hand scale), and a period of rebound could now materialize. It could last between 3 weeks to 1.5 months, take the shape of the model described in our medium term oscillators (lower rectangle) and possibly run 4 to 5 figures. Following that, a further period of weakness is expected into February.

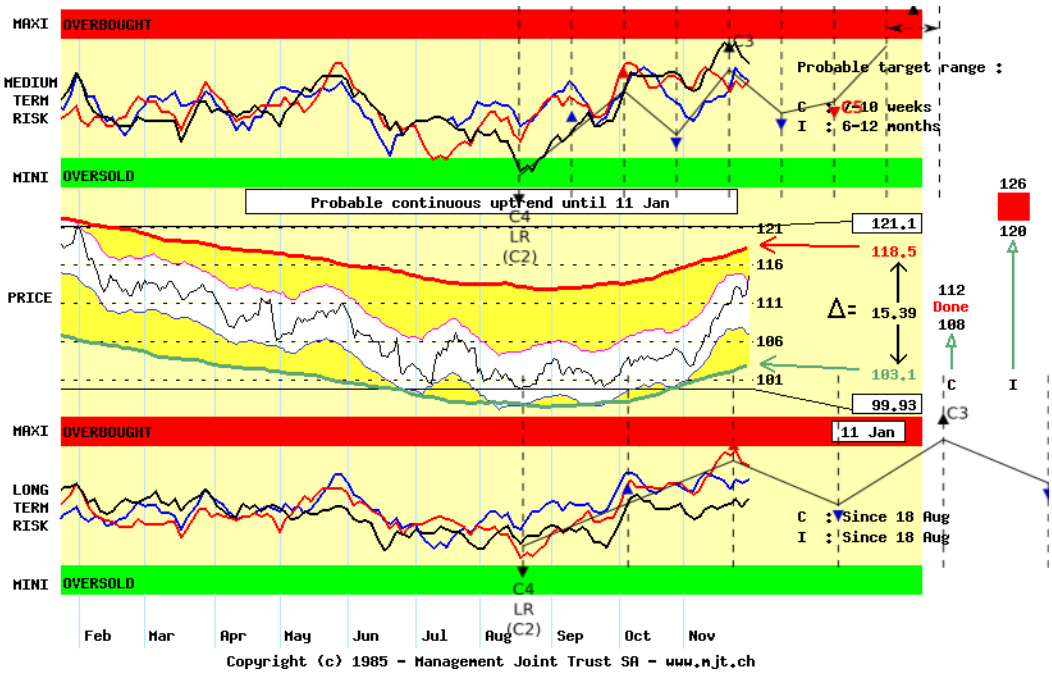


17 / MJT TIMING INSIGHT

USD medium term positioning, Dollar Index, EUR/USD, USDJPY:

USD/JPY (Daily Graph or the perspective over the next 2 to 3 months):

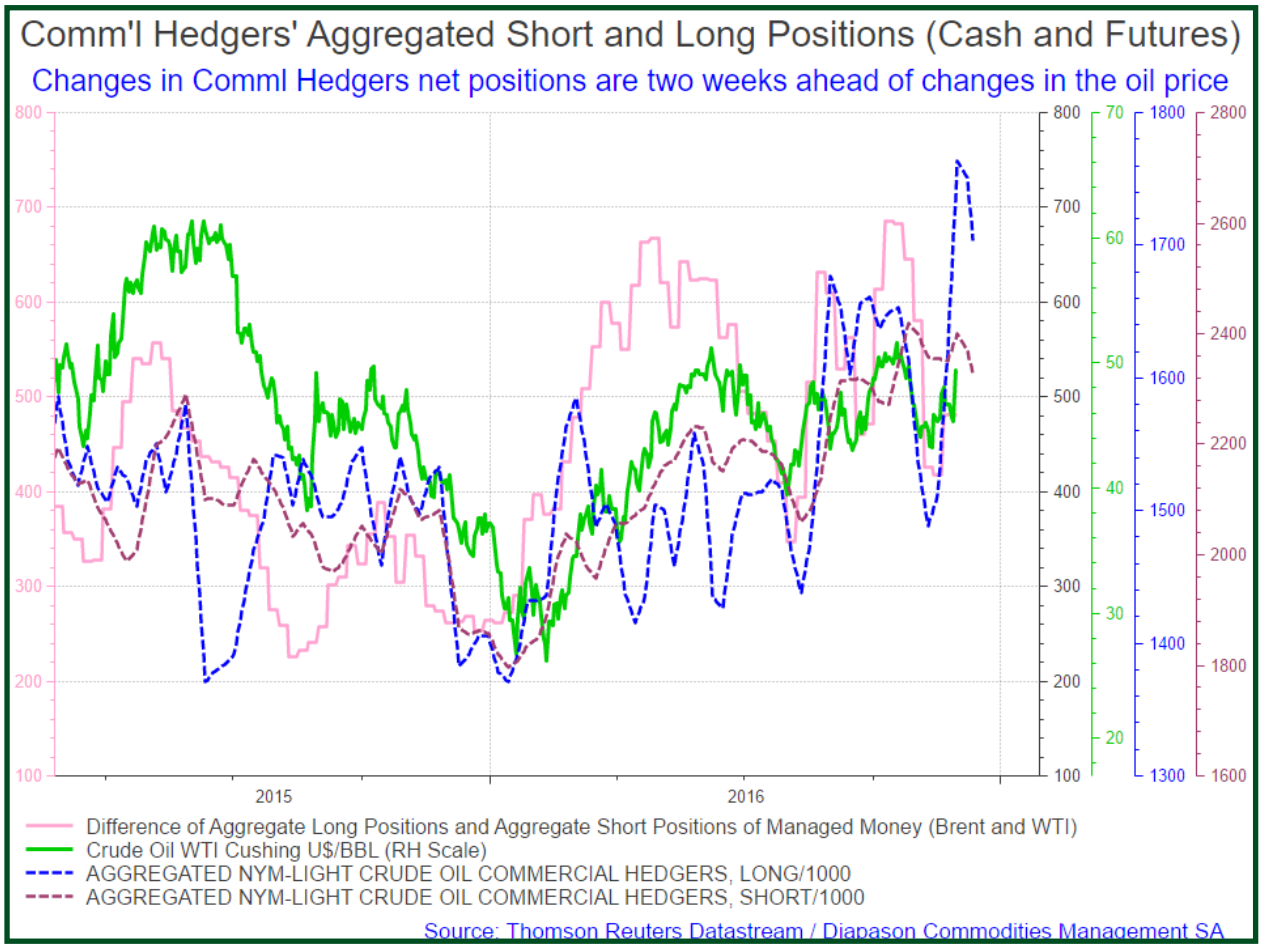
Dollar/Yen follows a similar dynamic to DXY and EUR/USD (inverted), i.e. it has reached an intermediate top on our long term oscillators (lower rectangle). After the recent surge, prices may now consolidate into mid December before resuming their uptrend towards mid February (the model we superimposed on our medium term oscillators – upper rectangle). In the move up since August, USD/JPY has made it above its corrective targets (112). This break opens the way to impulsive targets towards 120 and above. These may be achieved early next year if, as we expect, risk-on persists into late January or February.



