THE CAPITAL OBSERVER

MARCH 2019

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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A stronger dollar, trade tensions with China and a wider global slowdown are all set to weigh on profits. Companies with more than 50% of sales in the US are expected to see a year on year increase in earnings of 1%. Those with less then half their sales in the US are expected to drop11.2% according to FactSet. " I think the investment universe might have underestimated the impact of the trade war as well as the Chinese and European slowdown"

R. Patterson, Bessemer Trust

4/ Executive Summary

12 / **Equities may have peaked and could decline until April, as a tripled-barrelled liquidity squeeze restricts money inflows** - The rally from the December 24 low, truly a gift of the Fed to the markets on the back of positive trade rhetoric, has likely ran its course. The rally may have peaked on March 4th based on the Dow Jones Industrial but growth stocks still seems to carry some momentum. Like any good story, it seems to be ending, and the prices of stocks should moderate somewhat while all the negative implications of declining systemic liquidity take its toll. We are now about to plunge into April where seasonal liquidity is lowest. This means less money around to buy assets of all kinds. As a consequence, it looks like equity indices have been topping one after another during a 3 to 4 week distribution phase starting on the 19th of February with the Dow Transport, followed by the Dow industrial and Russell 2000 on the 25th of February and the S&P500 double topping between the 4th of March and mid-month. Finally the Nasdaq100, will be the last one to peak benefiting from the reallocation to growth. This could be followed by a correction(30 to 50 pct) of the upside gains. The dearth of liquidity is not a fatal blow, however, and just part of a seasonality pattern that governs all institutional procedures. This correction, however, should be seen as an opportunity going into Summer, when liquidity levels again rise until Q3, as it has often done over the years.

15 / **Timing and Tactical Insight - Equity Markets could work the 2'850 – 2'650 range on the S&P500 until end April, before they move up again towards midyear -** Last week, Global equity markets finally saw some retracement. Yet, looking forward, our oscillators do indicate the possibility of further upside retests until late March. From early April, a new intermediate top should then materialize. It may lead equity markets lower during April, and possibly even into early May. In the near term, equity markets may still consolidate slightly over the next few days, and then attempt to push up once again to retest their current highs, perhaps making new highs into the mid 2'800s on the S&P500. Following that, the corrective potential we expect could lead us back down to the mid 2'600s. Then, from early/ mid May, Equity markets should reaccelerate up towards midyear / the Summer. Some of them will probably make new highs. Focusing on the Shanghai Composite, which recently broke out to the upside, it may continue to dip slightly over the next week or so, and then should move up again into early April. Following another correction down towards early May, it then continues higher towards the 3'300 – 3'500 range along with other equity markets.

23 / **Despite the anticipation of a sharp setback in Q2, the US Dollar should continue to rise until Q3 2019** - Since Q1 2018 we have turned more favourable to the dollar as factors contributing to the dominance of the US currency have been lining up. We go from the macro scale, represented by (1) the growth or non-growth of the Rest of the World vs US, (2) differentials in central bank monetary policies, (3) by differentials in regional capital flows, to micro scale represented by (a) domestic systemic liquidity proxied by the level of term (money) market rates, and (b) by the spreads of those short-term market rates. We point out that the factors which we identified in 2018 , as pushing the US Dollar higher, are still with us. It is the prospect of variance in growth between the US and the ROW going forward that has lately powered the ascent of the US currency. And it still does. There is also the power of US Capital Account to buttress the domestic currency. Changes in the US capital account have large impact on the US Dollar exchange rate, and its impact normally shows up in the valuation changes of the US currency 5 to 6 quarters later. However on the shorter time horizon, the evidence shows that there could be a brief but sharp correction in the course of the US Dollar, and that may stem from a forthcoming correction of the recent equity market gains from the December 24 low. We remain convinced that the US Dollar (DXY) still has potential left in this overall bull phase, which started in early 2018 and could last until Q3 2019. We also anticipate the Fed to pause in March, but subsequent FOMC meetings may become alive for policy hikes. Our primary reason is that core inflation will become a problem for the Fed after March. We expect core CPI to be driven higher by accelerating wage growth as the job situation becomes even more critically tight.

26 / **Timing and Tactical Insight - Strong US Dollar towards the Summer, yet with an intermediate correction during April and perhaps into May -** The FED has turned dovish, yet the US Dollar remains strong for now. This is especially the case vs the Euro and other European currencies. We expect this uptrend to continue, probably towards late March / early April, when the US Dollar could make an intermediate top, and start consolidating down for 3 to 6 weeks. This slowdown may correspond to some negative surprises on the US data front, yet, could also be the result of increasing inflationary pressures in the US, while the FED is "on halt". Perhaps a bit of both (temporary Stagflation scare?). Nevertheless, according to our timing and trend indicators, the Dollar appears to resume higher once again, from mid Q2 into the Summer. Among the various currencies, the Yuan and Asian Growth currencies seem to remain strong into late April, perhaps May, the EUR, the Yen and Developed Markets Commodity currencie should continue lower into late March, but then bounce during April / early May. Emerging Commodity Currencies, on the other hand, could weaken throughout the next couple of months, probably until late April / May. Sterling could push higher over the next few days, yet we do not believe this upswing will be long-lasting.

33 / **The US bank sector should perform well from early Q2 going into Q3 at least, as inflation surprises may cause the US yield curves to initiate steepening after March** - The banking sector looks to be in trouble again. The flattening yield curve as a result of aggressive tightening by the Fed throughout 2018 and in early Q1 this year, has dampened investor sentiment towards the financial sector, as markets perceive that banks' ability to generate earnings is constrained. But that is not the complete story, and there are a lot of myths that we have to lay to rest to tell the full story. It is true that flattening yield curves depress banks equity prices, but NOT for the reason that is almost universally quoted – that banks do not loan out when yields curve flatten, as there is very narrow spread margin per loan. While the narrow spread is essentially true, in reality, banks tend to increase loan issuance when yield curves flatten because what they cannot make in profitability per loan they try to make up in a larger volume of loan portfolios. That consequently increases costs in the effort to maintain the level of income from these portfolios. There are other myths that we can slay. For instance, it is clear that there is a negative covariance between the size of the loan portfolio with the growth of banks equity prices. More loans correlates with weaker equity prices, and vice versa. We feel very strongly that we will have a surprise surge in core inflation after March. Presume that inflation surprises will significantly raise the term premium and that will help steepen the yield curves – and that should help kick start a rise of the financial sector, which has lately showed signs of flagging, and has trailed the broader markets again. Bank shares outperform when yield curves and the net income margin steepen, meaning banks do not need to make so many loans (lower operating cost) while making the same relative level of profitability.

5/ Executive Summary

36 / **Timing and Tactical Insight - More Patience is required before Banks and the Financial sector start to outperform -** Since December, the US Financial sector has stabilized vs the market. It did indeed rebound in December and January, yet, has since lost momentum. Its relative performance seems to follow US Treasury yields (which have been resuming lower) as well as the US 10-3Y yield curve spread (which has flat-lined). Going forward we expect more downside on US Treasury yields, probably into April, perhaps May. The yield curve should also resume its flattening. Hence, US Financials should continue to underperform until then. This is also the case, when we compare US Banks vs the US Real Estate or Insurance segments. In Europe, the downtrend on bank stocks and their persistent relative underperformance seems more durable. For now, we see little chance for them outperforming at least until late Q2, perhaps even the Summer. This is also true vs the European Real Estate and Insurance sectors, which hence offer better alternatives in the Financials space.

43 / **The Eurozone slows down rapidly, as Germany's exports and industrial production falter; flexibility on national budget limits necessary to prevent further deterioration** - Germany has been the workhorse that has pulled the European economy back from the brink time and time again, and pushed bloc-wide growth along despite internal and external pressures, as well as political crises, over the last decade. As the de facto economic and political leader of the bloc, the country has spearheaded and supported rescue plans for the Eurozone's weaker links. However, Germany's economic outlook has turned dark, therefore concerns over potential knock-on effects on the entire monetary union have risen. Trade tensions, the threat of a hard Brexit and weaker emerging markets growth have all played a part in dampening Germany's nine-year-long economic upswing. Recently released figures also cast large shadows over Germany's formidable manufacturing sector, with industrial output much lower than expected. Germany's labour market is one of the key problems. Grave shortage of skilled workers is presenting massive obstacles industrial growth and has been crimping operational efficiency. The Eurozone as a whole is showing negative industrial production growth at-3.3% year over year, something uncharacteristic of an economy not in recession. The trend across the broad EU composite manufacturing PMI and the major countries is all the same; one of sharp deceleration. National governments and the European Central bank have taken note of the deteriorating fundamentals. However, the largest issue Europe faces today is what the governments will do from a fiscal and monetary standpoint in order to stimulate out of a growth slowdown. With the weakening outlook in the entire Eurozone, the directorate in Brussels may finally find more application of practicality versus an ideological approach of fits-one, fits-all, all-the-time approach to national fiscal expenditures.

46 / **Timing and Tactical Insight - Sustainable European outperformance, probably not until late this year -** Over the last 10 years, Europe has suffered secular underperformance vs Global equity markets. This trend was partly due to a declining EUR/USD exchange rate, but also to the underperformance of European markets in nominal terms (i.e. when hedged for currency movements). The trend now seems Oversold on our long term bi-monthly graphs. Yet, it may take a few more quarters to start reversing up. Our timing suggests that it could start to happen from late Summer, and that it may coincide with the end of the rally up we expect on global equities into the Summer. Indeed, over the last 10 years, Europe does appear rather counter-cyclical in relative terms, and may well outperfom (decline less), when other markets start to resume lower. Shorter term, we expect European markets to bounce vs Global markets in US Dollar terms during April, as the EUR/USD is also expected to correct up. Hedged for currency risk, Europe may on the contrary underperform again due to the stronger Euro.Intra Europe, we would see the CAC40 as being rather pro-cyclical, while the DAX appears stuck in a secular downtrend vs the EuroStoxx 600. Switzerland on the other hand is clearly defensive, while Italy and the UK may underperform during Q2 due to political issues.

54 / **Splicing the markets - A short term battle between Growth and Cyclicals, yet Defensives should get the final word -** In recent days, the Nasdaq 100 and Growth sectors have proven extraordinarily resilient, while more cyclical portions of the market have started to correct. Over the next week or so, both growth sectors and cyclicals may retrace or retest down. The second half of March could then see a brief cyclical bounce. Growth may then make new highs, while cyclicals catch up some of their recent underperformance. From late March / early April, both should start to correct down. Growth profiles could hold up rather well, while Cyclicals may sell-off. It is Defensive sectors, however, that should outperform both, probably from late March into late April/early May, thereby confirming the risk asset correction we expect during this period.

6/ Mapping the markets

Last month, when we published on the 12th of February, we expected that equities had reached an intermediate top, and that they could retrace down into late February / March. If the more cyclical parts of the market did start to move lower from late February (Dow Jones Industrials, Russell 2000, most sectors), Technology, the Nasdaq, Utilities or Real Estate are still making new highs. As a resultant, the S&P500 has flat-lined around its February tops around the 2'800 levels, and European markets have corrected slightly since early March, but are still very close to their post December highs. We had also expected that Yields could continue lower, bounce late February and then retest down into March, and that the Dollar's uptrend could take a brief pause until late February, allowing Gold to make one last move higher, before the US Dollar then continued up into late March. These projections on asset classes other than equities have all materialized. In general, we were too defensive on equities last month, Cyclicals did however correct, yet Growth stocks outperformed massively as interest rates started to move lower again from early March. As a result, the S&P500 held its ground.

Going forward, the main equity indexes are still levitating close, or at, their recent highs, and their uptrend doesn't seem quite finished yet. Indeed, by next week (3rd week of March), the cyclical part of the market could make an intermediate low (a last sell-off until then is still possible). It should then start to rebound towards late March, while Growth themes, and the general market indexes make a last push higher. By late March / early April, all should then reach a new intermediate top. It could trigger 3 to 6 weeks of correction to the downside, and could lead the S&P500 back below 2'700 and possibly towards the low 2'600s. Defensives profiles would then outperform both Growth and Cyclicals, while Cyclicals would be hit the hardest. This scenario also implies further retracement on Gold and Treasuries from next week into late March, and probably a stronger Dollar. Then from late March / early April, Gold and Treasuries would then move up again for several weeks, while the US Dollar corrects down. We still expect US 10 years Treasury yields to reach down into the 2.3 – 2.5 % range, before they reverse up from mid/late Q2 into the Summer.

From late April / May, following this April setback, the cyclical re-acceleration we had expected late Q1 / early Q2, should finally materialize. It probably lasts into the Summer and could lead US Treasury yields, Oil, US equity markets, China back to their 2018 highs. The yields curve should steepen, Financials should outperform, and the Dollar should also move higher once again as it becomes clear that the FED may resume its rate hiking program by midyear. US markets should then continue to outperform, vs Europe especially, as the US continues to drain liquidity from the rest of the world. We view this strong residual uptrend as a late cycle phenomenon, and by late Summer / the Fall, it should reverse down again, probably towards mid 2020, as again, a more hawkish FED collides with investors' aspirations.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	US markets could push slightly higher until late March / early April. Following that, they retrace down during April (target 2'700 – 2'600 range on the S&P500)	From mid Q2, US Equity markets should resume their strong rally probably towards midyear and perhaps the Summer.
	Europe EuroStoxx50	European markets could push slightly higher until late March / early April. Following that, they retrace down during April (target 3'200 – 3'100 range on the S&P500)	From mid Q2, US Equity markets should resume their strong rally probably towards midyear and perhaps the Summer.
	EMs MSCIEM USD	Emerging Markets could retest their February highs until late March / early April and then retrace down during April towards the highs made last November / December.	From mid Q2, US Equity markets should resume their strong rally probably towards midyear and perhaps the Summer.
Treasuries	US10Y Bond prices	US Treasuries yields should continue to retest lower towards their 2.5 – 2.3% range, and until late April.	From mid Q2, we expect Treasury yields to resume their uptrend, possibly making it back above 3 %, perhaps retesting highs, towards midyear / the Summer.
	Germany 10Y Bund prices	German Bund Yields (10Y) should remain under pressure until late April and could dip below zero.	From mid Q2, we expect Bund yields to start to bounce, possibly by 30 to 40 bps towards midyear / the Summer.

Legend:	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight

Main Equities

World markets
p 15-17

The intermediate top we were expecting last month triggered little reaction. While Cyclical sectors did correct down from late February, Growth themes continued to marginal new highs. As a resultant, the S&P500 and European markets are still very close to/retesting their post December highs. By next week (the 3rd week of March), following some consolidation equity markets could retest higher once more into late March / early April. They should then correct down for 3 to 6 we weeks into late April / early May.

Main Regional picks
p 16-18, p 46-53

Growth themes are currently outperforming, and we still believe the US is the main growth motor for now. Asian Growth countries such as India and China may also prove quite strong. Europe and Japan may lag again (in local terms at least), especially from late March as their currencies start to strengthen temporarily vs the US Dollar.

Emerging markets
p 15, 20-22

As mentioned above, Asia growth countries could continue to outperform over the next couple of months, as their currencies remain strong against the US Dollar and interest rates remain under downside pressure. Commodity countries may bounce short term, yet from end March / early April, should resume lower again, along with cyclical themes, probably until the end of April. In general, the Emerging Markets Index (circa 70% weighted towards Asian Growth) seems rather defensive. In US Dollar terms, it should continue to consolidate vs Global markets until late March and then rebound during April.

Volatility

Volatility has reversed its Q4 excesses, and for now, still seems positioned in a downtrend, probably towards late March, where it could find an intermediate low and bounce into April.

Government Bonds

US & European Benchmarks
p 40

US 10Y Treasury yields may continue to push lower towards the 2.3% – 2.5% range over the next month or so. By late April, early May, we expect them to start reversing up. They may then accelerate up into midyear, probably back above 3% and perhaps above their 2018 highs. In Europe, 10Y Bund yields made new lows and could dip below 0% over the next month or so. Here also, by late April, early May, these could reverse up and rally by 30 to 40 basis points into midyear.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	The ratio could continue higher until late March / early April, before it retraces down during April.	From mid Q2, the ratio should bounce towards midyear, perhaps the Summer, along with equities and yields.
	Europe	The ratio could continue higher until late March / early April, before it retraces down during April.	From mid Q2, the ratio should bounce towards midyear, perhaps the Summer, along with equities and yields.
Duration		US and European yield curve spreads should continue to flatten into late April as long bonds initiate a last move higher during April.	From mid Q2, Yield curves could start to steepen quite rapidly towards mid year, as long term yields follow risk assets up and the FED is "on halt".
Credit		Credit follows a similar path than equities. Corporate spreads could retest down towards late March / early April, and then bounce again during April.	From late April, Credit spreads retrace once again as risk assets bounce towards midyear and perhaps the Summer.
TIPs/Treasuries		Inflation expectations (TIPs vs Treasuries ratio) may hold up until late March / early April, and then retrace down again during April.	The TIPs vs Treasury ratio bounces strongly from mid Q2 towards the Summer.
Oil		Oil probably continues higher towards the low 70s USD/barrel on Brent, the low 60s on WTI until late March / early April. It then retrace down during April.	By mid Q2, Oil initiates a strong rally towards the Summer.
Industrial metals		Industrial metals continue higher towards late March / early April, before retracing down during April.	By mid Q2, Industrial metals initiate another rally towards the Summer.
Gold		Gold retests down, yet gradually builds a base until end March. Following that, it may retest its February highs towards late April / early May.	From mid Q2, Gold retraces down into the Summer as the risk off sentiment collapses, and the US Dollar regains strength.

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

Equity to Bond Ratios

US & Eurozone Markets

The Equity to Bond ratios in the US and Europe did dip briefly early March, yet their uptrend for now still seems in place, at least until end March / early April, when the next intermediate top is expected.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 40

The US yield curve should continue to flatten a while longer, while short term yield are "on halt" and long term ones may continue to retrace until late April, perhaps early May. Following that, we expect long term yields to start moving up again towards midyear, thereby steepening the curve.

Credit Credit spreads have been consolidating up/sideways since January, following the strong retracement they saw in January following their December highs. We expect them to attempt a new move lower towards end March / early April, before they correct up again towards late April, early May.

Rate Differentials p28 The rate differential between the US and Europe is still rebounding from its early January lows as despite the recent sell-off in US yields, European yields have been falling more drastically. On the other hand, vs Japanese yields, the differential recently made new lows. In general, yield differentials could hold up until late March, yet could then retrace down in April (thereby weakening the US Dollar). Following that, we expect them to move up again from late April / May into the Summer.

Tips p28 The TIPs / Treasury inflation breakeven ratio has been timidly following risk assets up since early January. We also expect it to hold up slightly longer until late March, and then retrace down into April. Following that, it should rise towards the Summer along with inflation expectations. TIPs could retrace slightly into late March and then resume up towards late April / May. Thereafter, they reverse down towards the Summer.

Commodities

Oil Oil could continue higher until late March / early April, and by then, it may test the upper end of our Daily C Corrective targets to the upside, around 72 USD/barrel on Brent, around 63 USD/barrel on WTI. It then corrects down with other risk assets during April.

Industrial metals Industrial metals did retrace slightly late February / March, yet could still push higher into late March / early April. Following that, they retrace during April along with other risk assets. Copper could test our Daily C Corrective targets to the upside, around 6'700 USD/ton (LME) and then retrace during April.

Gold & PMs Gold corrected down sharply during late February / early March. It may retest down, yet should gradually build a base between now and late March / early April. During April, it then retests up towards its February highs around 1'350 USD/oz.

Agriculture Agricultural Commodities could bounce slightly during the 2nd half of March, yet remain under pressure until late April.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	The US Dollar could still push slightly higher vs the Euro into late March (1.12 – 1.10 range ON EUR/USD), it then corrects down into late April, perhaps early May (towards 1.15-1.17 on EUR/USD).	From mid Q2, the US Dollar should resume its uptrend towards the Summer
	GBP	Cable is currently testing higher. Yet, we do not believe this rally is long-lasting. It should then consolidate into late March / early April. It could bounce again in April as USD corrects.	From mid Q2, the US Dollar should resume its uptrend towards the Summer
	JPY	USD/JPY could push slightly higher until late March / early April (112-113), before it retraces down during April towards the 110-108 range.	From mid Q2, USD/JPY resumes its uptrend as risks subside, probably towards the Summer and towards 115-116.
	CHF	USD/CHF could still push slightly higher into late March (1.02) and then corrects down into April into the 0.99-0.97 range.	From mid Q2, USD/CHF resumes up quite strongly towards midyear and the Summer.
EUR vs	GBP	EUR/GBP is currently testing crucial support around 0.86, and could drop towards 0.84-0.82 if it breaks. It should then rise in April as EUR is more Defensive than GBP.	From mid Q2, EUR/GBP could fall further on risk-ON considerations, yet the Brexit process is still very unpredictable and may surprise negatively for GBP.
	JPY	EUR/JPY could hold up until late March. It then resumes lower until late April (target 123-122).	EUR/JPY should find support towards mid Q2 and then rises strongly towards midyear / the Summer.
	CHF	EUR/CHF could hold up until late March. It then resumes lower until late April and could retest its base around 1.12.	EUR/CHF should find support towards mid Q2 and then rises strongly towards midyear / the Summer.
GBP vs	JPY	Brexit remains a high uncertainty factor, yet GBP could hold up and even test higher until late March. It then resumes lower during April, target: 143-140	GBP/JPY should find support towards mid Q2 and then rise strongly towards midyear / the Summer, yet Brexit remains a strong factor of uncertainty.
	CHF	Brexit remains a high uncertainty factor, yet GBP could hold up and even test higher until late March. It then resumes lower during April, target: 1.31-1.29.	GBP/CHF should find support towards mid Q2 and then rise strongly towards midyear / the Summer, yet Brexit remains a strong factor of uncertainty.

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

US Dollar
p 26-27

We remain constructive on the US Dollar until late March. Following that, it should correct down towards late April, early May, yet probably resumes up again thereafter towards midyear and during H2 2019.

Euro
p 27, 46

EUR/USD probably remains under pressure until late March. It may retest its recent lows or slightly lower in the 1.12 – 1.10 range. Vs CHF, EUR seems to be holding up for now, probably towards late March. It then resumes lower during April and could revisit its December lows towards 1.12. EUR/GBP has been very volatile lately given the Brexit deadline, which is rapidly approaching, and the crucial votes currently taking place. These developments are indeed adding much uncertainty to the future prospects of the pair. For now, EUR/GBP is still attempting to hold crucial support around 0.86. If it does break through, the next level of support is in the 0.84- 0.82 range.

Yen
p 29

Since it Flash Crashed below 105 early January, USD/JPY has rebounded back to slightly below our C Corrective targets to the upside between 111 and 113. Hence, for now, the bounce since early January is still labeled as countertrend. Our timing suggests that, along with risk assets, USD/JPY could attempt to test the higher end of this range towards late March, early April. Following that, during April, we expect it to retest down in the 110 – 108 range. Similarly, EUR/JPY GBP/JPY could hold-up /retest-up until the end of March / early April, and then retrace down during April (towards 143-140 on GBP/JPY, towards 123-122 on EUR/JPY).

Sterling
p32

The fate of Sterling is still hanging onto the bumpy Brexit process. Historically, Sterling is rather pro-cyclical against the Dollar. Hence, given the risk asset correction we expect during April (and the concomitant EUR/USD rebound), it should normally bounce less than the Euro. Furthermore, in the meantime, our Daily oscillators on GBP/USD are approaching a top again. The current rally may not be long-lasting. Indeed, the short term is anybody's guess given the series of crucial parliamentary votes taking place this week. We would hence remain prudent on GBP/USD for now.

Oil & Commodities currencies
p 31

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR): While developed Commodity currencies (AUD, CAD, NOK, NZD) may be starting to build a base vs the USD, and could bounce from end March towards late April, more EM driven Commodity currencies such as BRL, RUB, CLP or ZAR may be approaching tops vs the US and could correct into April. This dichotomy probably reflects the risk asset correction we expect during April.

Asian currencies
p 30, 32

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) still seems quite strong vs the USD, probably towards end April, early May.

Equities Markets Segmentation

Core Sector Weightings			Next 2 months					3 to 6 months ahead				
US Sectors - S&P500 (general comment)			**Although Industrials and Energy may bounce slightly until late March, we would then Overweight Defensive and Growth sectors from early April. We remain Underweight Financials until end April.**					**From mid Q2, we would Overweight Cyclical sectors and Financials, Neutralize Growth and Underweight Defensives.**				
Sectors	Proxy ETF symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Technology	XLK	21%										
Healthcare	XLV	15%										
Financials	XLF	14%										
Discretionary	XLY	10%										
Communication	XLC	10%										
Industrials	XLI	10%										
Staples	XLP	7%										
Energy	XLE	6%										

			Next 2 months					3 to 6 months ahead				
European Sectors - Europe Stoxx 600 (general comment)			**Although Industrials and Energy may bounce slightly until late March, we would then Overweight Defensive sectors from early April. We remain Underweight Banks until end April.**					**From mid Q2, we would Overweight Cyclical sectors, Financials, Neutralize Growth and Underweight Defensives.**				
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 19, p36-42, p54-55

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

Until late March, Cyclical sectors, Industrials or Energy may bounce slightly on a relative basis. Yet, from late March / early April, Growth, and Defensive sectors especially, should outperform, given the risk asset correction we expect during April.

By mid Q2, we believe that the risk-off period should have come to an end. We then expect a strong risk asset rally into the Summer. We also believe that the yield curve will steepen quite rapidly. We will hence reverse our allocations, overweight Value and Cyclical sectors (Financials, Industrials, Energy), neutralize Growth and underweight Defensive sectors.

Countries allocation

Core Countries Weightings			Next 2 months					3 to 6 months ahead				
All World Country Index Currency hedged (general comment)			**From late March until late April, we expect the Euro and the Yen to strengthen, we would hence underweight Europe and Japan, and Overweight Defensive Switzerland and the Growth laden MSCI China.**					**From mid Q2, we will favour the US and Japan on a stronger USD, and also more cyclical France and Germany. We will underweight Switzerland and the MSCI China.**				
Countries	Index symbols	Benchmark-weights	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
US	S&P 500	52%										
Canada	TSX	3%										
Europe	SXXP	21%										
-UK	FTSE	6%										
-France	CAC40	3%										
-Germany	DAX	3%										
-Switzerland	SMI	3%										
Japan	N225	8%										
China	MSCICN	3%										

Main Country Allocation

p 15-18, 20-22, 46-53

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

Over the next few weeks, we still expect the US and Canada to outperform a while longer into late March. Yet, from early April, they should then underperform slightly with the risk assets correction we expect during April. On a hedged currency basis (nominal like to like performance), Europe and Japan should then also start to underperform due to the correction down we expect on the US Dollar from late March vs Euro and Yen. The UK may continue to deceive as the GBP is currently bouncing short term, and the medium to long term prospects of Brexit for UK companies are rather negative. Switzerland may deceive slightly as the current rally extends into late March, yet should recuperate much of this underperformance in April, due to its very defensive sector mix. Finally, the MSCI China is very Growth oriented (strong exposure to the BATs – Baidu, Alibaba, Tencent) and could continue to outperform until late April / early May.

From mid Q2, we expect the April risk asset correction to come to an end, and would await the start of a strong cyclical upswing. Hence, until the Summer we would shun Growth and Defensives profiles and favor the US as well as cyclical plays such as Canada, France and Germany. Japan should also outperform as we expect USD/JPY to rise again.

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

Core factors and Themes

Core Factor/Themes Weightings	**Next 2 months**					**3 to 6 months ahead**				
General Comment	**Although Cyclical themes may still surpise to the upside until late March, we would then favor Growth and Defensive profiles.**					**From mid Q2, we would favor Cyclical themes and Value, Underweight Defensive and Growth profiles**				
Themes	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight	Strong Under-weight	Under-weight	Neutral	Over-weight	Strong Over-weight
Nasdaq 100 (vs S&P500)										
DJ Industrial (vs S&P500)										
Russell 2000 (vs S&P500)										
Wilshire REITs (vs S&P500)										
US Value (vs US Growth)										
Southern EuroZone (vs Stoxx EZ 600)										
EuroZone Small Cap (vs Stoxx EZ 600)										
Japanese Small Cap (vs N225)										
GDX - Goldmines										
XME - Diversified Mining										

Core factors and Themes

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Cyclical profiles such as Diversified Mining or Small caps may still bounce until late March as the risk asset rally extends. Yet, from late March, early April we expect them to underperform again as the risk asset correction takes hold. We would then favor growth profiles such as the Nasdaq or Defensive ones such as REITs.

From mid Q2, we expect the start of a strong cyclical rally that could last into the Summer. We also believe the US yield curve could reverse up and start to steepen quite aggressively. We would hence favor Value and Cyclical profiles vs Growth and Defensive ones.

12 / Equities may have peaked and could decline until April, as a tripled-barrelled liquidity squeeze restricts money inflows

Last month, as we published on the 12th of February, we addressed the state of the equity markets at The Capital Observer with these following observations:

Equity markets have been on a tear since the December 24 low; the Great Correction is likely over. The market is now on the way to complete the first impulsive rally since last month's low, which could be followed by a large (50 pct or more) correction of the upside gains.

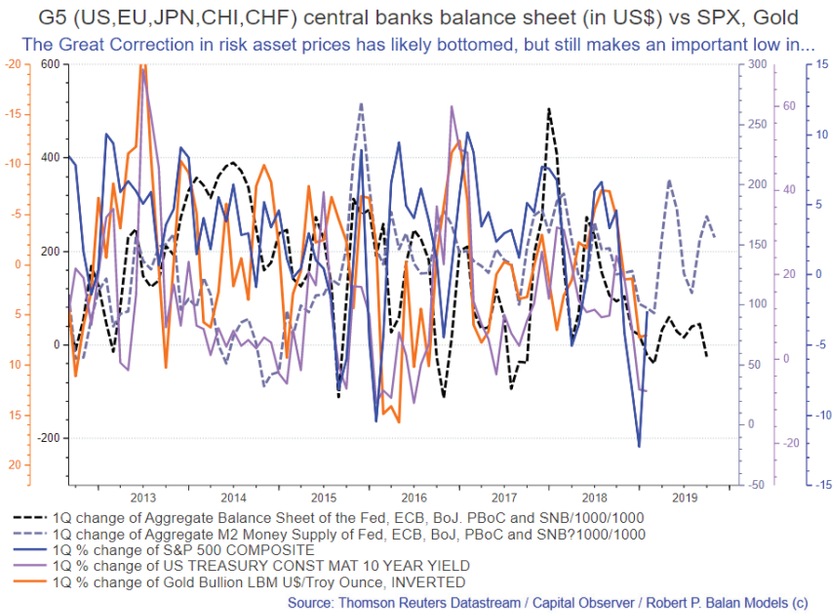
In coming to these conclusions, we have been guided by various systemic liquidity models, from the G-5 central bank balance sheets (which determine the broad trends of risk assets) to Fed and Treasury liquidity flows, which provide the variability provided by high-frequency turns in those data (*see both graphs on this page*).

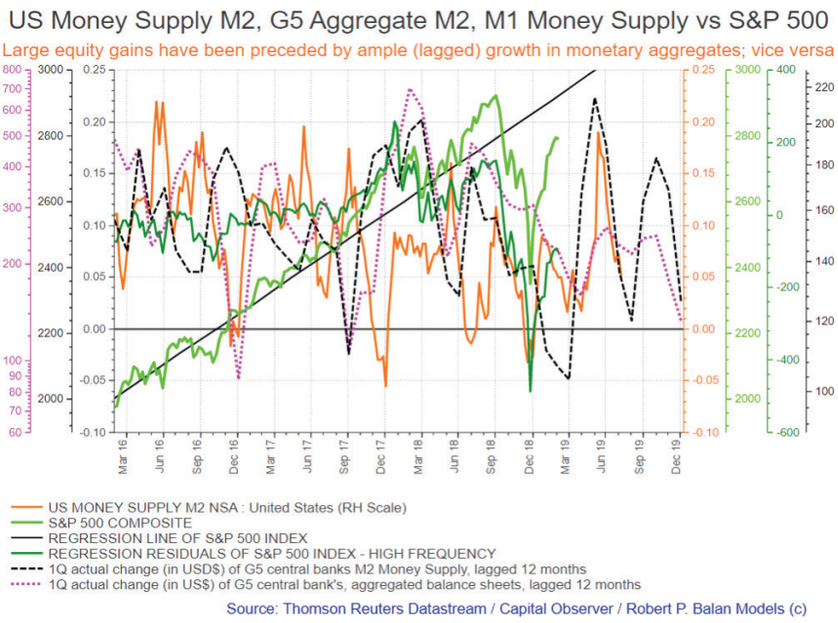
We are also republishing in this issue our US M2 money supply with juxtaposed data on G5 central banks' balance sheets and aggregate M2 money supply. This consolidated graph of several data provides a view of the lagged impact that domestic and global money supply has on US equities.

