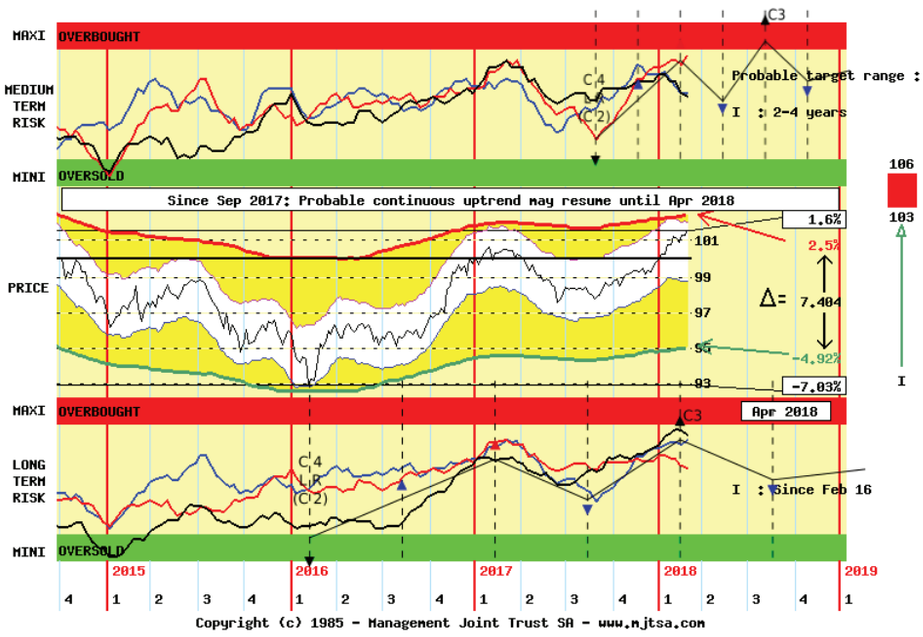
34 / MJT - TIMING AND TACTICAL INSIGHT

Inflation anticipations may subside until end Q1, yet should rise again in Q2

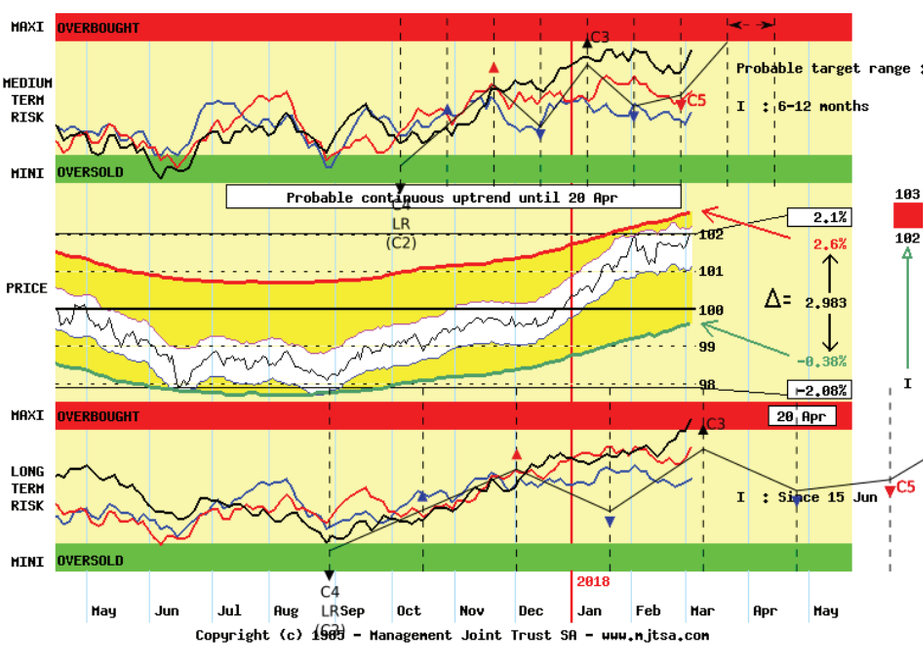
We are late in the business cycle and typically, a tight labour market, rising commodities and weakening US Dollar are putting upside pressure on prices. The inflation dynamics have started to accelerate, and the market seems to anticipate that they could continue to do so, as proxied for example the strong performance of breakevens (Tips vs Treasuries) and Gold over the last 3 months. In this article, we will consider these market expressions of inflation, and several others, in order to assess the current state of the inflation perception by the markets and its dynamics going forward.