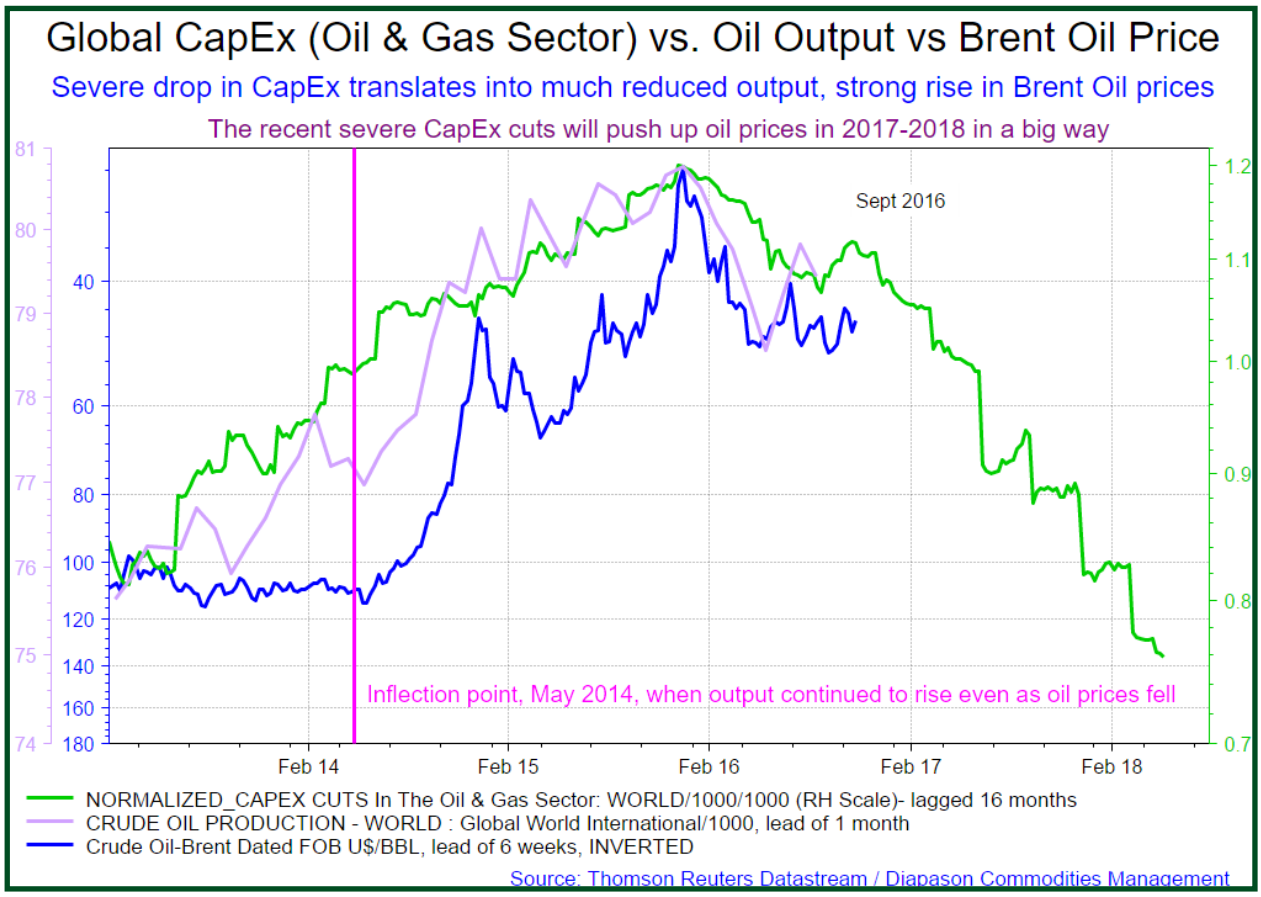
Summary:

The Dollar index, EUR/USD and USD/JPY have had an impressive run since August and, more recently, since the US election. As with interest rates, we expect some consolidation down into December (up on EUR/USD). By and large, the trend should resume up (down for EUR/USD) by year end or early January, before toping out again (bottoming for EUR/USD) in February. The upside potential to February may be particularly strong on USD/JPY, especially if as we believe, the risk-on environment persists until then.

CRUDE OIL : What to expect after OPEC's decision to cut production?



After being left for dead, OPEC pulled some very sticky levers, agreed on a still-murky deal, and oil prices soared since November 30. OPEC may be back in the driver's seat, but with this what appeared to be an OPEC coup, be wary, very wary. There are many reasons not to get too delirious about the agreement to curtail output by 1.2 million barrels a day. We still do not know the other details, aside from the speculative conclusion that Saudi Arabia will be hit with the biggest cut. Russia agreed to participate in the output cut output – which actually made the deal more believable. But now comes the hard realities, post the Algiers deal -- the most prominent being the cheating of OPEC's own members. The agreement depends on self-compliance, and the commitment to cut from key countries, particularly Iraq, has been described as "weak". Iran, which was allowed to produce more, but agreed to a cap of 90,000 barrels a day, is described by veteran OPEC watchers of showing signs it could go rogue and produce more than they pledged. There are still disagreements among OPEC members on how to measure production, so the deal will be hard to implement. The next three weeks will be crucial. What commercial hedgers and shale producers do following the price rise will be key to the short-term oil price moves. There is already evidence that commercial hedgers are starting to hit the currently elevated oil prices (see graph Comm hedgers positions). We think the hedging process will start hitting crescendo once $55 is taken out. Our reckoning shows that the oil price may have to rise to



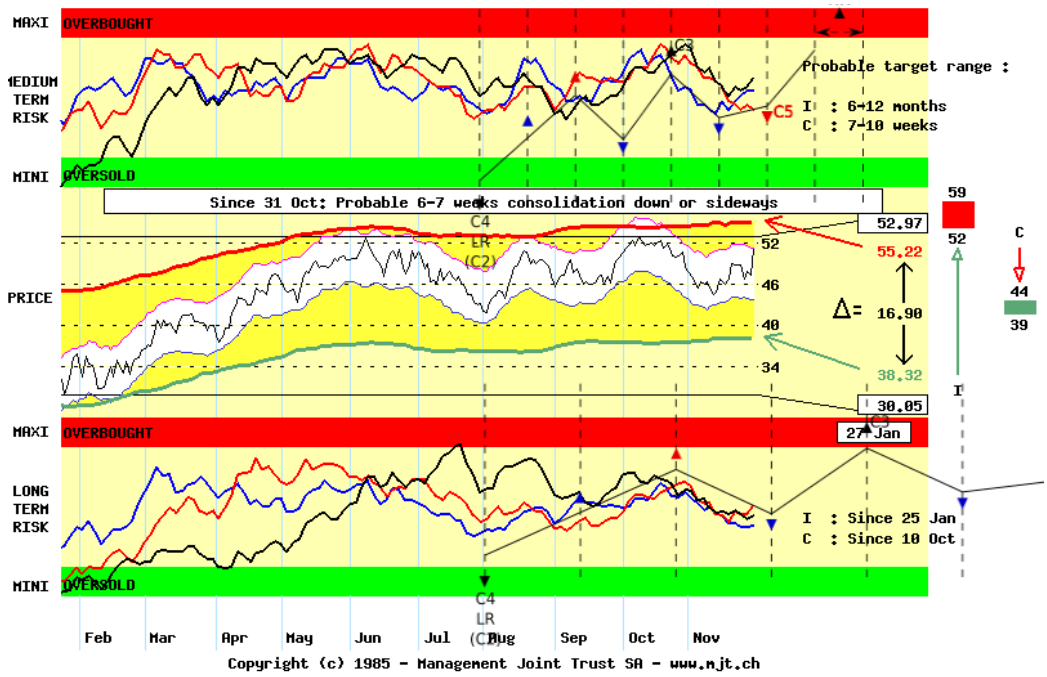
$55-$60 per barrel before drilled, but left uncompleted wells (DUCs) are reworked on a larger scale. Our read for short term oil moves: if the output cut details remain murky by mid-month, this and pressure from hedging which is sure to follow, those factors can easily create some sharp price set backs.

