THE CAPITAL OBSERVER

JULY 2020

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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

JULY 16, 2020

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Many investors have been perplexed by the equity market racing away from so-called "fundamentals", which in our view they misguidedly define as earnings growth. We think this approach is incomplete, has proved to be so in the past, and will likely keep tripping up earnings growth fixated investors in the future.

AS Kapur, BofA

4/ Executive Summary

12 / **Commodities emerge from the COVID-19 lows, as China's TSF rise in the back of significant government fiscal expenditures and recovery in imports** - China, a primary factor in commodity demand, has bounced back from the depths of COVID-19 devastation. We cannot stress enough how crucial is the Chinese growth outlook to commodities. Chinese appetite for commodities had slackened somewhat from 5 to 7 years ago, but Chinese demand and consumption of raw materials is still the largest in the world, comparatively speaking. Despite lower growth rates, China has kept consumption of commodities still at high levels because the size of its economy has grown in the interim. The percentages may have shrunk but the nominal volume of commodities consumption is still very decent. The measure we use to gauge the future prospects of Chinese growth and activity is the Total Social Financing (TSF) aggregate. TSF has been rising sharply, following last year's growth in fiscal expenditures in China. The latest report from China are encouraging. China's imports in June rose for the first time since the coronavirus crisis paralysed the economy this year, as demand for commodities surged on the back of government stimulus, while exports also rose in a sign the country's recovery is gaining traction. The importance of China's fiscal expenditures and its subsequent impact on commodities is immense. So, it looks like commodities should do well until Q4 2020. But we may have to expect some pullback in 2021. On the bigger picture we also look at the relative performance of commodities vs equities where there seems to be a highly cyclical behaviour over time with a period of 15 to 18 years.

15 / **Timing and Tactical Insight - Commodities may have made a secular bottom in March/April -** Most Commodities had suffered a two years downtrend since early 2018, along with China and many cyclical factors. The COVID sell-off in March and April resulted in many (and oil and copper in particular) making a climax sell-off, i.e. potentially a long term climax low. The rebound since then has been swift and may be approaching an intermediate top. We now expect a couple of weeks of consolidation to downside into late July, perhaps early August, followed by a new upside attempt into late August, perhaps September. Oil and Copper especially may then break out to new highs since March and possibly recuperate much of their Q1/early Q2 sell-off, while Gold could continue to rise more a subtly yet linearly until it reaches our 2'000 USD/oz targets, at some point between late Summer and Spring next year. In the meantime, more cyclical commodities (oil, copper) could see a correction to the downside this Fall, but should then attempt another leg up from late Q4 into Spring 2021. More generally, when considering the wider Reuters Commodities Futures price index, Commodities may have made a secular bottom in April, but will now need to maintain their upside momentum, with higher highs into late Summer and then again next Spring to confirm this reversal. Otherwise, 2021 may see further weakness and perhaps new lows.

23/ **China growth and activity is indeed picking up in early Q2 as we expected; China could lead a global growth rise in H2 2020 -** What has changed since mid-May 2020 when we last discussed China? For one, the Citi Economic Surprise Index (CESI) for China has improved significantly since we published it in May. And Manufacturing PMI-- Export Index is now rising sharply, adding some needed confirmation to the PMI Index which has risen sharply as early as May (and had been suspect). TSF has continued to rise sharply, following last year's growth in fiscal expenditures in China. The multi-month growth of the TSF has yielded some impressive returns.
China's imports in June rose for the first time since the coronavirus crisis paralysed the economy this year, as demand for commodities surged on the back of government stimulus, while exports also rose in a sign the country's recovery is gaining traction. China's imports in June rose 2.7% from a year earlier, customs data showed on Tuesday, confounding market expectations for a 10% drop. They had fallen 16.7% the previous month. Exports also rose unexpectedly, up 0.5%, suggesting global demand is starting to pick up again as many countries begin to ease tough anti-virus measures that have pushed the world's economy into its biggest slump in almost 90 years. We see that clothing and footwear exports have increased, which signals that external demand is recovering. The data shows positive signs of a global economic recovery in the second half of the year.
The trade balance shrank to $46.2 billion in June from $62.93 billion in May. Net exports were nonetheless smaller in June and will not change the trend of a contraction in GDP growth in 2Q20. Analysts' consensus puts China's GDP growth in 2Q20 at -3.1% YoY. We agree that those targets are optimal for China in Q2. That should make a Chinese recovery sustainable. Indeed, China could lead global growth in H2 this year.

26 / **Timing and Tactical Insight - The Chinese rally could hold up into late August, perhaps early September** - Chinese equity markets have seen a strong breakout over the last few weeks. Although, this rally is labelled as been artificial by many market watchers, it has achieved strong breakouts on many Chinese indexes on an absolute and relative basis. Shorter term, a couple of weeks of high level consolidation may now lie ahead, Yet, following that, we believe that Chinese equity markets should see a further leg up, probably until late August, perhaps into September. A stronger correction to the downside may then materialize during the Fall along with global equity markets. Sector-wise, domestic segments have led the recent rally, yet typical growth themes such as Chinese Technology or Consumer Discretionary could soon take up the lead into late Summer. This is rather risk-ON for Chinese equity markets and perhaps more generally global markets (i.e. a typical growth extension following a stimulated bounce).

5/ Executive Summary

34 / **The equity rally may peak again soon, and thereafter expect declining markets in August again as the Fed goes on Quantitative Tightening mode -** In the last 4 weeks since we wrote the June article, the Fed did a remarkable volte-face with regards to its QE regime. Thus, the bar for higher highs in September relative to peaks in May has just become significantly higher. What exacerbates the situation is that the current liquidity profile a waning during the period from late July to late August that has historically been dangerous for risk assets. And this is why: Looking at 2020 liquidity aggregates falling sharply as we are seeing, lack of current support comes at a time when institutional memory is cued into the great seasonal drought of late summer. As the seasonality of the S&P 500 Index shows, the largest valuation decline in any given year in the past ten years at least, has happened during this period. A more disturbing reality is that unless the Fed pauses its on-going Quantitative Tightening mode, markets will be hard pressed to show outperformance in September. There is real risk that we could just get a weak bounce in early Q4, and weakness could extend towards the year-end. This message also seems to be confirmed by the aggregate balance and money supply of the G5 central banks which are a source of global systemic liquidity.

37 / **Timing and Tactical Insight - Further DIPS are still possible into early August before the uptrend resumes into September** - Shorter term, our timing on the S&P500 and the EuroStoxx50 seems to imply that the high level consolidation period that started early June may still be underway, and that further intermediate dips could still materialize until early August. Thereafter, global equity markets should continue their recovery, probably into late August / September, while cyclical factors may then even outperform shortly. While, some of the stronger markets may make new highs by September (e.g. the S&P500 index), weaker ones could at least approach them (e.g. SX5E). Following that, we expect an intermediate correction to the downside from mid/late September into mid/late Q4, and then a new leg up, with potentially new highs, into next Spring. Longer term, on our bi-monthly graphs, we would also remain positive on equity markets first into early next year (following an Autumn correction), and then potentially once again into late 2021/2022. Geographically, the S&P500 looks more extended to the upside than the EuroStoxx 50 or the MSCI Emerging Markets index, while these global markets look very Oversold on a relative basis vs the S&P500, following ten years of underperformance. We believe they could be the main beneficiaries over the next 24 months of the huge reflationary efforts done by Central Banks, and the FED especially, as the economy gradually recovers, rates remain low and the US Dollar potentially continues to reverse down.

45/ **The 10yr yield should spiral lower until late August; fast deterioration of 2020 liquidity flows should keep yields under pressure until year-end -** The 10yr yield has been faithfully following its own trajectory in previous years. Notable was the persistence of similarities between current, 2020 yield, and its trajectories in 2015 and 2019. If the 10yr yield remains faithful to its performance during those years, there will just a few days of rising yields before yields spiral lower again until late August-early September. We could see again the lows made in March. That would be the 0.41 % area in the 10yr yield; we may even see lower lows at a later time.
Nonetheless, the current change rates in 2020 liquidity flows from the Fed and Treasury have been deteriorating at a fast clip. This adds a new wrinkle to the forecasting of interest rate levels based on liquidity flows. The current 2020 liquidity profile is so very different from historical norms – we fear that its after effects may be completely different from what we have seen in the past 7 years at least.
It may even happen that we will not see a robust rally in yield as from early September until early December. The 10yr yield could stay low until year end.

48 / **Timing and Tactical Insight - Rates may hold up this Summer, yet remain in a persistent longer term downtrend -** Fixed Income markets on under control. We expect benchmark bond yields to continue in their current downtrend into this Fall in first instance and then perhaps into mid/late next year. US10Y yields may then reach down to 0.2% while German 10Y Bund yield may approach-1.0% once again. This, we believe, is part of the recovery process, where yields/rates remain/are kept under pressure as long as risk assets haven't gained sufficient upside momentum. In the meantime, benchmark yields could hold up during the Summer, probably until late August / early September, and may even see some small bounces along the way, which may correspond to some short term cyclical pick-ups. Likewise the US to Europe interest rates differential may also hold up into September and then drop into the Fall, while the US10Y-US3Y yield curve spread may attempt to push slightly higher over the next month or so, and then also drops down into Q4. The above, we believe, translates into a rather benign environment where benchmark bond yields remain under control. This stable situation is also confirmed by Credit markets, where both US Investment Grade and US High Yield Bonds should continue to linger on higher into late Summer, while Sovereign spreads continue to drop back down. The Fall may then see some stress situations reappear.

56 / **Splicing the markets - Splicing the markets : Further upside into late Summer for Cyclical Currencies vs the US Dollar** - EUR/USD, GBP/USD and AUD/USD all made important lows in March and have since been bouncing. Typically, such situations usually trigger a six months bounce at least (i.e. into late Q3 in this case), if not a new uptrend. In first instance, EUR/USD could reach back up into the 1.15 – 1.19 range, probably until late Summer, GBP/USD may challenge its 1.32 resistance, while AUD/USD, which has already broken above its 0.68 resistance, could move up into the mid 0.70s. The Fall should then see some retracement.

6/ Mapping the markets

Last month, when we published on the 16th of June, we believed that risk assets and equities could see further consolidation in a range until late June / early July and that thereafter these could rise until mid/late Summer. This is pretty much correct for now, although many risk assets haven't yet broken above their June highs, and cyclical factors especially, have remained quite weak. We then also expected that the US Dollar could drop back down during July, while Gold could reach to above 1'800 USD/oz, which is precisely what happened.

Going forward, we continue to believe that equities and more generally risk assets could maintain their positive trend into late Q3 (late August/September). In the meantime however, we are wary that the consolidation period since early June on risk assets may not be quite finished yet. Indeed, as mentioned above, while some markets have since made new highs, many markets are still below these June intermediate tops, and we believe the risk of further dips over the next few weeks remains quite high, probably until late July/ early August. At most, we see downside risk towards the mid/low 2'900s on the S&P500, towards the 3'100 – 3'000 range on the EuroStoxx 50. Other risk assets, along with cyclical Commodities such as Oil, Copper and perhaps Silver are also at risk of this further dip. Yields may remain under pressure until then while the US Dollar may attempt another short term bounce. Gold on the other hand should hold up rather well. Then, during August, we expect most risk assets to resume their uptrend, probably towards late August / September. The S&P500 may see new all-time highs, while the EuroStoxx 50 may approach its year-to-date highs. Emerging markets and China as well as cyclical Commodities could be particularly strong as the US Dollar probably resumes lower into late Q3. Yields may bounce slightly or at least hold up.

From late Q3 / early Q4, we then expect the risk asset rally as well as cyclical strength to gradually fade out. Yields should resume their downtrend into the Fall and towards their March lows, while Gold could continue to rise possibly towards 2'000 USD/oz. The main equity indexes could then see a new 2-3 months period of correction to the downside (probably a strong intermediate correction, rather than a new market rout as in March). A year-end rally could then materialize from late Q4, probably extending into Q1 2021.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	The S&P500 could continue to consolidate until late July / early August, but then rises into late Summer and potentially new highs.	From late Q3 / early Q4, we expect the S&P500 to enter an intermediate correction. It could last 2-3 months into mid/late Q4.
	Europe EuroStoxx50	The EuroStoxx 50 could continue to consolidate until late July / early August, but then rises into late Summer and could approach its year-to-date highs.	From late Q3 / early Q4, we expect the EuroStoxx 50 to enter an intermediate correction. It could last 2-3 months into mid/late Q4.
	EMs MSCIEM USD	Emerging markets could still suffer a short correction towards late July / early August, but should then rise into late Summer and towards their year-to-date highs.	From late Q3 / early Q4, we expect Emerging Markets to enter an intermediate correction. It could last 2-3 months into mid/late Q4.
Treasuries	US10Y Bond prices	The US10Y Treasury yield is still in a persitent downtrend, yet quite Oversold, and could see a slight bounce during August, perhaps September.	The US10Y Treasury yield should resume its downtrend by late Summer, probably retesting its March lows or perhaps even below during Q4.
	Germany 10Y Bund prices	The German 10Y Bund yield could continue to retrace into late July / early August, and then could rise moderately into late August / September.	The German 10Y Bund yield should resume its downtrend by mid Summer, probably retesting its March lows or perhaps even below during Q4.

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

Main Equities

World markets
p 34-36, 37-39

The consolidation of global equities since early June is still underway and it could continue for another couple of weeks in the same range (3'250 – 2'900 on the S&P500, 3'400 – 3'050 on the EuroStoxx 50), probably into late July / early August. From early/mid August we then expect them to break out to the upside into late Summer and possibly towards their February highs. The Fall could then see a new period of correction to the downside.

Main Regional picks
p 40

We believe the rally into late Summer on equities will continue to be accompanied by a weaker US Dollar. We would hence favor European markets vs US ones from August into September.

Emerging markets
p 12-13, 23-25, 26-32, 41-42

Emerging markets remain very differentiated between China and Taiwan on the one hand, and other Emerging markets on the other as these mostly have more cyclical profiles. During late June and early July, the performance of China has been stellar. The trend may extend into late July / early August, but thereafter other Emerging Markets may start to catch up during August as more cyclical profiles take up the lead. Late Q3 could then see China outperform again. On average, we believe Emerging Markets could outperform developed ones into late Q3.

Volatility

VIX may bounce back once again into the mid/high 30s, perhaps into the 40s towards late July / early August. It then drops into late Summer, probably towards the mid 20s.

Government Bonds

US & European Benchmarks
p 45-47, 48-49, 51

Treasury and Bund yields could see more retracement into late July / early August, but should then bounce again during August and perhaps September. These bounces will probably remain quite subdued e.g. probably below the top of the early June bounce on the US10Y, i.e. below 0.9%. From late Q3, we expect them to gradually roll-over again and probably retest down towards their March lows into mid/late Q4.

Equity to Bond Ratios, Fixed Income Dynamics & Commodities

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Equity / Bonds	US	The US Equity to Bonds ratio (S&P500 vs 10Y Treasuries) could continue to consolidate into late July /early August and then rises into late Summer.	The ratio probably tops out again by late Summer and corrects down into mid/late Q4.
	Europe	The European Equity to Bonds ratio (EuroStoxx 50 Futures vs Bund Futures) could continue to consolidate into late July /early August and then rises into late Summer.	The ratio probably tops out again by late Summer and corrects down into mid/late Q4.
Duration		US Yield Curve Spreads could continue to consolidate into late July / early August and then rise moderately into late Summer.	US Yield Curve spreads probably resume lower from late Summer into mid/late Q4.
Credit		US Investment Grade Credit spreads could continue to drop linearly into late Summer as the market is backstopped. High Yield Bonds may outperform again from August into September.	From late Summer, Credit Spreads could widden again into mid/late Q4 although Credit markets will probably remain well supported.
TIPs/Treasuries		Inflation Expectations probably continue to rise moderately into late Summer.	From late Summer, Inflation expectations could retrace down moderately again into mid/late Q4.
Oil		Oil could see an intermediate correction into late July / early August, but then probably rises into late Summer. Breaking above 48 USD/barrel on Brent would be a strong bullish signal.	From late Summer, Oil could correct down again for 2 to 3 months into mid/late Q4.
Industrial metals		Industrial Metals and Copper could still see some correction into late July / early August, but then rise into late Summer.	From late Summer, Industrial Metals and Copper could correct down again into mid/late Q4.
Gold		Gold should continue to make new highs over the next couple of months.	Gold could continue to rise towards 2'000 USD/oz into early/mid Q4.

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

Equity to Bond Ratios

US & Eurozone Market

Equity to Bond ratios should follow equity markets up and down as the equity side is clearly more volatile than the bond one.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 52

With short term yields now near zero, the yield curve will mainly follow the direction of long term yields. Yield curve spreads may hence steepen along with the small rebounds we expect in long term yields during August and perhaps September, but should then roll-over / flatten again into the Fall.

Credit
p 53-55

Credit Spreads in the US and Europe are back-stopped by the FED's and the ECB's massive buying programs. Hence, they should continue to contract into late Summer at least. US High Yield may still see some consolidation into late July / early August, but then rises again into late Summer along with risk assets.

Rate Differentials
p 52

The rate differential between the US and Europe should follow US rates lower into late July / early August, as these are more volatile than European ones. The differential should then bounce into late Summer.

Tips
p 50

The TIPs / Treasury inflation breakeven ratio should continue to rise moderately into late Summer.

Commodities

Oil
p 12-14, 15-17

Brent Oil could still see a short period of retracement into late July / early August. Downside risk over the next couple of weeks is probably in the mid/high 30s USD/barrel on Brent. Oil should then rally again from early August into late Summer, potentially into the 50S USD/barrel, perhaps even higher.

Industrial metals
p 12-14, 19-20

Copper and Industrial metals could also see some consolidation into late July / early August, potentially back towards 6'200 – 6'000 USD/ton for Copper, before rising again towards the 6'800 – 7'000 range into late Summer.

Gold & PMs
p 21

Gold remains in a strong long term uptrend, which should lead it above 2'000 USD/oz over the next few quarters, potentially into early this Fall, if not into early 2021. Shorter term, it remains rather correlated with risk assets and should continue to rise into late Q3 / early Q4. Silver is more cyclical, could retrace slightly with risk assets into late July / early August (potentially towards 18 USD/oz), but then rises again from early August into late Summer, towards the 20-21 USD/oz range. The Gold to Silver ratio could hence bounce slightly into late July / early August and then resume lower into late Summer. Gold and Silver mines should follow similar dynamics than Silver.

Agriculture
p 22

Agricultural Commodities may bounce slightly from late July / early August following other risk assets. They should then retrace down / retest down from late Summer into the Fall. Into late Summer, more cyclicalagricultural plays (e.g. Cotton or Lumber) may prove more dynamic.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	EUR/USD may continue to consolidate in the 1.14 - 1.12 range into late July / early August and then rises towards 1.15 - 1.18 into late Summer.	From late Summer EUR/USD could start retracing down towards 1.11 - 1.12 into mid/late Q4.
	GBP	GBP/USD may continue to consolidate in the 1.27 - 1.23 range into late July / early August and then rises towards 1.32 - 1.37 into late Summer.	From late Summer GBP/USD could start retracing down towards 1.27 - 1.25 into mid/late Q4.
	JPY	USD/JPY may continue to trade in a range between 106 and 109 until mid August and then starts to resume lower.	From late Summer, USD/JPY continues to drop into mid/late Q4 and potentially to below 104.
	CHF	USD/CHF may rebound into the 0.95-0.96 range into late July / early August. It then drops towards the 0.93 range into late Summer.	USD/CHF remains under pressure into early/mid Q4 potentially towards the low 0.90s.
EUR vs	GBP	EUR/GBP continues to hold up in the high 0.80s / low 0.90s until late July / early August. It then drops to the mid 0.80s by late Summer.	From late Summer, EUR/GBP could start to resume up into mid/late Q4 and potentially to above 0.90.
	JPY	EUR/JPY continues to consolidate in the low 120s until late July / early August and then rises towards 125 - 128 into late Summer.	From late Summer, EUR/JPY could start to drop back down into mid/late Q4 and the low 120s.
	CHF	EUR/CHF continues to trade in a range between 1.08 and 1.06 until late July / early August and then rises towards 1.10 into late Summer.	From late Summer, EUR/CHF could start to resume down into mid/late Q4 and towards 1.07 - 1.05.
GBP vs	JPY	GBP/JPY continues to consolidate in the 137 -132 range until late July / early August and then rises towards 145 into late Summer.	From late Summer, GBP/JPY could start to drop back down into mid/late Q4 and the mid 130s.
	CHF	GBP/CHF continues to consolidate in the 1.21 - 1.18 range until late July / early August and then rises above 1.25 into late Summer.	From late Summer, GBP/CHF could start to drop back down and into mid/late Q4 and the low 1.20s.

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

US Dollar

The US Dollar (i.e. the Dollar Index) could see a weak bounce into late July, perhaps early August and then resume its downtrend into late August / September. The Dollar Index could reach down towards 91. It then bounces back during Fall towards the mid 90s.

Euro
p 56

EUR/USD could also consolidate at high levels over the next couple of weeks, probably in the 1.14 – 1.12 range. From late July / early August, it then resumes its uptrend into late August / September, probably towards the 1.15 – 1.18 range. EUR/JPY and EUR/CHF could also see some retracement into late July / early August, but should then also rise into late Summer, probably above 125 on EUR/JPY and towards 1.10 on EUR/CHF. Then from late Q3, cyclicity should start to fade and the Euro should then retrace down again vs the US Dollar, the Yen and Swiss Franc.

Yen

The Yen is traditionally risk-off vs the US Dollar. Yet during the March sell-off and its aftermath, the funding needs on the US Dollar were so strong that it was more defensive than the Yen. Hence, during March USD/JPY rose with falling risk assets, while during the April recovery, it fell. This is very atypical. Since mid May, USD/JPY appears to have shifted back to its usual risk-ON / risk-OFF correlation. That said, going forward, we expect the US Dollar to remain weak across the board. Vs Yen, it may hold up in a range until early/mid August (109 – 106), but then drops into the Fall, probably to below 104.

Sterling
p 57

Sterling is the more cyclical of the majors. It could still retrace 2-3 figures into late July / early August vs the US Dollar, the Euro, the Yen or Swiss Franc, but then probably resumes higher during August, probably towards its February levels.

Swiss Franc

Swiss Franc is the other defensive currency. Yet, recently, it has been less defensive than the US Dollar. Hence, when risk assets rise, USD/CHF currently weakens, while EUR/CHF rises. Until late July / early August, USD/CHF may move back into the 0.95 – 0.96 range as risk assets retrace slightly, but should then drop into late Summer, probably into the 0.93- 0.91 range. The slide may extend into early/mid Fall and the low 0.90s as the Swiss Franc still appears strong vs the US Dollar.

Oil & Commodities currencies
p 57

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) and AUD especially have seen a strong rally since March and the downtrend which had been in place since late 2017 / early 2018 is now probably reversing. The basket could still retrace slightly vs the US Dollar towards late July / early August, but should then continue to rise into late Summer. Vs the EUR, the move will probably be less spectacular, but the basket should also rise into late Summer.

Asian currencies
p 32

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) is more defensive that the Commodity portfolio above. Vs US Dollar, it does show a similar profile than it, but probably with less upside potential into late Summer. Vs the EUR however, the situation is less clear as the EUR also appears strong into late Summer. We would hence probably remain neutral for now on the EUR vs Asian Growth Currencies.

Equities Markets Segmentation

Core Sector Weightings | **Next 2 months** | **3 to 6 months ahead**

US Sectors - S&P500 (general comment)			**We expect a modest cyclical bounce during August and perhaps into September as risk assets also resume higher**					**From late Q3, we would turn defensive again for 2-3 months into the Fall.**				
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%										

European Sectors - Europe Stoxx 600 (general comment)			Next 2 months: **We expect a modest cyclical bounce during August and perhaps into September as risk assets also resume higher**					3 to 6 months ahead: **From late Q3, we would turn defensive again for 2-3 months into the Fall.**				
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 18, 45

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

On the sector front, we expect a new rally to materialize from late July / early August, probably into late August / September. Cyclical factors could also bounce during this period. We would hence favor more Cyclical sectors during August and would underweight Defensive ones.

Following that, from late Summer, we would reverse this allocation and favor Defensives sectors vs Cyclical ones into mid/ late Q4.

During the next 6 months, we will probably neutralize Growth sectors as these do seem extended vs the market, although probably still uptrending.

Countries allocation

Core Countries Weightings			Next 2 months					3 to 6 months ahead				
All World Country Index Currency hedged (general comment)			**We would continue to underweight North America as the USD remains under pressure, and Overweight Cyclical Europe and China**					**From late Q3, we would Overweight more defensive geographies (US, Canada, Switzerland), neutralize China and Underweight the rest**				
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 20, 23-25, 26-32, 44

Please read the detailed allocation comments in our time frame boxes on the previous page.

Regionally, we would continue to underweight the US and Switzerland, ideally from late July / early August into late August / September. China may continue to outperform into late Q3, while France and Germany could bounce with cyclical factors during August.

Thereafter, from late Q3, we would probably favor defensive profiles such as the US, Canada and Switzerland and underweight Europe and Japan. China will be kept at neutral as it can also be quite counter-cyclical.

Note: the country and regional allocations in the table above are considered hedged for currency risk, i.e. the relative performances are compared and forecast in local currency (except for the S&P500 and the MSCI China Index 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	**We expect a slight cyclical bounce druing late Summer, we would neutralize most cyclical themes (from Underweight), even Overweight US Small Caps and Diversified Mining.**					**From late Q3, we would turn more defensive on our factor allocation.**				
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										

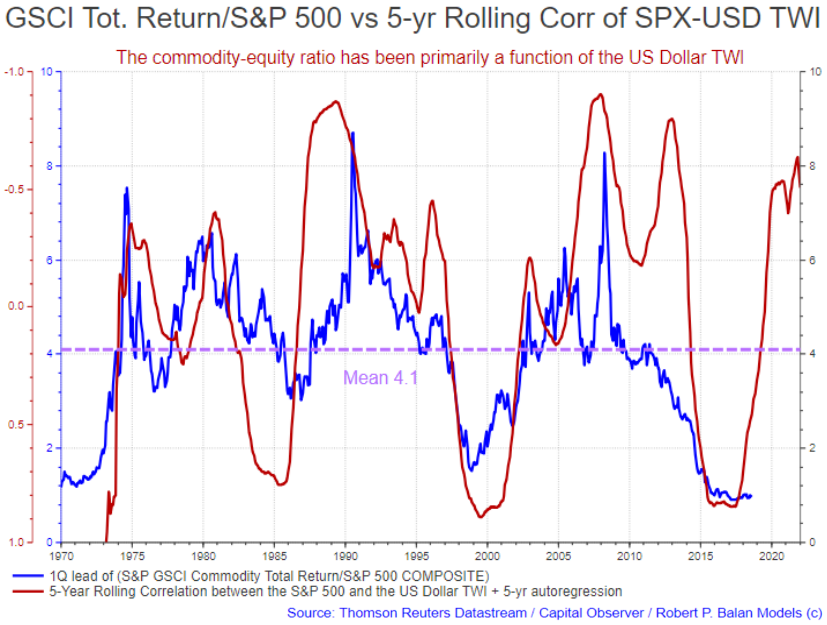
Core factors and Themes
p 43

On the factor front, we would favor cyclical and value plays from late July / early August into late August. Thereafter, from early/mid September, we would probably shift back to more Growth and Defensive themes as we expect the cyclical bounce to start to fade.

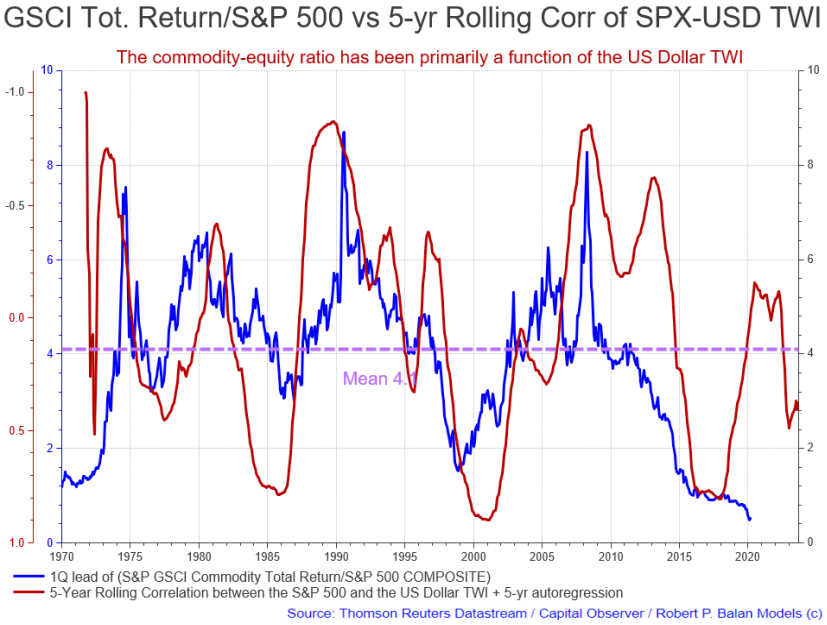
12 / Commodities emerge from the COVID-19 lows, as China's TSF rise in the back of significant government fiscal expenditures and recovery in imports

The last time The Capital Observer discussed commodities as an asset class was in April 2019 ("*Commodities outperformance over equities: we may have to wait a little longer.*") we published a graph that has held a lot of promise but not delivered yet and therefore has been tracked by us very closely. In the graph, we juxtaposed the rolling correlation between the S&P 500 and the US Dollar TWI, with a 5yr autoregression, which defined and illustrated the highly cyclical performance of commodities as an asset class versus the S&P 500 Index (as proxy for the equities asset class). This is how that model looked then (*see 1st graph on this page*).

Original graph from April 2019 Capital Observer



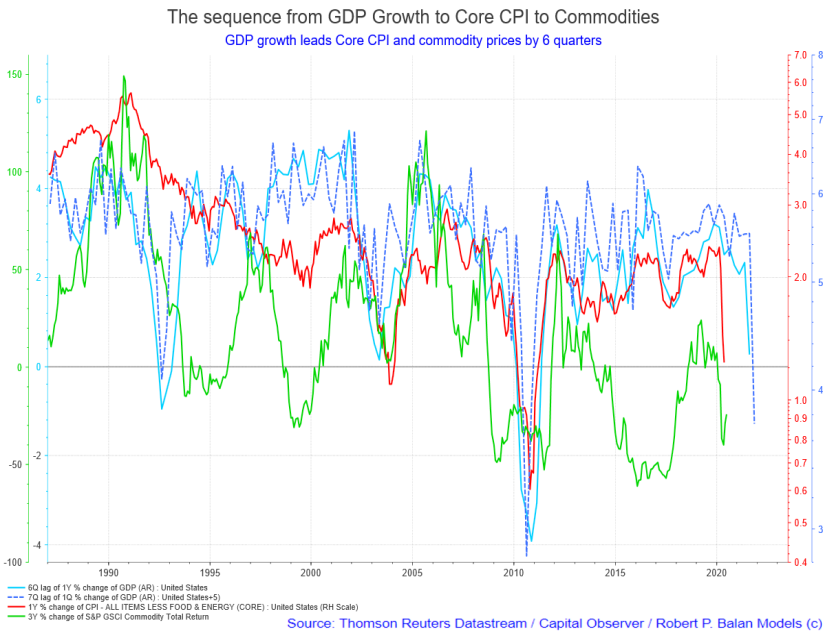
This is how this model looks today



Commodities vs the stock market

The model shows a highly cyclical phenomenon with a period of 15 to 18 years, marked by a significant outperformance of commodities over equities. At that time, there were high hopes that the cycle was about to reassert – commodities were going to outperform equity once again. We listed several events that have to happen for the commodities outperformance to take hold, namely: (1) commodities could rally while equities decline (or vice-versa); (2) commodities and equities fall together but equities decline at a faster and larger degree relative to commodities, and (3) commodities and equities rise together, but the former outpacing the latter.

At that time, we were focusing on factor (3) where commodities and equities will continue to rally, but with commodities outperforming equities. And for that to happen, growth has to sufficiently high, so as to generate relatively high inflation rates. Alas, that did not happen. GDP did not grow that high and quickly enough to generate inflation; and from early 2020, the COVID-19 pandemic cut down GDP growth prospects, and inflation came tumbling down as consequence (*see*



3rd graph on this page).

The pandemic depressed equities to relatively low levels, but commodity prices were hit even worse. And the bottom of commodity prices lagged behind the trough of equities, and came a full month later (*see 1st graph on this page*).

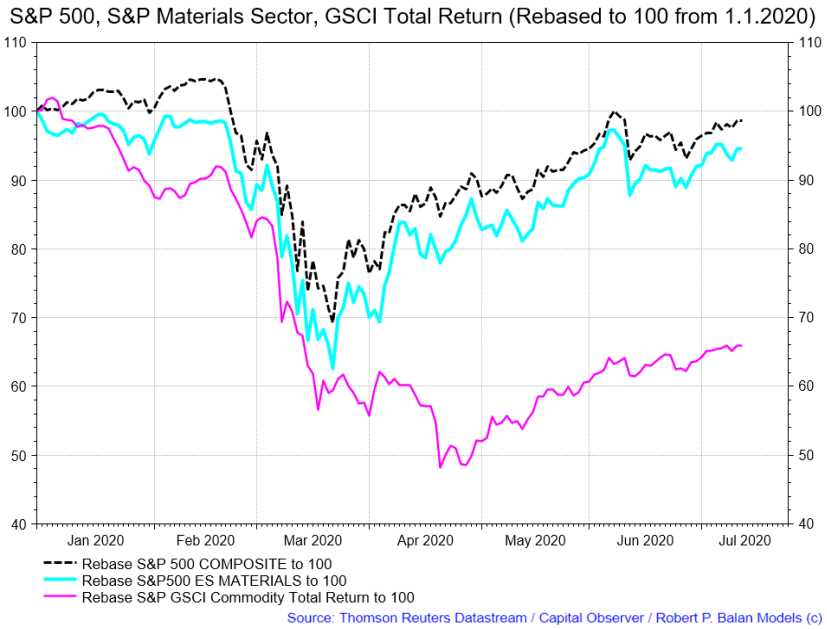
China remains the singular factor in commodities

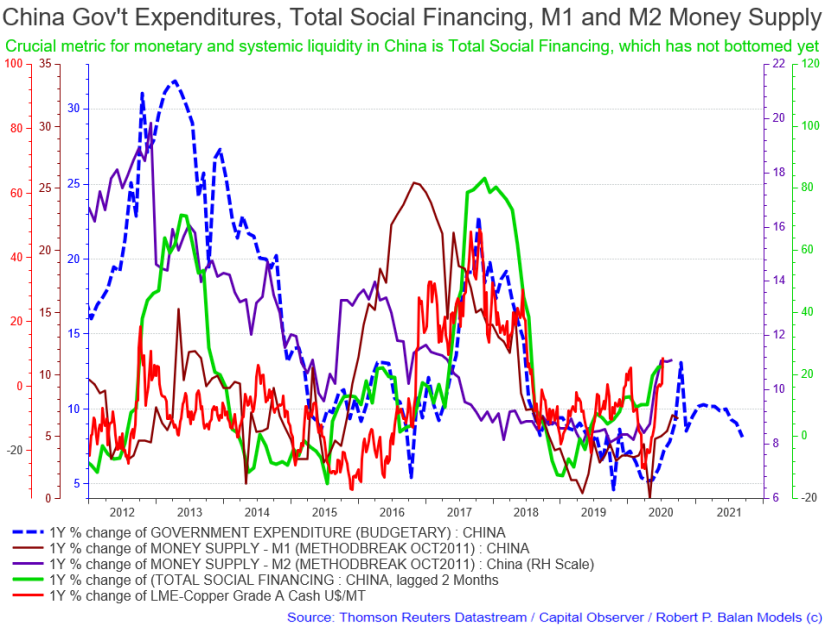
Therefore, it looks like we have to continue waiting for commodities to re-establish parity with equities. However, the outlook is not so bleak. **China, a primary factor in commodity demand, has bounced back from the depths of COVID-19 devastation**.

