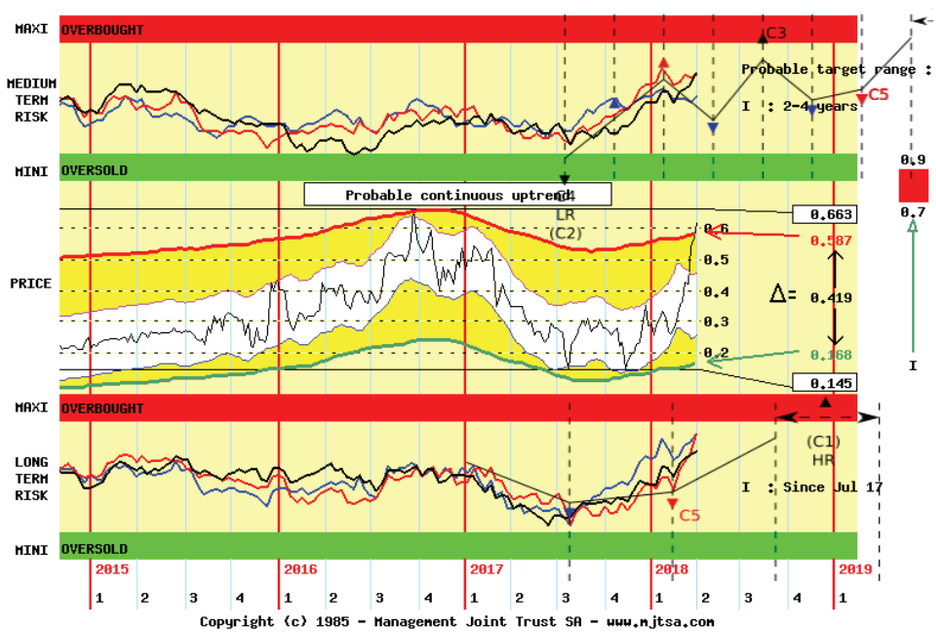
29 / MJT - TIMING AND TACTICAL INSIGHT

Is the widening of LIBOR-OIS spread already affecting the pricing of Banks and of listed Credit instruments?

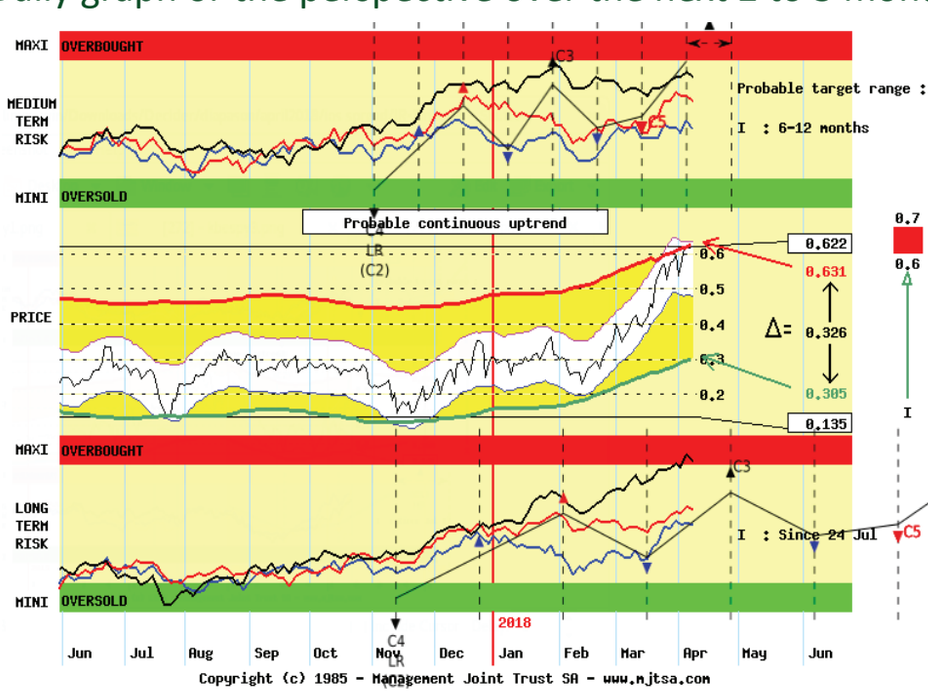
Since November, the Libor-OIS spread has shot up drastically. Such a move has been unseen since the 2007 – 2008 financial crisis, and it does raise some concern about the tightening conditions in the interbank lending market. Although, much of this move can be explained by regulatory and/or fiscal structural changes, its impact on bank financing costs and more generally on credit markets is bound to affect pricing, especially if the spread widening trend persists. In this article, we will review the relative strength of bank stocks vs their index, as well as a selection of listed credit instruments in order to spot any deterioration in their recent uptrends.