Nonetheless, OPEC's decision to drive down prices since 2014 has dried up Capital Expenditure (capex) flows around the world. $200 billion was removed from global energy capex budgets in 2015, with a similar amount due to be lost this year as well. Let's just focus on the actual capex which were lost. It means that $400 billion that was earmarked to keep global oil production growing roughly in lockstep with demand growth was gone. And that number will grow, and maybe by a lot, for as long as oil prices remain low (as in below $60.00 per barrel) for long. Discussion on the subject of oil well natural decline rates is a big omission on most discussions of supply-demand aspect of the oil market. Natural decline rates (NDR) globally are hard to nail down with great precision – rates vary depending on amounts of maintenance capital available and incurred, for example – but some reasonable assumptions can be made. Most studies to put the number at circa 5 percent, but we get slightly conservative, and pick on 4 percent. That simply means that each year natural declines will take about 3.6 million b/d out of the 90 million b/d production base. Or put in a better context, the NDR of oil wells globally is close to one entire shale-revolution, a revolution that took more than 5 years to develop. Our proposition therefore is that the price of oil will materially strengthen over the next few years, and that argument owes it origin to the situation explained by the graph of Global capex and oil output.

Oil and Oil sector perspectives following OPEC:

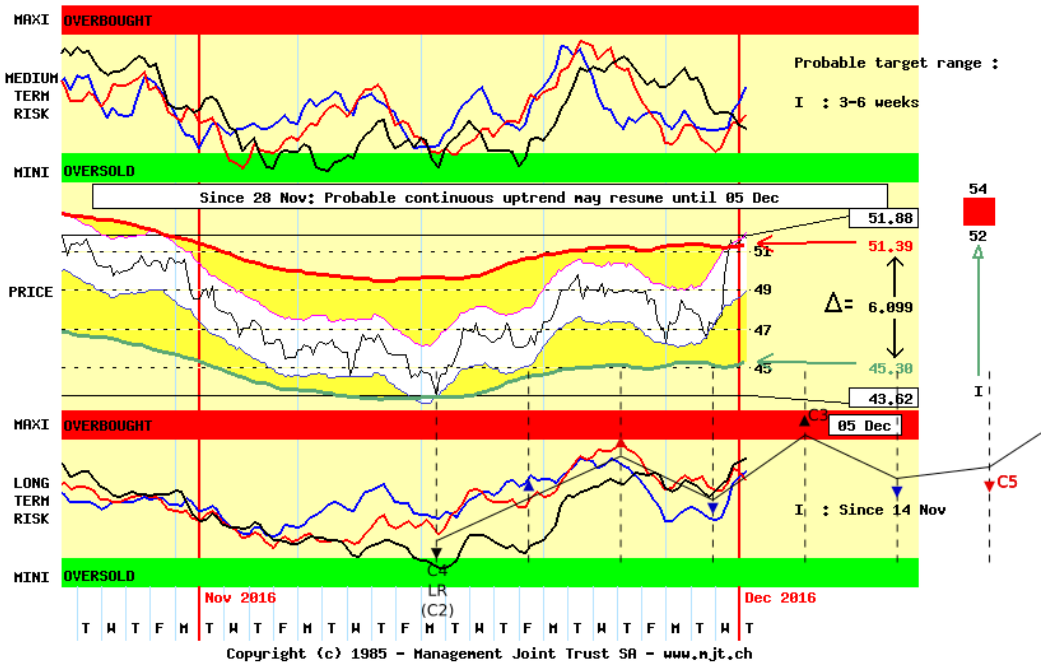
Brent Oil (Daily graph or the perspective over the next 2 to 3 months):

The second leg up on Oil, which started early August is now accelerating up again. It should do so until a top is reached towards the end of January. Possible price targets could lead us into the high 50s (right hand scale).



Brent Oil (Hourly graph or the perspective over the next 2 to 3 weeks):

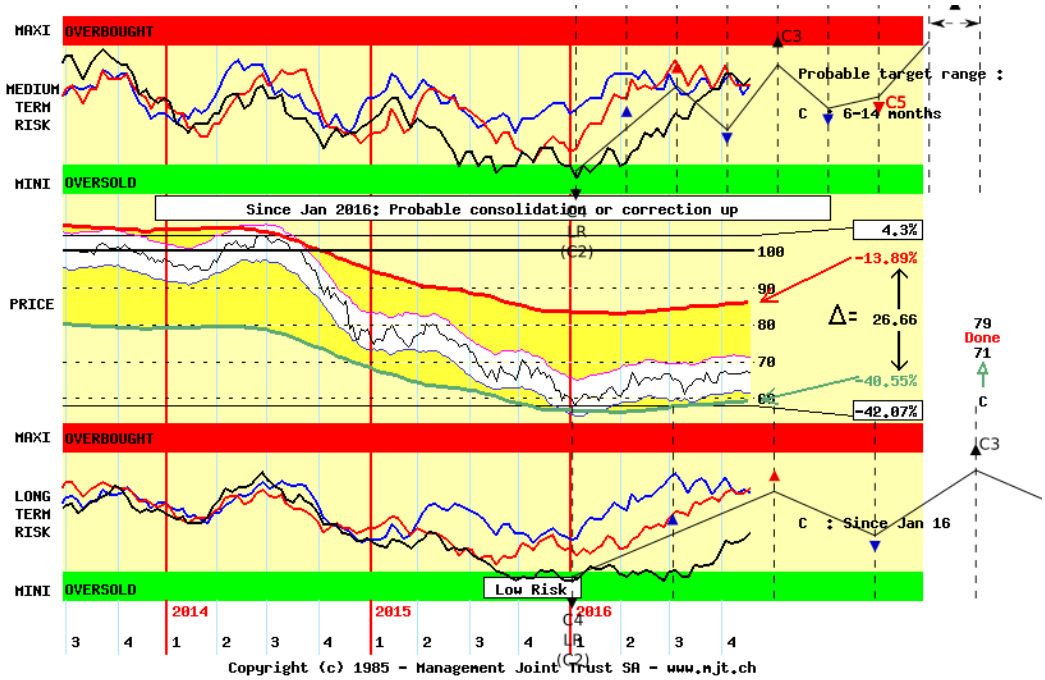
Following the November 30th OPEC deal, Brent has accelerated up and broke the tops it made a week ago. This move up should persist until early in the second week of December on our long term oscillators (lower rectangle) and create new highs for the year towards $54/barel (right hand scale). Following that, a week to 10 days of consolidation may materialize (possible retracement below $50/b) until Brent moves up again towards year end.



Oil and Oil sector perspectives following OPEC:

XLE - Energy Select Sector SPDR Fund / SPY - SPDR S&P 500 (Weekly graph or the perspective over the next 2 to 4 quarters):

Comparing the US Energy sector with the S&P500 ETF, we can confirm that the uptrend which was initiated earlier this year should find an intermediate top in the first half of 1Q2017 on both our oscillators series (lower and upper rectangles). Following that, a consolidation should materialize which could last several months before the uptrend resumes in the middle of 2Q2017.