We cannot stress enough how crucial is the Chinese growth outlook to commodities. Chinese appetite for commodities had slackened somewhat from 5 to 7 years ago, but Chinese demand and consumption of raw materials is still the largest in the world, comparatively speaking. Despite lower growth rates, China has kept consumption of commodities still at high levels because the size of its economy has grown in the interim. The percentages may have shrunk but the nominal volume of commodities consumption is still very decent.

The measure we use to gauge the future prospects of Chinese growth and activity is the Total Social Financing (TSF) aggregate. TSF has been rising sharply, following last year's growth in fiscal expenditures in China (*see 2nd graph on this page*).

The importance of China's fiscal expenditures and its subsequent impact on commodities is immense, as the graph illustrates. We have copper prices as proxy for commodities in general, and it is demonstrably true that where China's fiscal outlays go, TSF follows, and in its heels, commodity prices tag along (*see 2nd graph on this page*). **So, it looks like commodities should do well until Q4 2020. But we may have to expect some pullback in 2021.**





The latest report from China are encouraging. China's imports in June rose for the first time since the coronavirus crisis paralysed the economy this year, as demand for commodities surged on the back of government stimulus, while exports also rose in a sign the country's recovery is gaining traction.

China's imports in June rose 2.7% from a year earlier, customs data showed on Tuesday, confounding market expectations for a 10% drop. They had fallen 16.7% the previous month. Exports also rose unexpectedly, up 0.5%, suggesting global demand is starting to pick up again as many countries begin to ease tough anti-virus measures that have pushed the world's economy into its biggest slump in almost 90 years. Analysts had estimated a 1.5% drop following a 3.3% decline in May.

Indeed, iron ore imports jumped to the highest in 33 months in June, the trade data showed, fuelled by rising shipments from miners and robust demand. Crude oil imports also hit an all-time high amid bargain hunting by Chinese refiners as oil prices collapsed.

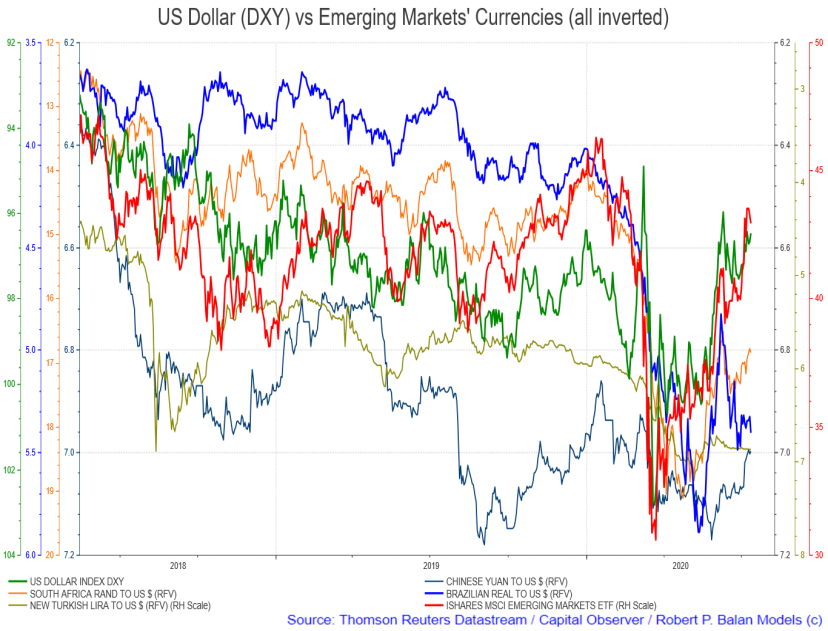
Commodities performance in Q2 2020

On the back of the Chinese recovery, there were also some impressive commodities performance during Q2 this year. Four of five sectors posted gains in Q2. There were double-digit percentage increases in three of six sectors. Energy is the biggest winner with an over 55% gain. There were double-digit percentage gains in the base and precious metals. In a sign of the recovery in the commodities sector, the Baltic Dry Index moved 227.37% higher in Q2.

The raw material markets made a comeback in the second quarter of 2020 after the global pandemic caused a deflationary spiral taking the prices of most assets lower in Q1, when the sector fell 17.77% relative to 2019 closing prices for the year.

The overall winner for the first quarter was gasoline that posted a gain of 102.72% in Q2 with NYMEX crude oil in second place with a 91.75% gain. The biggest loser for the quarter was the ICE coffee market that fell 15.93% with Palladium in second place on the downside with a 14.66% loss in Q2.

Sector-wise, Energy was the best-performing sector in Q2 as the commodities that power the world rose by 55.73%. Base metals posted a 12.88% gain as copper prices moved over 20% higher for the quarter. Precious metals were just over 11.5% higher, led by silver and gold. The yellow metal continued to power higher and was breaking the $1800 per ounce level last week. Soft commodities were 4.24% higher on the quarter with cotton and sugar leading the way on the upside during the three months. Grains rounded out the winners with a 2.97% gain led by nearby oats and rice futures.



The impact of the US Dollar on commodities

The U.S. dollar is typically a significant factor when it comes to commodity prices, as it tends to have an inverse value relationship with raw material prices. The dollar index posted a 1.76% loss in Q2 but was still 1.35% higher for the year. The dollar index was 0.34% higher in 2019.

The Fed pushed the Fed Funds rate to zero percent in 2020. Quantitative easing is back, and more substantial than ever in the US and Europe as central banks seek to stabilize markets until scientists can develop treatments and/or a vaccine for the virus. **The Fed continued to signal that interest rates would not rise anytime soon in Q2. This had significant impact on the US Dollar, which gave back the gains it made during the height of the COVID-19 pandemic.**

Continued decline in US yields and further rise in the Fed's QE program plus US Treasury debt issuance would continue to have a dampening effect on the exchange rate of the US Dollar. We believe that this should give a positive spin on commodity prices and in the exchange rate of Emerging Market currencies. That in turn has supported the shares of Emerging Market countries (*see graph above*).

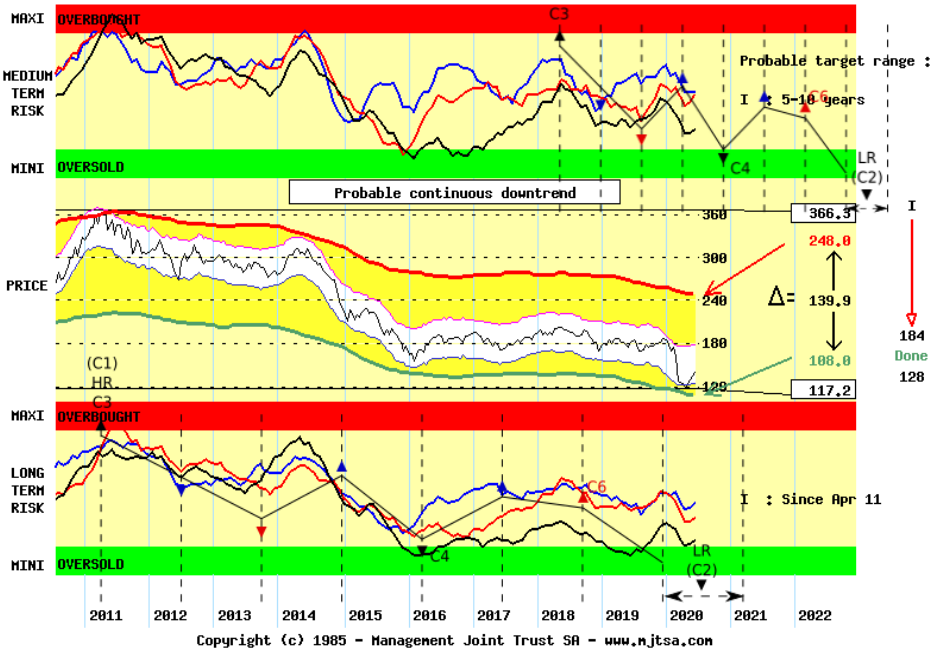
As we head into the third quarter, 2020 is anything but a typical year in all markets, and the spread of Coronavirus is a primary issue that will influence prices over the coming months. The economic fallout from the pandemic will affect prices in the years ahead but also both demand and supply side dynamics. Nonetheless, commodities have seen some impressive comeback from COVID-19 lows, and with China looking to have better growth and activity prospects in H2 2020, commodities, especially copper should carry on to do relatively well.

15 / MJT - TIMING AND TACTICAL INSIGHT

Commodities may have made a secular bottom in March/April

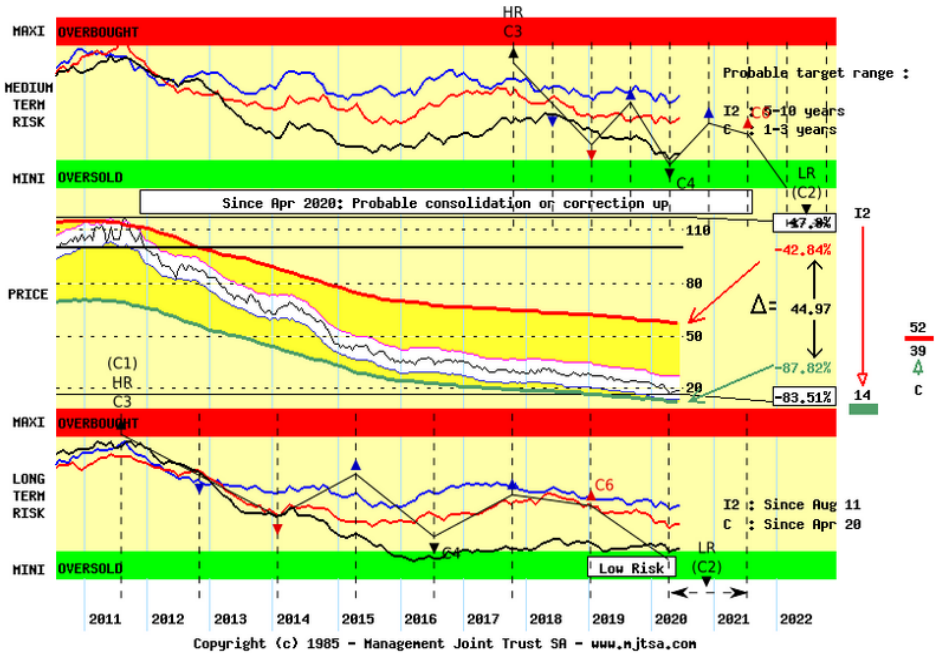
The long term downtrend of Commodities dates back to 2011. More recently, following the 2016 – 2017 reflationary trade, they had suffered a further 2 years of cyclical downturn. These negative developments may have been concluded in March or April with the climax sell-off that then materialized on many commodities. In this article, we attempt to gauge the strength of the recovery and its sustainability in order to understand if a secular bottom may have been made, and if it could lead into several years of uptrend for Commodities.

Reuters Commodities Futures price index
Bi-monthly graph or the perspective over the next 1 to 2 years



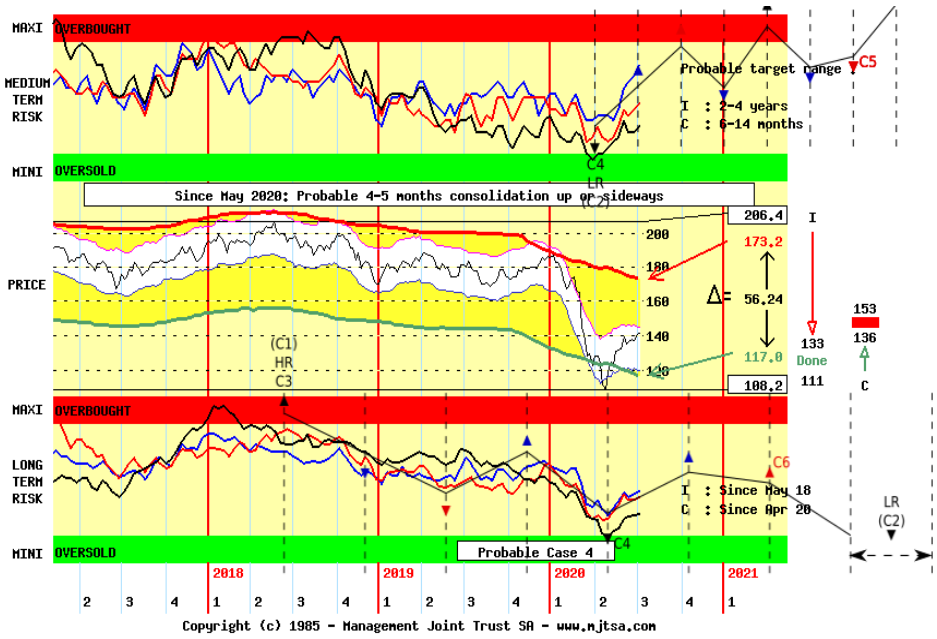
The Reuters Commodities Futures price index is a price weighted commodities index which is quite diversified with circa 40% Energy exposure, 40% Agricultural exposure and 20% Precious and Industrial metals exposure. Most other Commodity indexes have a dominant exposure to Energy and Oil products and are hence less representative of the whole Commodity space. **On this bi-monthly graph, following 10 years of persistent downtrend, the index is approaching a Low Risk position** on our long term oscillators (lower rectangle). **The move, which reminds us of the long term downtrend of most currencies vs the US Dollar, does seem quite exhausted**. Indeed, our I Impulsive targets to the downside (right-hand scale) have been achieved (the upside is starting to look advantageous in terms of risk/reward). **Shorter term however, it is still unclear if a secular bottom has been made, as our medium term oscillators (lower rectangle) seem to point to further downside retesting towards late this year.**

Reuters Commodities Futures price index vs the S&P500 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



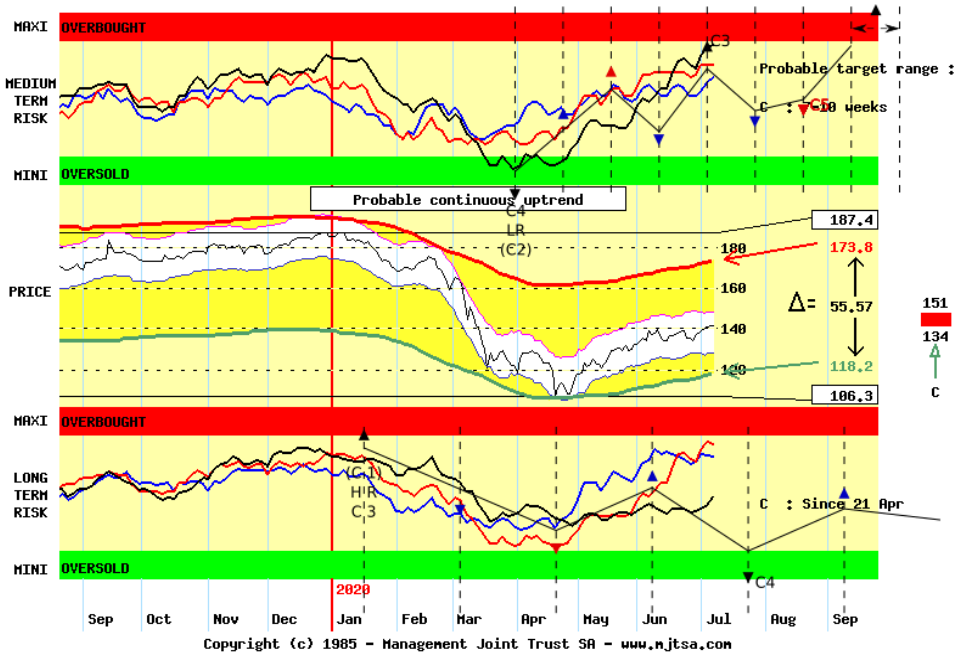
Compared to Equities, the ratio of the Reuters Commodities Futures price index vs the S&P500 is also very Oversold, and extended to the downside. Our long term oscillators have reached a Low Risk position (lower rectangle) while our I2 Impulsive 2 extended targets to the downside have almost been achieved (right-hand scale). Hence, **longer term and on a relative basis, it is probably time to start taking a closer look at the Commodity space, although as shown our medium term oscillators (upper rectangle) a secular reversal cannot be confirmed yet.**

Reuters Commodities Futures price index
Weekly graph or the perspective over the next 2 to 4 quarters



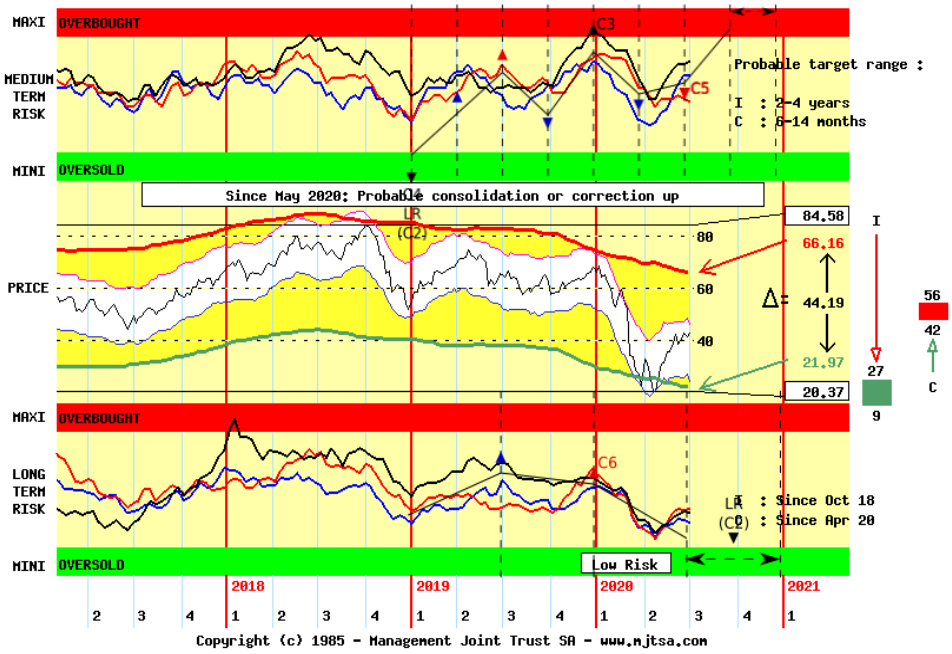
We now move back to the Reuters Commodities Future price index on an absolute basis on this Weekly graph. The climax low which was done late April (a month later than on equity markets) may have plugged a secular bottom. Indeed, in term of risk/reward, the downtrend was then very much exhausted with prices below our I Impulsive targets to the downside (right-hand scale). On our long term oscillators (lower rectangle), we would initially consider the bounce since April as a rebound. It may last into late Q3 / early Q4, but could then theoretically still roll-over again to the downside into 2021. On our medium oscillators (upper rectangle) we show a more positive sequence. It probably makes **higher highs into late Q3, retraces down during Q4 and then extends higher again into Spring 2021. Such positive momentum would then probably confirm a secular reversal**. Breaking above the resistance of our C Corrective targets to the upside around 153 (right-hand scale), or circa 10% above current levels, would also provide a positive confirmation. **On the other hand, any failure to maintain this positive momentum into late Q3 and then Spring next year would be negative**. This analysis is quite similar to the one on EUR/USD, GBP/USD and AUD/USD in the Splicing the Markets section of this issue of The Capital Observer.

Reuters Commodities Futures price index
Daily graph or the perspective over the next 2 to 3 months



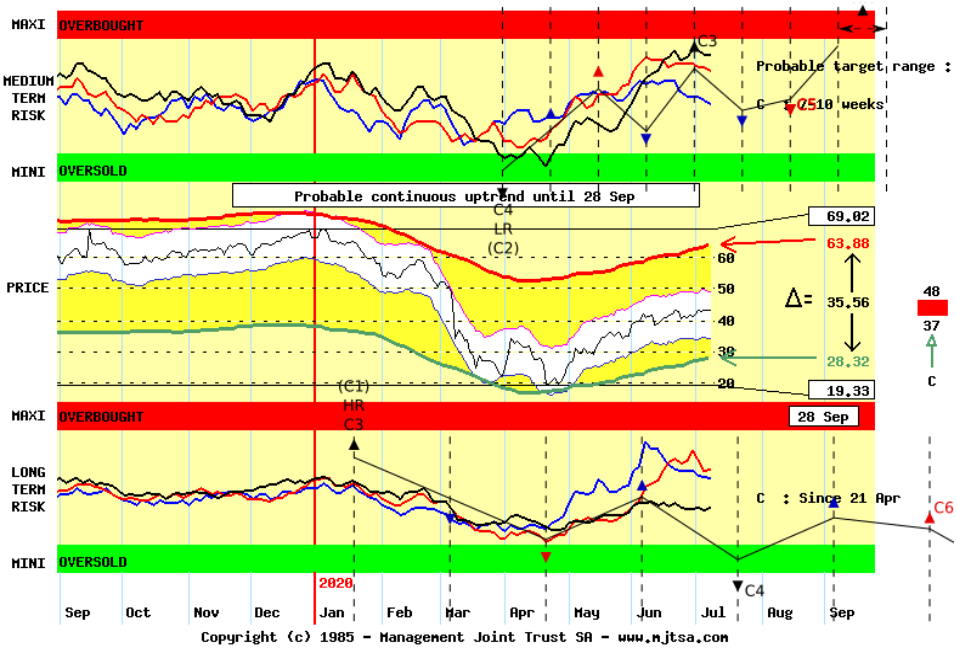
Shorter term, on a Daily basis, the Reuters Commodities Futures price index has been quite resilient since it started to rebound in late April. It could now be **ripe for some kind of intermediate correction**. Both our oscillator series (lower and upper rectangles) suggest that it **may happen over the next couple of weeks. Following that, we would then expect further upside into September**. Breaking above the resistance of our C Corrective targets to the upside (above 151, i.e. 8% above current levels; right-hand scale) would then provide an initial confirmation that Commodities may be in the process of performing a secular reversal to the upside. If not, new lows may be expected this Fall or perhaps during 2021.

Brent Oil (USD/barrel)
Weekly graph or the perspective over the next 2 to 4 quarters



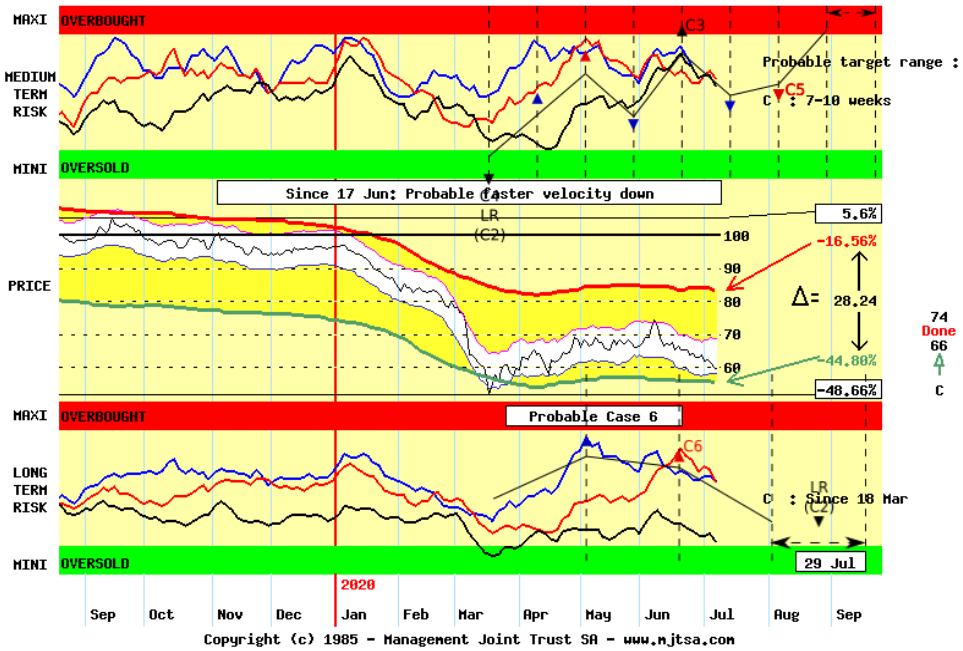
Energy is historically the more volatile segment of the Commodity space. Oil's sell-off since October 2018 has indeed been impressive (circa -80%) while the rebound since late April has been equally dynamic with more than a 100% of performance. **For now, this rebound is however still countertrend. It may last into late Q3** as shown on our medium term oscillators (upper rectangle), **but then probably suffers a downside retest during Q4** as shown on our long term ones (lower rectangle), which are still under downside pressure. **The next couple of months will be crucial in understanding if a secular bottom was made in April. Indeed, if prices manage to break above the resistance of our C Corrective targets to the upside (i.e. above 56 USD/barrel; right-hand scale), it then probably becomes likely that the uptrend can extend into 2021.**

Brent Oil (USD/Barrel)
Daily graph or the perspective over the next 2 to 3 months



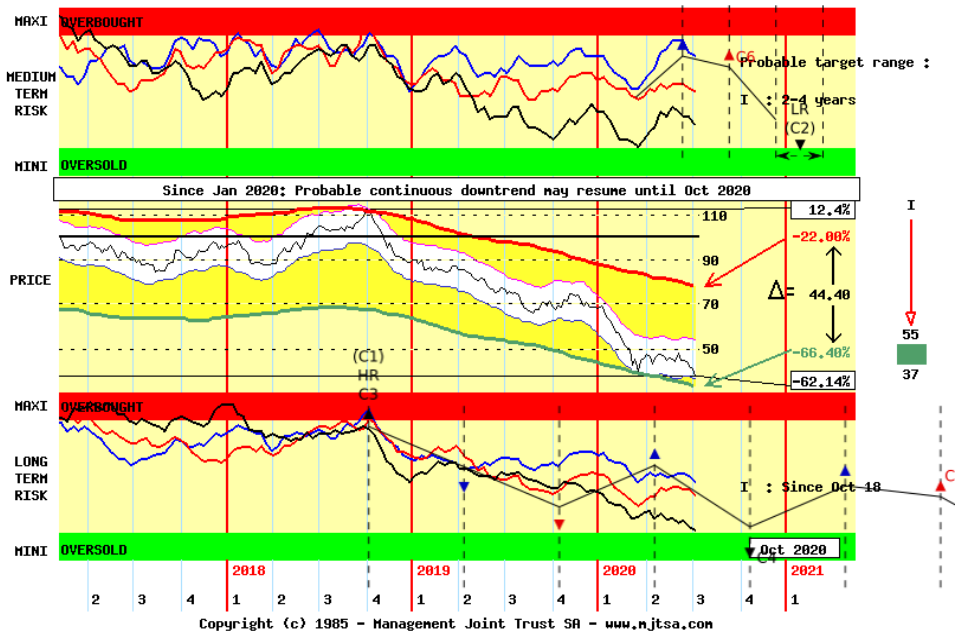
On the Daily graph, similarly to the Reuters Commodities Futures price index, an intermediate correction may materialize over the next couple of weeks on both oscillators series (lower and upper rectangles). Then, from late July, perhaps early August, Brent probably resumes higher into September. It will then be crucial that it breaks above our C Corrective targets to the upside around 48 USD/barrel (right-hand scale), and if so, it could then even push to our next level of targets (our I Impulsive targets to the upside), which we calculate in the 66 – 80 USD/barrel range over the next 3 to 6 months (1.3 to 1.7 times our historical volatility measure "Delta", here at 35.56 USD/barrel – middle rectangle; right-hand scale- added to the graphs lowest point at 19.33 USD/barrel). This sounds aggressive, yet as mentioned above, Oil is indeed very volatile. In the meantime, however, **our analysis will be focused the likelihood for Oil to resume its uptrend from late July into August and on its capacity to break above its 48 USD/barrel resistance. If it fails to do so, it then probably reverses down from early September and towards a deep downside retest during Q4**, as shown on our long term oscillators (lower rectangle).

S&P Energy Sector vs the S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



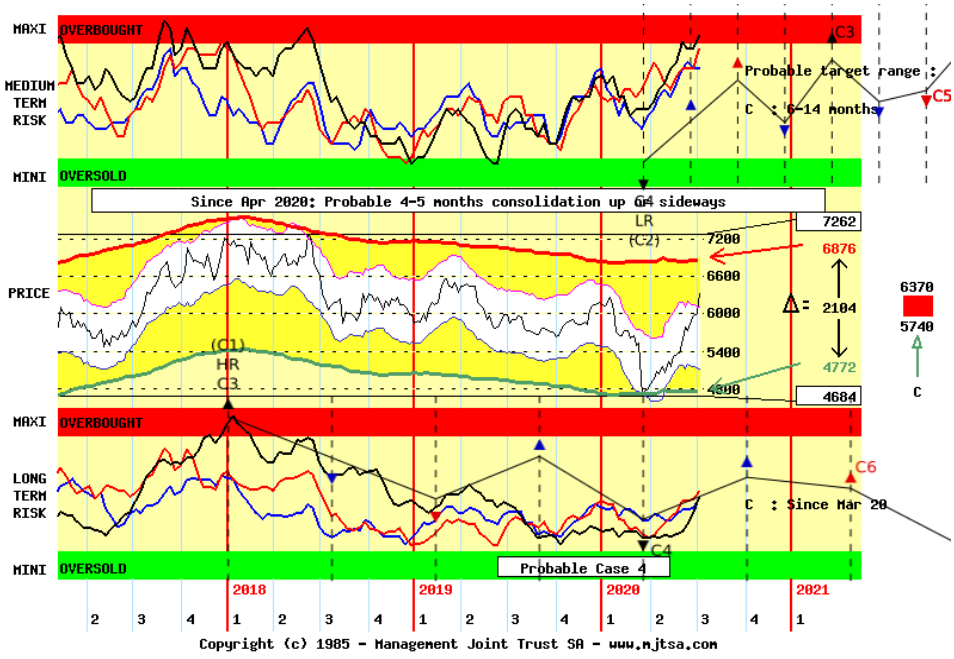
When considering the equity side of the Energy nexus, it is still difficult for now to forecast a strong upside reversal. Indeed, on this Daily graph, the ratio of the US Energy sector vs the S&P500 remains very weak. It did bounce between March and June, along with equities, but is now suffering **a deep downside retest, which probably extends into late July/ early August at least, and could even make new lows. A slight bounce is then expected into early September, but we doubt it will have enough strength to break above the resistance of our C Corrective targets to the upside around 74** (i.e. 14% higher than today on a relative basis; right-hand scale), and reverse the ratio's persistent downtrend. Hence, as far as the Energy sector is concerned, further downside is then probably expected into Q4. The ratio has historically been much weaker than Oil prices, yet its dynamics do follow Oil quite closely. Hence, **unless the August rebound is much stronger than we expect, we would probably turn very prudent on Oil and Energy from late Q3 into Q4.**

Global Solar Energy vs Global Clean Energy
Weekly graph or the perspective over the next 2 to 4 quarters



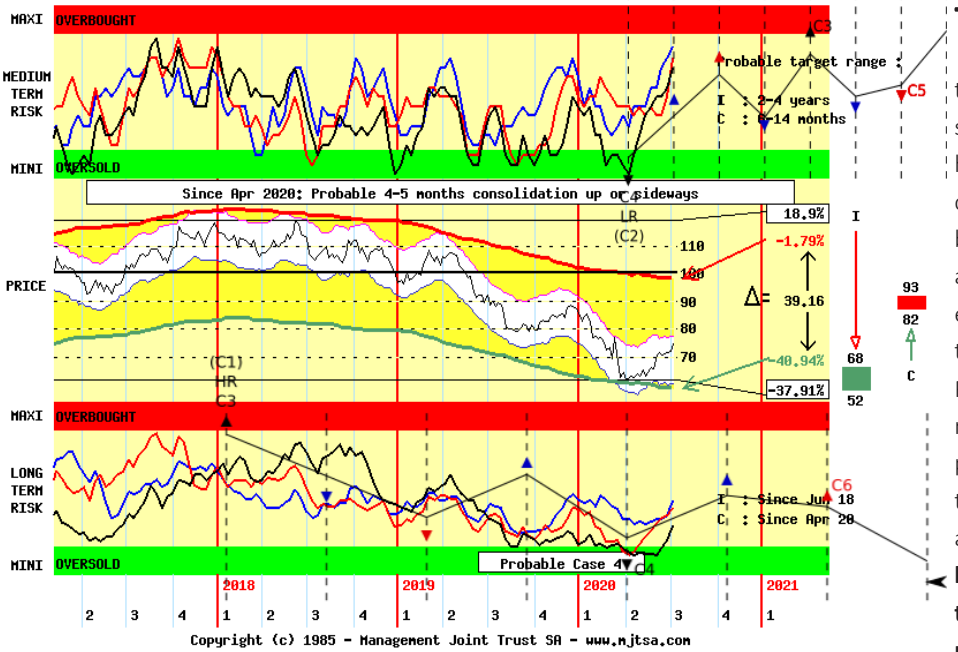
There is a lot of talk today about the structural switch from Fossil Energy to Alternative Energy production. This issue is crucial for Oil and the Energy sector, and indeed the ratio of the Global Energy sector vs the Global Clean Energy sector is usually well correlated to Oil prices. The ratio is currently quite Oversold in terms of targets (right-hand scale), and **a short bounce is still possible during the Summer** on our medium term oscillators (upper rectangle). Yet, **from late Summer**, both oscillator series (lower and upper rectangles) do suggest **further downside into Q4 and perhaps year-end. Hence, this ratio also suggests that although Fossil Energy could see another bounce into late Summer, a downside retest is then awaited this Fall.**

Copper Spot (LME, USD/ton)
Weekly graph or the perspective over the next 2 to 4 quarters



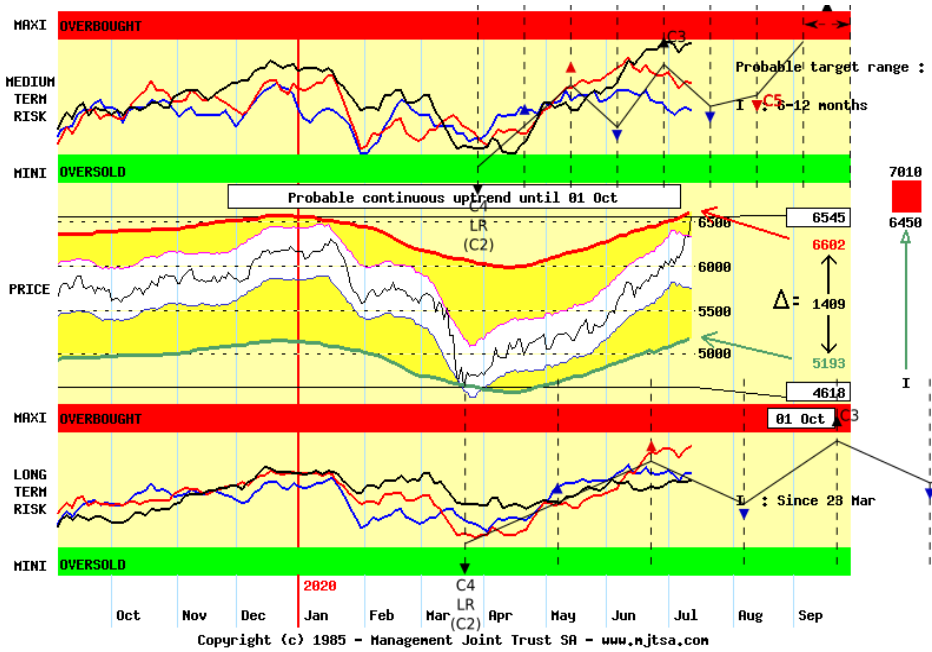
We now turn to the Industrial Metals segment and more specifically to Copper, which saw a strong climax sell-off in March. It has since been rebounding, and both oscillator series (lower and upper rectangles) suggest that this bounce may last into late Q3. Following that, we expect some retracement during Q4 on both oscillator series, and then perhaps a new upside attempt into next Spring. **If Copper manages to maintain its upside momentum with higher highs into late Q3 and then next Spring, a new secular uptrend will probably have started. In the meantime, as a first step, it would be very promising if Copper manages to break above the resistance of our C Corrective targets to the upside, i.e. above 6'370** (right-hand scale). This would theoretically confirm further upside potential towards its early 2018 highs. As we write, Copper is currently just shy of these breakout levels. Hence, **we are quite positive on Copper until late Summer, yet do expect some retracement this Fall, probably without new lows.**

Copper / Gold ratio
Weekly graph or the perspective over the next 2 to 4 quarters



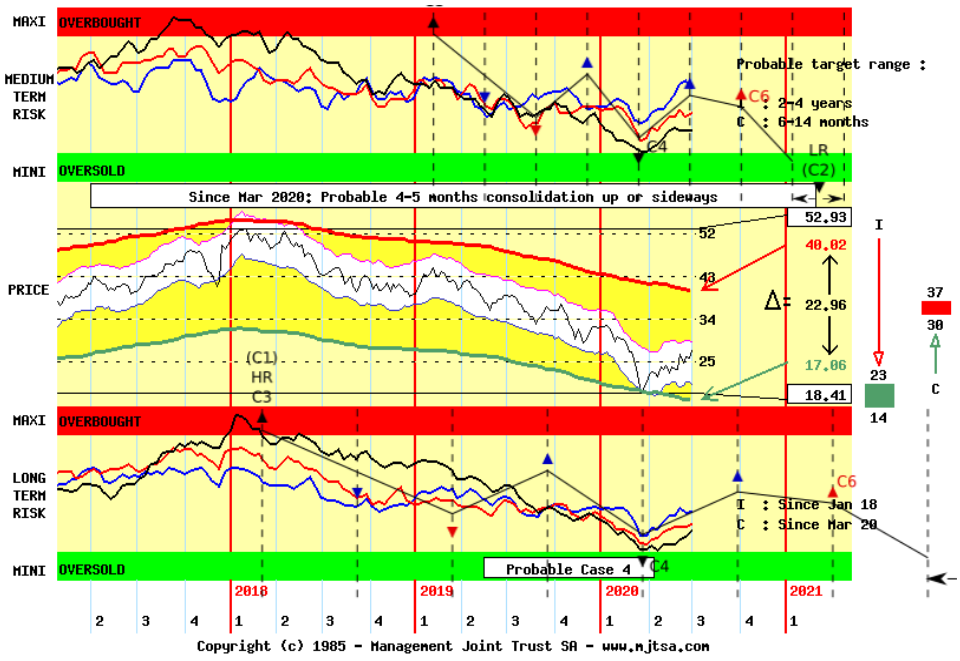
The Copper to Gold ratio is a classical cyclical ratio. It too has been in a downtrend since early 2018 and could have made an important secular bottom in early Q2. On both oscillator series (lower and upper rectangles), we now expect the current rebound to continue into late Summer. Following that we expect some retracement into Q4 and then potentially a new upside attempt into next Spring. Here also, **confirming the ratio's long term reversal will require that upside momentum is maintained, with potentially higher highs towards late Summer, and then next Spring (upper rectangle)**. If not, the ratio could then resume lower this Fall, and following a bounce early next year, could continue lower into next Summer.

