THE CAPITAL OBSERVER

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the technical analyst
AWARDS 2018
WINNER

A DC&C publication,
featuring MJT's timing methodology

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THE CAPITAL OBSERVER

A Monthly Macro and Asset Review

Featuring MJT's Timing Methodology

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CONTENTS

"

In times of change learners inherit the earth; while the learned find themselves beautifully equipped to deal with a world that no longer exists. "

E. Hoffer

4/ Executive Summary

12 / We expect falling GDP in Q2 and Q3 2020, but recovery during late H2; the Fed and Treasury are doing the right things to boost nominal GDP and risk asset prices - One of the significant question is how long will this shock recession last? Based on our capital account and government expenditures model, GDP growth will fall in Q2 and Q3 2020, but should recover in Q4, before falling again during H1 2021. We believe that this zig zag scenario makes sense. Covid-19 statistics seem to be on the flattening stage for most large economies. The momentum of GDP decline may spill over into Q3, but by Q4 this year, GDP should bounce back. Many investors are assuming the worst scenario can happen. Primarily, one general misconception which investors embraced is that it is difficult for the economy to recover once the COVID-19 crisis is over, because many companies have gone bankrupt. Nothing is further from the truth -- US economic history is full of examples of explosively fast recoveries when the initial problem is no longer impacting the economy. We see examples during the recessions of 1958, and 1982. The US economy has also the advantage of a fiat money system, a global reserve currency, and hence, the Fed can print enough money to get nominal GDP back up to the trend line by 2022. The US service industry also has the advantage of wage flexibility today. The forthcoming recovery should be faster, and more so because the recession prime mover is a medical emergency, rather an economic systemic failure. After the industrial shutdown for medical reasons, the US economy is capable of rapidly returning to full employment, especially so since the Fed and the US Treasury as combining their efforts to generate adequate nominal GDP. We expect business to ante up with the essential goods and services. Even now, it is apparent the Great COVID-19 Recession will be deeper than the Great Recession of the 1930s. However, deeper does not mean it will be worse or will be longer. There are indications that the worst scenarios of the epidemiologists may not happen. In that case, we will indeed see economic growth and activity during the latter part of H2, and could move on to full employment by 2022.
The price of risk assets tends to respond very well to the Fed's policy actions in terms of providing systemic liquidity in the aftermath of the Great Covid-19. The equity markets have responded well to the rise in the Fed's balance sheet as it acquires more liabilities in the form of Treasury purchases. These purchases set into action the rise of bank reserves, which have correlated well with rallies in equity prices. And now all of these factors are rising sharply, as the Fed ramps up its effort to rescue the financial markets. Risk assets lead economic growth, not vice versa. We do believe that the worst is over for the financial markets hammered to its knees by the COVID-19 epidemic.

15 / **Timing and Tactical Insight - Growth continues to outperform Cyclical factors into June at least -** Cyclical commodity profiles such as Copper, Oil or the Copper to Gold ratio seem to remain weak into June, perhaps midyear. This is also the case for cyclical equity themes such as small caps or cyclical sectors vs their reference indexes. Short term, the current cyclical bounce may continue another couple of weeks. Yet, the rebound has already been quite strong, and many cyclical sectors are approaching important resistance levels on a relative basis. We would hence expect them to underperform again from late April into late May, perhaps into June. US Energy for example may pump for another week or so, then dump during May. US Materials are more resilient yet should also underperform the S&P500 over the next couple of months. European Banks seem weak across the board into midyear. On the other hand, we expect growth themes to continue to outperform over the next few months. The Nasdaq 100 could also retrace down from late April into May, but will probably not make new lows. Alternative Energy is another Growth theme we like on a relative basis. It widely underperformed in March yet could now resume its uptrend vs the S&P500 into mid/late May. European Retail also looks appealing vs the Europe Stoxx 600 Index. Given its strong on-line focus, it has proven very resilient since the beginning of the crisis.

24/ **The Fed and US Treasury are not done supporting the markets and the economy -** Following the March 2020 article of The Capital Observer which chronicled the efforts of global central banks and global governments to arrest a financial market melt-down as a consequence of the COVID-19 pandemic, we are now updating the situation as it is continuing to evolve. Since then, the Fed has ratcheted up its intervention to save the economy and financial markets. During the past six weeks alone, the Federal Reserve has supplied $1,925 billion in assets to its balance sheet. In just 14 days, the Fed has literally pumped almost two years of normal QE monthly buying regime($60bb to $80bn) into the bond market. It does not stop there: on Thursday the 9th of March, the Fed announced another $2.3TT of incremental purchases, spanning a wide range of asset classes. The Federal Reserve assets now total more than $6.1 trillion. They said they aren't done yet. Total Fed potential buying will be borderline "unlimited." With $1.5trillion of purchases to date, and the other $2.3trillion which went to backstop a variety of struggling fixed income asset classes, there is unfathomable quantities of capital which is flooding the markets. That cash, $3.8trillion in capital is 19% of the size of the entire US equity market, and it will find its way to the stock market which is responding correspondingly.
So, what happens next? The effort to ameliorate the impact of the COVID-19 pandemic will become even more dramatic, as the fiscal side takes its turn to lend a hand. The US deficit is expected to reach 13% of GDP this year, with a $2trillion stimulus bill already passed. Discussions of another $1trillion infrastructure bill could take these numbers even higher. On the Fed's liability side, it looks like the Treasury department is building up funds there for impending check writing to bail out Main Street which is suffering from the side effects of the COVID-19 pandemic. This account will be one to watch this year as an indication of how the federal government is spending. The Fed's intervention may have only just begun, as they themselves have implied. The Fed's total balance sheet may approach $10.0 trillion. The Fed could be doling out stimulus well into Q3 this year. This scenario represents, for us, a Federal Reserve that is trying to err on the side of too much monetary ease. The current Federal Reserve is making it known that they don't want to take a chance on collapsing the banking system or the financial markets. With this kind of resolve, we believe financial markets and the US economy will be able to cope up better with the negative consequences of the COVID-19 pandemic.

27 / **Timing and Tactical Insight - The FED has backstopped risk assets, for now** - Following their 35% flash sell-off last month, equity markets along with most risk assets have since reversed up aggressively thanks to the FED, the ECB, the US Treasury as well as European Governments, which all rapidly rolled out massive monetary and fiscal stimulus programs. We expect this rebound to continue, probably into late April, potentially up to 2'900-2'950 on the S&P500 Index, perhaps towards 3'100 on the EuroStoxx 50 Index. Following that, most risk assets should see a consequent downside retest during May. Equity markets in the US, but especially some of the weaker markets in Europe or in Emerging Markets (ex Asia) could even retest their March lows. Volatility may be an interesting indicator to follow over the next couple of weeks. If indeed, by late April, the VIX does drop down to the low 20s / high teens, a deep downside retest is probably unlikely. On the other hand, if it remains in the low 40s / mid 30s, as it did for several months in 2008, new lows cannot be excluded. As for Credit markets, they have pretty much been backstopped in the US and in Europe and we would hence expect a shallower consolidation during May. Then, from late May / early June, we believe that most risk assets should stabilize again and probably initiate a new rally into the Summer at least.

5/ Executive Summary

35/ **The long yields are indeed in a bottoming phase: expect rising yields until late April-early May, then followed by declining yields as Fed stimulus hits a plateau -**In the March 2020 edition of The Capital Observer, we considered that the long bond yields may have bottomed as the seasonal liquidity flows swing higher – the market healing began as rising yields signal the worst is over. nHow regular is the seasonality tendency of US liquidity flows? We presented the basic framework, which has been consistent since the Fed started doing Quantitative Easing programs since 2009. 2020 10yr Treasury yield to show the tremendous fidelity the Treasury long bond has shown in following the trends of the Treasury Cash Balance. Of course, with the large-scale changes brought about by global central bank and global government intervention in global finance and governance, it is germane to ask whether these seasonality features would still exert the same influence that they used to. 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 leaves no much doubt that equities will benefit in a large way, following the tsunami of new money unleased by the Fed and US government. 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.

38 / **Timing and Tactical Insight - Yields remain under downside pressure along with Cyclicity** - We've considered the various portions of the US yield curve, inflation expectations, oil, other inflationary/deflationary ratios such as Copper/Gold as well as Government Benchmark Bond yields in the US, Germany, Japan or Switzerland. All seem to point to further downside pressure on yields from late April into late May / June. In the US, we expect all tenures from the US3M to the US10Y to converge down towards 0% and hence the whole front of the US yield curve should flatten out. The US30Y-US10Y spread on the other hand may rise, yet, we believe it is following opposite dynamics, as it is more influenced by more longer term inflationary trends. Hence the US30Y yield may drop, yet more slowly than the US10Y one. Fundamentally, we believe this weakness we expect on yields has 2 main underlying factors. The first one is related to the huge uncertainty around the actual damages the lock-down is inflicting to the various economies. The second is driven by the FED's likely intention to keep yields under downside pressure until the economic situation and credit markets stabilize ("unlimited QE"). From late Q2, we could then envisage a Summer bounce in yields, yet following that, long term graphs on ratios such as US TIPs vs Treasuries or Copper/Gold do seem to point to a downside retest into Q4.

47/ **Gold uptrend carries on. Gold continues to be a primary defensive asset even after the COVID-19 crisis blows over: US and global growth slows, and inflation is stoked by tremendous amount of global money supply -**Gold is keeping its longer-term utility as a safe haven asset and it is displaying its immense relative price strength versus other major assets in the face of global economic uncertainty. Even with the risk of some temporary set backs on account, the metal's dominant intermediate-term rising trend is in place as US and global growth falters – there is strong inverse correlation between US and global GDP growth and the price of gold, with a slight time lag . Put another way, if US and global growth take a beaten during Q2 and Q3 2020 (as we expect), then there is tremendous potential for Gold to outperform at that time. After the COVID-19 pandemic struck with full force, Gold has seen its biggest demand since the 2008 credit crisis. At this stage of the pandemic scare, Gold has outperformed other safe haven assets like the Japanese Yen or Swiss Franc. That outperformance continues today. That's a trend we expect to see as long as uncertainty around the full impact of COVID-19 on the global economy remains. Gold will also benefit from the latest emergency steps taken by the world's leading nations to forestall a global recession which added significantly to the global money supply. Why would inflation become a threat this time around? Here is the situational difference between the COVID-19 crisis and the GFC: instead of incentivizing banks to cling to their reserves, this time around the Fed is actively using moral suasion to push banks to make loans – and indeed they have done so with gusto. Also, the federal government is putting money directly in the hands of consumers and small businesses. The banking system is working as intended (which was not the case during the GFC). That's the part that's not at all different this time from the other times that inflation was stoked by infusion of large amount of money into the system in a rapid pace. This time, inflation will be a significant issue further out.

51 / **Timing and Tactical Insight - Defensive assets should benefit from a period of residual risks -** Gold is currently breaking out. We expect its strong acceleration to the upside to continue into late May/June at least, perhaps until the Summer. It may reach 2'000 USD/oz by then. It may hence widely outperform equities which we expect could be retracing down at best over the next couple of months. Goldmines and Silver could also perform strongly, yet less that Gold in this defensive environment. Treasuries should also remain strong, yet underperform Gold, which suggests a period of residual risks rather than disorderly deleveraging as was the case in March. Over the next couple months, we also expect Defensive equity sectors to outperform their respective index. Some of the longer term graphs even suggest that this outperformance may last into late this year. This is also the case for US Treasuries vs European markets or the Bund, which potentially implies further downside for US yields as well as continued US Dollar strength. Indeed, when considering the US Dollar vs commodity currencies or developped ones, it seems to extend higher into the Summer at least.

60 / **Splicing the markets - US Dollar update vs other Majors** - Many corporations around the world rely on US Dollar funding to match their US Dollar revenue streams. The lock-downs related to the COVID-19 pandemic are putting large chunks on this US Dollar denominated debt a risk. The world is hence scrambling for US Dollar and the situation will persist the longer lock-downs are extended. Despite the FED's efforts to mitigate this funding crisis, the US Dollar still appears very risk-OFF. We hence expect it to rise during the downside retest we expect on risk assets from late April into late May/June, most probably vs the Euro and the Pound, but potentially also vs the Yen. As we advance towards late Q2, the US Dollar may gradually become more neutral in terms of risk-ON / risk-OFF (vs JPY especially) as the funding shortage situation may then start to improve.

6/ Mapping the markets

Last month, when we published on March 17th, we believed that the sell-off on risk assets could end towards late March / early April and that a strong rebound could then materialize until early May. Our macro strategists were even more aggressive considering that helped by a near doubling of the FED's balance sheet, the worst may soon be over for financial markets and that the S&P500 could recuperate 60% of its losses within 6-8 weeks, while the Nasdaq 100 may even make new highs. On the yield front, we were rather negative into late March / April and then expected another bounce into late April / May (it has been rather weak for now), we then expected yields to resume their downtrend towards midyear, perhaps the Summer and new lows. These projections are still on track. At the time, we were also positive on the US Dollar, which for now hasn't been proven incorrect yet, while also being very bullish on Gold which we saw accelerating above 1'700 USD/oz, which has been the case. On the sector front, we remained negative on cyclical themes into late Q2 and specifically on Oil and Energy. This is still the case today.

Going forward, we believe the current risk assets rally could stall over the next couple of weeks, towards late April / early May. The 2'900-2'950 levels on the S&P500 or the 3'000 – 3'100 levels on the EuroStoxx50 should indeed act as strong resistance. We then expect risk assets and equities to retrace down into late May, perhaps June. Some weaker, more cyclical sectors and regions (which may include parts of Europe and most Emerging Markets ex Asia) may retest their March lows, while Growth and Defensive profiles, potentially the S&P500 and most probably the Nasdaq100 will probably see a mere 50% to 60% retracement of the current bounce. US and European Credit should also hold up rather well given the FED and ECB backstops, although Emerging Markets could see more damage. Similarly, large QE programs in the US and Europe should keep rates under downside pressure into June. Gold continues to rise in this period of residual risks, although the US Dollar could also remain quite strong. Other Commodities hence remain weak. Cross assets, we expect a risk assets correction during May and perhaps into June, which should however be less disorderly than in March given the backstops put in place by major Central Banks and the Treasuries of most developed countries.

From late Q2, risk and cyclical assets may have built a base and could bounce into the Summer.

Main Equities & Government Bonds

Main Asset Allocation Drivers		Next 2 months	3 to 6 months ahead
Main Equities	US S&P500	The current rally should be retraced on the S&P500, at least partially, probably from late April into mid/late May, perhaps into June. The 2'500-2'400 range may provide strong support once again.	From late Q2, the S&P500 could stabilize again and begin to rally into the Summer. It will then probably break above the 2'900 - 2'950 resistance range.
	Europe EuroStoxx50	The EuroStoxx50 could also correct down from late April into late May/June. It appears weaker than the S&P500 and may retest down to its lows.	From late Q2, the EuroStoxx50 may attempt to bounce into the Summer, the 3'000 - 3'1000 levels may then provide strong resistance.
	EMs MSCIEM USD	Emerging markets could also retest down during May and perhaps into June. We see strong differentiation beetween Asia, which could hold up rather well, and Commodity exporters which should remain very weak into late Q2.	From late Q2, Emerging Markets could attempt to bounce into the Summer and may even outperform developed ones.
Treasuries	US10Y Bond prices	The US10Y Treasury yield could resume its downtrend from late April into late May, perhaps June and could make new lows.	The US10Y Treasury yield could then bounce from late Q2 into the Summer, but may then retest down again into the Fall.
	Germany 10Y Bund prices	The German 10Y Bund yield could resume its downtrend from late April into late May, perhaps June and could retest its lows.	The German 10Y Bund yield could then bounce from late Q2 into the Summer, but may then retest down again into the Fall.

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

Main Equities

World markets

p 12, 24 - 26, 27- 28

Global equities have been rebounding vigorously since early in the 4th week of March. We believe they are currently reaching resistance zones around 2'900 – 2'950 on the S&P500 and 3'000 – 3'100 on the EuroStoxx 50. We hence expect this rebound to stall over the next couple of weeks and from late April, most markets should resume their downtrend towards late May, perhaps June. The US will probably find support towards the 2'400-2'500 range once again, while Europe appears weaker and could retest its lows.

Main Regional picks
p 32

We believe that over the next couple of months at least, the US appears less cyclical than Europe and Global markets and could hence outperform.

Emerging markets
p 33 - 34

Emerging markets will probably underperform developed markets into late May. Yet, this performance should very differentiated between some Asian countries such as China and Taiwan, which appear very resilient, while other regions including India or Commodity exporters such as Russia, South America or Afrika may be much weaker and widely underperform.

Volatility
p 31

VIX topped out around 80 and has since retraced down to below 40. In 2008, it did hold at these levels for several months allowing for some nasty downside retests. We expect it to bounce during April and believe that a lot will depend on how deep it can retrace until then, i.e. if VIX does start to bounce from the low 20s rather than the mid 30s, the retracement on risk assets may be shallower.

Government Bonds

US & European Benchmarks
p 24-26, 35-37, 38-39, 44-46

Treasury and Bund yields will probably resume their downtrend from late April into late May, perhaps June. The US10Y yield may reach down to new lows, possibly down to 0.1%, while Bund yields could retest towards their lows in the -0.6% to -1.1% range.

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) probably retraces down from late April into late May/June.	The ratio probably rebounds from late Q2 into Summer, yet could then still see a downside retest into the Fall.
	Europe	The European Equity to Bonds ratio (SX5E vs 10Y Bund) probably retraces down from late April into late May/June.	The ratio probably rebounds from late Q2 into Summer, yet could then still see a downside retest into the Fall.
Duration		US Yield Curve Spreads could flatten into late May/June as most tenures up to the US10Y converge towards 0%.	US Yield Curve Spreads may bounce from late Q2 into the Summer, yet could still see a downside retest into the Fall
Credit		Credit instruments could consolidate from late April into late May/June, yet given the FED's backstop, less so than other risk assets (in the US at least)	From late Q2, most Credit Spreads should retrace down, probably into the Summer at least.
TIPs/Treasuries		Inflation Expectations probably resume their downtrend from late April into late May/June, potentially making new lows.	From late Q2, Inflation Expections may then bounce into the Summer, yet could still retest down once again during the Fall.
Oil		Oil probably resumes its downtrend from late April into late May/June and may break below 20 USD/barrel on both WTI and Brent until then.	Oil may then bounce from late Q2 into the Summer, but probably retests down this Fall.
Industrial metals		Industrial Metals and Copper could resume their downtrend from late April into late May/June, possibly with new lows (Copper could reach down towards 4'400 USD/ton).	Industrial metals and Copper could then bounce from late Q2 into the Summer.
Gold		Gold should continue to make new highs over the next couple of months.	Gold could reach towards 2'000 USD/oz by the Summer.

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

Equity to Bond Ratios

US & Eurozone Market
p 54, 58

Equity to Bond ratios should also resume their downtrend from late April into late May/June as Equity markets retrace down and benchmark bond yields resume lower.

Fixed Income Dynamics

Duration (10Y - 3Y/3M)
p 39 - 42

US Yield curve spreads could also resume their downtrend from late April into late May/June as we expect most tenures from the US3M to the US10Y to converge towards zero. The longer end of the curve (US30Y-US10Y) may steepen slightly, yet this should be the resultant of the US30Y falling less than the US10Y. This should remain a friendly environment for duration as we don't expect this steepening on the long end to get out of control given the FED's "unlimited QE" program and the debt deflationary dynamics currently at play.

Credit
p 29- 31

Credit Spreads have been backstopped in the US and to a certain extent in Europe and many credit indexes are back towards their February highs. We expect them to see a shallow consolidation while other risk assets correct down during May. Debt in other regions, especially Emerging Markets debt denominated in hard currency may be more at risk into June.

Rate Differentials
p 58

The rate differential between the US and Europe is quite Oversold, yet, could continue to slide lower over the next couple of months at least.

Tips
p 42- 43

The TIPs / Treasury inflation breakeven ratio has rebounded with risk assets since mid March. Yet, its strong downtrend since last December is still under way and we would expect the ratio to resume its downtrend from late April into late May/June.

Commodities

Oil
p 16, 43

WTI Oil briefly broke below 20 USD/barrel and then rapidly rebounded as production cuts were being discussed. It has since resumed its downtrend and according to both our oscillator series could continue to do so from late April into June. Brent may break below 20 USD/barrel, WTI could reach down to 15 USD/barrel. From late Q2, Oil may then initiate a bounce into the Summer.

Industrial metals
p 15, 16, 44

Copper and Industrial metals have also been bouncing over the last few weeks, yet here also, we expect them to resume their downtrend from late April into May/June. Copper may reach down the 4'400 USD/ton by then.

Gold & PMs
p 16, 42, 44, 47-50, 51-54

Gold should continue to make new highs for this cycle over the next couple of months at least and we would expect that by the Summer it could reach new all-time highs towards 2'000 USD/oz. Other precious are also rising and should outperform risk assets, yet Gold should remain stronger than Silver or Goldmines probably into June or as long as the cross-asset environment remains rather defensive. Thereafter, Silver and Goldmines could outperform Gold into the Summer as all three should accompany risk assets in their recovery from late Q2.

Agriculture

Agricultural Commodities are mostly following the path of risk assets and we expect them to remain under pressure into mid May at least.

Foreign Exchange

		Next 2 months	3 to 6 months ahead
USD vs	EUR	The rebound on EUR/USD could stall towards 1.10 - 1.11 late April before resuming lower into late May and the 1.07 - 1.05 range.	EUR/USD may then bounce back towards 1.08 - 1.10 during the Summer.
	GBP	The rebound on GBP/USD could stall between 1.26 and 1.28 late April before resuming lower into late May and the 1.18 - 1.15 range.	GBP/USD may then rebound during the Summer, probably back to the mid/high 1.20s.
	JPY	Lately, USD appears more defensive than the Yen, the current correction could find support towards late April (106-105) and then bounce during May towards 108 - 109.	USD/JPY could gradually regain its risk-ON status from late Q2 / the Summer, it may then rise back above 1.10.
	CHF	Lately, USD appears more defensive than the Swiss Franc, the current correction could find support towards late April (0.96 - 0.95) and then bounce during May towards 0.97 - 0.98.	USD/CHF could gradually regain its risk-ON status from late Q2 / the Summer, it may then rise towards parity.
EUR vs	GBP	EUR/GBP could bottom out late April towards 0.85 - 0.86. It may then bounce into late May and the 0.90 - 0.93 range.	EUR/GBP probably falls back to the mid 0.80s during the Summer.
	JPY	From late April, EUR/JPY could drop into late May and to below 115.	EUR/JPY may then bounce back towards 1.18 during the Summer.
	CHF	EUR/CHF probably continues to slide towards 1.04 - 1.03 by late May.	EUR/CHF could then bounce back to the 1.05 - 1.06 range during the Summer.
GBP vs	JPY	The rebound on GBP/JPY could stall between 136 and 139 late April before resuming lower into late May and the 126 - 123 range.	GBP/JPY then probably bounces back from late Q2 into the Summer and the mid/high 130s.
	CHF	The rebound on GBP/CHF could stall between 1.21 and 1.24 late April before resuming lower into late May and the 1.13 - 1.10 range.	GBP/CHF then probably bounces back from late Q2 into the Summer and the mid 1.20s.

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

US Dollar
p 59

The US Dollar has roller-coastered vs most currencies over the last 6 weeks. While its defensive character vs Commodity currencies, Asian Growth Currencies or even the Euro or the Pound is rather common, it has surprised us by being even more defensive that the Yen or the Swiss Franc. Likewise, as risk assets have rebounded over the last 3 weeks, the US Dollar has been weaker across the board. We believe that for now, this defensive positioning may persist. The Dollar Index could hence remain under pressure over the next couple of weeks while risk assets finish their rebound. We would then expect the Dollar Index to strengthen again during May, perhaps reaching back above 100 again by late May.

Euro
p 60

EUR/USD could reach into the 1.10 – 1.11 range over the next couple of weeks. Yet, by late April, it should resume its downtrend towards late May, perhaps June and potentially down to the 1.07 – 1.05 range. It could then bounce back from late Q2 into the Summer. EUR/JPY and EUR/CHF could follow similar dynamics with the Euro holding up until late April, then dropping into late May/June before regaining strength into the Summer.

Yen
p 61

USD/JPY could continue to retrace down to the 1.06 – 1.05 range over the next couple of weeks and then potentially bounces back towards 1.08 – 1.09 into late May, as risk assets correct and US Dollar funding pressures resume. Yet, both the Yen and the US Dollar are rather defensive and we would probably remain neutral on the pair over the next few months.

Sterling
p 61

Sterling has made a great recovery vs the more defensive currencies since the beginning of the 4th week of March. It may push slightly higher over the next couple of weeks vs EUR, USD, CHF or JPY, but should then reverse down again, possibly retesting its March lows by late May/June. It may then bounce quite dynamically once again into the Summer.

Swiss Franc

Similarly to USD/JPY, USD/CHF could retrace down 1 or 2 figures into late April, before bouncing back into late May/June, potentially towards the 0.97-0.98 range. Here also, we would more generally be quite neutral on the pair over the next couple of months as both currencies can be quite defensive.

Oil & Commodities currencies
p 34, 59

Commodity currencies (our equal weighted portfolio containing AUD, BRL, CAD, NOK, NZD, RUB, CLP and ZAR) should resume their downtrend vs USD and EUR, probably from late April into late May/June. They could then bounce from late Q2 into the Summer.

Asian currencies
p 34

Our Asian Growth equal weighted portfolio (CNY, INR, KRW, THB and TWD) should also continue to drop vs USD and EUR probably into mid/late May, perhaps June. It may then bounce from late Q2 into the Summer.