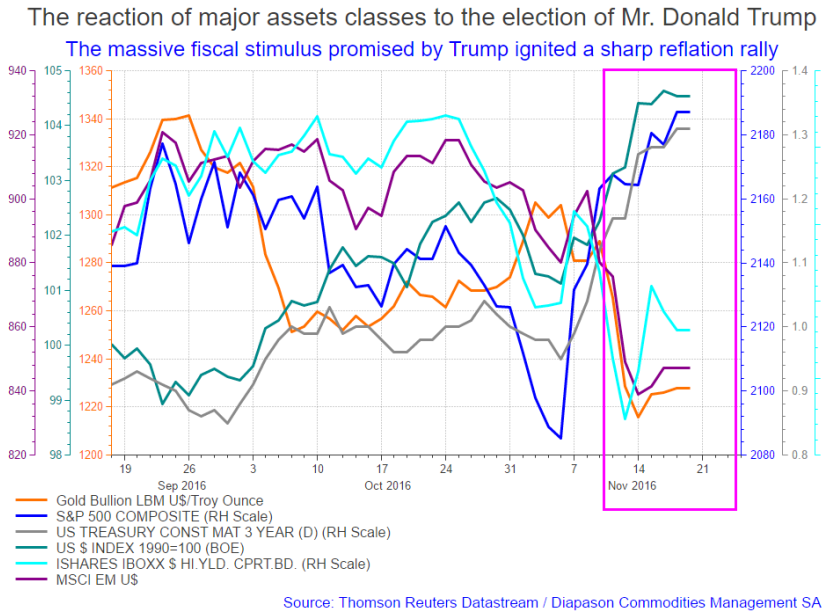


Summary:

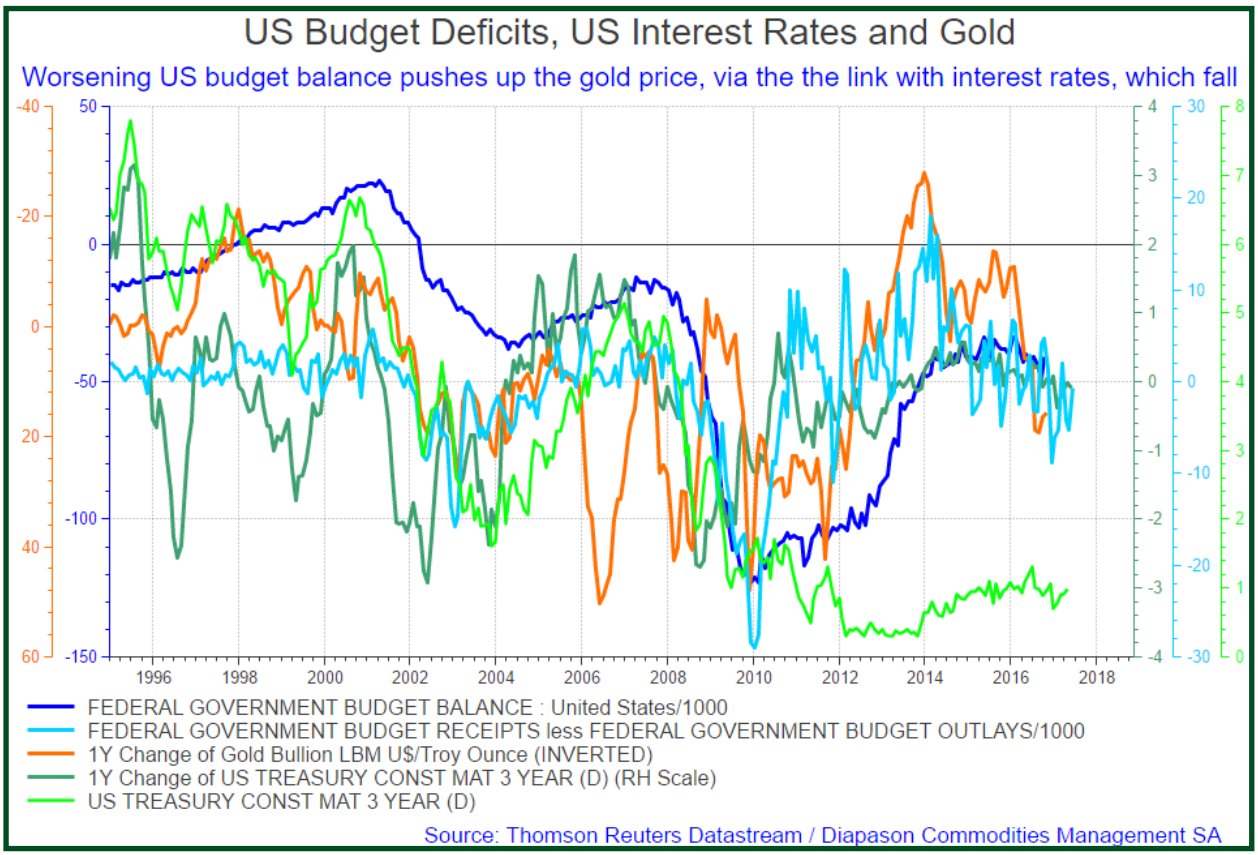
Oil and the Energy sector are a key reflation asset. We believe their uptrend should persist until late 2017. However over the next few months, oil should move up towards the high 50s to create an intermediate top towards end January. In the meantime, a consolidation may materialise during the first half of December once the current short term rally is exhausted.

22
GOLD:

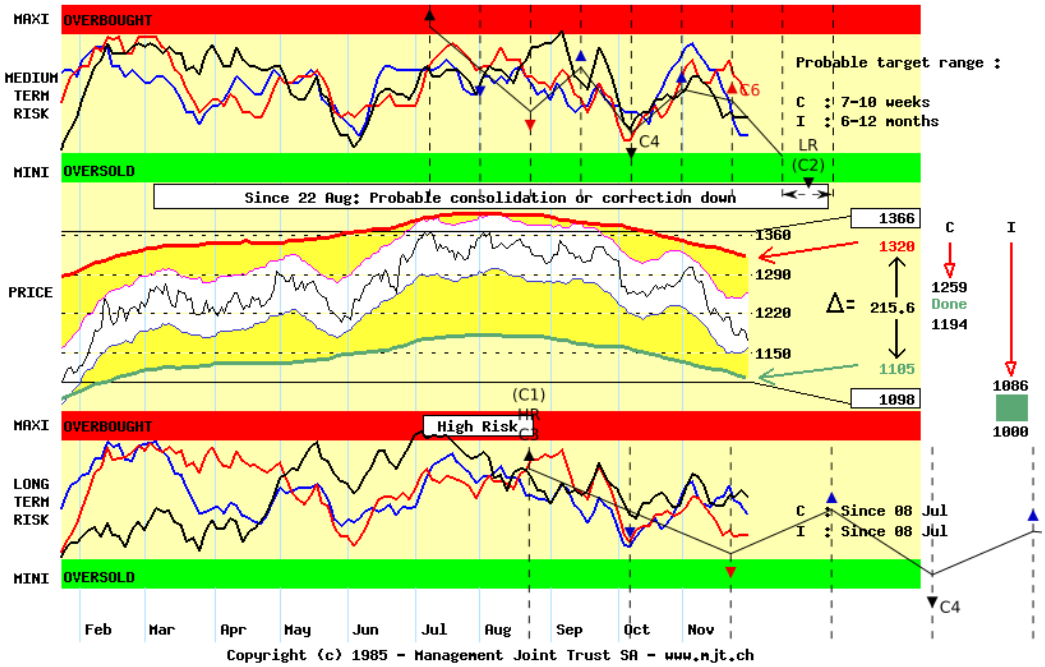
Gold had a phenomenally volatile day after the US presidential election, even more volatile than the famed Brexit gyrations. It rose as much as $60, breaching $1,300 an ounce, before ending the day sharply lower after U.S. equities rose and the US dollar strengthened. Since then, Gold continued to spiral lower and it is now trading are the $1175 level. What happened? Gold was supposed to be a safe haven play, given the supposed uncertainties that a Trump presidency brings. But the market apparently did a rapid recalculation, and this is what we believe took place in the collective minds of investors. The reason for the whipsaw moves in Gold (which was true for the other assets as well) was that much of the initial reaction was completely emotional due to the surprise outcome of the election. But investors took a step back when they realized that Trump's plan to spend massive amounts on infrastructure was good for stocks and commodities -- in other words, it's risk-on. And gold (also EM, High Yield) did not figure much in those calculations see graph Reaction of major asset classes).