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



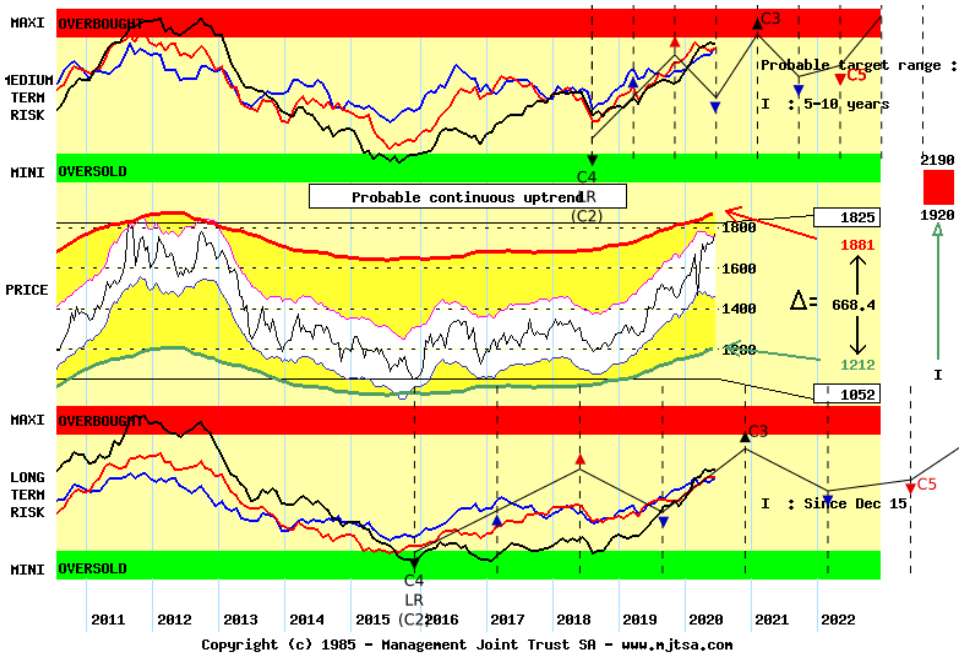
On a Daily basis, the Copper rally since March has been impressive. On both oscillator series (lower and upper rectangles) an intermediate top should now have been reached. **We would expect 2 to 3 weeks of consolidation to the downside at least, probably into late July, perhaps early August. Following that, a further leg up should materialize into September, potentially with higher highs in the 6'370 – 6'910 range** (right-hand scale). Late September / October could then see another intermediate top and a correction to the downside which may last 2 to 3 months.

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



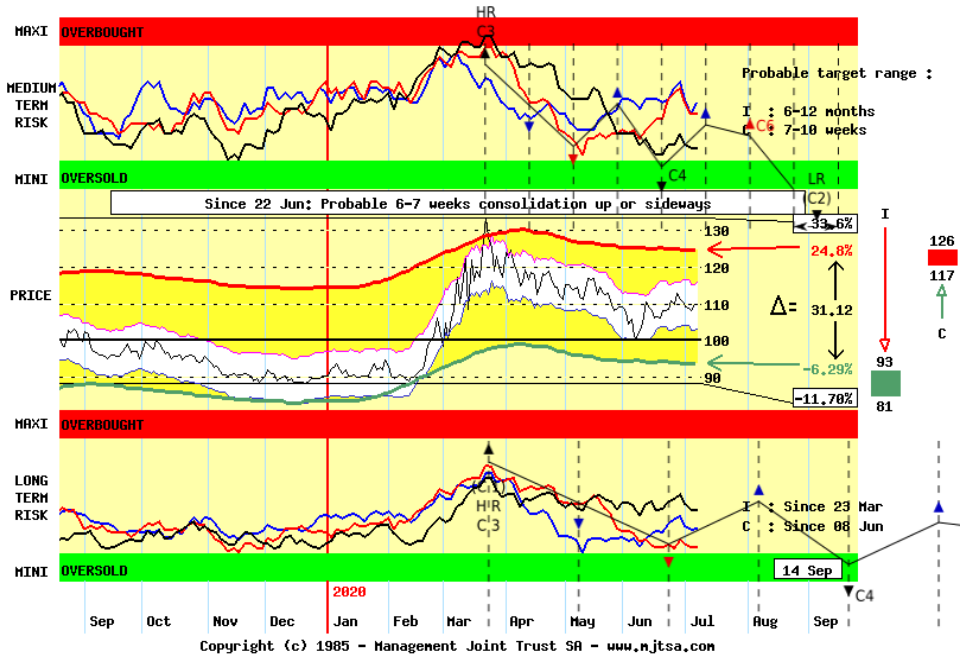
While China, the largest source of demand for industrial metals, seems very well positioned into the Summer (i.e. its equity markets), Chile (ECH ETF in US Dollars used as proxy for the MSCI Chile Index) is also interesting to consider as the country is its largest producer. On our long term oscillators (lower rectangle), the sequence we show is similar to many other sequences featured above where following 2 years of downtrend, the MSCI Chile could bounce into late Q3, before retracing into Q4. **On our medium term oscillators (upper rectangle) we are slightly more negative compared to the Commodity graphs featured above. Indeed, a new sequence down starting early 2019 is quite visible. It would imply that the rebound since March dies out this Summer without new highs and then probably makes new lows towards early next year. Although rather negative, this projection may provide an interesting monitoring tool, as any positive deviation from it could eventually confirm a more positive outcome. Nevertheless, the MSCI Chile index does seem to hold up until late Q3 in first instance, which allows us to give the index the benefit of the doubt for now.**

Gold Spot (USD/oz)
Bi-monthly graph or perspective over the next 1 to 2 years



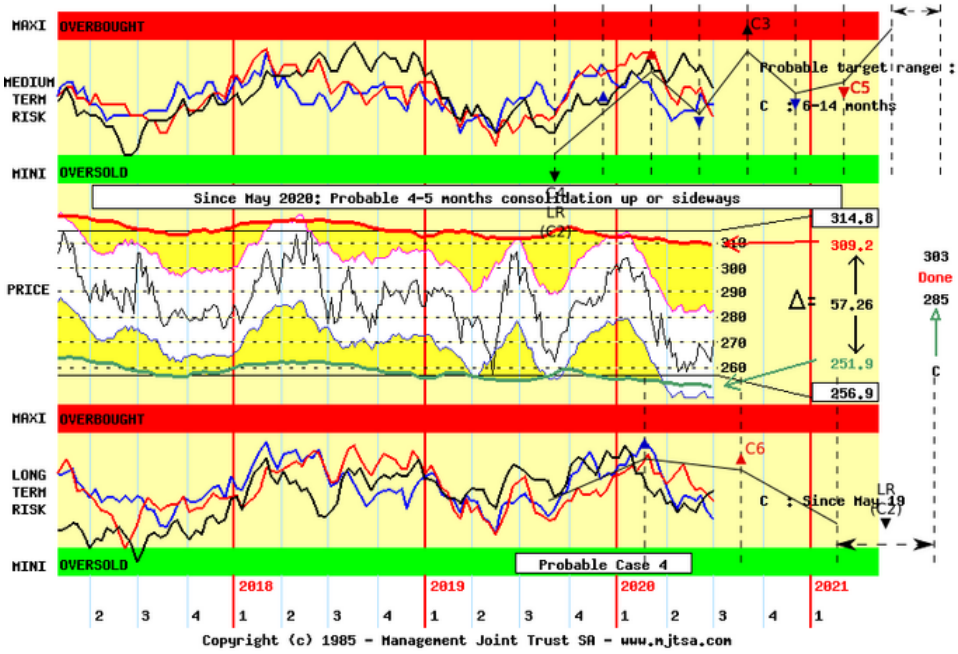
Over the last few months, and quarters, Gold has been difficult to time on a short to medium basis. Indeed, apart from its deleveraging and re-leveraging swing during March and April, it has typically risen during risk-off phases and consolidated at high levels during risk-on ones. Hence, **its long term trend is skewed to the upside, probably until late this year / early next year at least** according to both our oscillator series on this long term bi-monthly graph (lower and upper rectangles). Until then, our I Impulsive targets to the upside (right-hand scale) indicate that **Gold could reach into the 1'920 – 2'190 range or potentially to new all-time highs. Hence, in this environment were central bank monetary policies are very reflationary, we believe Gold remains a strategic asset to hold. This is probably true as long as the economic recovery doesn't accelerate.**

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



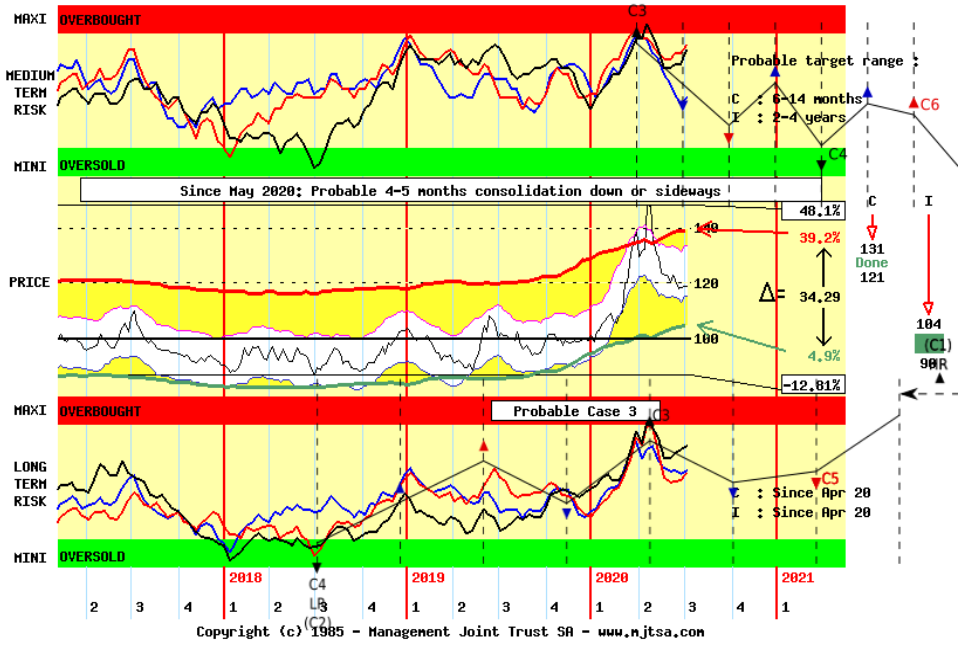
While Gold benefits from loose monetary policies, the positive effect on equity markets is usually much stronger. Hence, the ratio of Gold vs the S&P500 is a good defensive risk-off / risk-on proxy. As seen on this graph, it did shoot up quite strongly during the February/March sell-off (40% outperformance for Gold vs Stocks), and this despite Gold having suffered from the deleveraging effect in March. Since then, equities have rebounded and the ratio has retraced circa half of its Q1 gains. On both oscillator series (lower and upper rectangles), **we expect this retracement to continue, probably into late August, perhaps September, which is a risk-on indication. Shorter term however, the rebound on the ratio since early June may continue for another couple of weeks, which suggests that risk assets could also see a further DIP during this period.**

Goldman Sachs Agricultural Commodities
Weekly graph or the perspective over the next 2 to 4 quarters



Agricultural Commodities (the Goldman Sachs Agricultural Commodities Index) usually outperform late in the cycle during stagflationary periods, less so during early recovery phases such as today. On average, they are slightly risk-on, but less so that most other risk assets. Since the beginning of the year, this has been the case, and Agricultural Commodities did drop during Q1 and into April, and have since been attempting to bounce. According to both oscillator series (lower and upper rectangles), we expect **this bounce to continue into mid/late Summer. Yet, Agricultural Commodities will probably lag other risk assets. Following that, we would expect them to retest down into late Q4 and probably even towards early next year. Hence, although some of the more cyclical Agricultural Commodities may be appealing over the next month or so (e.g. Cotton or Lumber), the segment as a whole should lag other risk assets for now.**

Goldman Sachs Agricultural Commodities vs the Reuters Commodities Futures price index
Weekly graph or the perspective over the next 2 to 4 quarters



On a relative basis, Agricultural Commodities (the Goldman Sachs Agricultural Commodities Index) are less cyclical than the wider Reuters Commodities Futures price index. Logically their relative ratio vs the wider Commodity index shows the opposite profile as many of the graphs above. Indeed, on our long term oscillators (lower rectangle) following 2 years of outperformance (Agricultural Commodities have dropped less than other Commodities), the ratio topped out in April and has since been retracing (as more cyclical commodities such as oil or industrial metals have rebounded aggressively). **Going forward, we expect this retracement period to extend into late Q3** on both oscillator series and perhaps even into Spring next year on our medium term ones (upper rectangle). Keeping this downside momentum on this ratio will be a further indication that the Commodity space in general can initiate a new secular uptrend, while Agricultural Commodities continue to lag.

Concluding Remarks:

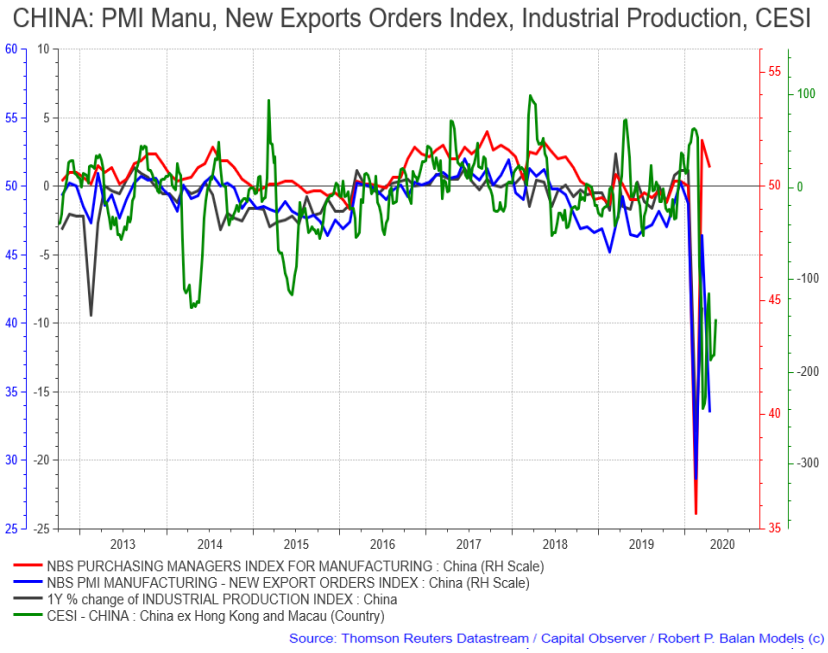
Most Commodities had suffered a two years downtrend since early 2018, along with China and many cyclical factors. The COVID sell-off in March and April resulted in many (and oil and copper in particular) making a climax sell-off, i.e. potentially a long term climax low. The rebound since then has been swift and may be approaching an intermediate top. We now expect a couple of weeks of consolidation to downside into late July, perhaps early August, followed by a new upside attempt into late August, perhaps September. Oil and Copper especially may then break out to new highs since March and possibly recuperate much of their Q1/early Q2 sell-off, while Gold could continue to rise more a subtly yet linearly until it reaches our 2'000 USD/oz targets, at some point between late Summer and Spring next year. In the meantime, more cyclical commodities (oil, copper) could see a correction to the downside this Fall, but should then attempt another leg up from late Q4 into Spring 2021. More generally, when considering the wider Reuters Commodities Futures price index, Commodities may have made a secular bottom in April, but will now need to maintain their upside momentum, with higher highs into late Summer and then again next Spring to confirm this reversal. Otherwise, 2021 may see further weakness and perhaps new lows.

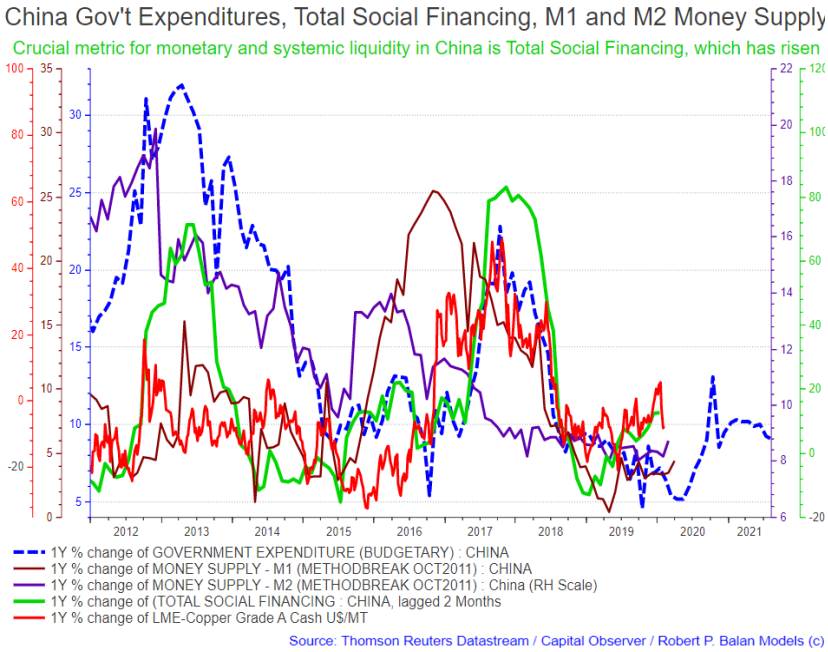
23 / China growth and activity is indeed picking up in early Q2 as we expected; China could lead a global growth rise in H2 2020

The last time we dwelt in depth about China was in May edition of The Capital Observer when we bannered the headline: "***China's "false dawn" became a nightmare, but post COVID-19 prognosis of Q2 turn-around looks good as TSF rises sharply.***" This is what we said then:

One sees from the updated chart (see 1st chart on this page) that China PMI for manufacturing has bounce backs, in a V-shaped recovery, above expansion. This is either an impressive feat of bouncing back smartly, or it is a contrived data. As the impartial (and severely underwater) Citi Economic Surprise Index indicates, it is probably more of the former. Even the companion series of the PMI, the New Export Orders Index, say so.

We also showed in February that the TSF made a slight uptrend (see 2nd graph on this page), but was tending to wilt from here, going into Q2 2020. The primary mover of the TSF, central government expenditures (dashed blue line), is indicating that redress will only come by early Q2 this year, and then some moderate increase in TSF funding until year end of 2020. Thereafter, TSF levels will fall again. Our lead indicator for TSF, the Copper cash price, is showing us that TSF, and thereby industry financing, is heading lower again. This is how these factors looked at that time (see 2nd graph on this page).





Total Social Financing has risen, and with it the prices of commodities (proxied by Copper). As we have always suggested, TSF will rise during Q2 2020, and with it, the money supply (both M2 and M1) and commodities should rise as well (see 2nd graph on this page). Here is a quick summary of TSF, and why it exerts a tremendous impact on Chinese activity and growth.

The TSF is derived from the changes in China's government expenditures, and so the combination provides a window into the process which stems from China's fiscal policy, through the TSF, and to the monetary aggregates and economic activity.

Total Social Financing (TSF) sums up total fundraising by Chinese non-state entities, including individuals and non-financial corporates. And it has become the signature metric for systemic liquidity in the country, and is deemed a better indicator of monetary policy than traditional measures of money supply (e.g., M1, M2). TSF was created to help Chinese leaders keep tabs on fundraising as the financial system diversified away from state-

controlled policy lending. TSF is being influenced to a large degree by the Federal fiscal and budgetary policies over the preceding 8 quarters.

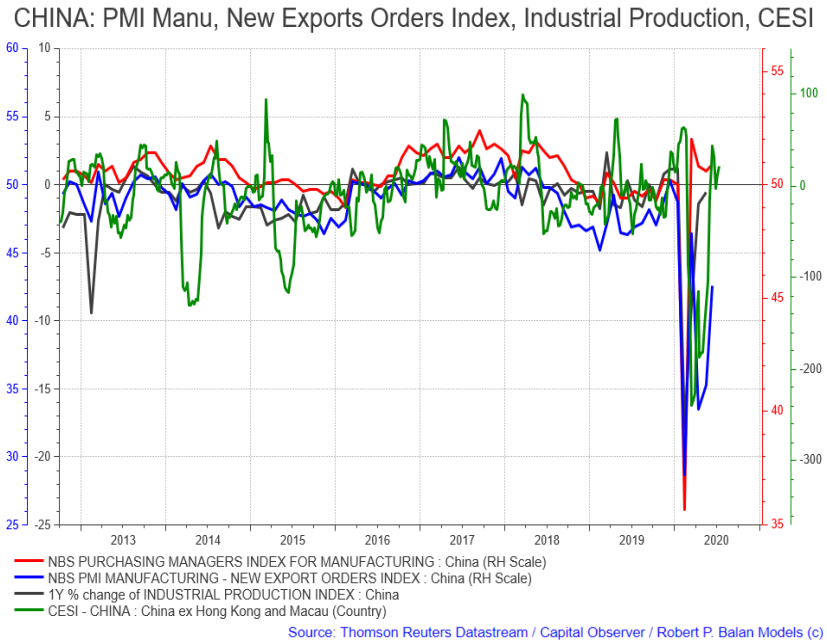
Total Social Financing has the power to project the course of growth and economic activity in China in the next 9 quarters -- TSF will remain a reliable "forecaster" of what will likely happen in China in the near-term.

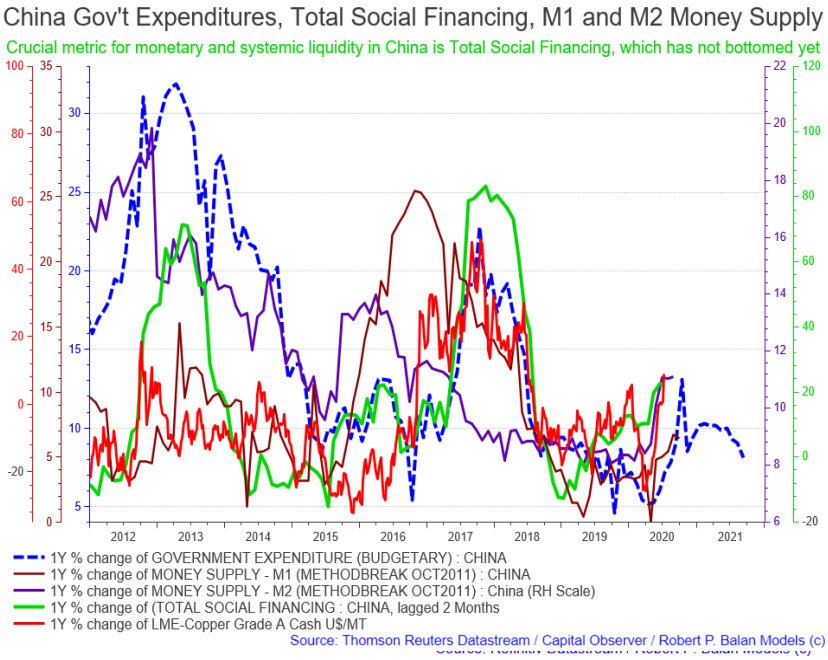
What also fed out optimism for a Q2 China recovery were some well-timed monetary policy initiatives. **The Chinese central bank deployed moves which kick-started the economy**. China's PBoC vowed that it will resort to "more powerful" policies to counter the hit to growth due to the coronavirus pandemic, which it did, and it dropped its previous vow "avoid excess liquidity flooding the economy." The PBOC's aggressive stance since late February to reignite the economy did continue in the past two months, with the central bank having put more emphasis on economic growth and employment since we last visited the China issue.

What has changed since mid-May 2020 when we last discussed China?

For one, the Citi Economic Surprise Index (CESI) for China has improved significantly since we published it in May (*see first graph on previous page*). And Manufacturing PMI -- Export Index is now rising sharply, adding some needed confirmation to the PMI Index which has risen sharply as early as May (and had been suspect); (*see 1st chart on this page)*

The other significant improvement was the continued rise in Total Social Financing since May. As said earlier, the measure we use to gauge the future prospects of Chinese growth and activity is the Total Social Financing (TSF) aggregate. TSF has continued to rise sharply, following last year's growth in fiscal expenditures in China (*see 2nd graph on this page*). The multi-month growth of the TSF has yielded some impressive returns.





The latest report from China are encouraging.

China's imports in June rose for the first time since the coronavirus crisis paralysed the economy this year, as demand for commodities surged on the back of government stimulus, while exports also rose in a sign the country's recovery is gaining traction. (*see 1st graph on the next page)*

China's imports in June rose 2.7% from a year earlier, customs data showed on Tuesday, confounding market expectations for a 10% drop. They had fallen 16.7% the previous month. Exports also rose unexpectedly, up 0.5%, suggesting global demand is starting to pick up again as many countries begin to ease tough anti-virus measures that have pushed the world's economy into its biggest slump in almost 90 years. Analyst had estimated a 1.5% drop following a 3.3% decline in May. Looking at the export items, we see that clothing and footwear exports have increased, which signals that external demand is recovering. The data shows positive signs of a global economic recovery in the second half of the year. That should make a Chinese recovery sustainable. Indeed, China could lead global growth in H2 this year.

Iron ore imports jumped to the highest in 33 months in June, the trade data showed, fuelled by rising shipments from miners and robust

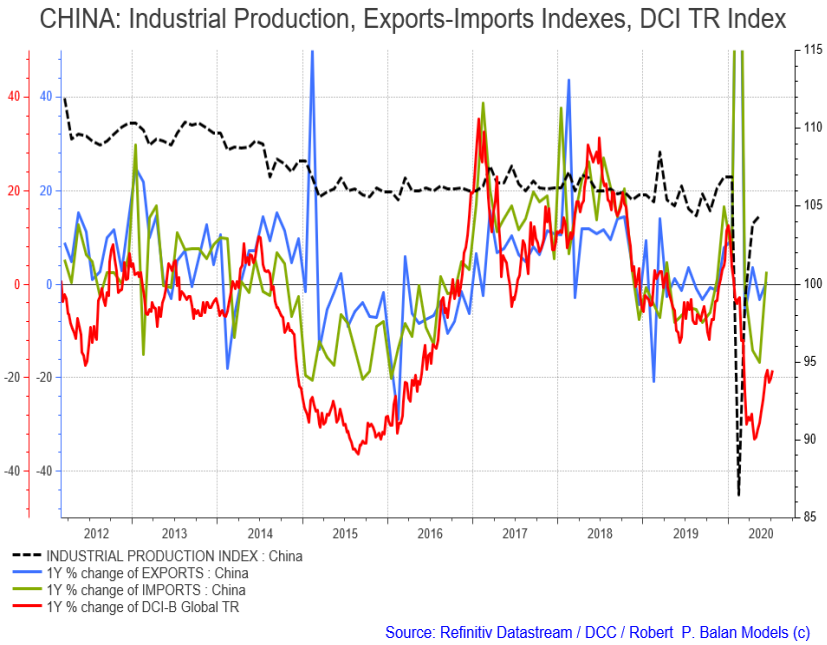
demand. Crude oil imports also hit an all-time high amid bargain hunting by Chinese refiners as oil prices collapsed.

More importantly, China's imports from the United States rose 11.3% in June, reversing a double-digit declining trend seen after the coronavirus outbreak. Imports from Brazil rose 34% in June.

Imports of grains (excluding soybean), which should serve the purpose of securing food as floods, which began in June, threatening to destroy land and crops, played a large role in China June imports profile.

China's trade surplus with the United States widened to $29.41 billion in June from $27.89 billion in May. However, many analysts say that worsening U.S.-China relations, shrinking global demand and disruptions in supply chains are also likely to pressure the China trade outlook over the long run.

The trade balance shrank to $46.2 billion in June from $62.93 billion in May. Net exports were nonetheless smaller in June and will not change the trend of a contraction in GDP growth in 2Q20. Analysts' consensus puts China's GDP growth in 2Q20 at -3.1% YoY. We agree that those targets are optimal for China in Q2. (*see 2nd graph on this page*)

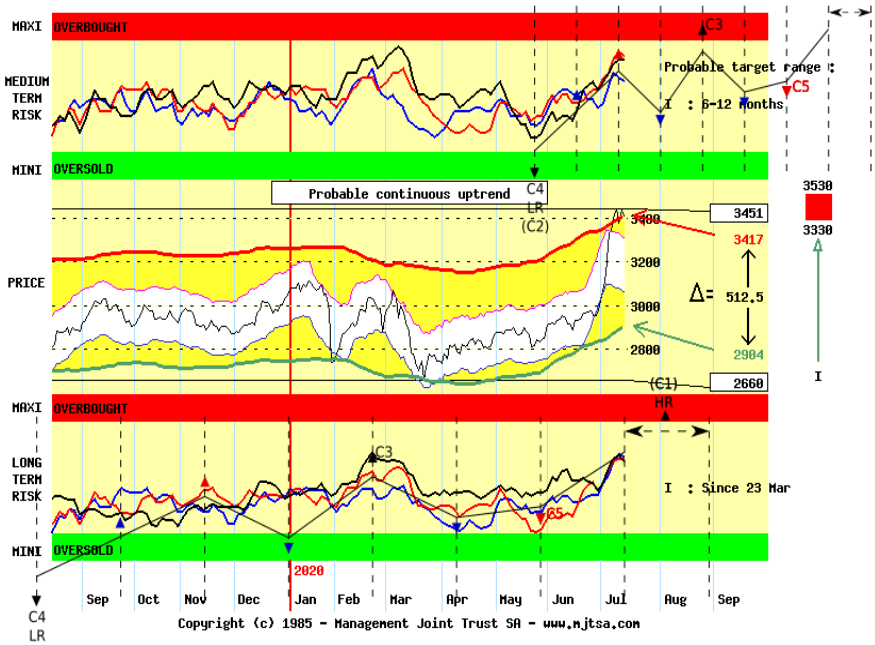


26/ MJT - TIMING AND TACTICAL INSIGHT

The Chinese rally could hold up into late August, perhaps early September

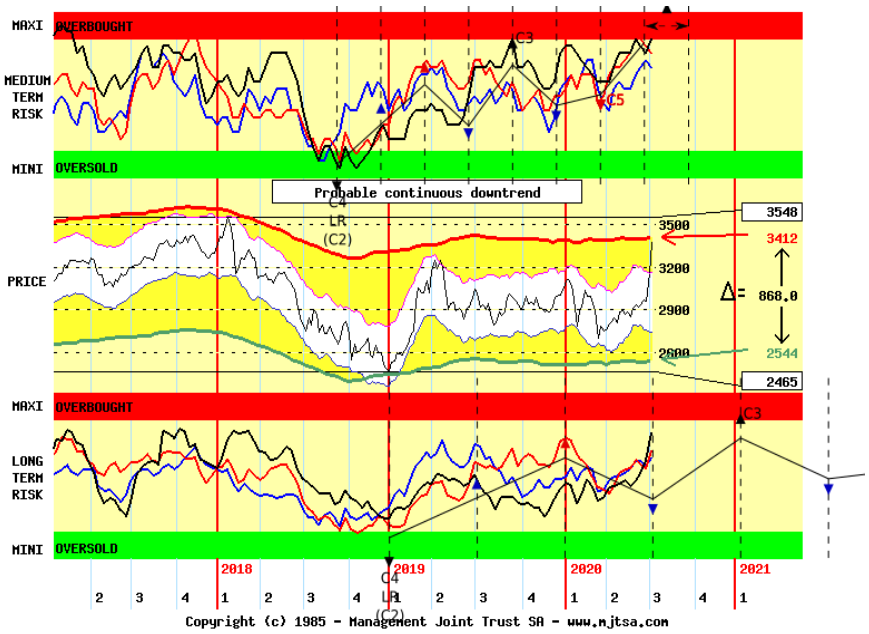
The Chinese rally, which started late June has been swift and sudden. While in May, when we last wrote on China, we did forecast Chinese equity markets to rise between 25 and 40% over the next 12 months, the rapidity of the current acceleration does raise several questions. How sustainable is this rally as Government propaganda attempts to push Chinese retail investors back into the stock market, and will this blow-off end suddenly and reverse down as was the case in 2015, or more recently in April 2019? Which sectors/profiles may prove more robust over the next few months? More generally, can China continue to outperform other markets into late Summer / the Fall following this huge acceleration?

