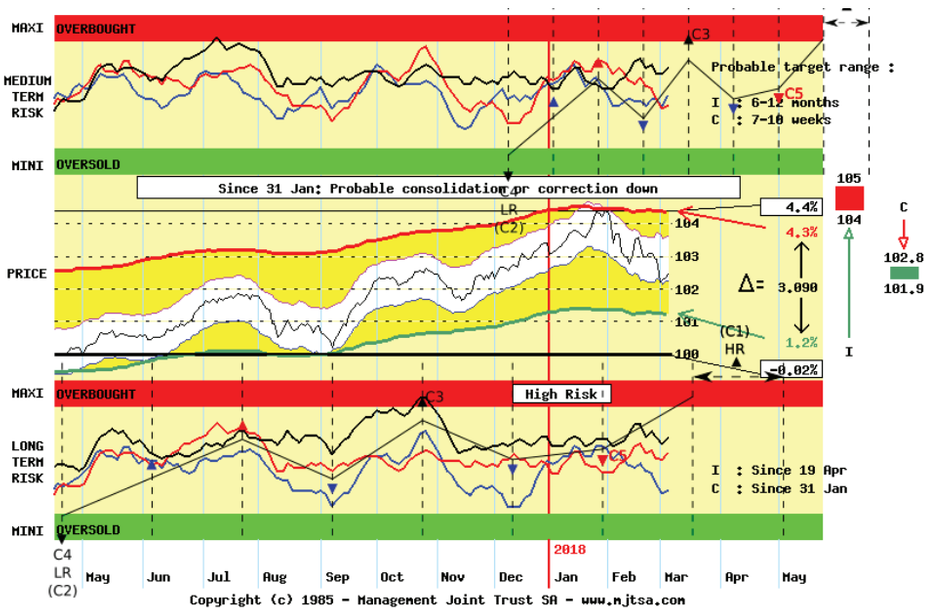
48 / Splicing the markets – Investment Grade Bonds are stuck between a rock and a hard place

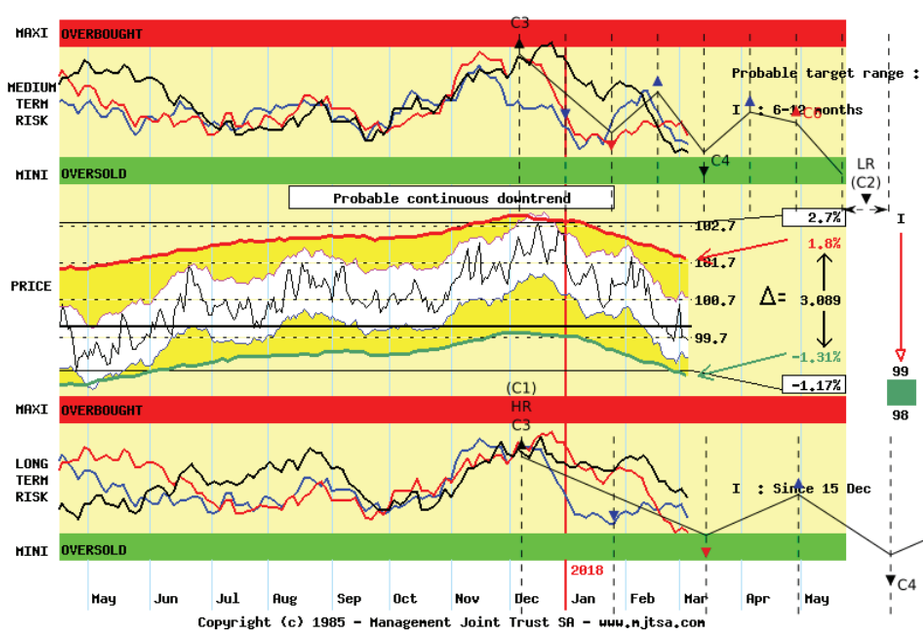
Recently, there's been a lot of negative new-flow on US Treasuries, amid quantitative tightening, massive future debt issuance and a few failed auctions. High Yield is also under some media pressure as concern over credit bubbles are mounting everywhere. Yet, at this late stage in the cycle, both these markets serve a purpose: Treasuries is the only, highly liquid, "Flight to safety" game in town, and High Yield offers protection against rising yields and inflation expectations in the fixed income market. Stuck in the middle, is the Investment Grade Corporate Bond market as it offers little protection against the risk of an inflationary acceleration, nor against the possible deflationary bust that may follow.