TIP/IEF - Weekly graph or the perspective over the next 2 to 4 quarters



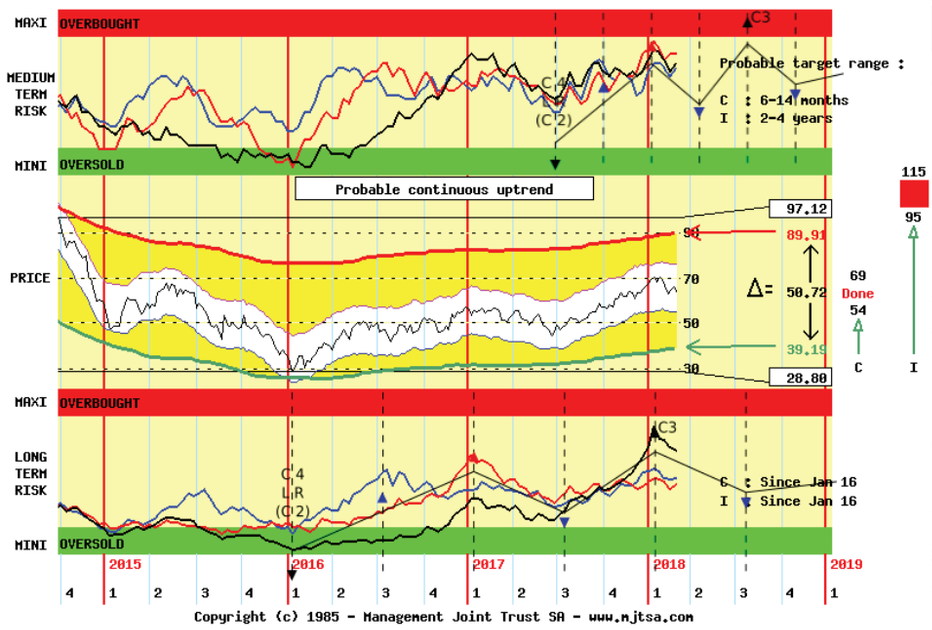
The TIP to IEF ratio compares inflation protected Treasuries vs Treasuries. When investors feel there is not enough inflation priced into Treasuries, they will buy Tips rather than Treasuries, the breakeven ratio then rises. Vis versa, when investors feel that there is too much inflation priced into Treasuries, they will revert to these and the ratio will fall. **Over the last 6 months, the ratio has been rising steadily, yet on both our oscillator series (lower and upper rectangles), it may be approaching an intermediate top and could consolidate into end Q1, and perhaps early Q2. Following that, the ratio should accelerate once more towards the Summer** as shown on our medium term oscillators (upper rectangle). Indeed, the uptrend does not seem exhausted yet, and there is still 2 to 5% upside left according to our I Impulsive targets up (right-hand scale). This is quite substantial given the low level of historic volatility of the ratio.