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



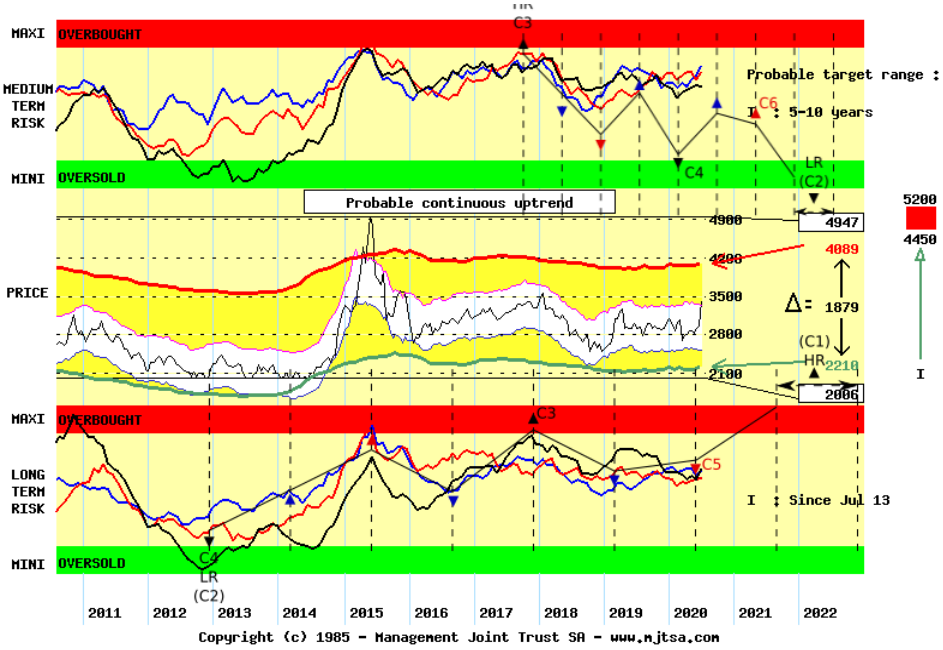
Following a base build-up between April and June, since late June, the Shanghai Composite has rapidly accelerated to new year-to-date highs. For now, this uptrend is still underway. Indeed, **while it may consolidate at high levels over the next couple of weeks, both our oscillator series (lower and upper rectangles) would suggest a continuation of the current uptrend from late July into mid/late August at least**. Price targets to the upside, as calculated by our I Impulsive targets to the upside, are rather exhausted for now (right-hand scale). Yet, a leap of faith may be required here as the Shanghai Composite is rapidly approaching its early 2018 highs on the Weekly graph below.

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



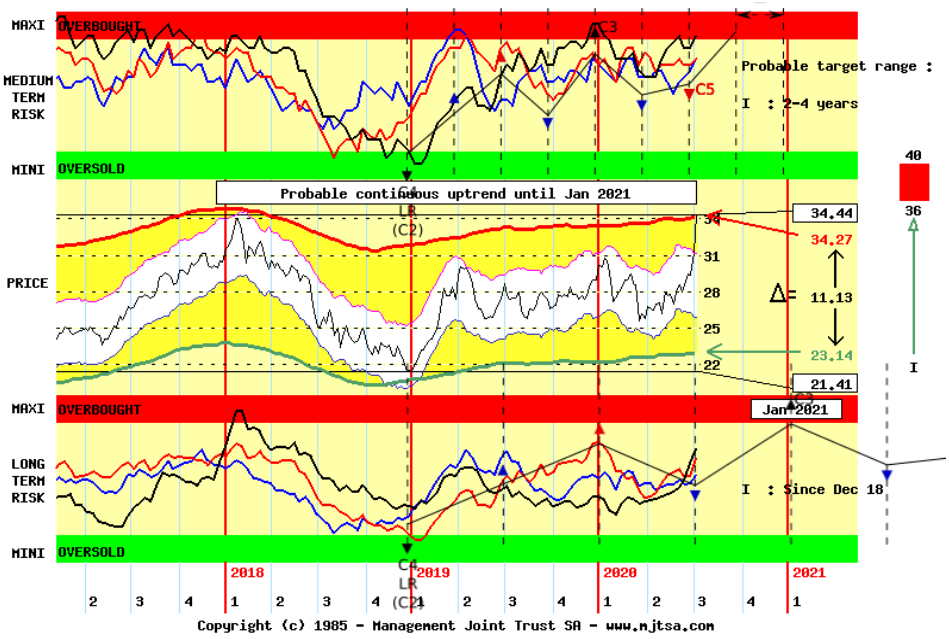
The acceleration to the upside is impressive on this Weekly graph of the Shanghai Composite as prices have shot up above their April 2019 spike and are rapidly approaching their 2018 highs. On the oscillator front (lower and upper rectangles), **this uptrending move doesn't seem quite over yet. It may extend higher until late Summer** on our medium oscillators (upper rectangle) **and perhaps even until early next year** on our long term ones (lower rectangle). **Targets-wise, the move recently broke above our C Corrective targets to the upside around 3'159** (or 0.8 times our historical volatility measure "Delta", here at 868 – middle rectangle; right-hand side- added from the graph's lows at 2'465). **The next level of targets, usually 6 to 12 months out, is towards our I Impulsive targets to the upside, which we calculate here in the 3'593 – 3'941 range** (or 1.3 to 1.7 times our historical volatility measure "Delta", here at 868 – middle rectangle; right-hand side- added from the graph's lows at 2465), **or above its early 2018 highs**.

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



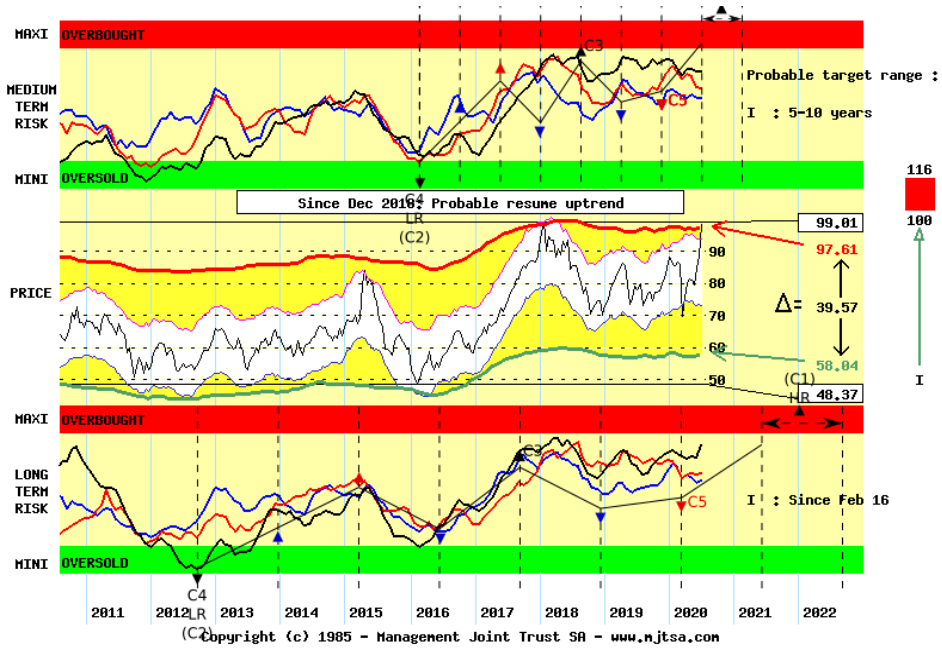
Long term on the bi-monthly graph, the Shanghai Composite has been consolidating for the last 5 years. On both oscillator series (lower and upper rectangles), it may have now reached sufficient support to resume its uptrend. **The sequence we show on our medium oscillators (upper rectangle) still suggests that the bounce may die out between this Fall and early next year. Yet, we would favor the sequence we show on our long term oscillators (lower rectangle), which is more positive, and points to further upside for the Shanghai Composite into late 2021 and 2022**. Initially, we would now need to break back above the resistance of our C Corrective targets to the upside (not shown here, but calculated around 4'000, i.e 0.8 times our historical volatility measure "Delta", here at 1'879 – middle rectangle, right-hand side – added to the graph's lowest point at 2'006). The next levels of targets (2021 – 2022?) are towards the index's 2015 highs.

CSI 300 Index
Weekly graph or the perspective over the next 2 to 4 quarters



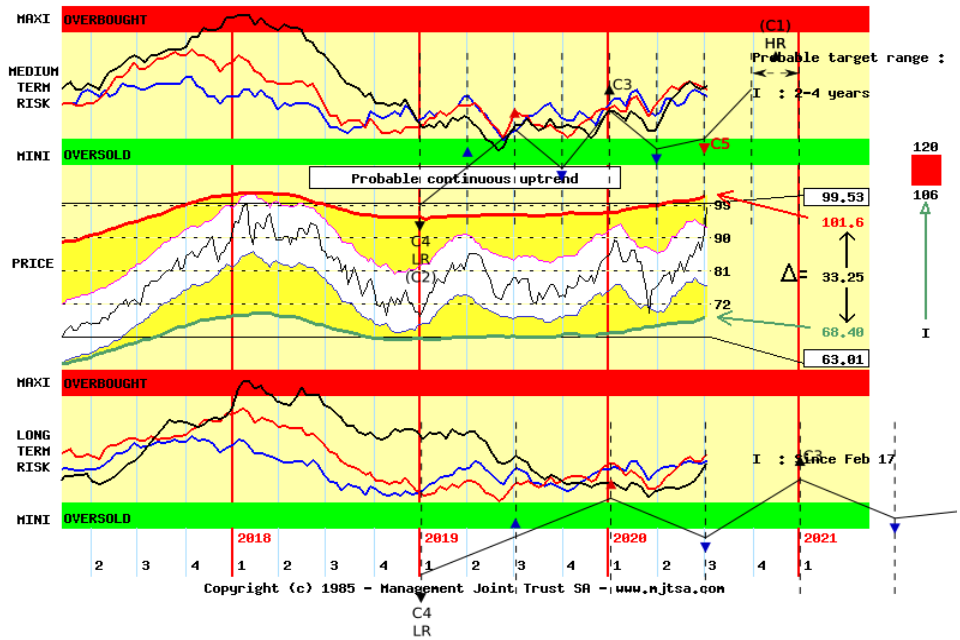
For the Chinese domestic market, we also consider the CSI 300 Big Cap Index (we use the ASHR ETF in USD as a proxy). It also recently broke above its C Corrective targets to the upside above 30 USD (not shown here anymore), and **is now eyeing our I Impulsive ones in the 36-40 USD range (another 5 to 15% above current levels**). The CSI 300 in US Dollars is more advanced that the Shanghai Composite as it has just broken above its early 2018 highs (this is also the case in CNY). **Given the velocity of this breakout, we are confident that it could continue to rise into late Q3 at least** as shown on our medium term oscillators (upper rectangle) and **potentially into early next year** (as suggested by our long term ones).

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



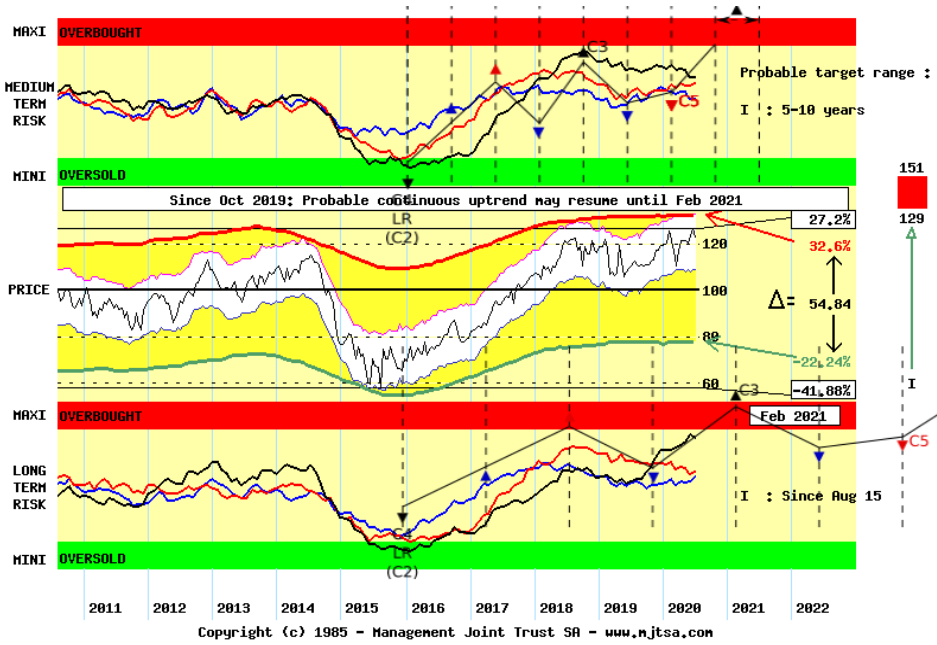
We now turn to the MSCI China index, which is more international than both the Shanghai Composite and the CSI300 Index. It also more weighted towards big Chinese technology companies (i.e. the BATS, Baidu, Alibaba and Tencent). Its long term bi-monthly graph is also **much more advanced in its uptrend than the Shanghai Composite, as it is currently working through its all-time highs around 99 USD. Both oscillator series suggest that this uptrend is still underway, probably until late this year/early 2021** on our medium term oscillators (upper rectangle) **and potentially into late 2021 / 2022** on our long term ones (lower rectangles). **Our I Impulsive targets to the upside also show further upside potential towards 116** (right-hand scale).

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



On a Weekly basis, both oscillator series (lower and rectangles) **are still uptrending, probably into late Q3** on our medium term ones (upper rectangle) **and potentially towards early next year** on our long term ones (upper rectangles). **The upside potential indicated by our I Impulsive targets to the upside is between 6 and 20% over the next 1 to 2 quarters** (right-hand scale).

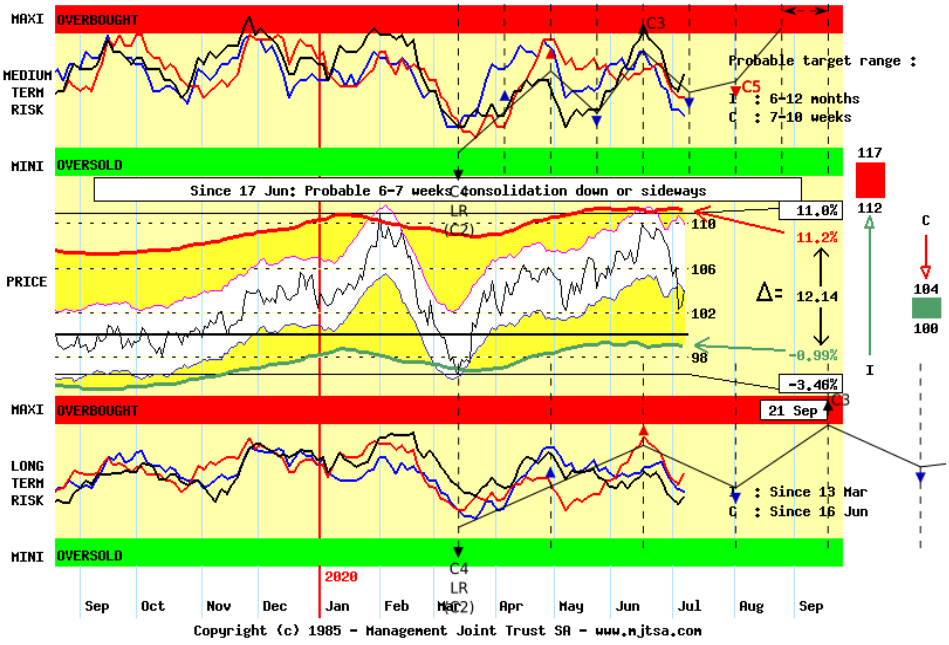
MSCI China Index vs the Shanghai Composite Index
Bi-monthly graph or the perspective over the next 1 to 2 years



The recent acceleration in Chinese equities is led by its domestic market (Shanghai Composite Index, CSI 300 Index). Some may argue that it can be widely manipulated by the Chinese media (as in 2015). Yet, **inherent strength in Chinese equity is often confirmed when its more international markets (the MSCI China) outperforms on a relative basis**. This was the case during the 2016-2018 reflation trade, during the rally between late last year and early this year, as well as during the rebound since March.

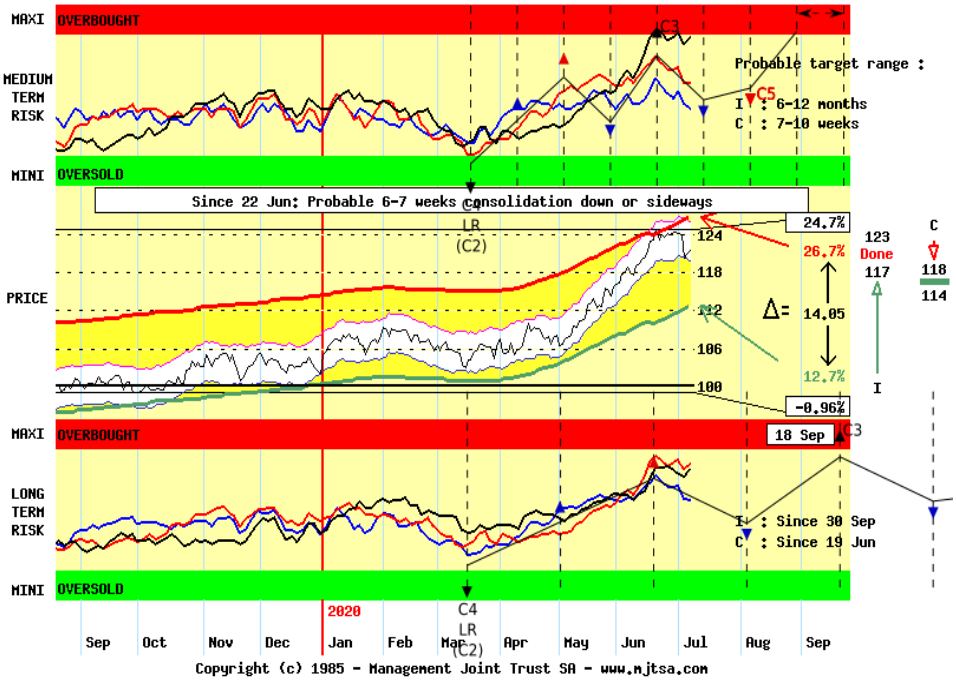
On this long term relative graph between **the MSCI China Index and the Shanghai Composite, the MSCI China seems to outperform again, probably until late this year / early 2020** according to both oscillator series (lower and upper rectangles). **This would suggest some follow through to the upside on Chinese equities more generally until then.**

CSI 300 Index vs the MSCI China Index
Daily graph or the perspective over the next 2 to 3 months



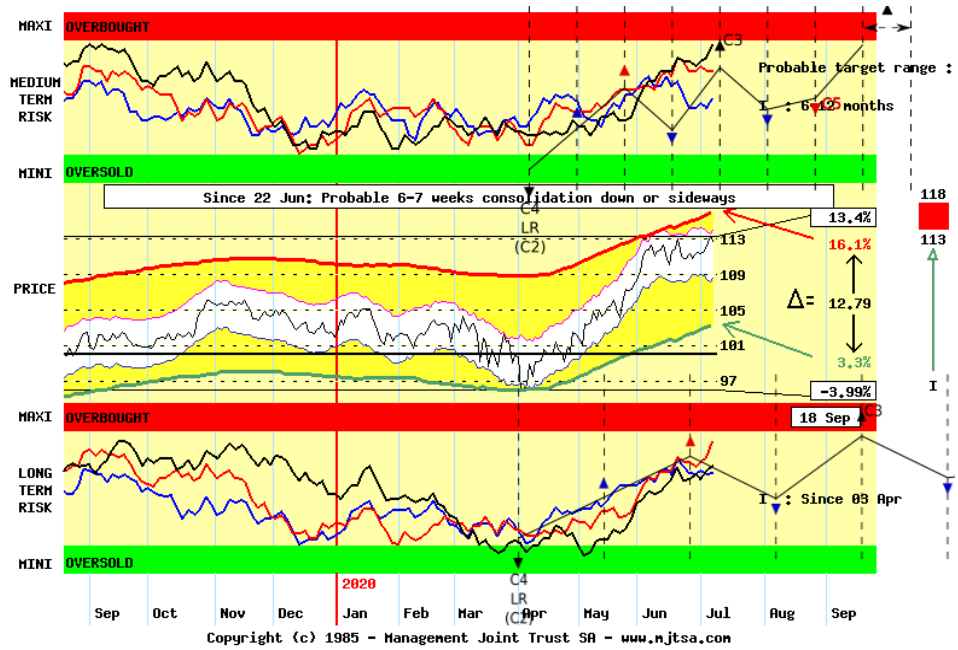
Shorter term, we consider the ratio of the MSCI China Index (MCHI ETF) vs the CSI 300 Index (ASHR ETF). **The sell-off since mid June on the ratio should find support over the next couple of weeks** according to both oscillator series (lower and upper rectangles) and towards the lower end of our C Corrective targets to the downside (around 100, or 2-3% lower than today – right-hand scale). **The ratio could then rise again into late August, perhaps September and towards new highs in the 112 – 117 range** (our I Impulsive targets to the upside). We believe this is positive for Chinese equity markets as the domestic market is usually more counter-cyclical. Indirectly, this may also be a positive sign for international markets more generally. Then, from September into the Fall, we would expect a new period of retracement.

Chinese Technology sector vs the MSCI China Index
Daily graph or the perspective over the next 2 to 3 months



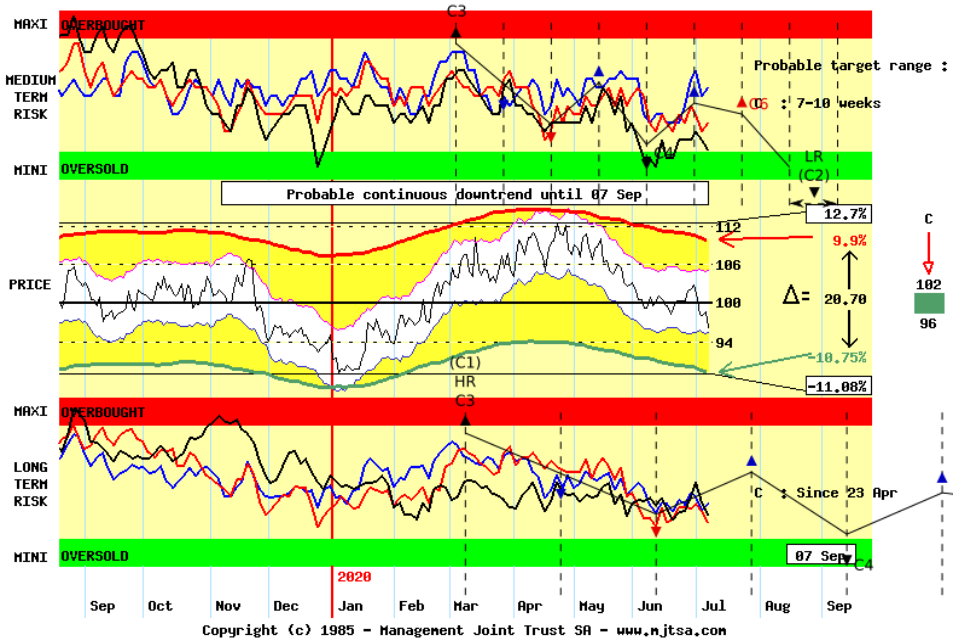
We now focus on certain sectors, which in the Capital Observer this May we decribed as potential all-weather outperformers, probably from late May / early June. We first review the Chinese CSI Internet Index (KWEB ETF used as a proxy), which is the more dynamic of several other Chinese Technology ETFs (e.g. CQQQ, CHIC), and compare it to the MSCI China Index (MCHI ETF). The ratio has indeed been very strong since late May, made an intermediate top to late June, but should soon continue to outperform again from late July / early August into late August, perhaps September. **The persistent strength of this Growth oriented, yet high beta sector, is again rather positive for Chinese equity markets in general into late Summer**

MSCI China Consumer Discretionary sector vs the MSCI China Index
Daily graph or the perspective over the next 2 to 3 months



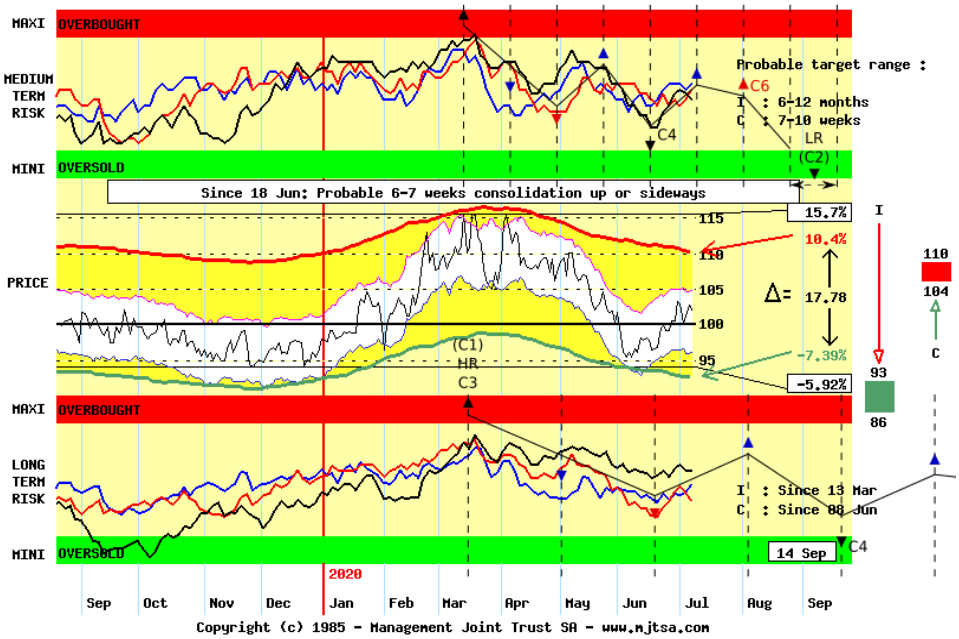
Another sector we favored in our May The Capital Observer issue was the MSCI China Consumer Discretionary sector (CHIQ ETF used as proxy). It has indeed widely outperformed the MSCI China (MCHI ETF) since then. **The ratio may have just entered a transitory consolidation period, but then probably outperforms again into September**. Here also, this would be quite positive for Chinese equities in general (and by extension for global equities) as the ratio seems rather risk-ON, at least since the beginning of the year.

Chinese HealthCare sector vs the Chinese Technology sector
Daily graph or the perspective over the next 2 to 3 months



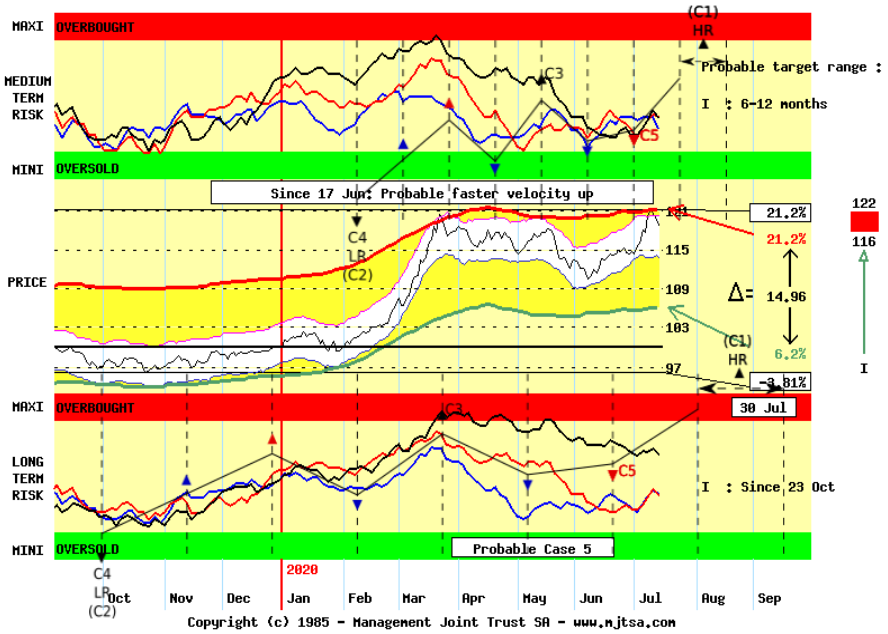
We confirm the rather bullish ratios above by comparing more defensive sectors such as China Healthcare (KURE ETF as proxy) to the Technology ETF analyzed above (KWEB ETF). **The ratio's profile is clearly defensive** having risen from January into April and having retraced since then. Both oscillators series (lower and upper rectangles) suggest that **it could continue to bounce slightly into late July, but should then resume lower into late August, perhaps September. This would be a further risk-ON confirmation for Chinese equity markets.**

Chinese Domestic Small/Mid Caps vs MSCI China Consumer Discretionary sector
Daily graph or the perspective over the next 2 to 3 months



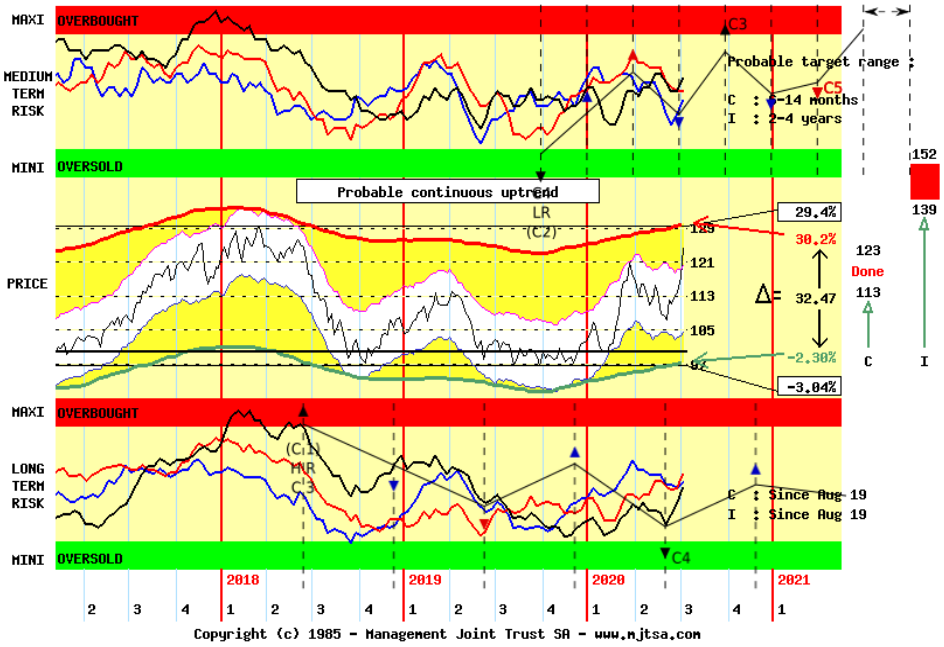
Similarly, we consider another domestic index, the Chinese Small and Mid Cap Chinext Index (CNXT ETF as proxy), which has been a strong performer over the last few weeks. We compare it to the MSCI China Consumer Discretionary Index (CHIQ ETF) already analyzed above. Here also, the ratio is rather defensive having risen from January into early April. It has since retraced. Both oscillator series (lower and upper rectangles) suggest that **it could continue its current bounce into late July, perhaps early August, but that it then underperforms again into late August, perhaps September. This again is rather risk-ON for Chinese equity markets and probably also for global equity markets.**

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



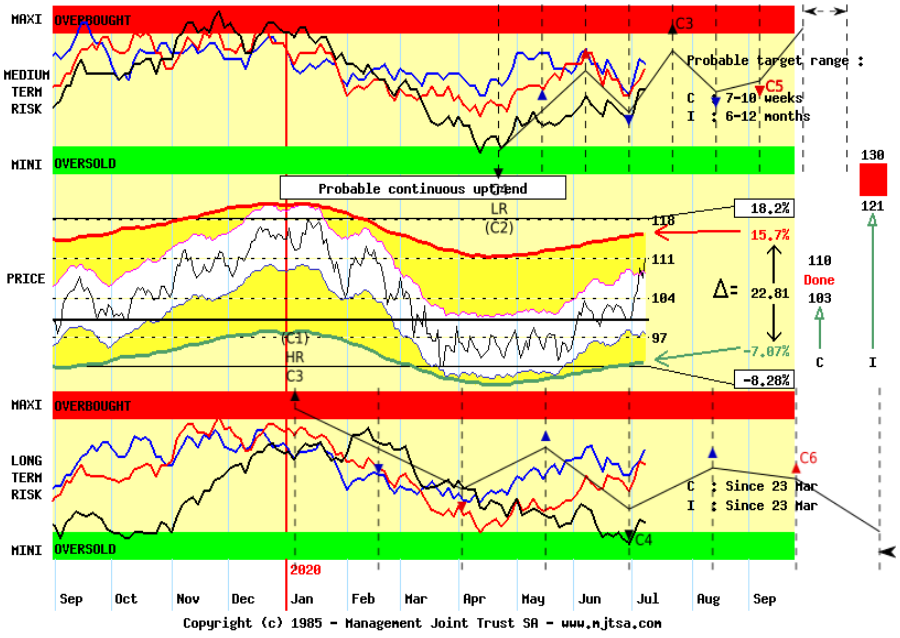
We now compare the MSCI China Index vs the wider Emerging Markets Index. The Chinese Index is usually more defensive/countercyclical than the wider Emerging market one. Contrarily to the sector ratios above, the ratio is still in an uptrend on both oscillator series (lower and upper rectangles). Yet, it may enter a High Risk position on both oscillator series towards late July / early August. This may trigger at least a counter-trend reaction to the downside while **China potentially underperforms other Emerging markets for a short period, probably during August. This again would be rather risk-ON.**

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



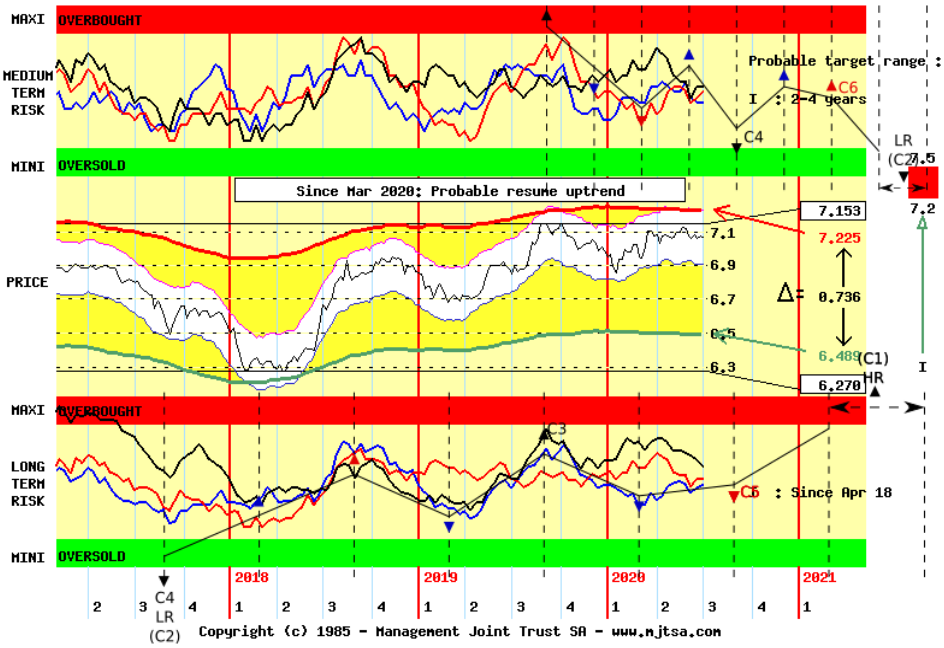
On the other hand, when comparing the MSCI China to the MSCI World Index, it is hard to pin down the ratio to a risk-ON / risk-OFF profile. Over the last few years indeed, China has been rather counter-cyclical during markets sell-offs (Q4 2018 or Q1 this year). Yet, on several occasions (Q1/ early Q2 2019 and just recently), Chinese markets have outperformed while global markets were rising. These periods have usually corresponded to strong upside acceleration in Chinese stocks. Considering our Weekly graph of the ratio, it is currently uptrending, and just broke out to new year-to-date highs. It also just made it above the resistance of the upper end of our C Corrective targets to the upside (i.e. above 123, right-hand scale). Our next levels of targets, our I Impulsive targets to the upside, suggest that it could reach up to the 139 – 152 range over the next few quarters, or well above its early 2018 highs. **This is indeed a strong breakout situation for China both on a relative and absolute basis (as analyzed above). Our oscillator series (lower and upper rectangles) suggest that the current leg up could last into late Q3 / early Q4. Some consolidation may then follow towards year-end and early 2021, before the uptrend probably resumes once again well into 2021.**

MSCI China Index vs Gold
Daily graph or the perspective over the net 2 to 3 months



We finally compare China to the ultimate deflator, Gold. Our long term oscillators (lower rectangle) may have just completed a base, and could now continue to bounce into late August, while our medium term ones (upper rectangle) **suggest a couple of weeks of consolidation on the ratio (along with other risk assets), and then further upside into late August, perhaps September**. Following that, as shown on our long term oscillator (lower rectangle), the ratio could roll-over form mid/late September into the Fall. Again, the ratio seems to **project a rather risk-ON environment where the MSCI China could outperform Gold into late August / early September**. Upside targets as indicated by out I Impulsive targets to the upside may be as high as the 125 – 134 range (right-hand scale), or between **7 and 15% higher than today**.