But that is not the last, dismal word for gold. Mr. Trump's infrastructure programs require massive budget deficits. Also, Trump's "protectionist" policies could have a negative impact on global trade, on top of the increase federal deficits, and both would be supportive of gold. The link between wider budget US budget balances (higher budget deficits) is not difficult to show. It runs through lower short term rates, which in turn act as headwind wind for the US Dollar, leading to the the appreciation of gold prices (see chart below). Widening US budget deficits have historically produced the best bull markets for gold (and the largest bear markets for the US Dollar).

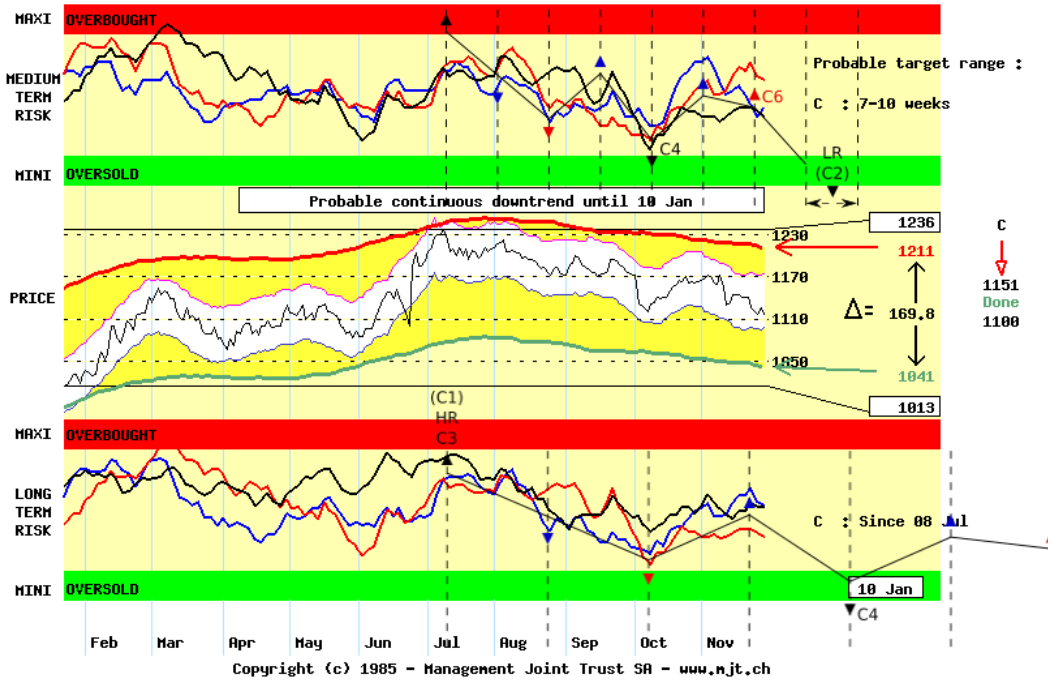


GOLD in USD and EUR:



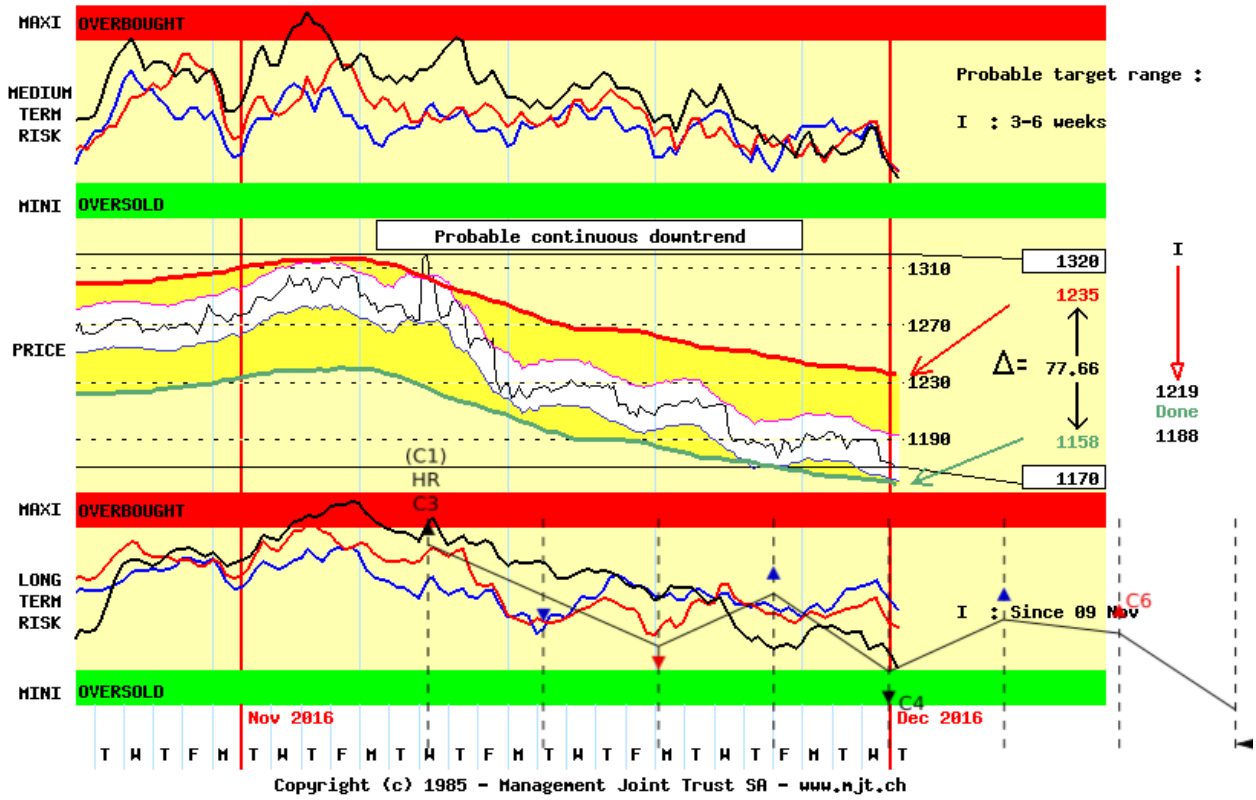
Spot Gold in USD (Daily graph or the perspective over the next 2 to 3 months):

Gold may have reached an intermediate bottom on our long term oscillators (model in the lower rectangle), yet the recent succession of descending tops on our medium term oscillators (upper rectangle) and the price break last week below our corrective targets down (below 1194, right hand scale) are calling for cautious.