TIP/IEF - Daily graph or the perspective over the next 2 to 3 months



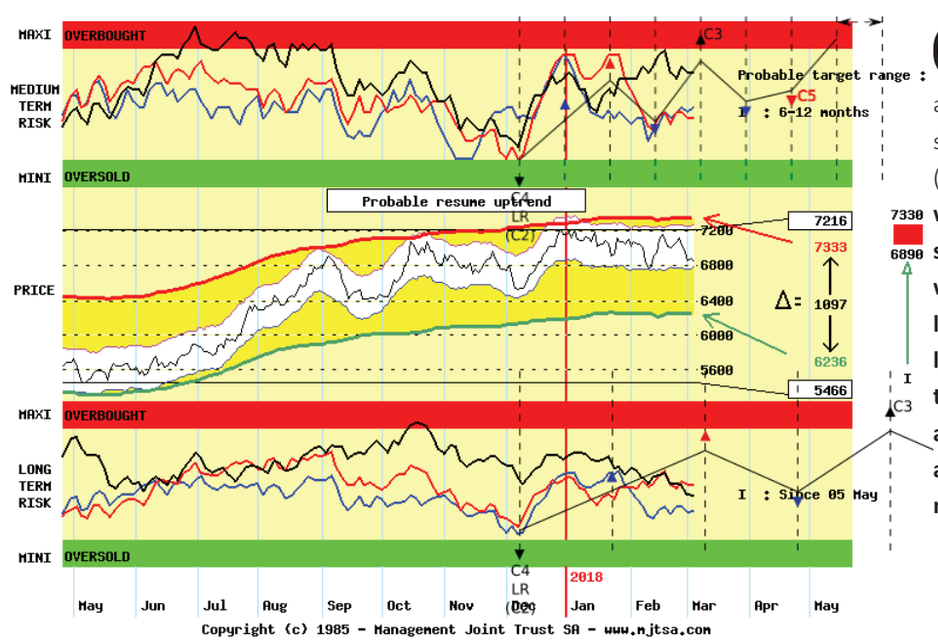
On our Daily graph, the uptrend sequence we show on our medium term oscillators (upper rectangle), and which is confirmed by our Automatic Messaging (message in the middle rectangle), would imply that the ratio could rise into late April. That said, our I Impulsive targets up (right-hand scale) have almost been reached and **the upside potential could be almost exhausted**. We hence show another sequence on our long term oscillators, which we expect to top earlier, probably over next week or so (lower rectangle). Given this discrepancy in timing, **we do not expect a huge sell-off of the breakeven ratio, but rather a high level consolidation, which could start soon and take place over the next couple of months. Following that, the ratio could start accelerating up again from early/mid Q2 into the Summer**.

Brent Oil
Weekly graph or the perspective over the next 2 to 4 quarters



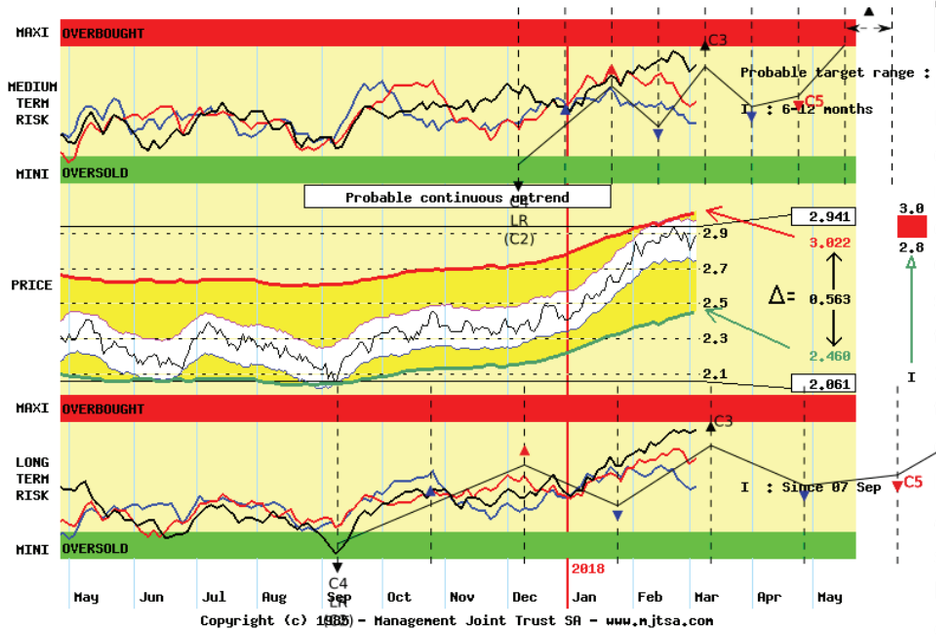
Inflation expectations have been closely linked to the rise of Commodities over the last 6 months. On our Weekly graph, Oil seems to have reached an important intermediate top on our long term oscillators (lower rectangle). The correction that follows may however be temporary. Indeed, on our medium term oscillators (upper rectangle), **we would expect Oil to correct into early Q1, before it reaccelerates up into mid year, possibly the Summer**. On the target front, we have reached the higher end our C Corrective targets up (right-hand scale) in the high 60s USD/barrel. Above that, the **next levels of targets could potentially reach up to the USD 100 mark/barrel. If this scenario (or even half of it) materialises during Q2, it should trigger a new acceleration in inflation expectations.**

