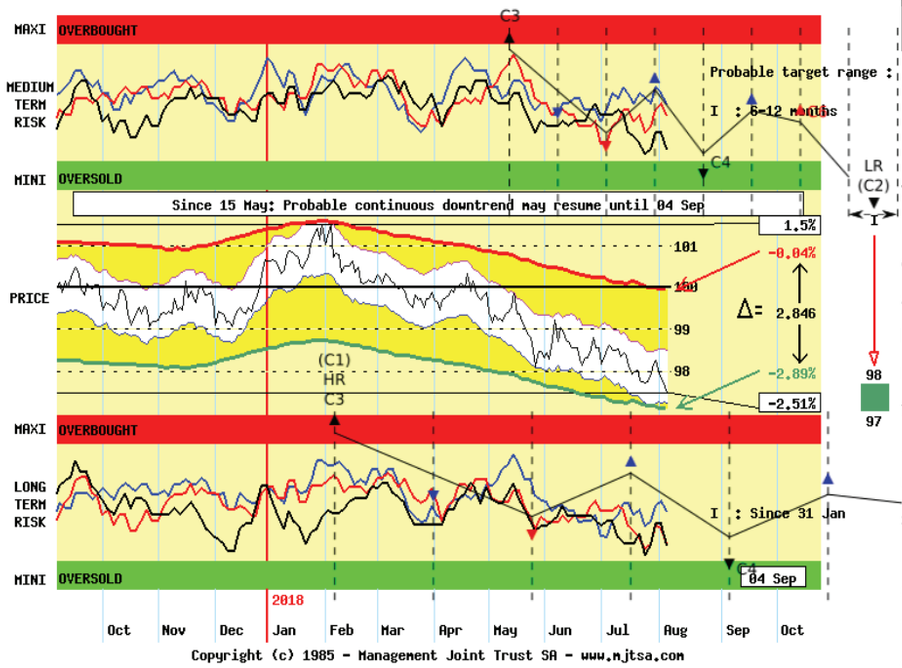
57 / Splicing the markets – Is the US Dollar risk-on or risk-off?

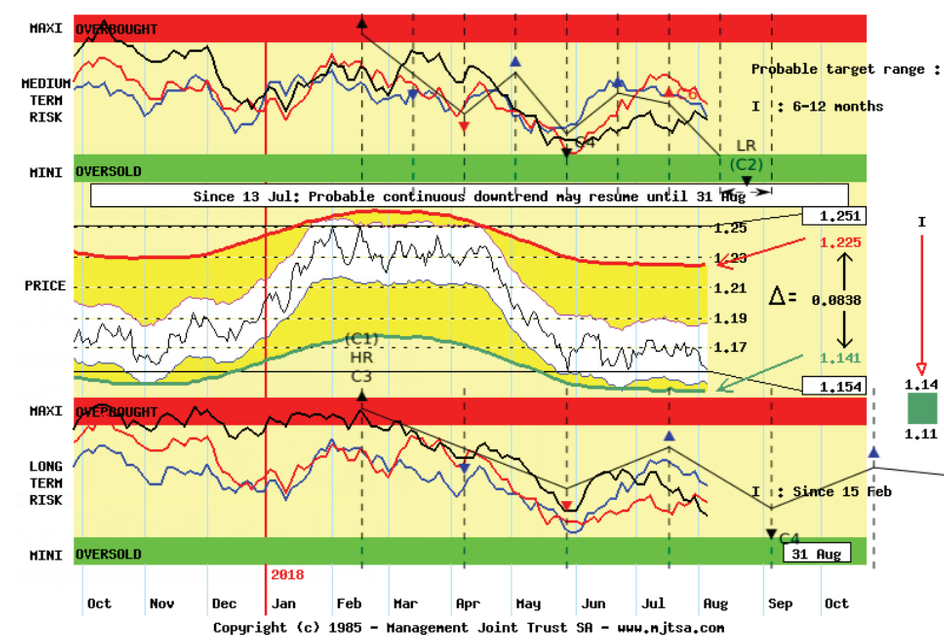
The above question is difficult to answer as the US Dollar and US market have been acting as a Growth trades since the Spring. Indeed, while the hard data is Europe is decelerating and the Trade War has rocked havoc in China, the US still appears as an island of stability and equity flows have pilled into the US and especially its Big Growth technology stocks. That said, at some point, we believe the US will reach its own deceleration problematics, this may be the case during the Defensive shift we expect between now and the Fall.