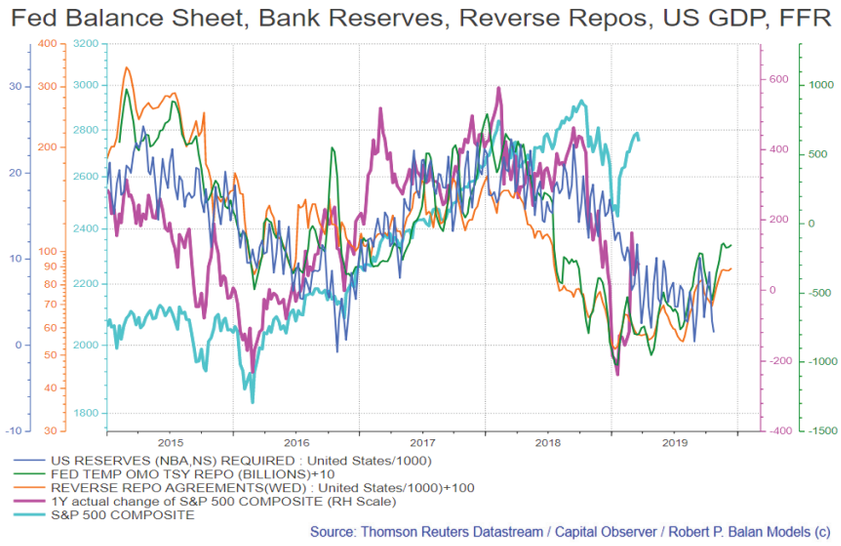
Both the G5 balance sheet model (*see 1st graph on this page*) and the US and global money supply data (*see 2nd graph on this page*) provides elements that suggest that the high level distibution of the equity market over the past several weeks is part of a correction process which could eventually retrace circa 30 to 50 percent of the impressively impulsive gains since December.

In recent issue of the Capital Observer, we have shown mostly liquidity-driven models derived from Fed and Treasury policy inflows and outflows. **We have added a few more tools in our kit since then – we have traced the impact of Fed SOMA transactions, on term (money) market rates. The changes in those term rates in turn affect the evolution of equities after a certain distributed time lag** (*see last graph on this page*).

G5 Central Bank Balance Sheet Model – original chart, February issue of Capital Observer



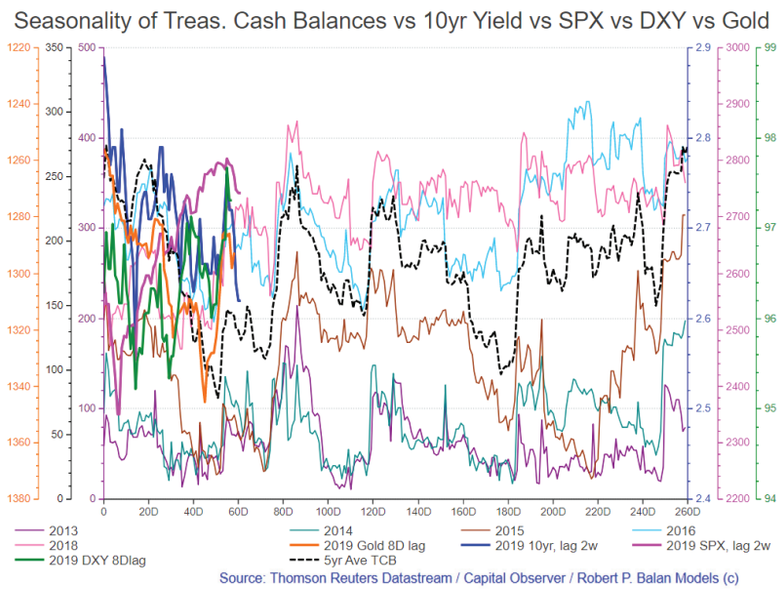




The importance of term market rates cannot be over-emphasized in liquidity-themed analyses because those rates determine the cost of money which passes between hands in the purchase and sale of risk assets. This is primarily so because the term market rates are first line liquidity flows for the US shadow banking. This sector has outsized impact on risk asset prices because this is where the funds for purchasing/selling assets come from or go to. This is a rough aggregation of the disparate impacts of these instruments; as is normal, the individual effect of each term rate varies, sometime significantly. **What the market rate liquidity model suggests is that the current rally will soon peter out, and a so-called "test of the low" will take place thereafter, at least a couple of times.**

This outlook is consistent with the time frame for these market moves, as forecast by the domestic and global M2 supply flows. That is true for the implications of the G5 central bank balance sheets as well. Moreover, this is also consistent with the bond yield outlook of declining yields until April, the low point of the liquidity cycle for the Fed and Treasury operations.

The Treasury Cash Balance is the operational account that the U.S. Department of the Treasury has with the Federal Reserve. This account is basically equivalent to the checking accounts individuals and businesses have with their banks. Indeed, the Federal Reserve acts as the U.S. government's bank. This account takes care of expected cash payments, check clearing, and outstanding wires done by the Treasury. The balance could be also used to reduce debt or be spent on goods and services, and is kept at the Fed to earn some interest. Since late 2015 the Treasury has been purposefully holding more cash to be prepared for any major disruptions, such as a potential cyber event or a systemic event like the crisis in 2008. The TCB is first-line liquidity resource for the US financial system.



This calendar period is a fairly consistent feature in the seasonality of the Treasury Cash Balance. April is a low point as the Treasury normalizes the balances it carries, coming from very high levels in Q4 of any year, as the usual year-end and holiday demand for cash spirals lower.

The systemic liquidity aspect becomes even critical at this time, as the Treasury has reached its legal bond selling limit (*see graph below*). Truly, the Treasury has stopped growing its cash balances – it will soon run out of cash. The Total Public Debt subject to limit is now equal to the Statutory Debt Limit. The Treasury cannot legally sell any more paper to acquire funds with which to provide funds to the US government's spending balance until the spending limit 'debt ceiling' is raised by an act of Congress.

TABLE III-C - Debt Subject to Limit

Balance Transactions	Closing balance today	Opening balance		
		Today	This month	Fiscal year
Debt Held by the Public	$ 16,220,221	$ 16,222,051	$ 16,250,898	$ 15,761,155
Intragovernmental Holdings	5,808,831	5,806,307	5,864,628	5,754,904
Total Public Debt Outstanding	22,029,052	22,028,357	22,115,526	21,516,058
Less: Debt Not Subject to Limit:				
Other Debt	480	480	480	480
Unamortized Discount	30,552	29,858	30,552	30,390
Federal Financing Bank	10,339	10,339	10,339	10,339
Hope Bonds	0	0	0	0
Plus: Other Debt Subject to Limit				
Guaranteed Debt of Government Agencies	0	0	0	0
Total Public Debt Subject to Limit	$ 21,987,681	$ 21,987,681	$ 22,074,156	$ 21,474,848
Statutory Debt Limit	$ 21,987,706	$ 21,987,706	*	*

*Statutory debt limit was temporarily suspended from February 9, 2018, through March 1, 2019. As of March 2, 2019, the debt limit was increased to $21,987,705,611,407.70.
Unamortized Discount represents the discount adj. on Treasury bills and zero-coupon bonds.

This further complicates the liquidity outlook in the near term. To see why this is the case, lets revisit the partnership of the Fed and the Treasury in fine-tuning the levels of cash in the system. **The FOMC and UST work together to manage system liquidity, that is the amount of money available in the US financial system. Too much money in the system and the FFR falls below the target level. Too little money in the system and the FFR rises above the target rate, and a liquidity crisis in the finance market could occur whereby one or more banks in the system cannot meet their reserve requirements at the end of the day's trading.**

The Fed is now alone in the role of liquidity provider and FFR maintainer and cannot rely on the UST to offset bank reserve drains and adds in the normal way. One half of the dynamic duo is artificially offline due to a legally imposed voluntary budget constraint. What makes this even worse is that tax time is coming, and at this time about half a trillion dollars' worth of liquidity will be drained out of the system when taxes are paid. That was the amount taken out of the system after taxes were paid in April last year.

We are now about to plunge into April where seasonal liquidity is lowest. This means less money around to buy assets of all kinds, falling bond yields, falling equities, and. Just possibly, a falling dollar due to perception of falling yields which are not going to be raised by a dovish and patient Fed.

Conclusion:

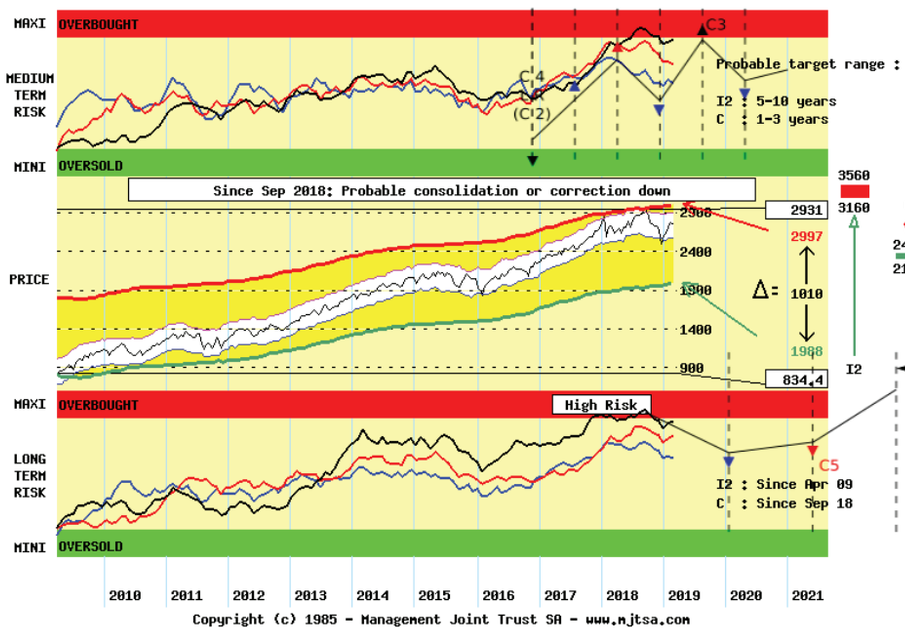
The rally from the December 24 low, truly a gift of the Fed to the markets, has likely ran its course, and the rally may have peaked on March 4th based on the Dow Jones Industrial but growth stocks still seems to carry some momentum. Like any good story, it has ended, and the prices of stocks should moderate somewhat while all the negative implications of declining systemic liquidity take its toll. As a consequence, it looks like equity indices have been topping one after another during a 3 to 4 week distribution phase starting on the 19th of February with the Dow Transport, followed by the Dow industrial and Russell 2000 on the 25th of February and the S&P500 double topping between the 4th of March and mid-month. Finally, the Nasdaq100 looks like it will be the last one to peak benefiting from the reallocation to growth. This could be followed by a correction (30 to 50 pct) of the upside gains. The dearth of liquidity is not a fatal blow, however, and just part of a seasonality pattern that governs all institutional procedures. The "noise" about debt limits will also come to pass, and order will be restored. But current rising levels of equity prices provide one last chance to leave the party if you have yet done so. The market often gives a second chance, before its goes full-tilt in "correcting" the exuberant gains from Christmas time. That, however, provides another opportunity going into summer, when liquidity levels again rise until Q3, as it has done so every year. We will pick up the story over the next few weeks when we feel it is time to wade back into the waters again.

15 / MJT - TIMING AND TACTICAL INSIGHT

Equity Markets could work the 2’850 – 2’650 range on the S&P500 until end April, before they move up again towards midyear

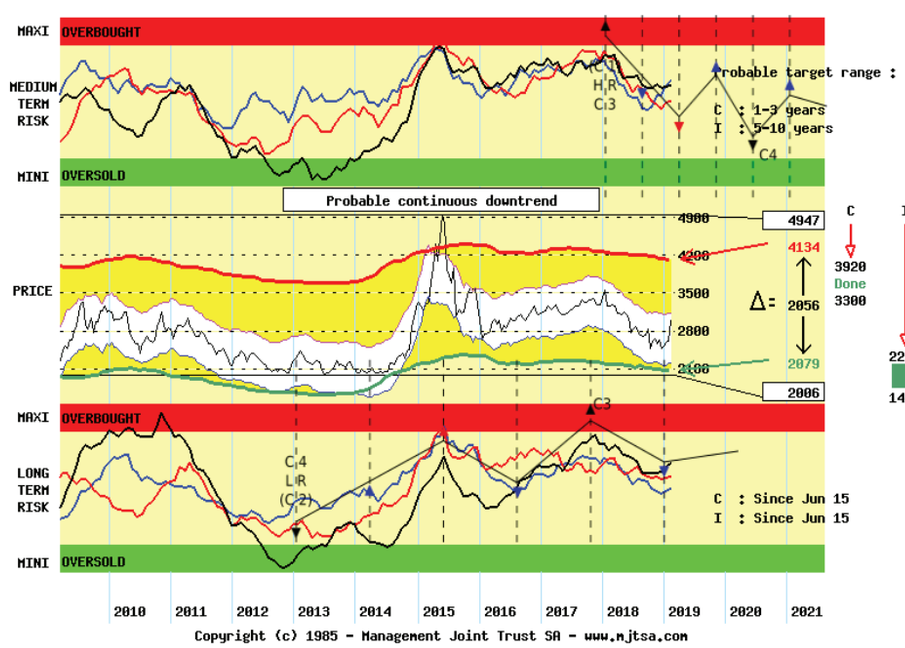
The Equity bounce since late December has been very resilient, yet the low 2’800s levels on the S&P500 seem to be providing some resistance. In this article, we consider global equity markets to understand their likely path going forward. Our view is rather constructive towards the Summer, although the market may be entering a one to two months digestion period of the recent rally. In this context, we also look at China and its domestic market to consider if its recent upside momentum may continue.

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



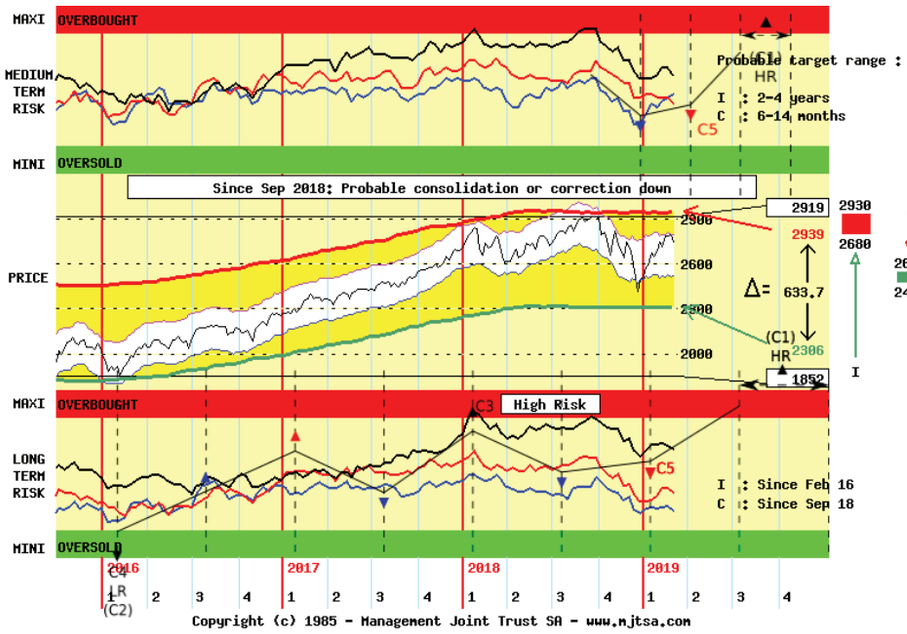
As shown on our long term oscillators series (lower rectangle), we believe that the market top made last October is of important nature, and that it could continue to negatively influence the S&P500 into late this year, possibly even as far as 2021. Hence, **our view is that we are in the middle of a long term consolidation pattern within the 2’000 – 3’000 range**. Our I2 Impulsive 2 extended targets to the upside (right-hand scale) could suggest more potential, above 3’200, yet, the probability of reaching these extended targets is usually quite low. At this stage, we would need more positive confirmations to consider them. On the other hand, to the downside, our C Corrective targets are still pointing towards the possibility of falling back into 2’400 – 2’100 range. **On the timing front, over the next few quarters, our medium term oscillators (upper rectangle) suggest a last push up towards the Summer, and then a new period of retracement towards early 2020.**

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



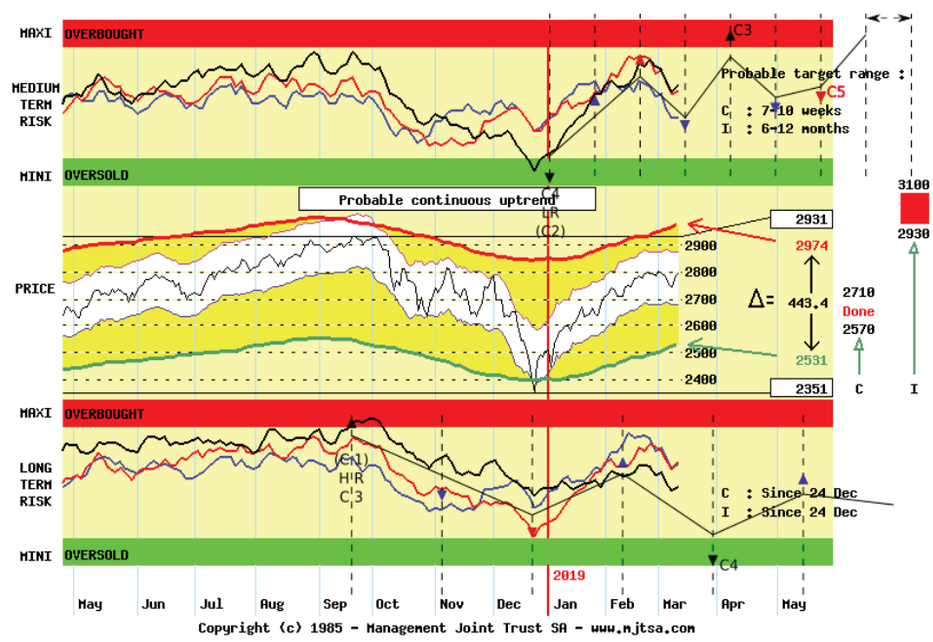
While Europe still seems to be stuck in chronic underperformance, China may be the other motor for equity performance in the near term. Both our oscillator series (lower and upper rectangles) suggest that the **Shanghai Composite has recently found and/or could soon confirm (during Q2) intermediate support levels. These could serve as a base for a rebound that could extend into this Summer, perhaps the Fall**. For now, the Shanghai Composite is still below its C Corrective targets to the downside (right-hand scale), and following the rebound, probabilities are that it should then resume lower once again from late this year into 2020. It may then reach down towards our I Impulsive targets to the downside in the 2’270 – 1’450 range. Hence, **the scenario we expect on China is one of a late cycle Indian Summer that may last a couple of quarters, rather than a Chinese Spring.**

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



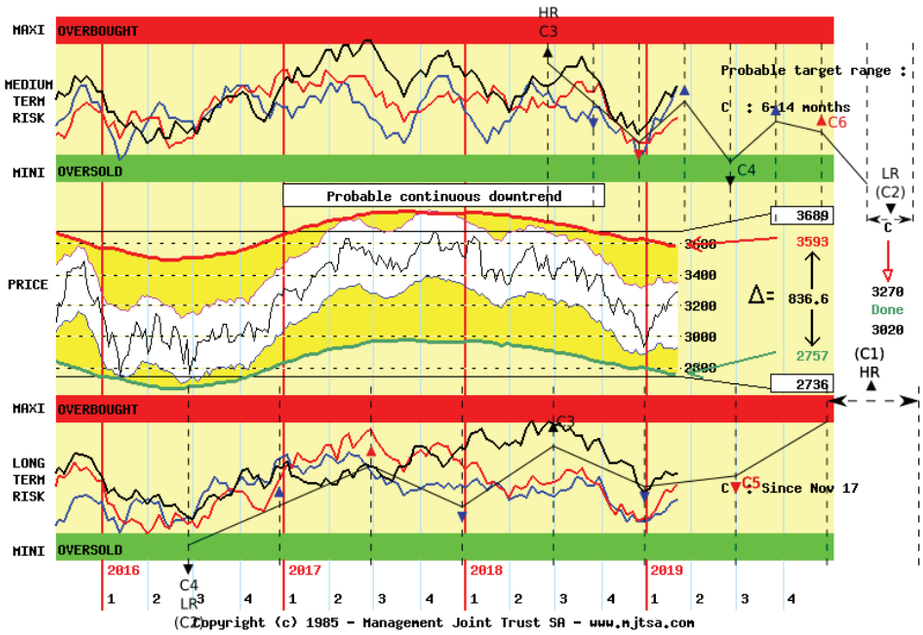
On the Weekly graph, the S&P500 found a strong support point in December towards the lower end of our C Corrective targets to the downside (right-hand scale). It has since been rebounding vigorously. Our long term oscillators (lower rectangle) suggest that **this new uptrend could continue until the Summer, and that, according to our I Impulsive targets to the upside (right-hand scale), it could retest last year's highs above 2'900. Our medium term oscillators (upper rectangle), point to some retracement probably until learly Q2, and then another bounce into midyear / the Summer.**

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



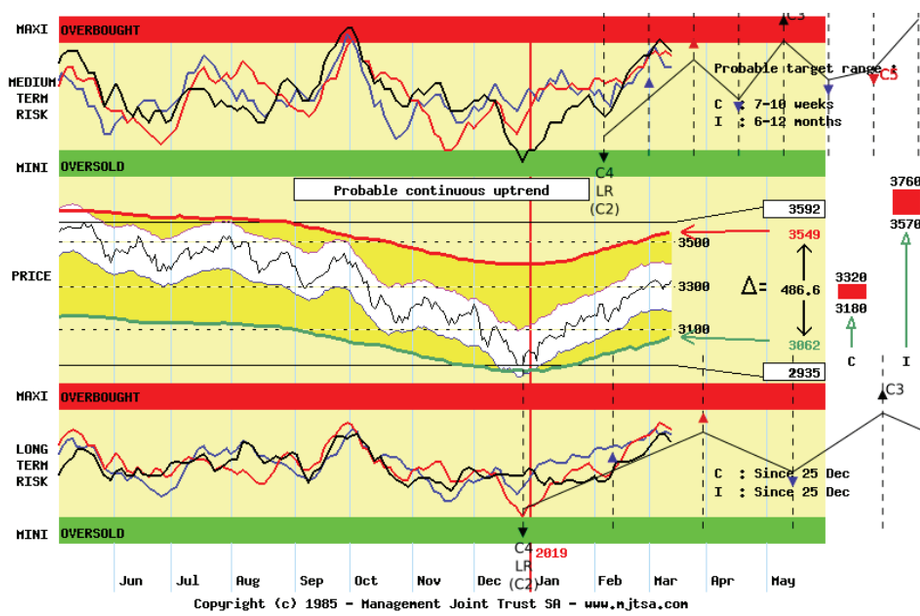
Our Daily graph offers two scenarios. One where the S&P500 now retraces back down towards late March and then moves higher into the Spring (lower rectangle), the other where the S&P500 could resume up again from the 3rd week of March to retest higher into late March, and then corrects down again into late April, perhaps early May. While the first scenario is already challenged by the strength and length of the January/February rally, the second is still working through resistance in the low 2'800s. The S&P500 will probably find it difficult to move much higher above these levels in the near term (2'850?). Combining both, **we hence expect a range-bound consolidation into the end of April. From next week indeed, the S&P500 may retest up one last time into late March / early April, which may or may not achieve marginal new highs, and then a new period of retracement materializes into late April. The range we expect for this price pattern over the next couple of months is between 2'850 + and 2'650 - . Following that, we expect the S&P500 to resume higher towards midyear, and reach our I Impulsive targets to the upside above 2'900, possibly even above 3'000** (right-hand scale).

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



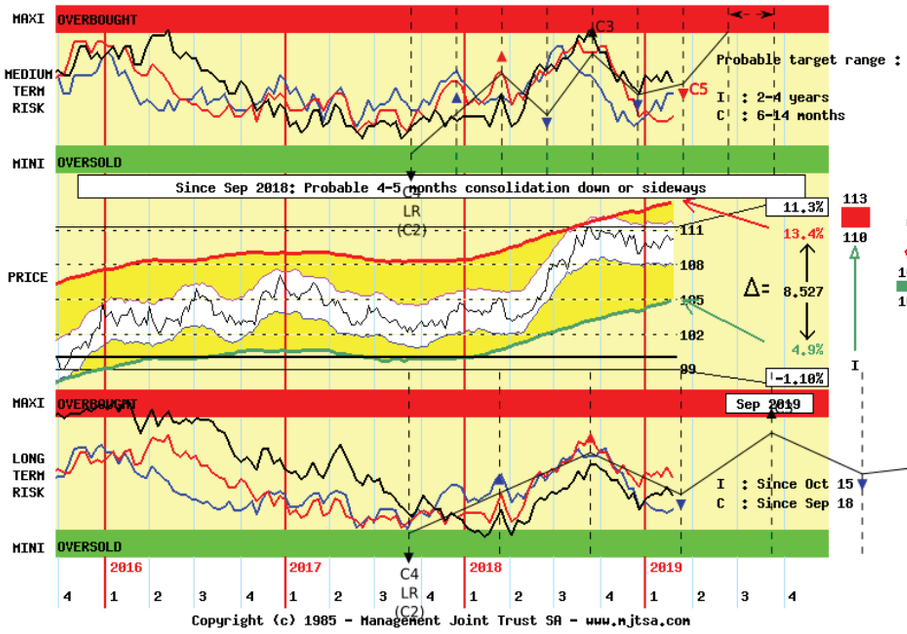
Looking to Europe, the rebound has also been impressive, especially given the previous downtrend. The sequence we show on our medium term oscillators (upper rectangle) suggests that the rebound could soon be coming to an end, and that the EuroStoxx could now retest down into late Q2, before a new bounce into the Summer. On our long term oscillator (lower rectangle), the scenario is more constructive. It outlines a more shallow consolidation during Q2 and then an acceleration up during the Summer. The truth is probably somewhere in between, with **some retracement expected into midQ2 and then a nice rally into the Summer. Following that, EuroStoxx 50 probably resumes its downtrend**. During the sell-off in December, the EuroStoxx50 index did make briefly below the support of our C Corrective targets to the downside (right-hand scale). This may imply further downside 12 to 18 months ahead. Our I impulsive targets to the downside (not shown here) would then calculate to below 2'600.

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



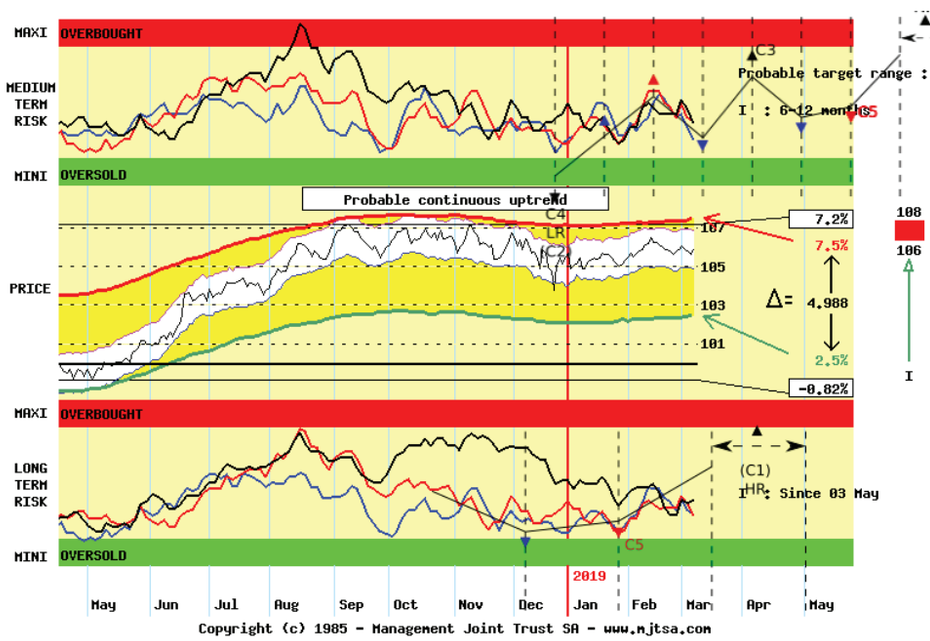
On Daily graph, the linear rebound since December doesn't seem quite finished yet. However, it has now reached the resistance of the higher end of our C Corrective targets to the upside around 3'320 (right-hand scale). While our long term oscillators (lower rectangles) do justify a continuation of the current uptrend into late March, our medium term oscillators (upper rectangle) are rather toppish and could suggest a period of distribution at high levels until late March.**From early April, we would then expect a 3 to 6 weeks consolidation period to the downside before the EuroStoxx 50 resumes its uptrend towards midyear**. Our I impulsive targets to the upside (right-hand) indicate that it may then attempt to retest its 2017 highs this summer.

S&P500 Index vs the All Country World Index
Weekly graph or the perspective over the next 2 to 4 quarters



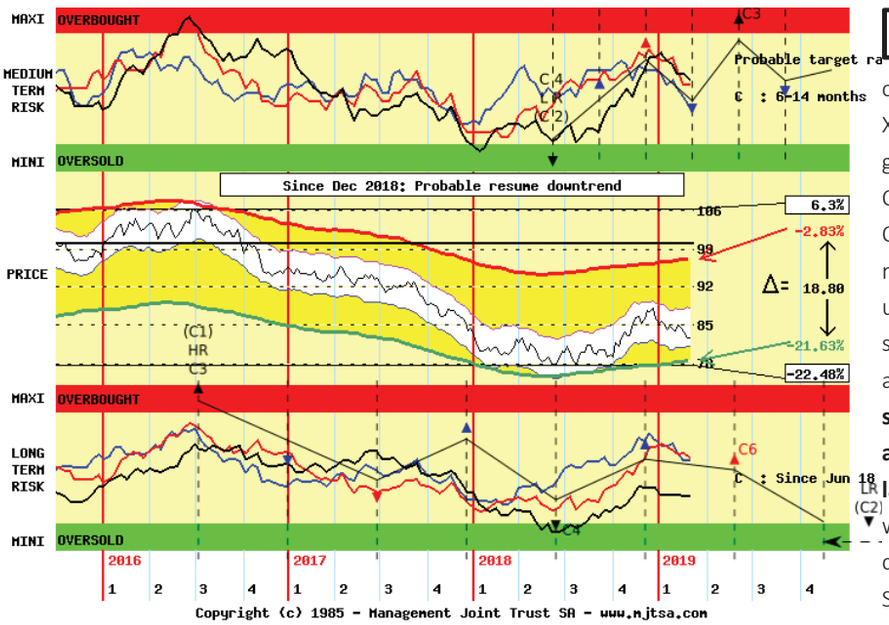
Despite the Dovish U-turn at the FED since late last year, the US Dollar and US Equities have remained firm vs other developed markets. US economic data is rather resilient, while other Central banks have also softened their tone. Consequently, **when comparing the S&P500 to the All Country World Index, we continue to expect more US outperformance into the Summer**. This is indeed what both our oscillator series (lower and upper rectangles) are suggesting. On the target front, we are less aggressive as following last year's strong outperformance, the upside potential is now rather limited. Our I Impulsive targets to the upside (right-hand) suggest that **the ratio may outperform by another 1 to 3% only over the next 6 to 9 months.**

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



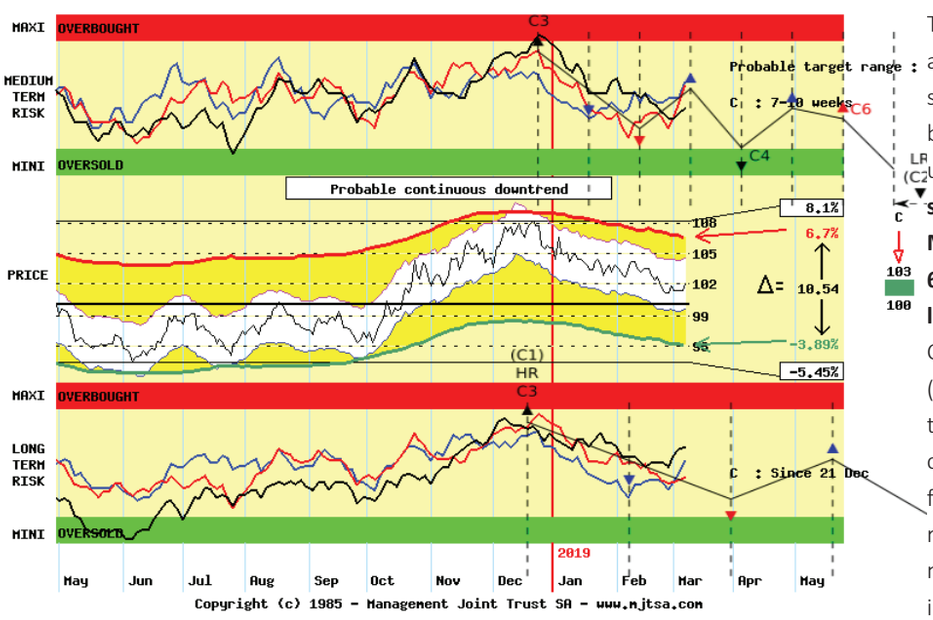
The Daily graph of this ratio is very similar to the one of the Dollar Index (see page __ in this issue of The Capital Observer). While both oscillator series (lower and upper rectangles) suggest a further move up into late March / April, our medium term oscillators (upper rectangle) are more precise. They point to an **intermediate top late March / early April, then followed by 3 to 6 weeks of correction to the downside. Then, from May, US markets resume their outperformance towards midyear**. Overall, as with the Weekly graph, **the upside potential over the next few months is rather limited** (I Impulsive targets to the upside circa 2% above current levels; right-hand scale).