Spot Gold in EUR (Daily graph or the perspective over the next 2 to 3 months):

When considered in EUR terms, Gold is still in a negative sequence on our long term oscillators (lower rectangle). Also, as with Gold in USD above, our medium oscillators (upper rectangle) just made a succession of two descending tops, confirming that the downtrend is still in place, probably into January. The support of our corrective targets (above 1'100, right hand scale) is holding for now. Moving below it would confirm our cautious bias.



Spot Gold in USD (Hourly graph or the perspective over the next 2 to 3 weeks):

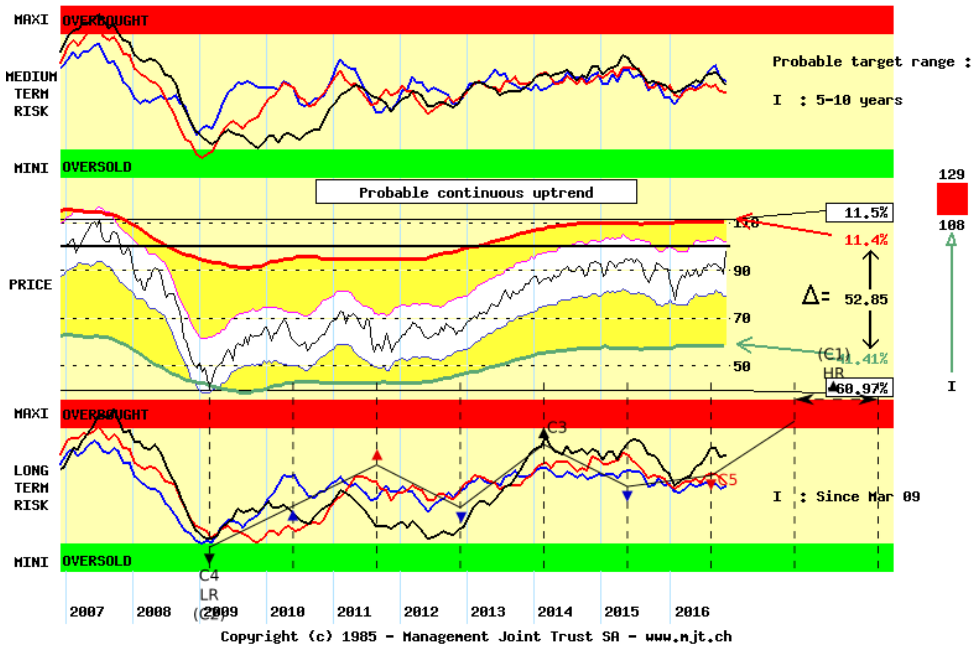
Since the US election, Gold has been negatively correlated to the reflation trade. Its price targets on the downside based on the hourly graph have now been achieved and surpassed (right hand scale). The Hourly graph is showing an oversold situation on our long term oscillators (lower rectangle) and an intermediate bottom may be forming. A rebound could materialise, and last a week to 10 days. It could lead us back towards the upper end of our envelope (1'220 – 1'240 in the middle rectangle).

Summary:

The hourly graph on Gold in USD (short term) is oversold and Gold could bounce over the next week to 10 days. A move up above our correction targets (proxied by the upper boundary of our Hourly envelope around $1'240/oz) may even trigger a more sustainable countertrend. Until this happens, we remain very cautious as the dynamics for both Gold priced in USD and EUR on our Daily graphs remain negative.

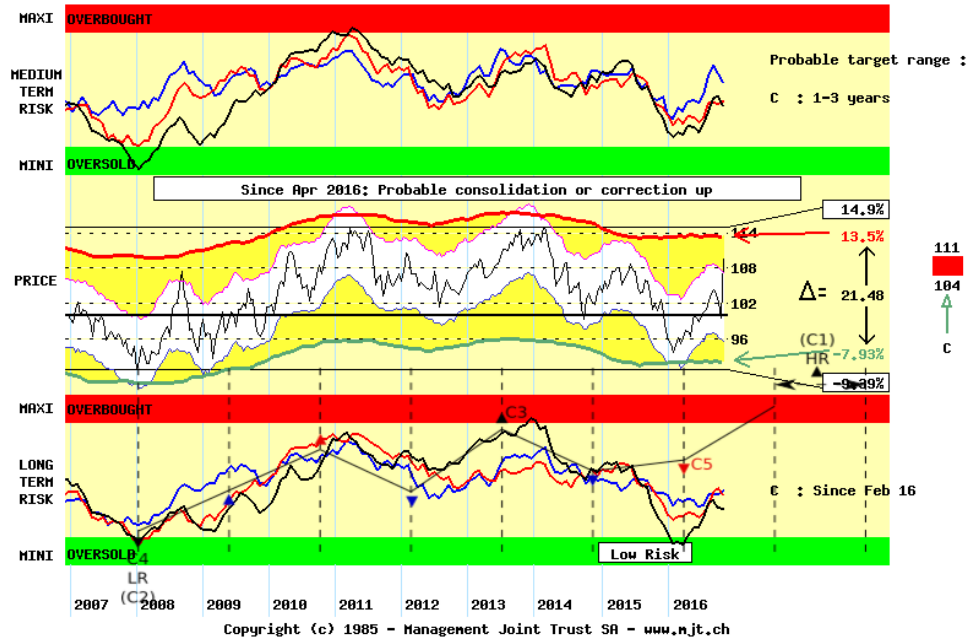
25 / Splicing the markets – An intermarket perspective:

Our cross-asset timing suggests that reflation drivers should continue their current uptrend into January or February next year. Longer term, following a consolidation period into 2Q2017, these could reaccelerate again into end 2017, early 2018. Below, we look at several bi-monthly charts, which we believe highlight some key investment focus points for the next 12 to 18 months.



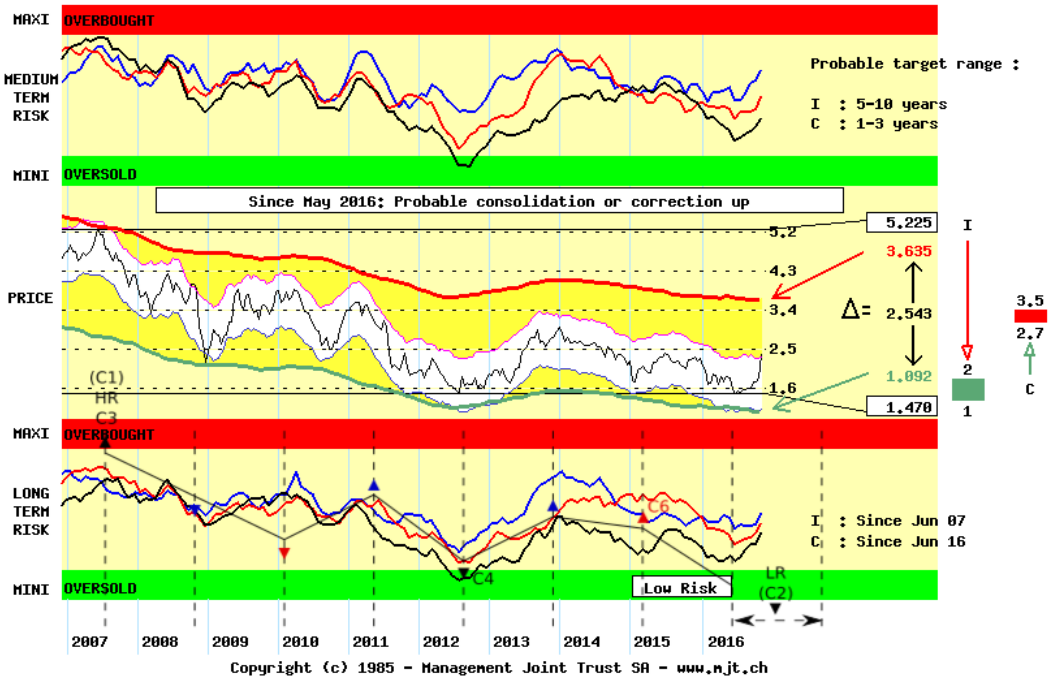
S&P500 vs Treasury Note 10Y Futures contract (Dec) (Bi-monthly chart or the perspective over the next 1 to 2 years):

Following a consolidation period from 2014 to early 2016 (a dis-inflationary period), this Equity to Bond ratio is now back in an uptrend (reflation). The sequence on our long oscillators (lower rectangle) would imply that equities continue to outperform long term government bonds until late 2017 / early 2018.