Copper LME Spot USD/ton
Daily graph or the perspective over the next 2 to 3 months



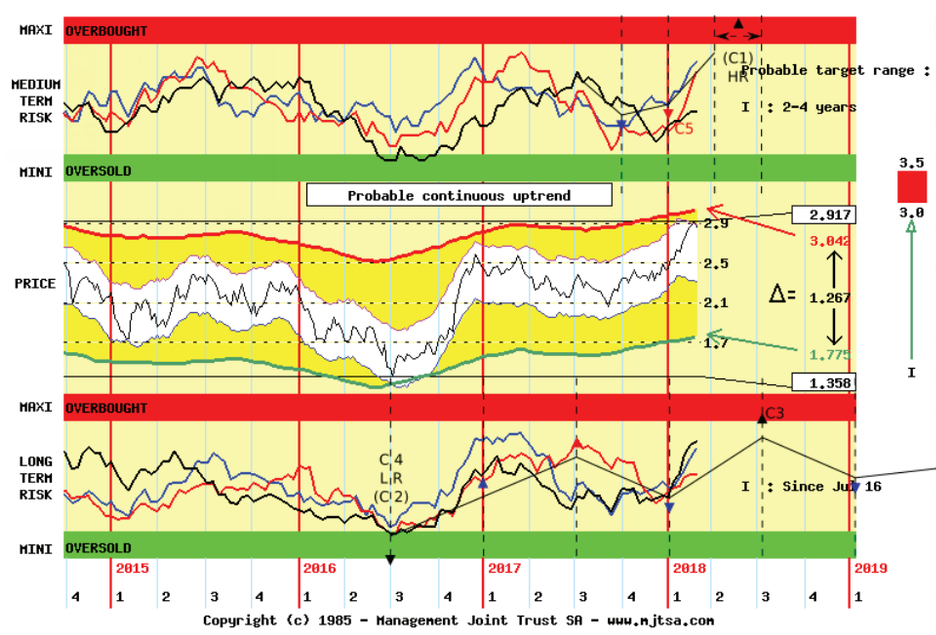
On this Daily graph, Copper may have already entered a high level consolidation. As show on both oscillator series (lower and upper rectangles), **we expect Copper to push slightly higher over the next week or so, before it consolidates down into April. Following that, we would await that Copper accelerates up again, possibly into mid year and perhaps even the Summer.**

US10Y Benchmark Bond Yields
Daily graph or the perspective over the next 2 to 3 months