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



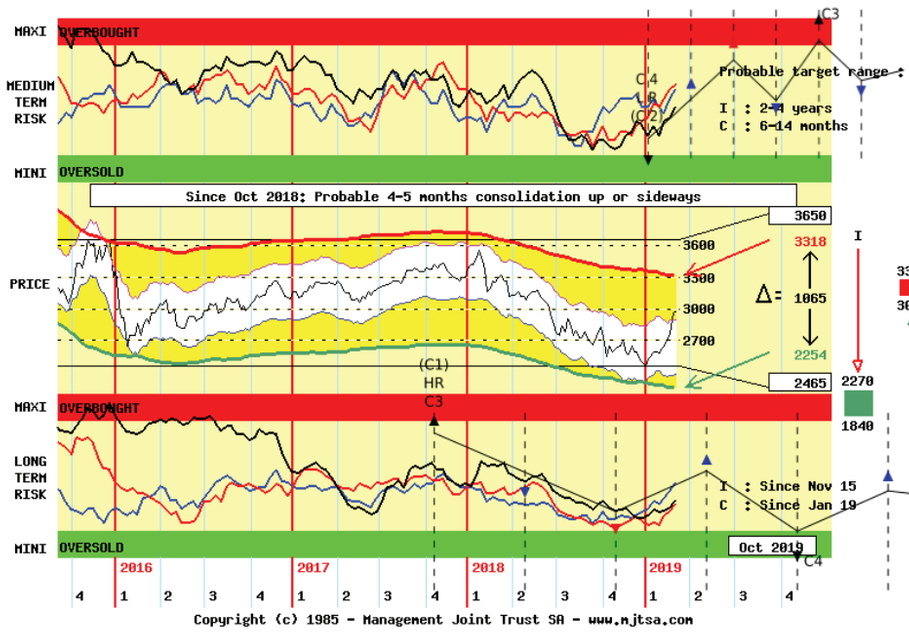
Defensive sectors in the US (our equal weighted portfolio comprising XLP, XLU, XLV, IYR and XTC) started to outperform the general market well before the Q4 risk asset correction last year. Obviously since the start of the recent market rebound, they have underperformed. Both our oscillator series (lower and upper rectangles) are now suggesting that **Defensive sectors could soon start to bounce again vs the S&P500, probably from late Q1 into mid Q2**. Following that, we expect them to resume their downtrend vs the market into the Summer, and perhaps even the Fall.

US Defensive Sectors vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



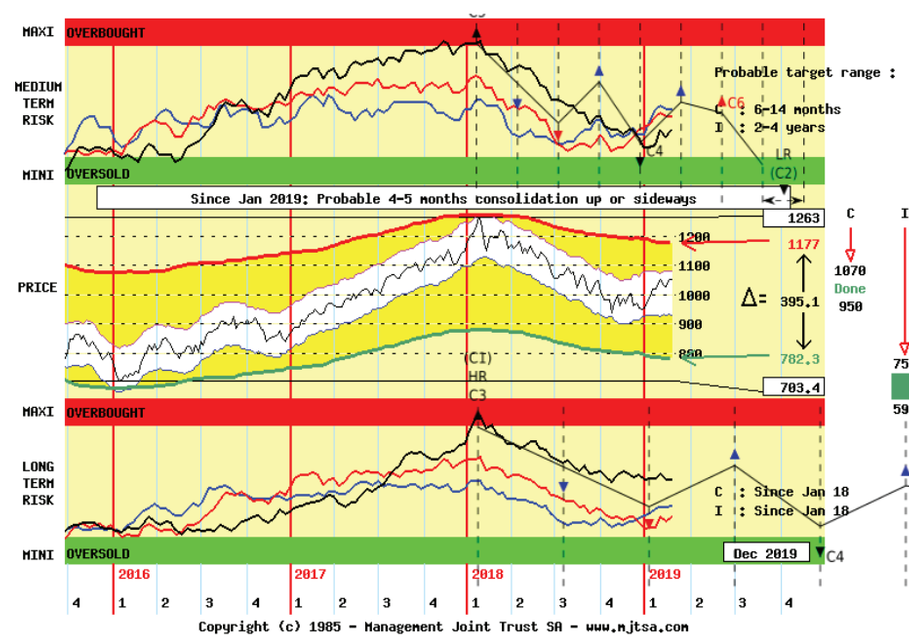
The Daily graph would confirm an early Q2 bounce for Defensive sectors vs the market. For now, both our oscillator series (lower and upper rectangles) are still suggesting **some underperformance until late March / early April, before a 3 to 6 weeks bounce materialises into late April, perhaps May**. Our C Corrective targets to the downside (right-hand scale) suggest that until then the ratio could find support circa 2% below current levels. Finally, from May, we expect the ratio to resume its downtrend, as equity markets potentially reaccelerate up into midyear and the Summer.

Shanghai Composite Index
Weekly graph or the perspective over the next 2 to 4 quarters



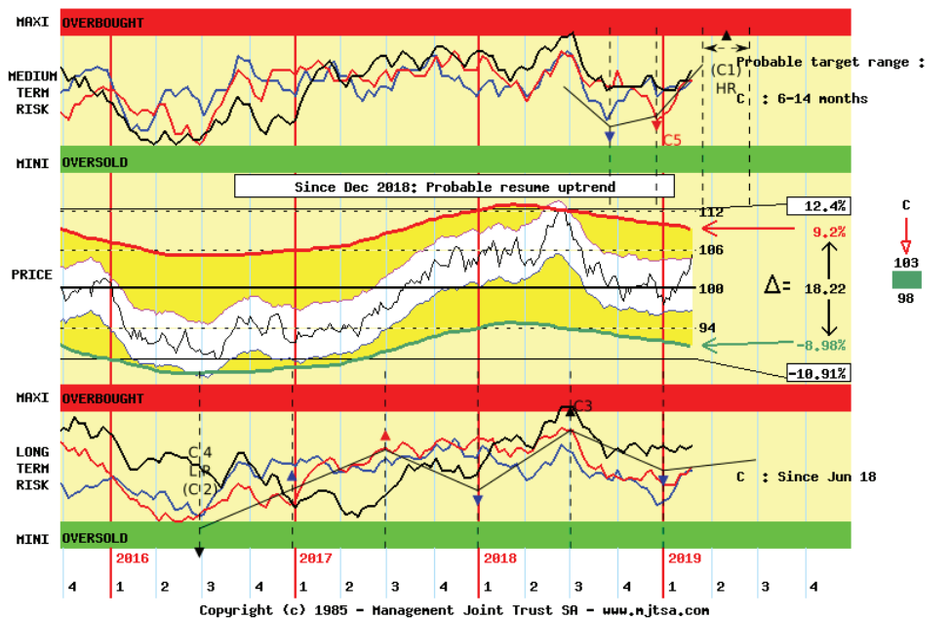
We now focus on China's domestic market and its recent strong upside break-out. For now, the long term downtrend is still in place, as suggested by our long term oscillators (lower rectangle). Yet, the current rebound will probably last for a few more months. On our medium term oscillators (upper rectangle), indeed, a new uptrend sequence may have started early January. **It suggests an intermediate top late Q1 / early Q2, and then following some retracement into mid Q2, a further push higher into mid/late Summer**. This scenario matches what we expect on other equity markets, and would justify the reversal up which has taken place since early this year. On the target front (right-hand side), we **expect strong resistance towards the higher end of our C Corrective targets to the upside towards 3'320 or circa 10% above recent highs** (right-hand scale). Beyond that, much will depend on how resilient the Chinese recovery actually is as we move into the Summer. For now, both our oscillator series are rather contradictory, and we will wait for more clarity to take position.

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



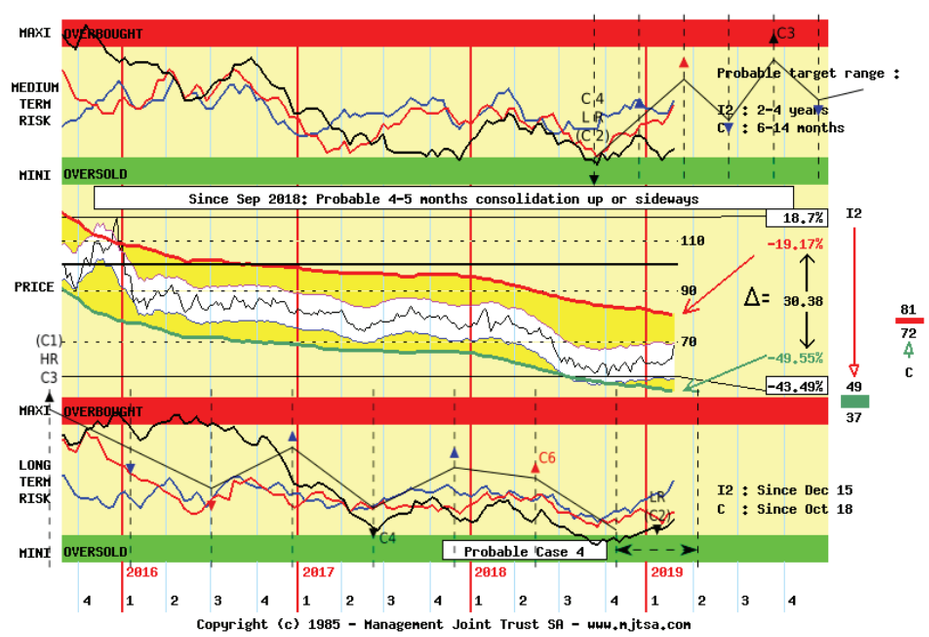
Other Emerging Markets have also rallied since January, yet the long term downtrend here seems clearer (strong US Dollar scenario?). On our long term oscillators (lower rectangle), we expect the current correction up to hold until midyear, while on our medium term oscillators (upper rectangle), the momentum may be starting to fade. Our view is that **Emerging will probably manage to hold up over the next few months. Yet, these could then start to decline again during H2 2019**. The lower end of our C Corrective targets to the downside (right-hand scale) may then be tested again, around 950. Below these, the next level of targets (our I impulsive targets to the downside) are in the 750 – 590 range. These could be achieved at some point in 2020.

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



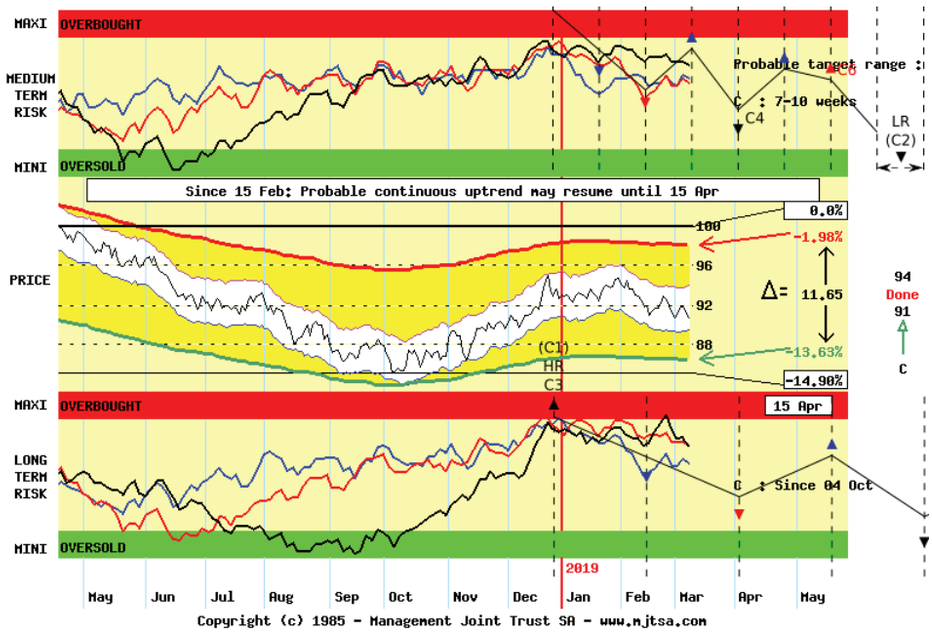
Comparing the MSCI China Index vs the MSCI Emerging Markets Index, it does seem that Chinese equities are stronger that other Emerging Markets. Both our oscillator series (lower and upper rectangles) are suggesting that they **could outperform the latter probably well into Q2, perhaps even until midyear**. The ratio has indeed found support on our C Corrective targets to the downside early January (right-hand scale) and has since been bouncing. Following its strong Q2 relative sell-off, China does indeed appear more reflationary, more pro-cyclical than other Emerging Markets. This is rather logical given the massive fiscal and monetary stimulus which is currently being rolled out in China. This is especially true for China's domestic equity market.

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



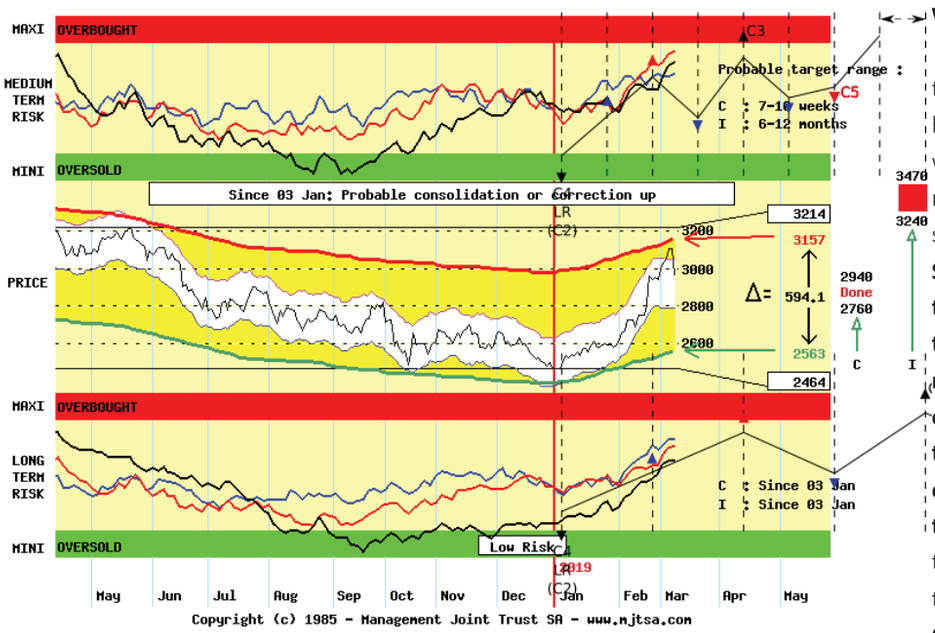
Vs Global markets, China's domestic market was indeed heavily Oversold late last year as signaled by on our long term oscillators (lower rectangle). It has since started to reverse up. The sequence we show on our medium term oscillators (upper rectangle) suggests that the rebound could continue over the next few weeks (until late Q1), before some underperformance in Q2. Following that, China could resume higher vs Global Markets, probably from mid/late Q2 into the Summer.

MSCI Emerging Markets Index vs the All Country World Index
Daily graph or the perspective over the next 2 to 3 months



Comparing the MSCI Emerging Markets Index vs the All Country World Index does highlight the differences in profile between China's domestic market and the Emerging Markets index. Indeed, **the MSCI Emerging Markets index looks rather defensive vs the All Country World Index**: it outperformed during Q4, and since the start of the rebound, has been lagging. Both our oscillator series (lower and upper rectangles) now suggest that the **ratio could continue to underperform over the next few weeks, probably until late March / early April**. This is the opposite of what we expect more generally on equity markets. It confirms the defensive bias of Emerging Markets, as well as the possibility for a further upside retest on equities during the 2nd half of March. **Following that, we expect Emerging Markets to outperform during April and perhaps into May, as global equity markets and the US Dollar correct down.**

Shanghai Composite
Daily graph or the perspective over the next 2 to 3 months



We finish off this analysis of world equities with the Daily graph of the Shanghai Composite Index, which has broken out quite rapidly over the last few weeks. Both our oscillators (lower and upper rectangles) suggest that an intermediate top should have been made late February. **The Shanghai Composite did overshoot during the first week of March, yet has now started to correct. This retracement may last until mid March, before the index pushes higher once again into late March / early April. It then corrects down into late April with other equity markets, before moving up again towards midyear**. Our I Impulsive targets to the upside (right-hand scale) are suggesting that **over the next few months, the Shanghai Composite could test its Weekly resistance (mentioned a few graphs above) around 3'300 and could even push slightly higher into the 3'400 levels.**

Concluding remarks

Last week, Global equity markets finally saw some retracement. Yet, looking forward, our oscillators do indicate the possibility of further upside retests until late March. From early April, a new intermediate top should then materialize. It may lead equity markets lower during April, and possibly even into early May. In the near term, equity markets may still consolidate slightly over the next few days, and then attempt to push up once again to retest their current highs, perhaps making new highs into the mid 2'800s on the S&P500. Following that, the corrective potential we expect could lead us back down to the mid 2'600s. Then, from early/mid May, Equity markets should reaccelerate up towards midyear / the Summer. Some of them will probably make new highs. Focusing on the Shanghai Composite, which recently broke out to the upside, it may continue to dip slightly over the next week or so, and then should move up again into early April. Following another correction down towards early May, it then continues higher towards the 3'300 – 3'500 range along with other equity markets.

23 / Despite the anticipation of a sharp setback in Q2, the US Dollar should continue to rise until Q3 2019

The last time we covered the US Dollar in depth at the Capital Observer was in October last year, when we assessed the prospects for the US currency going into H1 2019 ("*Macro and micro factors are aligning to push the US Dollar even higher going into H1 2019: winners and losers in its wake*"). We said then:

"There is nothing like weaker growth in the RoW that pushes the US Dollar higher. There is a negative covariance between Global GDP and the US Dollar. Weaker global growth strengthens the US Dollar (see 1st graph on this page), and vice versa. And the outlook of weaker RoW growth during early 2019 has really provided impetus for a USD ascendance.

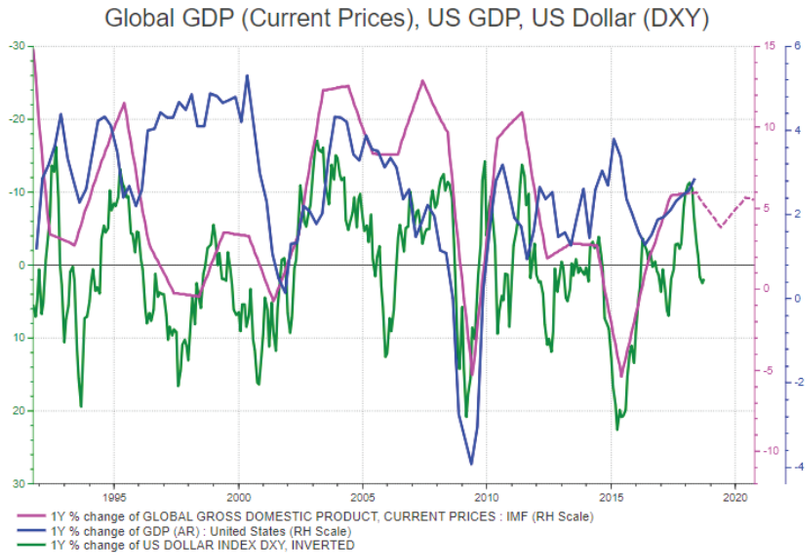
There are also other factors contributing to the dominance of the US currency at this time. And we go from the macro scale, represented by (1) the growth or non-growth of the Rest of the World vs US, (2) differentials in central bank monetary policies, (3) by differentials in regional capital flows, to micro scale represented by (a) domestic systemic liquidity proxied by the level of term (money) market rates, and (b) by the spreads of those short-term market rates."

We concluded the following: *" The evidence convinces us that the US Dollar (DXY) is about to embark on a new bullish phase, which could last until late Q2 2019. The shift of the Fed from pseudo-dovish stance to overt bullishness over monetary policy will also help drive the upwards trend. This is happening during a time when the distributed lag of the Capital Account inflows begins to reassert as well – and its lagged impact is estimated to last until mid-2019."*

So we are going into the 3rd month of Q1 2019, with the US Dollar still strong and firm, despite prognostications that the new dovishness of the Federal Reserve and the policy pause that it implies will bring down the US Dollar. Here is a typical summation of reasons cited for becoming bearish on the US Dollar. No attribution is necessary because it is so typical of the incoherence of the reasoning calling for a weaker US currency::

We continue to expect the US dollar to weaken against a backdrop of renewed global growth convergence. This will likely be driven by the unwind of the US exceptionalism theme of 2018 and the pivot toward a more dovish Federal Reserve policy going forward. Additionally, US budget and current account deficit concerns will likely persist and could be negative for US dollar performance.

Original chart in the Capital Observer 2018 issue



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

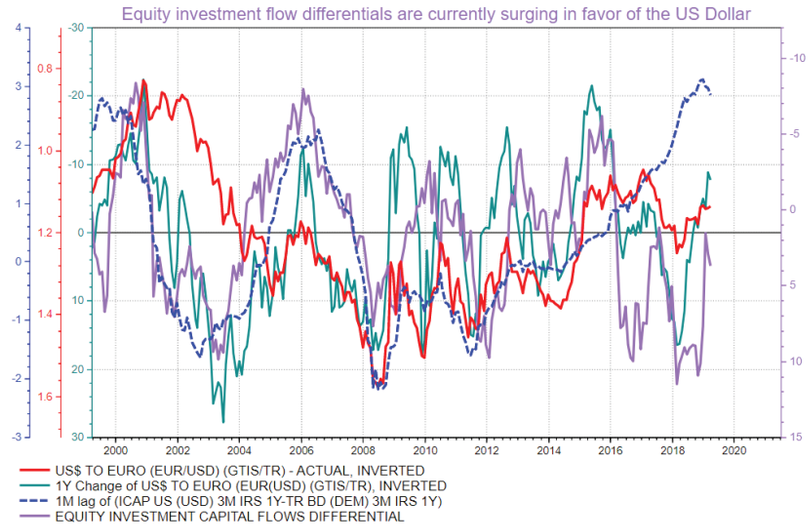
We have seen these arguments used to justify calls for a weak dollar last year, and the year before that, and even earlier. The concept of this rationale seems to be that the Dollar has already been higher, so it could not go any higher anymore. Full stop.

There seems to be a willful amnesia of the fact that other major countries' growth outlooks have turned dismal, and that interest rate differentials remain one-sidedly in favor the US currency. Moreover, and more importantly, investment capital flows remain in favor of the greenback, as investors flock to US equities and shun other equity markets, contributing also to the outperformance of US equities versus its peers (*see graph below*).

USD/EUR Models: based on swap rates, capital/trade flow differentials

Interest rate and capital flows differentials will widen in favor of the USD in 2019

Equity investment flow differentials are currently surging in favor of the US Dollar



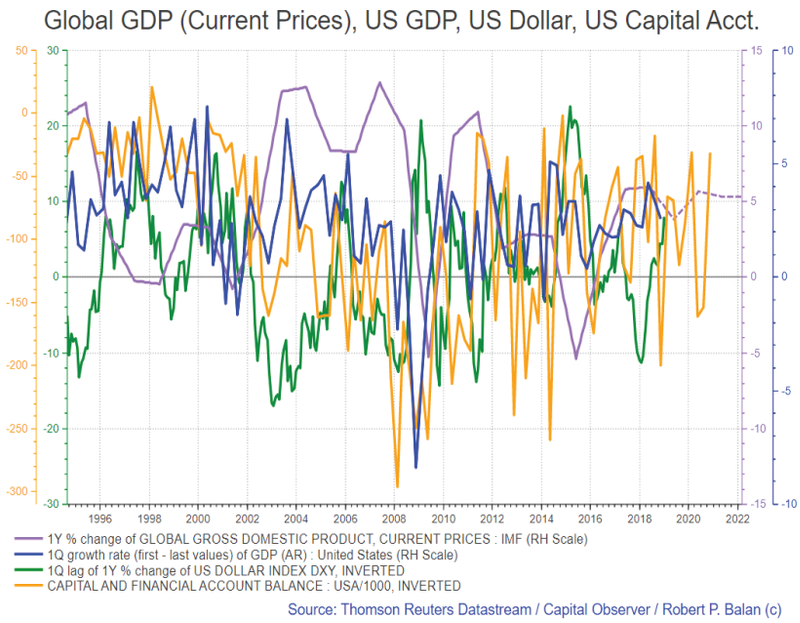
Source: Thomson Reuters Datastream / Capital Observer / Robert P. Balan (c)

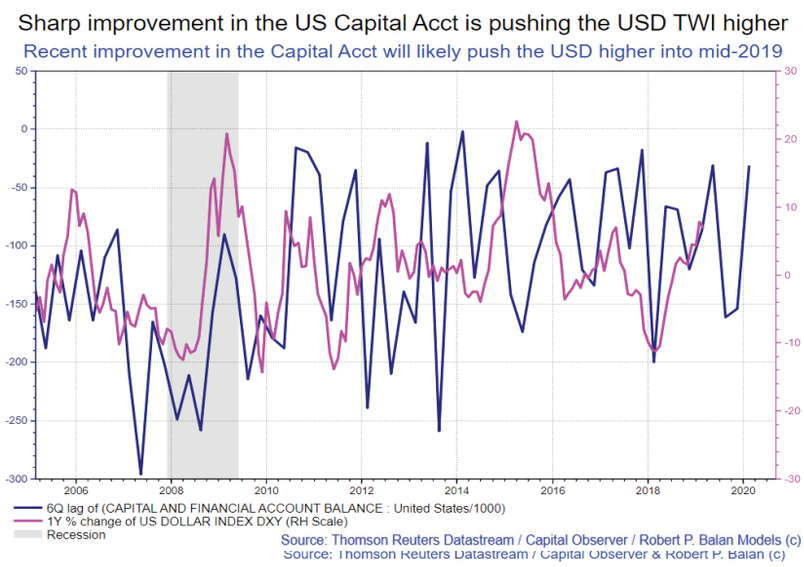
We point out that the factors which we identified in the October 2018 issue of Capital Observer, as pushing the US Dollar higher, are still with us. For instance, the most basic argument, the relative growth between US GDP and global GDP still favors the US currency. We said then that the Rest of the World (RoW) has grown along with the US, but **it is the prospect of variance in growth between the US and the ROW going forward that has lately powered the ascent of the US currency. And it still does.**

Despite the frenetic downgrading of the US Q4 GDP by investment banks, growth at 2.6% QoQ was still significantly higher than most investment bank estimates, although that number will likely be revised lower in subsequent readings. **Global GDP estimates have largely been flat in the interim. On that basis alone the US Dollar can continue to outperform other currencies in the near-term** (*see 1st chart on this page*).

The 1st graph on this page also illustrates the power of US Capital Account to buttress the domestic currency. Changes in the US capital account have large impact on the US Dollar exchange rate, and its impact normally shows 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 early last year will therefore likely to result in further rise of the US dollar until the first half of 2019 (*see 2nd chart above*).

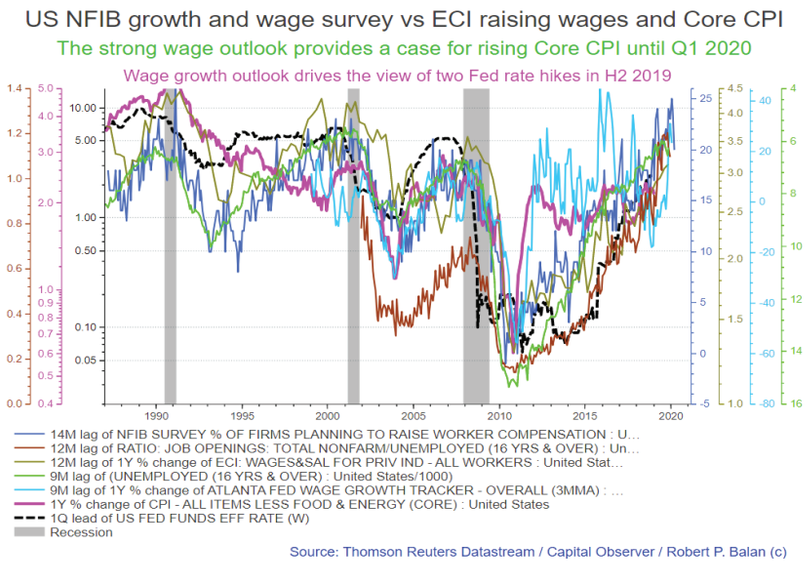
Left unsaid is the fact that that Capital Account inflows to the US are both symptom AND cause of financial and economic crises elsewhere in the globe. That describes the Emerging Market situation very clearly up until the end of 2018. At this juncture – capital has been coming back to the EM regions because of the lower US bond yields as a direct result of the Great Correction in equities since October last year. With yields likely to fall in the event that the Great Rally since December 24 will be retraced, some of the fundamental support for the US Dollar will be knocked away.





The effect of the distributed lag in the US Capital Account can make demand for bonds and Dollars stronger, the combined effect of which tend to weaken equities. **Strongest Capital Account inflows happen during market and/or economic crises, so yields fall on demand for safe haven paper, strengthening the DXY -- that weakens equities, assuming of course that the market crisis carry on for a while. However, for a brief period in Q2 2019, as the correction to the Great Equity Rally takes place, get used to falling yields, and for a short time, a weaker US Dollar**. This forthcoming equity market sell-off will not probably be marked by a large-scale migration to the US currency.

Summary: **The evidence shows that there could be a brief but sharp correction in the course of the US Dollar, and that may stem from a forthcoming correction of the recent equity market gains from the December 24 low**. But there is just as compelling evidence that this coming US Dollar weakness is just that, a brief episode of lower FX valuation which may accompany lower equity prices soon. We remain convinced that the US Dollar (DXY) still has potential left in this overall bull phase, which started in early 2018 and could last until late Q3 2019. We also anticipate the Fed to pause in March, but subsequent FOMC meetings may become alive for policy hikes. Our primary reason is that core inflation will become a problem for the Fed after March. We expect core CPI to be driven higher by accelerating wage growth as the job situation becomes even more critically tight. Wage growth has been a reliable prime mover of Core CPI in past years, and will remain so over the next two years at least (*see chart on this page*).

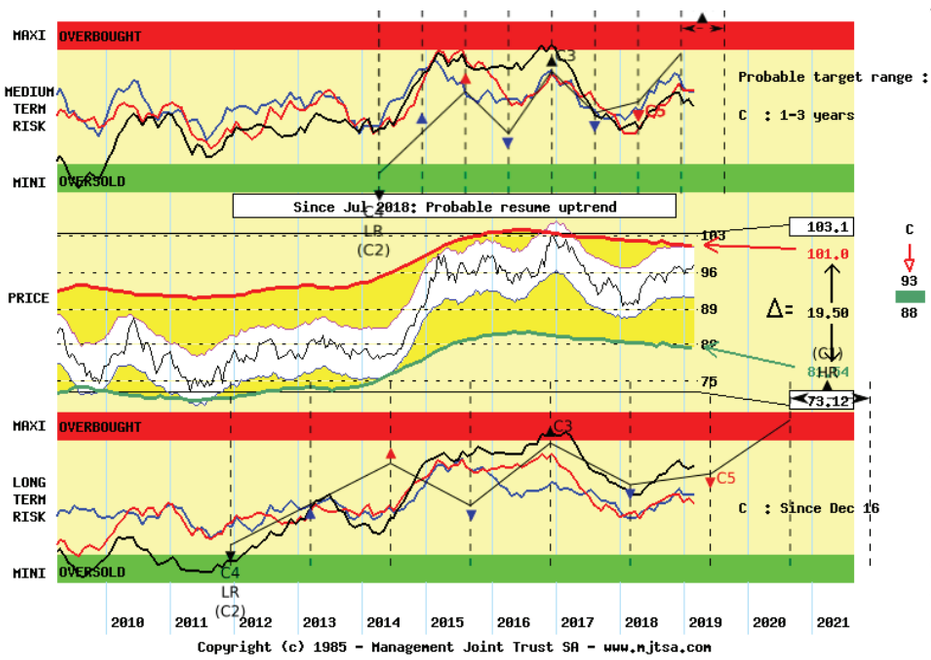


26 / MJT - TIMING AND TACTICAL INSIGHT

Strong US Dollar towards the Summer, yet with an intermediate correction during April and perhaps into May

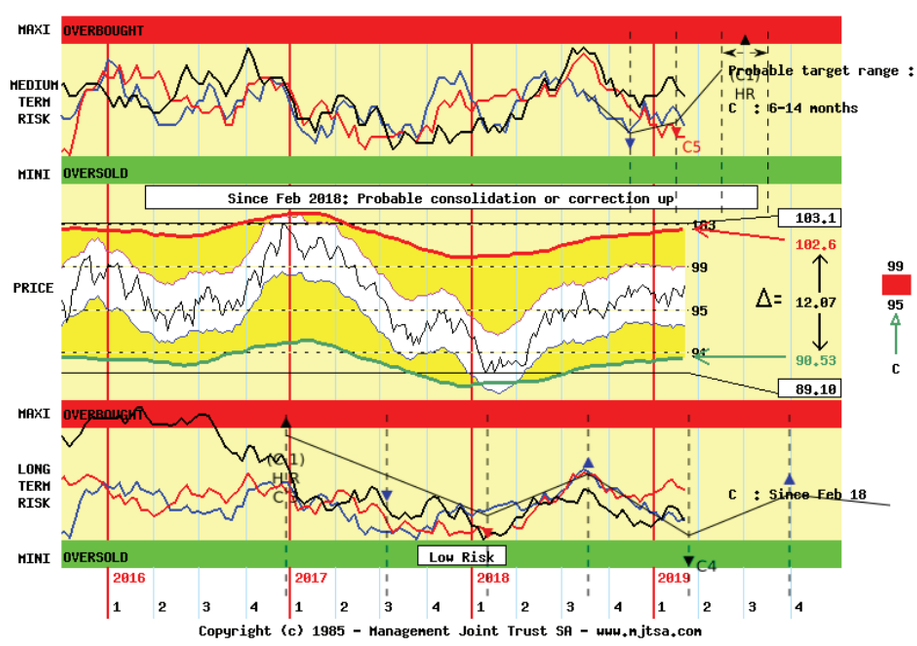
Over the last year, the US Dollar has been one of the only games in town. Indeed, in this late cycle environment, the US seems to remain the main motor driving global growth. Even following the FED's recent dovish U-turn, the US Dollar has remained strong. Indeed, other Central Banks have also confirmed their dovish stance, while US inflation and growth data have maintained their positive momentum. Shorter term, towards April, an intermediate correction may well materialize, yet we expect it to be contained and rather short lived.