USD 3 Months LIBOR fixing – US 3 Months Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



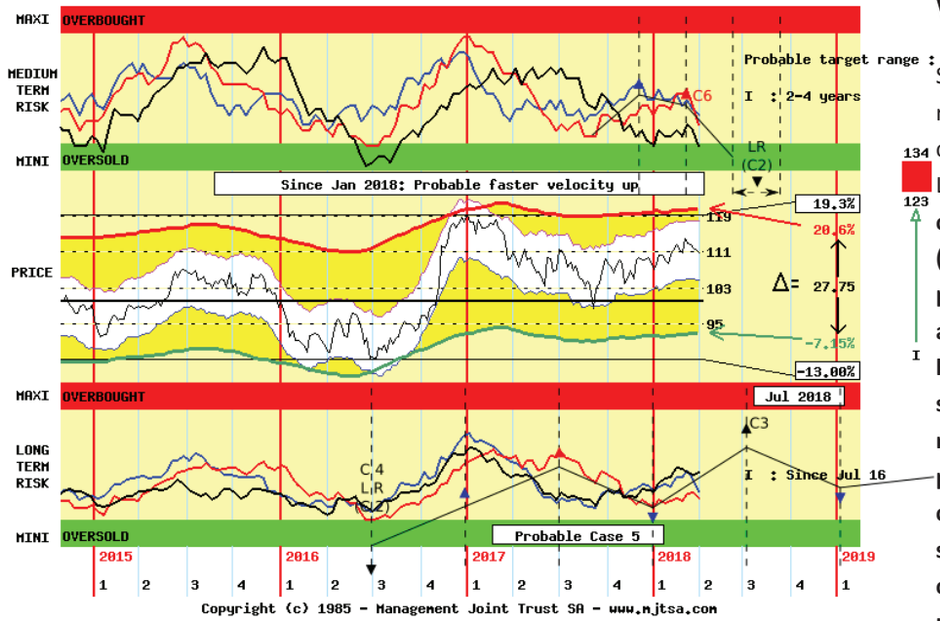
As a proxy for the LIBOR-OIS, we will be using the LIBOR-US3M Treasury spread. Although, it may be slightly more volatile, it shows similar dynamics as it also captures the credit element embedded in the LIBOR-OIS spread. The spread bottomed out last Summer and retested down in November, it has since been moving up rapidly. On our long term oscillators (lower rectangle) we believe that the spread recently broke-out from a base (H2 2017) and that it now has the potential to accelerate up towards late 2018 / early 2019. On our medium term oscillators (upper rectangle), the spread is now also in an uptrend. Its progression probably continues towards the Summer, then into 2019. Hence, **from what we can monitor from the LIBOR-US3M Treasury yield spread, the LIBOR-OIS spread could continue to trend up over the next 12 months.** Given the parabolic features of the recent price action (and the rather short price history featured here), it is difficult to set precise targets to the upside for this move. That said, our I Impulsive targets would suggest initial resistance somewhere between 0.7 and 0.9% (right-hand scale).

USD 3 Months LIBOR fixing – US 3 Months Benchmark Bond Yield
Daily graph or the perspective over the next 2 to 3 months