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



As a last check, we consider the USD/CNY exchange rate, which we believe should **continue to consolidate down until mid/late Q3 (circa late August / early September)** on both oscillator series (lower and upper rectangles). We believe this Yuan strength vs the US Dollar may correspond to stronger Chinese equity markets on an absolute and relative basis, perhaps as Chinese outperformance eventually triggers much wanted capital inflows.

Concluding remarks:

Chinese equity markets have seen a strong breakout over the last few weeks. Although, this rally is labelled as been artificial by many market watchers, it has achieved strong breakouts on many Chinese indexes on an absolute and relative basis. Shorter term, a couple of weeks of high level consolidation may now lie ahead, Yet, following that, we believe that Chinese equity markets should see a further leg up, probably until late August, perhaps into September. A stronger correction to the downside may then materialize during the Fall along with global equity markets. Sector-wise, domestic segments have led the recent rally, yet typical growth themes such as Chinese Technology or Consumer Discretionary could soon take up the lead into late Summer. This is rather risk-ON for Chinese equity markets and perhaps more generally global markets (i.e. a typical growth extension following a stimulated bounce).

34 / The equity rally may peak again soon, and thereafter expect declining markets in August again as the Fed goes on Quantitative Tightening mode

The last time The Capital Observer discussed the equity markets last month (June 2020) we pinpointed the possibility of a setback and a buy opportunity in July (*Set back Risk remains for equities, more importantly, prepare for a buy opportunity in July; the next bull phase thereafter could extend to September 2020*).

This is what we said then:

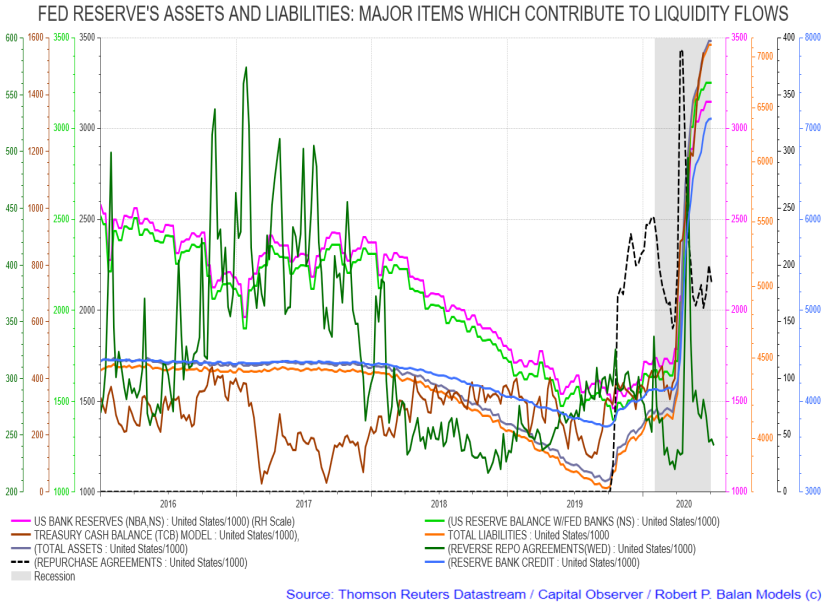
It is clear that our premise last month was correct – that the Fed has become less generous to the financial markets, what with some indices hitting new all-time-highs, and liquidity flows should become less and less. Nonetheless, we stand by our May projections that QE (in various forms) should continue in much smaller amounts, until September, when the Fed should declare a moratorium ahead of the November presidential elections.

We continue to be guided by our work in modelling the response of equities to Fed and US Treasury liquidity infusions, as recorded by the historical seasonality of the Fed's SOMA transactions (balance sheet) and the current QE 4 SOMA transactions. We showed an earlier version in May Capital Observer issue; the graph has been updated to show the effect of slower liquidity flows on risk asset prices, as proxied by the NDX 100 and S&P 500 Indexes (see 2nd & 3rd graphs on this page and 1st graph on the next page).

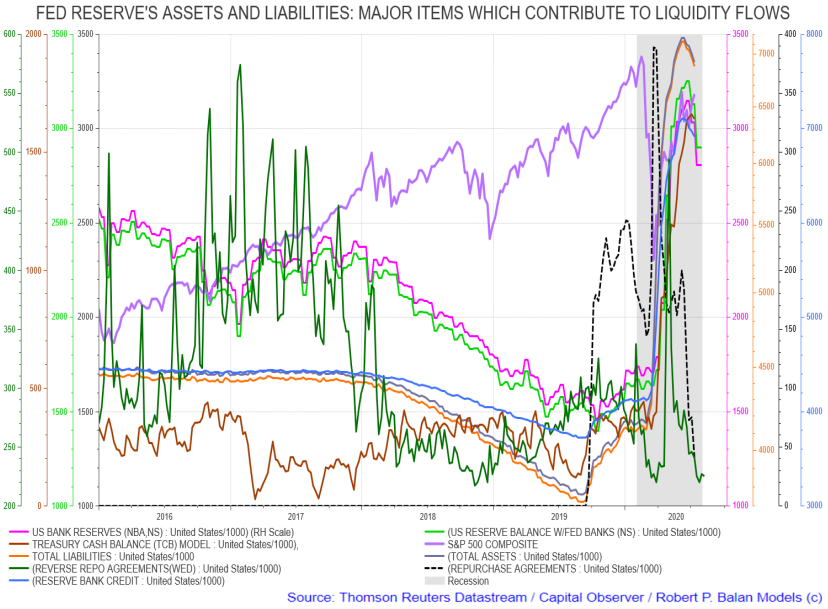
We said in May: *based on historical NDX performance (and SOMA seasonality again), plus the lead from our other modelling work, there could be a* ***Buy In July*** *opportunity.*

In the June edition of The Capital Observer, *we said explicitly that the NASDAQ will very likely test (even exceed) its all-time-high (ATH) before a September peak in 2020. The NDX new ATH objective was met at the end of May – first mission accomplished. All that we need to prove from here is another higher ATH and a 2020 peak by September.*

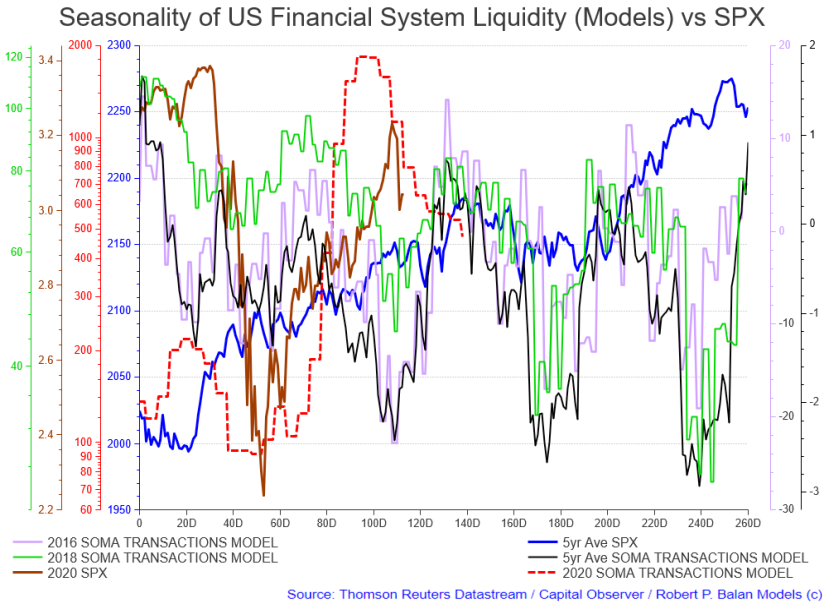
Original chart in the June 2020 Capital Observer.



This is how the graph above looks now.



Original graph from the June edition of The Capital Observer



And those events, of course, came to pass and all we need to focus next is whether or not we will see a higher high by September this year.

In the last 4 weeks since we wrote the June article, the Fed did a remarkable volte-face with regards to its QE regime. Thus, the bar for higher highs in September relative to peaks in May has just become significantly higher. In the updated graph (*see 1st graph on this page*), we see that the rate of change 2020 of the liquidity flows fell drastically. And no relief is in sight yet. **What exacerbates the situation is that the current liquidity profile a waning during the period from late July to late August that has historically been dangerous for risk assets. And this is why:**

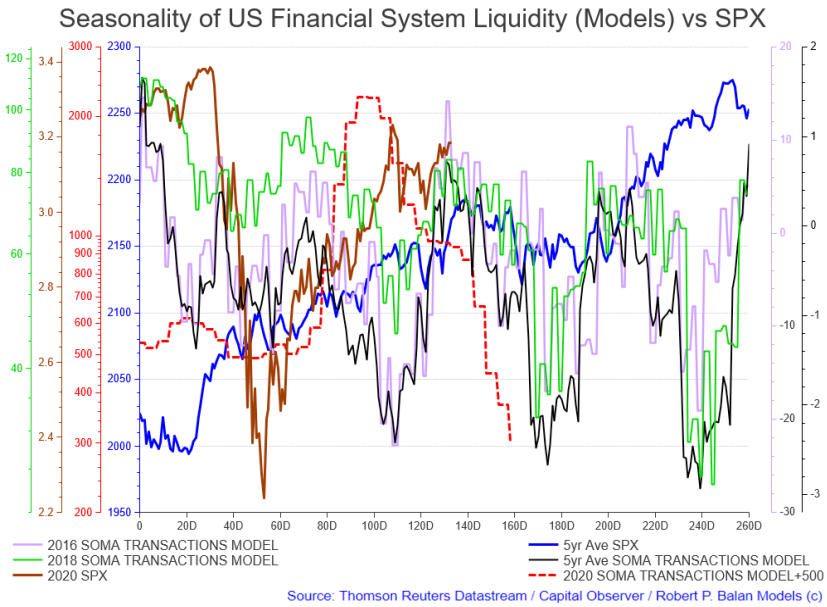
With 2020 liquidity aggregates falling sharply as we have shown in the graph prior, lack of current support comes at a time when institutional memory is cued into the great seasonal drought of late Summer. As the seasonality of the S&P 500 Index shows, the largest valuation decline in any given year in the past ten years at least, has happened during this period.

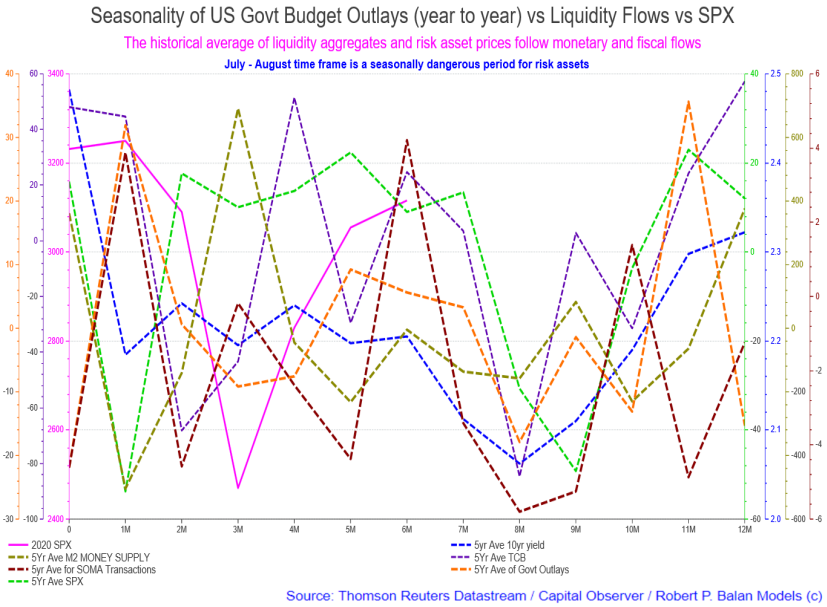
A more disturbing reality is that unless the Fed pauses its on-going Quantitative Tightening mode, markets will be hard pressed to show outperformance in September. There is real risk that we could just get a weak bounce in early Q4, and weakness could extend towards the year-end. That would be entirely out of synch with the 5-year averages of changes in Bank Reserves and SOMA Transactions which have historically powered rallies in equities from late Q3 to a rip-roaring Santa Claus rally until year-end (*see 3rd graph on this page*).

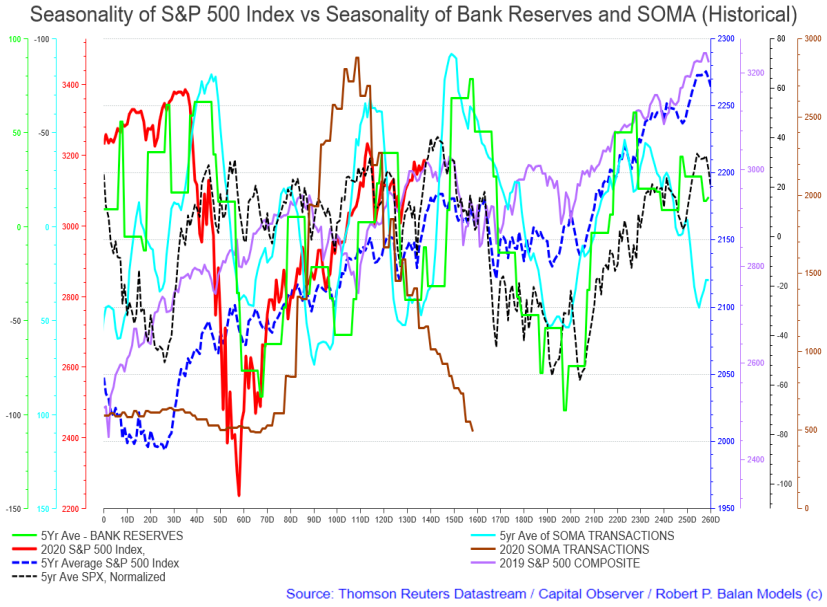
Our biggest fear at this time is that institutional memory of support (from historical liquidity flows pattern) may not show up this time around, aside from localized support provided by high frequency liquidity data.

There is a distinct possibility that from a peak sometime within the

This is how the graph above looks now.





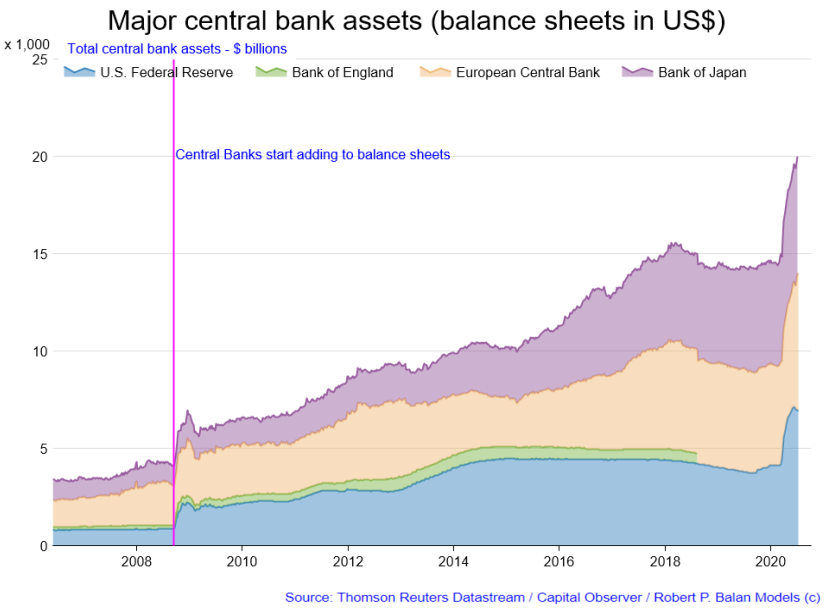


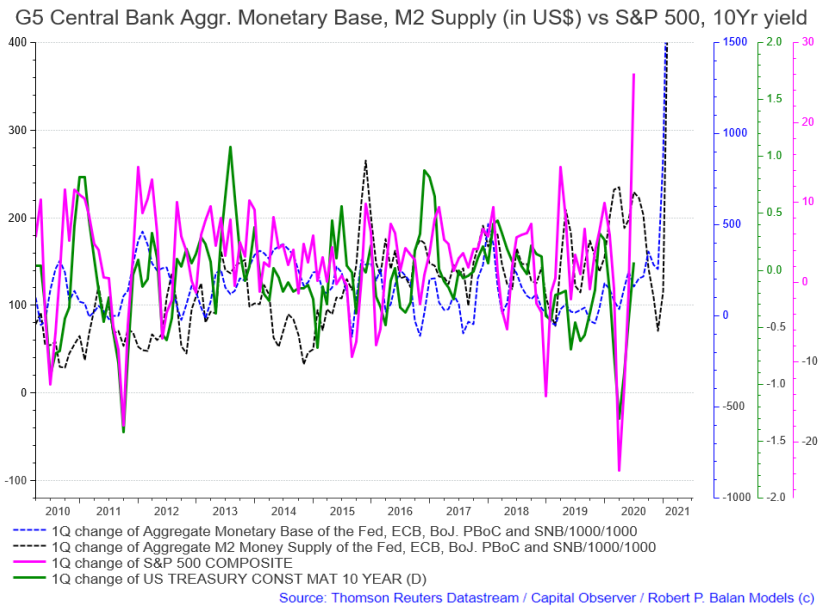
next few weeks, equities may just descend progressively until year end. The Fed's current Quantitative Tightening and a likely full stoppage of any market support by September could derail the markets from patterns that have been historically set by the impact of the seasonality of systemic liquidity flows. It is likely that it will be different this time around. There would be no Santa Claus rally from September; however, the markets could start 2021 with a big bang.

In fact, that is exactly what is being suggested by uber-source of global systemic liquidity – the aggregate balance sheet and Money Supply of the so-called G5 central banks that are still doing Quantitative Easing. These central banks are the Federal Reserve, the European Central Bank, Bank of Japan, People's Bank of China, and the Swiss National Bank. The aggregate global balance sheet has risen again since February after a brief hiatus last year (*see 1st graph on this page*).

The rate of change of this global aggregate balance sheet is what is linked to the rate of change of risk assets. We have put this model through a validation process in the past 6 years, and it had provided some interesting turning points in the past several years (*see 2nd graph on this page*).

What this robust model suggests is that we should see a major inflection point in risk assets and in bond yields within the next few weeks. There will be a broad, and general decline until year end. But by January 2021, we will have a rip-roaring rally in equities and in yields.



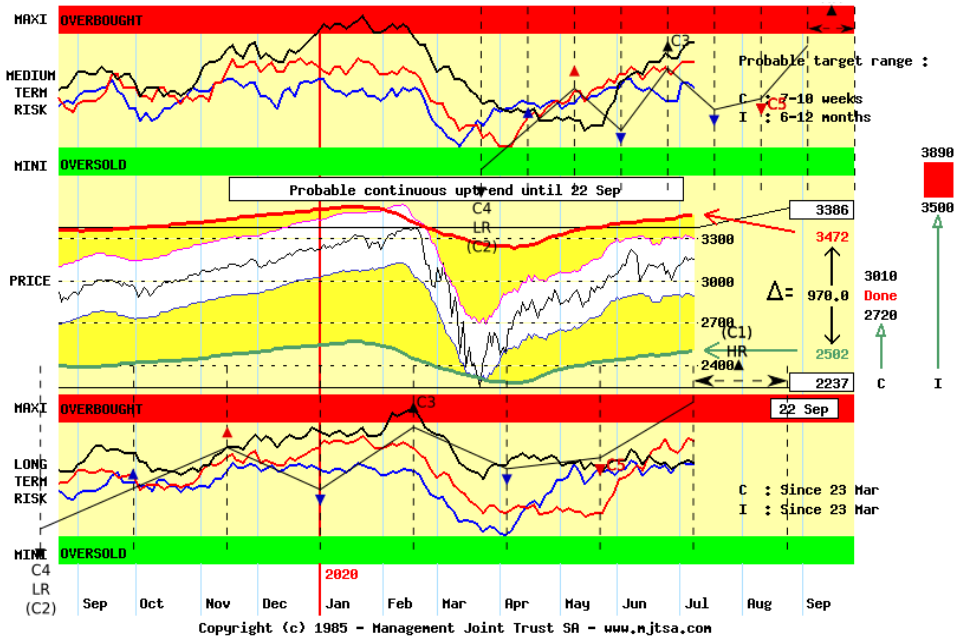


37 / MJT - TIMING AND TACTICAL INSIGHT

Further DIPS are still possible into early August before the uptrend resumes into September

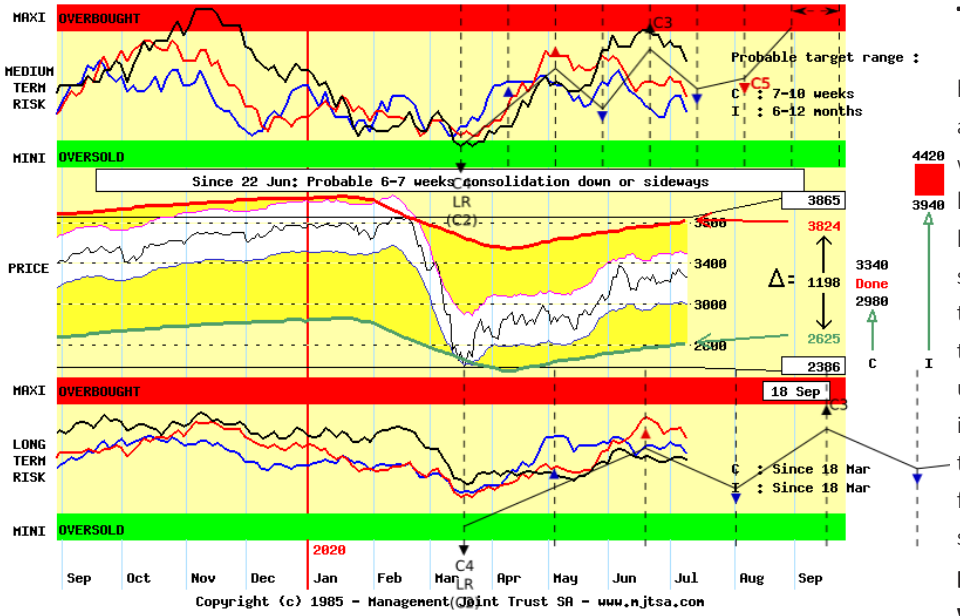
Equities have seen an impressive rebound since late March, yet over the last few weeks, this rebound has started to stall. This consolidation coincides with a slowdown of the liquidity provided by the FED and raises the question as to the fate of global equity markets if this liquidity provision is further reduced as the US November election approaches. In this article, we consider our oscillator sequences for the main equity markets into late Summer and then the Fall. We will also review, with a longer term perspective, the different equity market geographies (US, Europe, Emerging Markets) on an absolute basis and against each other.

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



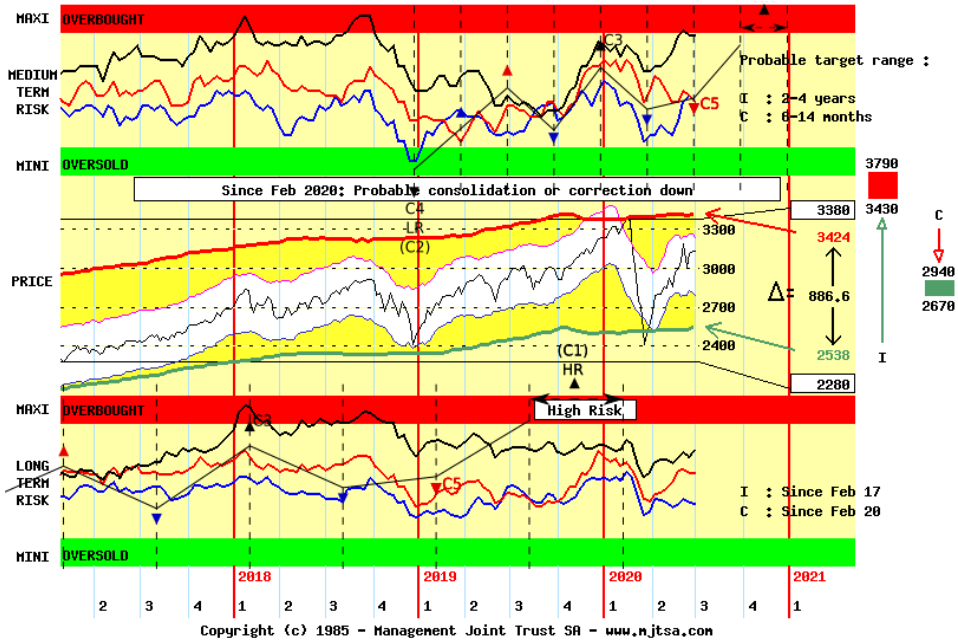
Last month, we expected that Equity markets, and the S&P500 in particular, could continue to consolidate at high levels into late June. This was pretty much the case. As we write, the S&P500 is currently retesting its early June highs, yet it is still difficult for us to call the "all clear". Indeed, while our long term oscillators (lower rectangle) are still uptrending, probably well into August, the sequence we show on our medium term ones (upper rectangle) still calls for more consolidation into late July, perhaps early August. The S&P500 should then resume its uptrend into early/mid September and possibly towards its February highs. Hence, **we would remain rather prudent for another couple of weeks, as further dips could still materialize, but would then turn positive again (from late July/early August) into late August / September.**

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



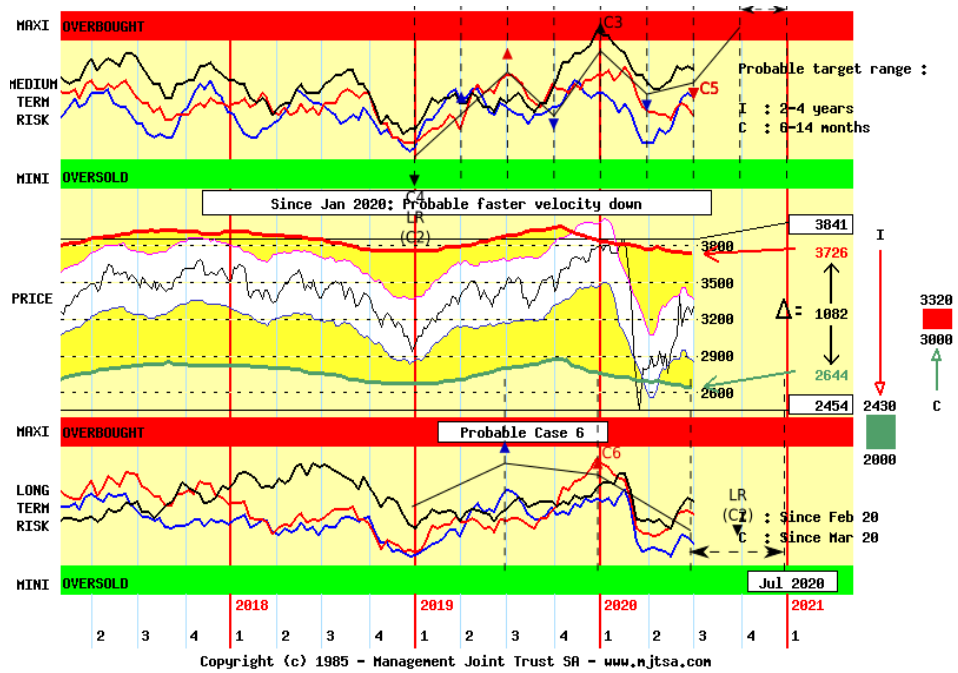
The EuroStoxx 50 is in a similar dynamic. As we write, it is also retesting its early June highs, yet, both our oscillator series (lower and upper rectangles) still suggest that a two weeks consolidation period may lie ahead. Following that, the EuroStoxx 50 should rise into late August / September. The Fall may then see some consolidation to the downside. On the targets front, prices have now tested several times above our C Corrective targets to the upside (i.e. above 3'340). This is promising, as it opens the door to further upside potential towards our Impulsive targets over the next few months (3'940 – 4'420 range; right-hand scale). **Hence, we would probably remain prudent into late July / early August and would then expect the EuroStoxx 50 to resume higher into late August / early September. By then, it may challenge its February highs.**

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



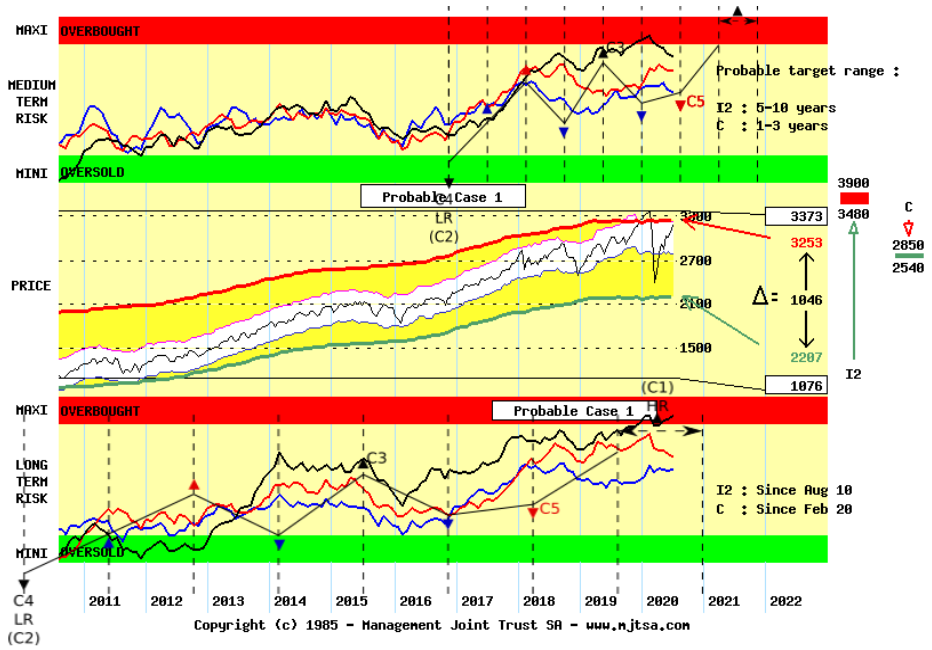
We now consider the Weekly graph of the S&P500. Our long term oscillators (lower and upper rectangles) had reached a High Risk position early this year, a situation that usually implies 6 to 12 months of consolidation to the downside. Hence, further downside retests, or at least strong retracements of the current recovery cannot be excluded. For the time being, however, we wish to remain constructive into late Summer, as shown on our medium term oscillators (upper rectangle). Indeed, these may be **approaching a new support point, which could then lead the index higher into late Q3 at least**. On the price targets front (right-hand scale), the S&P500 is now back well above the support of our C Corrective targets to the downside and hence our I Impulsive targets to the upside can be considered. They are pointing to the 3'430 – 3'790 range over the next few quarters, **or towards new all-time highs. We would then probably expect some retracement this Fall.**

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



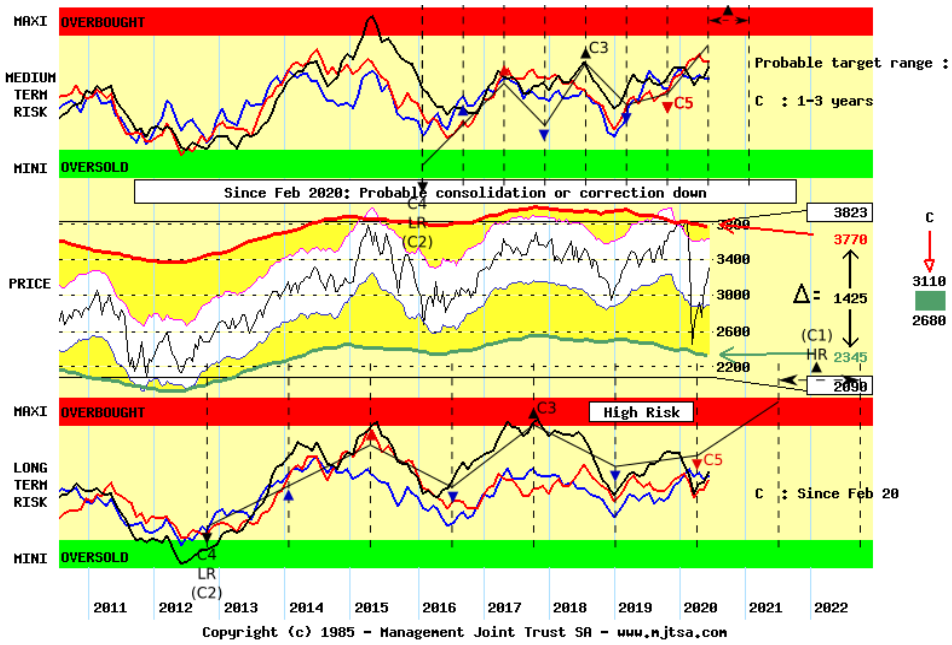
On the EuroStoxx 50, the sequence we show on our long term oscillators (lower rectangle) does point to further downside pressure into late this year. Yet, in the meantime, we believe that **the EuroStoxx 50 may be approaching a new support point on our medium term oscillators (upper rectangle) and that it could rise into late Q3. The Fall could then see a period of retracement to the downside**. On the targets front (right-hand scale), prices have been testing above the resistance of our C Corrective targets to the upside (i.e. 3'320) since early June. A clear break above these levels would open the door towards our I Impulsive targets to the upside, which we can calculate in the 3'861 – 4'293 range or towards new year-to-date highs (or 1.3 to 1.7 times our historical volatility measure "Delta", here at 1'082 – middle rectangle, right-hand side – added to the graph's lowest point at 2'454).