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



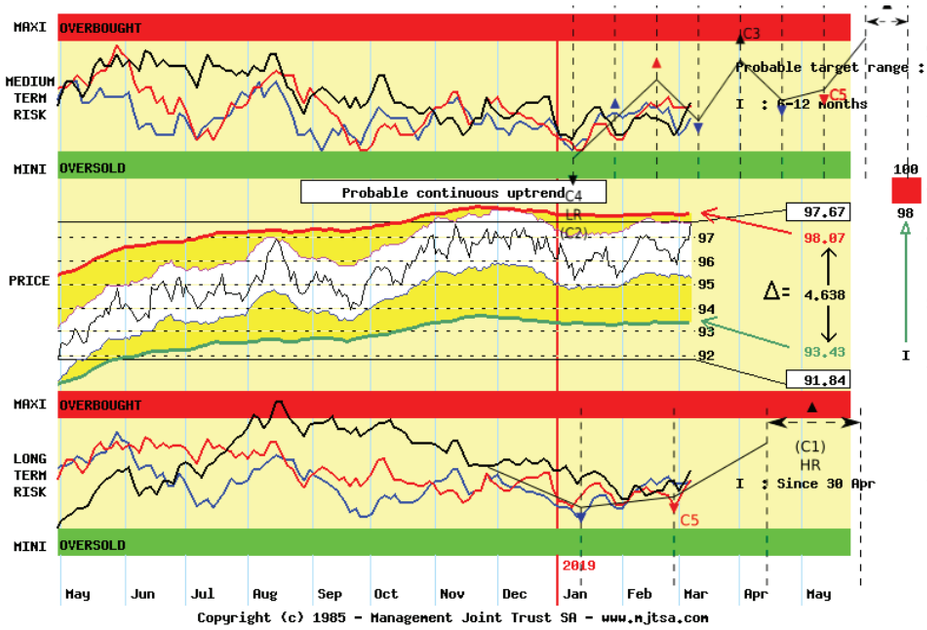
The long term uptrend of the US Dollar is still theoretically underway. Indeed, although it did correct down quite strongly during 2017, the lower end of our C Corrective targets to the downside (now at 88; right hand scale) has held. The Dollar has since resumed its uptrend. Our medium term oscillators (upper rectangle) suggest that it may soon reach a zone of potential tops, once again. Yet, any correction should be short lived as our long term oscillators indicate that it could find support before midyear to move higher towards yearend and 2020. Hence, **we do expect a correction at some point over the next few months, yet believe it will be of intermediate nature.**

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



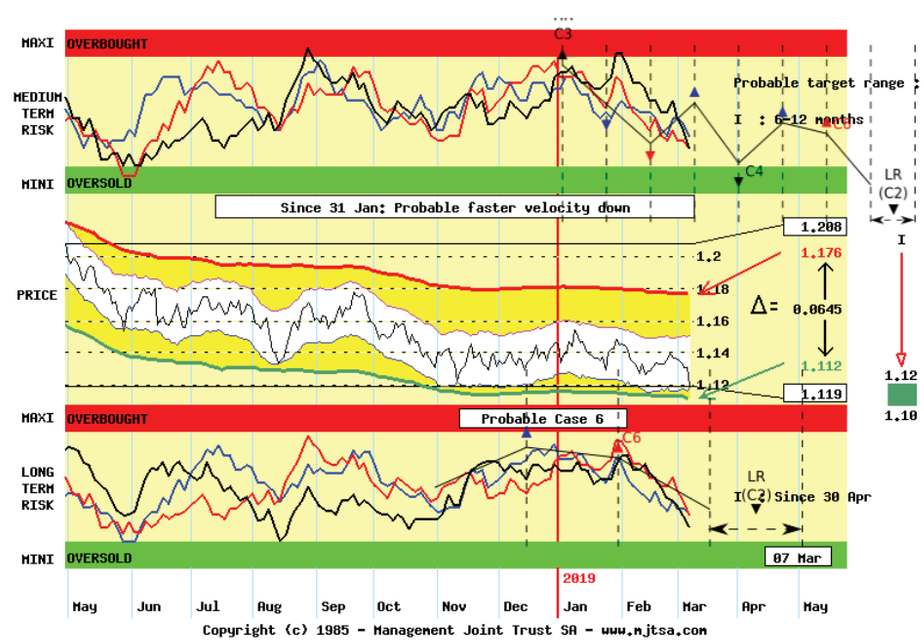
The oscillators on our Weekly graph are difficult to read, yet the sequences we show are still quite bullish on both oscillator series (lower and upper rectangles). The price action since early last year is also quite encouraging. Indeed, following the strong rally into last August, prices have since consolidated in a tight range and at high levels. **The next step in this uptrend would be to go and test the resistance of the upper end of our C Corrective targets to the upside (at 99; right-hand scale). We believe this could happen over the next few months. Above these levels, the Dollar Index will then be targeting its late 2016 tops.**

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



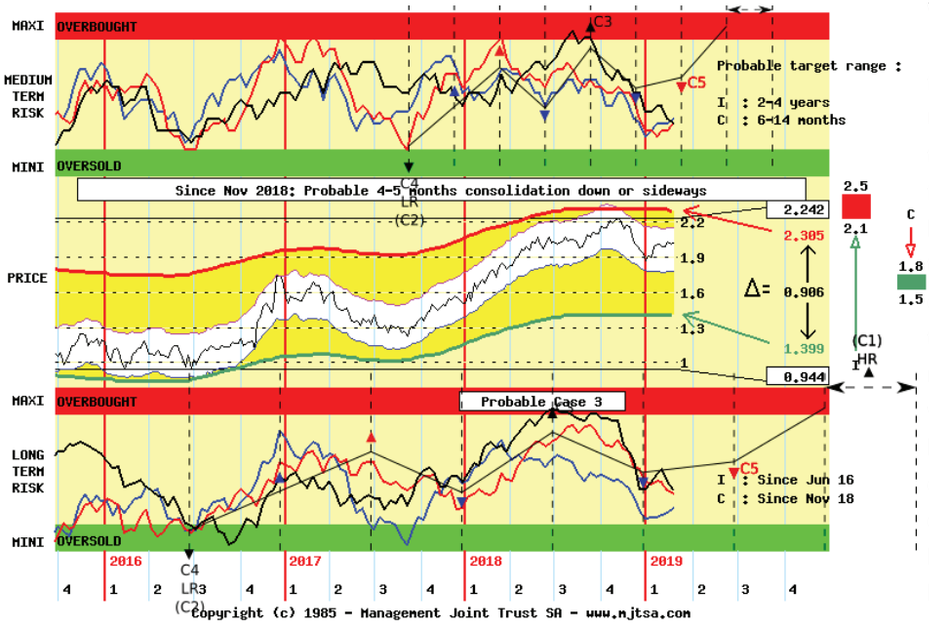
Shorter term however, the Dollar Index may prove more volatile over the next 2 to 3 months. For now, both our oscillators series are pointing to **further upside into late March / early April at least. Our I Impulsive targets to the upside suggest a move into the 98-100 range** (right-hand scale). Thereafter, our medium term oscillators (upper rectangle) indicate the beginning of a retracement period, which could last 3 to 6 weeks and amount to minus 2 to 4 figures (our historical volatility measure "Delta", here at 4.638 – middle rectangle; right-hand side – multiplied by our standard corrective factor between minus 0.5 and 0.8), before the Dollar resumes higher again from May into midyear.

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



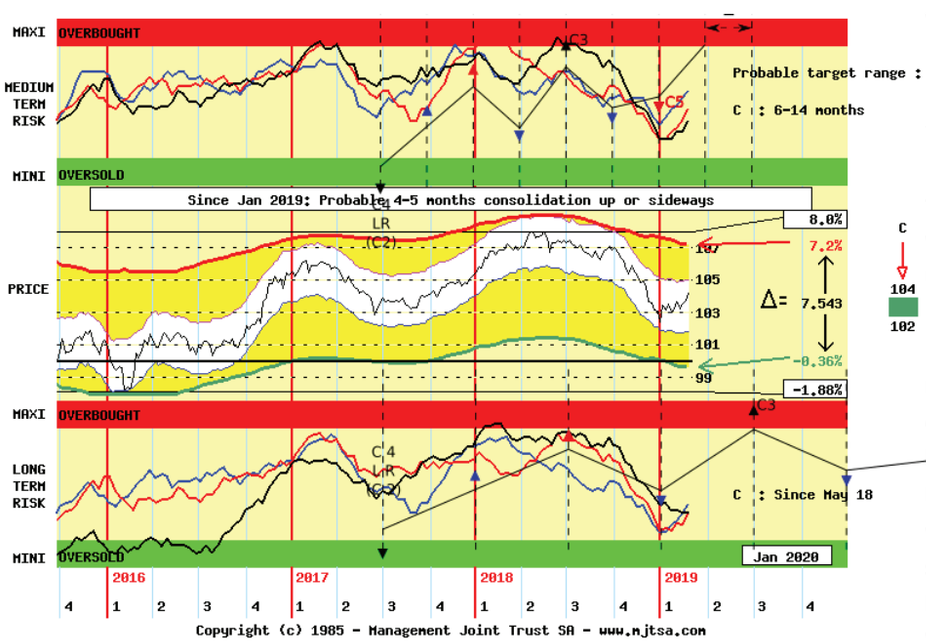
The daily graph of EUR/USD shows a similar dynamic in reverse. Both oscillator series (lower and upper rectangles) suggest that **the current sell-off could continue until late March / early April, and could push lower into the bottom our I Impulsive targets to the downside around 1.10** (right-hand scale). Following that, we would expect a bounce during April, perhaps into May, which could amount to 0.5 to 0.8 time our historical volatility measure "Delta" (middle rectangle; right-hand side), or to 3 to 5 figures (back to the 1.13 – 1.15 range). Finally, from May, we then expect a new leg down to begin. It could lead us lower into midyear and the Summer.

USD – EUR 10Y Interest Rate Swap spread
Weekly graph or the perspective over the next 2 to 4 quarters



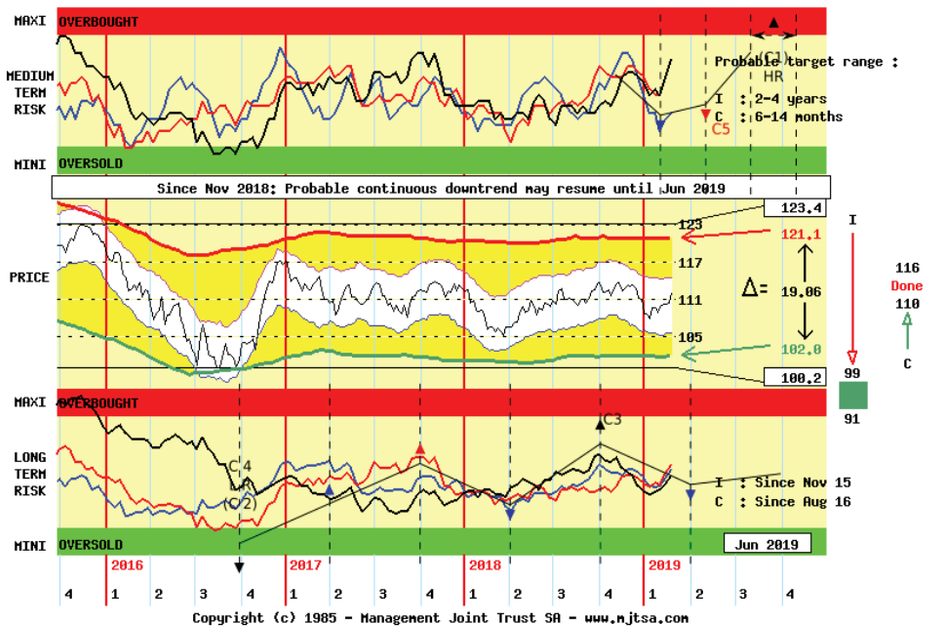
We believe that the two main underlying market factors for moves in the EUR/USD are the US to Europe interest rates differential and inflation expectations (see graph below). The third factor being the FED's reaction function to developments in these two factors. In Q4, the interest differential corrected down with yields given that US yields have been more volatile that Europe ones. Since early this year, the differential has been bouncing back. Indeed, while US yields have been treading sideways/down, European yields are currently pushing lower quite aggressively. On both oscillator series (lower and upper rectangles), **we now expect the differential to continue its gradual shift back towards an uptrend, between now and late Q2, thereby supporting the US Dollar. The ratio could make new highs in H2 this year, potentially towards the upper end of our I Impulsive targets to the upside towards 2.5%.**

TIPs vs Treasuries Breakeven Ratio
Weekly graph or the perspective over the next 2 to 4 quarters



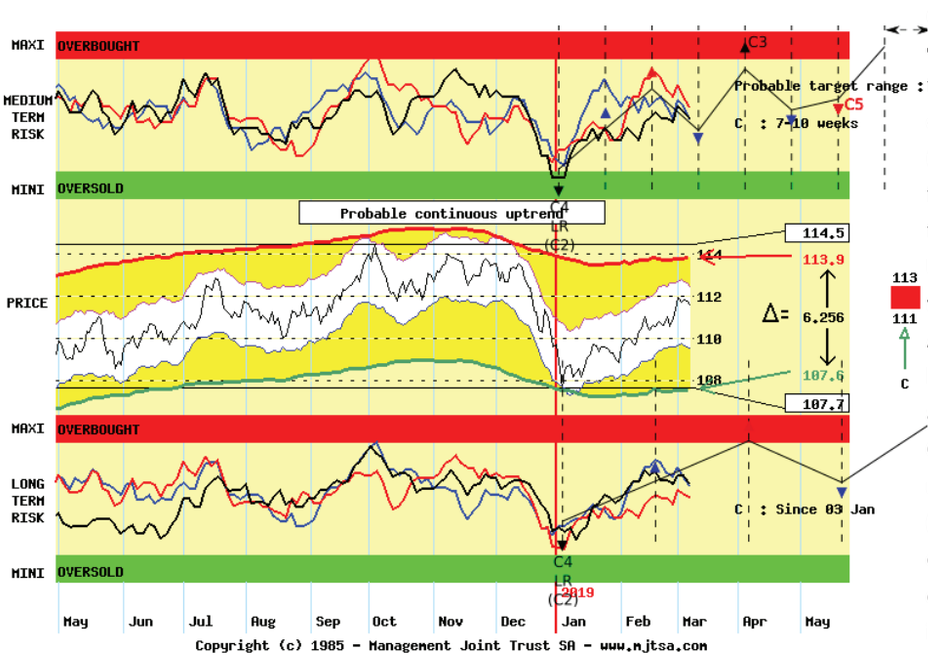
While the interest rate differential positively influences the US Dollar, inflation expectations may have a negative impact on it. Indeed, **if the TIPs to Treasuries breakeven ratios starts to accelerate up** (as shown on both oscillator series; lower and upper rectangles), **while the FED is rather dovish, the market may consider that the FED is falling behind the curve. With the FED currently on "halt", and wage growth accelerating, such a situation may materialize over the next few months. We still believe that the interest rate differential will provide strong support for the US Dollar, yet it may suffer temporary setbacks as the inflationary pressure intensifies**. Ultimately, at some point, if inflation data continues to rise, the FED will have to resume hiking. If this is the case, expected inflationary pressures would then ease, while the interest rates differential and the US Dollar would then continue higher.

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



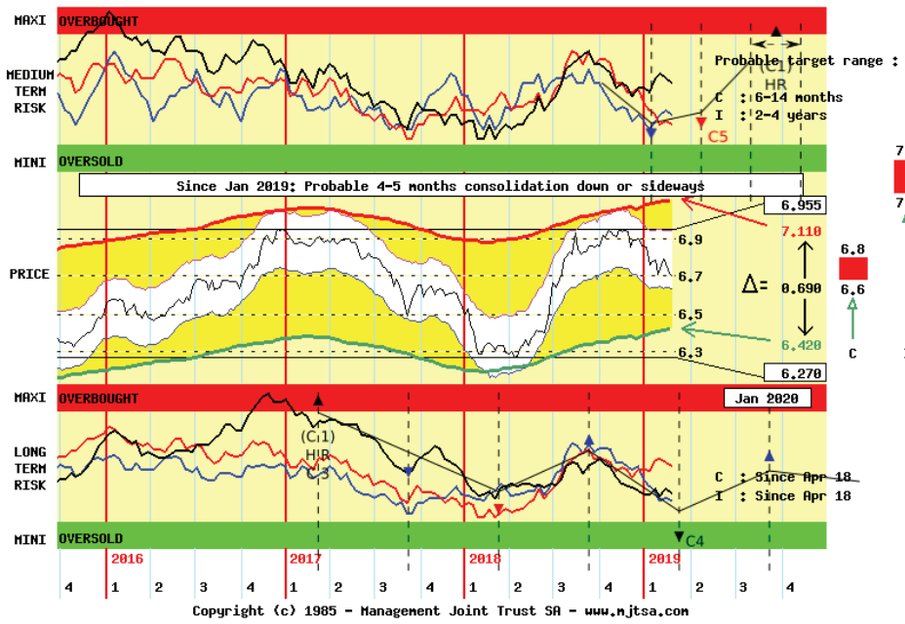
We now switch to the US Dollar vs Yen, which is often considered a risk-ON / risk-OFF pair. Indeed, it is often tributary to repatriation flows form Japanese investors, when global risk-assets start to correct. For now, following the sell-off in Q4, which ended with the early January USD/JPY Flash Crash, USD/JPY has been rebounding along with risk assets. Both our oscillator series (lower and upper rectangles) suggest that **it may now pause, correct or build a base, before it moves higher again from mid Q2 into the Summer. Our C Corrective targets to the upside indicate that it may push back up towards the higher end of our C Corrective targets to the upside over the next couple of quarters (around 116**, right-hand scale). Following that it probably resumes lower from mid/late Summer towards 2020, and our I impulsive targets to the downside (right-hand scale) below the 100 mark.

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



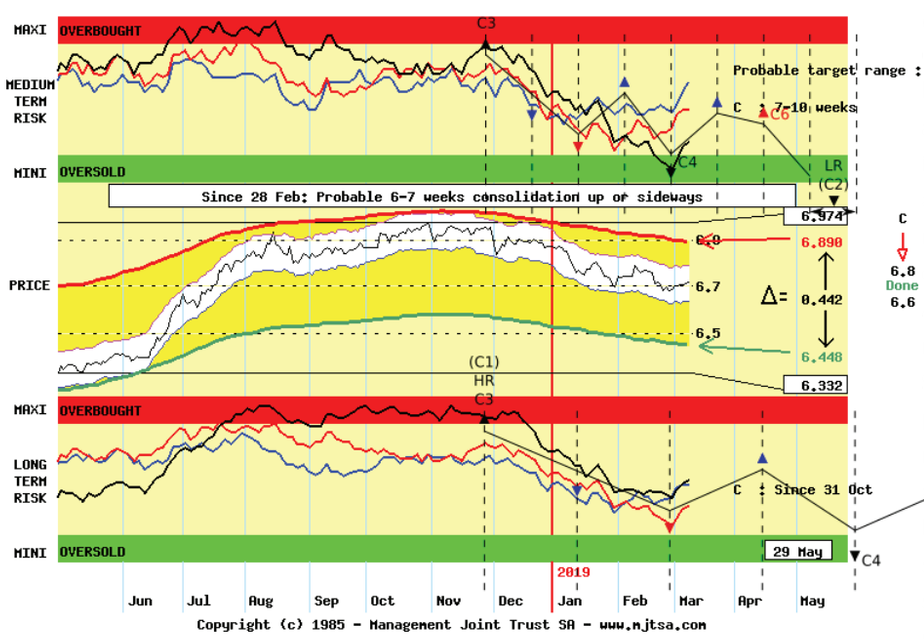
Shorter term, our Daily USD/JPY graph is very similar to the ones of equity indexes. According to both oscillator series (lower and upper rectangle), following the slight correction that is currently underway, **USD/JPY may attempt to retest up until late March / early April. The potential is however limited** as it is already banging **against the resistance of our C Corrective targets to the upside between 111 and 113 (right-hand scale). We then expect a period of correction down during April, perhaps into May, probably towards the 110 -108 range, before USD/JPY resumes higher again into midyear.**

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



As we have mentioned before in previous issues of The Capital Observer, the Yuan's daily fixing is very dependent on the evolution of its trade-weighted basket of currencies vs the US Dollar. Hence, when the USD rises vs the other currencies, USD/CNY ultimately has to follow to retain China's competitive position (and this despite any trade deal arrangement). **With the Dollar in a uptrend vs most currencies towards the Summer, USD/CNY will eventually have to rise again at some point**. On our long term oscillator series (lower rectangle), it is currently retracing, yet could find a base over the next few months, while our medium term oscillators (upper rectangle) suggest that it **may retest lower until early/mid Q2 before rising again towards the Summer.** In its push up last year, USD/CNY made it above our C Corrective targets to the upside (right-hand scale). **Over the next few quarters, it may hence move towards our I Impulsive targets to the upside in the 7.2 – 7.4 range, or more than 10% above current levels.**

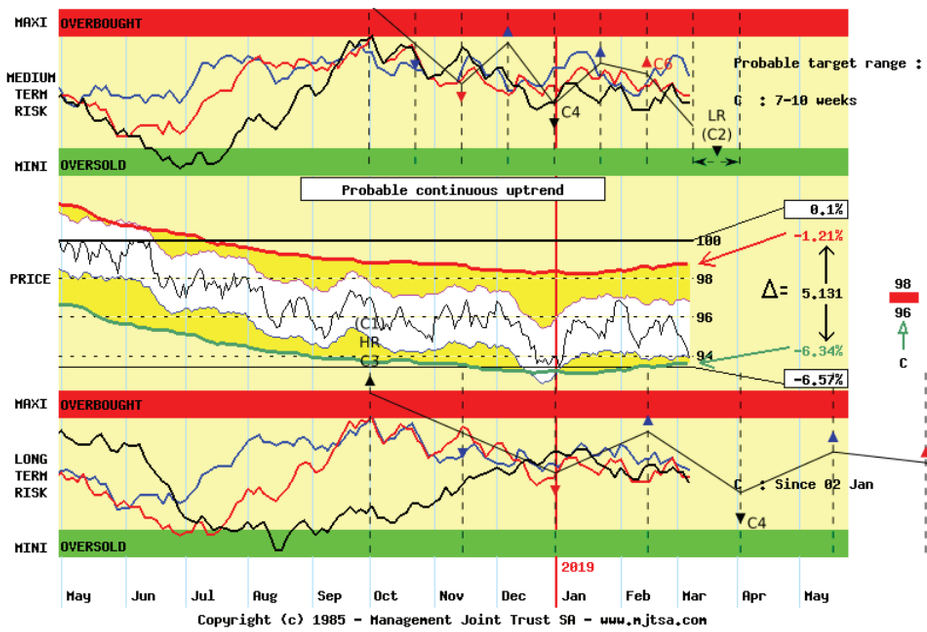
USD/CNY
Daily graph or the perspective over the next 2 to 3 months



Shorter term, on the Daily graph, USD/CNY could rebound slightly until late March along with US Dollar pairs. This is what both our oscillator series are suggesting (lower and upper rectangles). **Following that, it could then retrace down during April, perhaps May, before it rises again into midyear and the Summer.** For now, we would expect it to hold above our C Corrective targets to the downside at 6.6 (right-hand scale). A move below these levels would imply a stronger correction to the downside. Yet, given our rather bullish medium term US Dollar scenario vs most currencies, we believe this is rather unlikely to happen.

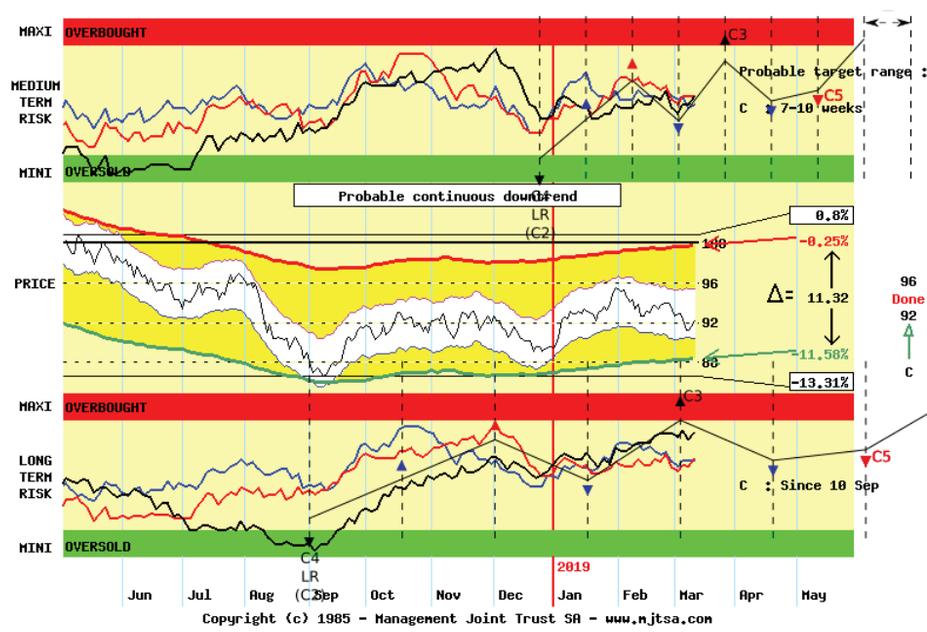
We now turn to other currencies vs the US Dollar and identify 4 distinctive group: 1. Currencies that pretty follow EUR/USD lower such as CHF, SEK, KRW, TWD (not featured here as their timing is similar to EUR/USD, yet CHF, SEK seem particularly weak, and have recently been making new lows vs the US Dollar, while KRW and TWD are more defensive), 2. Developed markets Commodity currencies such as CAD, AUD, NZD and NOK (featured below), 3. Emerging market Commodity Currencies such as BRL, CLP, RUR and ZAR (featured below), 4. Asian Growth currencies such as INR, IDR, THB, MYR, SGD (featured on the next page). Last but not least, we also had a look at GBP/USD.

Developed Commodity currencies
Daily graph or the perspective over the next 2 to 3 months



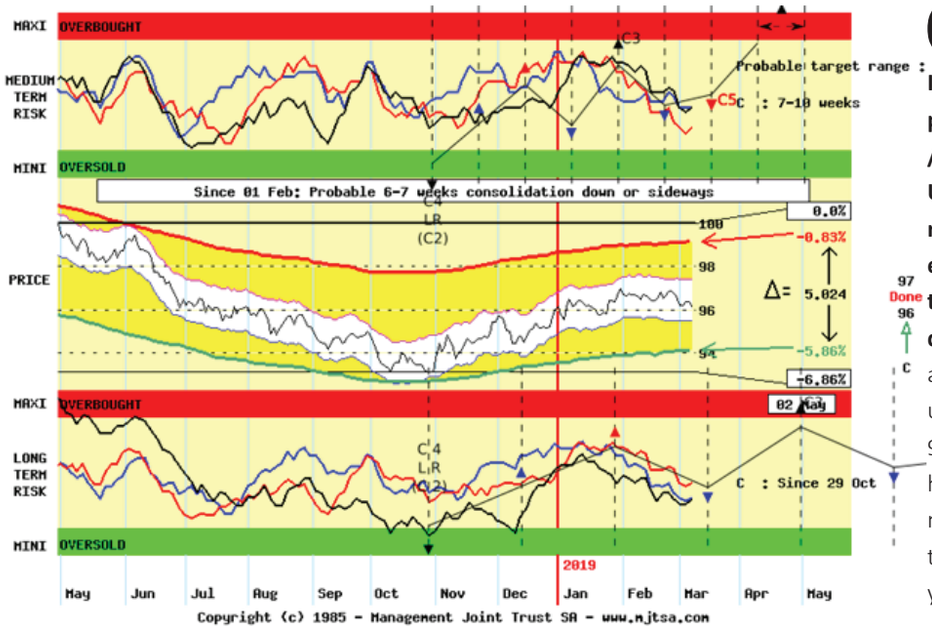
Over the last 6 months, these **Developed Commodity currencies (CAD, AUD, NZD, NOK)** have followed a similar path than the Euro vs the US Dollar. Yet, they suffered a deeper retest down in late December with new lows when the risk asset correction climaxed. Following that, they rebounded with risk assets until late January, but have since been resuming lower. Both our oscillators suggest (lower and upper rectangles), that **this move to the downside is probably coming to sn end between now and late March. We then expect them to bounce vs the US Dollar into April/May.**

Emerging Commodity currencies
Daily graph or the perspective over the next 2 to 3 months



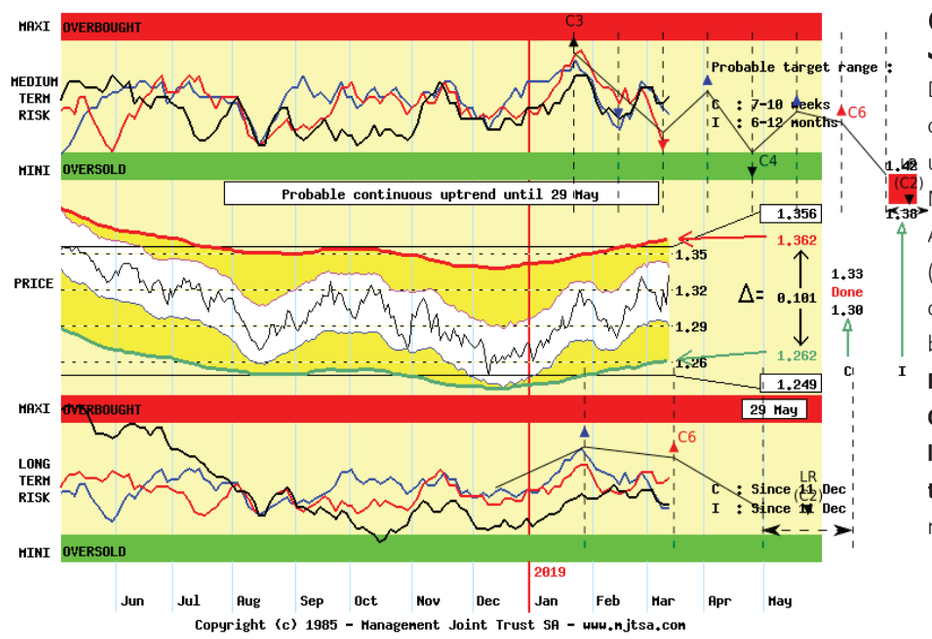
Following 6 months of uptrend since September (despite a US Dollar which has been rather strong), we believe that **Emerging Markets Commodity currencies (BRL, RUB, CLP, ZAR)** are probably topping out vs the US Dollar in the 2nd half of March. Both oscillator series (lower and upper rectangles) are indeed suggesting **that these could start to underperform into April, probably even late April**. This, in our view may imply a rather risk-off environment during April. Following that, we would still expect these to outperform once again from May into midyear.

Asian Growth Currencies
Daily graph or the perspective over the next 2 to 3 months



Our Asian Growth Currencies portfolio, which includes INR, IDR, THB, MYR, SGD has been outperforming the US Dollar since early / late October. For now, despite the US Dollar's recent strength, they have resisted rather well, and we would expect then to resume higher over the next few weeks, probably towards late April / early May. Making it above our C Corrective targets to the upside during this period (here above 97; right-hand scale) could imply much higher targets over the next couple of months, possibly back towards 100 or towards the levels achieved before last year's drastic sell-off.