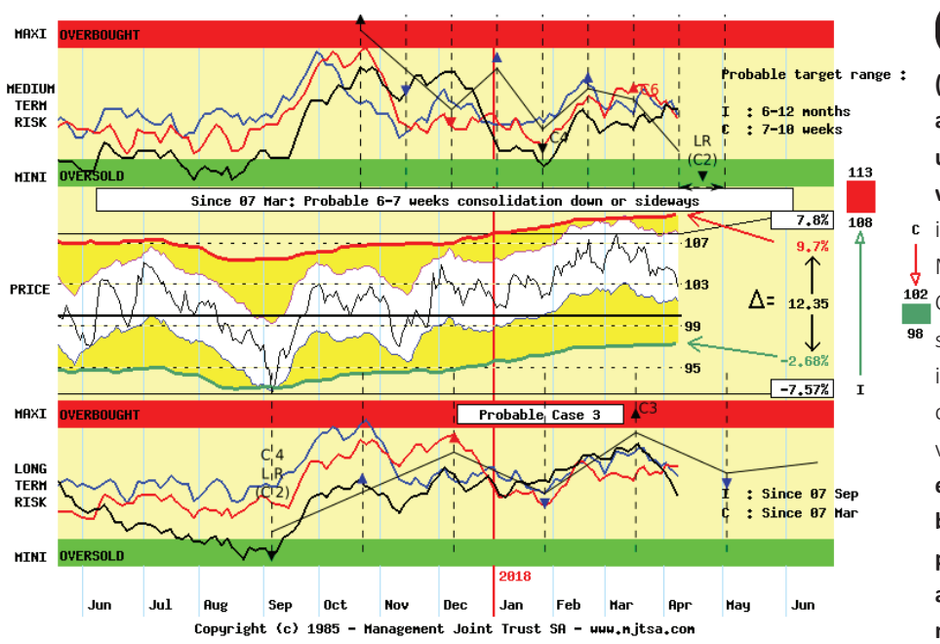
On both our oscillator series (lower and upper rectangles), the LIBOR-US3M Treasury spread could be approaching an intermediate top between now and late April. This could lead to some consolidation down, possibly into late May / early June. On the target front, the move up since November has reached our I impulsive targets up between 0.6 and 0.7% (right-hand scale). Hence, the uptrend may be somewhat exhausted for now, and may experience a temporary pause (although again, the price history featured here is very short given the parabolic nature of the recent move). **Making some metal shortcuts, we may consider that this consolidation could correspond to some temporary easing of financial conditions over the next 1 to 2 months.**

KBE - SPDR S&P Bank ETF / SPY - SPDR S&P 500
Weekly graph or the perspective over the next 2 to 4 quarters



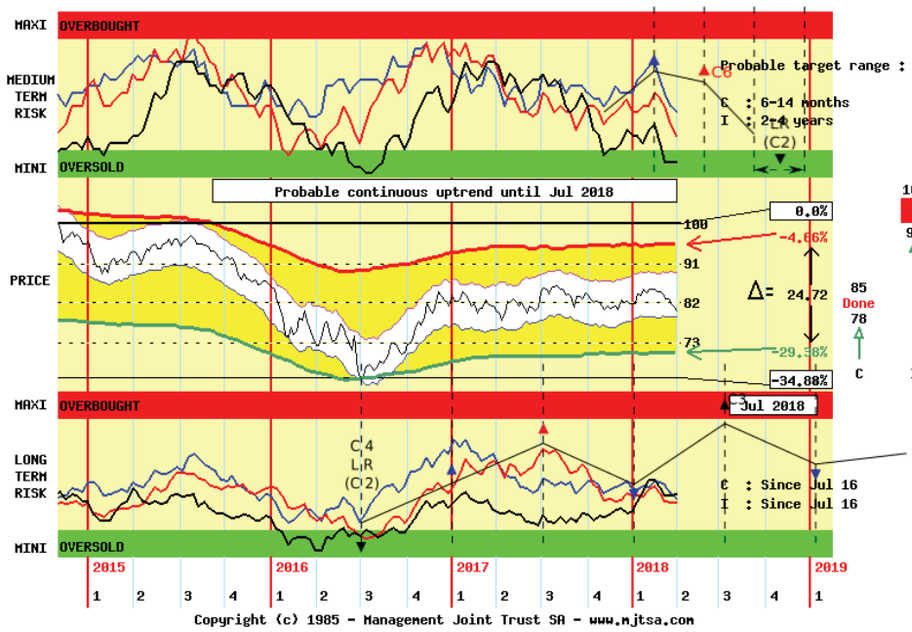
We now look at the US banking sector vs the S&P500 to try to assess if the ratio may be strained by the current acceleration in the LIBOR-OIS spread. **For now, our long term oscillators (lower rectangle) are still positioned in an uptrend, and the ratio should continue higher possibly into July as suggested by our automatic messaging. Our I Impulsive price targets up are still compelling (right-hand scale) suggesting a further 10 to 20% of potential outperformance until then. That said, the picture on our medium term oscillators has weakened somewhat lately** (upper rectangle). Indeed, although prices have held up since September, the sequence on these oscillators is showing declining tops. This may be an early signal of further weakness to come. Yet, we will keep our medium term bullish bias for now, probably towards mid-year.