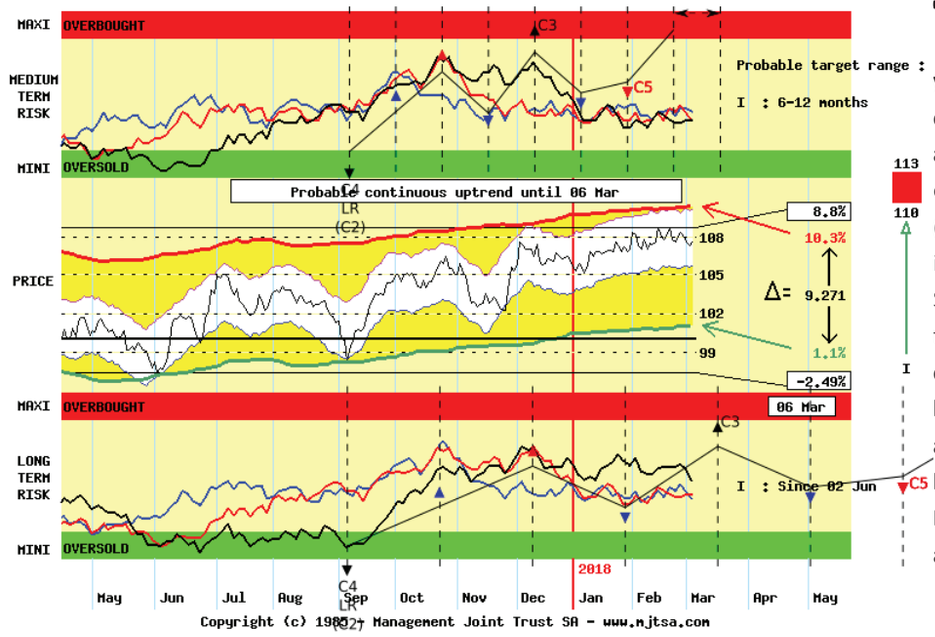
If the rises in inflation expectations pauses over the next couple of months, while Brent and Copper consolidate, US long term interest rates should follow suit. This effectively seems to be the case: on both our oscillator series (lower and upper rectangles), we would expect US 10Y benchmark bond yields to make an intermediate top early March and start consolidating towards early, mid April. Indeed, the move up since September is quite exhausted for now, it has reached our I Impulsive targets to the upside (right-hand scale). The C Corrective potential to the downside we can calculate is between 25 and 45 bps (0.5 to 0.8 times our historical volatility measure "Delta", here at 56 bps; middle rectangle, right-hand side), and could **hence bring the US 10Y treasury yield back into the 2.7 – 2.5% range**. Following that, US long term yields could start accelerating up again towards mid year (as shown on our long term oscillators series; lower rectangle).

US10Y Benchmark Bond Yields
Weekly graph or the perspective over the next 2 to 4 quarters



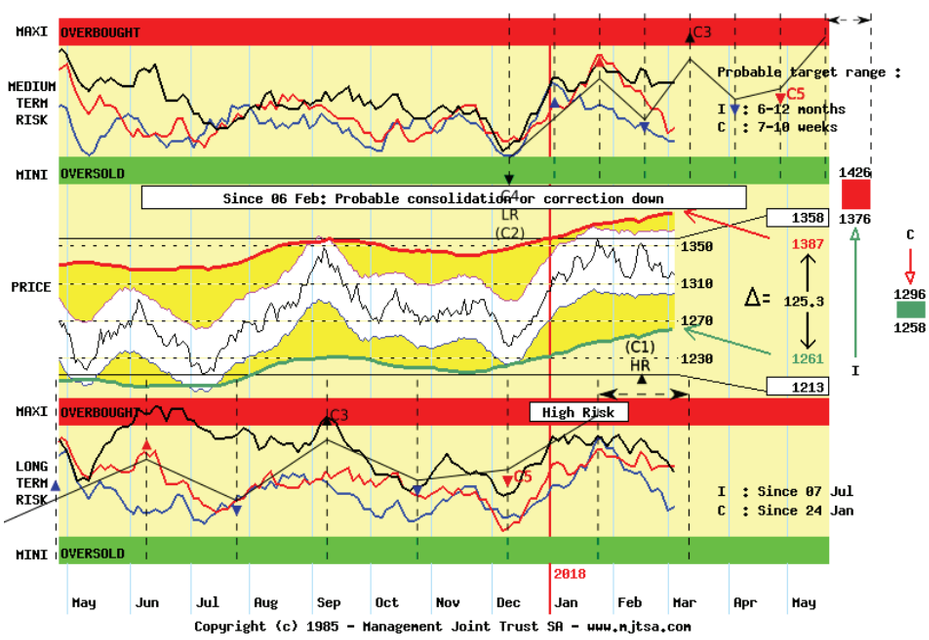
Our Weekly graph would confirm this view: our medium term oscillators (upper rectangle), may be entering a High Risk zone, while our longer term oscillators (lower rectangle) would still have time to rise towards mid year / early Summer. **This may confirm a succession of two final tops, one towards the lower end of our I Impulsive targets up (right-hand scale) around 3.0%, which is probably currently being made. Another in 4 to 5 months time towards the higher end of these I Impulsive targets up towards 3.5%.**