TIP - iShares TIPS Bond ETF / iShares Government Germany 5.5-10.5yr UCITS ETF
Daily graph or the perspective over the next 2 to 3 months



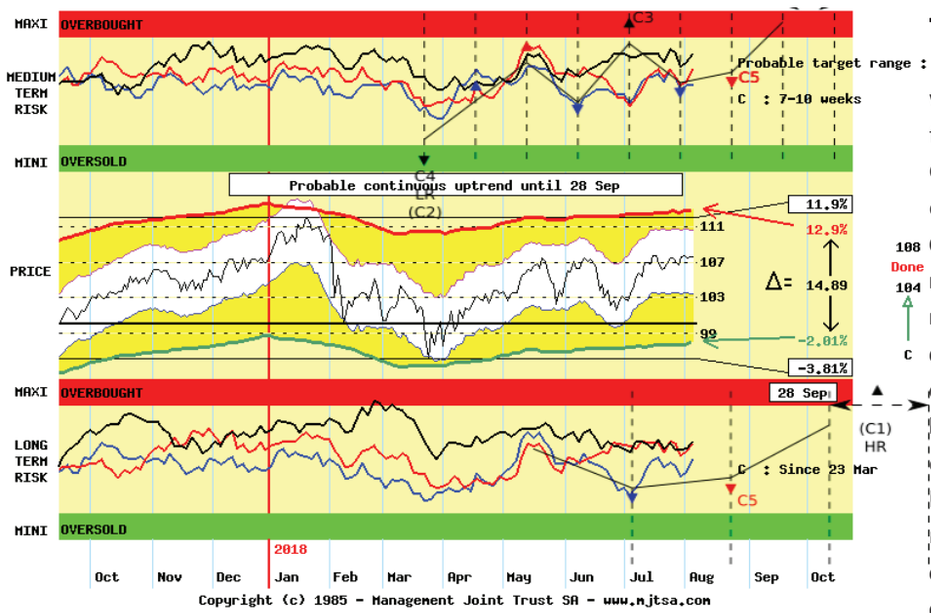
In previous issues of The Capital Observer, we attempted to single out the different drivers of the EUR/USD relationship. **Our conclusion led us to believe that the pair is currently reacting to two main factors, inflation expectations in the US and the interest differential between the US, and Europe. We've hence come up with this ratio, which take both into account, i.e. US TIPs vs German Goverment Bond on a hedged currency basis**. The ratio rises when inflation expectations in the US rise faster than the deceleration perspectives in Europe. On both oscillators series (lower and upper rectangles), we believe **that the ratio should reach an intermediate low between mid/late August and early September.** On a price target the downtrend since February is also reaching exhaustion as it has reached our I Impulsive targets to the downside (right-hand). **Hence, during this Fall, we would probably expect a counter-move on the ratio (inflation expectations in the US may be slowing? Or is it Europe that is feeling slightly better?).**