Equities Markets Segmentation

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

US Sectors - S&P500 (general comment)			**Following the current equity bounce, we would underweight cyclicals sectors again between late April and late May/June.**					**From late Q2, we would neutralize Growth and Defensive sectors and attempt to slightly Overweight Cyclicals.**				
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: **Following the current equity bounce, we would underweight cyclicals sectors again between late April and late May/June.**					3 to 6 months ahead: **From late Q2, we would neutralize Growth and Defensive sectors and attempt to slightly Overweight Cyclicals.**				
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- 21, 23, 55- 57

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

Cyclical sectors in the US and Europe should resume their downtrend vs Growth and Defensive ones from late April into late May, perhaps June. We then expect them to initiate a bounce from late Q2 into the Summer on a relative basis.

In the meantime, we would Overweight Defensive sectors and neutralize Growth.

Countries allocation

Core Countries Weightings: All World Country Index Currency hedged (general comment)			Next 2 months: **From late April to late May/June, we would underweight most of Europe and Overweight the US, Switzerland and China.**					3 to 6 months ahead: **From late Q2 into the Summer, we would probably neutralize most positions, but would keep as positive bias towards Eastern Asia.**				
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 32- 33

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

We believe risk assets could resume lower from late April into late May/June. We would hence Overweight the US, which we believe is rather Growth oriented due to its strong weighting to Big Technology, and due to the huge fiscal and monetary stimulus plans which is being pushed through. We would also favor China, which is probably a couple of months ahead of the West in coming out of the COVID-19 crisis, as well as Switzerland, which is traditionally defensive.

From late Q2, we would neutralize most of these positions but keep a favorable weighting towards China, Japan, Taiwan or South Korea.

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	**Deliquencies and Bankruptcies should continue to negatively impact Small Caps, REITS or Southern Europe. Technology and the Nasdaq100 should see less disruption than the general market. Goldmines should follow Gold higher.**					**From late Q2, we would neutralize Growth and gradually re-enter the cyclical space. Goldmines should continue to perform.**				
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 17, 22

Cyclical and Value Themes, Small Caps or Southern Europe could underperform again while risk-assets retrace down form late April into late May/June. Many of them could make new lows on an absolute basis.

Big Technology and the Nasdaq100 should be less impacted and will probably see a mere retracement of the current rally during May. They should hence outperform on a relative basis.

Goldmines (and Gold) are profiting from the huge fiscal and monetary stimulus that have been put in place and should continue to rise.

From late Q2, we would then neutralize Growth and start venturing into selected cyclical themes as they should then be quite Oversold.

12 / We expect falling GDP in Q2 and Q3 2020, but recovery during late H2; the Fed and Treasury are doing the right things to boost nominal GDP and risk asset prices

In the March 2020 issue of The Capital Observer, **we wrote an article dealing with the relationship between the state of capital account and systemic liquidity flows versus economic growth and the price of financial assets:** *"US GDP may suffer after Q1 2020, but that wouldn't preclude large equity and yield rallies until May-June this year"*. We said then:

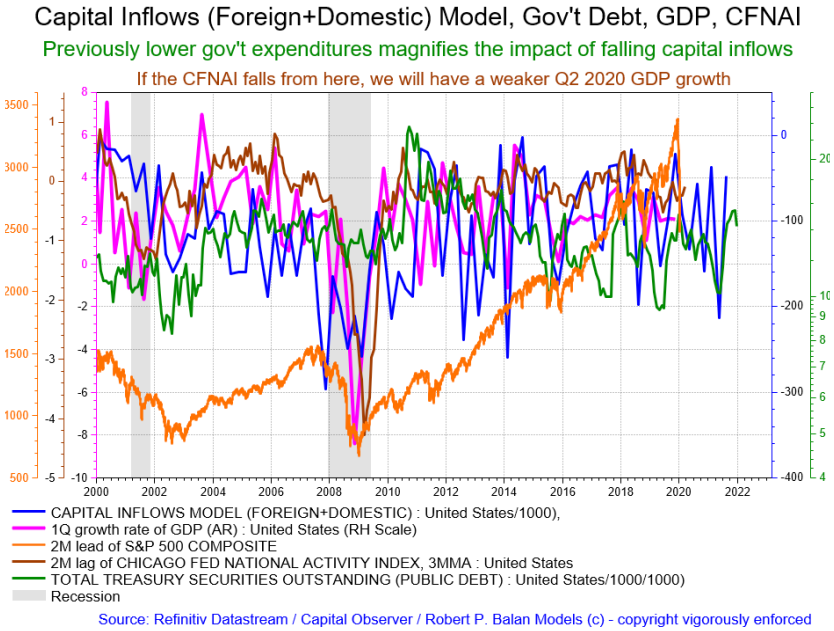
*" **The role of capital flows and liquidity drought in the Great COVID-19 sell of :***

The equity market aspect has become even more interesting and intriguing in the context of the global COVID-19 virus epidemic that is running rampant, and will remain a negative factor for growth and the risk asset markets for a while. From what we see in the situation captured by the series of graphs above, the COVID-19 infestation struck at the same moment that the markets have been weakened systemically by a seasonal liquidity drought. The main actors, capital flows and fiscal expenditures have been on a simultaneous downswing (see graph below, blue and green lines), and at the same time, the change rates of bank reserves and of the Fed's balance sheet were also on a yearly seasonal contraction (see 1st graph on this page).

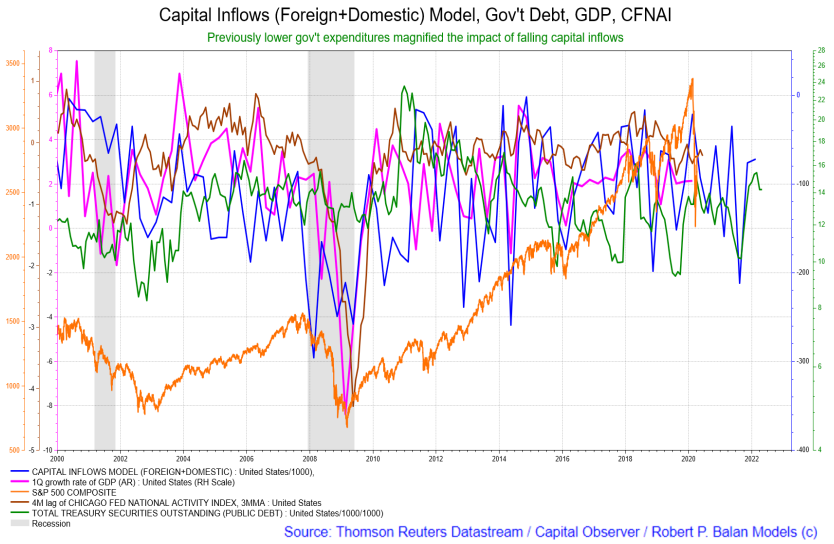
The result – a perfect storm of liquidity drought (which would have cut down risk asset prices on its own merit), and then the COVID-19 virus struck. You can see the potential extent of the fall in yields and equities pre-determined by negative liquidity factors, and further depressed by the panic generated by the spread of the CV virus

The stock market did crash as was warned by the confluence of declining capital flows and falling government expenditures. That was regardless of the positive outlook from the yardstick which we have added to the underlying liquidity tool – the US CFNAI. This is an indicator that is composed of 88 indexes of US activity and growth. It is designed to oscillate, with zero as mean (denoting neutral growth). Its inflection points have been useful in pinpointing likely periods when US GDP and the SPX (as proxy of risk assets) will likely turn. Since CFNAI is available monthly (in its raw form and as a 3-month moving average), it is one of the best indicators we can use to pinpoint turning points in growth, as well as major inflection points of the S&P 500 Index (see 1st chart above). "

Original chart in the March 2020 The Capital Observer



This is how the chart above looks now



The widespread work stoppage brought about by the necessity of social distancing has inevitably brought with it a growth recession, which some banks have estimated to be as low as -40%. Ignore those numbers for a while because it is tantamount to saying that the ground will be wet (by an x amount of degree) after a downpour. **What is more significant question is how long will that recession last?**

Based on our capital account and government expenditures model *(see 2nd chart on this page)*, **GDP**

growth will fall in Q2 and Q3 2020, but should recover in Q4, before falling again during H1 2021. How reasonable are those assumptions, given that the media is replete with Cassandras bemoaning that, post-Covid-19, it is the end of the Western civilization as we know it?

We believe that this zig zag scenario makes sense. Covid-19 statistics seem to be on the flattening stage for most large economies (*see 1st & 2nd graphs on this page)*.

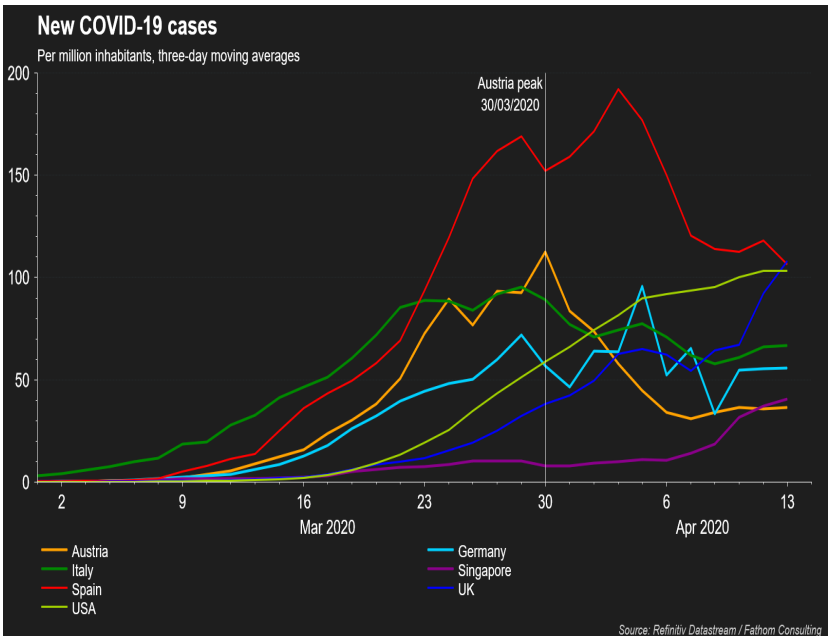
New Covid-19 cases are flattening; and the number of deaths are starting to level out.

The momentum of GDP decline may spill over into Q3, but by Q4 this year, GDP should bounce back. However, we fear that once that happens, the Fed and the US government, post the November presidential election, will slacken. Given that, growth will backslide during H1 2021.

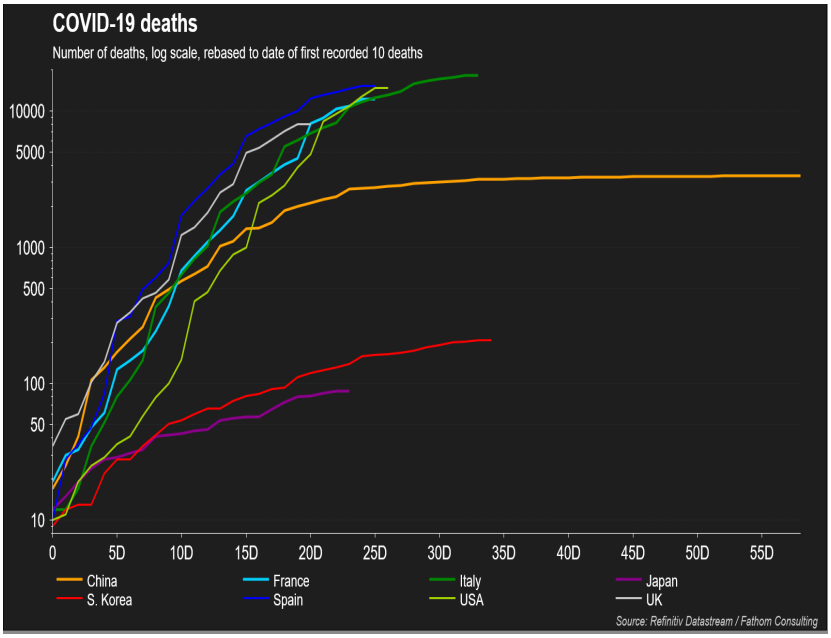
Investors, too are assuming the worst scenario which can happen. Primarily, one general misconception which investors embraced is that it is difficult for the economy to recover once the COVID-19 crisis is over, because many companies have gone bankrupt. Nothing is further from the truth -- US economic history is full of examples of explosively fast recoveries when the initial problem is no longer impacting the economy. We see examples during the recessions of 1958, and 1982. *(see third chart on this page)*

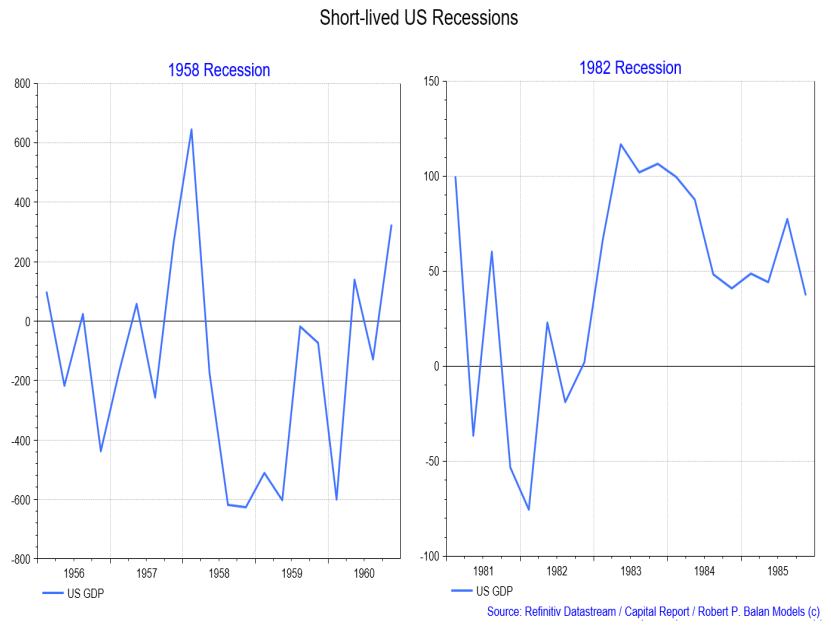
Pre-WW II economic history also has lessons for us. Economist Scott Sumner provided one such example. He said:

US economic history is full of examples of explosively fast recoveries when the initial problem is no longer impacting the economy, and even when it is (as in March-July 1933, a period when much of the banking system was shut down). A good example is the extremely fast 1921-22 recovery. In July 1921, we were at the bottom of a very deep recession, and by December 1922, we were booming - "the Roaring '20s". How about having an extremely fast 2021-22 recovery?



New Covid-19 cases are flattening; and the number of deaths are starting to level out.





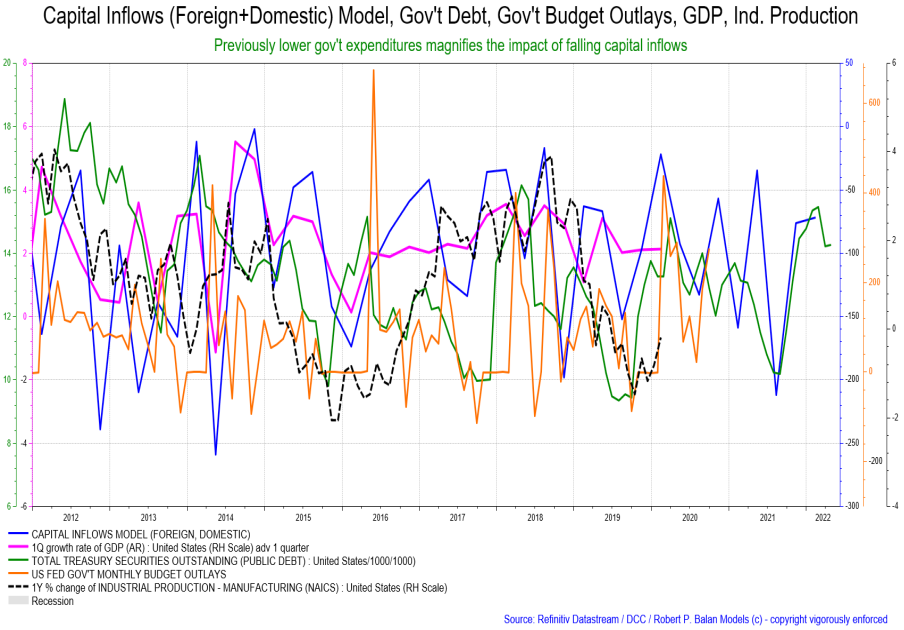
The US economy has also the advantage of a fiat money system, a global reserve currency, and hence, the Fed can print enough money to get nominal GDP back up to the trend line by 2022. The US service industry also has the advantage of wage flexibility today.

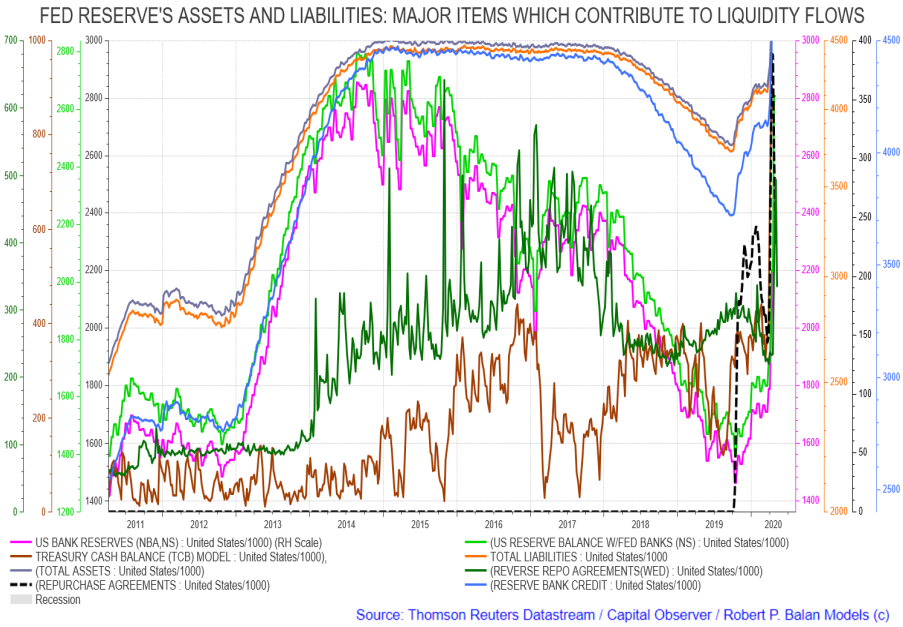
The forthcoming recovery should be faster, and more so because the recession prime mover is a medical emergency, rather an economic systemic failure. After the industrial shutdown for medical reasons, the US economy is capable of rapidly returning to full employment, especially so since the Fed and the US Treasury as combining their efforts to generate adequate nominal GDP. We expect business to ante up with the essential goods and services.

Even now, it is apparent the Great COVID-19 Recession will be deeper than the Great Recession of the 1930s. However, deeper does not mean it will be worse or will be longer. It all depends on how virulent COVID-19 virus will actually prove. **There are indications that the worst scenarios of the epidemiologists may not happen. In that case, we will indeed see economic growth and activity during the latter part of H2, and could move on to full employment by 2022**. This is all in accordance with the capital accounts and fiscal expenditure model of growth that we have been showing here at The Capital Observer for the past three years *(see 1st graph on this page)*.

Don't believe the pessimists – they also said the current recovery will be a "dead cat bounce." But rapid price gains have a way of changing even gloomy perspectives, when FOMO kicks in. A 50% recovery in 3 weeks has the same quick change-rate as the previous asset price collapse, which basically took place in 6 weeks. That pace of recovery can turn a bearish brain inside out.

The key to quick recovery of course depends on what the Fed and the US government will further do. We fully expect the Fed to provide the wherewithal to generate adequate nominal GDP once the epidemic is over. **Fed Chairman Jay Powell seems determined to deliver the right amount of stimulus to do the job. He said that the Federal Reserve would use its powers "forcefully, proactively and aggressively" until the economy recovers from the coronavirus shock, as the US central bank moved to offer an extra $2.3tn in credit and support the market for high-yield corporate debt – the central banks latest foray to rescue the financial markets.**





Risk assets lead economic growth, not vice versa

The price of risk assets tends to respond very well to the Fed's policy actions in terms of providing systemic liquidity in the aftermath of the Great Covid-19. The equity markets have responded well to the rise in the Fed's balance sheet as it acquires more liabilities in the form of Treasury purchases. These purchases set into action the rise of bank reserves, which have correlated well with rallies in equity prices. And now all of these factors are rising sharply, as the Fed ramps up its effort to rescue the financial markets *(see 2nd graph above)*.

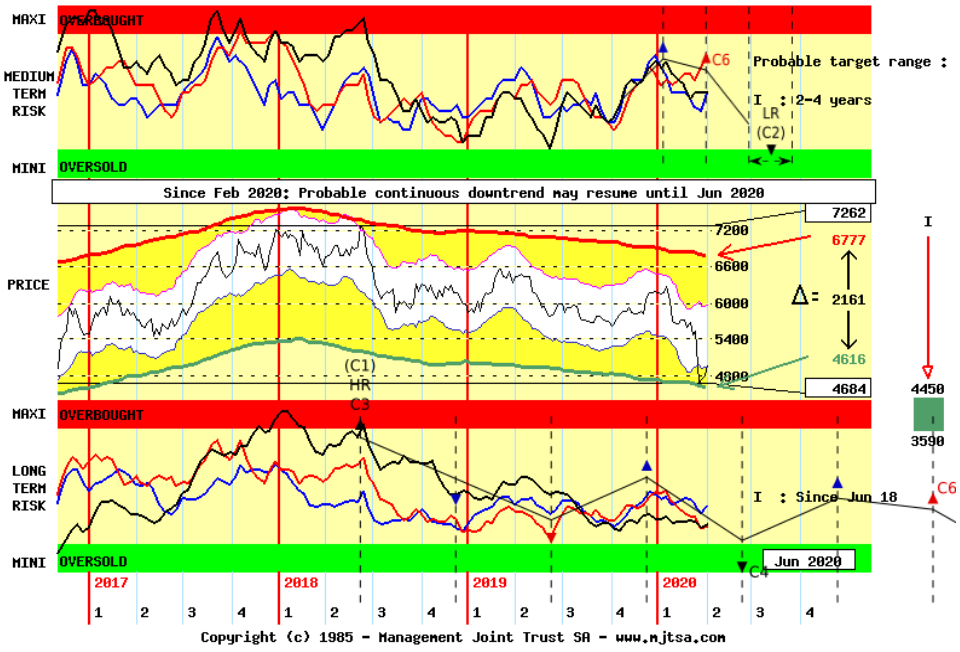
As discussed in another article in this issue, **we do believe that the worst is over for the financial markets hammered to its knees by the COVID-19 epidemic**. The Fed and other central banks, supported by more flexible monetary and fiscal policy all over the globe, should pull the markets out of the abyss that foul sentiment has brought the markets into. We expect rising risk asset prices first into May, and that be followed by a GDP recovery during Q4 this year.

15 / MJT - TIMING AND TACTICAL INSIGHT

Growth continues to outperform Cyclical factors into June at least

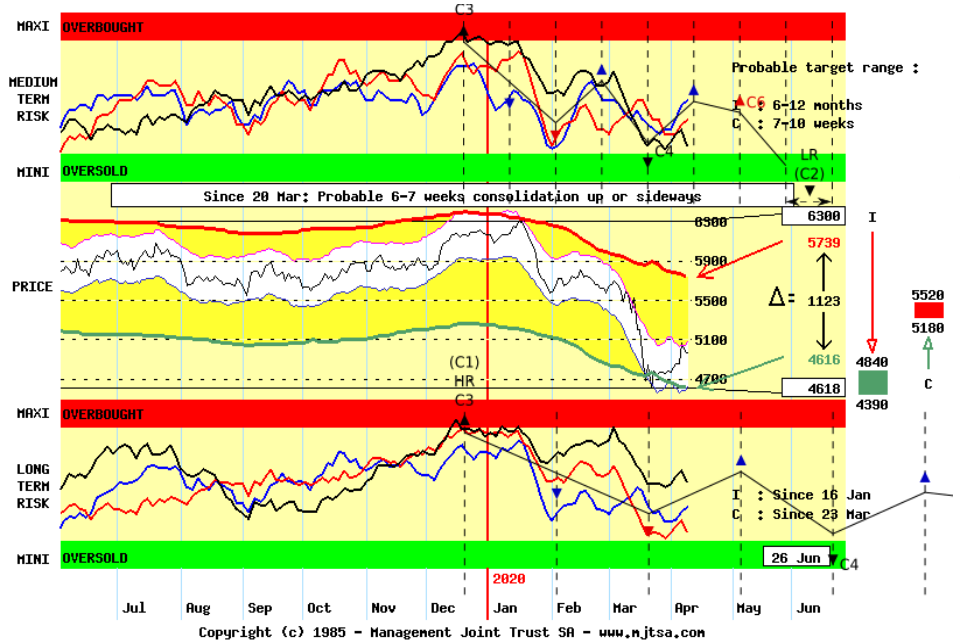
Cuts in FED Fund Rates usually steepen the yield curve while boosting the value of short term cash flows vs long dated ones. During such periods, Cyclical assets and themes would typically outperform Growth and Defensives ones. Yet, if this is true during a mild economic slow-down, as was the case last Summer when the FED started to cut rates and cyclical assets performed a decent rally into November, it probably doesn't apply to the type of emergency rate cuts we have just seen. Indeed, this time around, the FED is responding to an acute fall-out in economic output, a series of industries which have virtually been shut-down (of which many are labor intensive cyclical industries), widespread uncertainty on when the situation will improve, a vicious deleveraging cycle and a FED which is doing what it can to keep rates low probably resulting in some flattening of the curve over the next few months. Hence, it may take some time until the situation stabilizes and delivers some visibility, before cyclical themes finally start to recover. In this article, we review a series of cyclical assets while attempting to assess the likely timing of a possible recovery. We will also look at several Growth themes which on the other hand may continue to outperform.