LQD - iShares iBoxx $ Investment Grade Corp. Bond ETF / IEF - iShares 7-10 Year Treasury Bond ETF
Daily graph or the perspective over the next 2 to 3 months



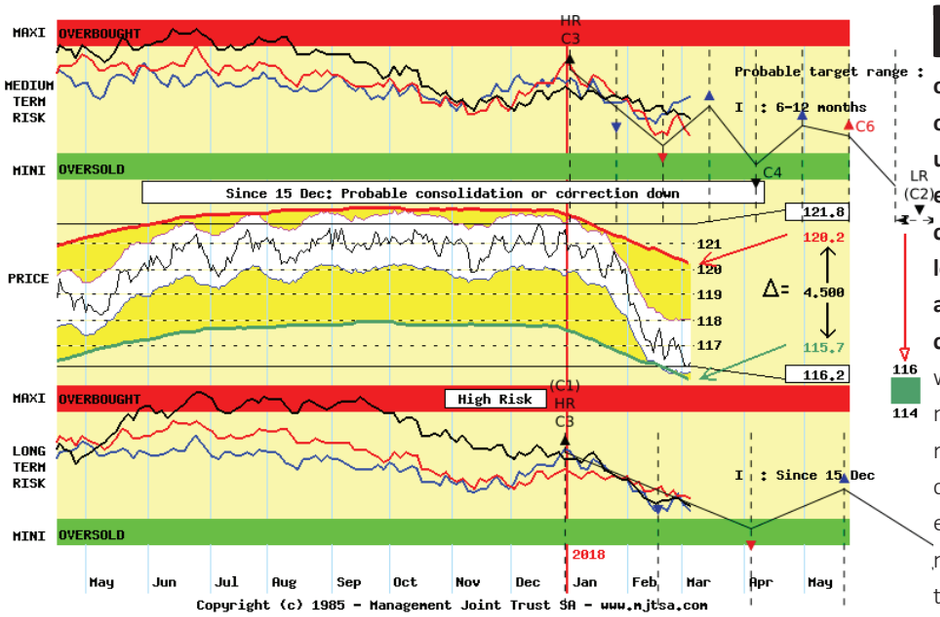
The ratio compares US Investment Grade Corporate bonds to US treasuries (both ETFs have similar durations). It is geared towards Risk-ON perspectives, i.e. when risk assets rise, the ratio usually follows suit, and vis versa. Lately, since the early February equity sell-off, it has been correcting down quite abruptly. While both our oscillator series (lower and upper rectangle) could justify a continuation or a rebound over the next couple of weeks, the uptrend since Spring last year is probably nearing exhaustion. Furthermore, our I Impulsive up targets to the upside (right-hand scale) were reached a month a go in January. There is hence little upside potential left over the next few months. **In the late cycle environment we are currently in, where equities and most risk assets are probably overvalued, there is little marginal advantage to own Corporate Bonds over Treasuries, while the risk of underperformance during market corrections is compelling.**

LQD - iShares iBoxx $ Investment Grade Corp. Bond ETF / HYG - iShares iBoxx $ High Yield Corp. Bond ETF
Daily graph or the perspective ovbert the next 2 o 3 months