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



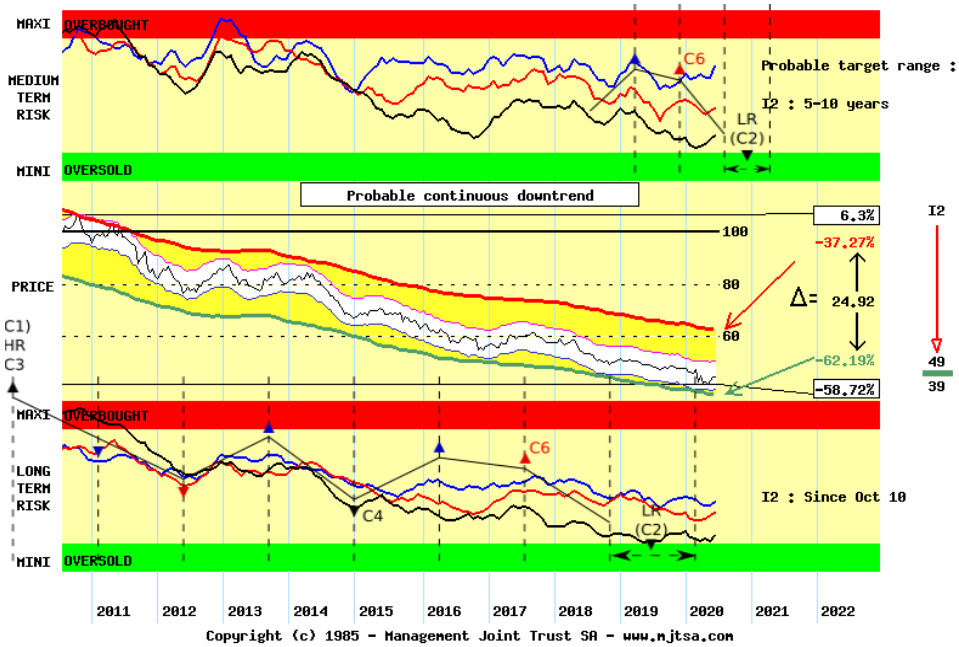
We now switch to the longer term bi-monthly graph or the S&P500 Index. Our automatic case recognition identifies that the top made earlier this year may be of important nature ("Probable Case 1") and indeed, on our long term oscillators (lower rectangle), it was made in a High Risk situation. That said if we run a similar model on our medium term oscillators (upper rectangle), it suggests that the S&P500 could still extend higher into early next year. For now, given our shorter term Weekly and Daily graphs analyzed above, which we thought were rather positive, **we would like to give the S&P500 the benefit of its long term uptrend**. On the price targets front, **our I2 Impulsive 2 extended targets to the upside could ultimately justify further upside potential in the 3'400 – 3'900 range (right-hand scale). These targets are also quite similar to the upside targets we have calculated above on our Weekly and Daily graphs.**

EuroStoxx50 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



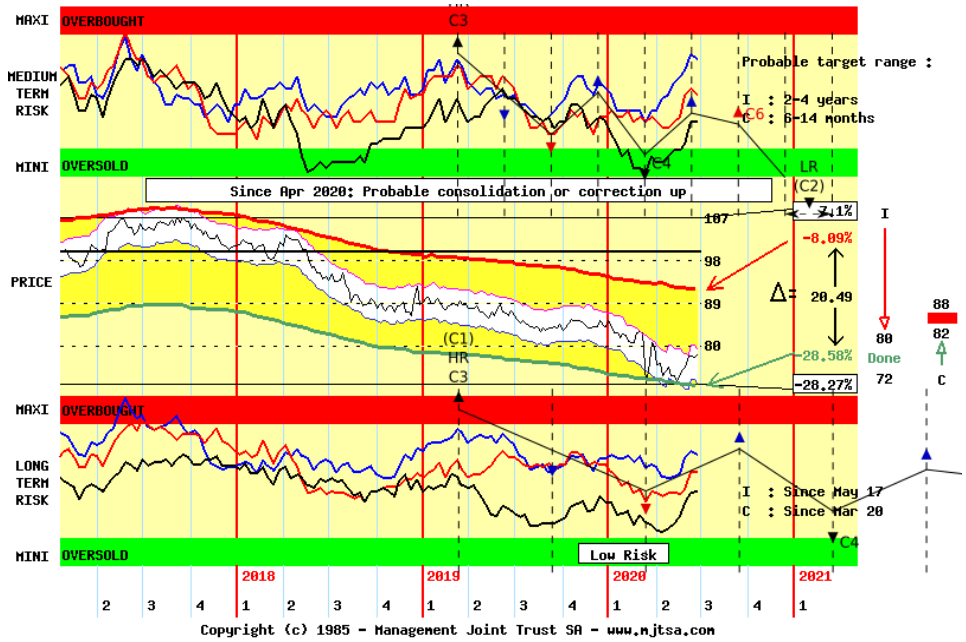
On its long term bi-monthly graph, the EuroStoxx 50 Index is in a different configuration. Indeed, instead of having followed a linear uptrend over the last few years, as the S&P500 has done, it has been consolidating in wide range since 2015. Its latest attempt to break-out earlier this year was indeed punished quite severely during the COVID sell-off. Going-forward, the index did rapidly shoot back up above the support of its C Corrective targets to the upside (right-hand scale) and **the sequence we show on both oscillator series are both uptrending, probably into early next year on our medium term oscillators (upper rectangle), perhaps even into late 2021/2022 on our long term ones (lower rectangle). Hence, after 5 years of consolidation, we believe that there is a good chance that the EuroStoxx 50 could break out to the upside and new highs over the next 18 to 24 months.**

Europe Stoxx 600 Index vs the S&P500 Index (in US Dollars)
Bi-monthly graph or the perspective over the next 1 to 2 years



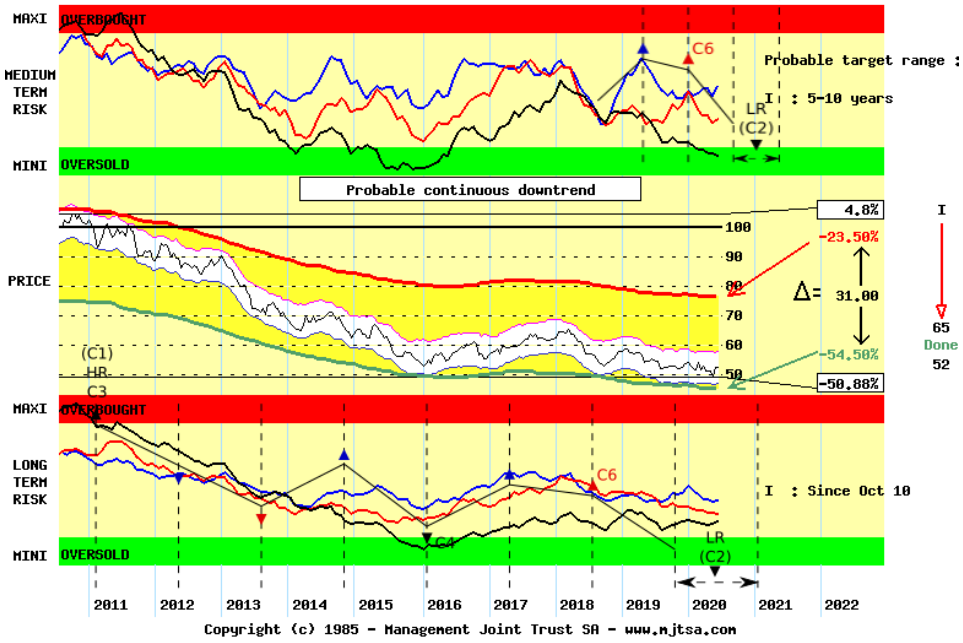
Our long term projections above may find some echo in the relative graph of the Europe Stoxx 600 vs the S&P500 (in US Dollars). Indeed, the long term uptrend of the S&P500 analyzed above is quite advanced, although still uptrending, while there is a chance that European Markets, which have lagged significantly over the last few years, could now accelerate up and break out to new levels over the next 18 to 24 months. These scenarios may be confirmed by this relative graph, where on both oscillator series (lower and upper rectangles), **the ratio could be approaching secular lows. While these may already be behind us on our long term oscillators (lower rectangle), they could take a couple more quarters to be confirmed by our medium term ones (upper rectangle). Targets-wise the ratio is very extended to the downside having reached our I2 Impulsive 2 extended targets (right-hand scale), which would support the probability of a reversal.**

Europe Stoxx 600 Index vs the S&P500 Index (in US Dollars)
Weekly graph or the perspective over the next 2 to 4 quarters



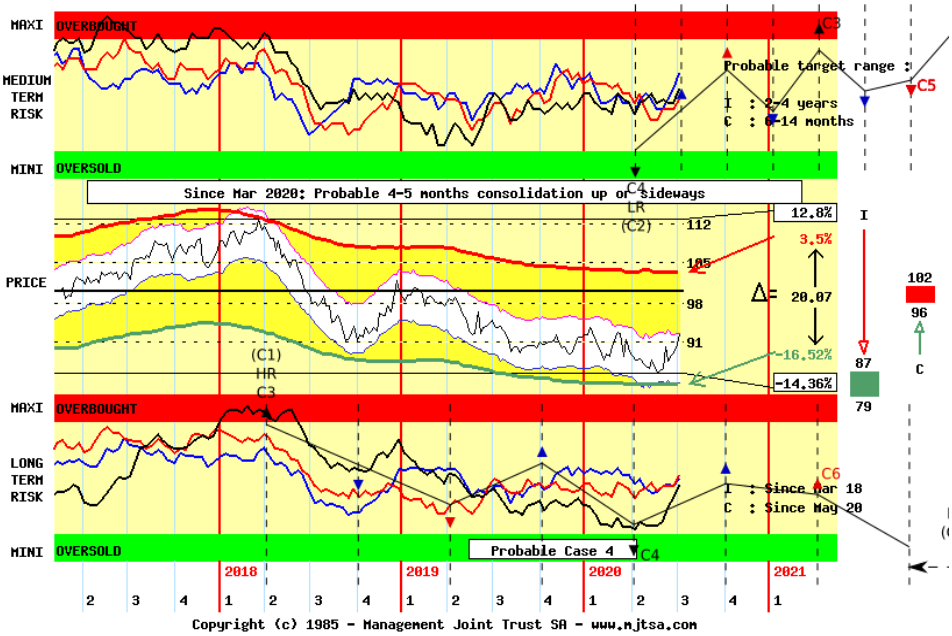
Shorter term, on the Weekly graph, it is still too early to confirm this upside reversal in the ratio of the Europe Stoxx 600 Index vs the S&P500. Indeed, **while both oscillator series (lower and upper rectangles) could support a bounce into late Q3, a further downside retest into the Fall, and perhaps into early next year is still likely.** On the other hand, the downside risk is now rather limited as our I Impulsive targets to the downside (right-hand scale) have pretty much been achieved. **We would hence treat any positive divergence from this still negative scenario as further confirmation that a secular reversal may be near.**

MSCI Emerging Markets Index vs the MSCI World Index
Bi-monthly graph or the perspective over the next 1 to 2 years



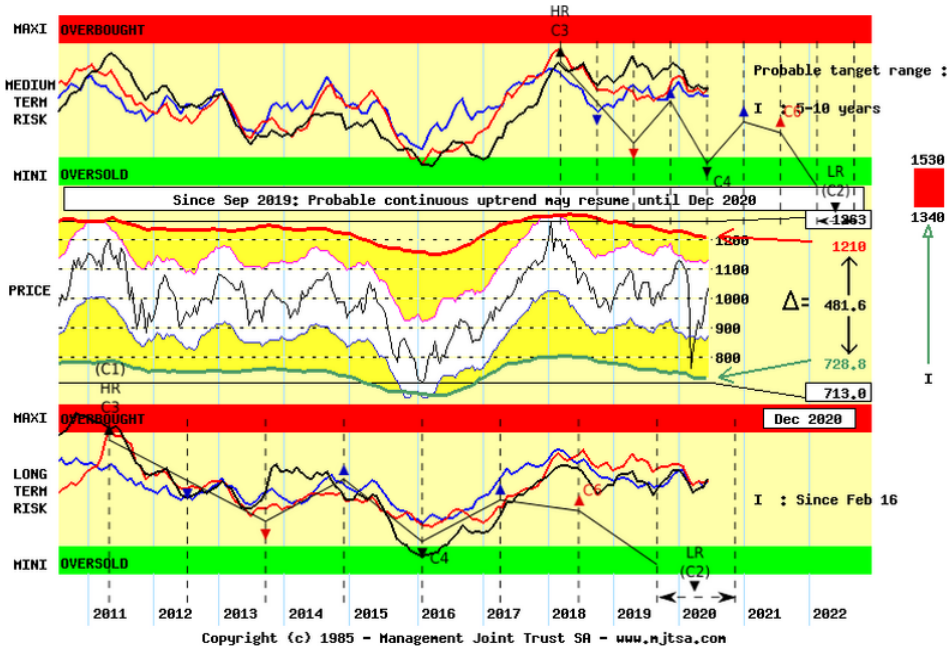
We perform the same ratio analysis on the MSCI Emerging Markets Index vs the MSCI World Index. The configuration is very similar to the ratio above comparing the Europe Stoxx 600 vs the S&P500 Index. Indeed, both oscillator series (lower and upper rectangles) are **approaching long term Low Risk situations between now and early next year, while our I Impulsive targets to the downside (right-hand scale) have been reached. Hence, here also, the ratio may enter a secular reversal to the upside over the next few quarters.**

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



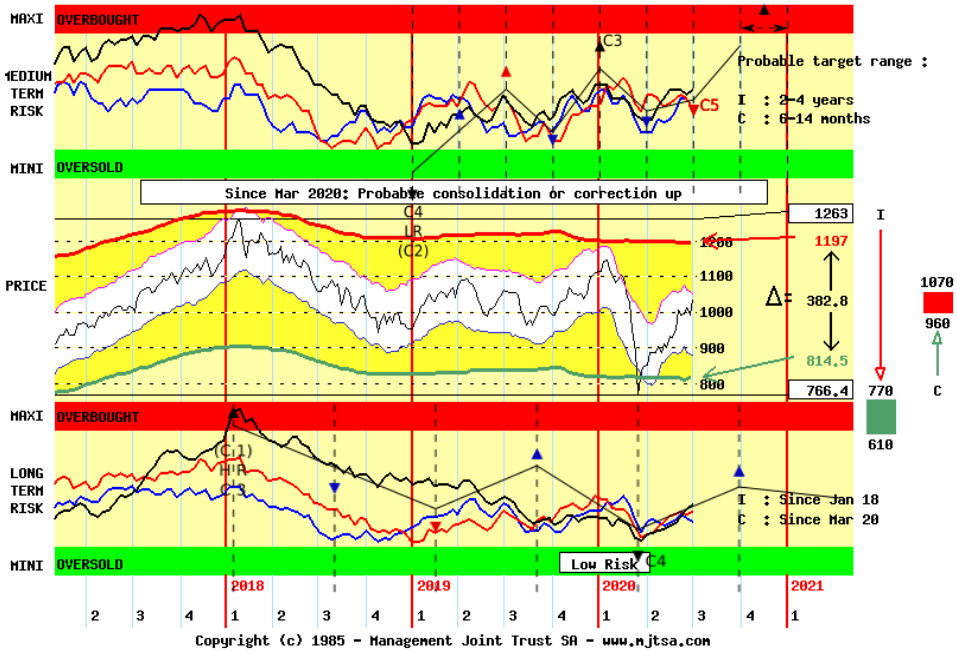
Shorter term, on this Weekly graph, the ratio of the MSCI Emerging Markets Index vs the MSCI World Index is currently bouncing, following 2 years of downtrend, and an important intermediate bottom during Q2 on our long term oscillators (lower rectangle). **For now, we would still consider this bounce as a rebound, which could extend into late Q3 and then gradually roll-over again during Q4 and Q1 next year, and possibly down into next Summer**. On our medium term oscillators (upper rectangle), we **present a more positive scenario, where the reversal may kick-start a new uptrend sequence, which first extends into late Q3, retraces into Q4 and then rises again to new highs into late Q1**. Such upside momentum would probably confirm this nascent uptrend as well as the secular reversal we expect on the bi-monthly graph above. Of course, **for this to happen, this upside momentum will have to be maintained with new highs late Q3 and then late Q1.**

MSCI Emerging Markets Index
Bi-monthly graph or the perspective over the next 1 to 2 years



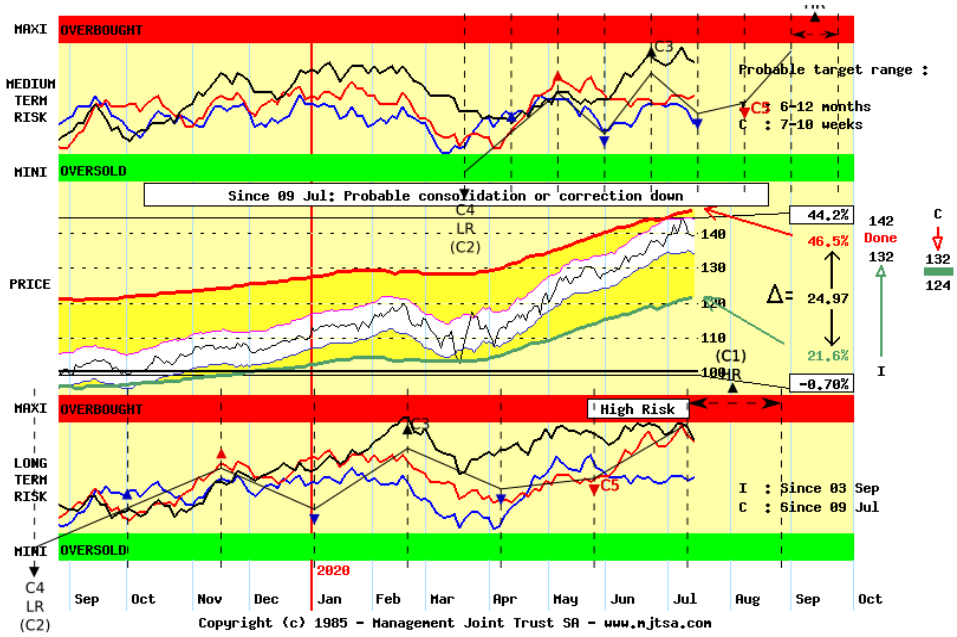
On an absolute basis, we believe the MSCI Emerging markets index may be ripe for such a long term upside reversal. On our long term oscillators, the sell-off this year may provide a strong initial downside retest in an early stage very long term uptrend. Indeed, it is positioned in the middle of a Low Risk zone (lower rectangle). On our medium term ones (upper rectangle), it is not yet clear if the bottom made early Spring is intermediate or final, but is does come after 2 years of correction to the downside and a 60% drawdown. Finally, **in term of targets, the potential looks appealing with our I Impulsive targets to the upside (right-hand scale) pointing to the 1'340 – 1'530 range, or potentially towards new all-time highs over the next couple of years.**

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



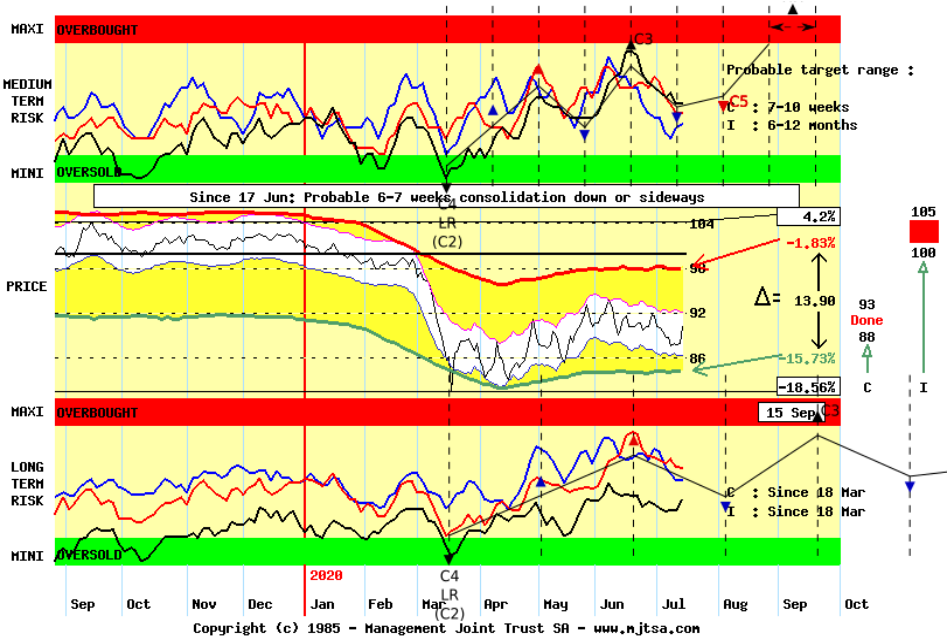
Turning to the Weekly graph, we can note the violence of the Q1 sell-off, but also the linearity of the Q2 rebound. Following 2 years of downtrend and an important low on our long term oscillators (lower rectangle), we believe this climax sell-off and rapid upside reversal is very promising. On both oscillator series (lower and upper rectangles), **we expect that the MSCI Emerging Markets probably continues to rise into late Q3 in first instance**. Until then, it may break above the resistance of our C Corrective targets to the upside (right-hand scale) which would open the door to **more upside potential over the next 6 to 12 months (between 1'264 and 1'437 according to our calculations, or to above the Q1 2018 highs). In the meantime, however, following a late Q3 intermediate top, we would expect some retracement into Q4.**

Nasdaq100 vs the S&P US Staples sector
Daily graph or the perspective over the next 2 to 3 months



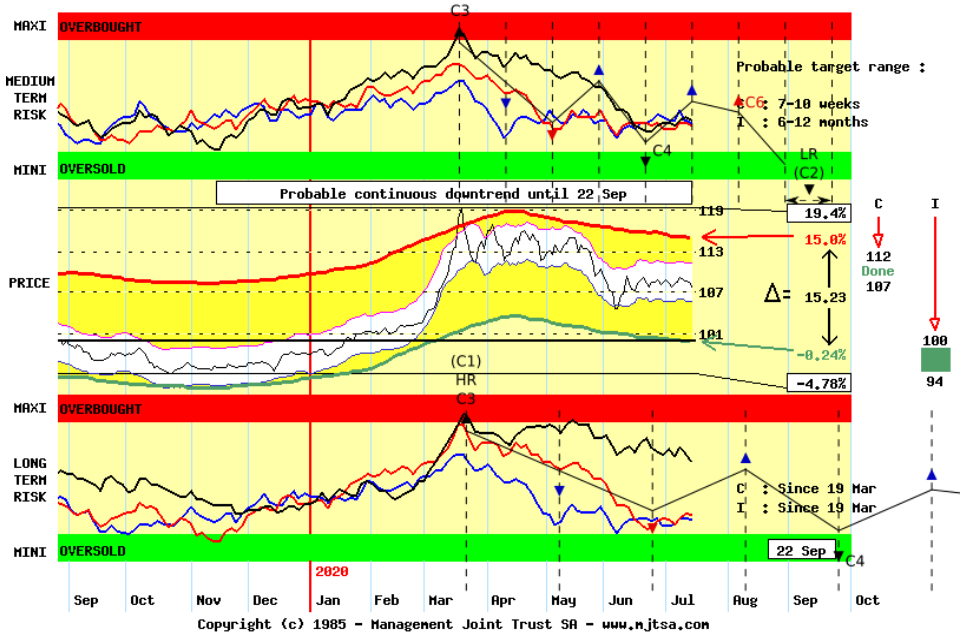
We now move back to our Daily timeframe and compare different equity profiles (growth, cyclicals, defensives) in order to refine our market timing and understand the rotations that may materialize this Summer. **We first compare the Nasdaq100 to the US Staples sector. The Nasdaq100 has assumed leadership to the upside on US equity markets for many years now, and the ratio is quite precise in pinpointing possible risk-off phases**. i.e. it usually drops only during strong risk-off phases. On our long term oscillator series (lower rectangle), the ratio is entering a High Risk zone, it may extend into late August until an important top is confirmed. On our medium term ones (upper rectangle), an intermediate consolidation is underway, it may last into early August, before the ratio resumes higher into late August / early September. Putting both projections together, **we expect a short risk-off phase until early August, then a last rally into late August / early September, and then a more consequent reversal to the downside into the Fall.**

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



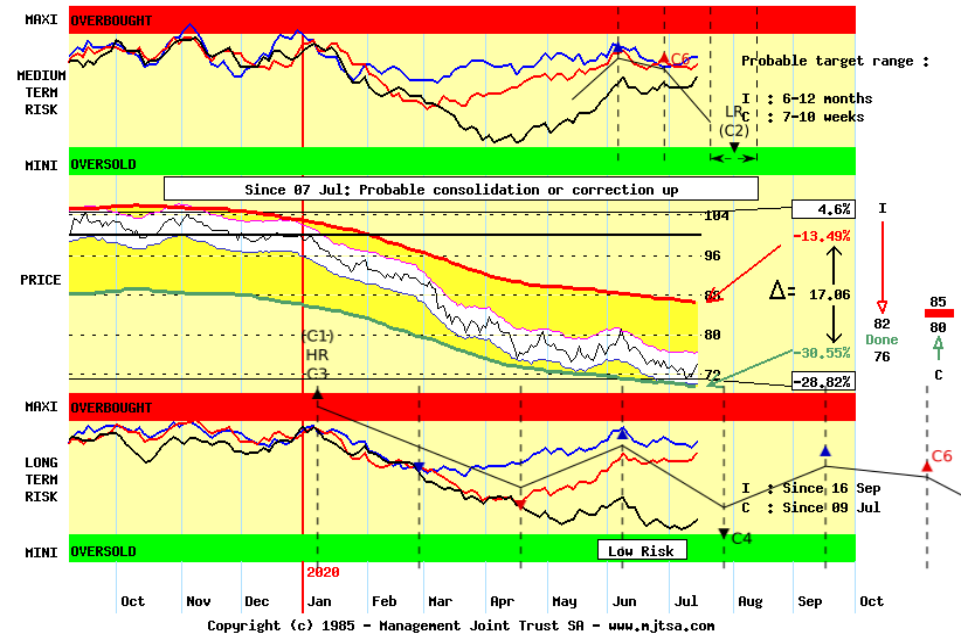
A more classic ratio is the one comparing the Russell 2000 vs the S&P500 Index. It captures risk-on / risk-off phases, but also cyclical strength. Following a choppy rebound into early June, the ratio has since been consolidating to the downside on both oscillator series (lower and upper rectangles). Although the ratio may have just found support on our medium term oscillators (upper rectangle), **downside pressure could persist into early August** on our long term ones (lower rectangle). **Thereafter, a new rally (a cyclical rally) could materialize in August, probably into late August, perhaps into mid September, before the ratio and cyclical factors roll over again into the Fall**.

Switzerland vs European Markets
Daily graph or the perspective over the next 2 to 3 months



In Europe, we like to use Switzerland as a defensive proxy (EWL ETF) and compare it to the wider European markets (IEV ETF). Following a huge defensive spike in March, the ratio then retraced into early June. It has since performed a weak bounce. On both oscillator series (lower and upper rectangles) **some defensive strength may persist until early August, when the ratio could start to resume its downtrend, probably until late August / early September** on our medium term oscillators (upper rectangle), into mid/late September on our long term ones. Thereafter, defensive themes in Europe should then start to outperform again into the Fall signaling a potential market correction.

European Cyclical sectors vs Europe Stoxx 600 Technology sector
Daily graph or the perspective over the next 2 to 3 months



On the cyclical front, we perform a cross factor analysis comparing an equal weighted portfolio of European Cyclical sectors (Europe Stoxx Chemicals, Banks, Automobiles, Energy, Industrials and Basic Materials sectors) to the Europe Stoxx Technology index. The ratio is Oversold in terms of price targets (right-hand scale) and may be approaching an intermediate low on both oscillator series (lower and upper rectangles). **A bounce could indeed start to materialize between late July and early August and probably extend into late August / mid September. The ratio then probably rolls over into the Fall.**

Concluding remarks:

Shorter term, our timing on the S&P500 and the EuroStoxx50 seems to imply that the high level consolidation period that started early June may still be underway, and that further intermediate dips could still materialize until early August. Thereafter, global equity markets should continue their recovery, probably into late August / September, while cyclical factors may then even outperform shortly. While, some of the stronger markets may make new highs by September (e.g. the S&P500 index), weaker ones could at least approach them (e.g. SX5E). Following that, we expect an intermediate correction to the downside from mid/late September into mid/late Q4, and then a new leg up, with potentially new highs, into next Spring. Longer term, on our bi-monthly graphs, we would also remain positive on equity markets first into early next year (following an Autumn correction), and then potentially once again into late 2021/2022. Geographically, the S&P500 looks more extended to the upside than the EuroStoxx 50 or the MSCI Emerging Markets index, while these global markets look very Oversold on a relative basis vs the S&P500, following ten years of underperformance. We believe they could be the main beneficiaries over the next 24 months of the huge reflationary efforts done by Central Banks, and the FED especially, as the economy gradually recovers, rates remain low and the US Dollar potentially continues to reverse down.

45 /The 10yr yield should spiral lower until early September; fast deterioration of 2020 liquidity flows should keep yields under pressure until year-end

We are updating of The Capital Observer's interest rate outlook, and to do this properly we build from the last two articles we did on rates: in March ("*The long bond yield has bottomed, as the seasonal upswing in liquidity starts; market healing begins very soon as rising yields signal that the worst is over*"), and in April ("*The long yield has indeed bottomed: expect rising yields until late April-early May, then followed by declining yields as Fed stimulus hits a plateau*").

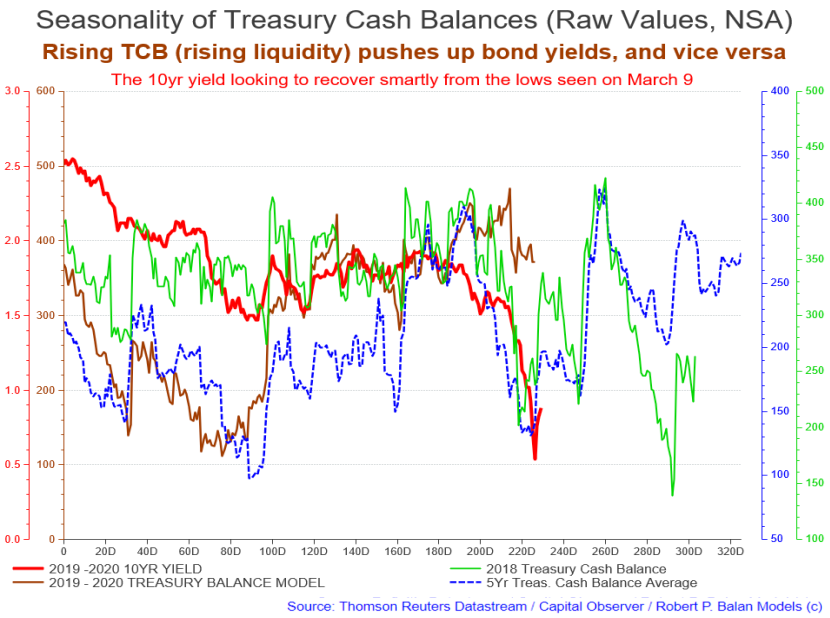
The March issue provided the baseline. We said in the March edition of The Capital Observer that the long bond yield has bottomed, as the seasonal liquidity flows swing higher – the market healing began as rising yields signal the worst is over. Indeed, just three days after we published the March edition, the stock market bottomed on March 22 , and equities started to rally, posting almost 50% gains since then.

The graph below, and similar graphs like it, show that changes in systemic liquidity have profound impact on the trajectory of bond yields. However, the situation comes with a twist: institutional investors are familiar with the regular seasonality of liquidity flows so therefore anticipate those expected changes.

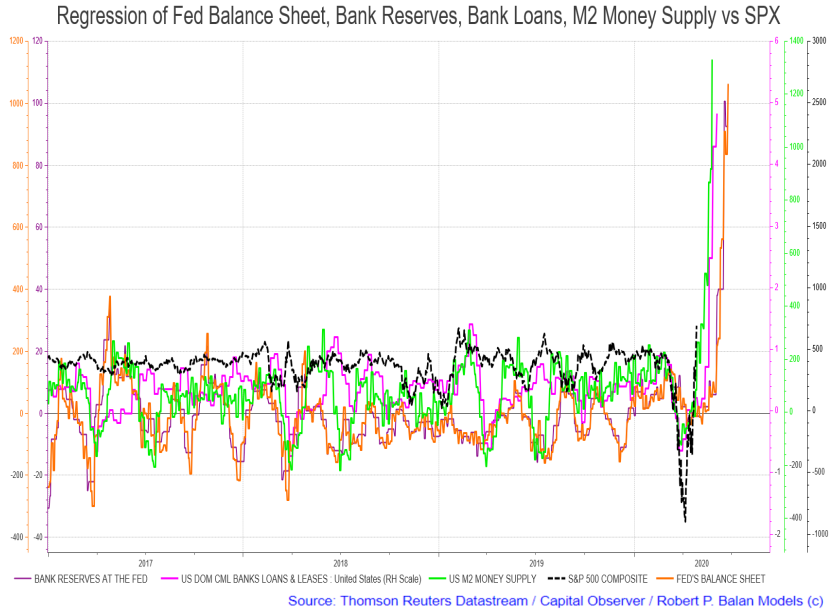
***The effect**: changes in bond yields lead the actual changes in Treasury Cash Balances (brown line, 1st graph on this page) by several days, and that front-run lead varies greatly from one liquidity season to the next. That of course introduces a lot of uncertainty over the very short-term outlook for bond yields. But if we go to the seasonal outlook (which can be as short as 4 weeks to as long as 10 weeks), we do have a good understanding of what bond yields will likely do longer term. That has provided a good platform to what we call "tactical positioning around the seasonal liquidity flows."*

In the April edition of The Capital Observer, we asked how did the models fare during one of the greatest dislocations in the bond market history due to the Corona Virus (COVID-19) epidemic that threatens to kill the long-running bull market in stocks, and also for a brief period made it look like 10yr yields are going to zero?

Original chart from the March edition of The Capital Observer



Original graph from the April edition of the Capital Observer



And we said:

The models not only predicted the high-frequency turns that preceded the plunge in the long bond yield, but also anticipated the extreme degree which the long bond yield actually did fall. More importantly the models are now providing evidence that yields in the back-end may have already made seasonal troughs. More importantly, long yields are now rising in response to the seasonal upswing in liquidity and the upside pressure from the massive monetary and fiscal stimulus that the Fed and the US government are pouring into the US financial system and economy.

This manna from the Fed and US government (through the US Treasury) has expanded the Fed's balance sheet, the US M2 Money Supply, deposited huge amounts of bank reserves, and consequently sparked massive lending by commercial banks. A regression of these data versus the S&P 500 Index (see 2nd chart above) leaves no doubt that equities will benefit in a large way, following the tsunami of new money unleased by the Fed and US government.

The key take-away from these charts and models: the seasonal upswing in liquidity has resumes, even as the Fed and US Treasury joined forces to boost risk asset prices in a scale that has not been seen before. The markets have healed – the worst is now way behind us. For financial instruments that are directly linked to the stability of bond yields, a great deal of normality will return.

Yields should be rising again until late April-early May, but yields may come under pressure again from there following the seasonality of systemic liquidity flows. We also expect the stimulus from the Fed to hit an initial plateau by that time. Why do we say a liquidity flow plateau is coming? There are troubling signs that an initial plateau in bank reserves is coming very soon. The Treasury Cash Balance has been persistently strong, and that will undercut the growth of Bank Reserves – the liquidity data that has the strongest covariance with the changes in Bank Reserves. A surge in repo rates in recent days suggests that temporary plateau in bank reserves comes very soon, and will depress sentiment against equities.

How those projections and predictions came to pass is what the current article on interest rates is all about.

These are the events which we got correctly.

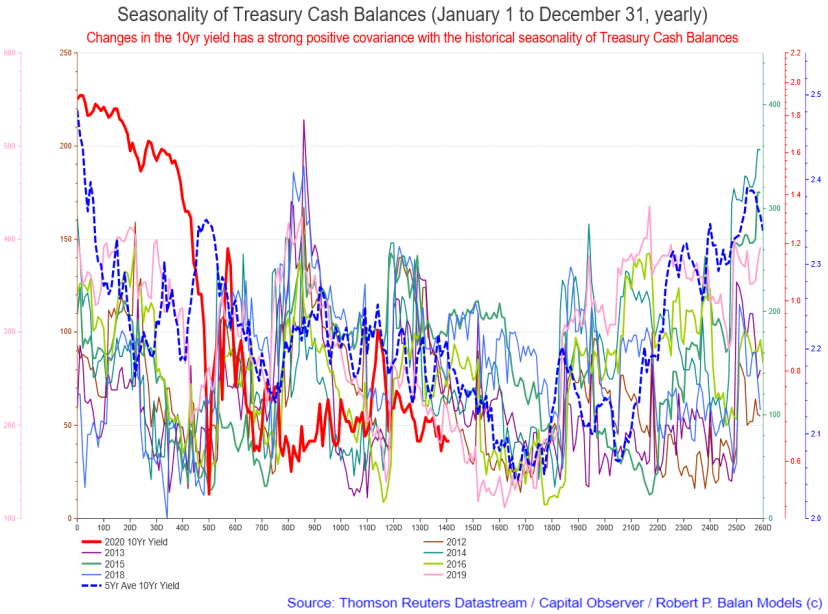
1. We predicted the March 22 upturn in the 10yr yield almost to the day.