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



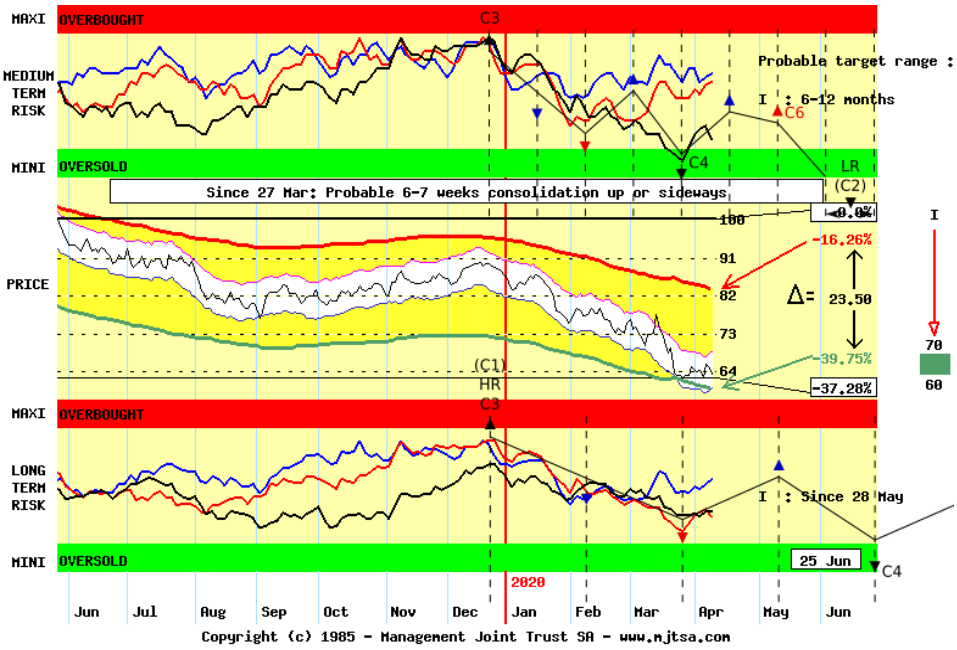
We will start this cyclical review with "Dr Copper" or the propensity of Copper prices to anticipate potential economic recoveries or slowdowns. Copper is nearing a 2 years bear market, which started when the US to China trade war began to turn sour in Spring 2018. **Recent events linked to the COVID-19 have triggered a new strong sell-off in Copper prices over the last 3 months. Both our oscillator series (lower and upper rectangles) are now suggesting that these could remain weak into late Q2, perhaps early Q3, while downside risk is still compelling as indicated by our I Impulsive targets to the downside in the 4'450 – 3'590 target range (right-hand scale) or between 5 and perhaps 20% below current levels**. Thereafter, Copper prices may see a rebound into the Summer, perhaps signaling the initial stages of a recovery.

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



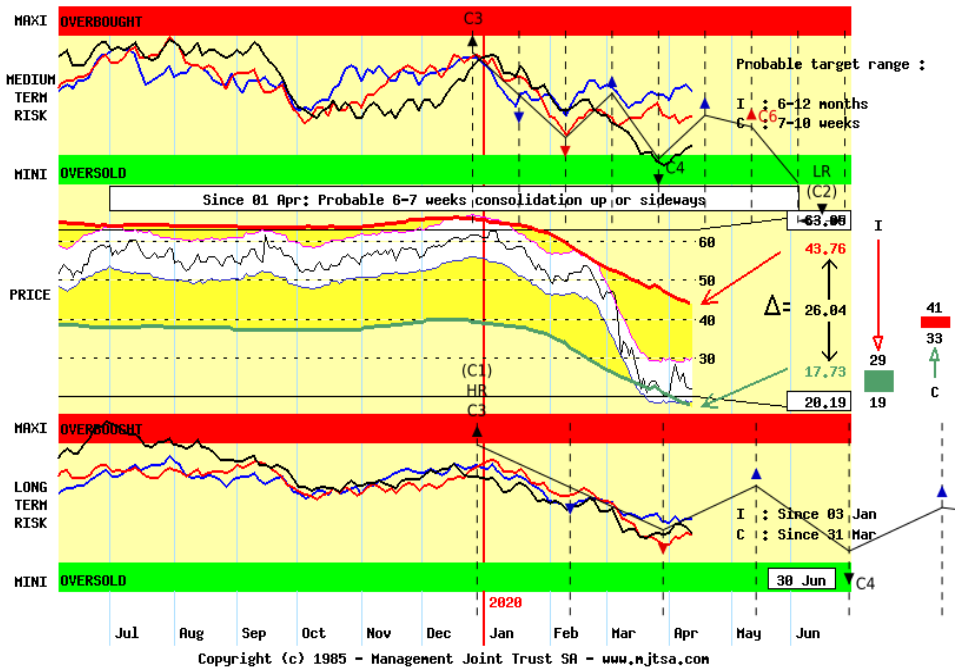
On a Daily basis, Copper remains in a strong downtrend, which according to both oscillator series could resume between now and late April, probably into late May / June. Following its rebound since mid March, our I Impulsive targets to the downside are suggesting that Copper could indeed make new lows over the next couple of months, probably deep in the 4'840 – 4'390 range according to our I Impulsive targets to the downside (right-hand scale), potentially even lower if our Weekly targets in the graph above are considered. Then, from mid/late June, Copper could then initiate a 2 to 3 months recovery into the Summer.

Copper / Gold ratio
Daily graph or the perspective over the next 2 to 3 months



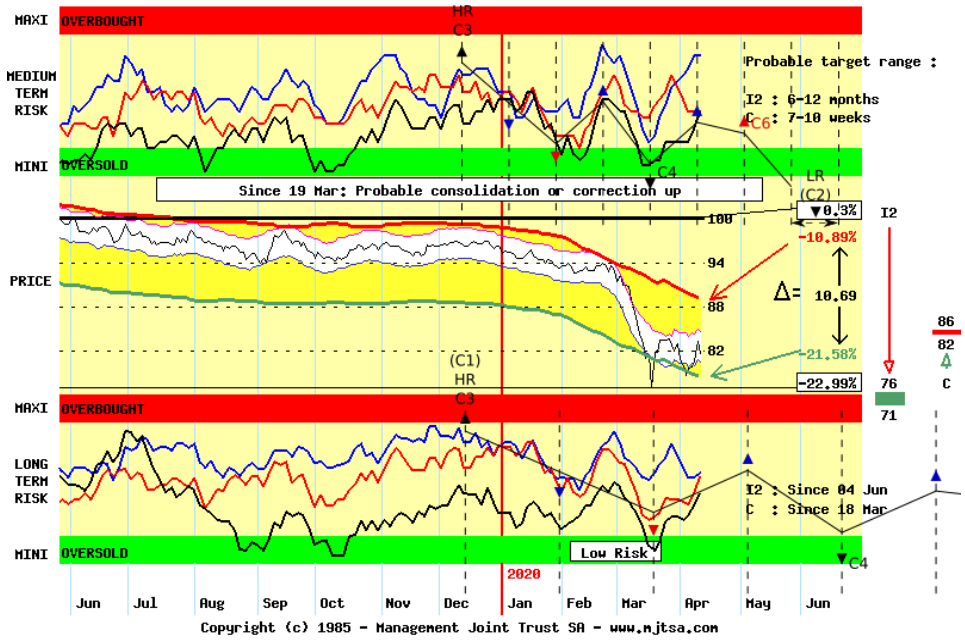
Copper / Gold is often considered to be the ultimate cyclical ratio. Indeed, while Copper does indeed tend to precede the economic cycle, Gold tends to sniff out forthcoming periods of risk and uncertainty. On both our oscillator series (lower and upper rectangles), the sequences seem quite clear, with **the current weak rebound dying out between now and early May, and a new leg lower then materializing into mid/late June. Following that, a 2 to 3 months rebound may materialize during the Summer.**

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



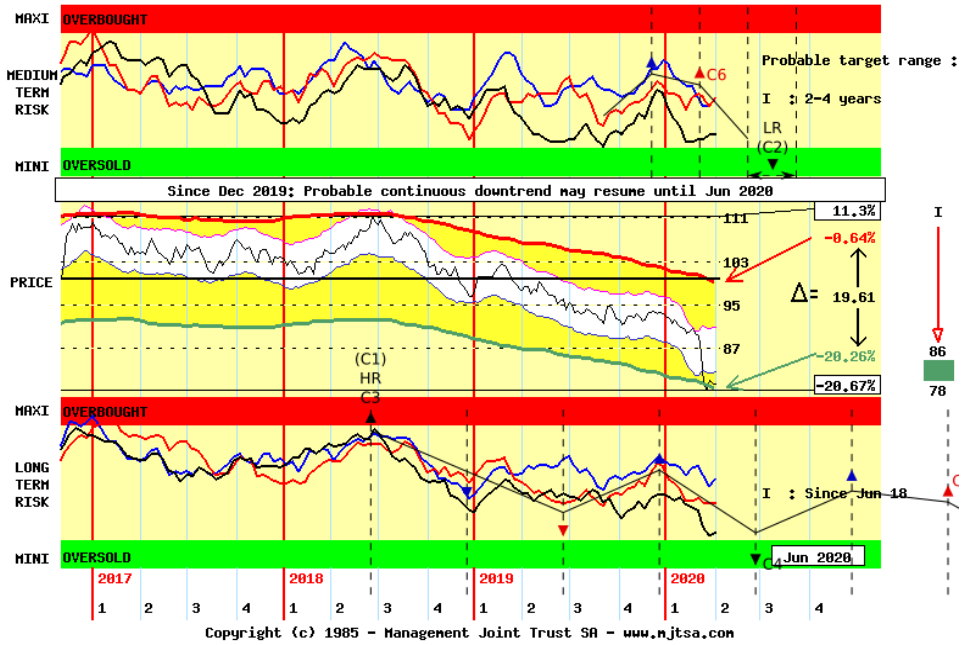
Oil has suffered a double whammy since the beginning of the year, with on the one hand a historical drop in demand as many of the world's economy have gone into lock down (according to estimates the drop off in demand is close to 30 million barrels/day or 30% of usual demand) while Saudi Arabia, Russia and the US have been battling it out to increase market share. The deal which was brokered over the weekend to cut output by 10 million/barrels a day is a start, yet, it will probably not suffice to compensate the current imbalances in a market where storage capacity is already exhausted**. We hence expect oil prices, as shown on both our oscillator series (lower and upper rectangles) to start resuming lower again by late April, at the latest early May, probably into mid/late June and to below 20 USD/barrel on WTI** as indicated by our I Impulsive targets to the downside (right-hand scale).

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



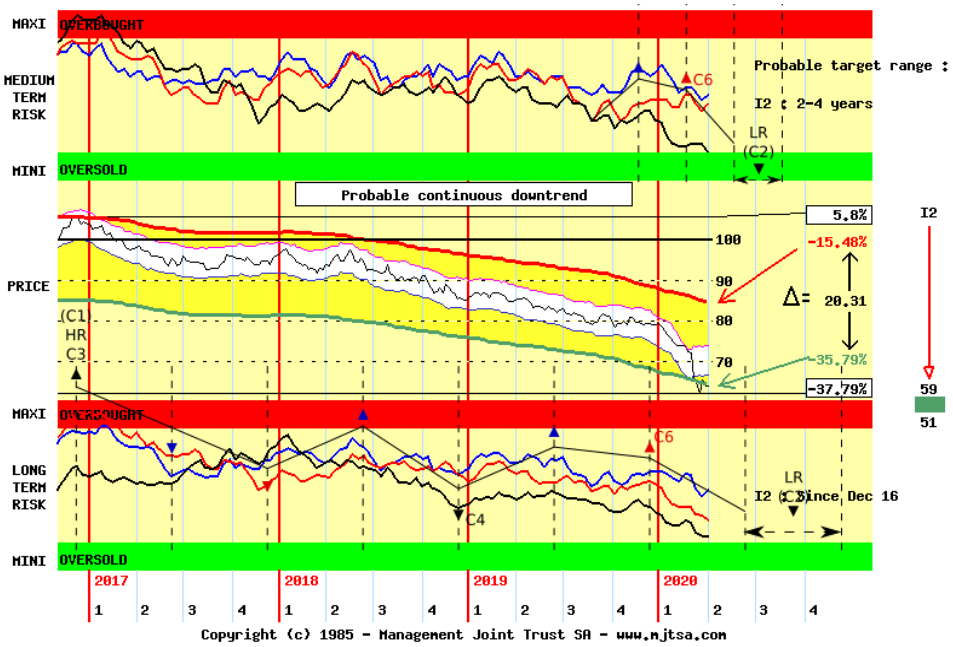
Small Caps are usually quite cyclical. In the current context where many small companies have had to close operations and probably don't have the financial strength many large caps enjoy, this trend may be exacerbated. Hence, the ratio of the Russell 2000 Index vs the S&P500 Index took a strong dive in March. It is currently attempting to bounce. Both our oscillator series (lower and upper rectangles) suggest **that the current rebound will probably die out between now and late April** as it is capped by the resistance of our C Corrective targets (right-hand scale) to the upside, 2 to 3 % above current levels. **We then expect the ratio to resume its downtrend probably into late May / June and potentially retest down to its mid March lows.**

Russell 2000 Index vs the S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



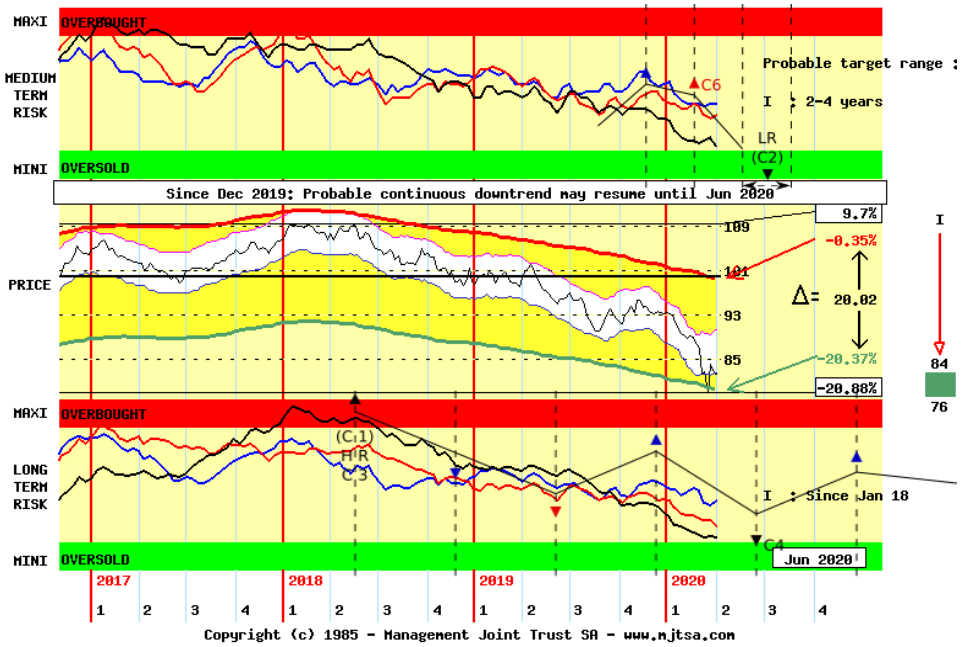
Longer term, on the Weekly graph, the ratio is still in free fall and both our oscillator series (lower and upper rectangles) do leave **little possibility of seeing a consequent rebound before late Q2 / midyear.** Following that, a bounce may materialize during the Summer at least, as shown on our long term oscillators (lower rectangle).

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



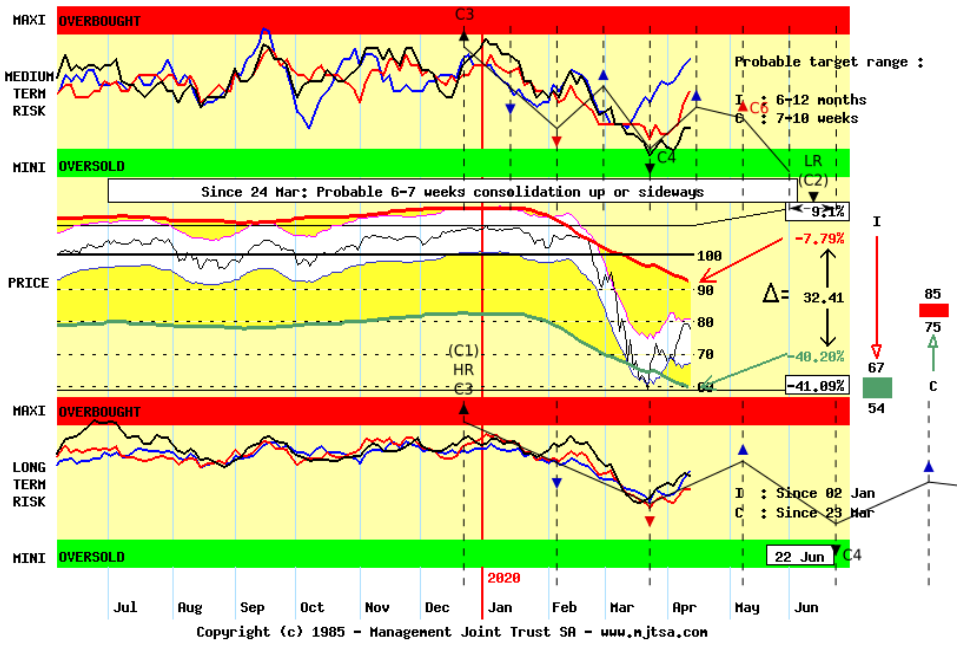
Similarly, we consider cyclical sectors in the US and compare them to the S&P500 Index. The equal weighted portfolio we use here includes the US Industrials, US Materials, US Energy and US Financials sectors. On both oscillator series (lower and upper rectangles), **this ratio probably continues to underperform the S&P500 into late Q2 / midyear**. Our I2 Impulsive 2 extended targets to the downside (right-hand side) would indicate **a further 10% of underperformance until then, although current levels on a relative basis are already very depressed.**

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



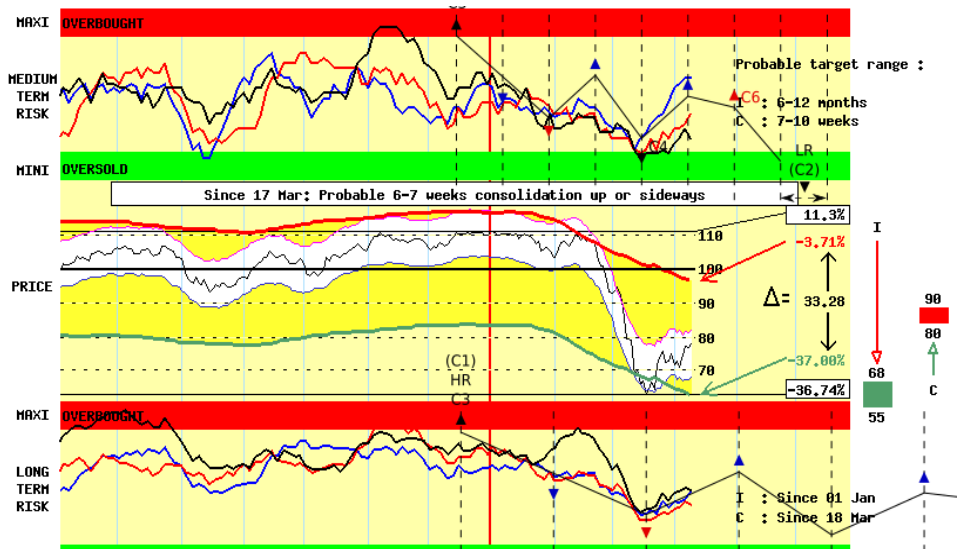
In Europe, we perform a similar analysis with an equal weighted portfolio, which includes European Chemicals, Industrials, Energy, Automobiles, Basic Resources and Banks and compare it to the Europe Stoxx 600 Index. Here also, both our oscillator series (lower and upper rectangles) suggest **further underperformance into late Q2 / midyear, with possible marginal new lows potentially 5% below the March ones** as indicated by our I Impulsive targets to the downside (right-hand scale).

US Cyclical Sectors
Daily graph or the perspective over the next 2 to 3 months



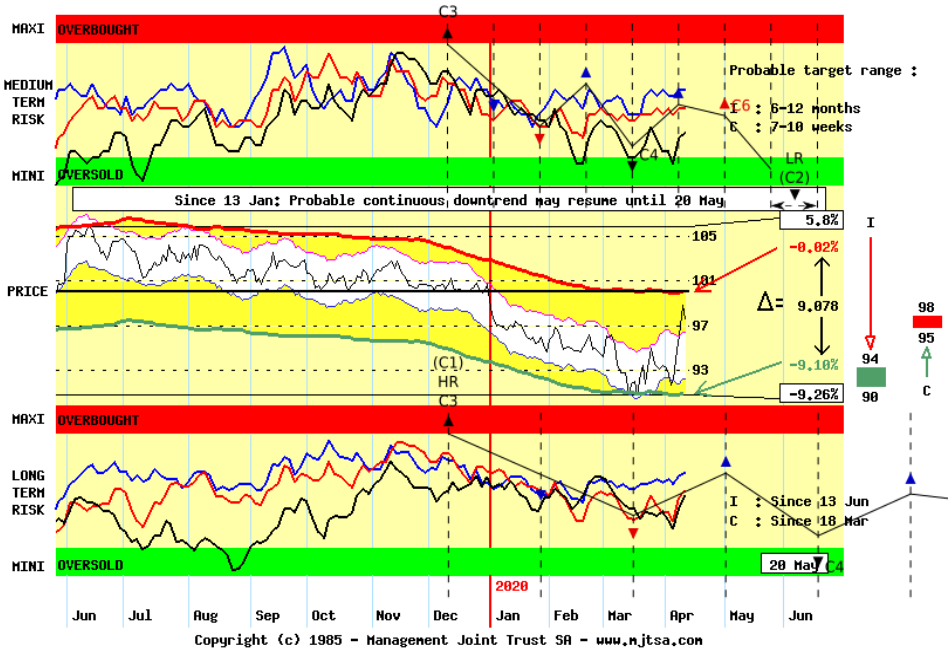
On an absolute basis, our equal weighted US Cyclical portfolio (XLI, XLB, XLE and XLF ETFs) has been bouncing quite vigorously since the 4th week of March. According to our C Corrective targets to the upside, this bounce may continue another 5% before it hits strong resistance towards the upper end of our C Corrective targets to the upside (right-hand scale). **On the timing front, the current rebound should also die out over the next couple of weeks and US Cyclical sectors will then probably resume their downtrend towards mid/late June. Our I Impulsive targets to the downside (right-hand scale) indicate that this equal weighted US Cyclicals portfolio could make marginal news lows by then.**

European Cyclical Sectors
Daily graph or the perspective over the next 2 to 3 months



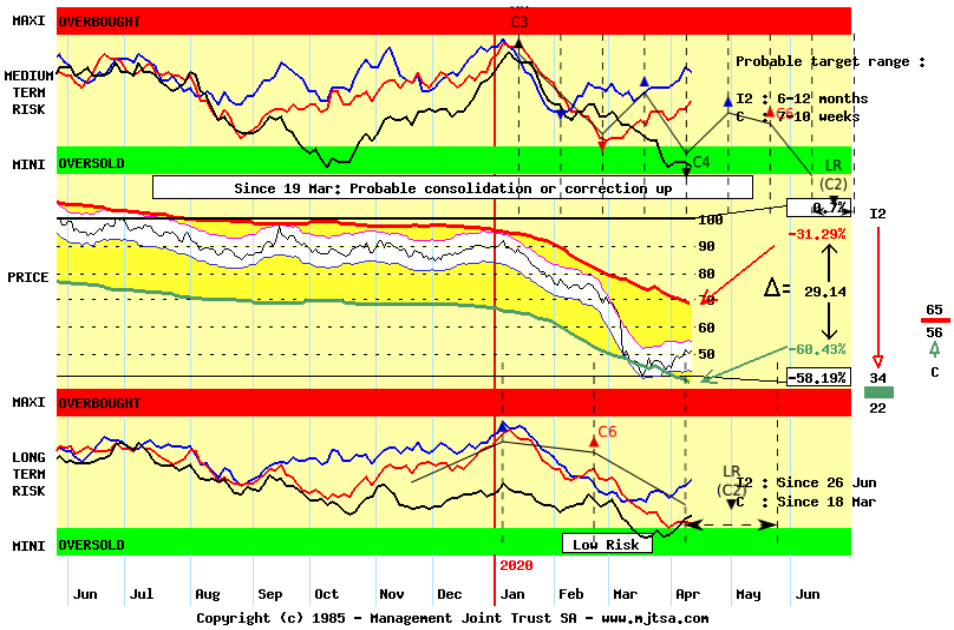
In Europe, our equal weighted portfolio comprising of cyclical sectors (SXAP, SXEP, SXNP, SXPP, SX4P, SX7P) is showing a similar profile as in the US. **We expect the bounce to die out between now and late April according to both our oscillator series (lower and upper rectangles), at best 5 to 10% above current levels** (our C Corrective targets to the upside – right-hand scale). **Following that, the downtrend should then resume, probably towards mid/late June and potentially towards marginal new lows** as indicated by our I Impulsive targets to the downside (right-hand scale).