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



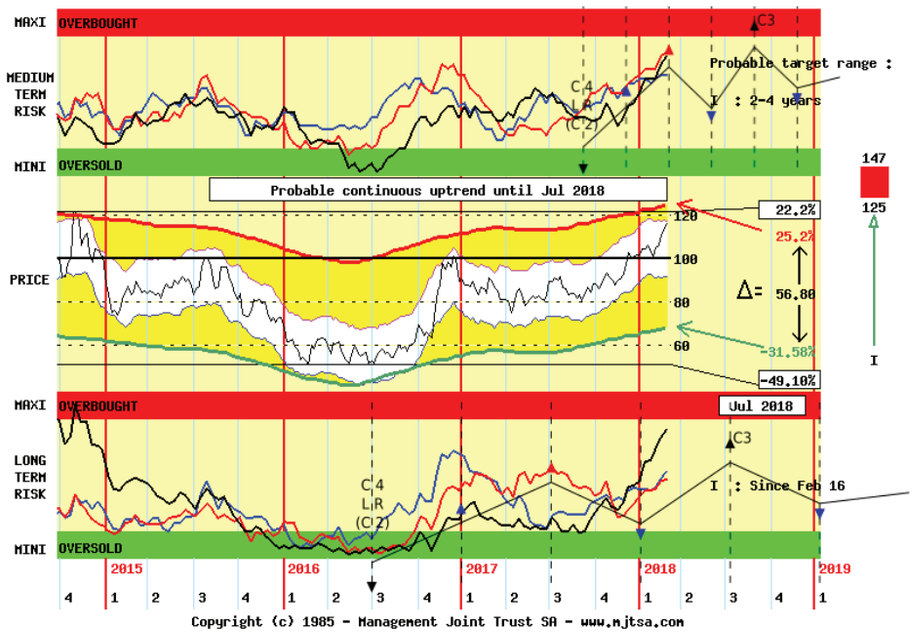
The Financials sector also confirm that long term yields, and by analogy inflation expectations, may be reaching an intermediate high. Indeed, on both our oscillator series (lower and upper rectangles), its Daily relative graph vs the S&P500 is also getting ready to consolidate down. **A top is expected on both sequence between now and mid March, and the consolidation could last into April. Following that, Financials should outperform again towards mid year.**

Gold Spot USD/oz
Daily Graph or the perspective over the next 2 to 3 months



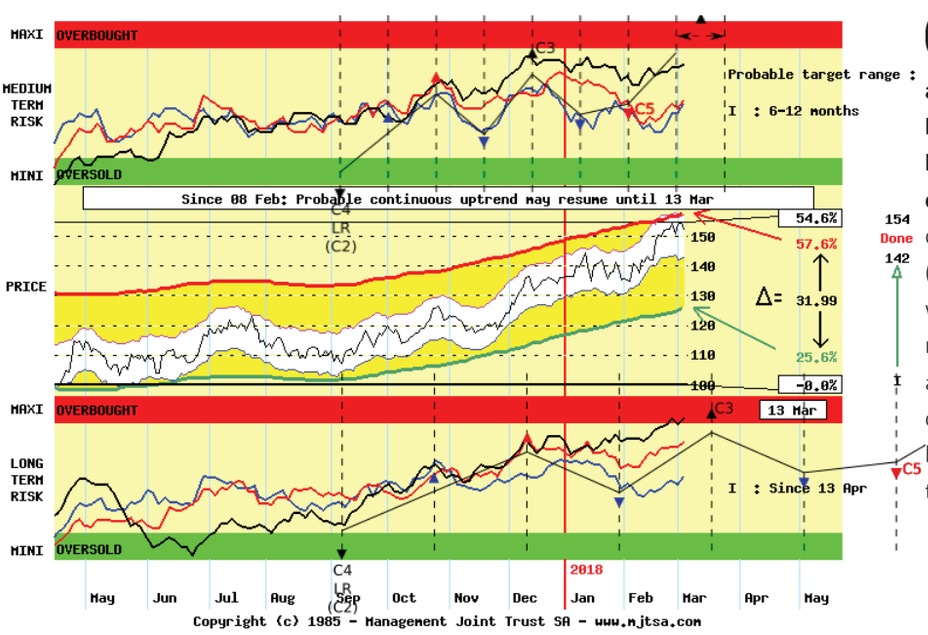
On the back of higher inflation expectations and a weaker US Dollar, Gold has been quite strong since December. **Yet, on our long term oscillator series (lower rectangle) it has probably reached a High Risk situation. Our medium term oscillators (upper rectangle) may justify one last push up over the next couple of weeks, yet following that Gold should correct down into early / mid April**. Our C Corrective targets to the downside (right-hand scale) suggest that Gold may move back below 1'300 USD/oz and possibly even towards USD 1'250 USD/oz. Such a correction down in Gold would fit quite well with a pause in the rise of inflation expectations as well as the US Dollar bounce we expect.