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



Sterling is being tossed around by the current Brexit process. Vs US Dollar, it should start to resume lower on our oscillator series (lower and upper rectangles), probably into end March, and potentially into mid/late April. On our mediumterm oscillators (upper rectangle), it may push higher over the next few days. Yet, we do not believe this rally will be long-lasting. **For now, we would remain neutral on Cable as long as the pair remains below the upper end of our C Corrective targets to the upside** (around 1.33; right-hand scale).

Concluding remarks

The FED has turned dovish, yet the US Dollar remains strong for now. This is especially the case vs the Euro and other European currencies. We expect this uptrend to continue, probably towards late March / early April, when the US Dollar could make an intermediate top, and start consolidating down for 3 to 6 weeks. This slowdown may correspond to some negative surprises on the US data front, yet, could also be the result of increasing inflationary pressures in the US, while the FED is "on halt". Perhaps a bit of both (temporary Stagflation scare?). Nevertheless, according to our timing and trend indicators, the Dollar appears to resume higher once again, from mid Q2 into the Summer. Among the various currencies, the Yuan and Asian Growth currencies seem to remain strong into late April, perhaps May, the EUR, the Yen and Developed Markets Commodity currencie should continue lower into late March, but then bounce during April / early May. Emerging Commodity Currencies, on the other hand, could weaken throughout the next couple of months, probably until late April / May. Sterling could push higher over the next few days, yet we do not believe this upswing will be long-lasting.

33 / The US bank sector should perform well going into Q3 at least, as inflation surprises may cause the US yield curves to initiate steepening after March

The last time we wrote about the US bank sector was in the June 2017 issue of the Capital Observer (“*The US financial sector is set to outperform during H2 2017, and may now provide opportunities to investors*”). The bank sector was then underperforming the broad market after a promising performance in Q1 2017. We said then:

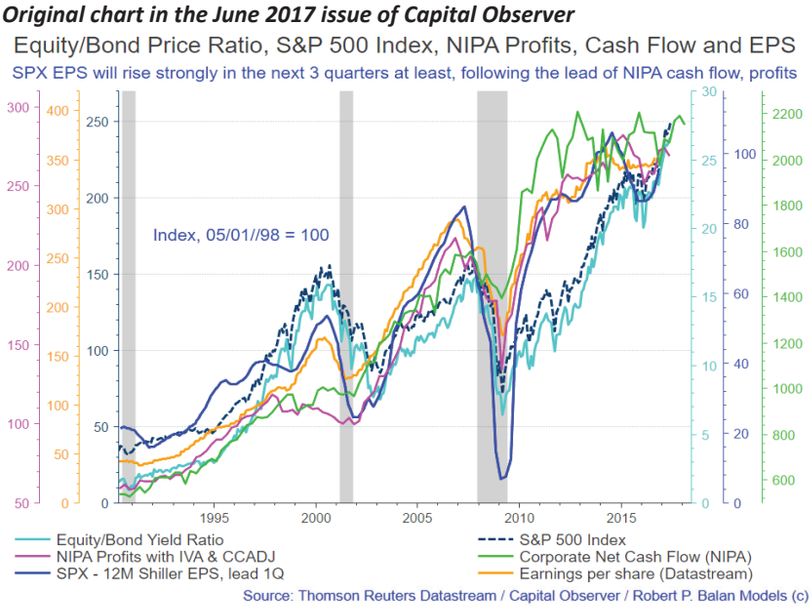
One of the reasons which encouraged us to write this article is that we believe that the financials will catch up to the broad S&P 500 index, for the economist's famous reason - "if a trend cannot continue forever, it will stop." And we think the banks have been undervalued for too long, and the day for that undervaluation to stop is nigh.

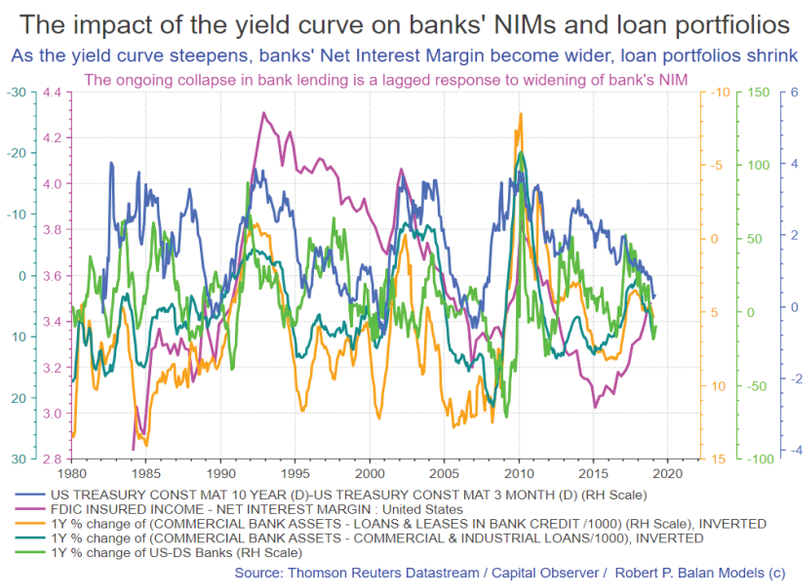
At that time, the markets were sidetracked by a surprise downturn in Q1 2017 and GDP growth surprised to the downside, then Mr. Trump`s agenda by tripped up by the Republican Congress' failure to pass an alternative to the ObamaCare, and subsequent scandals along with unfortunate backlash from the Trump`s dismissal of James Comey as FBI director.

But WE pointed out that:

The present economic situation is not dire at all. After a weak Q1 growth, activity is rebounding during the second quarter. The Atlanta Fed’s GDPNow model is predicting growth of 3.2% while the NY Fed’s Nowcast is calling for 2.3%. The Q1 2017 earnings season was a strong one. Moreover, our leading indicators predict continued healthy profit growth for the remainder of the year in the U.S. and into Q1 2018 at least (see 1st chart on this page). As long as corporate earnings are rising, investors will largely shrug off the reality show in Washington DC.

Original chart in the June 2017 issue of Capital Observer



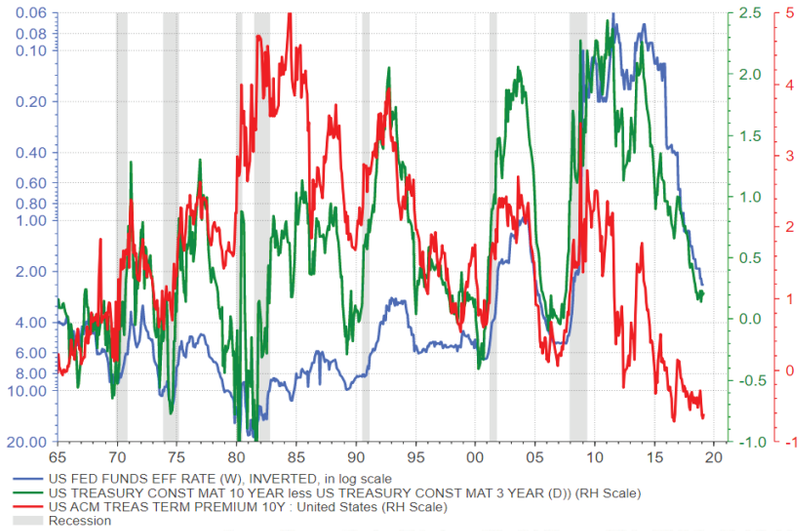


Now, the banking sector looks to be in trouble again. The flattening yield curve as a result of aggressive tightening by the Fed throughout 2018 and in early Q1this year, has dampened investor sentiment towards the financial sector, as markets perceive that banks' ability to generate earnings is constrained. But that is not the complete story, and there are a lot of myths that we have to lay to rest to tell the full story.

It is true that flattening yield curves depress banks equity prices, but NOT for the reason that is almost universally quoted – that banks do not loan out when yields curve flatten, as there is very narrow spread margin per loan. While the narrow spread is essentially true, in reality, banks tend to increase loan issuance when yield curves flatten because what they cannot make in profitability per loan they try to make up in a larger volume of loan portfolios (*see 2nd chart above*). That consequently increases costs in the effort to maintain the level of income from these portfolios.

There are other myths that we can slay by using the chart above. For instance, it is clear that there is a negative covariance between the size of the loan portfolio with the growth of banks equity prices. More loans correlates with weaker equity prices, and vice versa. The Net Income Margin (NIM) of banks, NIM being equal to a bank's total interest income minus total interest expense, rises when yield curves steepen and falls when yield curves flatten (after a time lag). That supports the notion that larger loan portfolios when yield curves are flattening increases costs that impinge negatively on bank shares. **Bank shares outperform when yield curves and the NIM steepen, meaning banks do not need to make so many loans (lower operating cost) while making the same relative level of profitability.**

The inverse correlation between FFR vs 3Y/10Y Yield Curve, Term Premium

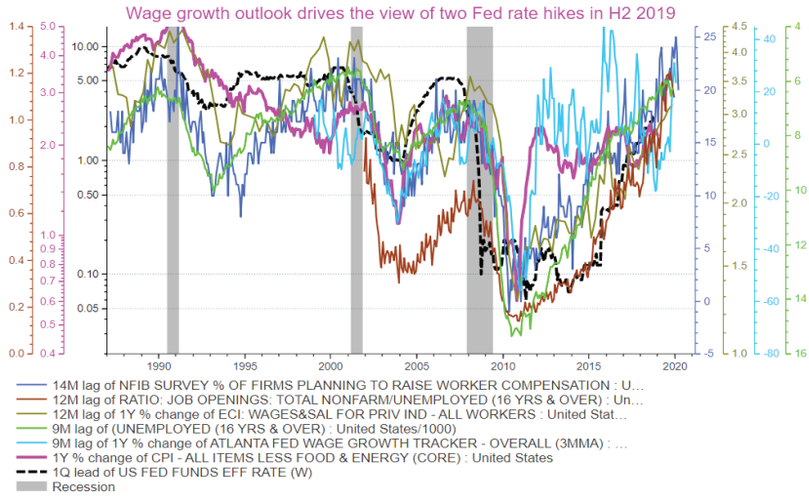


Source: Thomson Reuters Datastream / Capital Observer / Robert P. Balan Models (c)

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

The strong wage outlook provides a case for rising Core CPI until Q1 2020

Wage growth outlook drives the view of two Fed rate hikes in H2 2019



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

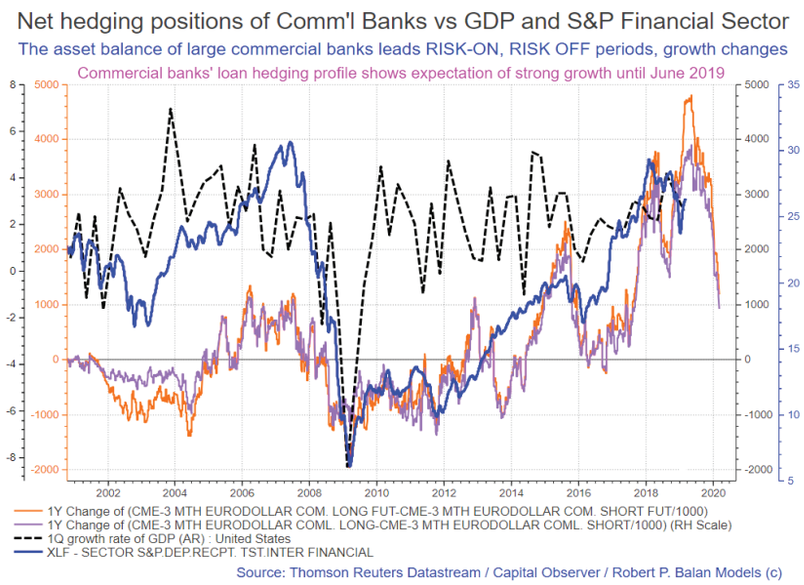
The key item to watch therefore is how much flatter the US yield curves can get. It is true that the key data which makes yield curves do what they do is the Fed Funds Rate (FFR). A rising FFR always flattens the yield curves, and the linkage between FFR and the yield curve runs through the bond yield term premium. "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. A key component of the term premium is investor expectations about the future course of short-term interest rates over the lifetime of the long-term bond. And those market expectations are impacted by projections of long-run inflation and the future path of short-term interest rates (*see 1st chart on this page*).

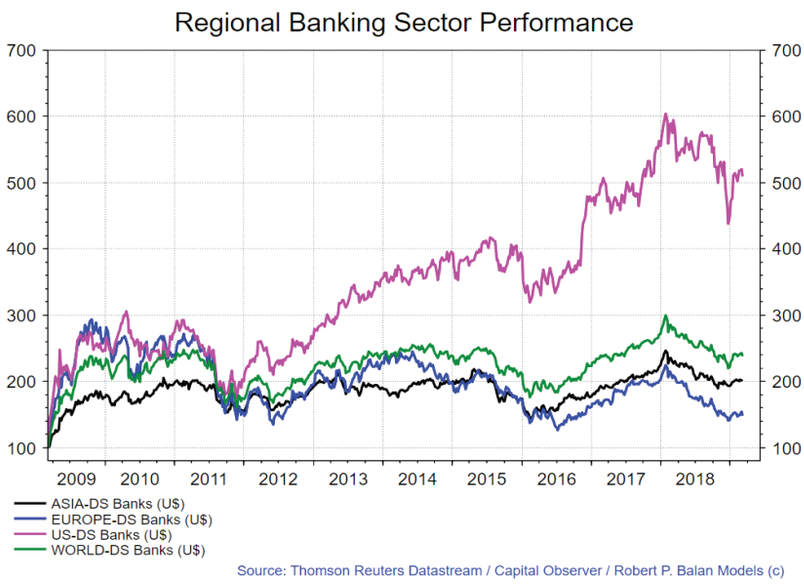
Term premium can become large or can become even negative depending on whether future inflation expectations are high or are low. And that, consequently, pushes the yield curve steeper or flatter, respectively. **The direct link to the FFR is in the function of higher policy rates to tamp down inflationary pressures – higher policy rates make for lower inflation down the road (lower term premium), and vice versa (higher inflation, higher term premium)**.

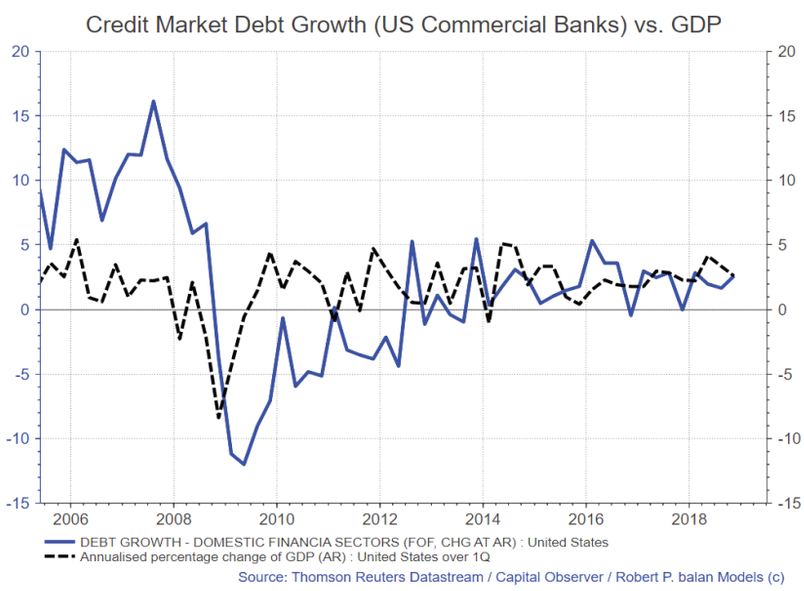
The yield curve tendency to remain flat is of course dependent on the expectations that inflation will remain tame, so that the Fed will not revert to a more hawkish stance. **But what happens if core inflation rises significantly in a move that will surprise the Fed? Indeed, such possibility may arise after March, when we expect the tremendous rise in wage growth to finally cascade into Core CPI and Core PCE. The Fed has turned dovish, and is willing to be patient, but left unsaid is the conditional clause that core CPI would have remain tame and stays below their 2.00% core PCE marker for the FOMC to stay loose. If Core CPI and Core PCE rises due to wage growth pressure after March, the Fed will likely become less accommodating**.

Conclusion: **We feel very strongly that we will have a surprise surge in core inflation after March. presume that inflation surprises will significantly raise the term premium and that will help steepen the yield curves – and that should help kick start a rise of the financial sector, which has lately showed signs of flagging, and has trailed the broader markets again**. Core inflation so lags behind wage and GDP growth in general that frequently, Core CPI will still be rising even as the domestic economy has already entered into a slowdown phase.

For whatever it is worth, we expect the financial sector to perk up in Q2 this year, but the sector might start getting into trouble again sometime in H2 of 2019. Even the hedging profiles of commercial banks suggest that as the case. The loan assets of the banks have been lightly hedged until July, this year. But after that those assets are heavily hedged, implying that the banks are expecting trouble from the economy and probably issues from falling price of risk assets as well. The banks' collective hedging profile has shown a very good positive correlation with the rise and fall of GDP growth and risk asset prices (*see graphs on this page*).





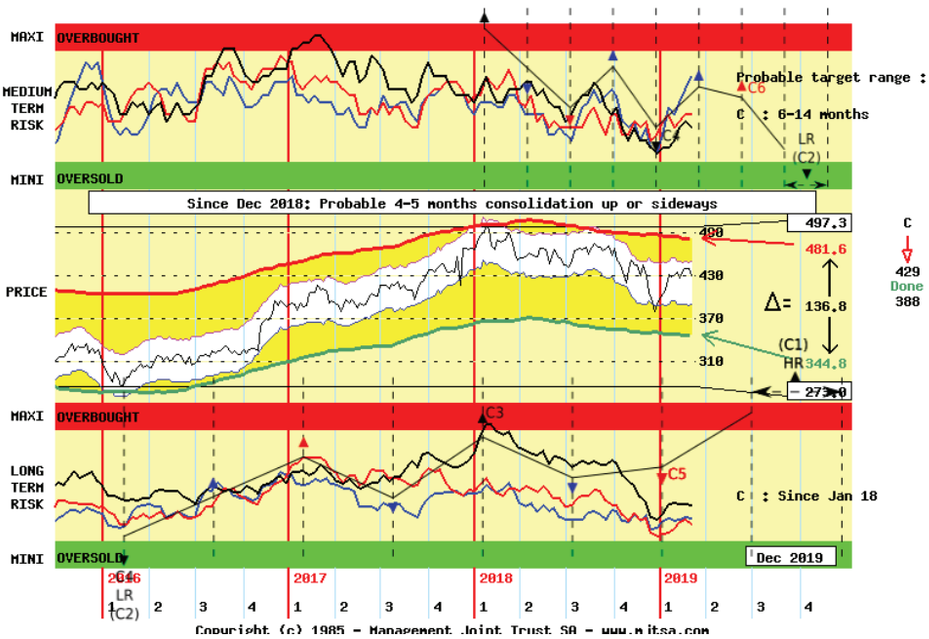


36 / MJT - TIMING AND TACTICAL INSIGHT

More Patience is required before Banks and the Financial sector start to outperform

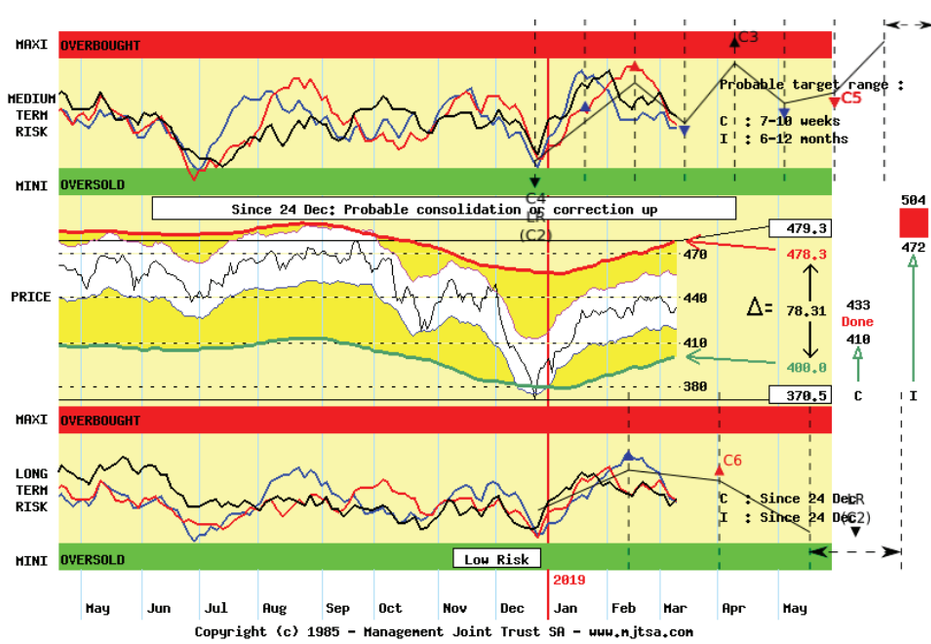
Our business case late last year was than Financials could start to outperform once the yield curve would start to steepen, sometime mid/late Q1 this year. In this article we review the situation for US and European Financials vs the market following the Fed's policy U-turn and the concomitant huge rally in equities. Indeed, Equities now seem rather Overbought and the case for an imminent yield curve steepening may be pushed back a couple of months.

S&P US Financials Sector
Weekly graphs or the perspective over the next 2 to 4 quarters



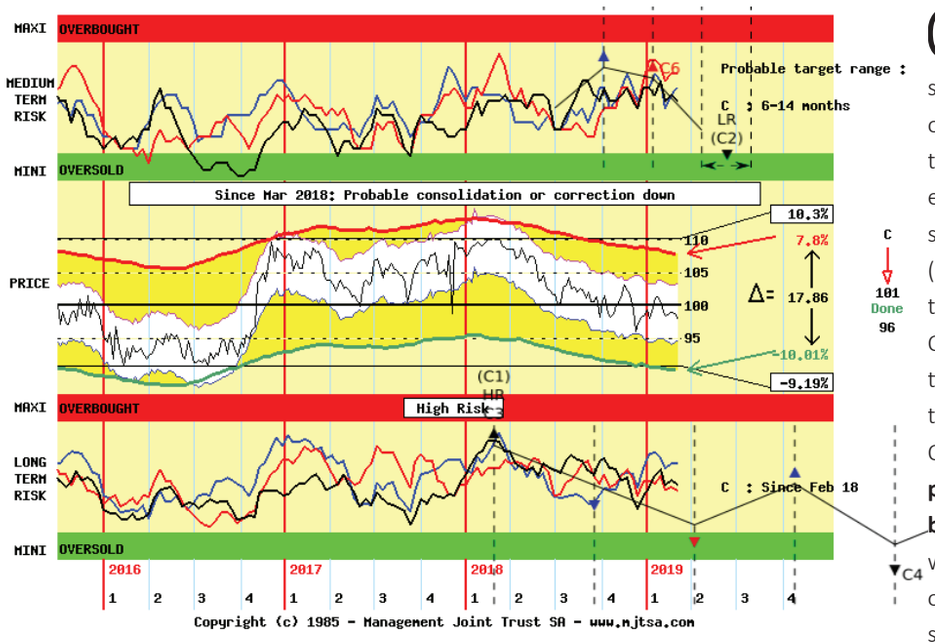
Financials have been consolidating down since early last year. This is in line with Global market yet weaker than the broader US Indexes. Indeed, while the FED was regularly raising rates last year, the US yield curve linearly flattened, thereby denting the prospects for the US Financials sector and leading it to underperform. Since December, the sector has bounced, yet as shown on our medium term oscillators (upper rectangle), it is still in a downtrend for now. Worse, it could be approaching an important countertrend top, and may start to resume lower into the Summer. Our long term oscillators (lower rectangle) are more encouraging and picture a gradual reacceleration up towards the Summer. This scenario is supported by the fact that during its correction down last year, the sector pretty much held the support of its C Corrective targets to the downside (right-hand scale). Theoretically, its long term uptrend since early 2016 is still in place. The truth is probably somewhere in the middle, with **some retracement down of the next couple of months and then an attempt to move up again into the Summer.**

S&P US Financials Sector
Daily graphs or the perspective over the next 2 to 3 months



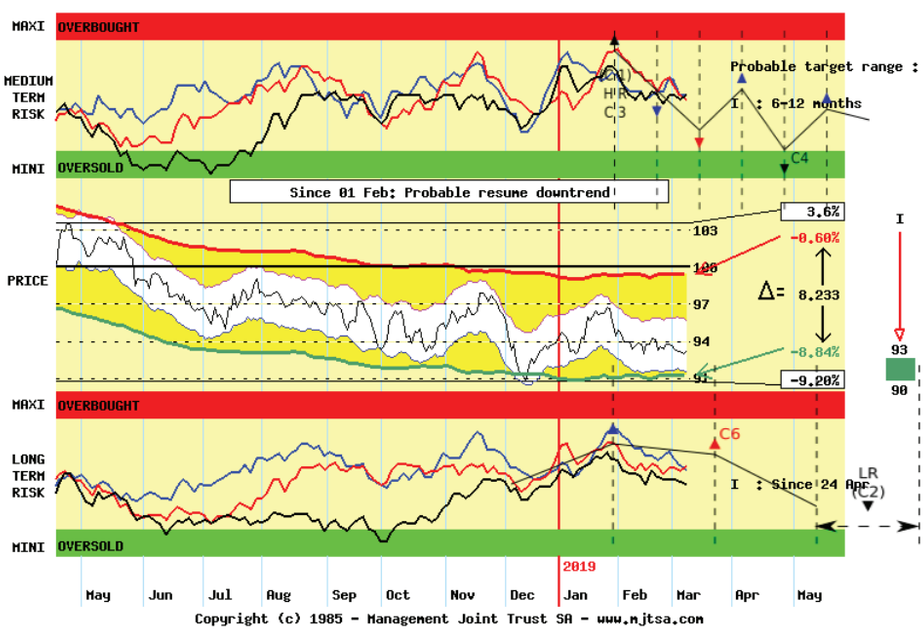
Shorter term, the US Financial sector has bounced with the general market since December. Yet, while rebound was very strong in January, it has since started to lose some momentum. Nevertheless, it did manage to make it above the resistance of our C Corrective targets to the upside (right-hand scale), thereby opening the door to our I Impulsive targets to the upside 10 to 15% above current levels. These could theoretically be achieved over the next 6 to 12 months. In the meantime, as shown on both oscillator series (lower and upper rectangles), **the current uptrend may retest up / die out towards the end of March, and correct down into late April, or perhaps in worst cases into May, before it finally resumes higher towards midyear and the Summer.**

S&P US Financials Sector vs the S&P500 Index
Weekly graphs or the perspective over the next 2 to 4 quarters



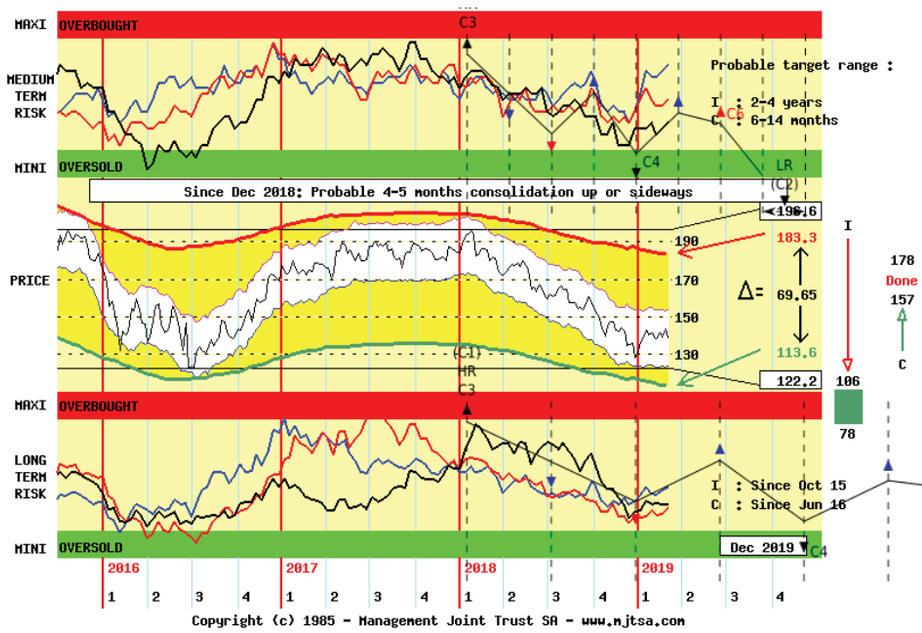
On a relative basis, US Financials have indeed been in a downtrend since Q1 last year. While our long term oscillators (lower rectangle) suggest that they could find support towards early Q2 this year, the sequence we show on our medium term oscillators (upper rectangle) would point to further downside pressure into mid/late Q2. This more negative scenario is justified by the series of declining tops on the ratio between late Q4 and early Q1 this year. **We would hence remain prudent for now on the sector, probably until mid Q2 at least**. Ideally, we would expect it to hold the support of our corrective targets to the downside some 2 to 3% below current levels (right-hand scale).

S&P US Financials Sector vs the S&P500 Index
Daily graphs or the perspective over the next 2 to 3 months



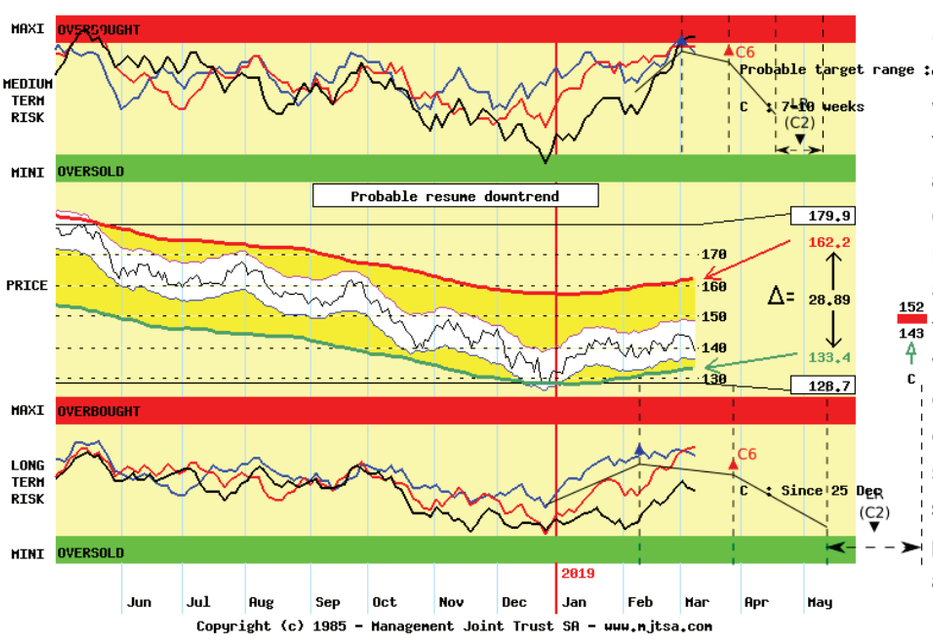
The ratio's Daily graph still seems downtrending on both oscillators series (lower and upper rectangles) until late April, perhaps May. Over the next few weeks, we could still see a rebound, yet from late March / early April, it resumes down towards our I impulsive targets to the downside (right-hand scale), potentially retesting its December lows.