KBE - SPDR S&P Bank ETF / SPY - SPDR S&P 500
Daily graph or the perspective over the next 2 to 3 months



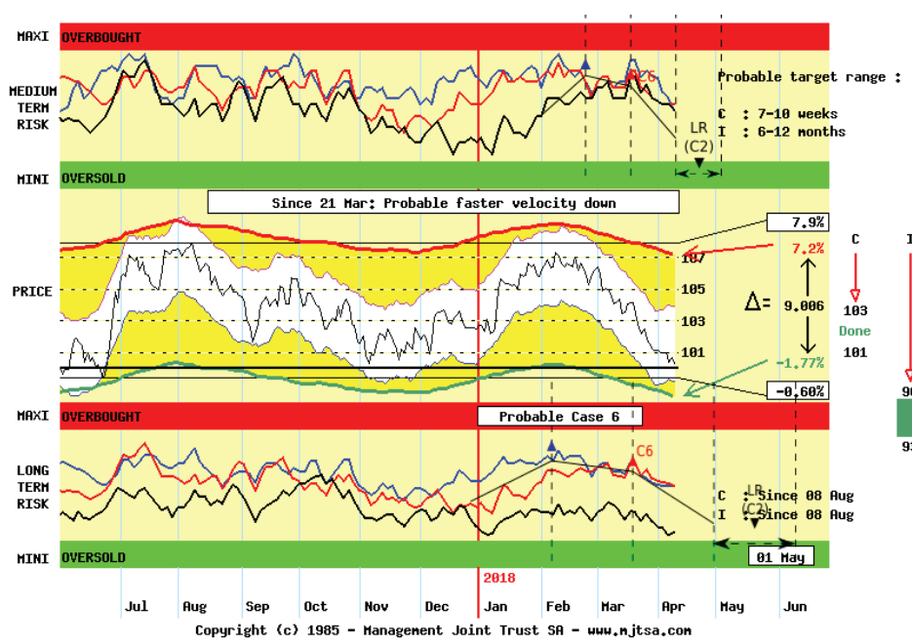
On the daily graph, both our oscillators series (lower and upper rectangles) are currently in a period of underperformance for Banks vs the S&P500. It could last into late April, possibly early May, and according to our C Corrective targets to the downside (right-hand scale), there is a risk of a further 5% of under-performance for the sector vs the market. **That said, from early May the uptrend should be reinstated, and our I Impulsive targets to the upside are still quite promising as we move towards late May and June.**

Banking sector – Dow Jones Stoxx / Dow Jones Stoxx Europe 600
Weekly graph or the perspective over the next 2 to 4 quarters



European Banks should theoretically be taking most of the hit of the widening of the LIBOR-OIS spread as the tax repatriation act is mainly draining USD liquidity for USD funding outside of the US. Although it is difficult to confirm a direct relationship for now, **it does seem like the uptrend on European Banks relative to Europe Stoxx Index has lost momentum over the last 2 months**. On on our long term oscillators (lower rectangle), the re-acceleration up towards July is stalling, while our I Impulsive targets to the upside (right-hand scale) are looking more and more like a distant "mirage". In fact, the ratio is still stuck within the range of our C Corrective targets to the upside, and we are wondering if it will ever manage to clearly break above these. Finally, on our medium term oscillators (upper rectangle), the sequence is now rather down-trending. **A reaction up is still possible towards late May, yet we doubt that it will be able to gather sufficient momentum to reestablish a clear uptrend. So indeed, over the last couple of months, the picture has deteriorated for European Banks vs the Europe Stoxx 600**.

Banking sector – Dow Jones Stoxx / Dow Jones Stoxx Europe 600
Daily graph or the perspective over the next 2 to 3 months