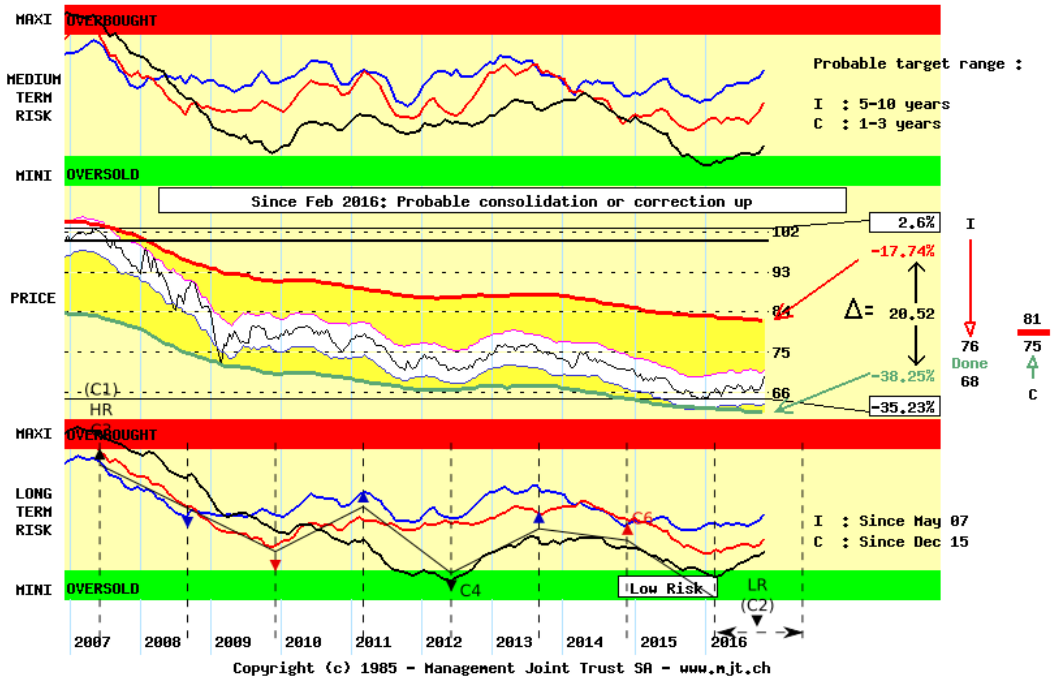
IWM iShares Russell 2000 ETF vs S&P500 Index (Bi-monthly chart or the perspective over the next 1 to 2 years):

This small cap to large cap proxy ratio offers similar perspectives as the equity vs government bond ratio above. Following a Low Risk position in early 2016 on our Long term oscillators (lower rectangle), small caps should now continue to outperform until end 2017 / early 2018.



US 10Y Treasury Benchmark Bond yield (Bi-Monthly graph or the perspective over the next 1 to 2 years):

The downtrend sequence in place since 2007 on our long term oscillators (lower rectangle) has now reached a Low Risk position. Without being able to call a secular reversal yet, typically, such situations are usually followed by 5 to 7 quarters of correction up. Possible targets for the US 10 Year treasury yields towards end 2017: between 2.7% and 3.5% (right hand scale).



IVE iShares S&P500 Value ETF vs IVW iShares S&P500 Growth ETF (Bi-Monthly graph or the perspective over the next 1 to 2 years):

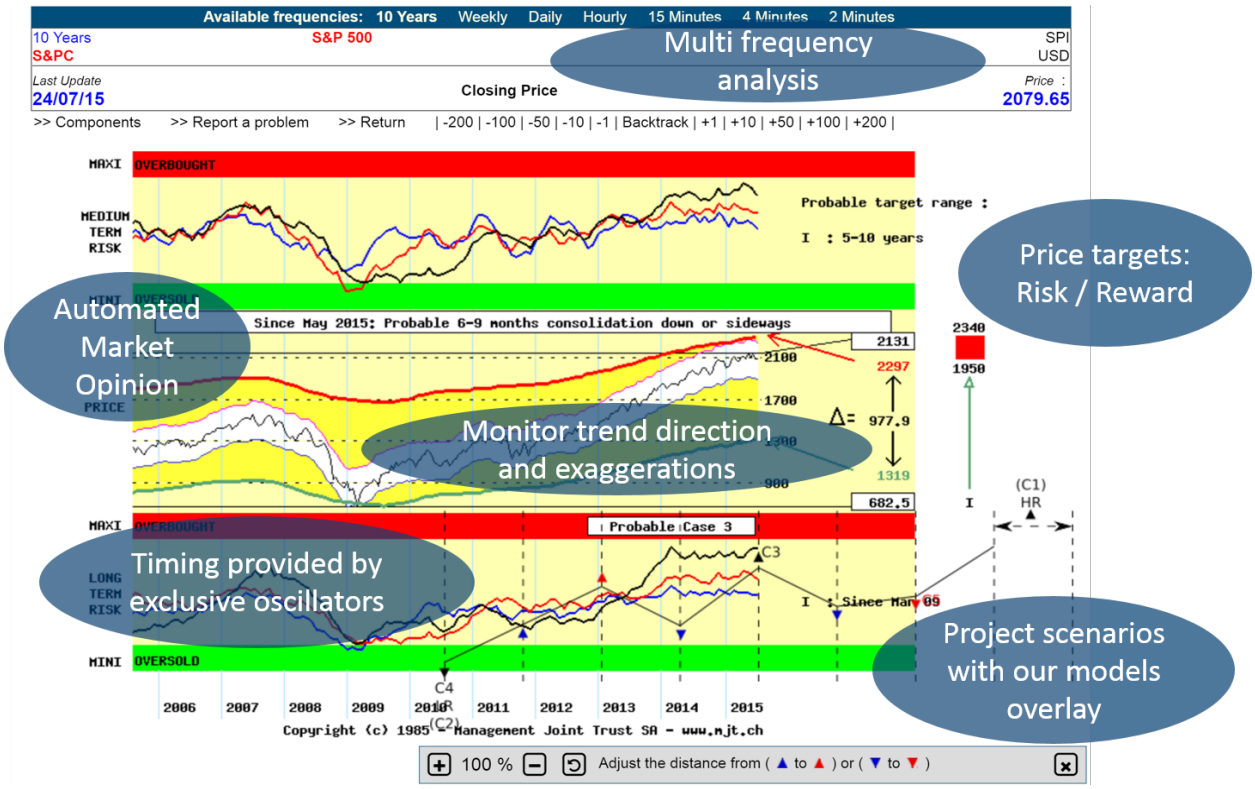
The chart of this Value to Growth ratio is extraordinarily similar to the US 10Y Treasury Benchmark Bond Yield. Indeed, as interest rates correct up, typical Value stocks with short duration or positive interest rate sensitivity (cyclicals and financials) should outperform longer duration Growth stocks and high yielding defensive stocks. Corrective potential over the next year: 10 to 15% (right hand scale, basis for calculation: start of chart)until Brent moves up again towards year end.