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



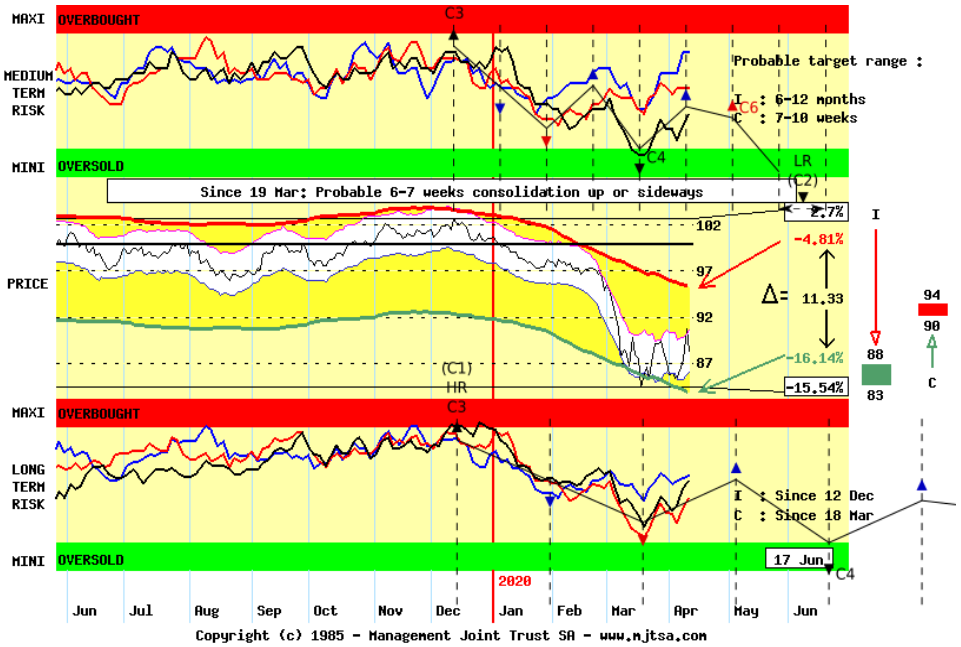
Among US Cyclical sector, we like US Materials (mostly Chemical stocks with some Goldmines and some Diversified Mining Companies) as the sector has proven rather defensives vs other US Cyclical sectors over the last couple of months. Indeed, Chemicals are benefiting from lower Oil prices, while Goldmines are tagging along Gold which is approaching new year-to-date highs. On a relative basis, the rebound of US Materials since the 4th week of March has been quite dynamic and although we expect some downside retesting into May vs the S&P500 on both oscillator series (lower and upper rectangles), the ratio may not make new lows (as suggested by our I Impulsive targets to the downside which were already pretty much exhausted in March – right-hand scale). Hence, **US Materials may constitute a good compromise for investors wanting to gain some cyclical exposure without betting against a strong relative downtrend. The Chemicals sector in Europe (SX4P) is also showing similar dynamics on a relative basis**. Note: on an absolute basis however, both sectors (US Materials and European Chemicals) will probably retest down below their March lows into late May.

US Oil & Gas Exploration & Production vs the S&P500 sector
Daily graph or the perspective over the next 2 to 3 months



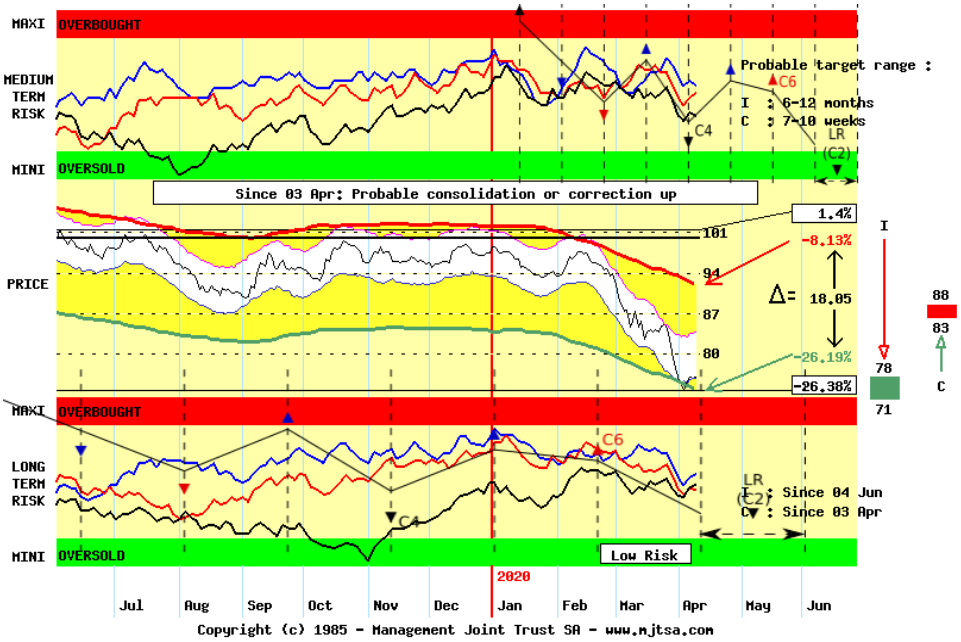
Following the Oil output cut deal which was struck over the Easter weekend, we also consider US Oil & Gas exploration vs the S&P500 Index (IEO ETF)- **The ratio is quite Oversold on both oscillator series (lower and upper rectangles) and its current bounce may persist another couple of weeks into late April. Yet, this relative bet is a volatile short term trading one, as by late April, the ratio could resume its downtrend towards late May / June and new lows** according to both our oscillator series (lower and upper rectangles).

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



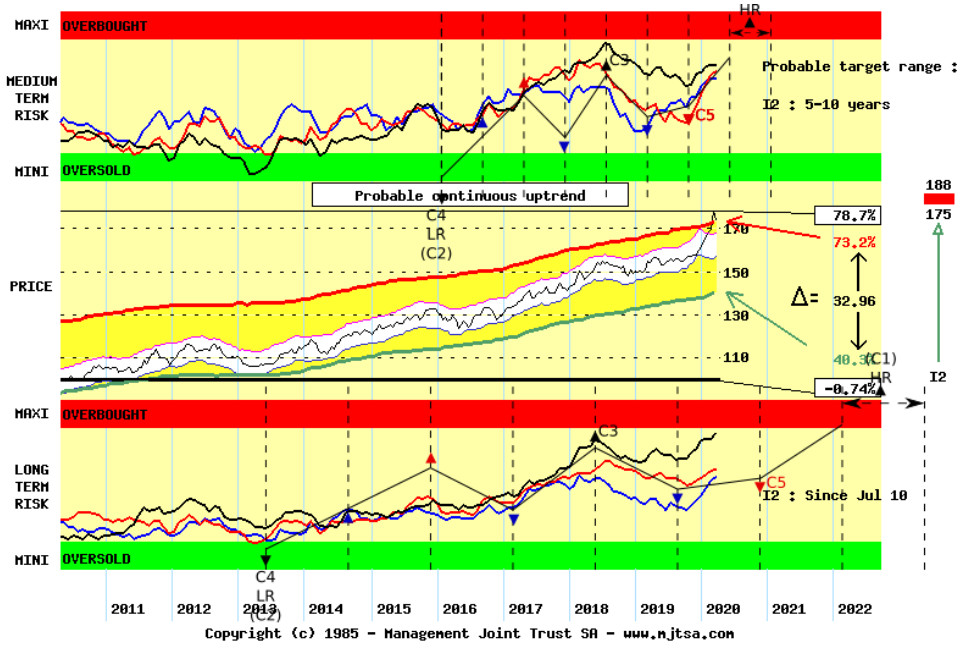
US Financials (XLF ETF) have also been bouncing quite dynamically vs the S&P500 since mid March. **The current rebound is however approaching important resistance on a relative basis vs the S&P500, probably 1 to 3% above current levels** according to our C Corrective targets to the upside (right-hand scale). **We then expect the ratio to resume its downtrend, probably into June** on both oscillator series (lower and upper rectangles) and **potentially towards marginal new lows** according to our I Impulsive targets to the downside (right-hand scale).

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



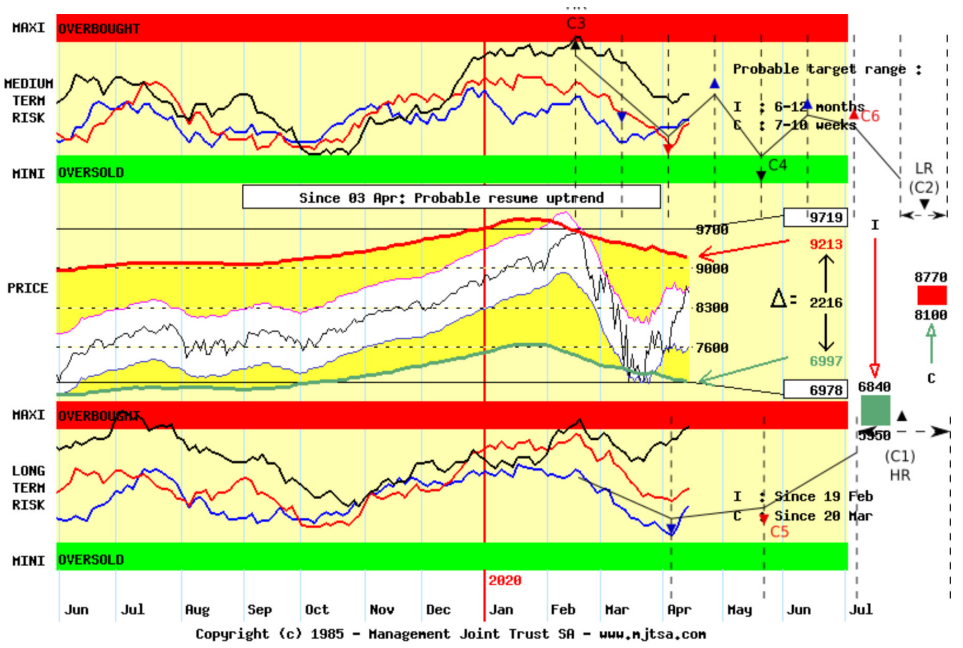
In Europe, the ratio of Banks (SX7P) vs the Europe Stoxx 600 Index is still in a strong downtrend and the reaction up since early April has been very subdued. **We hence expect the ratio to resume its downtrend sooner than later, probably over the next couple of weeks and towards late May / June.** As indicated by our I Impulsive targets to the downside (right-hand scale), **we do expect the ratio to continue to slide and make new lows over the next couple of months**. Indeed, European Banks do appear as one of the weaker sectors for now on a relative basis.

Nasdaq 100 Index vs the S&P500 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



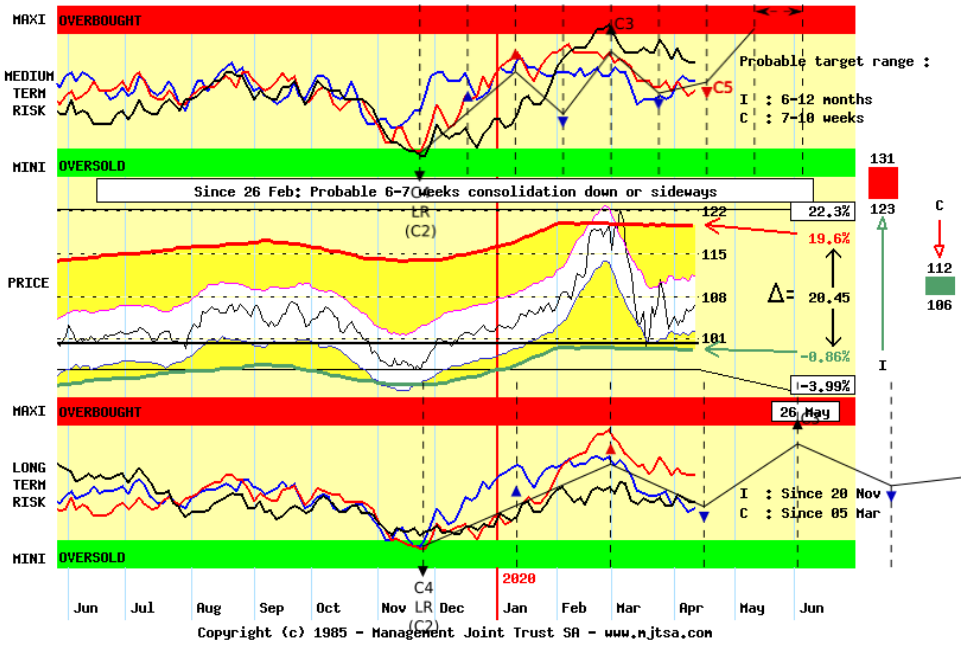
We now consider the other end of the factor spectrum and specifically Big Growth stocks which are very much represented in the Nasdaq 100 index. When comparing the Nasdaq 100 with the S&P500 Index, the resulting ratio is still in a very strong long term uptrend. While our medium term oscillators (upper rectangle) suggest that **the Nasdaq 100's outperformance may continue into midyear at least, our longer term oscillators (lower rectangle) would point to further outperformance probably into 2021 and perhaps even 2022**. Our I2 Impulsive 2 extended targets to the upside indicate that despite the Nasdaq 100's 78.7% outperformance since 2010, further 10% outperformance may lie ahead over the next couple of years.

Nasdaq 100 Index
Daily graph or the perspective over the next 2 to 3 months



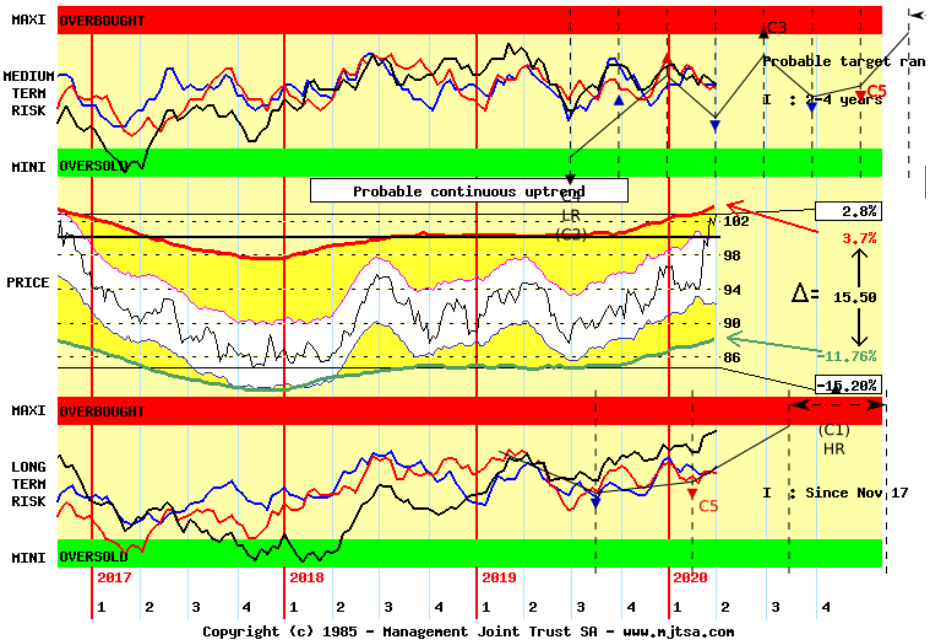
Shorter term, on the absolute basis, the Nasdaq 100 has held up very well despite the crash as it barely broke below last Summer's lows. Its sell-off also stayed short of our I Impulsive to the downside (right-hand scale) and the rebound since the 4th week of March has now reached back up well into our C Corrective targets to the upside. **We would however expect this bounce to stall towards the higher end of this range (8'700 - 8'800s), probably over the next couple of weeks. Indeed, we believe that the index could retrace down into mid/late May with other equity markets, although we would suspect that this retracement will most probably not make new lows** as suggested by the sequence we show on our long term oscillators (lower rectangle).

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



A typical growth sector we also like is alternative Energy. In this graph we present the Global Clean Energy ETF (ICLN ETF) vs the S&P500 Index. Over the last 18 months, it has been one of the more aggressive growth themes. **Following strong underperformance during the short deleveraging period mid March, we believe it is ideally positioned to outperform once again.** This is what both our oscillator series (lower and upper rectangles) seem to suggest with **a possible new leg up which could start over the next couple of weeks on a relative basis, and probably extend into mid/late May. On the target front, we would probably expect the ratio to retest its year-to-date highs.**

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



European Retail (SXRP) is a specific sector we also like in Europe. It comprises a mix of pure on-line retail franchises combined with some of the largest European grocery chains which on-line presences are rapidly growing. Most of the constituents in this sector have been rather resilient throughout the recent crisis. Some may have even gained market share vs smaller brick & mortar operations. The relative ratio of the sector vs the Europe Stoxx 600 Index was already in a strong uptrend last year and has since accelerated up once more as the COVID-19 crisis hit Europe. Both oscillator series (lower and upper rectangles) on this Weekly graph suggest that **the sector could continue to outperform into late Q2, perhaps even into the Summer. Our I Impulsive targets to the upside (right-hand scale) are pointing to between 3 and 8% of further outperformance over the next few months.**

Concluding remarks :

Cyclical commodity profiles such as Copper, Oil or the Copper to Gold ratio seem to remain weak into June, perhaps midyear. This is also the case for cyclical equity themes such as small caps or cyclical sectors vs their reference indexes. Short term, the current cyclical bounce may continue another couple of weeks. Yet, the rebound has already been quite strong, and many cyclical sectors are approaching important resistance levels on a relative basis. We would hence expect them to underperform again from late April into late May, perhaps into June. US Energy for example may pump for another week or so, then dump during May. US Materials are more resilient yet should also underperform the S&P500 over the next couple of months. European Banks seem weak across the board into midyear. On the other hand, we expect growth themes to continue to outperform over the next few months. The Nasdaq 100 could also retrace down from late April into May, but will probably not make new lows. Alternative Energy is another Growth theme we like on a relative basis. It widely underperformed in March yet could now resume its uptrend vs the S&P500 into mid/late May. European Retail also looks appealing vs the Europe Stoxx 600 Index. Given its strong on-line focus, it has proven very resilient since the beginning of the crisis.

24 / The Fed and US Treasury are not done supporting the markets and the economy: expect the Fed's balance sheet to grow further well into Q3 this year

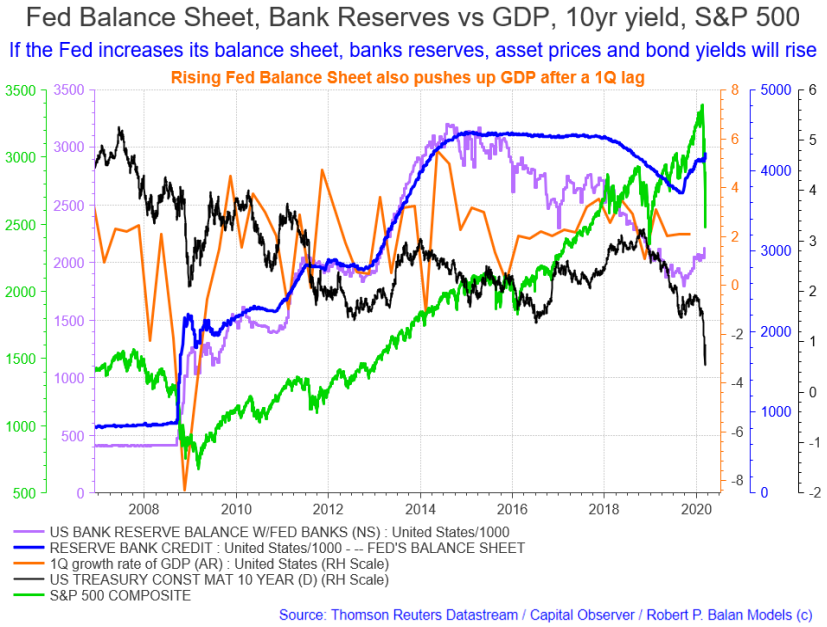
Following the March 2020 article of The Capital Observer which chronicled the efforts of global central banks and global governments to arrest a financial market melt-down as a consequence of the COVID-19 pandemic, we are now updating the situation as it is continuing to evolve. We said then:

"The worse this COVID-19 situation gets, the larger the ultimate policy response" – we have been repeating that mantra for readers of Capital Observer who have been asking us about the likely policy responses from central banks and governments. And, indeed, in the US and in Europe that has been the case. The Germans have finally capitulated and gave on the "big black zero" meme as German Olaf FinMin Scholz unleashes a real late last week, shocking FISCAL "whatever it takes" moment.

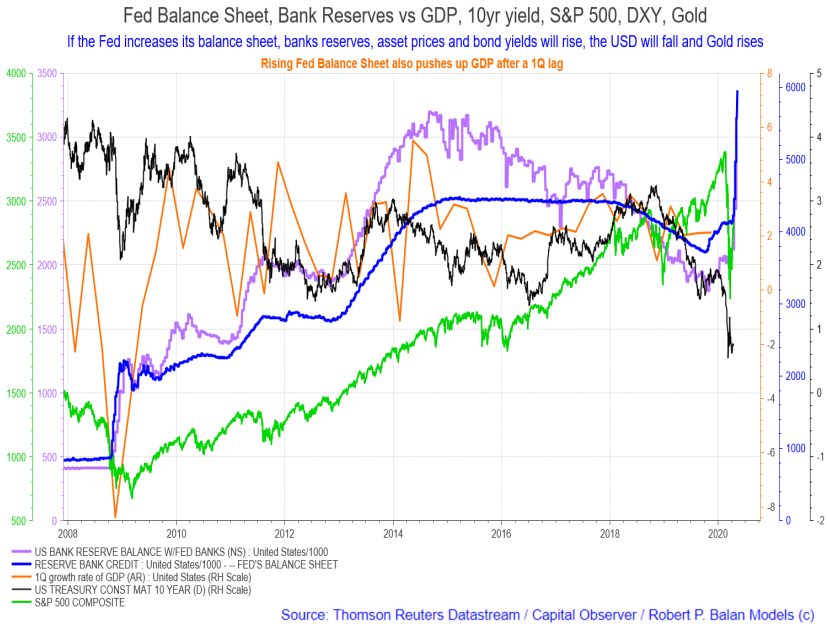
In the US, fiscal policy finally got its act together. Treasury Secretary Steven Mnuchin and House Dems reached an agreement last night to move forward with legislation that would shore up the US public health response to COVID-19, while also blunting some of the economic impact.

This coming week (the week of March 16), the Fed will offer another $1 trillion: next Monday, $500 billion in one-month repos; and next Friday, $500 billion in three-month repos. This will continue in each week, the same procedure of $1 trillion a week plus all the other repos, through Monday, April 13. It will amount to $4.0 trillion in new money over the four-week period.

In total, this would amount to nearly $4.5 trillion through April 13 that the Fed is offering to create to bail out Wall Street, repo market participants, the asset holders, the banks, and Corporate America. It would more than double the already re-ballooned balance sheet (currently $4.3 trillion). It could push the balance sheet to nearly $9 trillion by April 13. And this is important because rising Fed balance sheet has always led to higher equity prices and bond yields (see 1st chart on this page).



Since then, the Fed has ratcheted up their intervention to save the economy and financial markets. The chart shown above last month, looks like this now. riginal chart in the March 2020 The Capital Observer



The 2nd graph above shows that the markets responded correspondingly – or at least the professional investors (including bond Primary Dealers) which benefited from the Fed's initial deployment of ex nihilo money creation. The group which acquired all that buying power (which we call the "Masters of the Universe" (MOTUs)) chose early European trading to make their move to deploy that new capital – pushing equity futures to limit up hours before the New York trading day opened, on Friday, March 13th. This event was repeated several times thereafter, until the equity market has finally lost its fright and stopped resisting the buying spree of the MOTUs. The equity markets finally

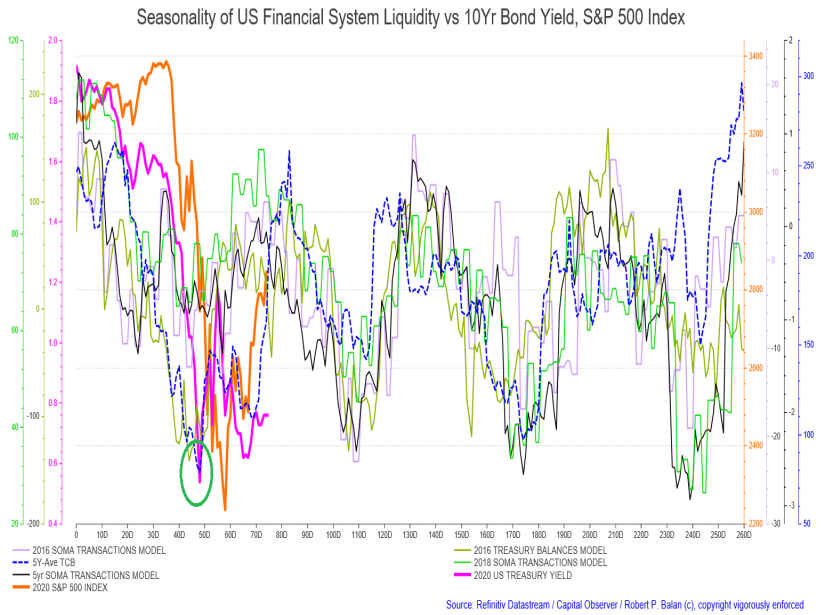
bottomed on March 22 (in Asian trading of the equity futures) – three days after we called for a market bottom.