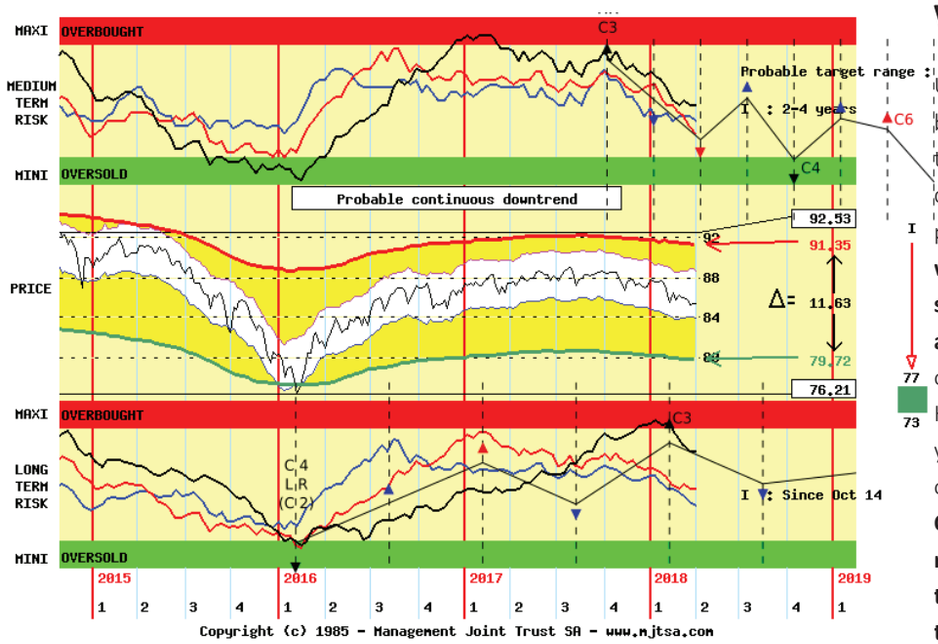


Shorter term, European Banks are now in a downtrend vs the Europe Stoxx 600. Both oscillator series (lower and upper rectangles) are currently in sell-off mode, possibly until early May. The tipping point in February does correspond to the beginning of the sharp acceleration of the LIBOR-OIS spread, yet more generally, since November, the ratio is also closely correlated with the path of European long term yields. Nevertheless, the ratio is heading lower for now **and has just broken through our C Corrective targets to the downside (right-hand scale). It may now be heading towards our next level of targets (I Impulsive targets down; right-hand scale), which imply between 4 and 7% of further underperformance.**

Initial remarks

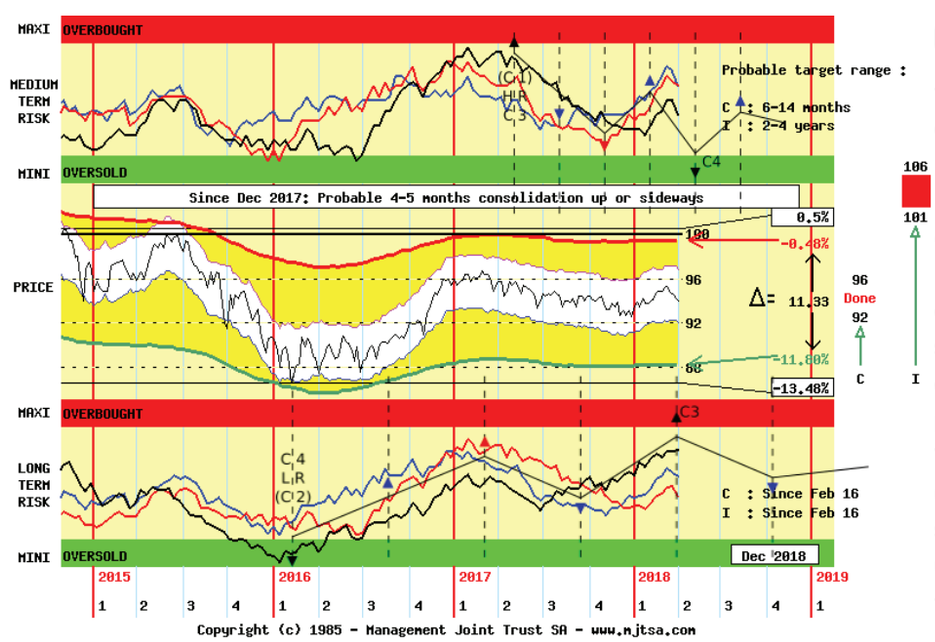
US and European Banks are currently under pressure vs their respective indexes. In fact. Last month, in our March edition of the The Capital Observer, we did go underweight on both sectors in our asset allocation. This weakness may be related to the sharp increase in the LIBOR-OIS spread, but could also be due to the consolidation we are currently seeing on US and European long term yields. Going forward, we do expect these long term yields to resume their uptrend towards mid year. We are also expecting a pause in the strong rise of the LIBOR-OIS spread. Hence, we will probably remain prudent on Financials until late April / early May, yet may seek to re-enter in May in an attempt to profit from the last move up towards June. H2 2018 may then spell another story as long term yields start to correct and short term financial conditions continue to tighten, certainly a recipe for increased financial stress as we approach the end of the year.