XME - SPDR S&P Metals & Mining ETF / HUI - Gold Bugs Index
Weekly graph our the perspective over the next 2 to 4 quarters



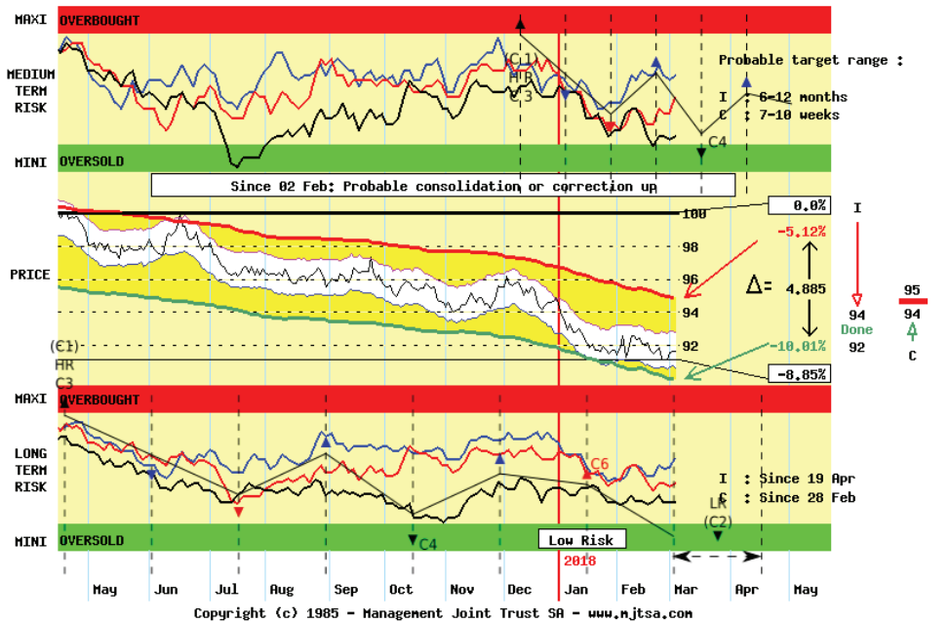
On the sector front, an interesting pair trade we have been monitoring, is the ratio between Diversified mining and Gold mines (XME vs HUI). **It is quite amazing how much this Weekly graph resembles the one on US long term yields shown two pages above. Similarly, we would also expect a succession of two tops over the next 6 months:** one pretty much now as shown on our medium term oscillator series (upper rectangle). The correction that follows could last into early/mid Q2. Another towards mid year, perhaps the Summer ,as shown on both oscillator series (lower and upper rectangles). Our I Impulsive targets to the upside (right-hand scale) still leave quite a lot of outperformance potential for XME vs HUI. Hence, the last leg up into the Summer could be quite strong. This we believe is quite bullish for US long term yields and inflation expectations from mid Q2 into Q3.