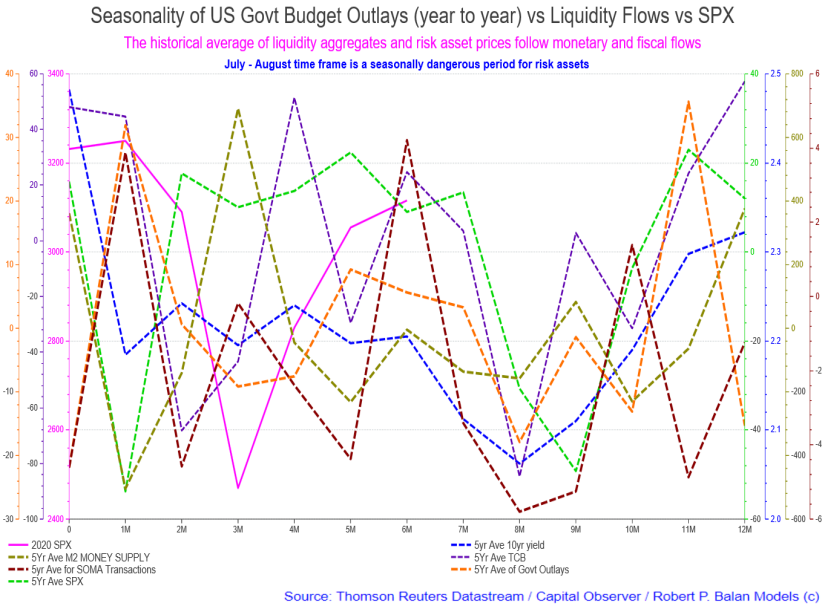
2. The historic seasonality of the Treasury Cash Balance provided a good guide to what the long bond yield did after the March 22 reversal to the upside.

3. The 10yr yield did fall in early May, but there was no prior sharp rise as expected.

4. Overall, after bond yields bottomed in March, the course of rates followed the seasonality of systemic liquidity flows pretty much.

5. The creation of new bank reserves ex nihilo by the Fed, and the massive issuance of new debt by the US Treasury healed the markets, prevented rates from collapsing to the zero bound, and engineered the rally to an initial new all-time high in May.





What we did not get:

A prediction that the 10yr yield will be at circa 2.00% by May-early June time frame.

What do we expect from here:

The 10yr yield has been faithfully following its own trajectory in previous years. Notable was the persistence of similarities between current, 2020 yield, and its trajectories in 2015 and 2019 (*see 1st chart above*)

If the 10yr yield remains faithful to its performance during those years, there will just a few days of rising yields in July before yields spiral lower until late August-early September. At that time, we could see again the lows made in March. That would be the 0.41 % area in the 10yr yield; we may even see lower lows later.

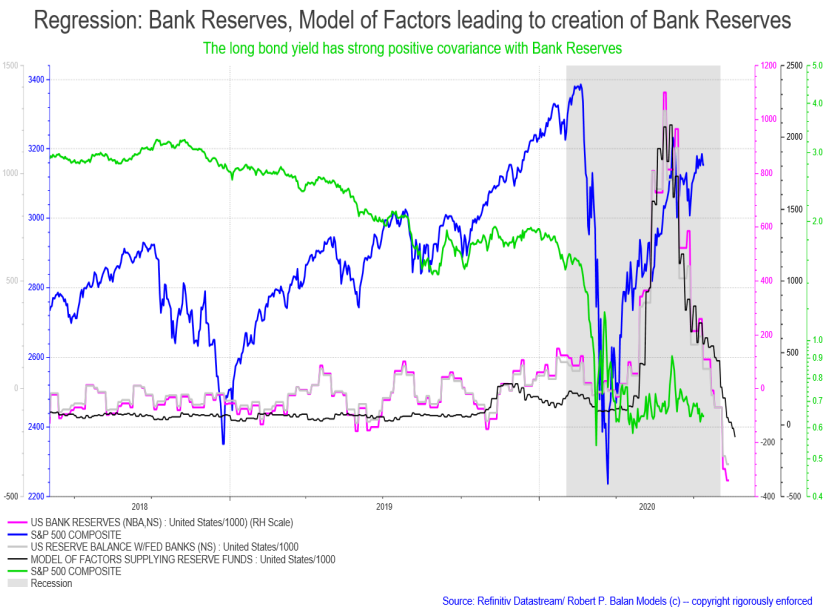
Those are the seasonal lows of almost all the liquidity sources that we are tracking (*see 2nd graph above*). In addition, that forthcoming period is traditionally punctuated by seasonal demand from foreign buyers of US securities. Moreover, this year, there is an ominous element added – the feared second wave of the COVID-19 could reach an apogee during that time.

So, if bond yields, specifically the 10yr yield again follows the seasonality of systemic liquidity flows, then it behoves that the bond bull market will be on track until early September.

Nonetheless, the current change rates in 2020 liquidity flows from the Fed and Treasury have been deteriorating at a fast clip (*see 1st graph on this page*).

This adds a new wrinkle to the forecasting of interest rate levels based on liquidity flows. **The current 2020 liquidity profile is so very different from historical norms – we fear that its after effects may be completely different from what we have seen in the past 7 years at least.**

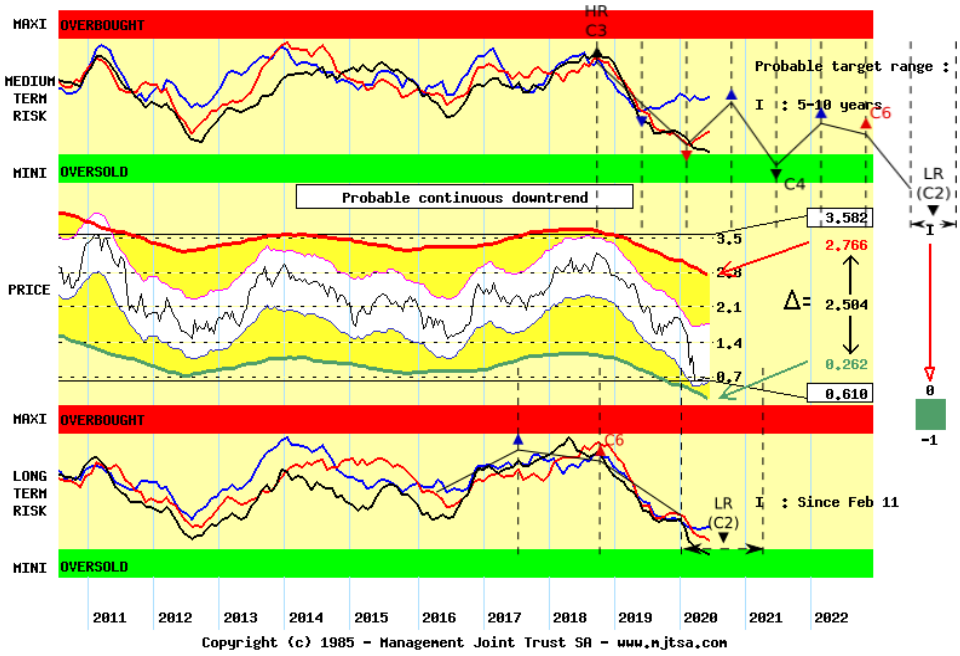
It may even happen that we will not see a robust rally in yield as from early September until early December. **The 10yr yield could stay low until year end**.



48 / MJT - TIMING AND TACTICAL INSIGHT
Rates may hold up this Summer, yet remain in a persistent longer term downtrend

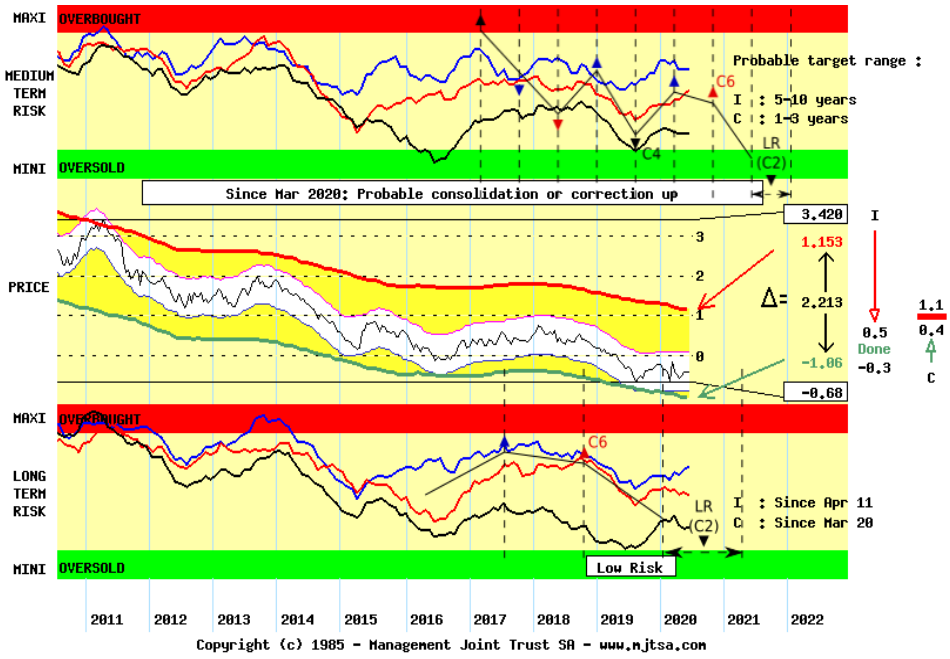
Given the suddenness of the COVID crisis and the scope of the anticipated GDP drop-off, the Central Banks' reaction was swift and massive. The future will tell us if these monetary interventions were/are sufficient, or perhaps exaggerated, and if there is any chance that the world's monetary system could be normalized again at some point. In the meantime, when considering previous accommodative sprees, it usually takes several quarters / several years until yields finally stabilize and bottom out. Hence given the severity of the current crisis, it is probably reasonable to assume that we are most likely not there yet and that the current downtrend will probably persist. We consider these long term perspectives in the coming graphs as well as shorter term developments into late Summer.

US10Y Benchmark Bond yield
Bi-monthly graph or the perspective over the next 1 to 2 years



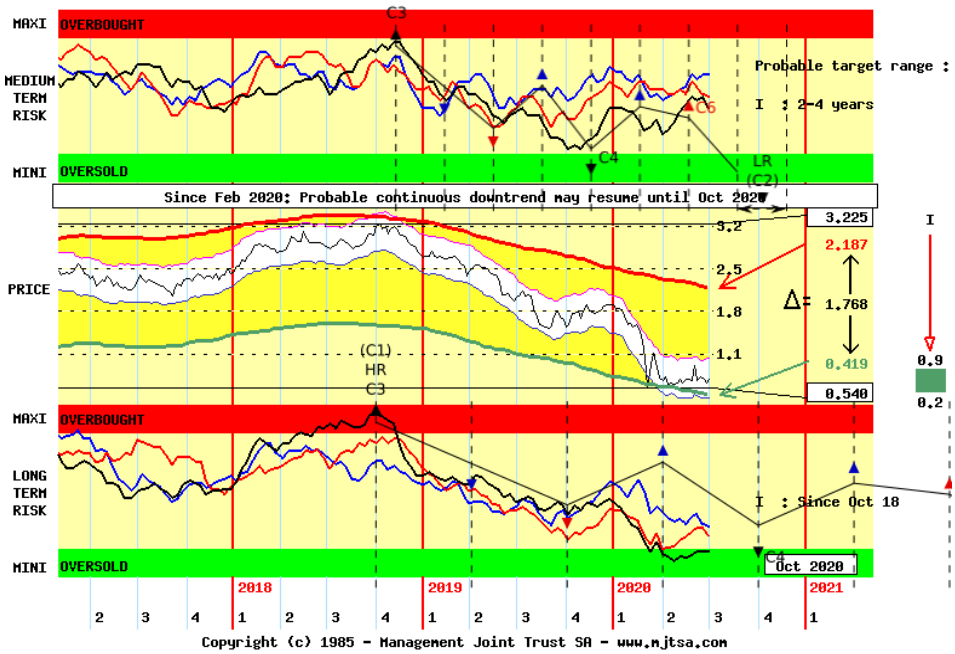
Since the October 2018 "Far from neutral" statement, risk assets have lived through several crisis, the FED has lowered interest rates down to zero and long term yields have reached historic lows. Yet, on both oscillator series (lower and upper rectangles), **it is for now difficult to confirm that a secular bottom is approaching. At best, both seem to signal that the downtrend probably persists into early, perhaps mid next year**. According to our I Impulsive targets to the downside (right-hand scale), rates could continue to make new lows, possibly down to 0%, perhaps even lower.

10Y German Bund yield
Bi-monthly graph or the perspective over the next 1 to 2 years



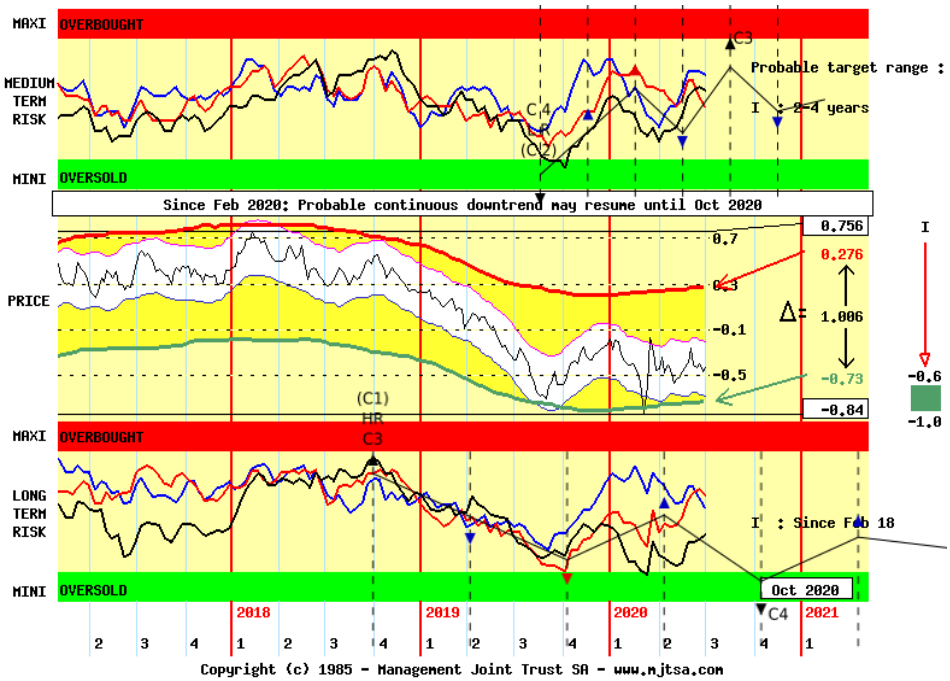
Similarly, on the German 10Y Bund yield, the downtrend seems persistent. According to our long term oscillators (lower rectangle), it may extend to early next year. On our medium term ones (upper rectangle), **the rebound since mid last year may soon die out, and further downside is probably expected from this Fall until mid/late 2021**. Although our I Impulsive targets to the downside have been achieved (right-hand scale), these may potentially continue to make new lows or at least retest their previous lows.

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



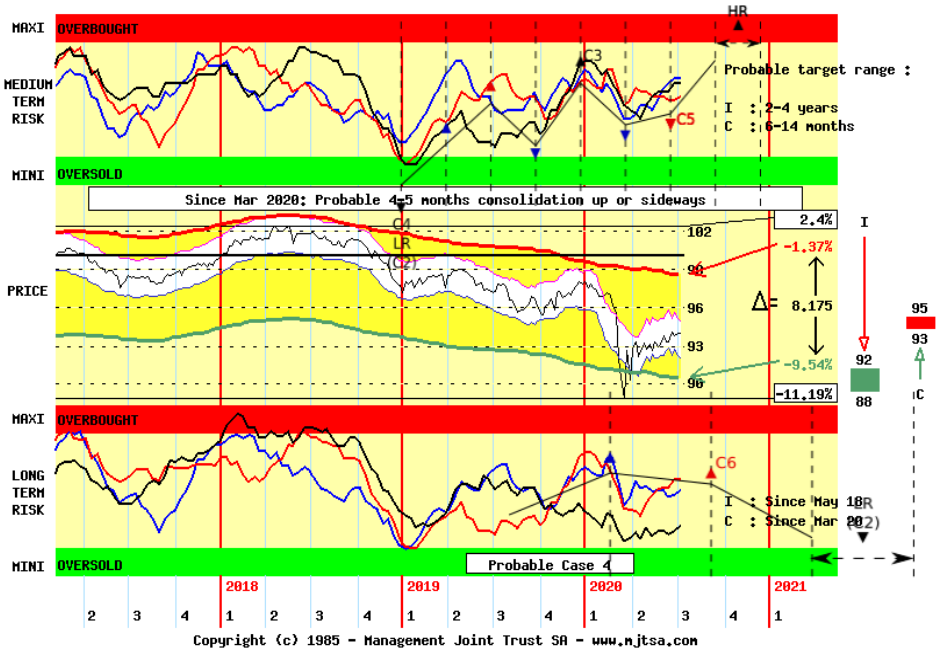
On our Weekly graph, **US10Y Government Benchmark yields may continue to drop into the Fall**. This is what both our oscillators are suggesting (lower and upper rectangles). **These may then bounce into Q1, but then probably retest down again into mid/late next year**, according to our long term oscillators (lower rectangle). Over the next 6 to 12 months, our I Impulsive targets to the downside (right-hand scale) indicate further downside potential towards 0.2%.

10Y German Bund yield
Weekly graph or the perspective over the next 2 to 4 quarters



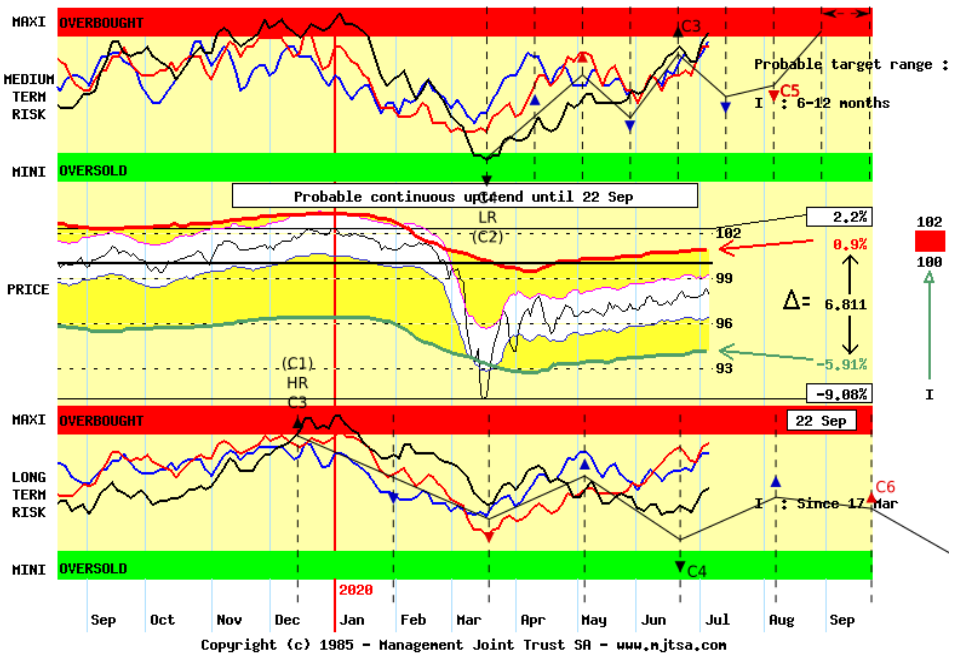
German 10Y Bund yields may also resume lower from mid Summer into the Fall, according to our medium term oscillators (upper rectangle). Then, from mid Q4, German 10Y Bund yields may attempt to bounce again into Q1 according to both oscillator series (lower and upper rectangles). The downtrend then probably persists into mid/late next year. Our I Impulsive targets to the downside (right-hand scale) suggest that new lows could be achieved over the next 6 to 12 months.

Inflation Expectations
Weekly graph or the perspective over the next 2 to 4 quarters



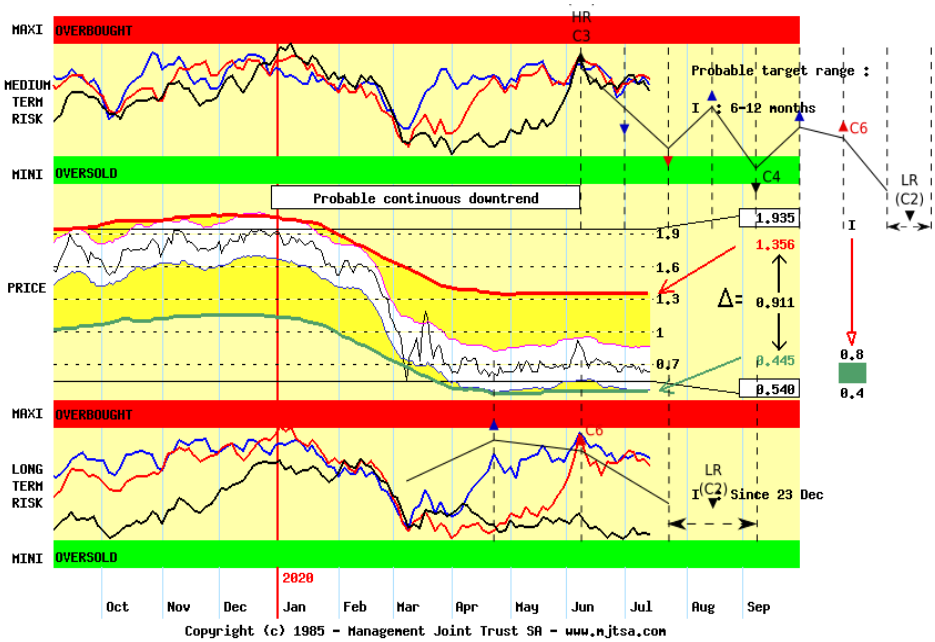
Inflation Expectations (10Y TIPs to Treasuries breake-ven ratio) often provide a link between rising/falling risk assets (and Oil especially), and interest rates. The rebound in March was quite swift, yet it has since stalled and for now remains in a Corrective bounce as it is still below the upper end of our C Corrective targets to the upside (i.e. below 95; right-hand scale). Considering our oscillators, our medium term ones (upper rectangle) are attempting to build a base to move higher into late Q3 /early Q4 when a High Risk situation is expected. Our long term ones (lower rectangle) suggest a more flattish scenario, where Inflation Expectations probably linger on slightly higher into mid/late Q3 and then drop into Q4 and perhaps even Spring next year. **Our consensus view is that Inflation Expectations may push slightly higher until September, but then probably drop into mid/late Q4**.

Inflation expectations
Daily graph or the perspective over the next 2 to 3 months



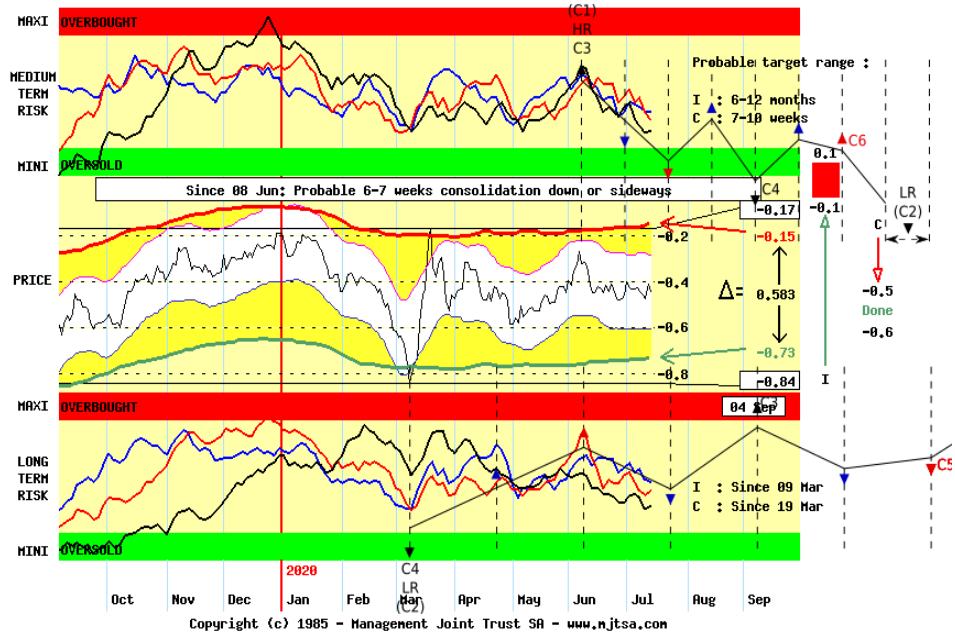
When looking at this daily graph, one may wonder if, since April, the price discovery mechanism of both TIPs and Treasuries has all but disappeared. The ratio is indeed very stable and slightly ascending. Nevertheless, the scenario outlined by both our oscillator series does seem to match our Weekly projections above. On our medium oscillators (upper rectangle), a slight period of consolidation may materialize into late July/early August, before the ratio lingers on higher into late August / September. On our long term ones (lower rectangle), the current sideways/up move lingers on into August and starts losing momentum in September. Hence, **we expect Inflation Expectations to maintain their slightly upwards trend until early/mid September, and then probably drop into the Fall.**

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



Considering our graphs above on Inflation Expectations, the Summer might be quite dull in terms of interest rate movements. Indeed, when looking at the US10Y Benchmark yields since April, price action is very much subdued. We believe this environment should continue during the Summer. On the oscillator front, our long term oscillators (lower rectangle) suggest that **a Low Risk situation may materialize between late July and early September. This Low Risk period may provide opportunities for the US10Y yield to bounce slightly (into early August, then perhaps in early September) on our medium oscillators (upper rectangle), but the sequence is probably downtrending and these bounces should be rather limited** (strong resistance probably towards the higher end of the early June bounce, i.e. towards 0.9%, if even). As with inflation expectations, **we then expect US10Y yields to weaken again from mid/late September into the Fall** as shown on our medium term oscillators (upper rectangles).

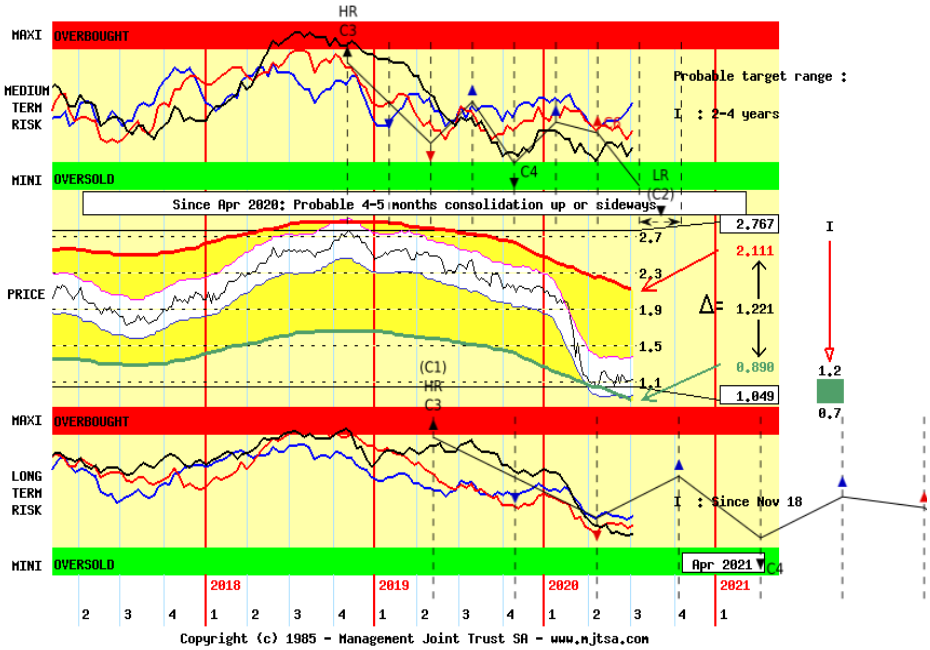
10Y German Bund yield
Daily graph or the perspective over the next 2 to 3 months



German 10Y Bund yields are also stuck in a range. On our long term oscillators (lower rectangle), we are slightly more positive here than on the US10Y graph above. German 10Y Bund yields may indeed attempt a new leg up from late July, potentially towards the higher end of their recent range and until early September. On our medium oscillators (upper rectangle), our scenario is more negative. The sequence we show is in a downtrend, with possibly some small bounces into early August and then early September.

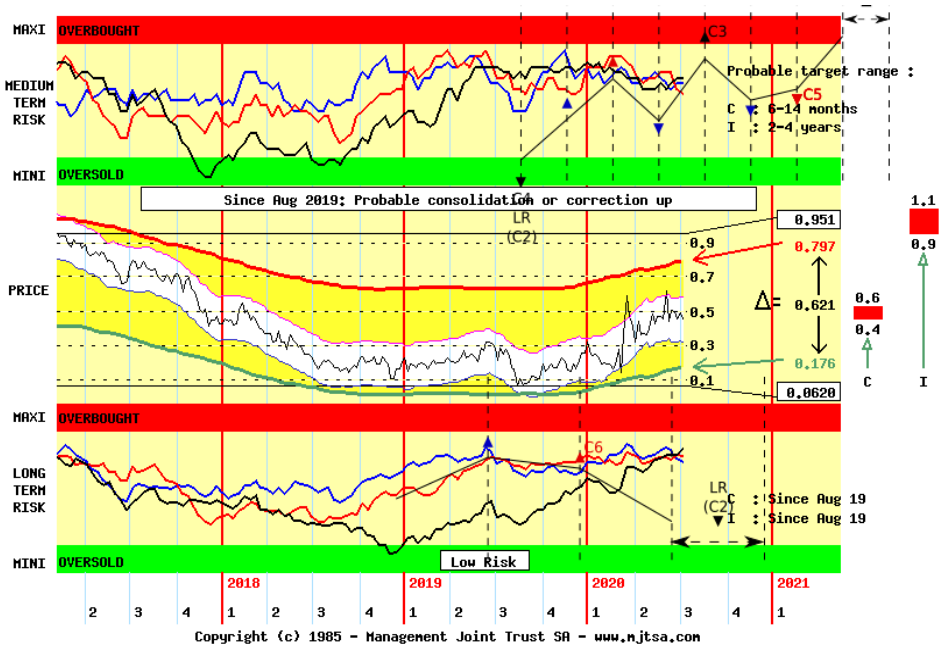
Considering both, **we expect German 10Y Bund yields to continue to retrace over the next week or so, then perform a weak sideways/up move into September, before dropping again on both oscillators series from early/mid September into the Fall.**

US10Y Benchmark Bond yield minus 10Y German Bund yield
Weekly graph or the perspective over the next 2 to 4 quarters



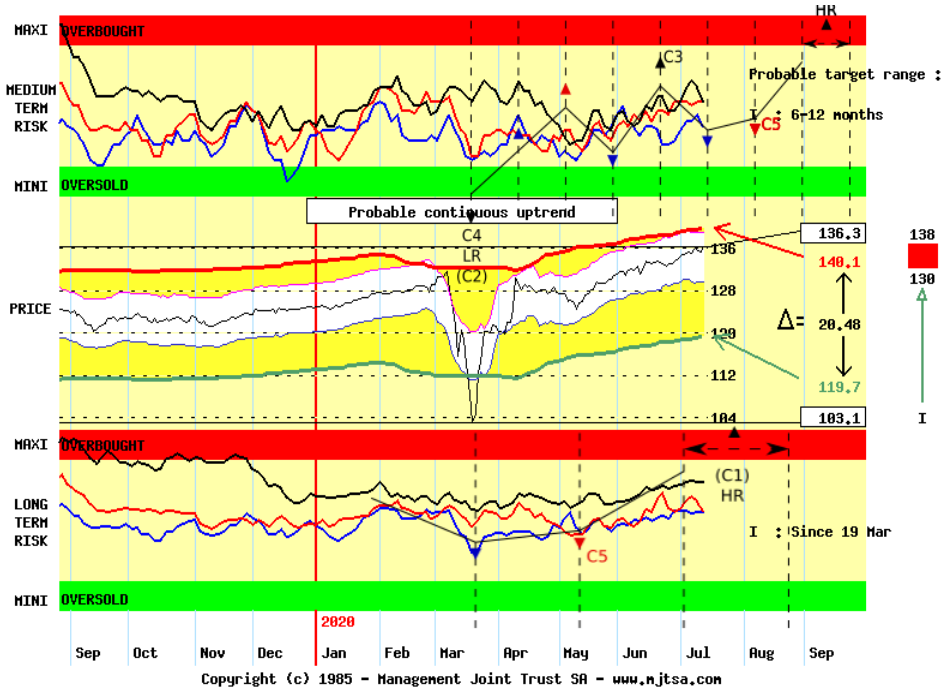
Considering our analysis on both the US10Y and German 10Y benchmark yields above, we also expect the Summer to be quite calm on the rates differential front. On our long term oscillators (lower rectangles), two downtrend sequences are visible: one with an intermediate red bottom last October, and another with an intermediate red bottom this Spring. Such situations where several downtrending sequences overlap are usually a sign of persistent downtrends. In this case we expect, the differential to continue lower into April next year at least as shown on our long term oscillators (lower rectangle). In the meantime, during the Summer, a slight rebound is expected on these long term oscillators, while our medium term ones (upper rectangle) may enter a Low Risk position. **Our consensus view is that the differential probably holds up into late Summer and then resumes lower into Q4.**

US10Y – US3Y benchmark Bond yield spread
Weekly graph or the perspective over the next 2 to 4 quarters



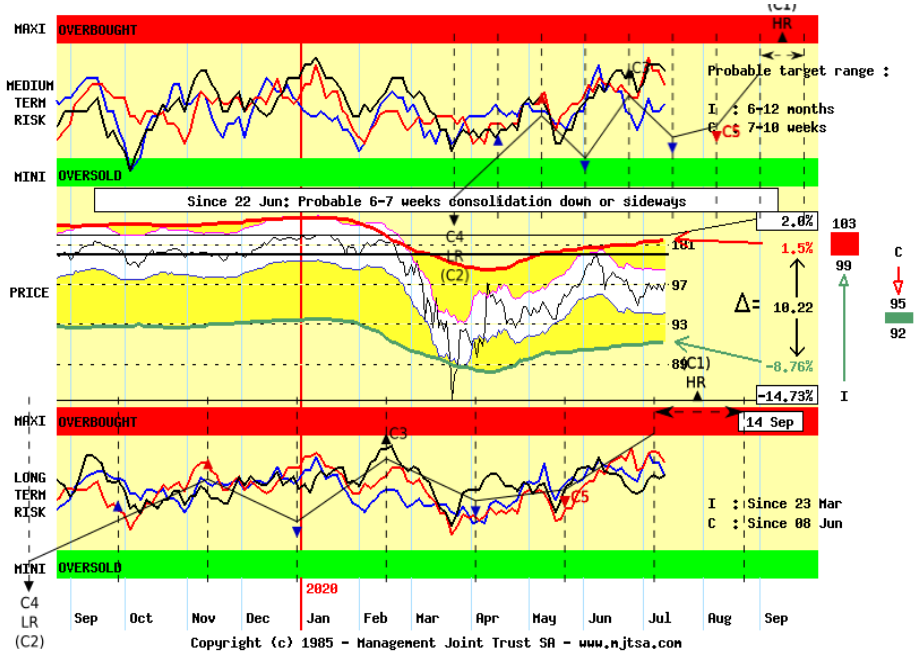
As for the US yield curve (US10Y-US3Y spread), it steepened sharply as short term interest rates were cut to 0% in March and has since be struggling to maintain this upside momentum. According to our medium oscillators (upper rectangle), it may continue slightly higher (or to hold up at least) into mid/late Q3 (mid/late August perhaps), and then probably retraces down into mid/late Q4. This could correspond to a period of downside retesting as shown on our long term oscillators (lower rectangle). With the front end of the curve (up to 3Y) pretty much stuck below 0.2%, long term yields are now the dominant factor driving yield curve spreads. The slight bounces we expect on the US10Y Treasury yields during the Summer (see graph on previous page) may help the US10Y-US3Y spread to hold up over the next month or so. Following that, the yield curve probably flattens again into the Fall along with declining US10Y yields.