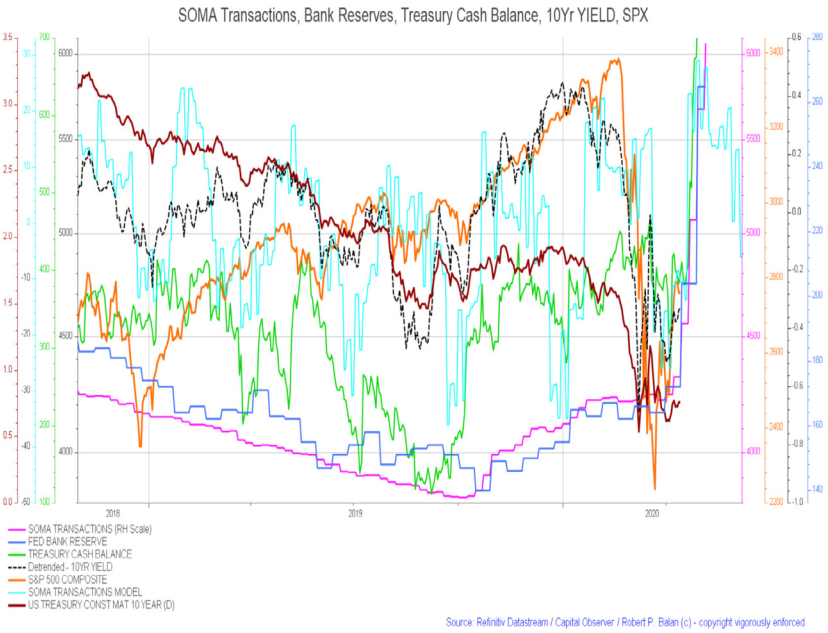
March 13 was a very auspicious date in another sense. This date marked the seasonal bottom of the seasonal liquidity drought which has exacerbated the negative impact of the COVID-19 epidemic, and turned what could have just been a market correction, into a humongous and swift panic move. But after Friday, March 13, there was a perfect storm of liquidity tsunami -- the new monetary and fiscal initiatives, the SEASONAL deluge of systemic liquidity starting at this time, and blow-out credit creation in the whole of February – these all came together *(see green circle, 1st graph on this page)*. **On top of that, came $4.5 trillion of new liquidity injected into the system during the subsequent 30 days.**

The results have been stellar. **The equity markets have recovered as much as 50 pct of previous losses in some indexes. If our models are correct, equities will continue to soar until end of April-early May**. The 10yr yield has also stabilized and is poised to ratchet up higher over the next few weeks, in lock step with an invigorated stock market (*see 2nd graph on this page*).

The effort to ameliorate the impact of the COVID-19 pandemic will become even more dramatic, as the fiscal side takes its turn to lend a hand. The US deficit is expected to reach 13% of GDP this year, with a $2trillion stimulus bill already passed. Discussions of another $1trillion infrastructure bill or could take these numbers even higher.

Even the Fed was not finished yet. In the past week, the banking week ended April 8, reserve balances with Federal Reserve banks increased by $90.0 billion. These reserve balances represent excess reserves within the banking system. **Since the banking week ended Feb. 26, 2020, basically**





the "tipping point" in the Fed's monetary stance, reserve balances with Federal Reserve banks have increased by almost $1.1 trillion. Note that this $1.1 trillion was around $350 billion more than was the whole Fed balance sheet just before the beginning of the Great Recession. The total amount of bank reserves with Federal Reserve Banks is $2.8 trillion.

During the past six weeks alone, the Federal Reserve has supplied $1,925 billion in assets to its balance sheet. The Federal Reserve assets now total more than $6.1 trillion. It is important to understand what these assets are and what important role they have to play in the creation of bank reserves, a data that is very important in the price discovery of risk assets.

$1,248.0 billion in securities to its securities portfolio;

$126.0 billion in securities premiums;

$358.0 billion in swaps with foreign central banks;

$43.0 billion in primary loans from the discount window;

$33.0 billion through the Primary Dealer Credit facility;

$53.0 billion through the money market mutual fund liquidity facility;

and

$43.0 billion through repurchase agreements.

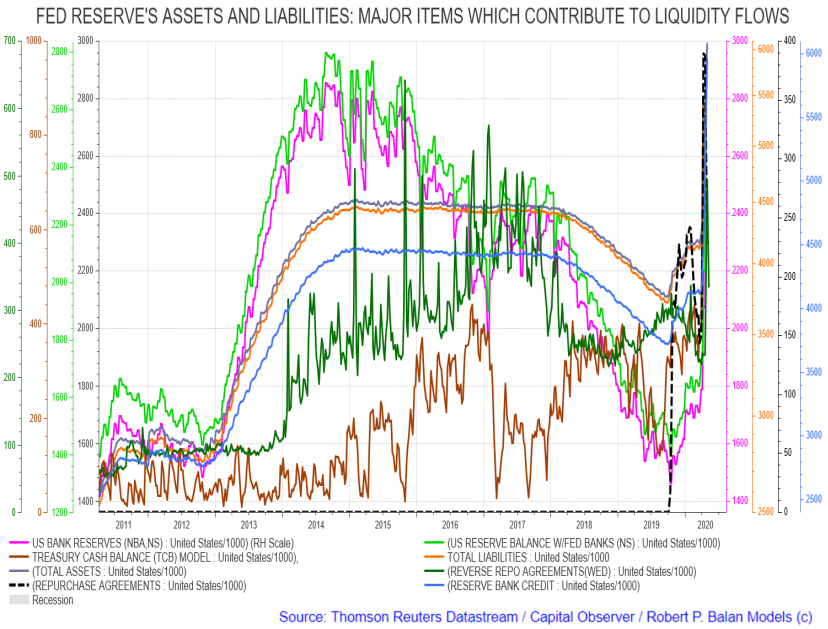
How about the Fed's liability side?

The biggest movement on the liability side of the balance sheet is the increase in the US Treasury, General Account. Since Feb. 26, this account has risen to more than $800.0 billion. Note that the General Account is the account that the government writes its checks against, so **it looks like the Treasury department is building up funds here for impending check writing to bail out Main Street which is suffering from the side effects of the COVID-19 pandemic. This account will be one to watch this year as an indication of how the federal government is spending.**

One other point: since Feb. 26, currency in circulation has increased by almost $84.0 billion. Currency in circulation usually does not increase during this time of year. As the pandemic spreads and as the economic conditions worsen, we believe currency in circulation will increase, and increase at an increasingly rapid pace. With all the jobs lost and all the businesses closed, people will move into more cash transactions and this increase in cash will end up being supported by the Federal Reserve.

To make sense of what the Fed has done so far, here is a chart of the major items which are components of what we at The Capital Observer called "systemic liquidity flows." Taken collectively, these are the data that have very significant impact on the price discovery of equities and bond yields *(see graph on this page)*.

The significant effect comes from the fact that the Fed is buying financial instruments. **The Fed in just a couple of weeks has already added over $1.5 trillion in assets to its balance sheet: Treasuries, commercial paper, muni's, Agencies. Under their old QE regime, the Fed typically purchased $60BB to $80BB of bonds per month. In just 14 days, the Fed has literally pumped almost two years of normal QE buying into the bond market.**



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

It does not stop there: on Thursday (March 9th), the Fed announced another $2.3TT of incremental purchases, spanning a wide range of asset classes including:

- Asset backed securities (ABS)
- Commercial mortgage backed securities (CBMS)
- Leveraged Loans
- Municipal bonds
- High Yield (BB rated)

They said they aren't done yet. Total Fed potential buying will be borderline "unlimited." With $1.5trillion of purchases to date, and the other $2.3trillion which went to backstop a variety of struggling fixed income asset classes, there is unfathomable quantities of capital which is flooding the markets. That cash, $3.8trillion in capital is 19% of the size of the entire US equity market, and it will find its way to the stock market.

That is a tremendous amount of equity-buying potential. Therefore, it shouldn't come as a surprise that these capital flows have flipped the switch from panic selling, to panic buying in just a couple of weeks. Even bear die-hards have flipped from outright pessimism and disdain to outright panic for fear of missing out (FOMO) and have now resorted to "buying the dip."

What can we expect further out?

The Fed's intervention may have only just begun, as they themselves have implied. The Fed's total balance sheet may approach $10.0 trillion. The Fed could be doling out stimulus well into Q3 this year. If this occurs, reserve balances with Federal Reserve banks, excess reserves in the banking system, could approach $7.0 trillion, up from the $2.8 billion now on the books. **This scenario represents, for us, a Federal Reserve that is trying to err on the side of too much monetary ease**, thereby hoping to avoid any disruptions to the banking system or the financial markets that could result in a further spiral downwards which will eventually impact the living standards of ordinary Americans. We believe they will do it.

The current situation, for us, is what the Federal Reserve has been created for. Former Fed Chairman Ben Bernanke showed us during the Great Recession and the subsequent recovery that the Federal Reserve, in a crisis situation, needs to err on the side of monetary ease. The current Federal Reserve is making it known that they don't want to take a chance on collapsing the banking system or the financial markets. **With this kind of resolve, we believe financial markets and the US economy will be able to cope up better with the negative consequences of the COVID-19 pandemic.**

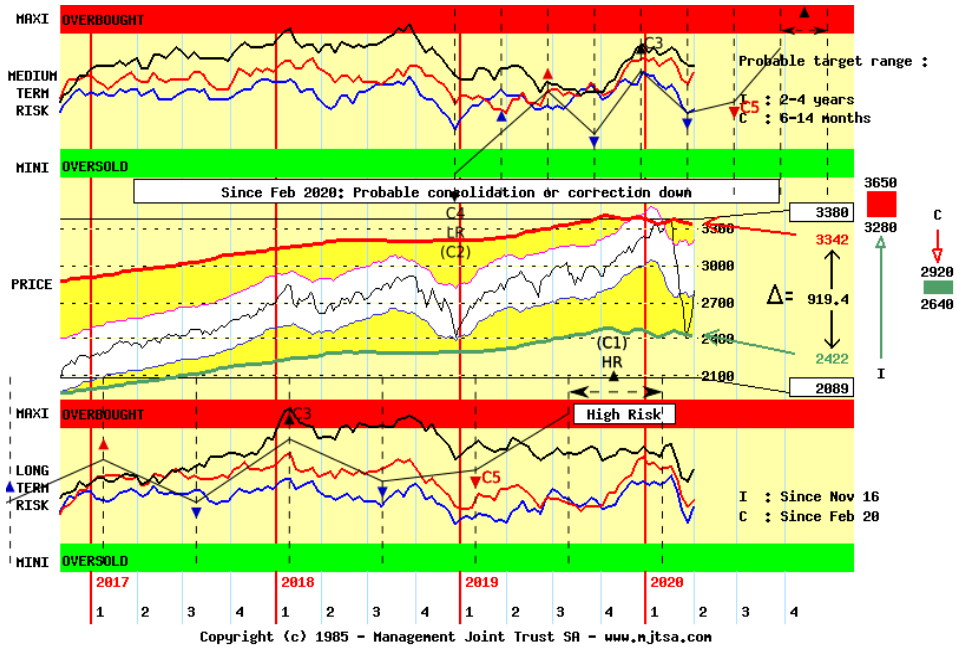
27 / MJT - TIMING AND TACTICAL INSIGHT

The FED has backstopped risk assets, for now

As Mohamed El-Erian mentioned last Thursday, the FED has now gone "all in" to backstop the bond market. In addition to buying Treasuries, then Commercial Paper, Investment Grade Bonds and ETFs, Municipal, Agency and States loans, it has recently extended its program to small and medium sized business loans, mortgage loans, Paycheck Protection Program loans, recently Fallen Angel bonds as well as Junk Bonds ETFs. The FED is now the buyer of least resort for most US fixed income assets, to which you can add the 150bps cut to 0% of FED Fund Rates last month, the 2 USD trillion + fiscal stimulus by the Treasury, as well as massive monetary and fiscal stimulus plans in Europe, Japan or China. One may wonder what could be next, such as Central Banks buying Equity ETFs "à la BOJ" for example. That said, for now, these measures have stabilized financial assets, and these have rebounded aggressively, up 26% in 3 weeks for the S&P500, while US Investment Grade and High Yield ETFs are nearing their pre-crash historical highs. Call it a Japanization of the US economy or a mutualization of global financial risks, price discovery will certainly suffer going forward. That said earning seasons is just starting, the COVID-19 pandemic has not yet peaked, and its true economic impact is still unknown. We would hence expect more volatility ahead. In this article, we aim to assess the situation going forward, for Equities, Credit and Emerging Markets.

S&P500 Index

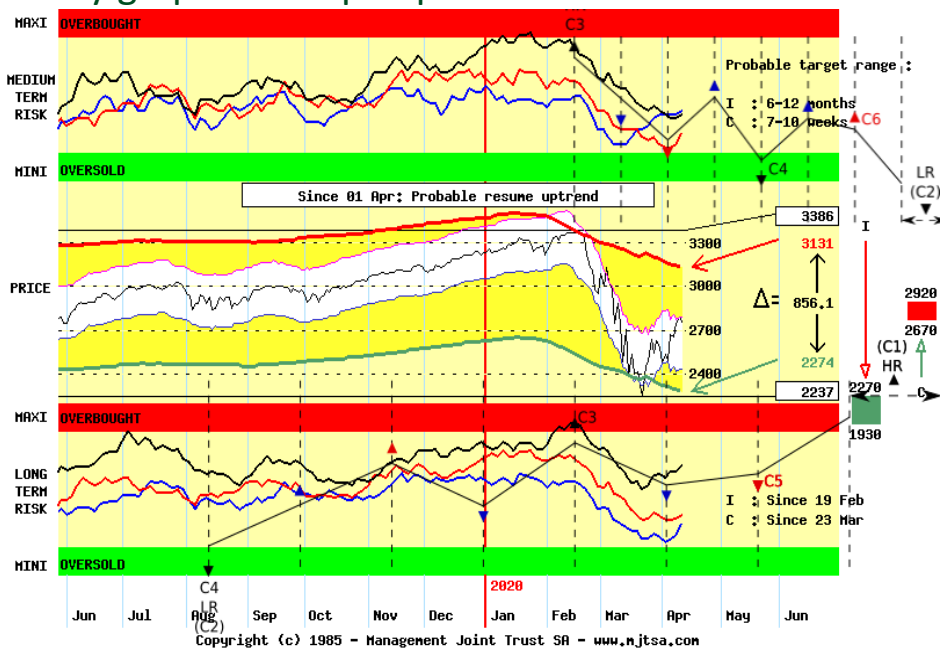
Weekly graph or the perspective over the next 2 to 4 quarters



Following 4 years of another historical bull markets, the S&P500 Index crashed below the support of our C Corrective targets to the downside in March (below 2'640). Theoretically, and although the rebound has since been swift, this breakdown could signal the beginning of a Bear market, as indicated by the High Risk situation identified on our long term oscillators (lower rectangle). Such situations usually call for 6 to 12 months of correction to the downside at least. **Yet, given the huge stimulus packages being put in place and the "whatever it takes" commitments of both Treasuries and Central Banks in all major economies, we would consider a more positive scenario. Indeed, as shown on our medium oscillators (upper rectangle), we believe strong support may have been reached in March, that the S&P500 Index could retrace, retest down, yet hold during Q2, and that it could then rally back, possibly towards its February highs into late Summer.**

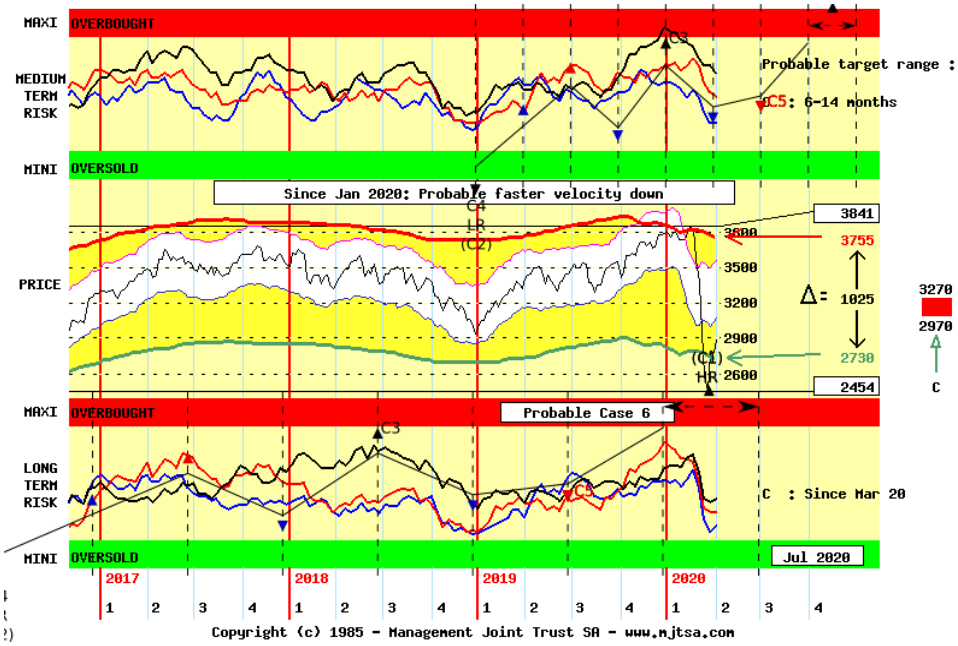
S&P500 Index

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



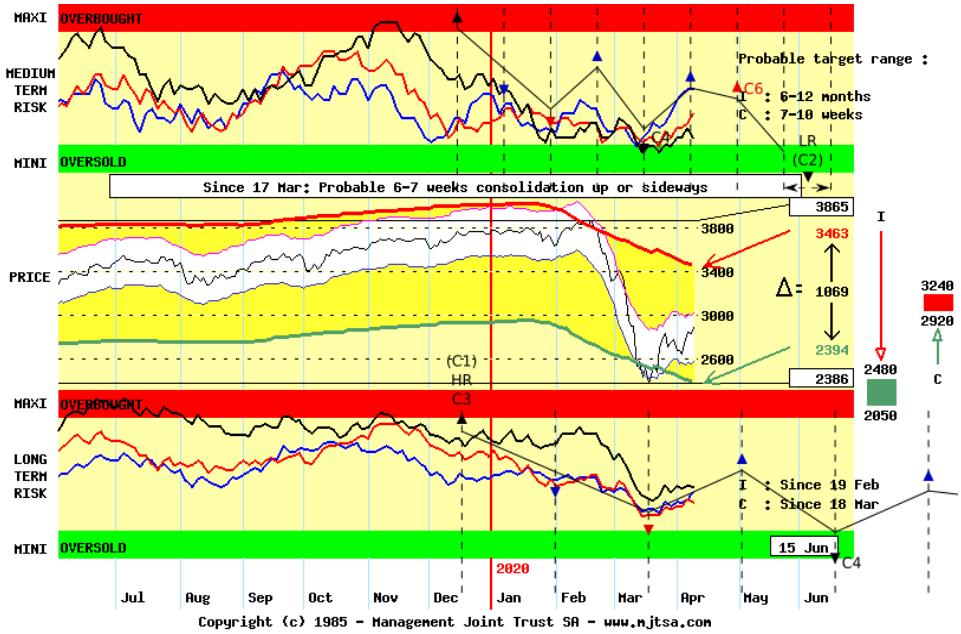
On a Daily basis, the current rebound started early in the fourth week of March as the US Treasury 2 Trillion USD fiscal stimulus package was being finalized and the FED committed to purchase US Investment Grade debt on top of Commercial Paper. Despite the aggressive 26% rebound that has since taken place, we are still, for now, well below the tops made back in February (some 18% below them) or close to the 50% upside retracement mark. Hence, it is still too early to conclude that the uptrend has now been reinstated. According to the sequence we show on our medium term oscillators (upper rectangle), **the S&P500 Index should meet strong resistance over the next couple of weeks, probably towards the upper end of our C Corrective targets to the upside at circa 2'920. We then expect a retracement period to materialize into mid/late May. For now, we cannot rule out (nor confirm) a deeper downside retest towards the March lows, although we do believe that from June at the latest, the S&P500 Index should have stabilized and initiate a new rally up into the Summer.**

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



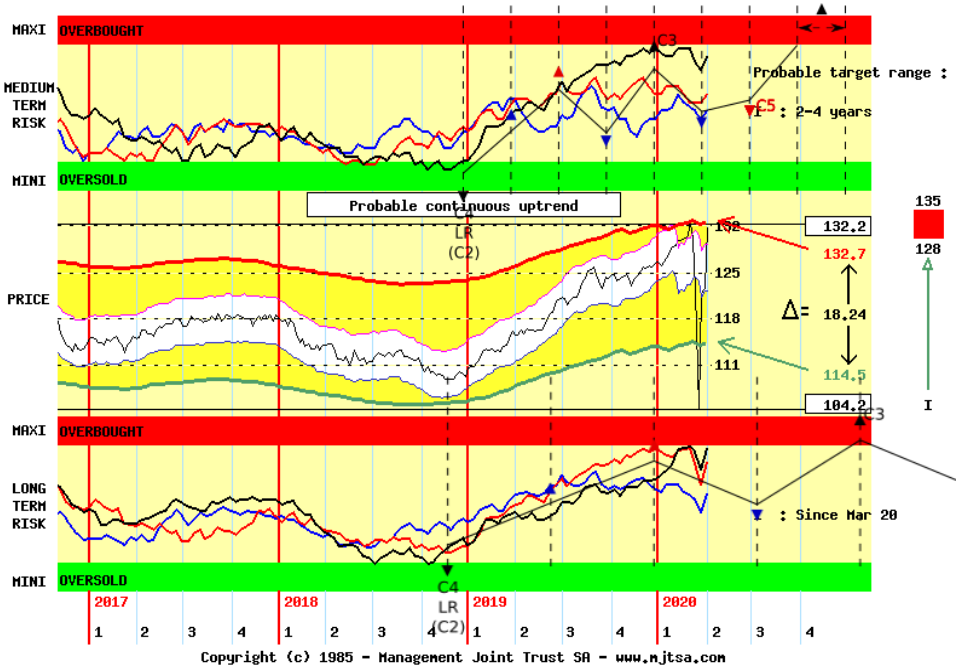
During March, the EuroStoxx 50 Index did also break below our C Corrective targets to the downside around 3'000 (not shown here anymore) and eventually went on to reach our I Impulsive targets to the downside below 2'500 (or 1.3 times our historical volatility measure "Delta", here at 1'025 – middle rectangle, right-hand side – subtracted for the February highs at 3'841), or into its 2011 – 2012 accumulation range! The EuroStoxx 50 Index is hence theoretically in a Bear market and the High Risk situation we show on our long term oscillators (lower rectangle) would usually mean that it could last at least 6 to 12 months. That said, as with the S&P500 Index, we are being more constructive on our medium term oscillators (upper rectangle) where **following a downside retest into late Q2, we would expect a new rally into the Summer. The upper end of our C Corrective targets to the downside, around 3'270 (right-hand scale) will then serve as strong resistance before we can confirm that the long term uptrend has been reinstated.**

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



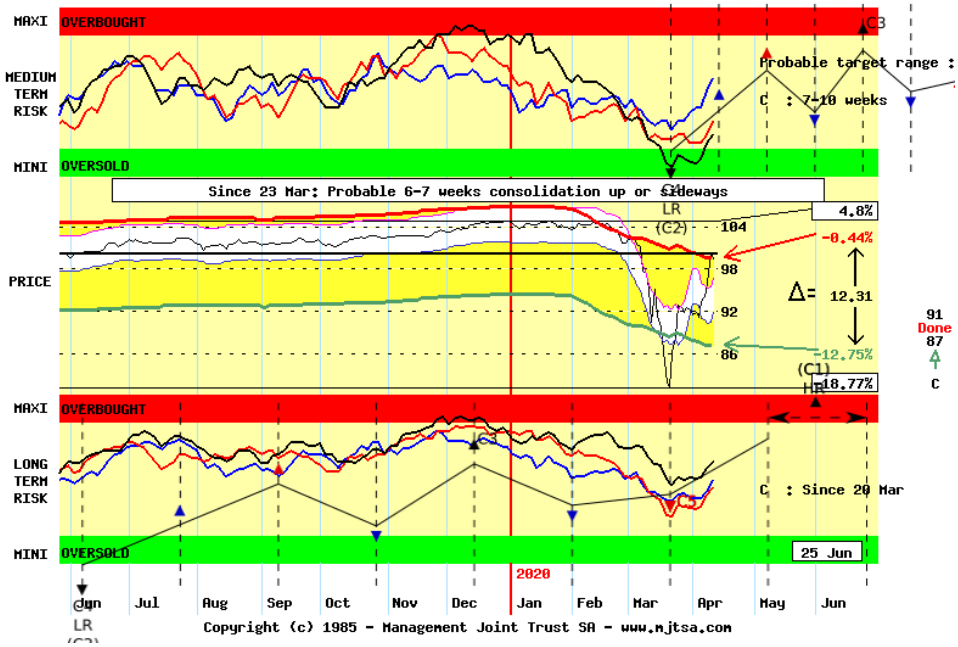
As much as we wish to be constructive, the next few months still seem challenging for the EuroStoxx 50 Index. Indeed, despite the recent rally, we are still well below the resistance of the upper end of our C Corrective targets to the upside around 3'240 (right-hand scale) and reaching above 3'100 could already be a challenge (i.e. the 50% retracement levels of the February/March sell-off). Both our oscillator series (lower and upper rectangles) would also suggest that **a new leg down could start between now and late April, probably into late May, perhaps even mid June. The downtrend since February is hence probably still in place, and the EuroStoxx 50 Index could retest down over the next couple of months, potentially back into our I Impulsive targets to the downside in the 2'480 – 2'050 range (right-hand scale), and hence possibly down to marginal new lows.**

US Investment Grade vs US Treasuries
Weekly graph or the perspective over the next 2 to 4 quarters