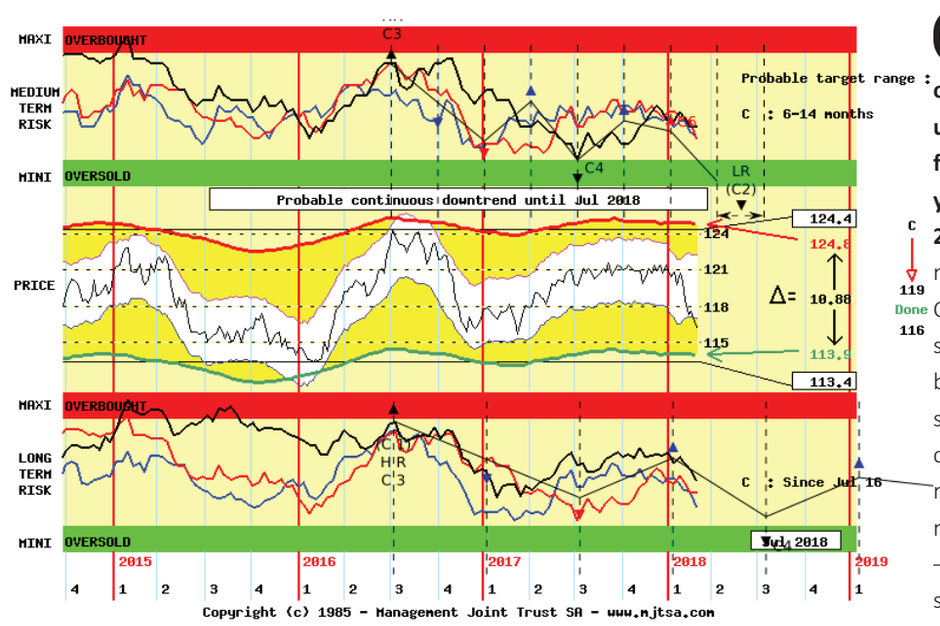
Against High Yield, Investment Grade Corporate bonds feature different dynamics that on the ratio above (the duration is shorter on the High Yield ETF, yet the Credit element is widely predominant). **Yet, interestingly, in this late cycle environment, these are not necessarily inversely correlated**. Indeed, since December, and more recently early February, Investment Grade has also been suffering vs High Yield. On both our oscillators (lower and upper rectangles), a bounce should materialise over the next few weeks into April. That said, following that, Investment Grade should continue to underperform, possibly towards June, i.e. **Investment Grade VS High Yield should suffer from the further inflationary acceleration we expect, probably from mid /late April into mid year.**

LQD - iShares iBoxx $ Investment Grade Corp. Bond ETF
Daily graph or the perspective over the next 2 to 3 months



Investment Grade Corporate bonds have been selling off since December. On both oscillator series (lower and upper rectangles), we would expect the downtrend to continue towards mid year at least, as risk assets corrections alternate with inflationary accelerations. On the sequences, we show, Investment Grade may bounce at some point during April, perhaps following a correction on risk assets during end March, and while inflationary pressures are taking time to re-accelerate, yet the window is probably quite short before the downtrend resumes, probably into May and towards the end of June.

LQD - iShares iBoxx $ Investment Grade Corp. Bond ETF
Weekly graph or the perspective over the next next 2 to 4 quarters



On this Weekly graph of Investment grade, both oscillator series (lower and upper rectangles) point to further declines towards mid year , perhaps even early Q3 2018. Prices have recently reached the support of our C Corrective targets to the downside (right-hand scale). If these break (below 116), our I Impulsive targets down would calculate towards the 110 – 106 range (our historical volatility measure "Delta", here at 10.88 – middle rectangle, right-hand side – multiplied by 1.3 to 1.7 times, subtracted from the the top of the graph at 124.4). **The downside risk on Investment Grade is hence still quite compelling.**

Concluding remarks

Until mid 2018 at least, we expect an environment of rising inflation expectations, rising yields and rising risks for risk assets. This is not a friendly environment for Investment Grade Corporate Bonds, which usually thrive when inflation diminishes, and growth and equity markets accelerate up. Indeed, Investment Grade does not address the two main risks in this late cycle environment. High Yield will protect you against short term inflationary pressures, Treasuries will protect you against the deflationary bust that may follow. Investment Grade addresses neither. It's like a siting Duck caught cross currents between inflationary and deflationary pressures.