XME - SPDR S&P Metals & Mining ETF / HUI - Gold Bugs Index
Daily Graph or the perspective over the next 2 to 3 months



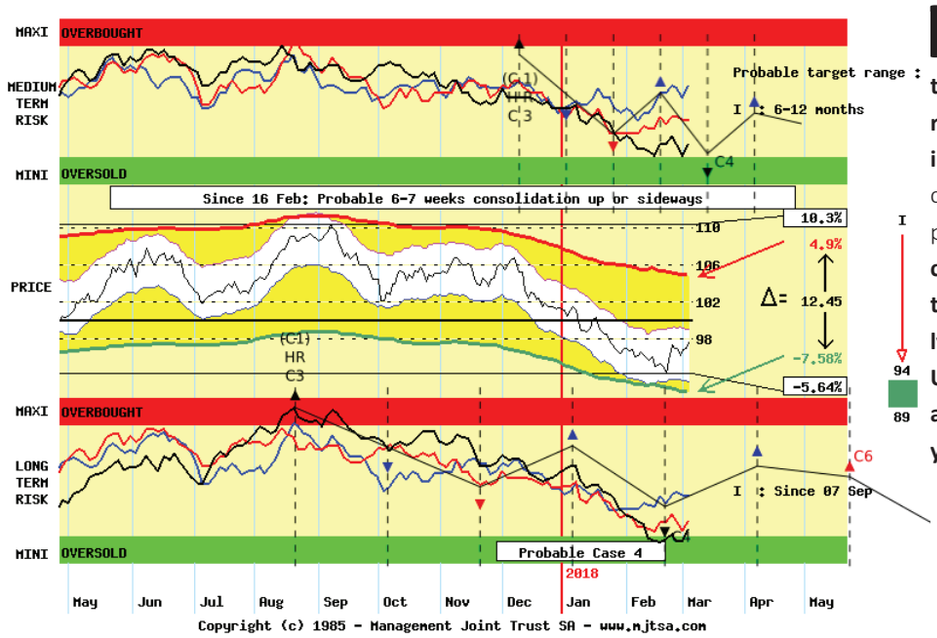
On the Daily graph of XME vs HUI, the picture is also similar to the ones on US long term yields, the TIP/IEF breakeven ratio or the Financials sector vs the S&P500. Indeed, on both oscillator series (lower and upper rectangles), we expect it to top out over the next couple of weeks and enter a consolidation period, which could last into mid/end April, before it accelerates up again towards the Summer.

DVY - iShares Select Dividend ETF / SPY - SPDR S&P 500
Daily Graph or the perspective over the next 2 to 3 months



We now look at the other side of these inflationary/reflationary trades, and for example at he Daily graph of higher yielding Equities (DVY ETF) vs the S&P500. These bond proxies have underperformed during most of 2017 on the back of the persistent risk-on environment which then prevailed, and since September especially have accelerated down as long term Treasury yields have started to rise again. On our long term oscillator series (lower rectangle), **we believe DVY is now in a Low Risk situation vs the S&P500 and is probably getting ready to bounce**. On our medium oscillators (upper rectangle), **the ratio could see a last downside retest over the next couple of weeks and then start moving up. This is the exact opposite of what we expect on the reflationary trades and ratios covered above.**

Utility sector - Dow Jones STOXX Europe / Dow Jones STOXX Europe 600
Daily Graph or the perspective over the next 2 to 3 months



In Europe, the situation is similar. Indeed, the ratio of the Utility sector vs the Europe Stoxx 600 is also reaching intermediate lows on both oscillators series (lower and upper rectangles). **Over the next couple of weeks, it may start to bounce, possibly into early / mid April. Following that, Utilities should underperform again, possibly towards mid year.**

Concluding remarks

Inflation expectations, Oil, Copper, Gold, long term yields and related sector trades are currently approaching intermediate tops. We expect them to consolidate at high levels probably until early / mid April. Following that, from mid Q2, inflationary/reflationary themes should accelerate up again possibly towards midyear, perhaps the Summer. The sector mix, which we see outperforming during this short pause in inflationary dynamics is quite defensive (high yielding stocks, Gold mines, Utilities), which may imply a rather risk-off bias.