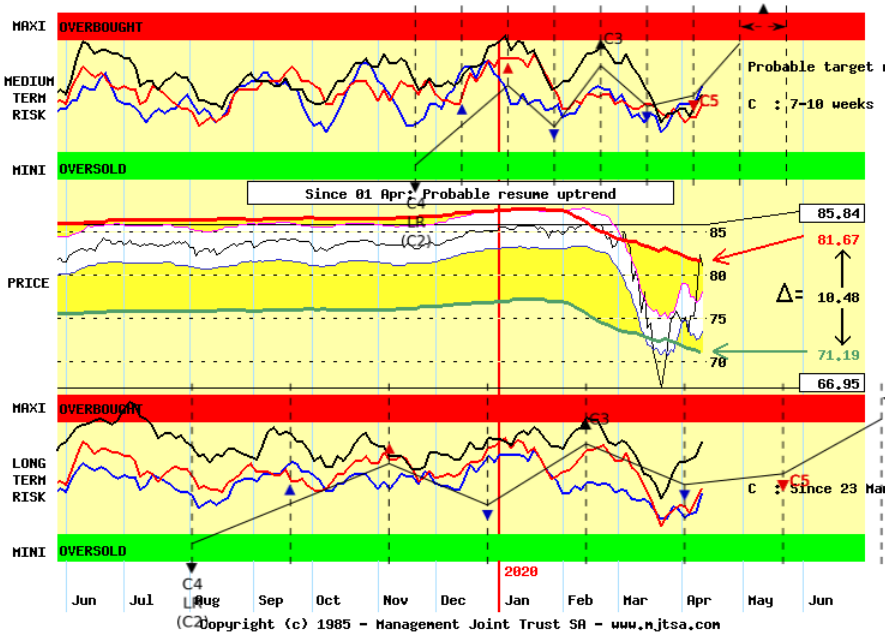
Considering US Investment Grade (LQD ETF), it is hard to call this market a free market anymore given that the FED's intends to purchase US Investment Grade Bonds and Loans in the primary and secondary markets as well as US Investment Grade ETFs. Since it was announced on the 23rd March, the purchase program has triggered a tremendous rebound in US Investment Grade markets, from low points not seen since 2011, almost back to its February all time highs, or more than 20% swings in both directions. **If our oscillators are any guidance anymore, we would expect some retracement into late Q2, and then a new rally into the Summer, possibly towards new highs considering the tremendous support this market is under.**

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



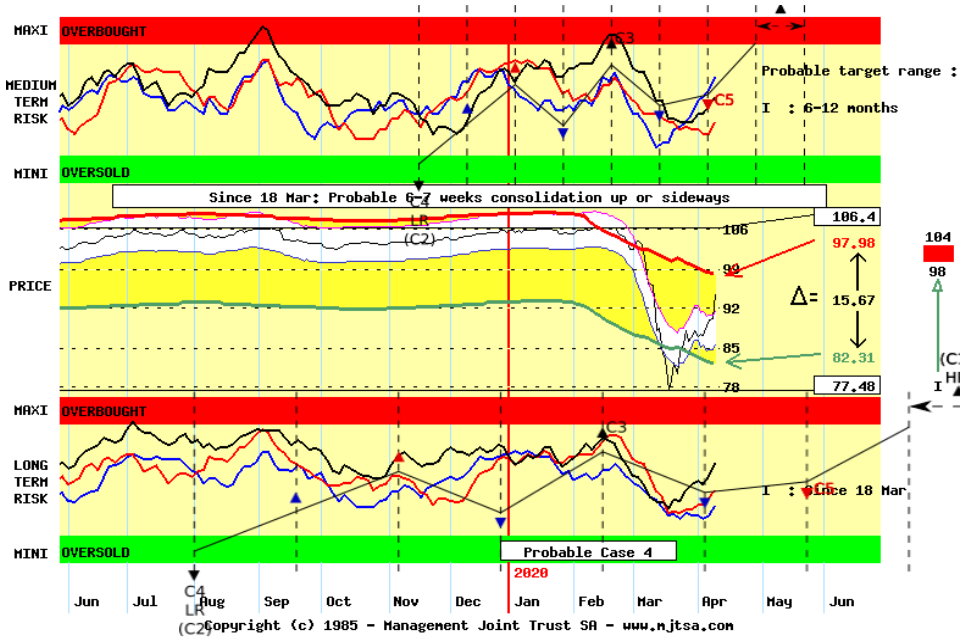
Considering the ratio of US Investment Grade (LQD ETF) vs US Treasuries of similar duration (IEF ETF) may offer a slightly more differentiating picture, as it may highlight some softness in US Investment Grade markets, probably during forthcoming risk-OFF periods, and while US Treasuries may be rallying. According to the sequences we show on both oscillator series (lower and upper rectangles), we consider that the ratio probably resumed its uptrend on the 23rd of March and that it may continue higher into midyear at least. Yet, as shown on our medium term oscillators (upper rectangles), **we would expect some underperformance during May, probably as risk assets correct, US Investment Grade consolidates slightly and Treasuries rally.**

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



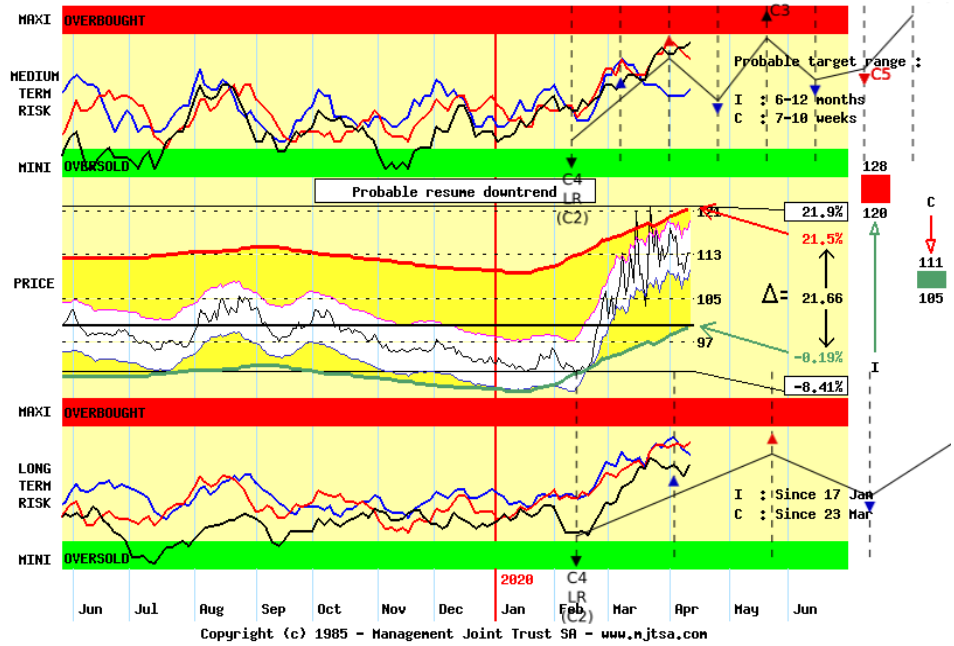
The US High Yield market is also bouncing back vigorously towards its February highs and the move has been accelerating up again last week as the FED announced that it would also support the issuances of Fallen Angels, as well as buy High Yield ETFs. Probably, if worse comes to worse, the FED will ultimately end up supporting the whole high yield space, given that it is already guaranteeing loans from medium and small businesses. **Hence, similarly to US Investment Grade, the current rally on US High Yield also seems artificially supported. It may last into the end of April when it could reach an Intermediate High Risk position on our medium term oscillators (upper rectangle). We would then expect some retracement into mid/late May on our long term oscillators (lower rectangle) before a new rally then materializes into the Summer, probably towards new highs.**

European High Yield
Daily graph or the perspective over the next 2 to 3 months



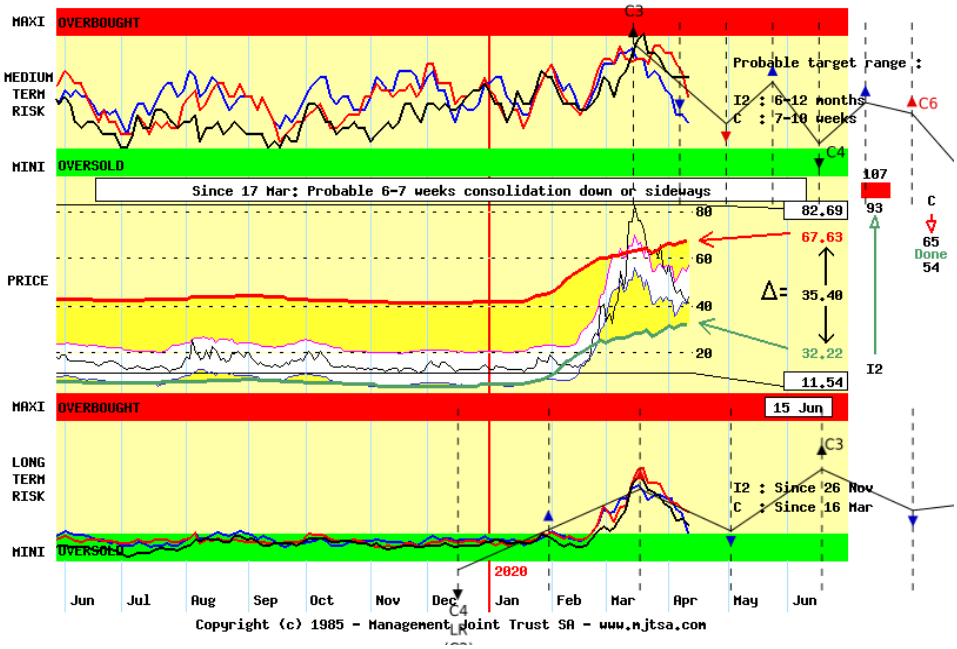
The strong rally from the March 23rd lows is not only US centric. Indeed, the European High Yield market has also bounced back vigorously (i.e. we use the IHYG ETF as a proxy for European High Yield). For now, the move has retraced circa 60% of its March sell-off and is hence lagging the US a bit. Yet, we also expect it to extend higher over the next couple of weeks until an intermediate High Risk position is reached towards late April / early May on our medium term oscillators (upper rectangle). **European High Yield may then consolidate down into mid/late May when it could find support again and start a rally into the Summer, probably from June**. While the ECB's response to the Coronavirus slowdown seems less ambitious than in the US, the 750 billion Euro program it released is nevertheless substantial. Add to that the numerous initiatives at national levels throughout Europe to support mid and small sized businesses and European High Yield did find support and could now bounce back towards its February highs, probably by this Summer.

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



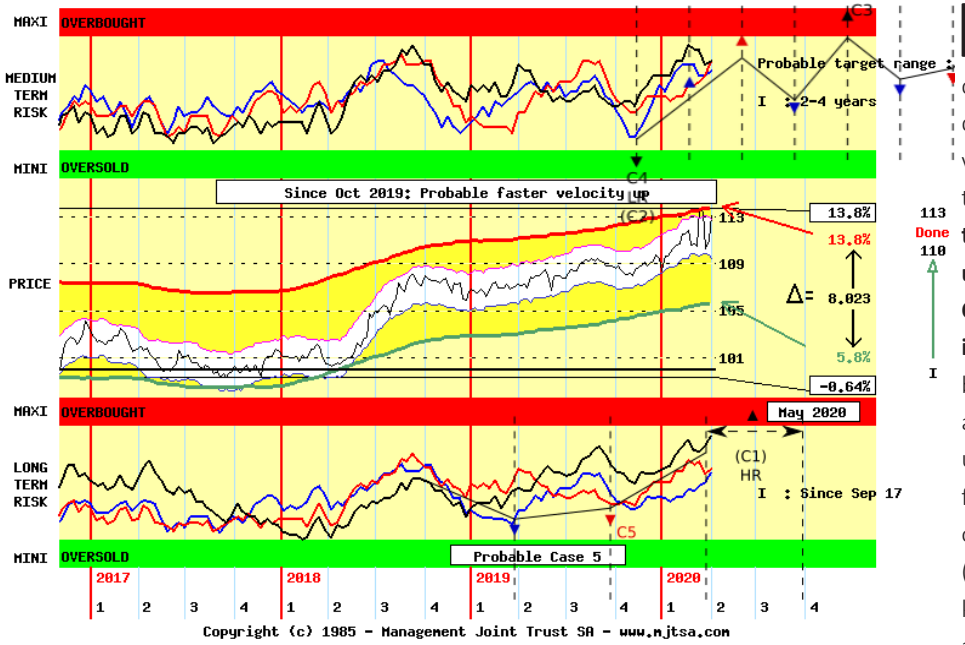
With Credit markets now under perfusion in the US and Europe, we move on to compare US Investment Grade (LQD ETF) vs US equity indexes (the S&P500 Index). On both oscillator series (lower and upper rectangles), the corresponding ratio **suggests that Investment Grade could continue to lag Equities in their rebound for another week or so, into late April, but should then outperform again into mid / late May. This, in our view, suggests a new period of risk-OFF from late April into mid/late May, when Investment Grade should hold up / consolidate slightly, while Equities correct back down. The upside potential for the ratio may be quite substantial, between 7 and 15% upside from current levels according to or I Impulsive targets to the upside. If we assume that US Investment Grade remains rather stable during this period, this suggests at least a 50% retracement of the current equity rally**. Note: the ratio of European Investment Grade vs the Europe Stoxx 600 Index shows a similar incidence in terms of timing and scope, while US and European High Yield should also outperform equities from late April into mid/late May, yet to a lesser extent, thereby confirming this risk-off period we expect during May.

VIX CBOE Volatility Index
Daily graph or the perspective over the next 2 to 3 months



We now consider Volatility and the CBOE VIX Volatility Index to confirm these dynamics. Although VIX has corrected down from the low 80s into the low 40s on the recent equity rebound, its level remains elevated on a historical basis. If 2008 is any reference, back then, VIX double-topped in October and November around 80 and then also retraced down to 40 by December. It then pretty much held up around these levels until April 2009, as residual risks remained high and Equity markets eventually made new lows in early March 2009. Hence, following the initial surprise shock in March this year with VIX spiking up to 80, **VIX probably doesn't need to retest its highs over the next few months to justify a deep downside retest. It would just need to remain elevated. Both oscillator series (lower and upper rectangles) suggest that from late April, VIX could bounce again during May, which given current levels would keep it quite high and justify the risk of a material downside retest for equities**. Note: our short term hourly graphs (not show here) indicate that VIX could drop down to between 34 and 18 over the next couple of weeks, yet should then bounce back to between 37 and 64 into May depending on how deep the current retracement is (down to 34, or down to 18?). A VIX bouncing back into the 50s and 60s would certainly imply a strong downside retest for Equities during May, while a bounce into the mid/high 30s may also inflict some damage, yet probably much above its March lows.

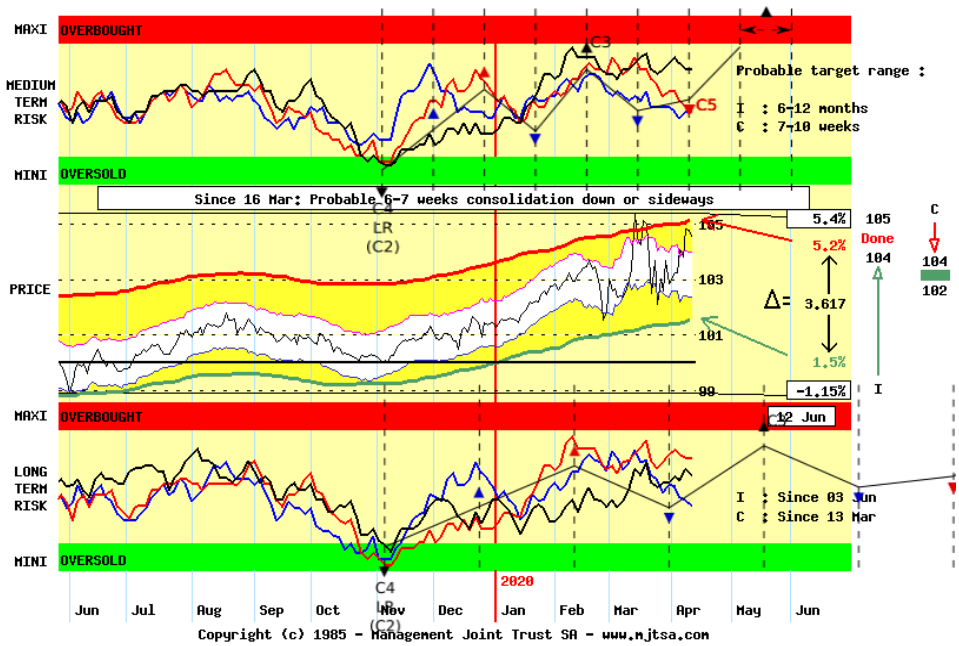
S&P500 Index vs the All Country World Index
Weekly graph or the perspective over the next 2 to 4 quarters



In this environment where we expect some downside retracement / retest risk on equities during May, we now consider various geographical relative ratios. **For now, US markets seem to maintain their 2.5 years upside momentum vs the All Country World Index, probably into May at least** according to both our oscillator series (lower and upper rectangles). Some underperformance may then follow during the Summer on our medium term oscillators (upper rectangles). Yet, US markets should then outperform again from late Summer into Q4.

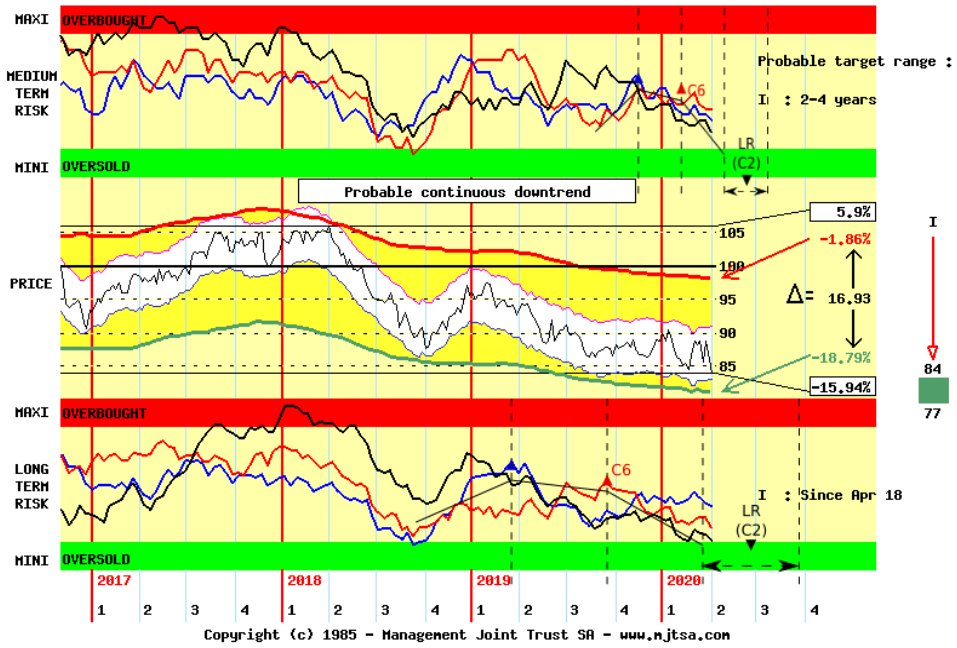
Given current dynamics, an outperformance by US markets is probably defensive, and would also indicate further US Dollar strength, probably also with a defensive bias. Note: next to the US, Europe is by far the highest weighting in the All Country World Index.

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



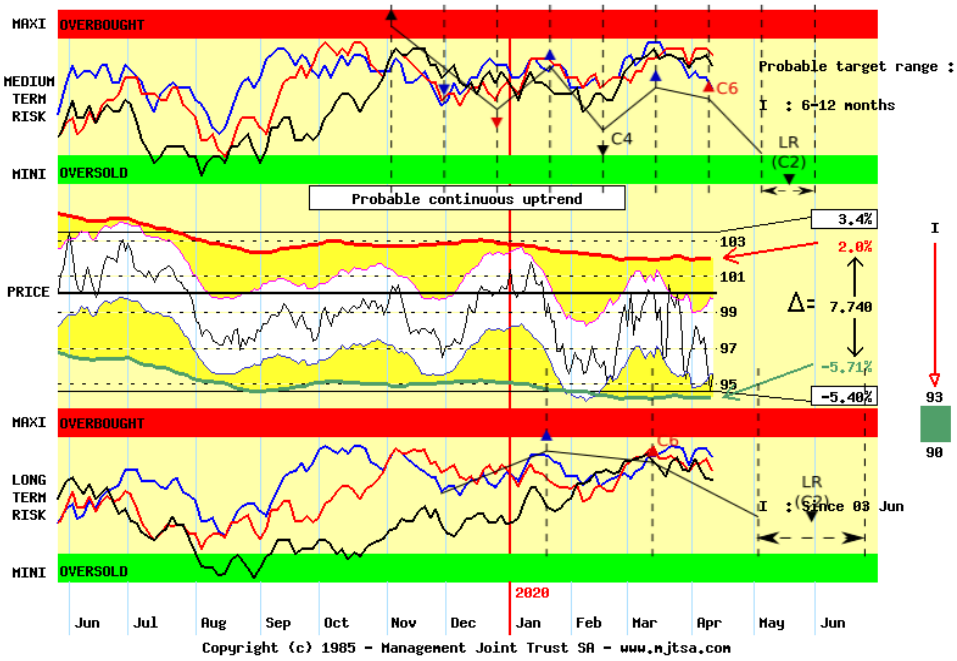
On a Daily basis, the S&P500 vs the All Country World Index ratio probably also continues to rise into mid/late May, according to both our oscillator series (lower and upper rectangles). Although the ratio has been quite volatile lately, we still believe it represents the US Growth trade and the S&P500's high weighting towards US Big Technology, vs the more cyclical All Country World Index. We also believe that these Big Technology profiles, and by extent US markets, have been the main beneficiaries of the liquidity injections by the FED from last November and once again recently. During the March sell-off, the S&P500 also proved to be more resilient. Indeed, as the deleveraging process intensified, the US Dollar spiked up as US Dollar funding seemed scarce, which helped US markets on a relative basis. **In general, we believe the US enjoys a more Growth / Defensive profile than the more Cyclical All Country World Index, and that Cyclical factors will probably not start to outperform again until late May / June, thereby allowing US markets to continue to outperform until then.**

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



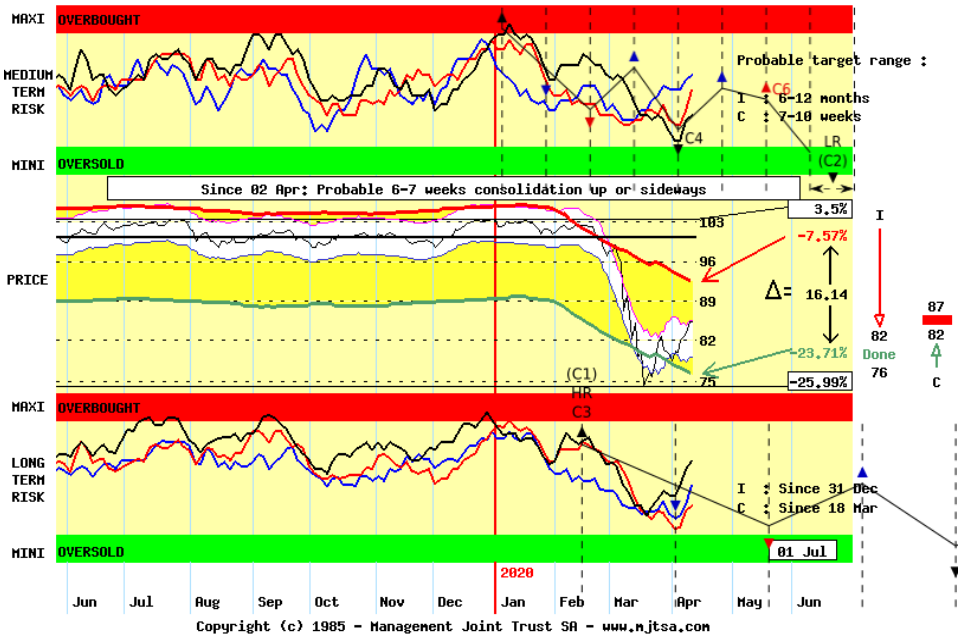
We now switch to the ratio of Emerging Markets (EEM ETF) vs the All Country World Index (ACWI ETF). **The ratio is still under downside pressure for now on both oscillator series (lower and upper rectangles) although we do expect it to gradually reverse up from late Q2 / midyear, probably for a Summer bounce at least**. Downside risk is still material according to our I Impulsive targets to the downside (right-hand scale) which point to potentially 7% of additional downside. **While China and Taiwan (more than 50% of the MSCI Emerging Markets Index) appear quite defensive in the current crisis, other regions, including Eastern Europe, the Middle East, South Korea and especially India, Afrika and South America could continue to widely underperform the All Country World Index. Incidentally, it is in these last 3 regions that the negative effects of the COVID-19 crisis over the next few months probably remain the most uncertain.**

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



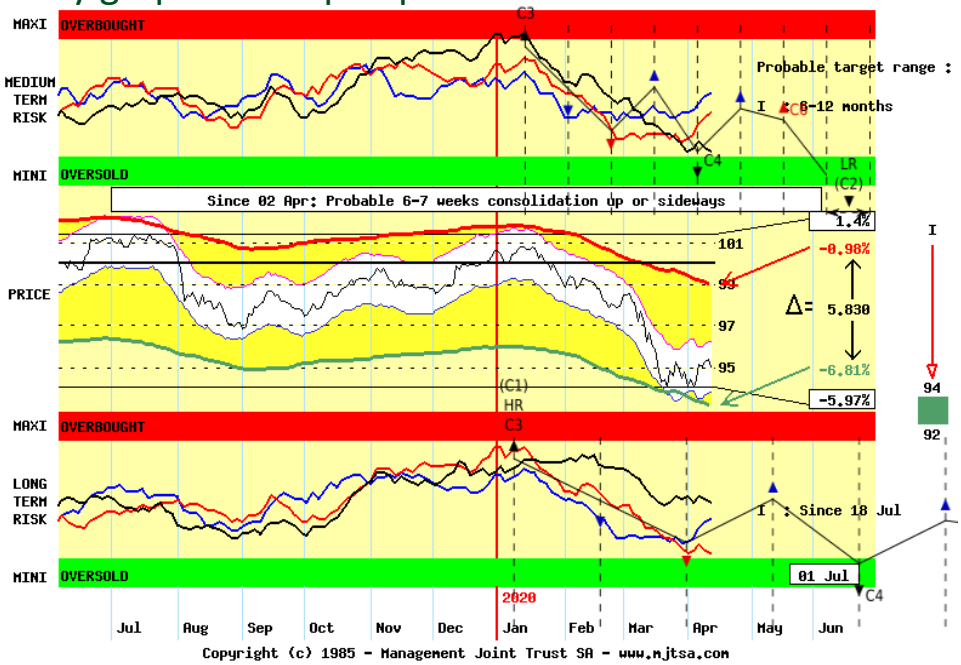
On a Daily basis, Emerging Markets (EEM ETF) seem to remain under pressure vs the All Country World Index (ACWI ETF), probably into late May, even June according to both our oscillator series (lower and upper rectangles). Our I Impulsive targets to the downside (right-hand) suggest 2 to 5% of additional downside risk until then. Such underperformance may result from further US Dollar strength during May and/or from further nasty surprises on the virus front in the weaker regions mentioned above (e.g. South America, Afrika or India)

USD denominated Emerging Markets Sovereign debt vs US Treasuries
Daily graph or the perspective over the next 2 to 3 months



On the Credit front, Emerging Markets debt may benefit from some IMF support at the margin, but will generally lack the kind of support offered by the FED or the ECB. In fact, these markets are still pretty much free of monetary intervention. Hence, **the ratio of US denominated Emerging Markets Sovereign debt (EMB ETF) to US Treasuries (IEF ETF) of similar duration is hence a good proxy for the status of risk-ON / risk-OFF in Emerging Markets. As with most risk assets, the ratio has been rebounding since mid March, yet much less than US or European High Yield. According to the sequences we show on both oscillator series (lower and upper rectangles), we expect the ratio to resume its downtrend from late April, probably into mid/late May and perhaps even June**. This downside retest on Emerging Markets Sovereign credit instruments could be quite deep, as it may indirectly find a negative feedback loop, as Flight to Safety to supported markets (US and Europe) accelerates, crowding out other markets on the fringe such as Emerging Markets.