European Banks – STOXX 600 Sector
Weekly graph or the perspective over the next 2 to 4 quarters



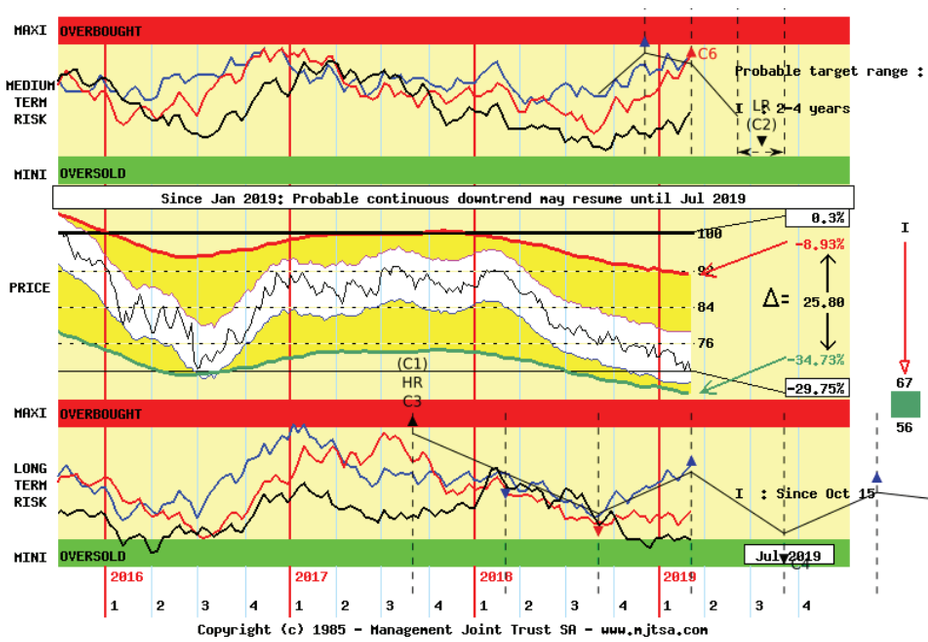
European Banks have also been downtrending since early last year. The move is stronger than on US Financials as European Banks have made it below our C Corrective targets to the downside (not shown here anymore), and are now in Impulsive territory. These I impulsive targets to the downside (right-hand scale) are pointing to much lower levels over the next 6 to 12 months, possibly to the 106 – 78 range, 25 to 45% below current levels. Hence, **the long term risk on European banks is still very compelling**. In the meantime, both oscillator series (lower and upper rectangles) suggest that an intermediate low was made in December, yet that it may now be approaching a first countertrend top. **We hence expect European Banks to resume lower over the next couple of months, before another bounce eventually materializes towards end Q2. In general, this downtrend seems quite strong, and for now, we would expect it to start resuming lower at the latest from this Summer. This scenario leaves little room for a strong rebound.**

European Banks – STOXX 600 Sector
Daily graph or the perspective over the next 2 to 3 months



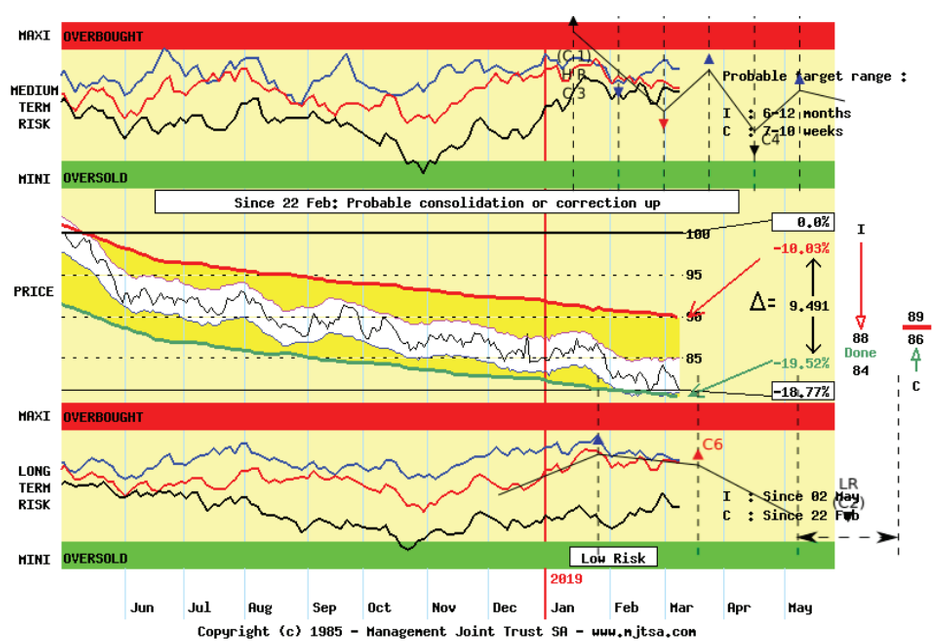
Shorter term, on the Daily graph, European Banks have bounced with other equities since December. Yet, **the rebound has been quite weak and may be already losing steam**. Our medium term oscillators (upper rectangle) are already Overbought, and we expect then to roll-over before the end of the month. Likewise, we expect a lower top towards the end of this months on our long term oscillators (lower rectangle). Both suggest that **European Banks could sell-off once again into late April, perhaps May, before they eventually attempt to rebound again.**

European Banks – STOXX 600 Sector vs the Europe STOXX 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



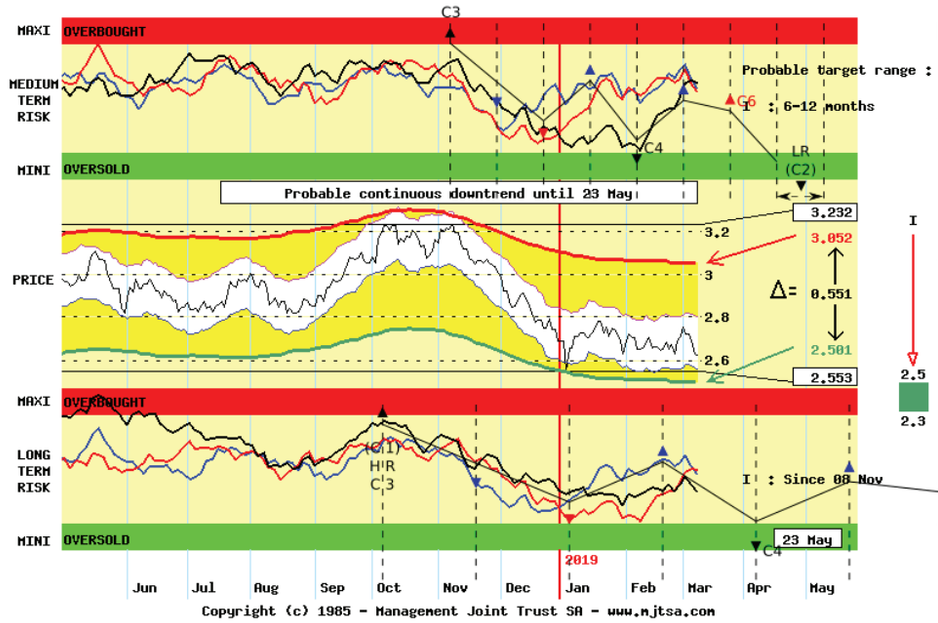
On a relative basis, vs the Europe Stoxx 600, the performance of European Banks has been heading linearly lower. While prices were falling, our medium term oscillators (upper rectangle) were rising (i.e. risk was rising), and these may now be approaching new countertrend tops. This suggests further downside pressure for the ratio into late Q2 at least. Our long term oscillators (lower rectangles) also indicate a "resume downtrend" situation, probably towards the Summer. **We hence see little respite for European Banks vs the market for now, and our I Impulsive targets to the downside (right-hand scale) point to further underperformance risk between 3%, yet perhaps even 20%.**

European Banks – STOXX 600 Sector vs the Europe STOXX 600 Index
Daily graph or the perspective over the next 2 to 3 months



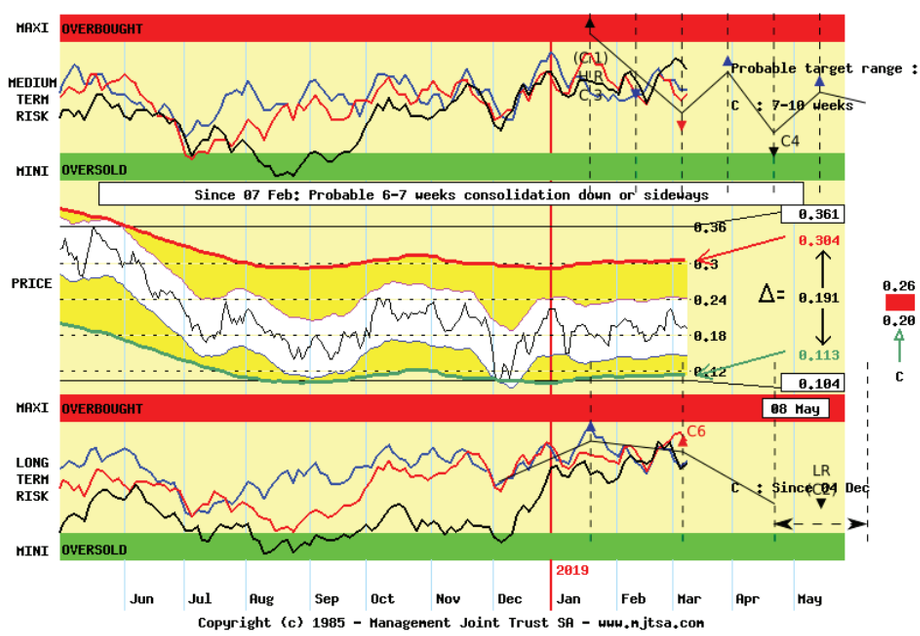
On the Daily graph, European Banks are very Oversold vs the market. Our I Impulsive targets to the downside (right-hand scale) have been achieved, and both our envelopes are touching each other (middle rectangle), a sign of exaggeration in the current trend. Yet, **despite leaving some room for a slight bounce over the next couple of weeks, both our oscillators are still pointing to a continuation of the downtrend, probably towards mid/late April, perhaps May.**

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



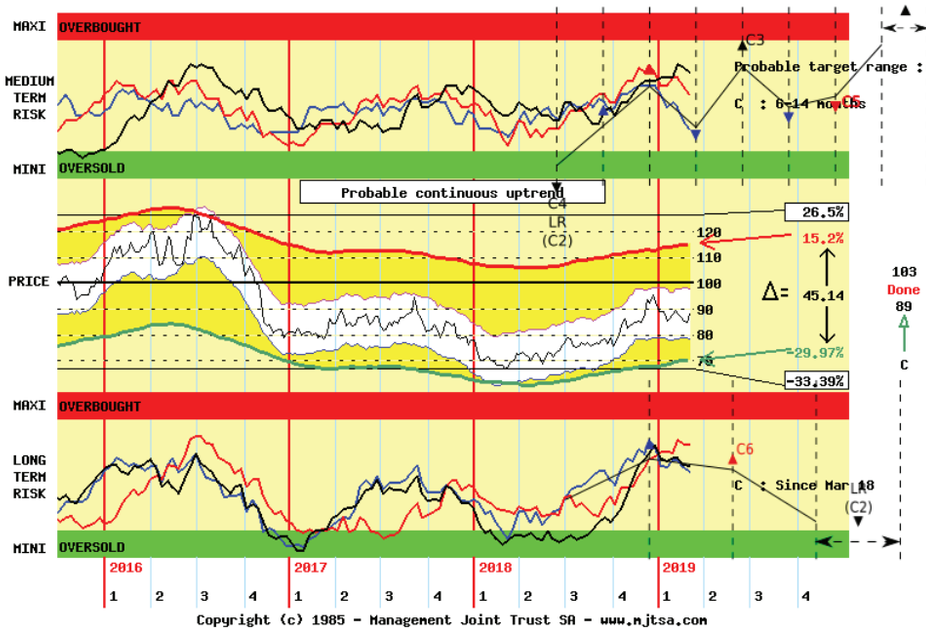
One reason why Financials are finding it so difficult to bounce is that yields since December have failed to follow equity markets higher. They did bounce a bit in January, and both US and European banks did also bounce vs their respective indexes. Yet, following that, they have since resumed lower. On both oscillator series, **the US 10Y Treasury yield's move lower is set to continue**, from now to early April on our long term oscillators (lower rectangle), and **from late March into late April / May on our medium term oscillators** (upper rectangle). This second scenario has our preference as it seems a better match for the risk asset correction we expect between now and late April. On the target front (right-hand scale), **we expect 10Y Treasury yields to dip below 2.5% over the next couple of months, probably making it as low as 2.3%**. We would probably consider any dip towards 2.4% as a take profit opportunity on Treasuries.

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



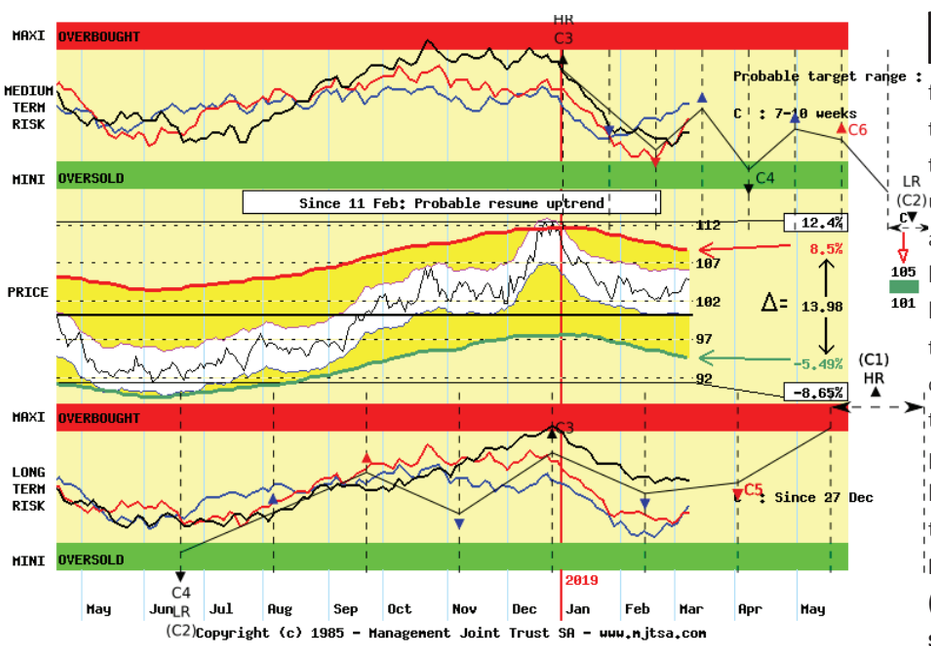
The US Treasury spread (the yield curve spread) is often considered as an important indicator for the profitability of US Financials. In this graph, we concentrate on the 10Y-3Y year spread, which bounced in December along with US Financials sector vs the S&P500. Since then, the yield curve spread has moved sideways, and on our long term oscillator series (lower rectangle) could be getting ready to resume lower, probably into late April / May. Our medium term oscillators (upper rectangle) also point to more flattening towards late April, yet holds up into late March before this. last move lower materializes. **Generally, we expect the spread to retest its December lows by late April / early May.**

IYR - iShares U.S. Real Estate ETF / KBE - SPDR S&P Bank ETF
Weekly graph or the perspective over the next 2 to 4 quarters



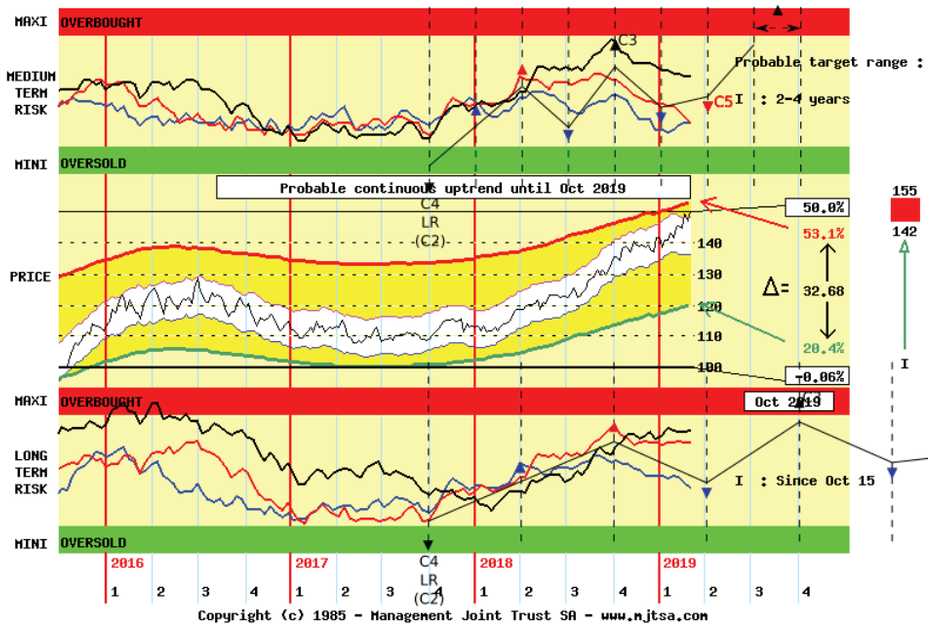
We now concentrate on comparing the US and European banking sectors vs other financial related segments. First, we compare the US Real Estate sector vs US Banks. The US Real estate sector stands on the other end of the interest rate equation. Indeed, when interest rates rise, it usually underperforms. It is also more defensive, less pro-cyclical, than the banking sector. In fact, the ratio started to rise in early Q1, inversely mirroring US Financials performance vs the S&P500 (see graph above in this article). Yet, the picture seems clearer here. Indeed, both our oscillator series reached an important intermediate top late December (upper and lower rectangles). Yet, our medium term ones are now suggesting that **US Real Estate could soon enter a new leg up vs US Banks**, probably towards late Q2. Our long term oscillators (lower rectangle) suggest less upside momentum, yet also a period of sideways consolidation, before US Real Estate starts to underperform again from mid/late Q2. Both hence suggest that **it still seems early to overweight US banks vs US Real Estate, and probably vs the market in general.**

IAK - iShares US Insurance ETF / KBE - SPDR S&P Bank ETF
Daily graph or the perspective over the next 2 to 3 months



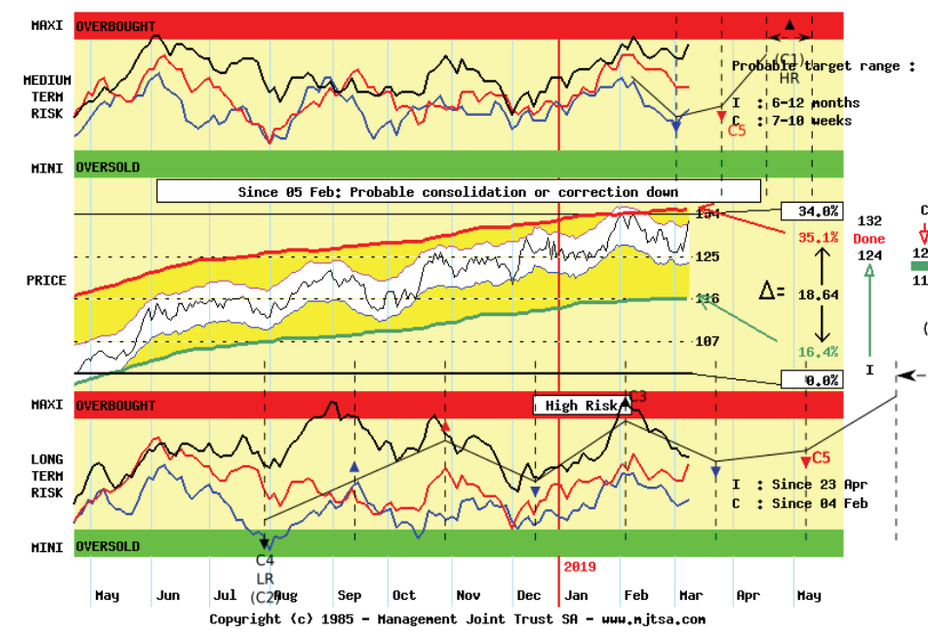
In the US Financials sector, US Insurance companies are also more defensive, less pro-cyclical, les sensitive to the yield curve than US Banks. On this daily graph, the ratio has been uptrending since last June and made an important top, while equity markets were bottoming, in December. It has since been retracing inversely to the equity market rebound. On both oscillators series (lower and upper rectangles), we now expect it to find support, probably towards late March/early April, and to start moving up again towards late April, perhaps May. **From May, on our medium term oscillators (upper rectangle), US banks may resume their recent outperformance. Yet, for now, we believe it is either too late, or too early to overweight them vs the US Insurance sector.**

European Insurance vs Europe Banks – STOXX 600 Sectors
Weekly graph or the perspective over the next 2 to 4 quarters



Similarly, the Weekly graph compares the European Insurance sector to the European Banking one. Although the ratio has reached our I impulsive targets to the upside (right-hand scale), suggesting little upside potential left, its uptrend still seems strong. Both our oscillators series (lower and upper rectangles) indicate that it could continue higher probably towards midyear and even the Summer. This leaves little hope for the European Banking sector until then, and **European Insurance companies would constitute a safer, less cyclical opportunity to invest in European Financials**.

AMUNDI European real Estate ETF vs European Banks – STOXX 600 Sector
Daily graph or the perspective over the next 2 to 3 months



Finally, we look at the daily graph of a ratio comparing European Real Estate to European Banks. Although quite advanced (our I Impulsive targets to the upside have been reached; right-hand scale), **this trend is still heading up**. Both our oscillator series (lower and upper rectangles) suggest that **it could find renewed support between now and late March to move higher, probably towards late April, and perhaps even into midyear.** For now, European Banks still seem at risk of further underperformance.

Concluding remarks

Since December, the US Financial sector has stabilized vs the market. It did indeed rebound in December and January, yet, has since lost momentum. Its relative performance seems to follow US Treasury yields (which have been resuming lower) as well as the US 10-3Y yield curve spread (which has flat-lined). Going forward we expect more downside on US Treasury yields, probably into April, perhaps May. The yield curve should also resume its flattening. Hence, US Financials should continue to underperform until then. This is also the case, when we compare US Banks vs the US Real Estate or Insurance segments. In Europe, the downtrend on bank stocks and their persistent relative underperformance seems more durable. For now, we see little chance for them outperforming at least until late Q2, perhaps even the Summer. This is also true vs the European Real Estate and Insurance sectors, which hence offer better alternatives in the Financials space.

43 / The Eurozone slows down rapidly, as Germany's exports and industrial production falter; flexibility on national budget limits necessary to prevent further deterioration

When we last wrote about Europe in the February 2018 issue of the Capital Observer ("*Eurozone will keep growth momentum going in 2018 on weaker EUR/USD, but political risks will become even more elevated*"), things were looking up in the region. We said then:

Last year, European economic growth accelerated after two years of steady but flat recovery, demonstrating once again the institutional resilience of the economic bloc -- consumer and business sentiment surged and the pace of economic growth was relatively unaffected by the political uncertainty that erupted during the year. The outstanding performance was driven primarily by exports, despite a surging currency (*see 1st chart on this page*).

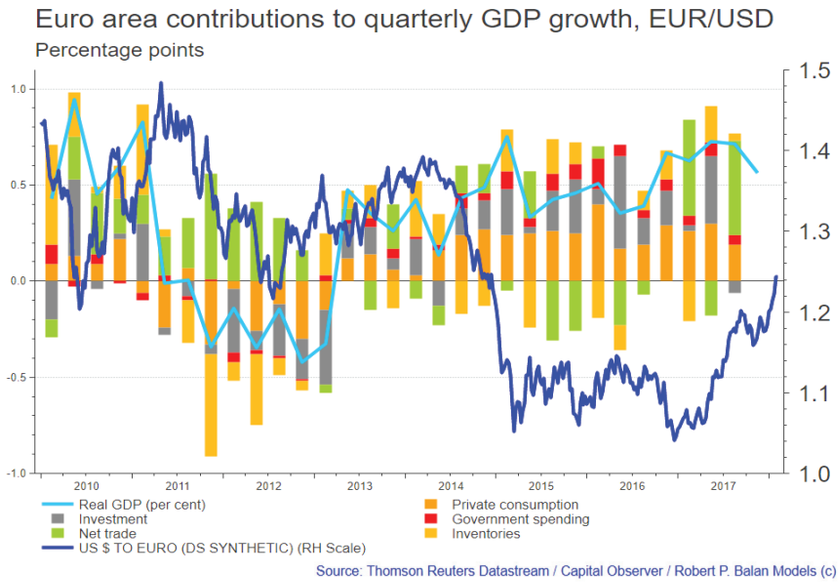
What a difference a year makes! That's was then (*1st chart of this page*) and this is now (*see 2nd chart on this page*).

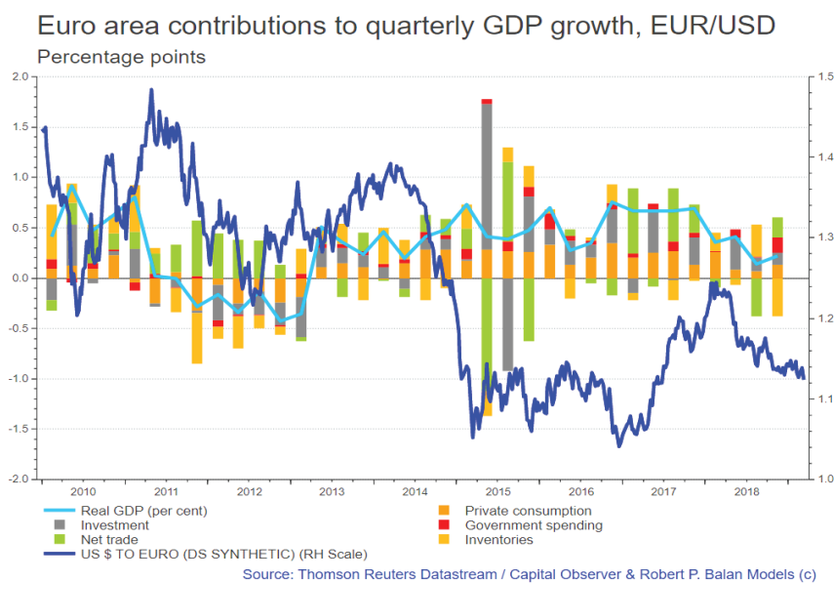
Rising employment, high levels of positive sentiment and a loose monetary policy stance should continue to underpin domestic demand in the entire Eurozone last year. Low inflationary pressures allowed the ECB to maintain its ultra-loose monetary policy stance, while robust global growth supported the exports sector. The ECB's ultra-accommodative monetary policy stance also bore fruit, corporate lending in the bloc hit a post-crisis high in December in Germany (*see 3rd graph on this page*). So the ECB's mission to shunt money to corporates largely succeeding, and is still going strong.

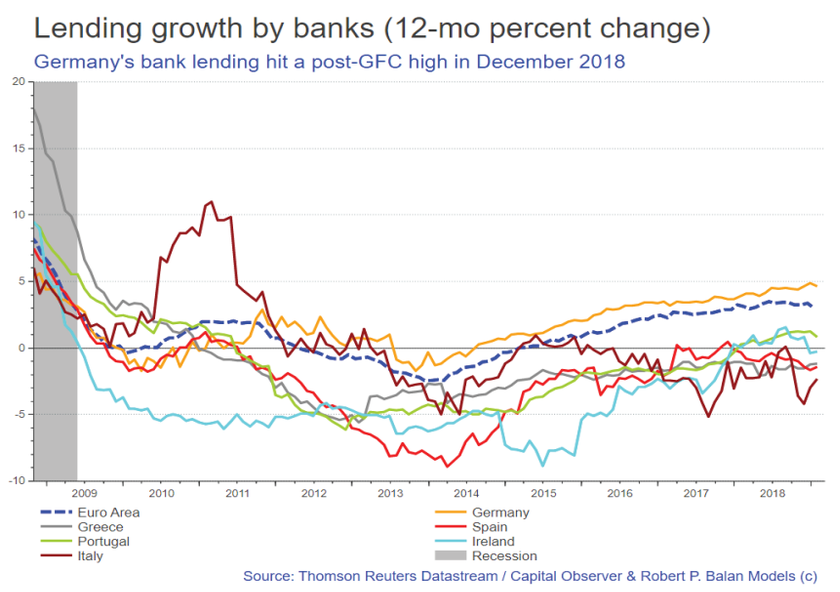
So what went wrong?

Germany has been the workhorse that has pulled the European economy back from the brink time and time again, and pushed bloc-wide growth along despite internal and external pressures, as well as political crises, over the last decade. As the de facto economic and political leader of the bloc, the country has spearheaded and supported rescue

Original chart from the Capital Observer February 2018 issue







plans for the Eurozone's weaker links. However, Germany's economic outlook has turned dark, therefore concerns over potential knock-on effects on the entire monetary union have risen.

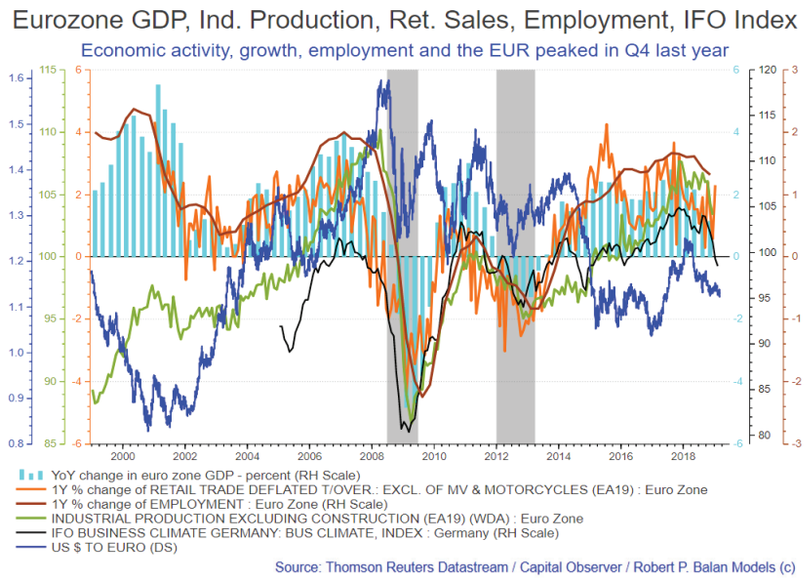
Trade tensions, the threat of a hard Brexit and weaker emerging markets growth have all played a part in dampening Germany's nine-year-long economic upswing. Recently released figures also cast large shadows over Germany's formidable manufacturing sector, with industrial output much lower than expected (*see 1st chart on this page*).

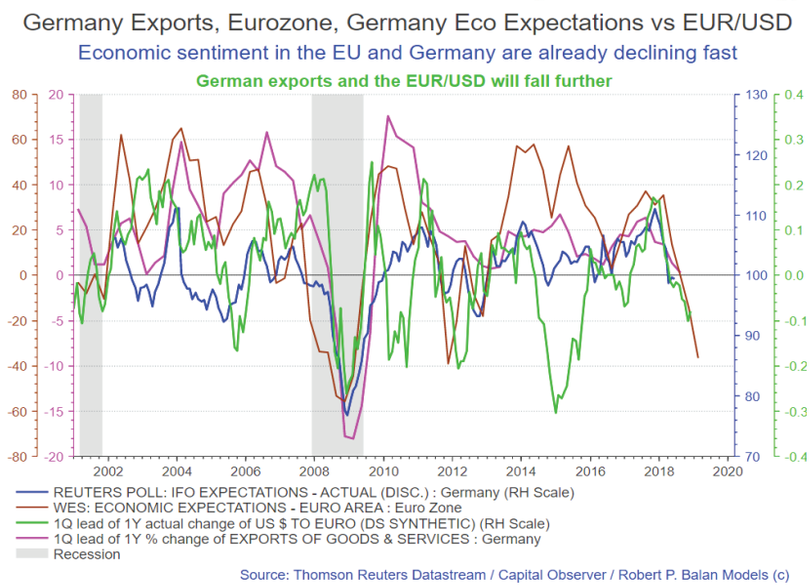
German economy is expected to expand at a rate below 1.5%, an estimate that has been revised lower several times. On top of that, Germany's exports have started to decline at a fast clip, and alongside, general sentiment has deteriorated quickly (see chart below). Industry leaders and investors sentiment is shifting from caution and hesitation to outright pessimism for the near-future. According to a recent survey by the BVMW industry association, 53% of small- and medium-sized companies in Germany believe that the country will slip into a recession next year.

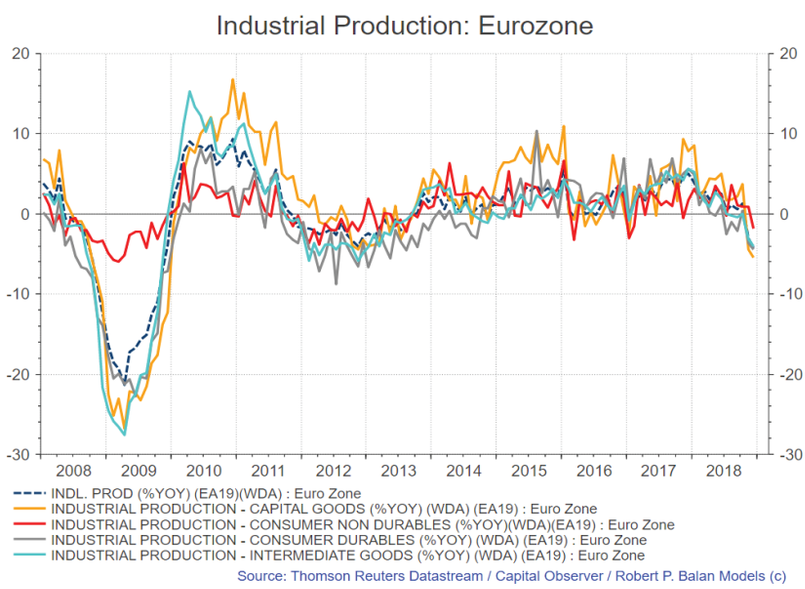
Germany's labor market is one of the key problems. Grave shortage of skilled workers is presenting massive obstacles industrial growth and has been crimping operational efficiency. On average, it takes 100 days for a company to fill a vacancy, with the hardest hit sectors being the tech industry, construction and healthcare.

Other countries are starting to show stress as well. Last week, data from Italy and out of the Netherlands showed that industrial production growth are plunging. France was in the contractionary territory before popping to a reading of 51.2 last month.

The Eurozone as a whole is showing negative industrial production growth at -3.3% year over year, something uncharacteristic of an economy not in recession. The trend across the broad EU composite manufacturing PMI and the major countries is all the same; one of sharp deceleration.