HYG - iShares iBoxx $ High Yield Corporate Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



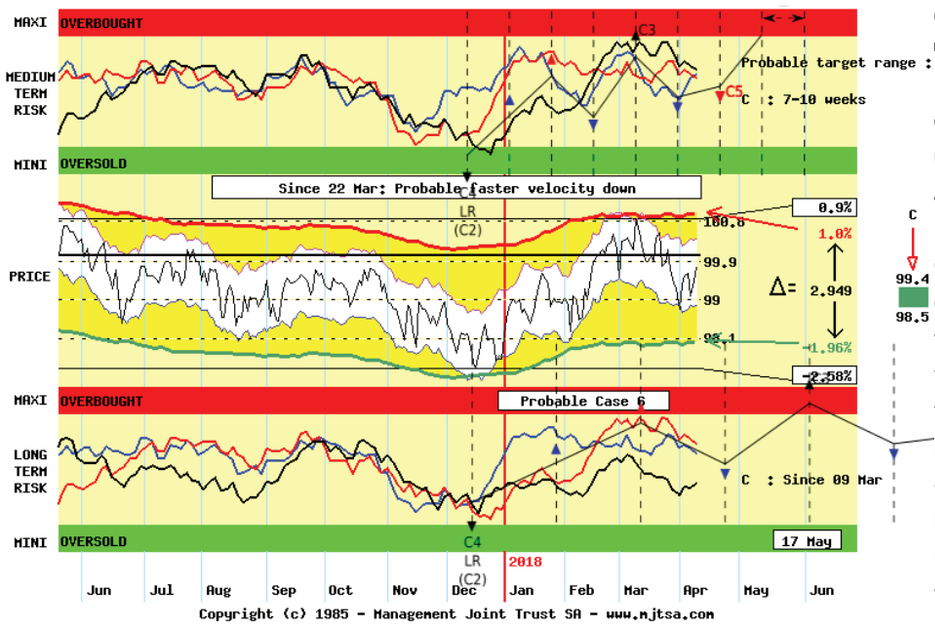
We now turn to Credit markets and first look at US High Yield on a standalone basis. On our long term oscillators (lower rectangle), the sequence up since early 2016 has probably been completed. **We would now expect HYG to resume lower towards year-end and 2019**. On our medium term oscillators (upper rectangle), HYG is already in a downtrend, yet it could see a reaction up over the next 2 to 3 months. **On the price target front, the risk is quite compelling over the next 12 months, probably towards the 77 – 73 range (or 10 to 15% below current levels)** according to our I Impulsive targets to the downside (right-hand scale). As it happens, High Yield, did offer some Credit cushion to rising interest rates since mid 2016, hence the slight rise in prices from mid 2016 to early 2018, while 5 year benchmark rates added 170 basis points (HYG has an average duration of 3.8Y). These dynamics are however fading as we approach the later stages of the business cycle. Worse in H2 2018, we expect them to reverse as the deteriorating Credit element takes center-stage, despite the retracement we expect in benchmark bond yields.

HYG - iShares High Yield Bond ETF / LQD - iShares Investment Grade Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



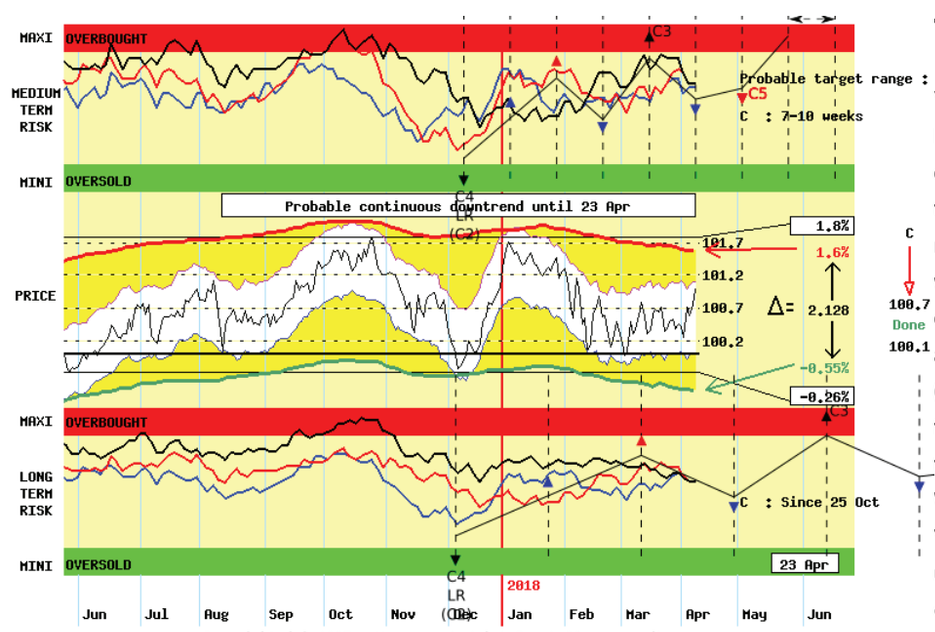
Comparing HYG to LQD strips out to some extent the rising benchmark yields element from the equation. Indeed, although both ETF have different durations, the credit element seems predominant. **Also here, we would expect that the sequence up since 2016 on our long term oscillators (lower rectangle) is probably nearing completion. Yet, on our medium oscillators (upper rectangle), we would still expect one last reaction up over the next 3 to 4 months**. Although, High Yield does provide a cushion vs Investment Grade in a rising yields environment, our I Impulsive targets to the upside (right-hand scale) do seem much too aggressive for now. We would rather expect **the ratio to retest its 2017 highs, possibly 2 to 3 % above current levels** (i.e. the upper end of our C Corrective targets up; right-hand scale).