Emerging Markets Currencies vs the US Dollar
Daily graph or the perspective over the next 2 to 3 months



On a Daily basis, **Emerging Markets (EEM ETF) seem to remain under pressure vs the All Country World Index (ACWI ETF), probably into late May**, even June according to both our oscillator series (lower and upper rectangles). Our I Impulsive targets to the downside (right-hand) suggest 2 to 5% of additional downside risk until then. Such underperformance may result from further US Dollar strength during May and/or from further nasty surprises on the virus front in the weaker regions mentioned above (e.g. South America, Afrika or India):

Concluding remarks

Following their 35% flash sell-off last month, equity markets along with most risk assets have since reversed up aggressively thanks to the FED, the ECB, the US Treasury as well as European Governments, which all rapidly rolled out massive monetary and fiscal stimulus programs. We expect this rebound to continue, probably into late April, potentially up to 2'900-2'950 on the S&P500 Index, perhaps towards 3'100 on the EuroStoxx 50 Index. Following that, most risk assets should see a consequent downside retest during May. Equity markets in the US, but especially some of the weaker markets in Europe or in Emerging Markets (ex Asia) could even retest their March lows. Volatility may be an interesting indicator to follow over the next couple of weeks. If indeed, by late April, the VIX does drop down to the low 20s / high teens, a deep downside retest is probably unlikely. On the other hand, if it remains in the low 40s / mid 30s, as it did for several months in 2008, new lows cannot be excluded. As for Credit markets, they have pretty much been backstopped in the US and in Europe and we would hence expect a shallower consolidation during May. Then, from late May / early June, we believe that most risk assets should stabilize again and probably initiate a new rally into the Summer at least.

35 / The long yields are indeed in a bottoming phase: expect rising yields until late April-early May, then followed by declining yields as Fed stimulus hits a plateau

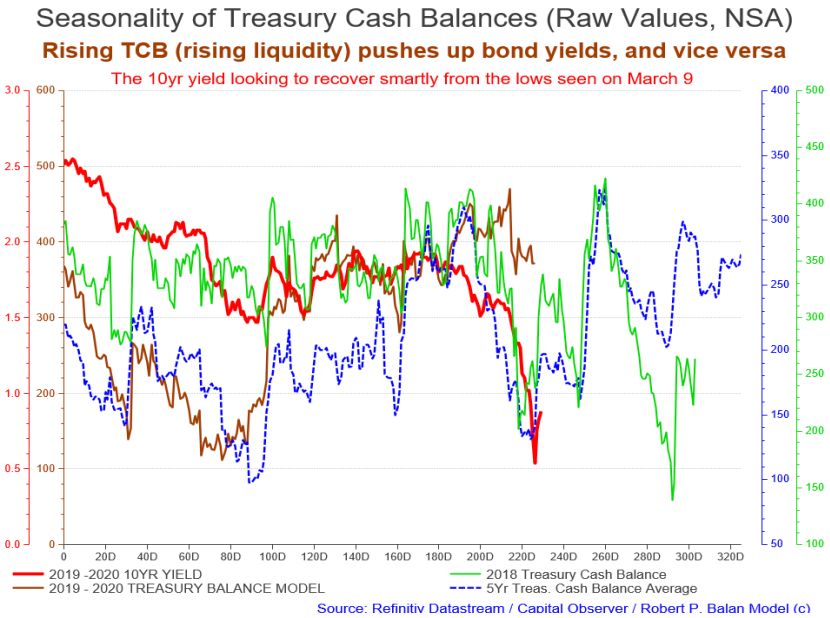
We said in the March 2020 edition of The Capital Observer that the long bond yields may have bottomed, as the seasonal liquidity flows swing higher – the market healing began as rising yields signal the worst is over. Indeed, just three days after we published the March edition, the stock market bottomed on March 22, and equities have rallied and posted almost 25% gains since then. This is what we said in the March 2020 issue:

The 1st graph on this page, 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 anticpate those expected changes.

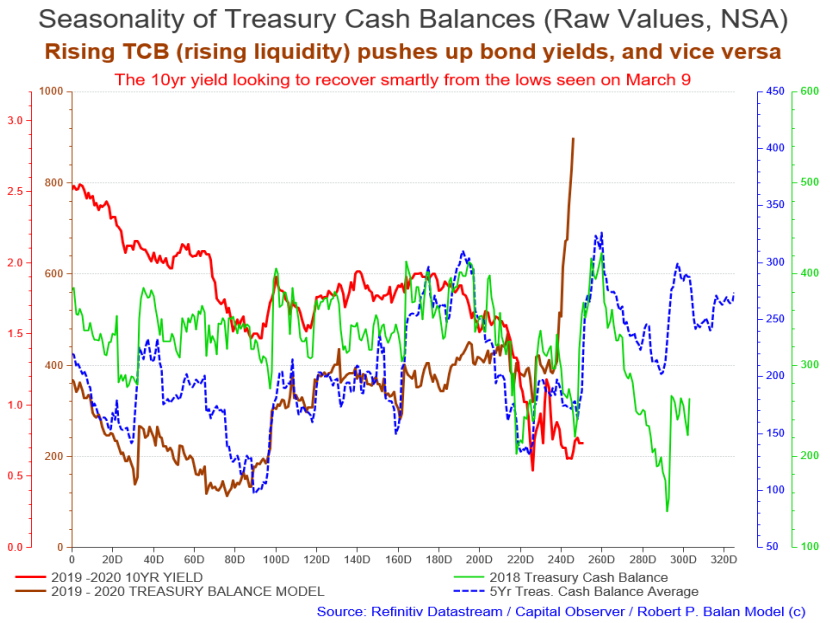
The effect: *changes in bond yields lead the actual changes in Treasury Cash Balances (brown line, 2nd graph on this page) by several days, and that front-run lead varies greatly from one liquidity season to the next. That of course introduces a lot of uncertainty over the very short-term outlook for bond yields. But if 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 at Capital Observer as "swing trading the seasonal liquidity flows."*

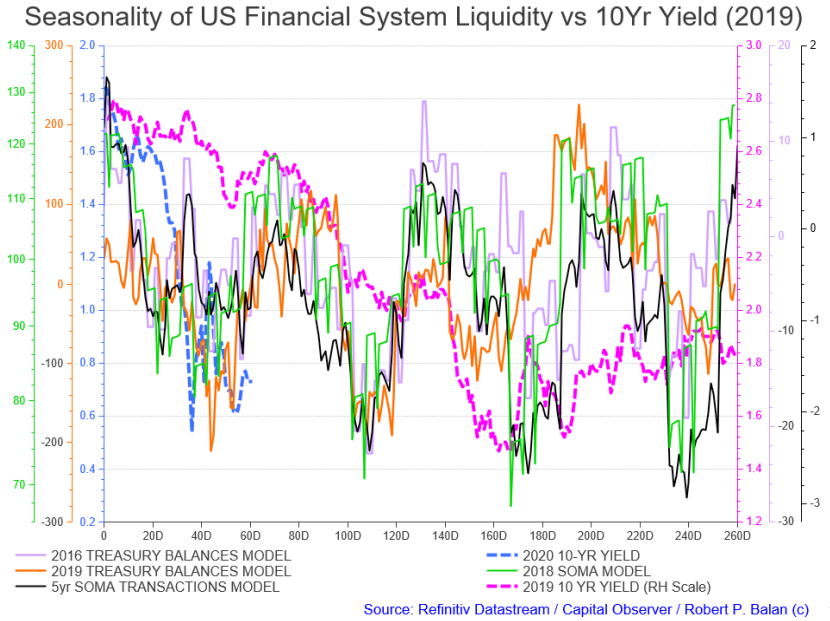
How regular is the seasonality tendency of US liquidity flows? We discussed this feature at length in an article in the Capital Observer in November 2019 *("Framing US Financial Systemic Liquidity For Tactical (Swing) Investing")*. **We presented the basic framework, which has been consistent since the Fed started doing Quantitative Easing programs since 2009, and it looks like this** (*see 3rd graph on this page*).

Original chart in the March 2020 Capital Observer



This is how the graph above look now





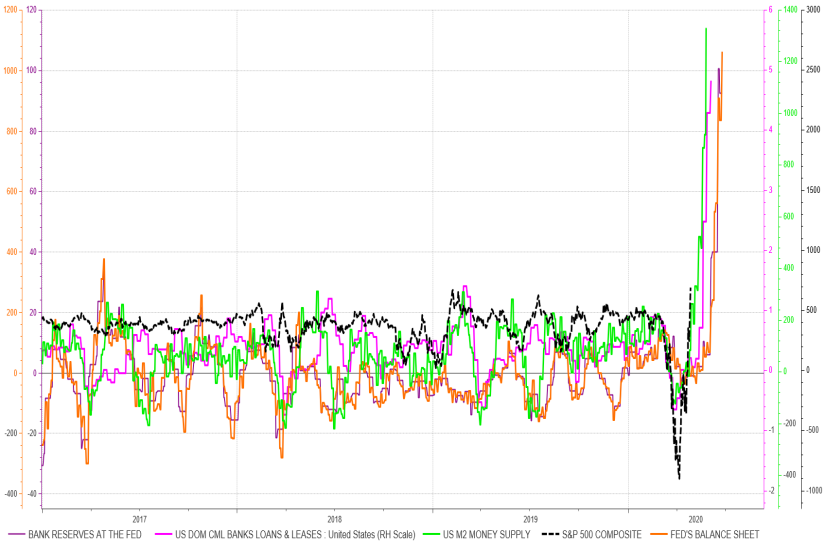
We added the plots of the 2019 and 2020 10yr Treasury yield to show the tremendous fidelity the Treasury long bond has shown in following the trends of the Treasury Cash Balance. Of course, with the large-scale changes brought about by global central bank and global government intervention in global finance and governance, it is germane to ask whether these seasonality features would still exert the same influence that they used to.

We asked this question in March, but we will ask again: *So 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?*

Answer: 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 (*see 3rd graph on previous page*). 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 1st graph on this page)* **leaves no doubt that equities will benefit in a large way, following the tsunami of new money unleased by the Fed and US government.**

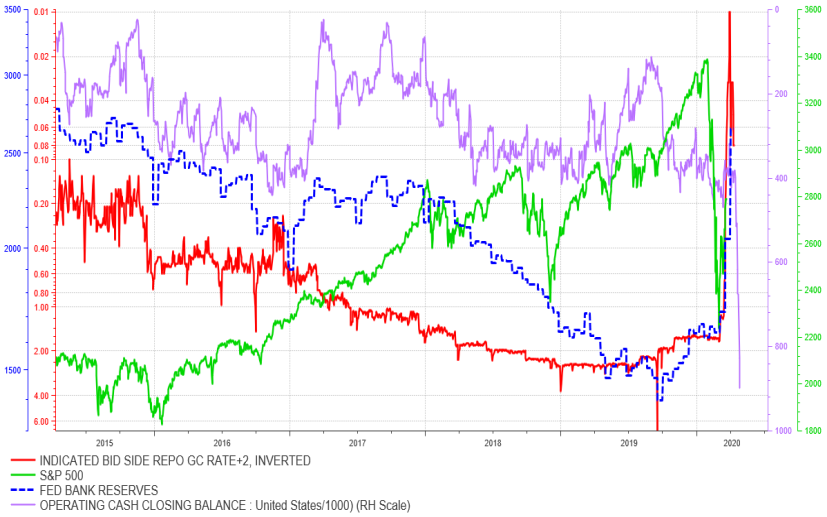
Regression of Fed Balance Sheet, Bank Reserves, Bank Loans, M2 Money Supply vs SPX



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

Bank Reserves at the Fed vs Bid Repo GC Rate, Treasury Cash Balance, S&P 500 Index

The persistent TCB rise undercuts the rise of Bank Reserves soon, as warned by rising repo rates



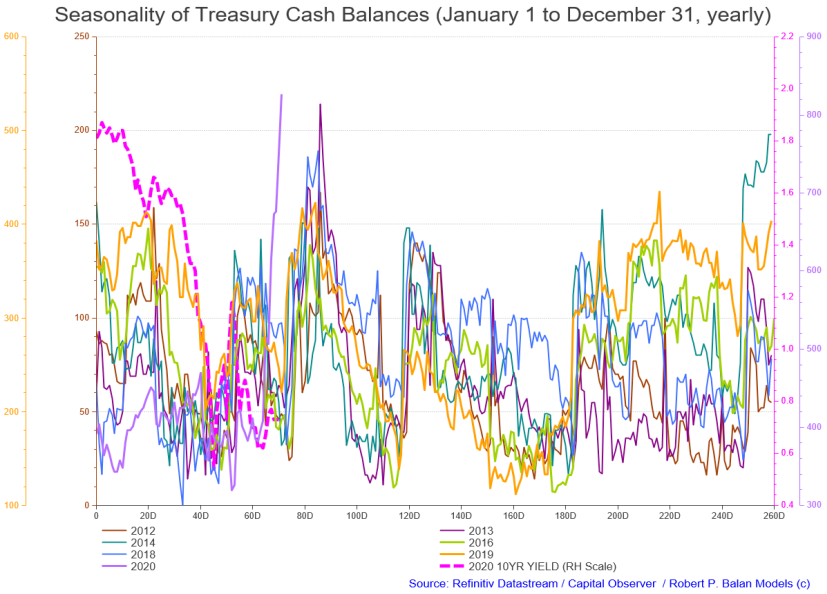
Source: Thomson Reuters Datastream / Capital Observer / Robert P. Balan Models (c)

The key take-away from these graphs 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 *(see 2nd graph above)*, 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 *(see 2nd graph above)*.

This may not affect the near-term trajectory of the 10yr yield which takes its cues from the Treasury Cash Balance. A more comprehensive template for how the 10yr yield may fare relative to liquidity flows being provided by the TCB for the entirety of 2020 is shown *the graph on this page*.



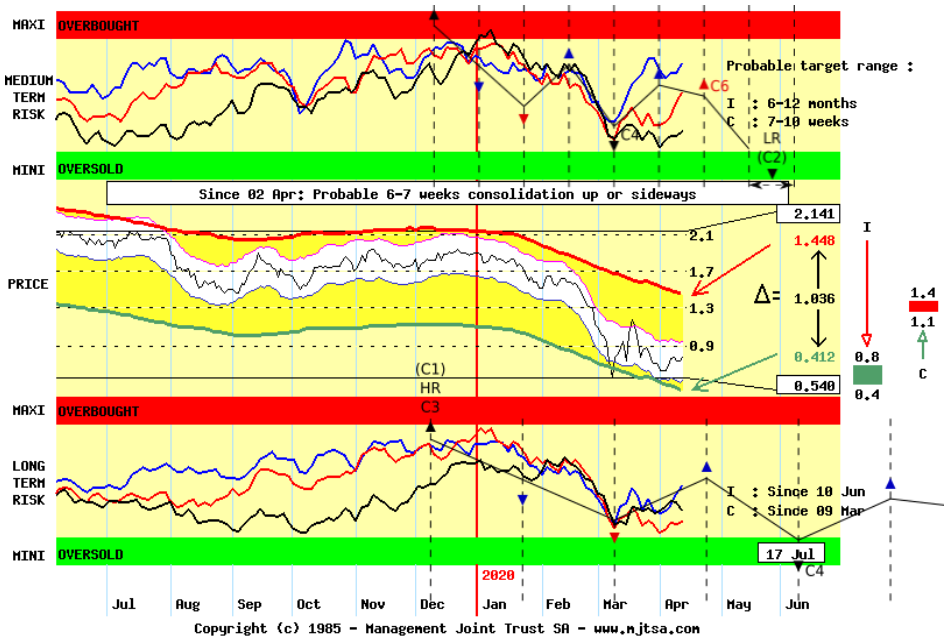
38 / MJT - TIMING AND TACTICAL INSIGHT

Yields remain under downside pressure along with Cyclical factors

During the height of the March sell-off and its disorderly deleveraging process, US Treasuries got dumped with other assets and yields initially started to bounce. Following that, US Treasury yields saw further upside pressure as Fed Fund rates got cut an additional 100 bps and large fiscal stimulus plans were announced, thereby fueling a short lived inflation scare. The "unlimited QE" program the FED then put in place rapidly reversed this trend and yields have since resumed their downtrend, while risk asset have performed a huge rebound. We believe that keeping a cap on long term yields is part of the FED's market stabilization process. Indeed, a strong rise in yields would evidently put further negative pressure on the still very fragile US Credit market and would also increase the need for further direct intervention. We believe it is not in the FED's interest to let this happen. Furthermore, it is still hard to evaluate today if 0% Fed Fund Rates and the 2 trillion USD Treasury fiscal plan will be enough over the next few quarters to compensate for the acute deflationary pressures resulting from the disruptions and economic consequences of the current lock-down period. In this article, we review Treasury yields in the US and abroad as well as standard inflation/deflation proxies with a 3 to 6 months investment horizon.

US10 Year Benchmark Bond yield

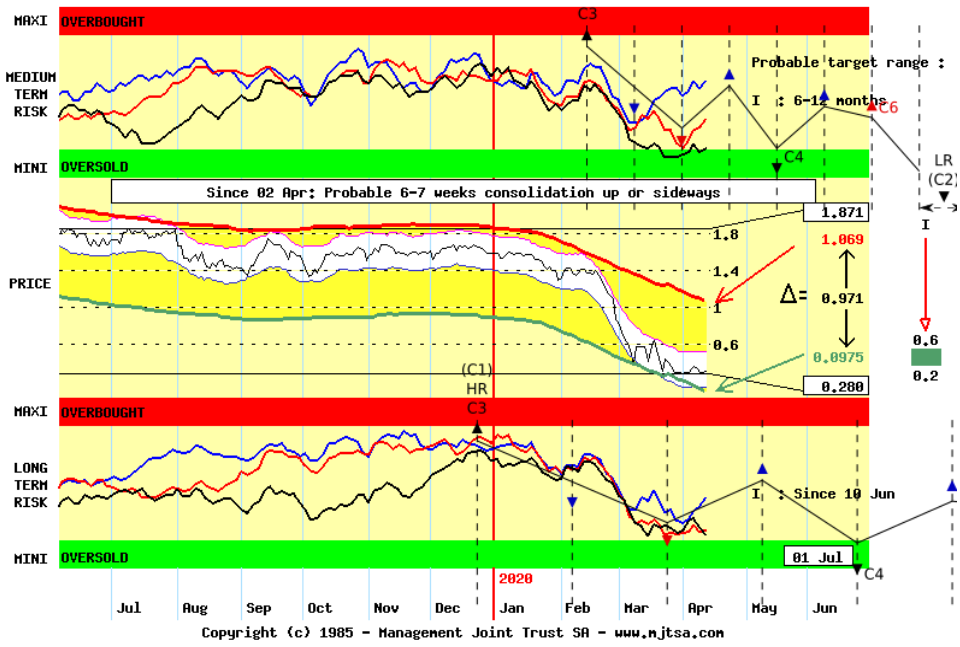
Daily graph or the perspective over the next 2 to 3 months



For now, the lows made on the 9th of March still hold, yet the downtrend is already resuming and as shown on both oscillator series (lower and upper rectangles), this process should accelerate further from late April into mid/late May, perhaps into June. Our I Impulsive targets to the downside (right-hand scale) suggest a potential retest down to 0.4%. Our I2 Impulsive 2 extended targets to the downside would calculate to zero % and perhaps even below. To the upside, this downtrend will eventually remain in place as long as the US 10Y yield remains below the upper end of our C Corrective targets to the upside around 1.4% (right-hand scale). We are still a long way below this resistance for now, and given the FED's unlimited QE program, we believe it should remain so with a continuation of this downtrend into June in first instance.

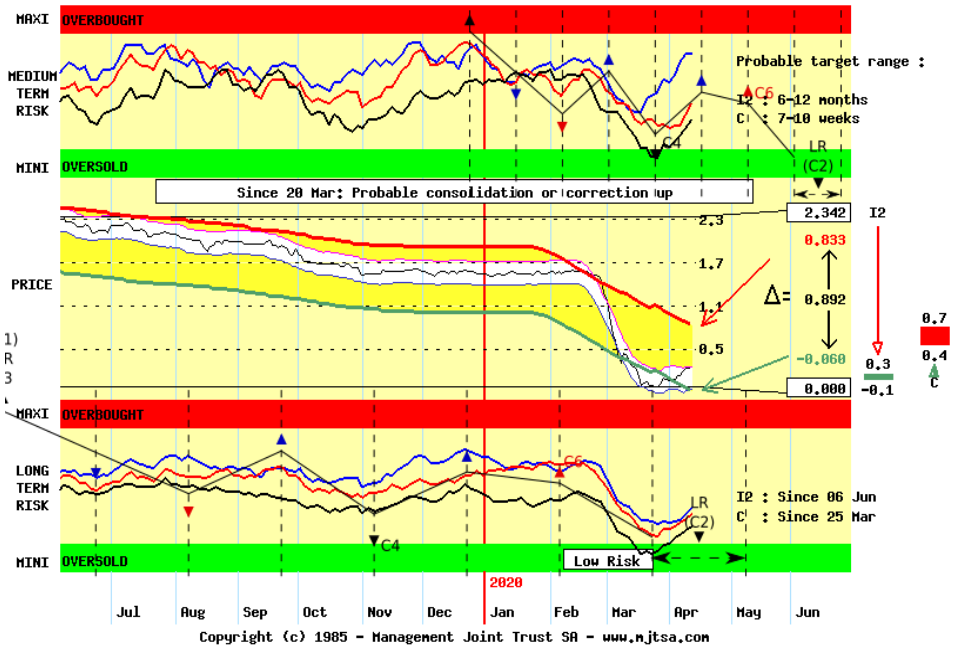
US 3 years Benchmark Bond Yield

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



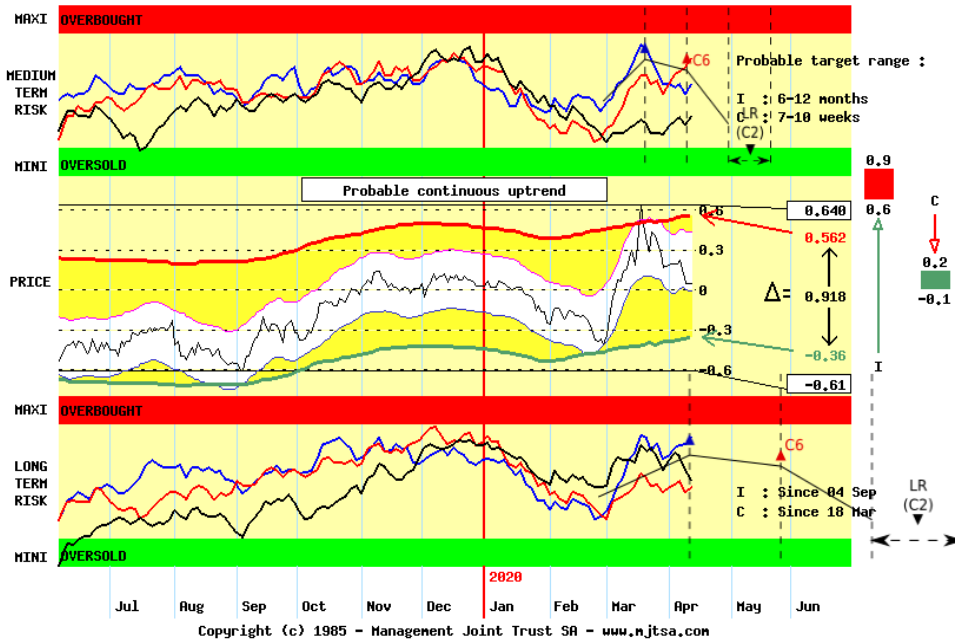
US 3 Year benchmark bond yields seem more Oversold as highlighted by the "Low Risk" position identified on our long term oscillators (lower rectangle). Yet, as suggested by both oscillators series (lower and upper rectangles), **we consider the recent bottoms as intermediate ones and would expect further downside pressure into mid/late May and perhaps even until midyear. Our I impulsive targets to the downside (right-hand scale) would point to downside targets towards 0.2%. Our I2 Impulsive 2 extended targets to the downside would calculate towards 0% and even below on this US3Y yield.** We believe that very low interest rates in the US are probably part of the FED's intended stabilization process. The outstanding amount of Negative Yielding Debt could hence make new highs globally this year as the US joins Europe and Japan in pursuing a very low, perhaps even a zero % interest rates policy through its "unlimited" purchases along the yield curve and perhaps even across large portions of the credit curve.