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



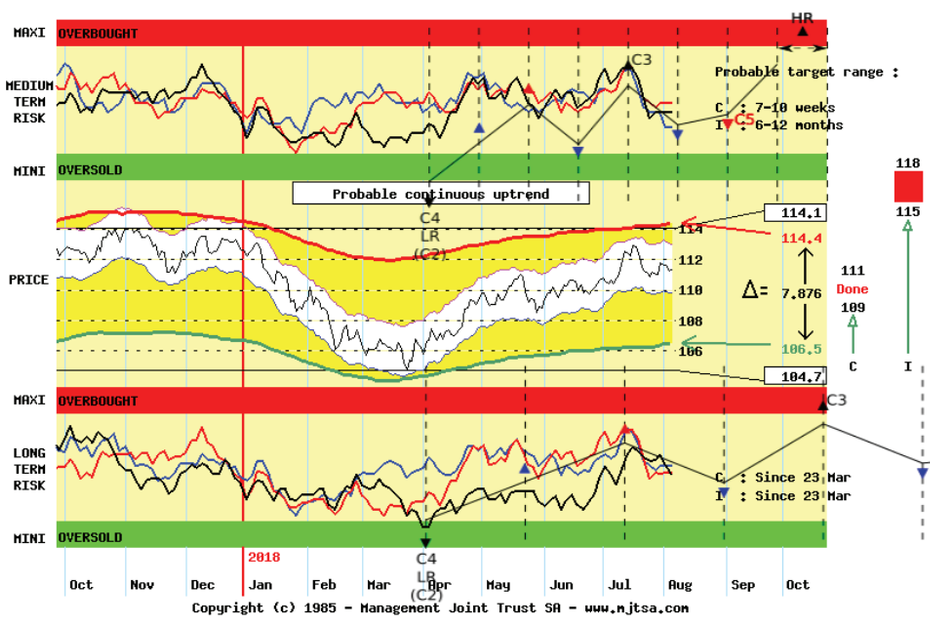
As you can notice, EUR/USD does indeed seem to follow the dynamics above, yet its moves are less gradual (long consolidation periods followed by rapid directional moves). That said, the scenario we map our on both our oscillator series is similar to the one above. We would expect that **the current downtrend finds a intermediate low, probably towards mid/late August, perhaps early September. The bounce that follows could last well into October**. On the price target front, EUR/USD may have some catching up to do vs the ratio as its I Impulsive targets to the downside have not yet been reached (right-hand scale). Indeed, **EUR/USD could reach the 1.14 – 1.11 zone during a final sell-off. Following that, the C Corrective targets to the upside we can calculate imply that EUR/USD moves back up towards the 1.17 – 1.19 range, probably towards late October** (or 0.5 to 0.8 times our historical volatility measure "Delta", here at 0.0838 added to the middle of the current downside target range, i.e. 1.125).

MSCI All Country World Index / Japanese Gov. Bonds (Sep)
Daily graph or the perspective over the next 2 to 3 months



Trying to understand the dynamics behind USD/JPY, we are attempting to use the following ratio: the MSCI All Country World Index vs JGBs, denominated in Yen. **The All Country World Index is the main volatility driver in this ratio, yet the JGBs and the Yen do have a negative influence, especially in periods of market turbulence**. From, what we can read from both our oscillator series (lower and upper rectangles), **we are currently expecting a slight period of consolidation on the ratio, probably into late August, before it moves up again towards late September and perhaps October.**

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



Similarly to the ratio above, USD/JPY has been moving up since late March. This is pretty standard as the pair usually follows risk assets up and down. According to both our oscillator series (lower and upper rectangles), **USD/JPY just made an intermediate top mid July, and is still is a period of consolidation, probably until late August. Following that, we expect it to move up gain, probably into late October. Depending on the sell-off we get during the rest of August our I Impulsive targets to the upside (right-hand scale), above 1.15 may or may not be difficult to achieve during September and October.**

Concluding remarks

Currently, the US Dollar is moving up vs both the Euro and the Yen. We believe that during the next few months, this relationship may change. Indeed, the Yen should first strengthen and then weaken again vs the US Dollar (risk-off, then risk-on), while the EUR/USD continues to weaken until late August before it rebounds into October (defensive/growth extension). These dynamics, if true, should trigger a rally in EUR/JPY from end August, and according to our tables, this cross usually correlates quite well with a flattening yield curve and a tightening of the US to Europe interest differential. During such periods, Defensive and Growth profiles usually also outperform. Not surprisingly, these are the basic tenants of our scenario from September into October. It remains to be seen however if we are correct in calling a worthwhile risk asset correction until the end of August, and then, following that, how strong the September/October recovery/extension actually turns out to be.