HYG - iShares High Yield Bond ETF / LQD - iShares Investment Grade Bond ETF
Daily graph or the perspective over the next 2 to 3 months



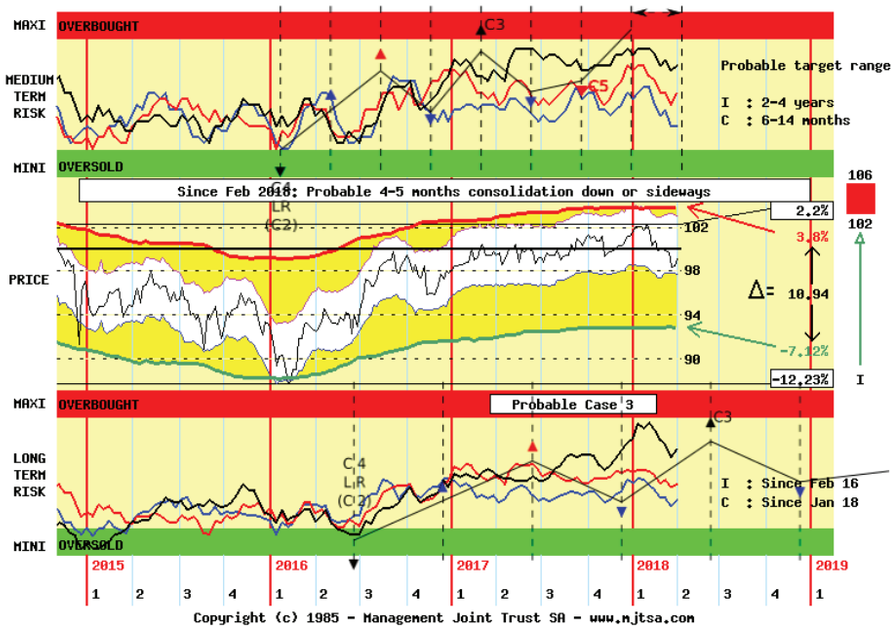
Shorter term, looking at the daily graph of the HYG/LQD ratio, we would probably expect its to continue its uptrend until late May / early June on both oscillator series (lower and upper rectangles). Our automatic messaging is currently more negative, yet we will keep our positive bias for now as our C Corrective targets to the downside (right-hand scale) seem to be providing worthwhile support. Below these, we would obviously have to reconsider. Hence, we would expect that the ratio reconfirms its uptrend over the next couple of weeks and then continues up towards June. **This is in-line with our more general view on risk assets, where we expect one last upside attempt towards late Q2. Incidentally, it also corresponds to the softening we expect over the next 1 to 2 months on the LIBOR-OIS spread.**

Amundi ETF Euro High Yield Bond ETF / Amundi ETF Euro Corporates Bond ETF
Daily graph or the perspective over the next 2 to 3 months