Concluding remarks:

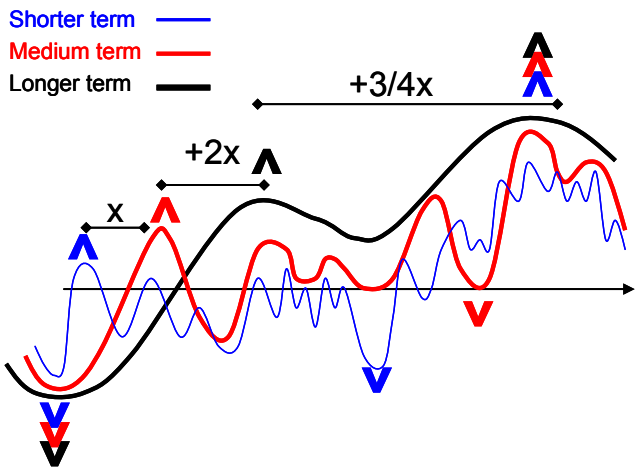
Rising interest rates and inflation anticipations are bringing differentiation back to the markets. Previously shunned assets such as value, small & mid caps or cyclicals are coming back in favour as investors start hunting again for bargains and trading opportunities rather than yield and carry.

27 / METHODOLOGY

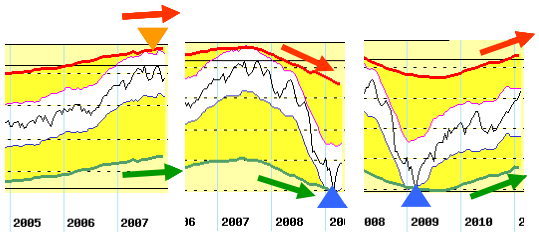
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



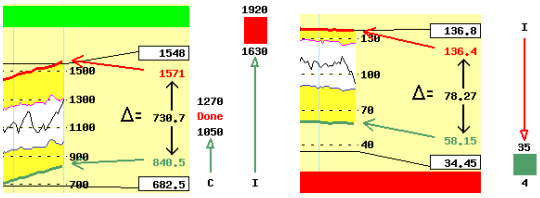
Timing oscillators: different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)

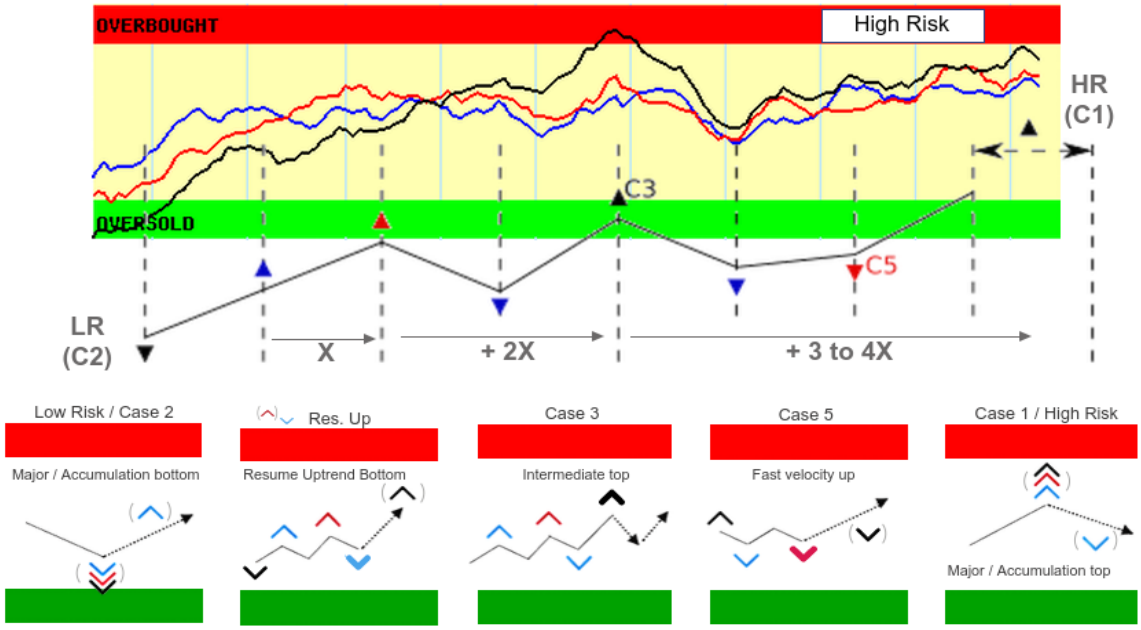


Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



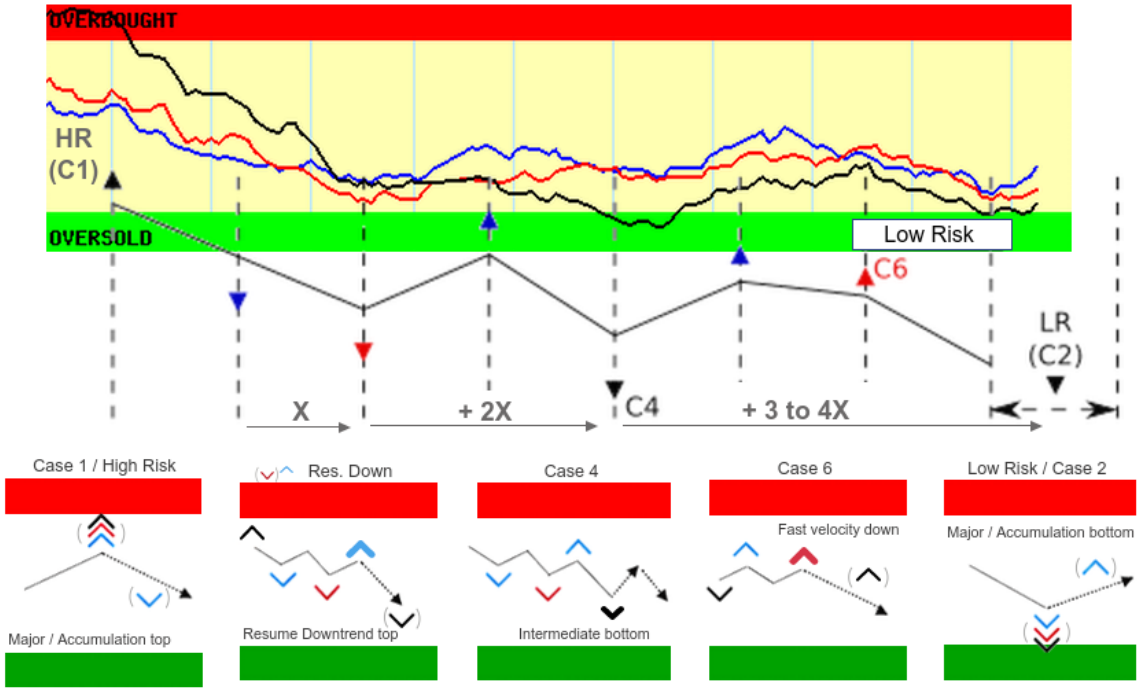
Price targets: based off historical volatity, they can highlight price potential or risk and, once achieved, define take profit or stop loss areas (e.g. below S&P500 in early 2011, Brent in October 2014).





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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