US Investment Grade Bonds
Daily graph or the perspective over the next 2 to 3 months



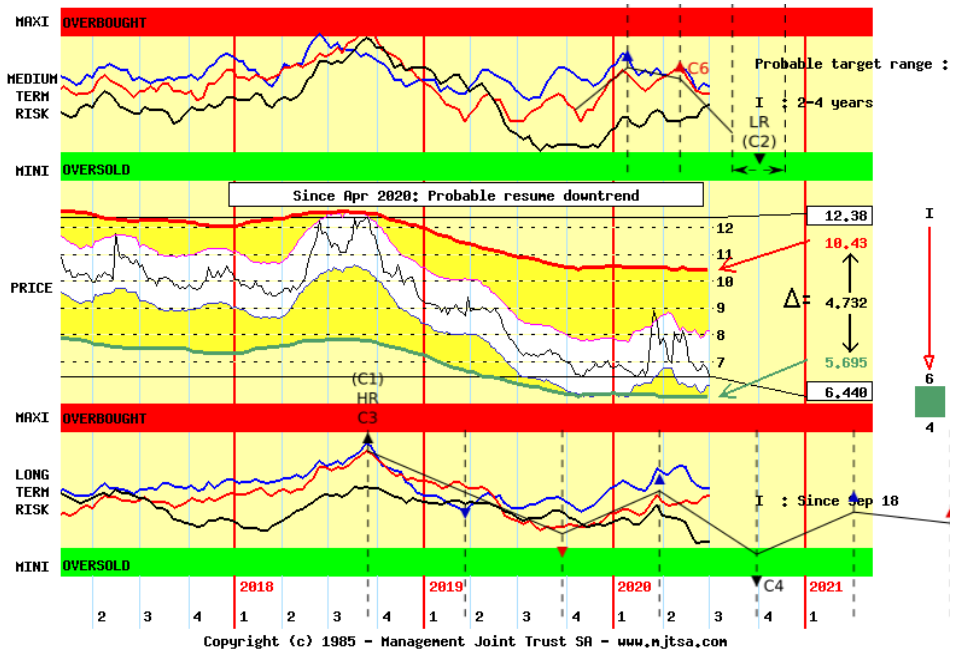
We now move to Credit markets and first to US Investment Grade (LQD ETF used as proxy). While it was spiraling out of control last March, the backstop which was announced by the FED towards the 3rd week of March did trigger an impressive upside reversal and the US Investment Grade market rapidly recuperated its March losses into early April. Since then, US Investment Grade has been grinding higher, continuously making new highs. **There is some talk in the market that solvency may become an important issue over the next few months, as the ongoing crisis gradually takes its toll on corporate balance sheets. For now, however, this is not yet visible on our graphs as the US Investment Grade market seems to linger on higher until late August, perhaps September** on both oscillator series (lower and upper rectangles).

US High Yield vs US Investment Grade
Daily graph or the perspective over the next 2 to 3 months



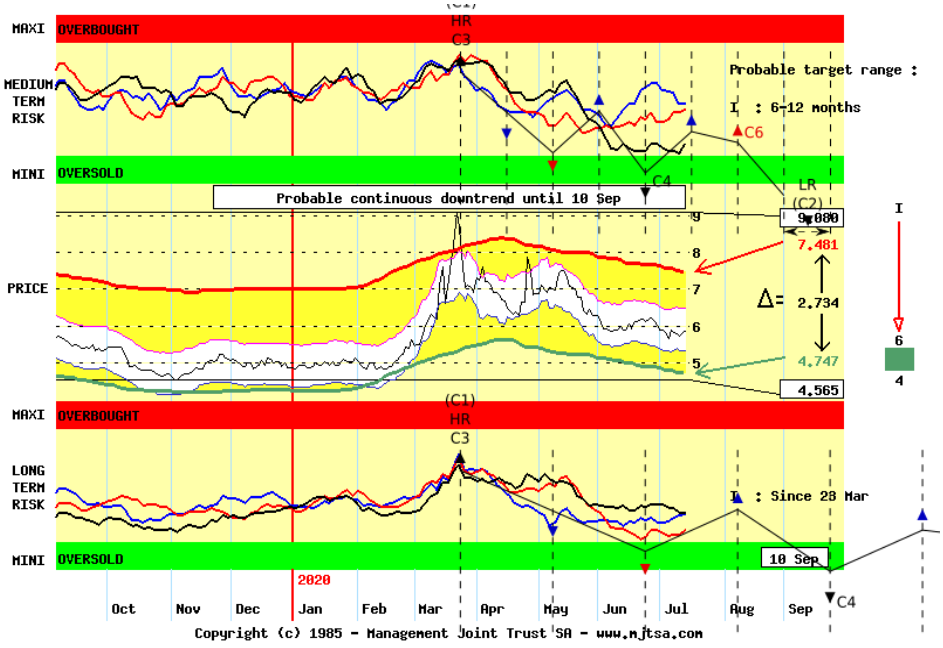
Moving out on the Credit curve, we now consider **the ratio of US High Yield (HYG ETF) vs US Investment Grade (VCSH ETF)**. Both ETFs have similar duration so that the ratio is pretty much the inverse of the credit spread differential between the two segments. Both our oscillator series (lower and upper rectangles) **still seem uptrending (declining credit spreads), probably into late August, perhaps September.** From mid/late September, we would then expect a 2 to 3 months correction into the Fall (rising credit spreads). These dynamics are similar to what we expect on most risk assets.

Brazilian 10Y Benchmark Bond yield
Weekly graph or the perspective over the next 2 to 4 quarters



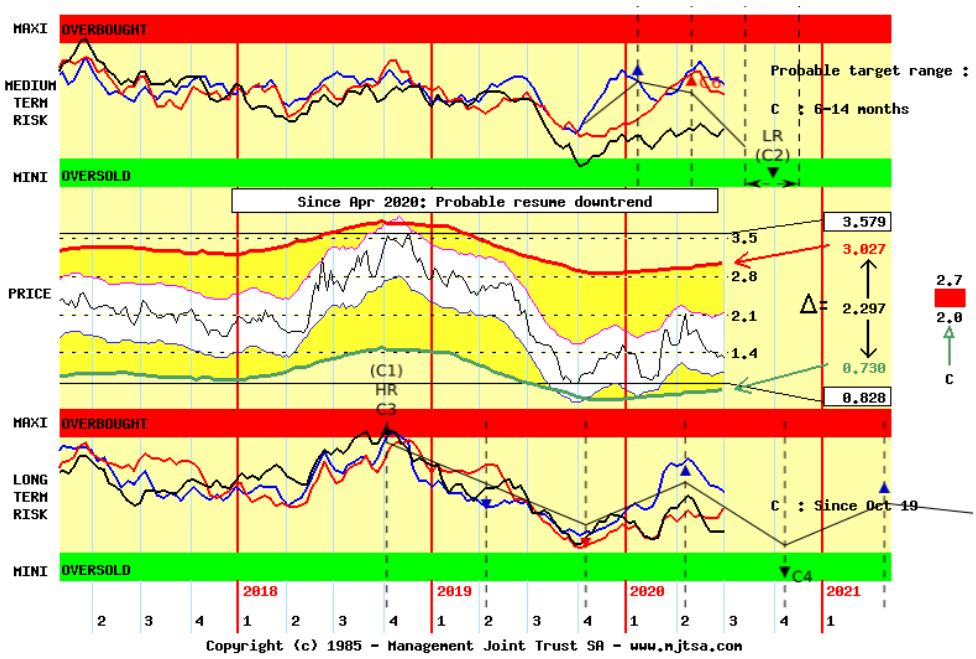
Emerging Sovereigns market also seem to be under control. We hereby take the 10Y Brazilian Benchmark Bond yield as a proxy. While yields did shoot up 250 bps during the crisis in March, this spike has since been retraced and both oscillator series (lower and upper rectangles) are now pointing to **further downside into late Q3 / early Q4. The Brazilian 10Y yield could reach down to below 6% by then** according to our I Impulsive targets to the downside. This is rather surprising given the severity of the COVID pandemic in Brazil.

Brazilian 10Y Sovereign spread to the US10Y benchmark Bond yield
Daily graph or the perspective over the next 2 to 3 months



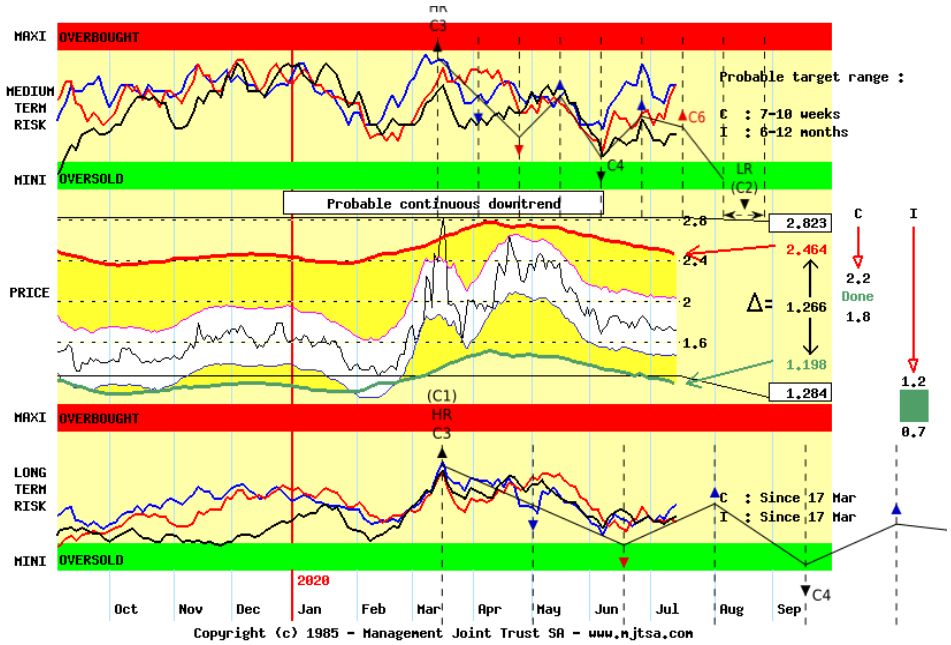
Looking at the Brazilian Sovereign spread, which shot up 450 bps in March. It has since retraced 2/3rds of this move. Both our oscillators series (lower and upper rectangles) suggest that the trend, which has attempted to bounce since early June, **could soon resume lower, between now and early August, probably into late August / September. Our I Impulsive targets to the downside (right-hand scale) suggest that by then the spread could drop deeper in the 600 to 400 basis points range. Hence, we don't expect much stress on Emerging Markets Sovereign spreads until late Summer at least.**

Italian 10Y Benchmark Bond yield
Weekly graph or the perspective over the next 2 to 4 quarters



In Europe, we use the Italian 10Y Benchmark Bond yield as a proxy for the weaker European Sovereigns. Both our oscillator series (lower and upper rectangles) suggest that following their late Q1 / early Q2 bounce, **the Italian 10Y Benchmark Bond yield is back in a downtrend, which can extend into late Q3 / early Q4 in first instance**. Most of this move will probably be due to the decline of its Credit spread, as shown below.

Italian 10Y Sovereign spread vs 10Y german Bund yield
Daily graph or the perspective over the next 2 to 3 months



The Italian 10Y Benchmark Bond spread vs the 10Y German Bund shot up 150 basis points in March and has since retraced 2/3rds of this move. According to both our oscillator series (lower and upper rectangles), **we expect the spread to resume lower again, between now and late July, probably until late August / September. According to our I Impulsive targets to the downside (right-hand scale), the spread could make new year-to-date lows in the 1.2% – 0.7% range. Hence, we don't expect any credit stress on European Sovereigns until at least late Q3**.

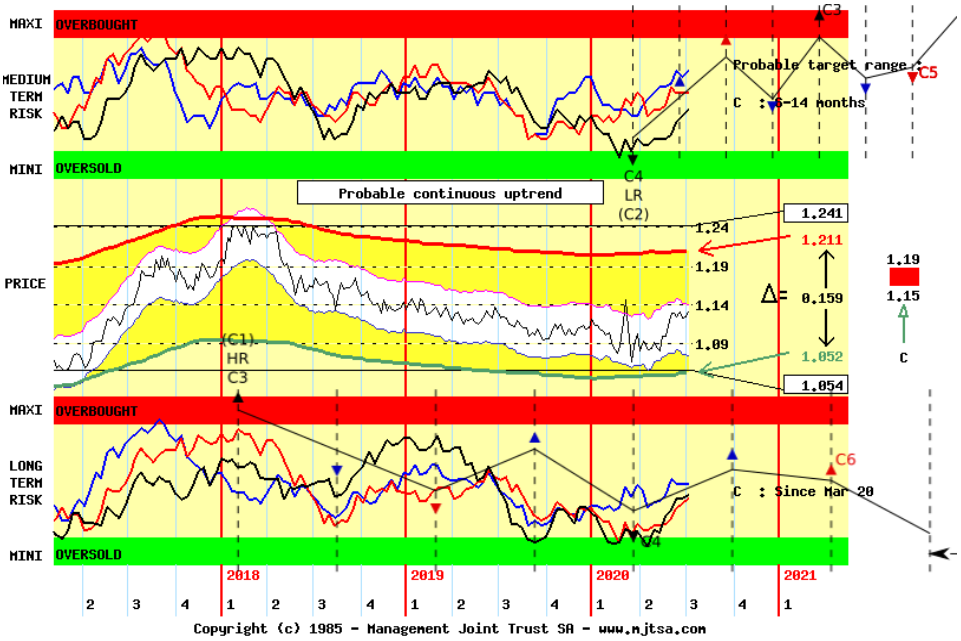
Concluding remarks:

Fixed Income markets on under control. We expect benchmark bond yields to continue in their current downtrend into this Fall in first instance and then perhaps into mid/late next year. US10Y yields may then reach down to 0.2% while German 10Y Bund yield may approach -1.0% once again. This, we believe, is part of the recovery process, where yields/rates remain/are kept under pressure as long as risk assets haven't gained sufficient upside momentum. In the meantime, benchmark yields could hold up during the Summer, probably until late August / early September, and may even see some small bounces along the way, which may correspond to some short term cyclical pick-ups. Likewise the US to Europe interest rates differential may also hold up into September and then drop into the Fall, while the US10Y-US3Y yield curve spread may attempt to push slightly higher over the next month or so, and then also drops down into Q4. The above, we believe, translates into a rather benign environment where benchmark bond yields remain under control. This stable situation is also confirmed by Credit markets, where both US Investment Grade and US High Yield Bonds should continue to linger on higher into late Summer, while Sovereign spreads continue to drop back down. The Fall may then see some stress situations reappear.

56/ Splicing the markets – Further upside into late Summer for Cyclical Currencies vs the US Dollar

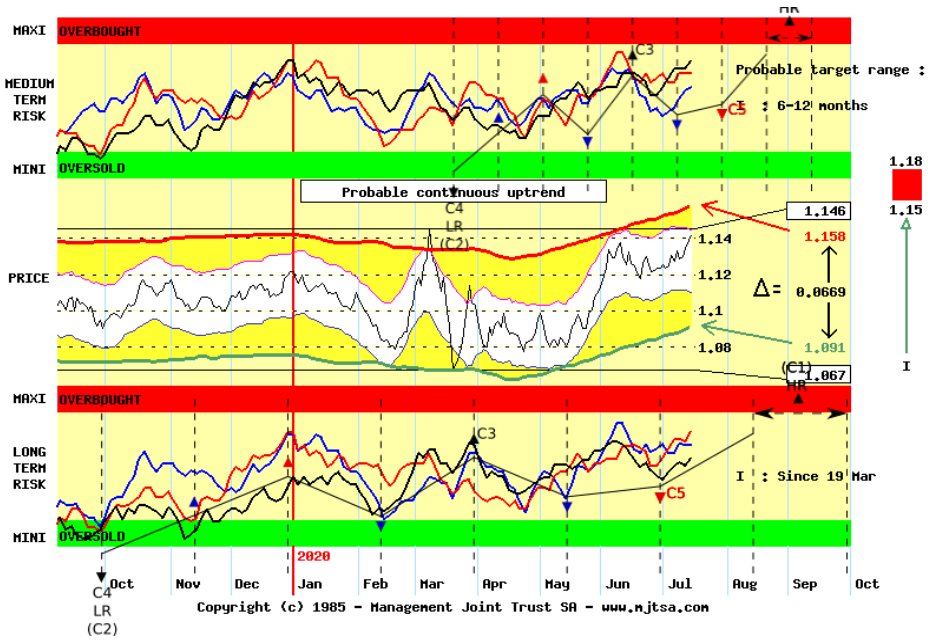
The Euro, the Pound or the Australian have followed cyclical factors lower over the last two years. This rather linear move to the downside may have ended with a climax low in March. These pairs are now rebounding and the progression of this rebound is rather promising. Eventually, it may prove to be the beginning of a longer term upside reversal.

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



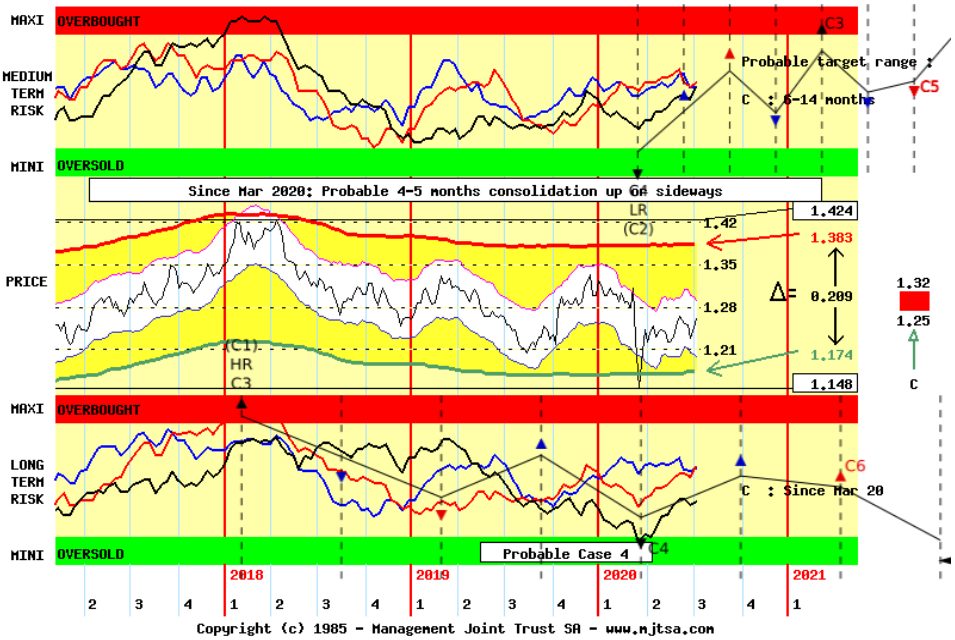
Following almost 2 years of a linear downtrend, EUR/USD was very oversold in March on both oscillator series (lower and upper rectangles). It has since been bouncing and could continue to do so until late Summer. Our C Corrective targets (right-hand scale) suggest that it could reach back into the 1.15 – 1.19 range by then. The Fall should then see some retracement. Further strength is then expected from year-end into late Q1 2021. This move will then provide clues as to the sustainability of this reversal. Indeed, if this new leg up into Q1 2021 can create higher highs as shown on our medium term oscillators (upper rectangle), EUR/USD could then rise for most of 2021. If, on the contrary, EUR/USD fails to make new highs early next year (or worse, makes new lows during Q4), then EUR/USD will probably remain weak at least into next Summer.

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



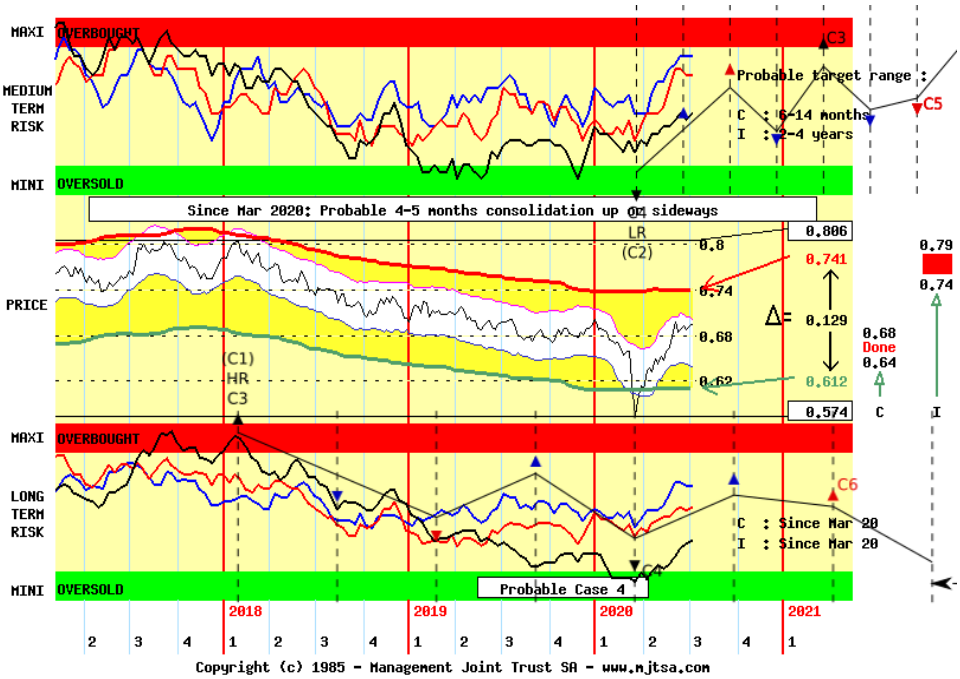
On a Daily basis, EUR/USD completed an initial leg up early June. The strong rally during May was triggered by the promise of coordinated fiscal stimulus in the EuroZone. While the sequence we show on our long term oscillators (lower rectangle) suggests further upside into late August, perhaps early September, our medium ones (upper rectangle) first point to **some consolidation into late July, and then to a new leg up into late August / early September**. Nevertheless, EUR/USD may reach the **1.15 – 1.18 range by late Summer** according to our Impulsive targets to the upside (right-hand scale), before it probably retraces back down into Q4.

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



The climax low during March on GBP/USD was impressive (more than 15 figures). The rebound has since been quite dynamic. On our long term oscillators (lower rectangle), the March lows created an important intermediate bottom. Such situations usually trigger circa 6 months of rebound at least (i.e. potentially into late Q3). **On our medium oscillators (upper rectangle), GBP/USD may have started a new long term uptrend. It should also continue into late Q3, may then see some retracement during the Fall and should finally rise again towards late Q1 2020.** Here also, its capacity to make new highs, first towards late Summer, then next Spring, will determine if a long term reversal to the upside has taken place (upper rectangle). Failing that, Cable will probably suffer another downturn during H1 2021 (lower rectangle). On the target front, **the next resistance levels are towards the upper end of our C Corrective targets to the upside around 1.32 (right-hand scale). These may be achieved over the next couple of months.**

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



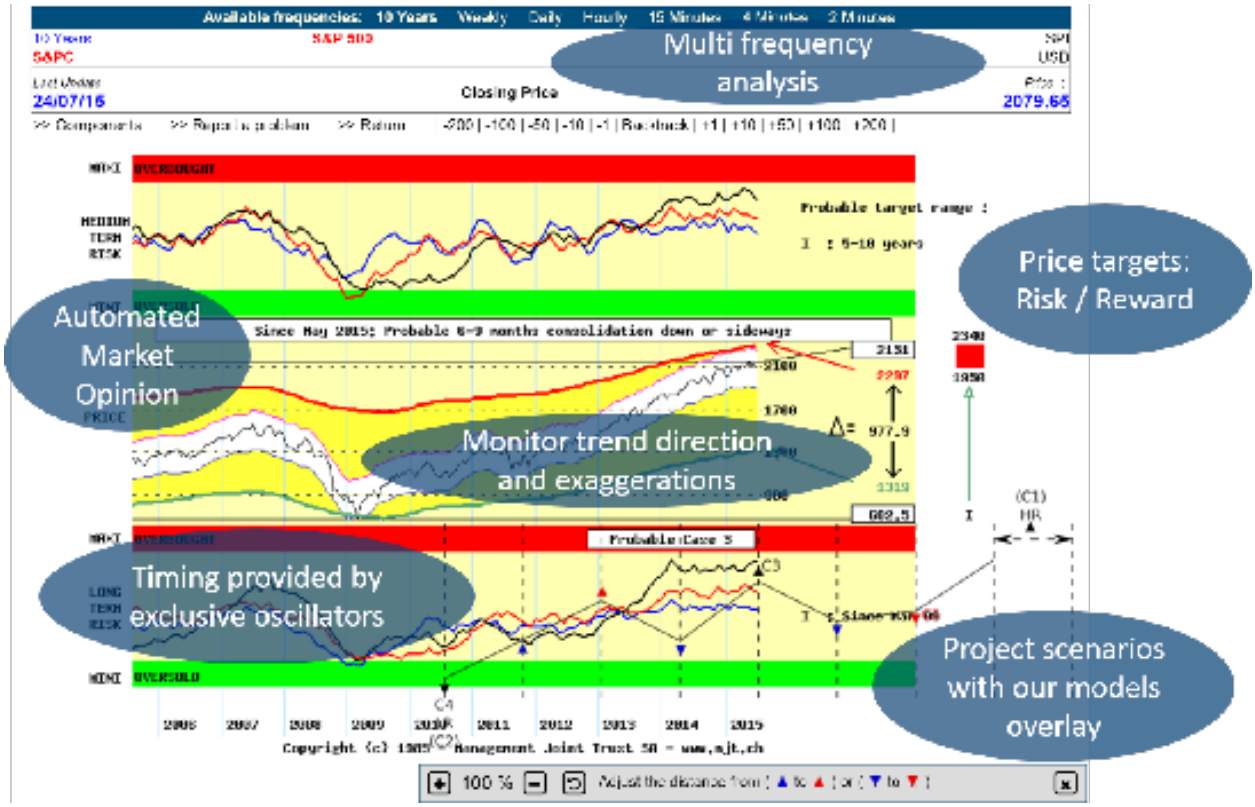
The reversal since March on AUD/USD has been even more impressive. Indeed, **following more than 2 years of downtrend and a sell-off of almost 13 figures between January and March, AUD/USD has since recuperated all of its Q1 drawdown, and even managed to make it above the upper end of our C Corrective targets to upside around 0.68 (right-hand scale). This break-out theoretically initiates a long term uptrend**, which could last a couple of years and could target our I Impulsive targets to the upside in the 0.74 – 0.79 range in first instance (right-hand scale). On the timing front, our long term oscillators (lower rectangle) made an important low in March and AUD/USD could initially bounce towards late Q3. The sequence we show on our medium term oscillators (upper rectangles) suggests that **a new uptrend is underway, with a further intermediate top late Q3 and then another one next Spring. Here again, prices will need to maintain their upside momentum to confirm this long term reversal**, but the fact that we are now above our C Corrective targets to the upside is rather encouraging.

Concluding remarks :

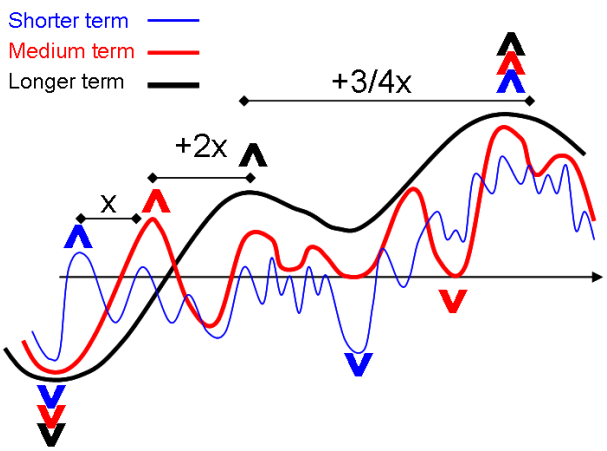
EUR/USD, GBP/USD and AUD/USD all made important lows in March and have since been bouncing. Typically, such situations usually trigger a six months bounce at least (i.e. into late Q3 in this case), if not a new uptrend. In first instance, EUR/USD could reach back up into the 1.15 – 1.19 range, probably until late Summer, GBP/USD may challenge its 1.32 resistance, while AUD/USD, which has already broken above its 0.68 resistance, could move up into the mid 0.70s. The Fall should then see some retracement.

58/ METHODOLOGY

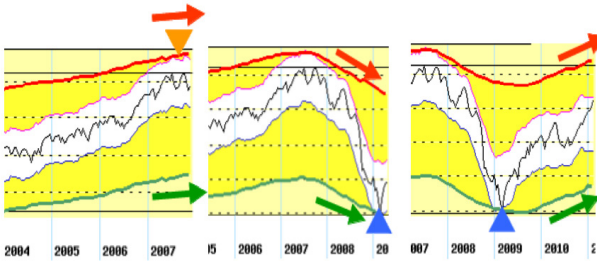
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative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



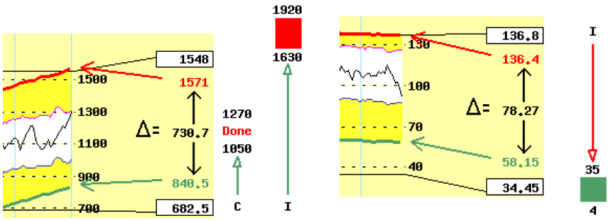
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)



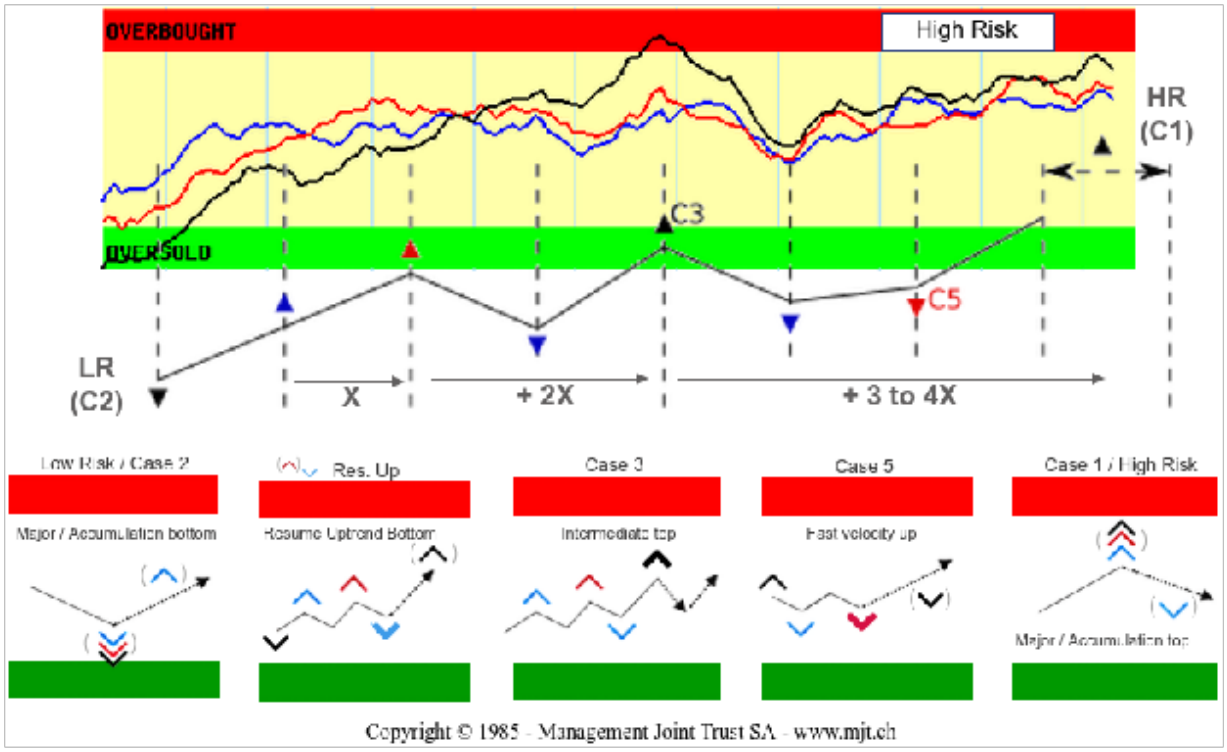
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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).

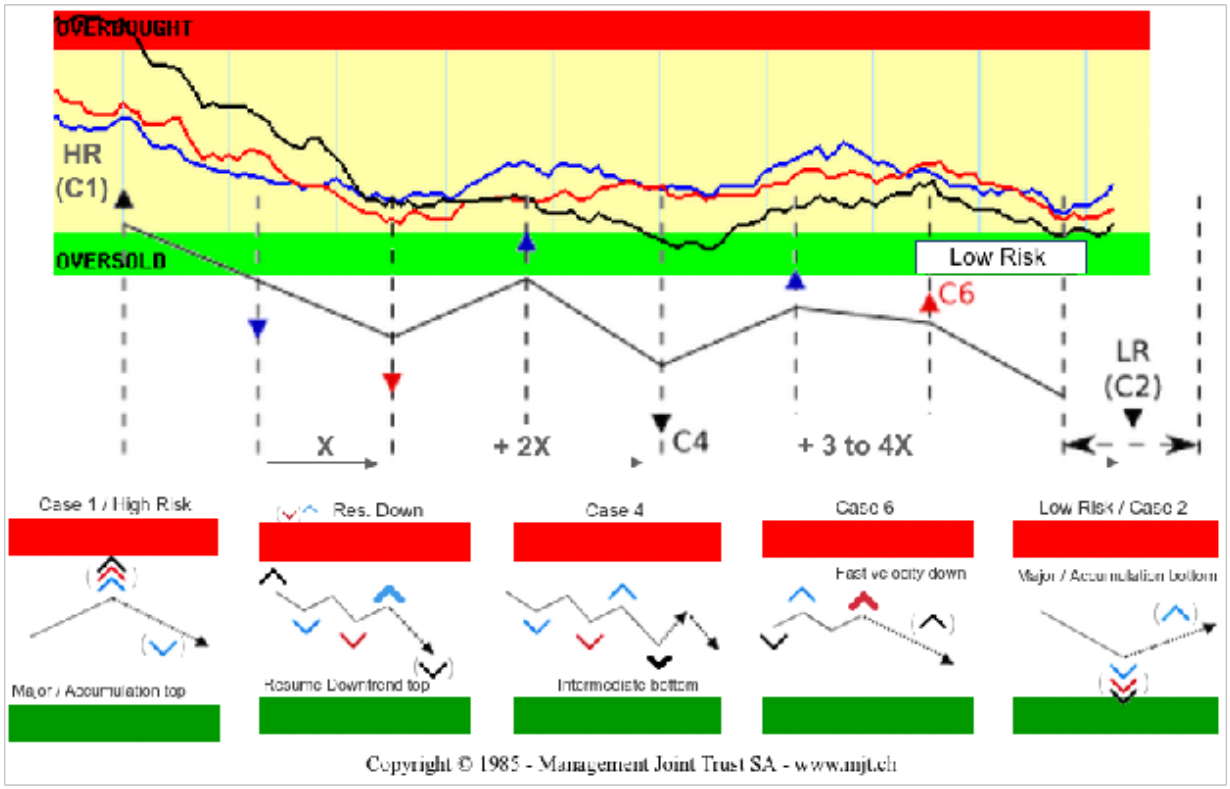


Ideal Uptrend Model



(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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