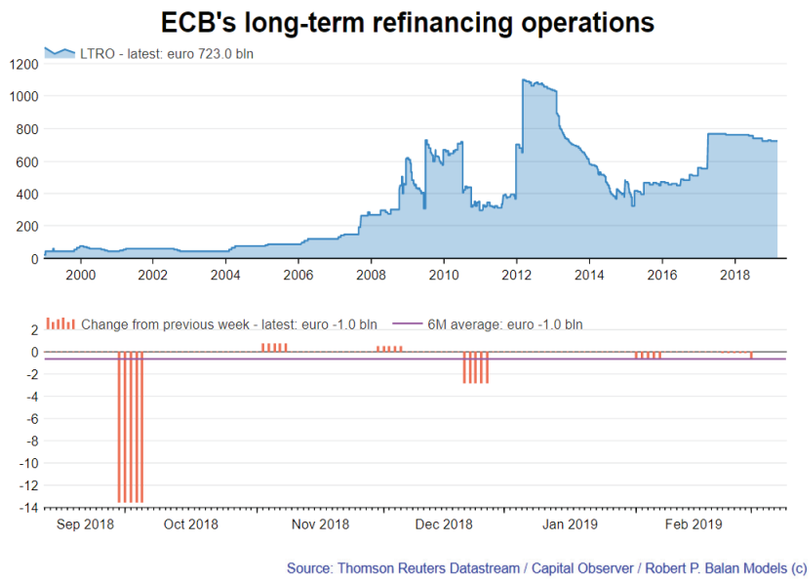


National governments and the European Central bank have taken note of the deteriorating fundamentals. France and Italy are embarking on new fiscal easing. Unfortunately, they already face fiscal sustainability issues due to either persistent deficits or elevated debt levels that are bumping into budget limits that Italy has been trying to exceed, with no success.

For its part, the ECB on Thursday last week postponed interest rate hikes to 2020, lowered its GDP expectations and launched a new round of even cheaper loans to banks in an effort to spark the eurozone economy. The ECB will likely offer another long-term refinancing operation to keep liquidity flowing to banks and the economy. Or they can build into the current programs by tacking in new loanable provisions to existing facilities (*see 1st chart on this page*).

Mr. Draghi did not say how much liquidity is available and at what interest rate; the ECB has kept flexibility to decide later on just how much support it's ready to provide. However, policy makers have pledged to replace expiring funding for euro zone banks with seven new loans lasting two years -- half as long as other so-called TLTRO operations. Analysts said the ECB essentially removed the problem of bank funding for the next couple of years, but the ultimate impact on the banking sector and the real economy will depend on the final TLTRO-III details. The world will know what those details are in September, when the new lending program starts.

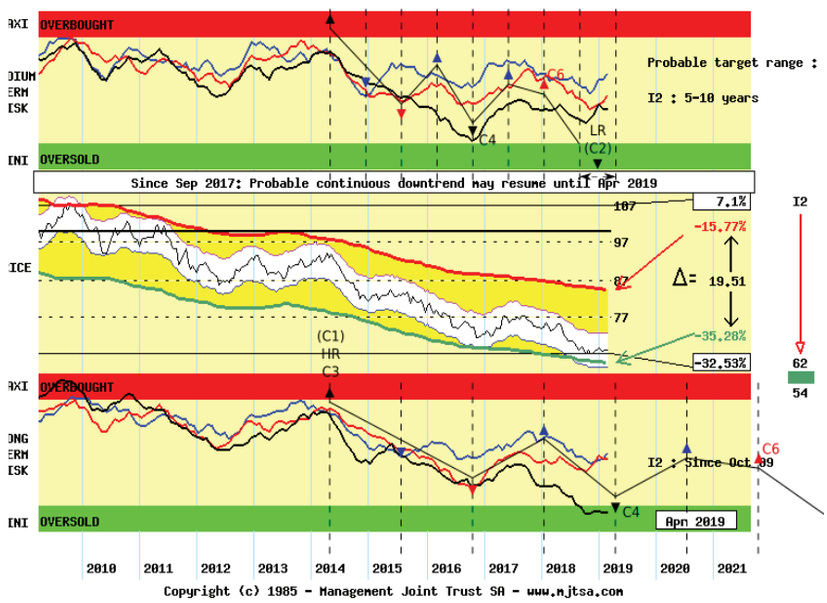
The largest issue Europe faces today is what the governments will do from a fiscal and monetary standpoint in order to stimulate out of a growth slowdown. This becomes crucial because as recent as a quarter ago, the central EUR directorate at Brussels were threatening to bring Italy to heel for setting a national budget that exceeded EU mandatory spending limits. With the weakening outlook in the entire Eurozone, the directorate in Brussels may finally find more application of practicality versus an ideological approach of fits-one, fits-all, all-the-time approach to national fiscal expenditures.



Sustainable European outperformance, probably not until late this year

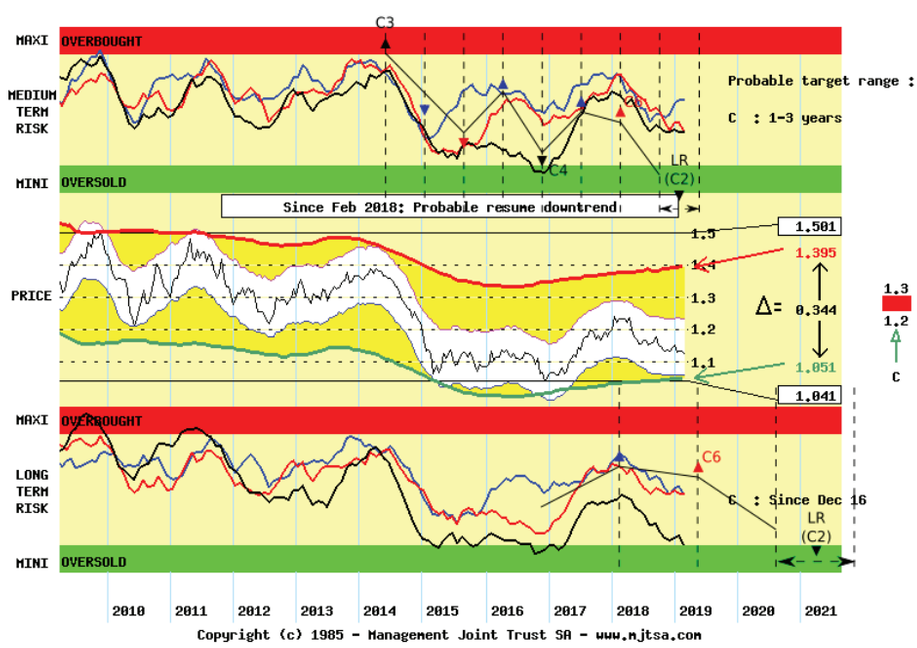
Following years of underperformance, European Equities are now considered better Value that their US, and probably their Asian counterparts. In this article, we review the technical case for Europe while the German economy is slowing, the Brexit process is reaching its climax, Italy's debt problems persist, and ahead on the May European parliamentary elections.

Europe Stoxx 600 Index vs the MSCI World Index
Bi-monthly graph or the perspective over the next 1 to 2 years



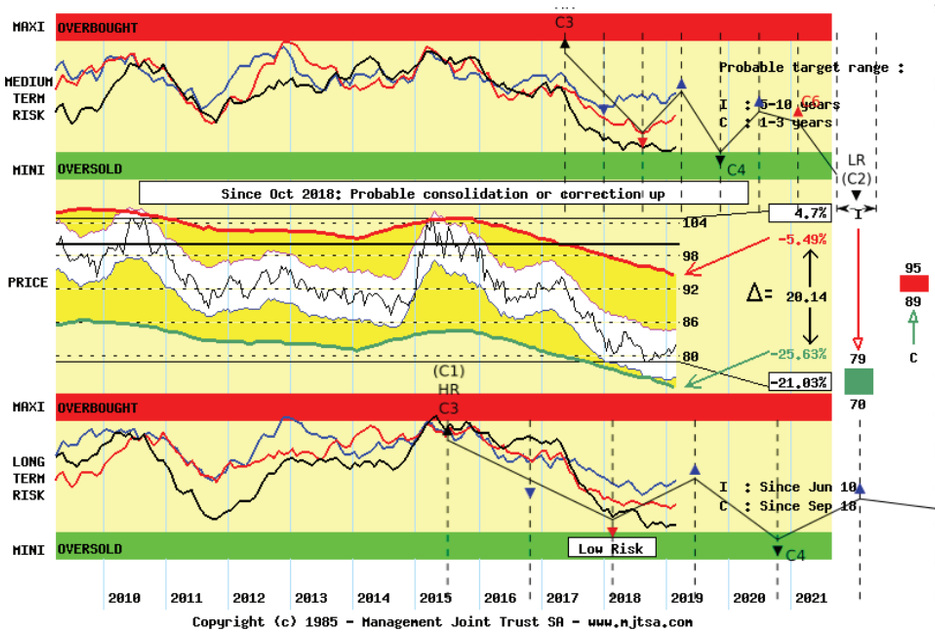
In US Dollar terms, Europe has suffered chronic underperformance over the last 10 years. Brief periods of outperformance can be spotted in 2012 and 2013 as well as in 2017 while the EUR/USD exchange rate was correcting up. On both our oscillator series (lower and upper rectangles), European equities are Oversold vs Global Equities in US Dollar terms. Yet, this is a very long term graph and a formal recovery could still be several quarters away. On the target front, the ratio is now eyeing its I2 Impulsive 2 extended targets (right-hand scale). Although it is fairly rare to fulfill such extended targets, these still point to between 10 and 20% of underperformance risk over the next few quarters. **Bottom line, European equities are indeed Oversold on a relative basis, yet a reversal point cannot be confirmed yet.**

EUR/USD
Bi-monthly graph or the perspective over the next 1 to 2 years



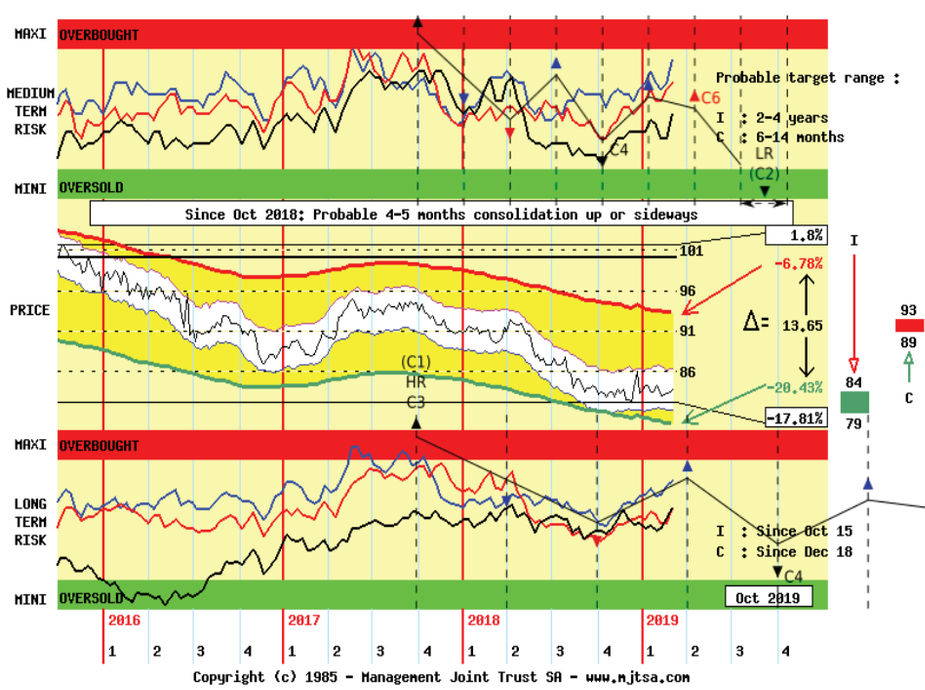
As briefly mentioned above, much of European Equities underperformance (or brief outperformance periods) can be attributed to the secular downtrend (or brief rebounds) of the EUR/USD exchange rate over the last 10 years. On our medium term oscillators (upper rectangle), the pair is looking Oversold. This could lead to a temporary bounce. Yet, our long term oscillators (lower rectangle) suggest that the pair could soon resume lower once again, between Q2 and midyear, probably towards 2020. **Hence, for now we remain long term bullish on the US Dollar, and this should continue to weigh on the performance of European Equities vs Global equities when considered in US Dollars.**

Europe Stoxx 600 Index vs the MSCI World Index (currency hedged)
Bi-monthly graph or the perspective over the next 1 to 2 years



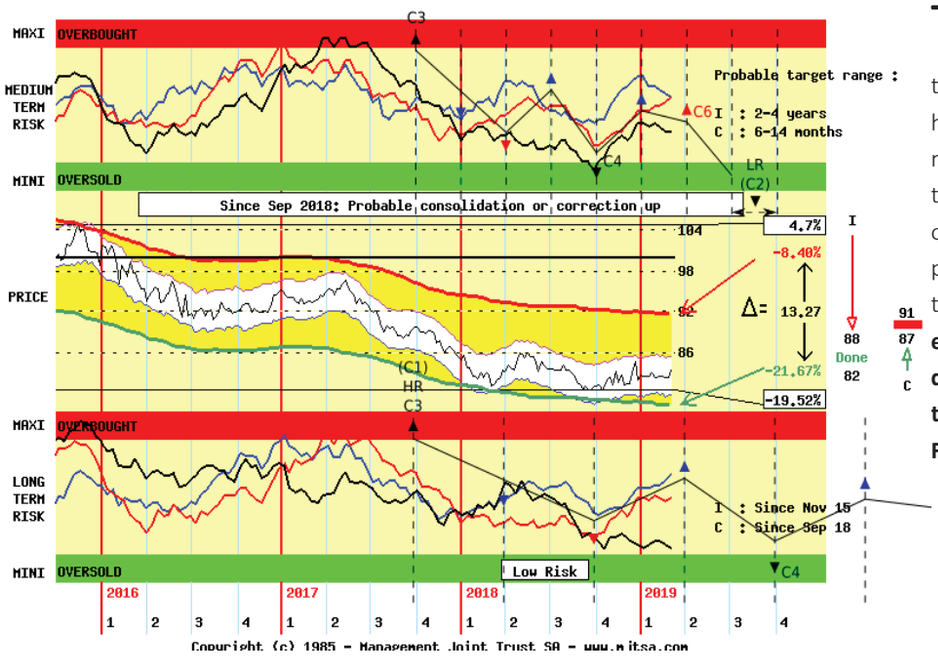
We now consider the ratio of European Equities vs the MSCI World on a hedged currency basis (prices are compared like to like as if the currency position was hedged out). The ratio is also Oversold, which highlights the fact that over the last 10 years, European equities have pretty much fallen in sync with the Euro. Brief periods of outperformance can be identified in 2010 while the EUR/USD exchange rate was selling-off, or late 204/2015, when the ECB introduced its QE program. Otherwise, European equities have generally underperformed along with their currency. Going forward, both oscillator series (lower and upper rectangles) are indeed quite Oversold, yet the sequences seem to extend one leg further to the downside into late 2019/2020. Our I impulsive targets to the downside (right-hand scale) also point to further underperformance risk over the next few quarters. Hence **for now, we do not expect a strong revaluation of European equities, nor in US Dollars, nor in nominal terms, at least until late 2019**.

Europe Stoxx 600 Index vs the MSCI World Index
Weekly graph or the perspective over the next 2 to 4 quarters



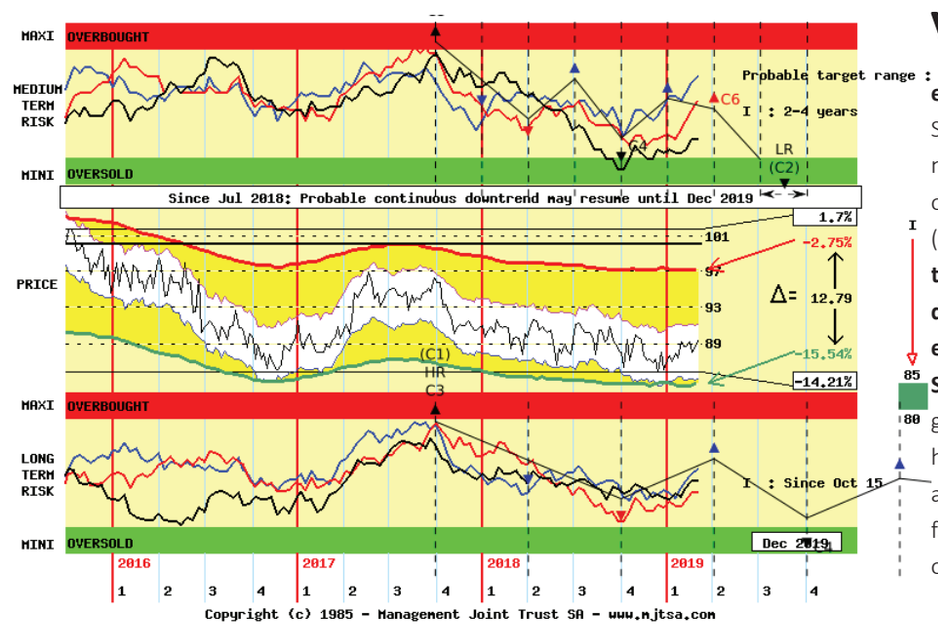
We now turn to the Weekly graphs of the above ratios to confirm this timing. In US Dollar terms, the ratio did bounce slightly late last year. This was probably the consequence of US markets, which recoupled to the downside, as well as the EUR/USD exchange rate, which from November managed to hold ground vs the US Dollar. According to both our oscillator series (lower and upper rectangles), **this weak rebound should be coming to an end towards early Q2 this year. The ratio should then resume lower towards late Summer, the Fall. This underperformance going forward could be the result of a stronger US Dollar, or of weaker European markets, perhaps both as was the case last year**. Our I impulsive target to the downside still suggest some remaining downside risk over the next few quarters (right-hand scale).

Europe Stoxx 600 Index vs the MSCI World Index (currency hedged)
Weekly graph or the perspective over the next 2 to 4 quarters



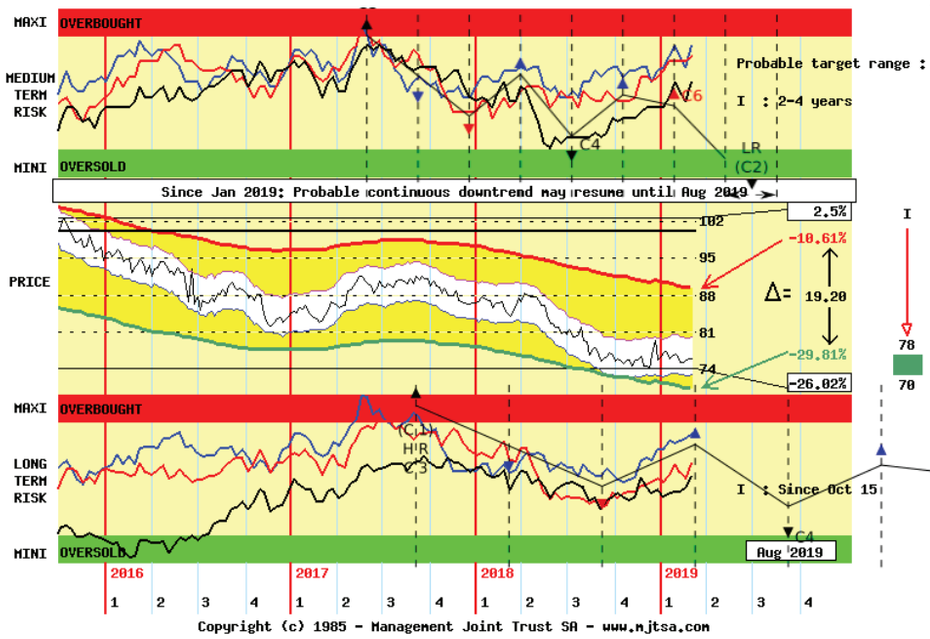
The nominal comparison between European equities and the MSCI World (on a hedged currency basis) does not improve the picture substantially. Here also, both our oscillator series (lower and upper rectangles) are suggesting that **by early Q2, European equities should resume their downtrend, in nominal terms, towards late Summer / the Fall vs the MSCI World.**

Europe Stoxx 600 Index vs the Stoxx 600 Asia/Pacific Index
Weekly graph or the perspective over the next 2 to 4 quarters



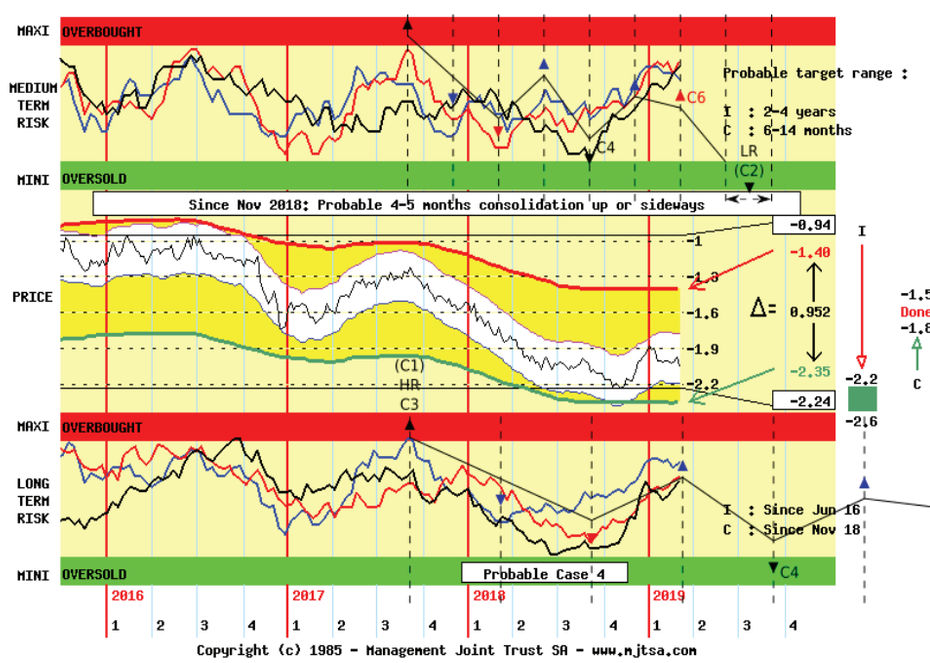
Vs specific regions, such as Asia/Pacific, European equities also seem quite weak. Since October, they have managed to rebound slightly. Yet, on both our oscillator series (lower and upper rectangles), **they should now resume their downtrend, probably from end Q1 into midyear and the Summer**. Our I impulsive targets to the downside (right-hand scale) suggest between 5 and 10% of further underperformance in US Dollar terms over the next few quarters.

Europe Stoxx 600 Index vs the S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



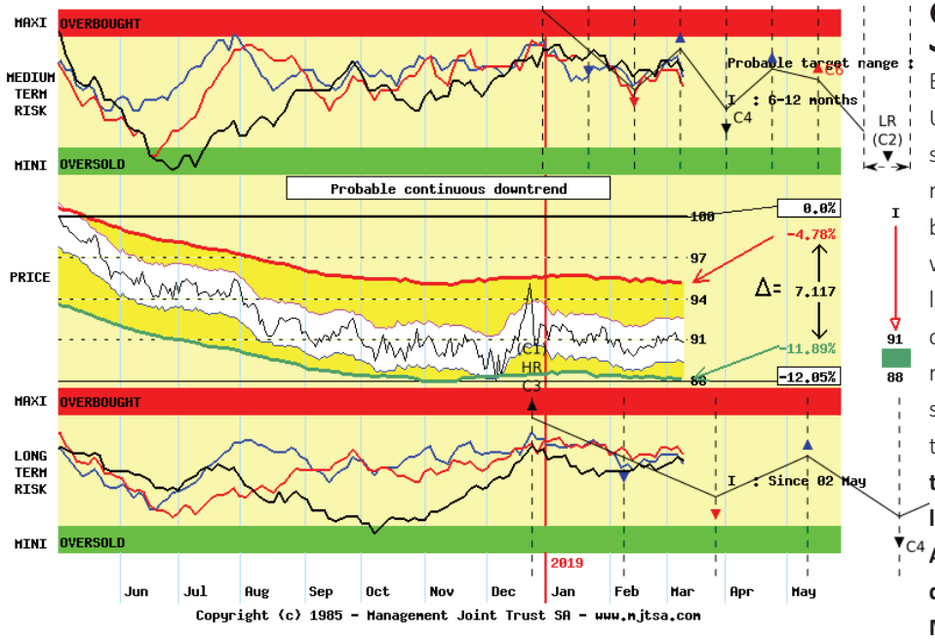
Vs the S&P500, European equities show a similar profile. **Following their weak bounce since late last year, we expect them to resume lower soon in US Dollar terms vs US markets, probably into the Summer**. Our I impulsive targets to the downside suggest 5 to 7% of remaining underperformance potential until then. Over the last few years, European markets have proven to be quite counter-cyclical vs US markets. **Our late Summer timing for a relative low of Europe vs US may correspond to the beginning of the next important leg down we expect on global equity markets, probably from Q4 into 2020. Until then, the US growth trend, along with stronger US markets and a stronger US Dollar, is likely to continue.**

10Y EUR – USD Interest Swap rate Spread
Weekly graph or the perspective over the next 2 to 4 quarters



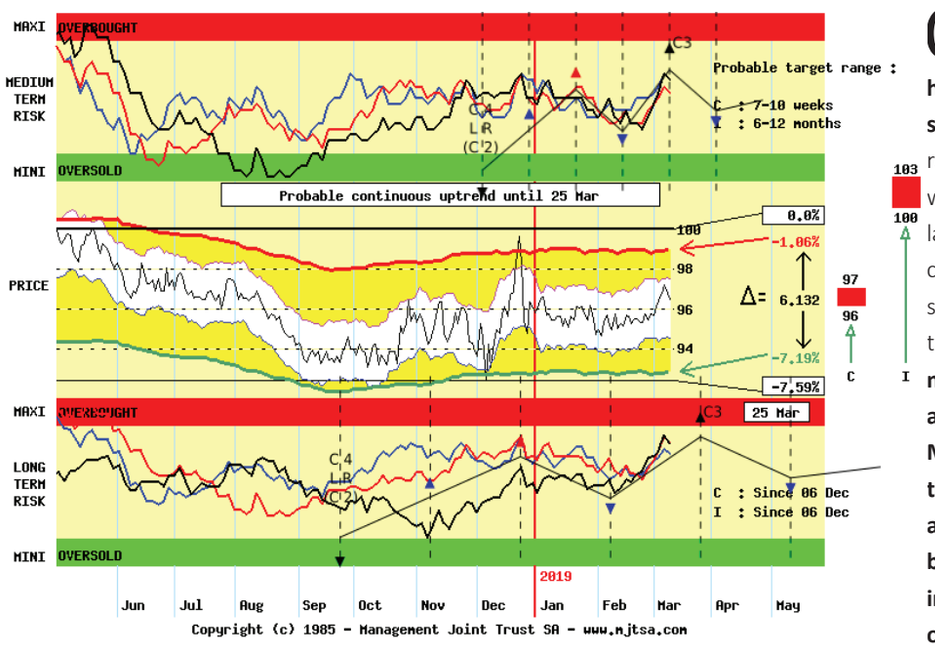
Indeed, this profile also matches the interest rate differential between the EuroZone and the US. It follows differences in growth rates, inflation expectations and interest rates policies. **Over the last few years, due to its marginal growth rates and interest rates advantage, the US has been sucking up liquidity from the rest of the world, and Europe especially. Over the next few quarters, into late Summer, we expect this situation to continue** as shown on both our oscillator series (lower and upper rectangles). Indeed, the EuroZone to US interest rates differential should continue to fall until then.

Europe Stoxx 600 Index vs the MSCI World Index
Daily graph or the perspective over the next 2 to 3 months



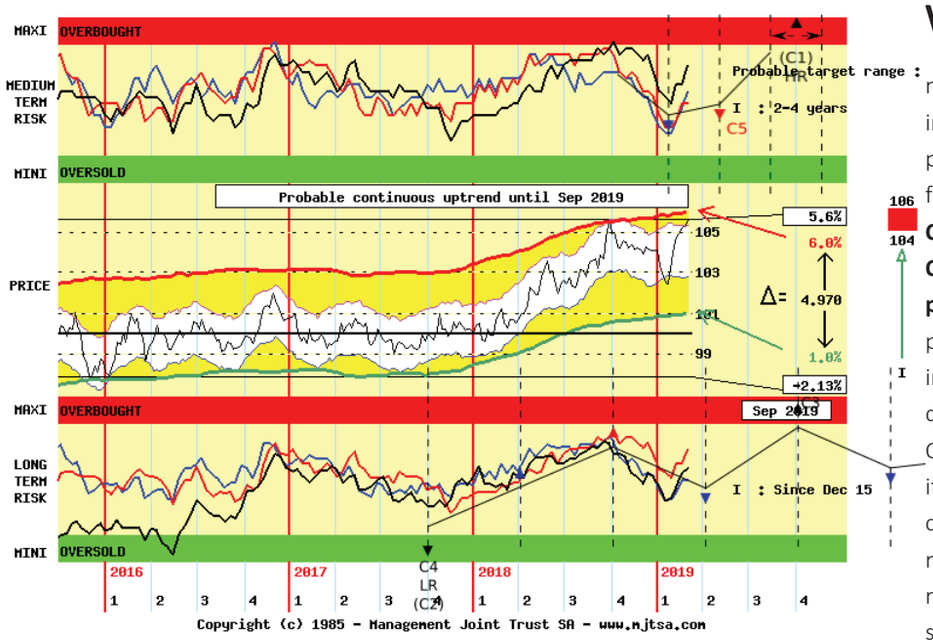
Shorter term, on the Daily graph, the ratio between Europe and the MSCI World in US Dollar terms has stabilized since Q4. In fact, it appears rather defensive and did rebound strongly in December, while US markets were selling-off. It has since consolidated lower with the risk assets rebound. Both our oscillator series (lower and upper rectangles) suggest that **the ratio may find an intermediate low towards late March/early April, and could then rebound during April, perhaps into May. This may correspond to a new period of risk asset correction we expect during this period, as well as a potential rebound in the EUR/USD exchange rate. Following that, it resumes lower towards midyear and the Summer.**

Europe Stoxx 600 Index vs the MSCI World Index (currency hedged)
Daily graph or the perspective over the next 2 to 3 months



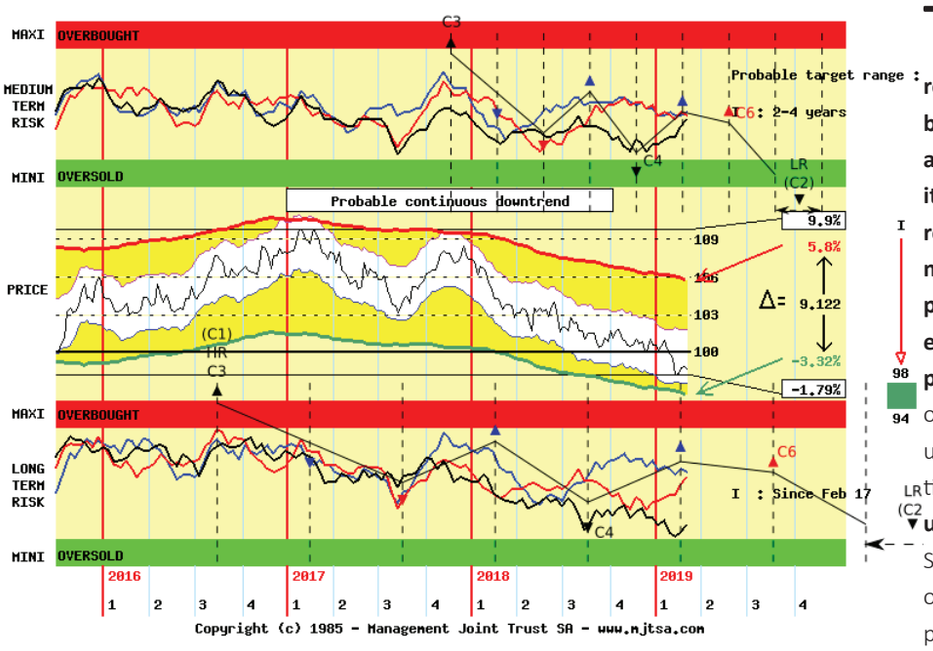
On a hedged currency basis, the Europe to US ratio **has been, and is still, slightly stronger.** This is probably the result of the US Dollar strength we saw last October or since late January this year. Yet, according to both our oscillator series (lower and upper rectangles), **this slight outperformance should be coming to an end between now and late March. European markets may then start to move sideways, at best, in nominal terms, probably during April and perhaps into May. Hence, the potential outperformance we expect above for European markets vs US ones in US Dollar terms during April will probably result from a rebound in EUR/USD, rather than a strong nominal outperformance of European equities vs US ones.**

CAC 40 Index vs the EuroStoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



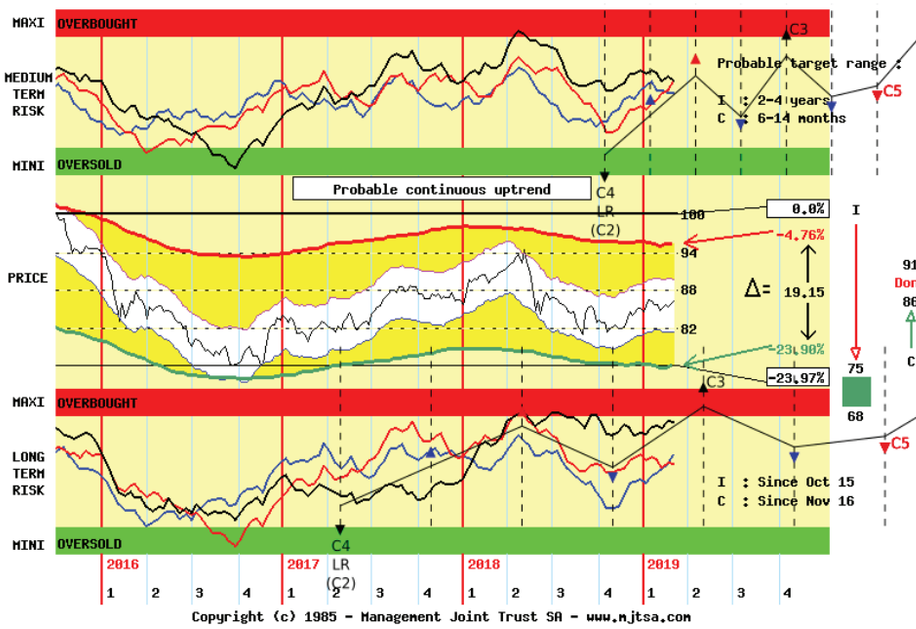
We now look intra Europe and consider its various markets vs their reference indexes to understand their performance profiles going forward. **We first compare the CAC 40 vs the EuroStoxx600. Over the last 3 years, it appears rather reflationary** with periods of outperformance in 2016 and during the first 3 quarters of 2018. Between last October and January, however, it underperformed as markets corrected, and then re-accelerated up as the rebound gathered steam. Both our oscillator series (lower and upper rectangles) are now suggesting that **it could retrace down again vs the EuroStoxx 600 into early/mid Q2 (short risk-off period ?), before it resumes higher into the Summer**. According to our I impulsive targets to the upside (right-hand scale), its outperformance potential over the next few quarters is however limited.