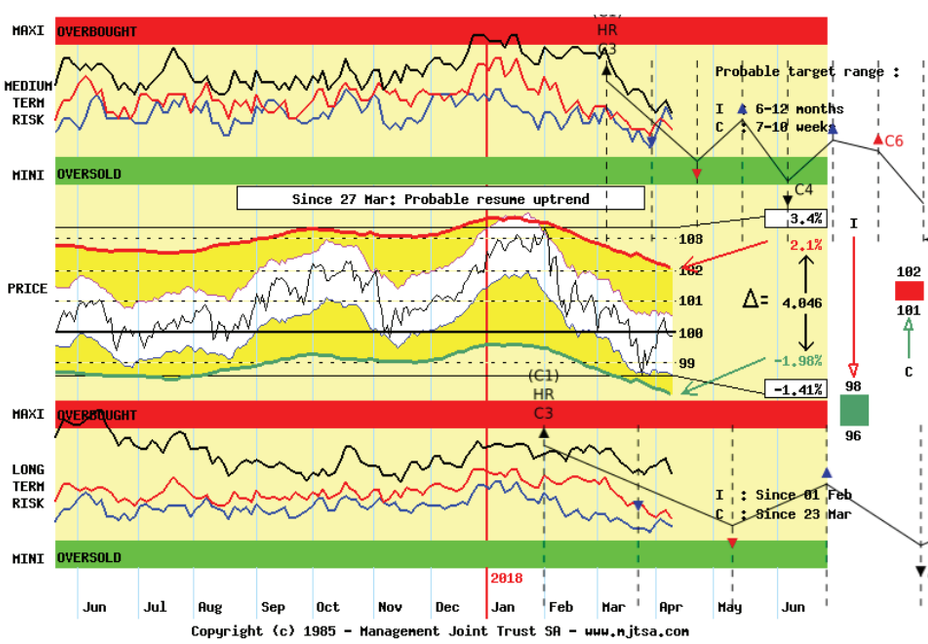
The scenario is probably similar to the one for High Yield vs Investment Grade in Europe. **On our medium term oscillators (upper rectangle), the ratio already seems to be re-accelerating up. That said, we would still be cautious over the next couple of weeks as our long term oscillators (lower rectangle) are calling for some retracement before the acceleration is confirmed. We would then expect High Yield to outperform, possibly until June**, which is in line with our forecast above for the ratio of US High Yield vs Investment Grade.

PCY - PowerShares EM Sovereign Debt ETF / IEF-iShares 7-10 Year Treasury Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



Finally we turn to another measure of global credit conditions looking at the ratio of Emerging Markets Sovereign Bonds vs US Treasuries (both ETFs we use here have similar durations). On our medium term oscillators, **the sequence up since early 2016 has probably come to an end** (upper rectangle). This is confirmed by our automatic messaging which has recognized an important top. Yet, on our long term oscillators, the ratio may attempt a last move up towards late Q2 2018. This could be signaling **some kind of an upside retest over the next 2 to 3 months.** Following that, we would expect the ratio to start weakening, potentially towards year-end and 2019. Risk/reward is neutral for now, stuck in the middle of our projections for I Impulsive upside potential and C Corrective downside risk (right-hand scale).

PCY- PowerShares EM Sovereign Debt ETF / IEF- iShares 7-10 Year Treasury Bond ETF
Daily graph or the perspective over the next 2 to 3 months



The Daily graph of the Sovereign credit ratio does give us a more precise picture. **The downtrend since February should reach an intermediate low between late April and early May on both oscillators series (lower and upper rectangles). This should trigger a sideways (upper rectangle) to slightly uptrending (lower rectangle) reaction into June. Following that, we would expect Sovereign credit spreads to resume their downtrend into Q3 2018**. Consequently, on this ratio, we would first expect a measured reaction up towards our C Corrective upside targets, 1 to 2% above current levels, and then a new sell-off towards our I Impulsive targets to the downside, 4 to 6% lower than today.

Concluding remarks:

Over the next couple of months, our graphs may suggest that the LIBOR-OIS spread may soften some, while Credit and potentially Banks regain some steam and attempt to recoup some of their recent underperformances. Both are probably driven by the more general reaction up we expect on risk assets, probably from late April into June. Looking into H2 2018, however, we are forecasting a rather strong deterioration in the cross asset picture. Equities, Commodities and Long term Yields should be topping out for this cycle between mid year and the Summer, while the Yield Curve continues to flatten aggressively again, Banks underperform and Credit starts to falter. We suspect that beyond the many regulatory and/or fiscal structural changes that are currently put forward as explanations for the recent widening LIBOR-OIS spread, these negative financial conditions will provide the type of environment that could see a strong increase in funding costs. We hence suspect that the LIBOR-OIS may gradually come back to haunt us as the year progresses, and it probably won't be due to specific changes in regulatory or fiscal conditions.