DAX Kurs Index vs the EuroStoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



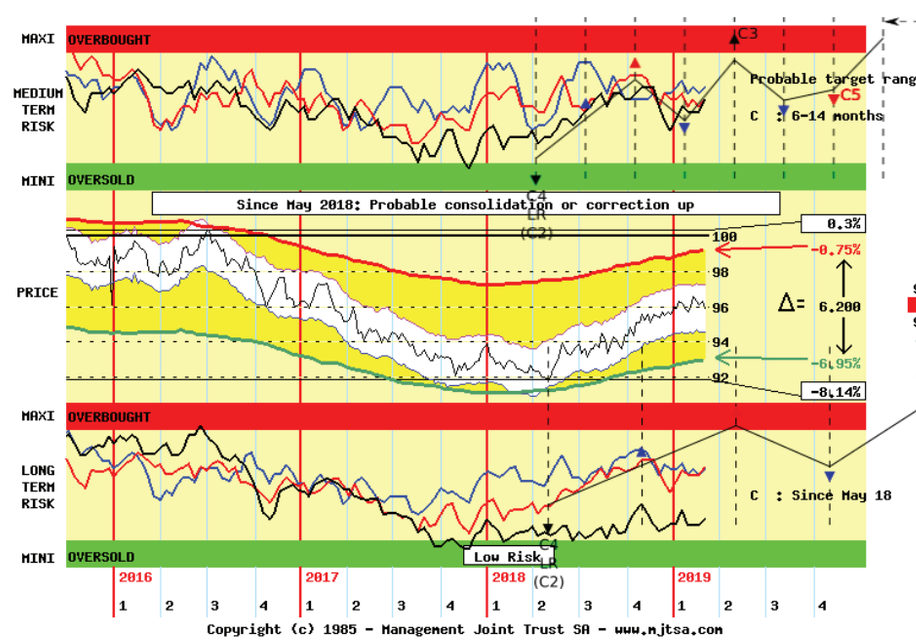
The Dax used to be the high beta market of Europe. This profile was probably still valid during 2016 and 2017, yet since late 2017, it has underperform the EuroStoxx 600 very linearly. This may highlight more structural problems with the German economy and its listed companies. For now, indeed, both our oscillator series (lower and upper rectangles) are suggesting **that the downtrend is still underway,** probably into late Summer on our medium term oscillators (upper rectangle), perhaps even into 2020 on our long term ones (lower rectangle). Our I Impulsive targets to the downside (right-hand scale) suggest further downside potential until then (circa 5%).

FTSE MIB vs the EuroStoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



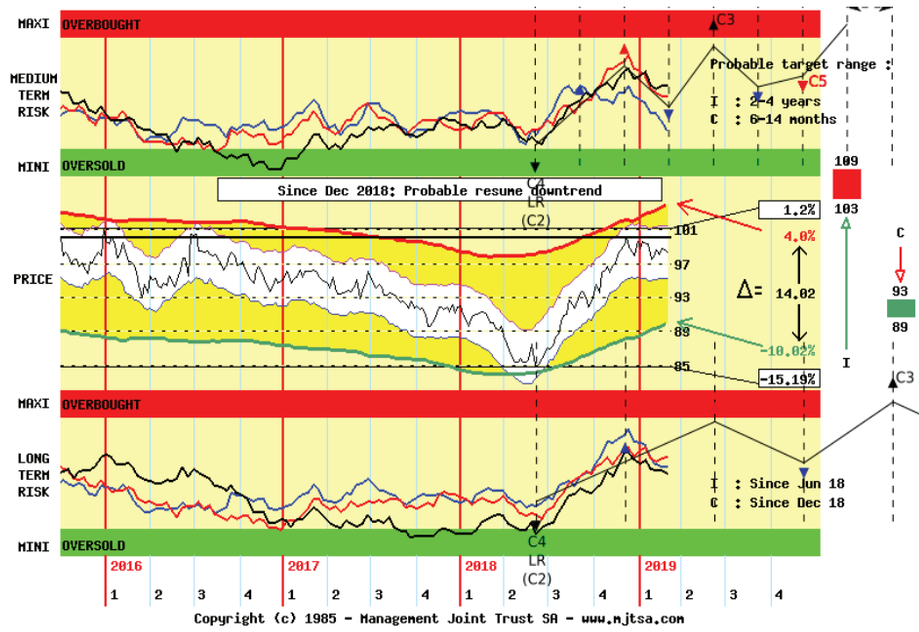
The graph of Italy's FTSE MIB vs the EuroStoxx 600 is more challenging to read. It suffered a strong sell-off during last year's Italian political crisis and has since recovered. While our medium term oscillators (upper rectangle) may have started a new uptrend, our long term ones (lower rectangle) may be just retesting up, before a new move down materializes into the Summer. Both sequences, however, would imply that **a top is approaching, probably towards early/mid Q2, and that a period of underperformance may follow towards midyear, at least. This period of doubt may correspond to the run-up and aftermath of the European parliamentary election towards the end of May.**

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



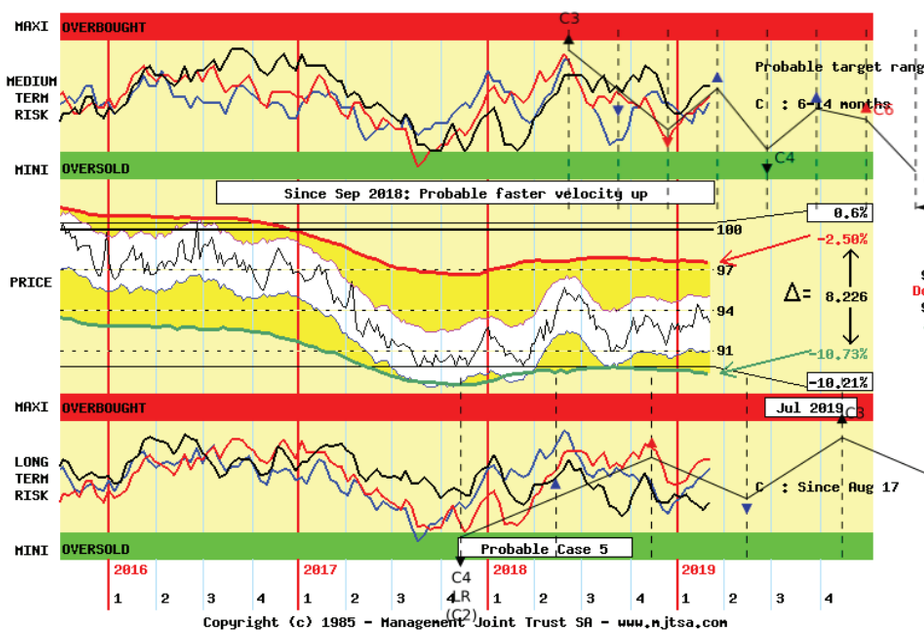
We now compare the broader Europe Stoxx 600 Index vs the EuroStoxx 600 Index. Apart from the UK, the additional countries included in the Europe Stoxx 600 Index are rather defensive (large allocations to Switzerland, Denmark or Sweden). This can bee seen in their relative profile, where **the Europe Stoxx 600 has outperformed the EuroStoxx 600 since Spring last year. It is indeed very similar to the performance of defensive sectors vs the market**. Both our oscillator series (lower and upper rectangles) are now suggesting that **this outperformance could continue slightly longer into early/mid Q2, and then start to retrace into the Summer. This correspond to our more general view on equity markets, where inversely we expect some correction down into early/mid Q2 and then a last rally into the Summer.**

Swiss Market Index vs the Europe Stoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



Taking this comparison slightly further, **we compare the Swiss Market Index and its very defensive mix of sectors vs the EuroStoxx 600** (in EUR terms). It has also been outperforming strongly since Spring last year. Both our oscillator series (lower and upper rectangles) suggest that, following some retracement since late last year, **the ratio should now resume higher again into mid/late Q2. Following that, it retraces down into late Summer / the Fall, before it resumes up again into 2020. Again, although slightly more defensive, this corresponds to the inverse scenario we expect more generally on equities.**

FTSE 100 vs the Europe Stoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



We conclude this comparative study with the ratio of the FTSE100 vs the EuroStoxx600 (in EUR terms). **Following the initial Brexit vote in mid 2016, it basically fell until late 2017 as both the FTSE vs the EuroStoxx600 ratio (hedged for currency risk), and the GBP/EUR exchange rate declined**. This is probably when the initial downside revaluation of the UK vs Europe actually happened. Since then the ratio has been bouncing in EUR terms. According to both our oscillator series (lower and upper rectangles), **a new period of underperformance may lie ahead (further acute Brexit uncertainty), probably towards mid/late Q2. Following that, the ratio could bounce into late Summer / the Fall.**

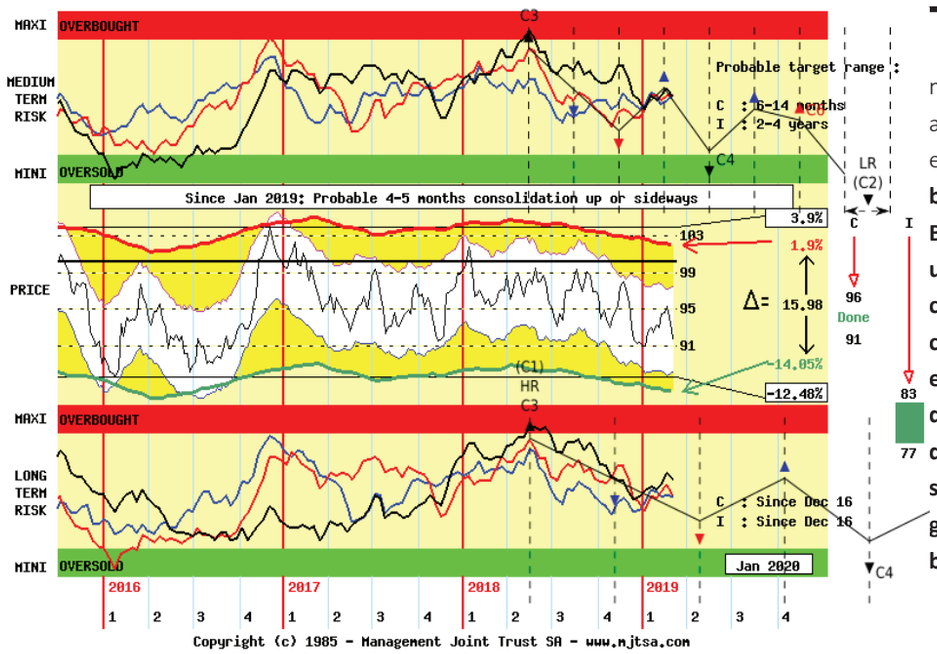
Concluding remarks:

Over the last 10 years, Europe has suffered secular underperformance vs Global equity markets. This trend was partly due to a declining EUR/USD exchange rate, but also to the underperformance of European markets in nominal terms (i.e. when hedged for currency movements). The trend now seems Oversold on our long term bi-monthly graphs. Yet, it may take a few more quarters to start reversing up. Our timing suggests that it could start to happen from late Summer, and that it may coincide with the end of the rally up we expect on global equities into the Summer. Indeed, over the last 10 years, Europe does appear rather counter-cyclical in relative terms, and may well outperfom (decline less), when other markets start to resume lower. Shorter term, we expect European markets to bounce vs Global markets in US Dollar terms during April, as the EUR/USD is also expected to correct up. Hedged for currency risk, Europe may on the contrary underperform again due to the stronger Euro.Intra Europe, we would see the CAC40 as being rather pro-cyclical, while the DAX appears stuck in a secular downtrend vs the EuroStoxx 600. Switzerland on the other hand is clearly defensive, while Italy and the UK may underperform during Q2 due to political issues.

54 / Splicing the markets – A short term battle between Growth and Cyclicals, yet Defensives should get the final word

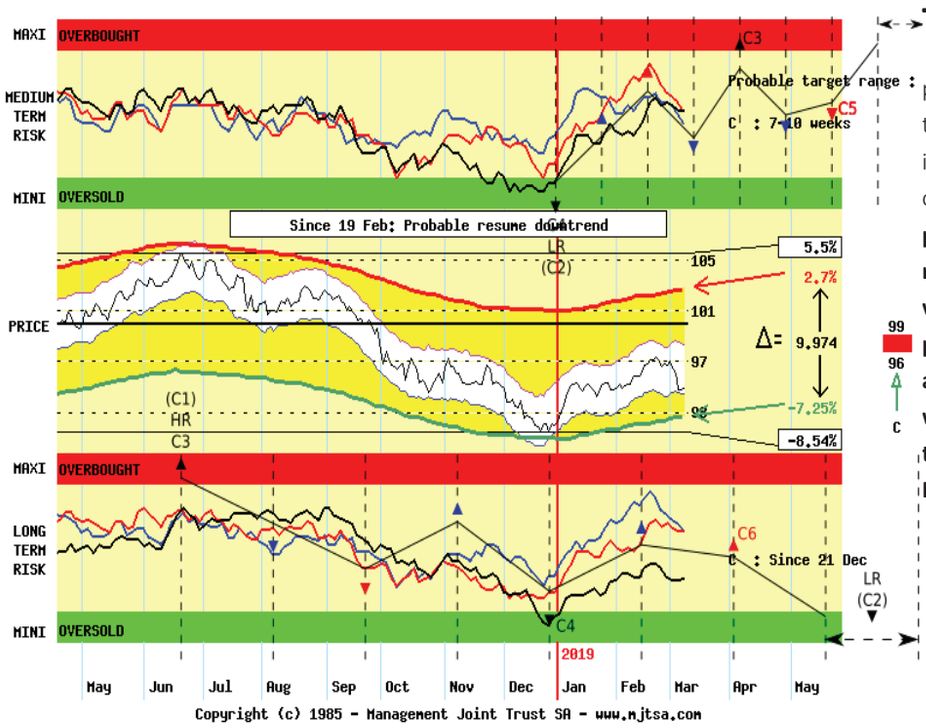
The rally since December may have lost momentum, yet it is proving extraordinary resilient. Some would argue that the Nasdaq just made new highs and that the S&P500 hasn't seen more than a 3% correction since the rebound started in December, others that the Dow Jones Industrial Index and the Russell 2000 have already started to retrace, that they peaked 2 ½ weeks ago, and that the S&P500 is just retesting up towards the low 2'800s for the 3rd time, before following them to the downside. The next couple of months may prove to be an interesting battle, probably between growth resilience (which has been strong in recent days), and cyclicals (which may bounce short term). Yet, we believe defensive sectors may have the final word.

IYT - iShares Dow Jones Transportation Average ETF vs the S&P 500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



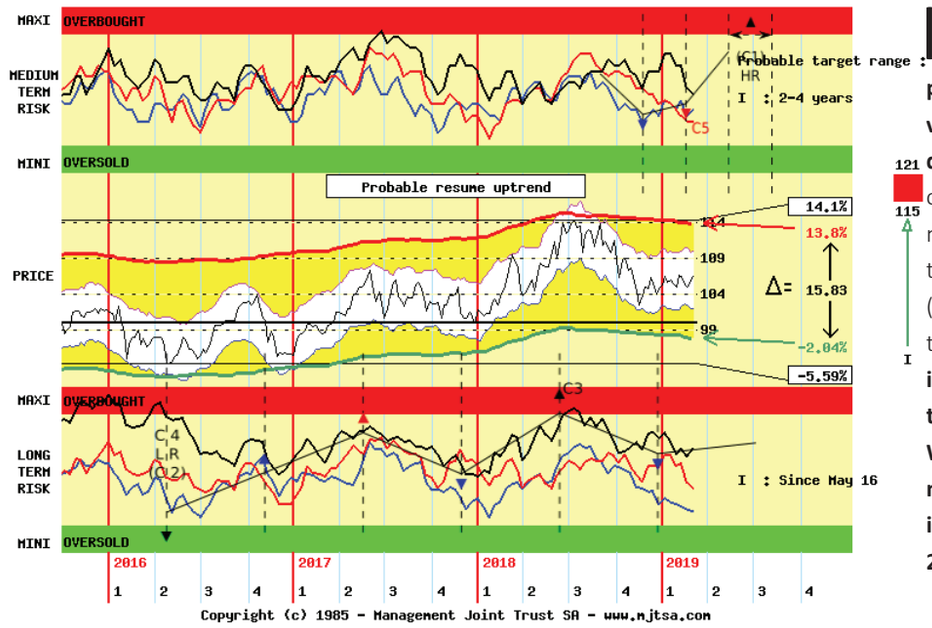
Transports is a typical cyclical sector. Over the last 3 years, it outperformed during every cyclical acceleration and underperformed during Growth extension. **Since early last year, it has been heading lower vs the S&P500. Both our oscillators series (lower and upper rectangles) now suggest that it could continue to do so over the next couple of months. Following that, we expect the ratio to find support towards mid Q2, and then start to bounce during the Summer. Hence, Cyclical sectors will probably remain week longer than we had initially expected, probably into mid Q2.**

Russell 2000 Index vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



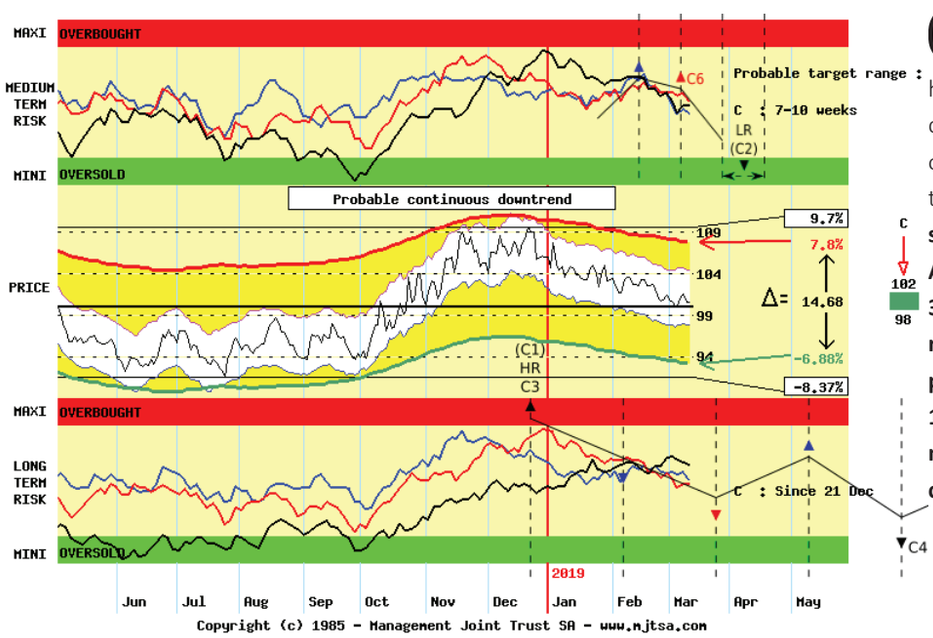
The Small Caps Russell 2000 index is also cyclical especially when compared to the S&P500. On both oscillator series (lower and upper rectangles), its pattern vs the S&P500 seems quite clear. **Shorter term, it may bounce (upper rectangle), or at least hold (lower rectangle) until late March/early April vs the S&P500. Following that, we expect it to underperform during April and probably into May. Here also, we would expect hence cyclical sectors to weaken again from early April into May.**

Nasdaq 100 Index vs Dow Jones Industrial Average
Weekly graph or the perspective over the next 2 to 4 quarters



In the meantime, Growth sectors could outperform. This ratio compares the Growth laden Nasdaq 100 vs the more cyclical Dow Jones Industrial Average. Following a deep correction in H2 last year, the ratio may have recently repositioned to the upside. Both our oscillator series (lower and upper rectangles) suggest that **it could now accelerate up again into mid Q2 at least on our medium term oscillators (upper rectangle). Will this growth outperformance manage to hold the market up, as it did in Q3 2016, H1 2017 and Q2 2018?**

US Defensive sectors vs the Nasdaq 100 Index
Daily graph or the perspective over the next 2 to 3 months



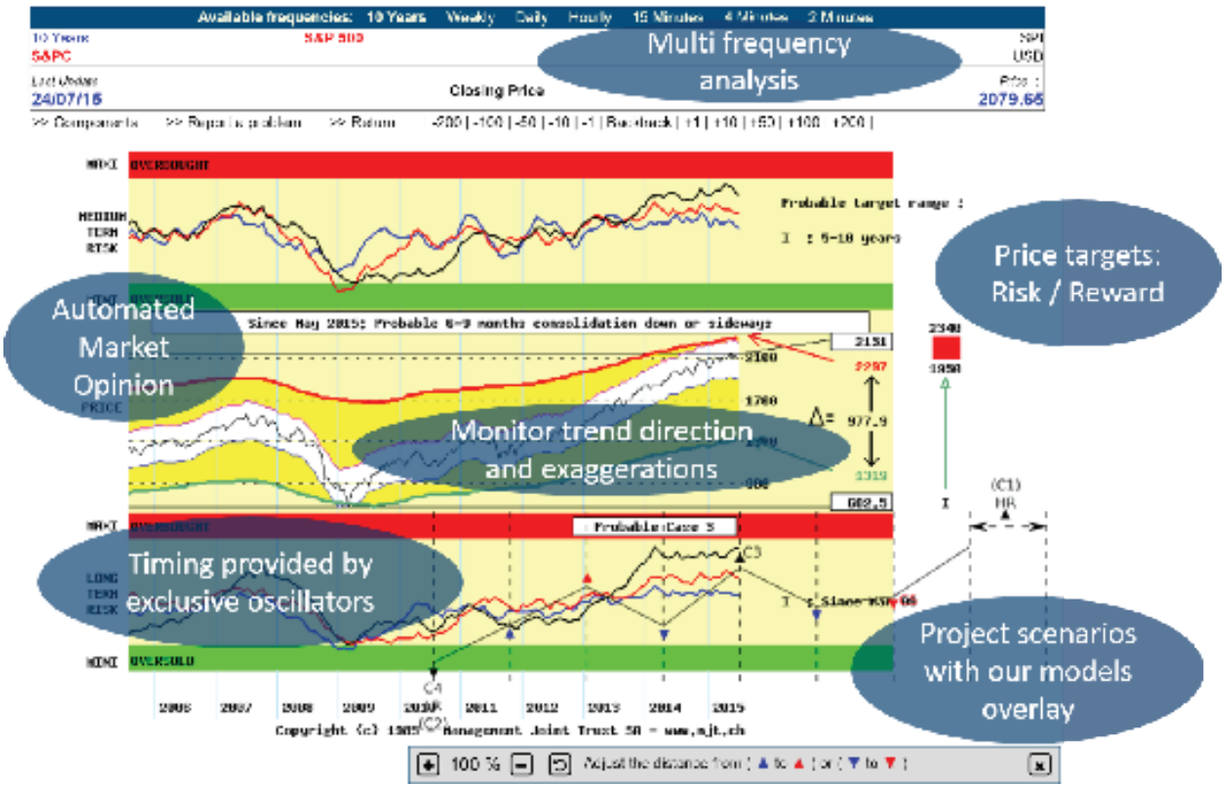
Our Equal US Defensive sector portfolio (XLP, XLV, XLU, IYR, XTC) has been underperforming the Nasdaq 100 since December. On both our oscillator series (lower and upper rectangles), **we expect the ratio to find support towards late March/early April. It could then bounce between 3 to 6 weeks towards mid April, perhaps early May. This defensive outperformance, even vs the Nasdaq 100, suggests a defensive environment and may confirm the risk asset correction we expect during April.**

Concluding remarks:

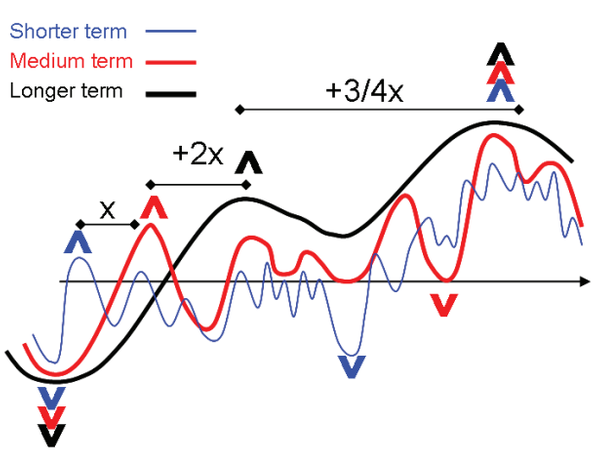
In recent days, the Nasdaq 100 and Growth sectors have proven extraordinarily resilient, while more cyclical portions of the market have started to correct. Over the next week or so, both growth sectors and cyclicals may retrace or retest down. The second half of March could then see a brief cyclical bounce. Growth may then make new highs, while cyclicals catch up some of their recent underperformance. From late March / early April, both should start to correct down. Growth profiles could hold up rather well, while Cyclicals may sell-off. It is Defensive sectors, however, that should outperform both, probably from late March into late April/early May, thereby confirming the risk asset correction we expect during this period.

56/ METHODOLOGY

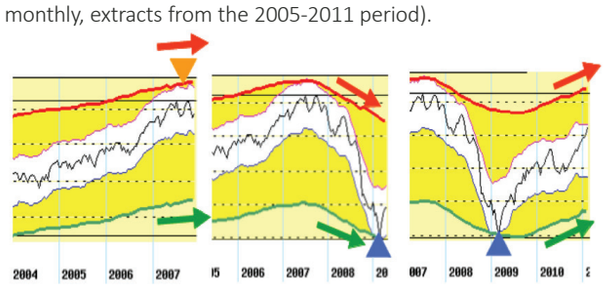
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



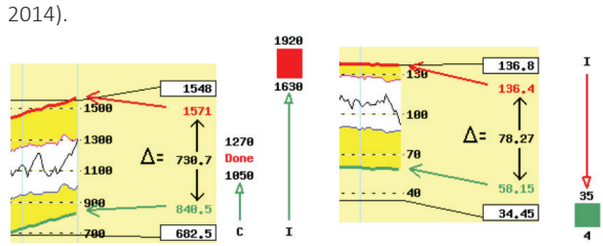
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)



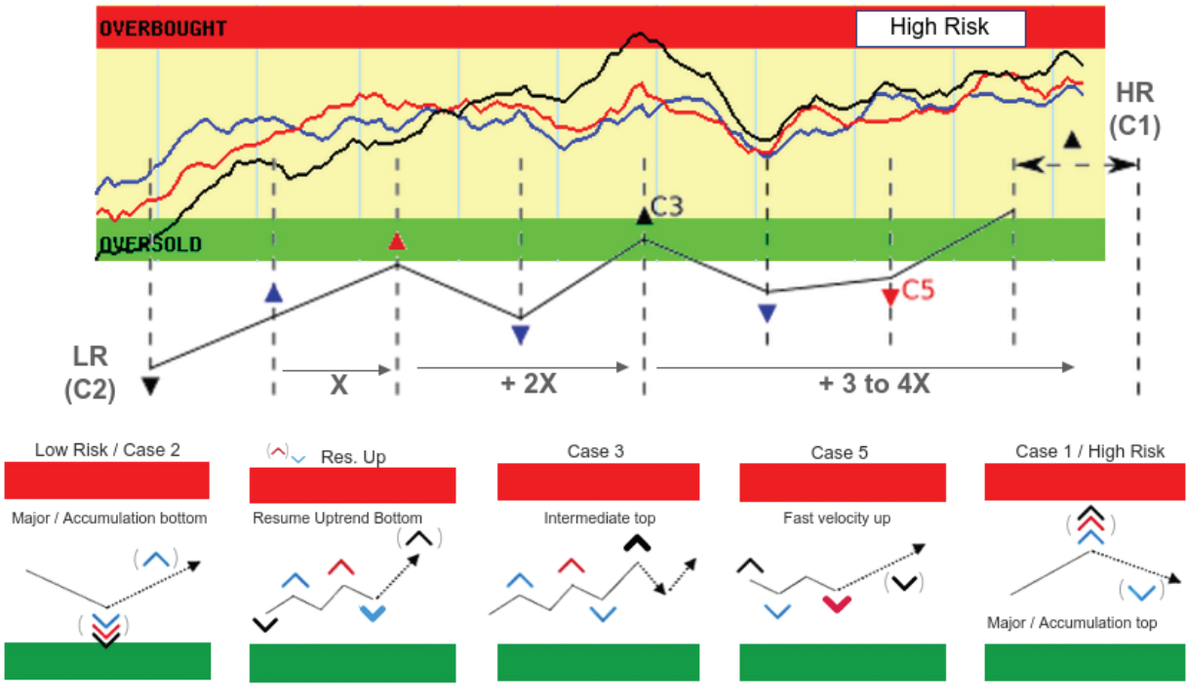
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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).

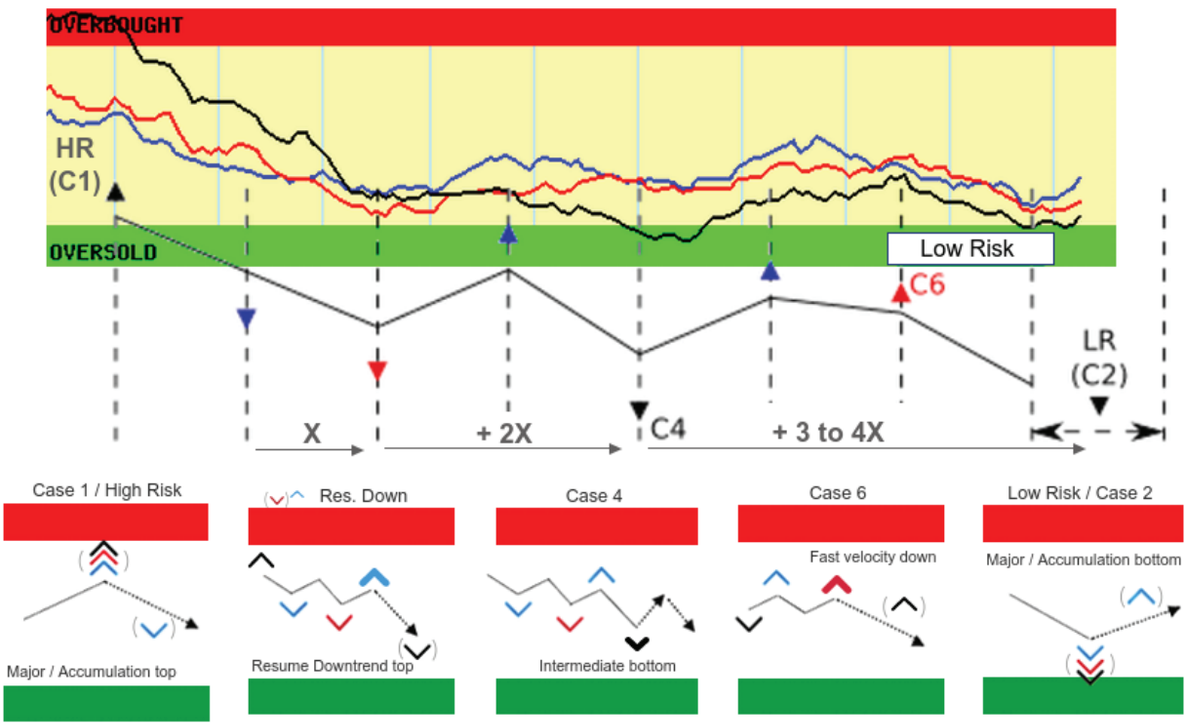


Ideal Uptrend Model



(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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