US 3 Months Benchmark Bond yields
Daily graph or the perspective over the next 2 to 3 months



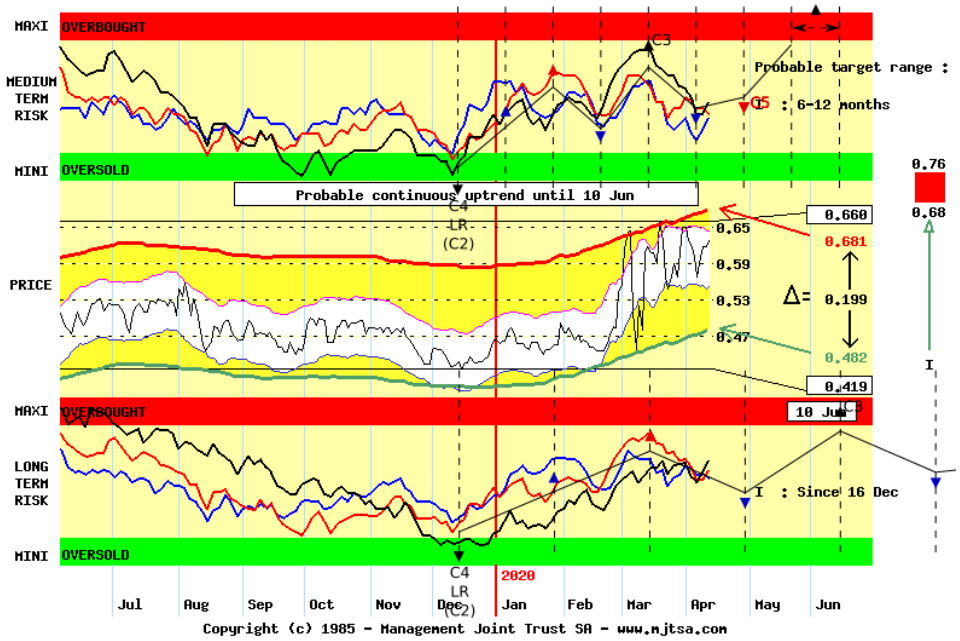
The US 3 months yield correctly anticipated the FED's 150 bps cut in March. Indeed, by Friday, the 13th of March, it had dropped to 0.28%, just before the FED eventually cut 100 bps to the 0.25 – 0.00% target range that Sunday. The US3M yield has since bottomed around 0% and is currently bouncing slightly with risk assets. **Although our long term oscillators (lower rectangle) are quite Oversold (a "Low risk position"), our medium term ones seem to point to a further downside retest, towards 0%, from late April into late May / early June. This would fit quite well with the retracement / retest down on risk assets we expect during May.**

US 3 Year – US 3 Months Treasury yields spread
Daily graph or the perspective over the next 2 to 3 months



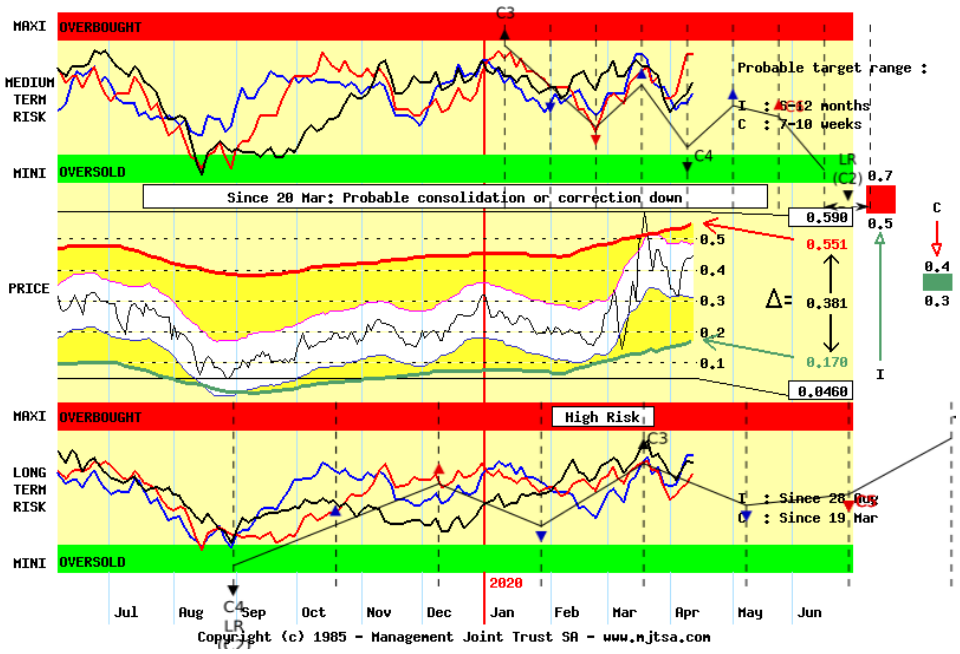
Traditionally, while the US3M yield attempts to front-run the FED's policy going forward, the US3Y would also integrate inflation anticipations as well as the impact of Flight to Safety flows (it is the most liquid portion of the US Treasury market and as such a safe-haven). Hence the spread has traditionally been a good proxy for risk-ON / risk-OFF periods in financial markets. It however suffered a huge distortion in March, as the US3M yield dropped aggressively in anticipation of the rate cuts, while the US3Y one briefly spiked up as Treasuries got sold as part of the deleveraging process. Since then, the spread has been contracting while risk assets have been bouncing. This is the inverse relationship of what we would usually expect. Over the next two months, we expect the spread to continue to show this inverse relationship until both the US3Y and US3M probably gradually drop to 0%. **The US3M yields may continue to rise until late April and the spread should hence contract. From late April however, we would then expect the US3M yield to drop down again while the spread could rise into mid/late May. Finally, during June, we then expect the US3Y yield to catch up with the US3M yield to the downside, resulting in a full flattening on this short end of the curve, with both the US3Y and the US3M yield settling close to zero% by mid year. So long for the price discovery process on the short end of the curve.**

US 30 Year – US 10 Year Treasury yields spread
Daily graph or the perspective over the next 2 to 3 months



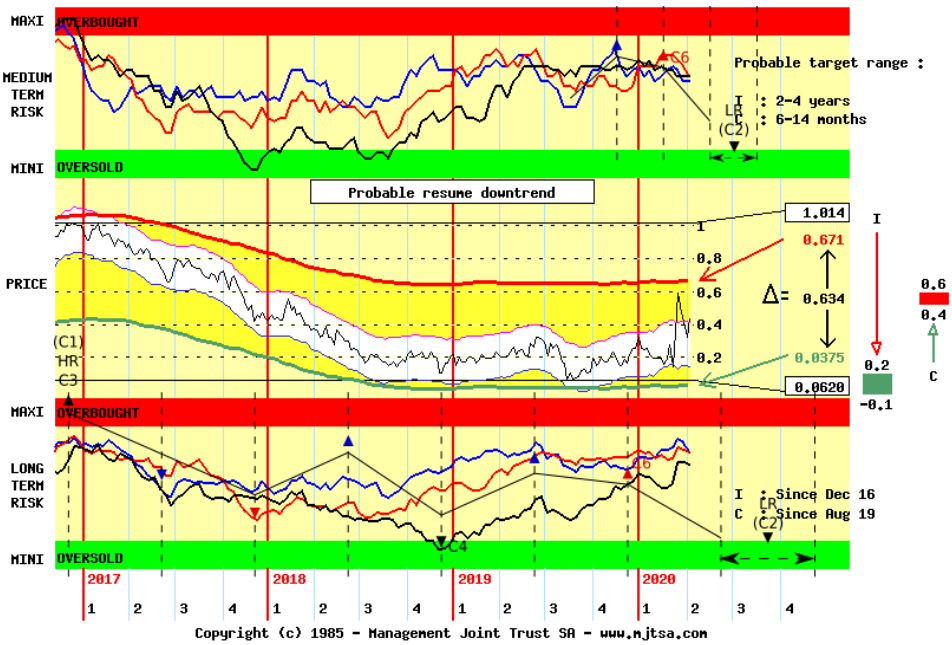
The longer portion of the US yield curve, the US30Y-US10Y yield spread historically moves in the opposite direction of the short end US3Y-US3M spread. Indeed, while the US30Y and US10Y are both impacted by monetary policy, often resulting in concomitant shifts up and down on both tenures, the US10Y seems more sensitive to medium term inflation expectations (10Y TIPs to Treasury breakeven ratios, Oil prices) than the US30Y, which seems to react to longer term secular inflation trends. Hence, **when Oil and inflation expectations drop, the US30Y-US10Y yield spread usually steepens. This has been the case since January and the beginning of the Oil sell-off, and this trend continued to accelerate during the March as risk assets sold-off. Going forward, both oscillator series (lower and upper rectangles) seem to suggest that following the current high level consolidation period (corresponding to a bounce in risk assets, oil prices and inflation expectations), the US30Y-US10Y yield spread should resume its uptrend into late May / June in first instance.** This could indirectly confirm a rather risk-off environment where Oil prices, inflation expectations and more generally risk assets retrace down during May. The US30Y yield should then drop more slowly than the US10Y one resulting in further 10 to 20 bps of steepening on the long end of the curve (i.e our I Impulsive targets to the upside – right-hand scale).

US 10 Year – US 3 Year Treasury Yields spread
Daily graph or the perspective over the next 2 to 3 months



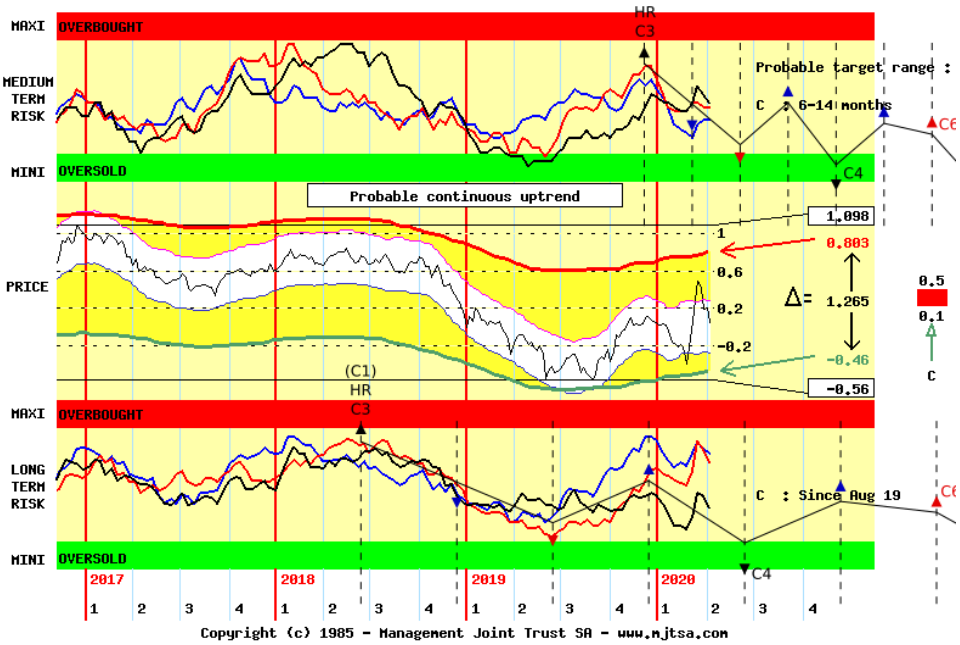
We believe that the middle portion of the US Treasury yield curve (US10Y-US3Y) is mostly influenced by the FED's interest rates policy. Indeed, inflation expectations probably have a similar influence on both tenures. Hence, historically, when the FED has lowered its Federal Funds Rate, the curve has steepened ("Bullish steepening" as the US10Y yield drops more slowly than the US3Y one). Inversely, when the FED is hiking rates, the curve usually flattens as US3Y yield rises more quickly than the US10Y one. Given the current situation, where US Federal Fund rates are already at zero %, there is little scope left for the FED to cut its Federal Funds rate further, unless it wishes to pursue a Negative Interest Policy, a strategy which it has excluded for now. **Hence, with the FED now neutralized in terms of interest policy, the US10Y-US3Y yield spread will probably bounce and fall with risk assets. Both our oscillator series (lower and upper rectangles) suggests that this could be the case, with the US10Y-US3Y bouncing slightly into late April and then falling back into May/June. A break below 0.3% during May (or below the lower end of our C Corrective targets to the downside – right-hand scale), will probably open the door to our I Impulsive targets to the downside, which we calculate towards 0%. We hence also expect this middle portion of the curve to flatten into midyear, while both the US10Y and US3Y tenures may converge towards a 0% yield.**

US 10 Year – US 3 Year Treasury Yields spread
Weekly graph or the perspective over the next 2 to 4 quarters



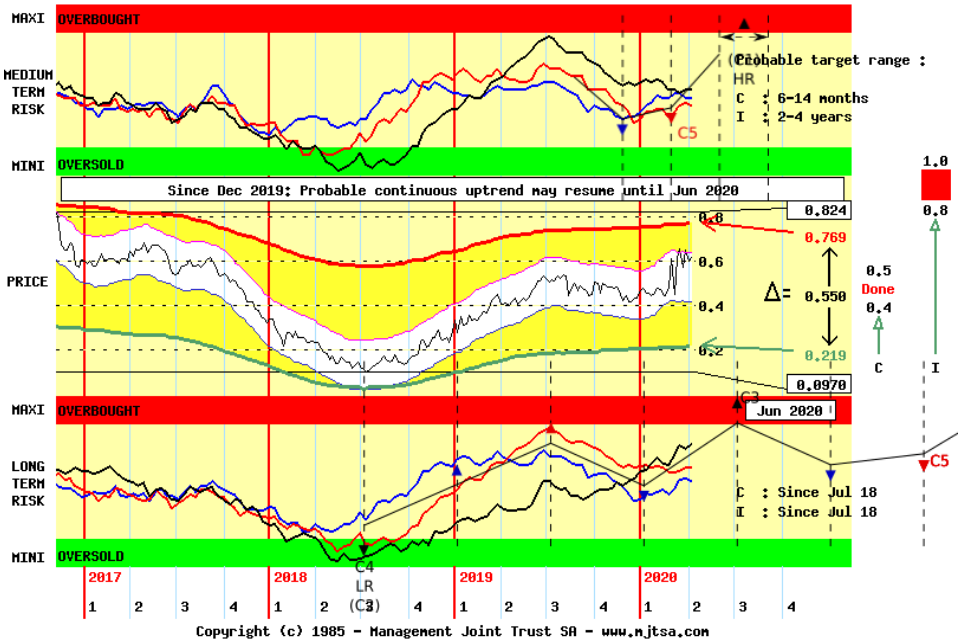
On the Weekly graph, we confirm this retest down which both our oscillator series (lower and upper rectangles) seem to point to. **The March spike was probably an outlier event triggered by a one-off period of exceptional deleveraging and the spread is now converging back towards zero into midyear (or towards the 0.2% to minus 0.1% range according to our I impulsive targets to the downside)**. During the Summer, this US10Y-US3Y spread may then attempt to bounce although the FED will not be able to help with further Fed Funds rate cuts (as it did for example last Fall). On the contrary, the FED may be inclined to put a cap on this spread through its unlimited QE as it would probably want to avoid that long term tenures start rising too quickly and eventually trigger new credit events.

US 3 Year – US 3 months Treasury Yields spread
Weekly graph or the perspective over the next 2 to 4 quarters



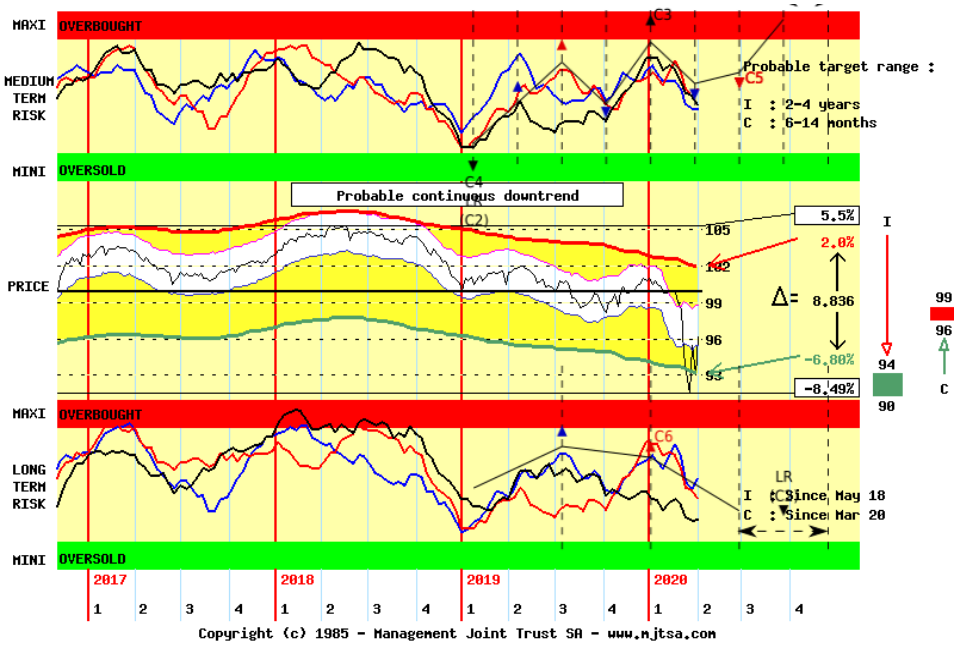
With both US3M and US3Y yields probably converging down to zero % over the next couple of months, we expect the US3Y-US3M spread to also flatten out completely into midyear. This is what both our oscillator series are suggesting (lower and upper rectangles) with a potential intermediate low expected late Q2. **Following that, the spread could bounce during the Summer (probably with a bounce in US3Y yields), yet, may then come under renewed pressure during the Fall**, as shown on our medium term oscillators (upper rectangle). **As explained above, spreads on this short-term end of the curve have historically been positively correlated with inflation expectations**. Note: on the contrary, if the spread does continue to rise and breaks above 0.4%, i.e. above the upper end of our C Corrective targets to the upside (right-hand scale), it would probably imply an acceleration upwards in inflation expectations. Given the uncertain, yet probably large economic impact of the current crisis, as well as credit markets which are still in disarray, we believe such an outcome is rather unlikely over the next few months. If the situation however does stabilize over the next few quarters, it may then potentially materialize towards year-end.

US 30 Year -US 10 Year Treasury Yields spread
Weekly graph or the perspective over the next 2 to 4 quarters



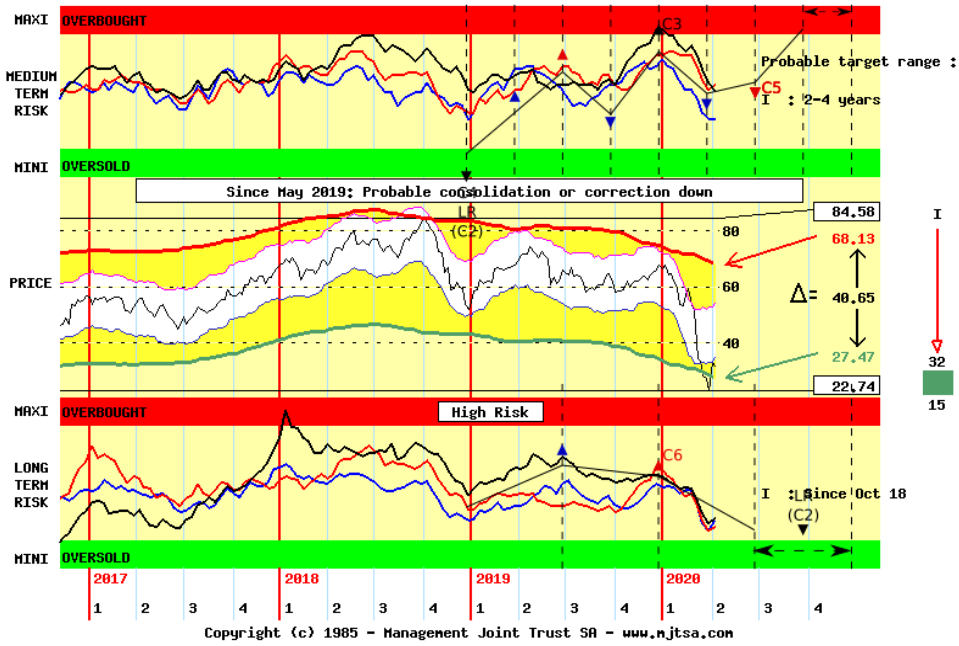
On the contrary and as explained above, the US30Y-US10Y spread is usually negatively correlated with inflation expectations (10Y US TIPs vs Treasuries ratio) as the US10Y seems to be more sensitive to them while the US30Y is more influenced by longer term secular inflation trends. Both oscillator series on this graph (lower and upper rectangles) hence confirm our scenario above, **with the spread rising into late Q2 at least, perhaps even into the Summer, while inflation expectations resume their downtrend** (inflation expectations are featured in the following few graphs). On the target front (right-hand scale), we are now above the resistance of our C Corrective targets to the upside and the spread may reach up to our I Impulsive targets to the upside over the next few quarters, potentially 20 to 40 bps higher than today. Note: there is some talk at the moment that despite its "unlimited QE" the FED could lose control over the long end of the curve. We believe that as long as the US30Y-US10Y spreads in negatively correlated to Inflation breakevens, Debt deflation is probably still too strong for it to happen.

US TIPs vs US Treasuries ratio
Weekly graph or the perspective over the next 2 to 4 quarters



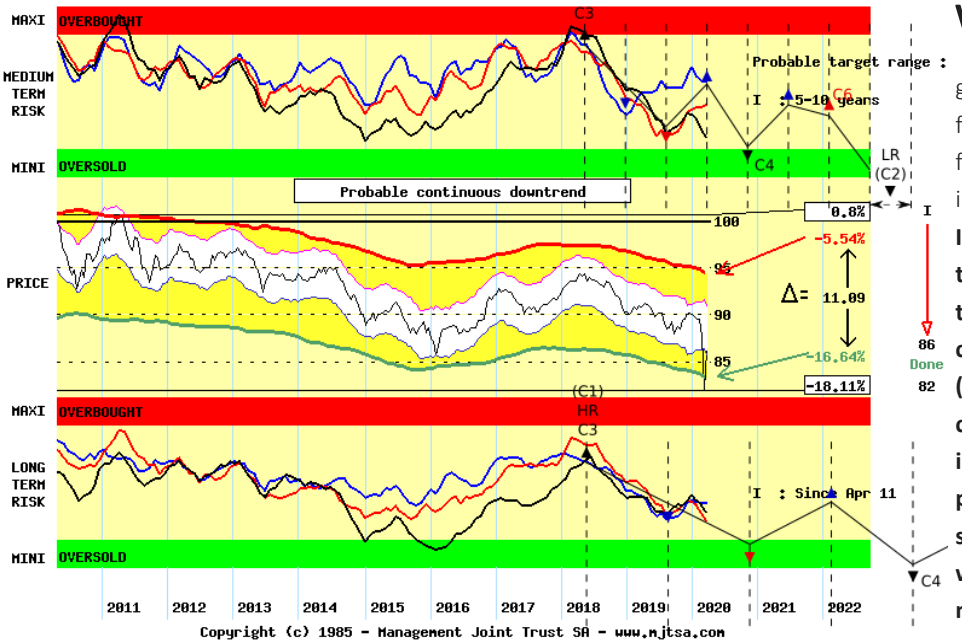
We now consider Inflation Expectations using the 10Y US TIPs to Treasuries breakeven ratio. On our long term oscillators (lower rectangles) we feature a scenario where the downtrend continues into midyear at least and potentially towards year-end. From a targets perspective (right-hand scale), our I Impulsive targets to the downside are suggesting that the ratio could make marginal new lows, below the March ones, over the next 2 to 3 quarters. On our medium term oscillators (upper rectangle), we indulges ourselves to consider a more constructive scenario, where Inflation Expectation may have found initial support in March, build a base during Q2 and then rally during the Summer. **Nevertheless, for now, both sequences seem to point to further weakness, or at best to some retracement, into midyear at least.**

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



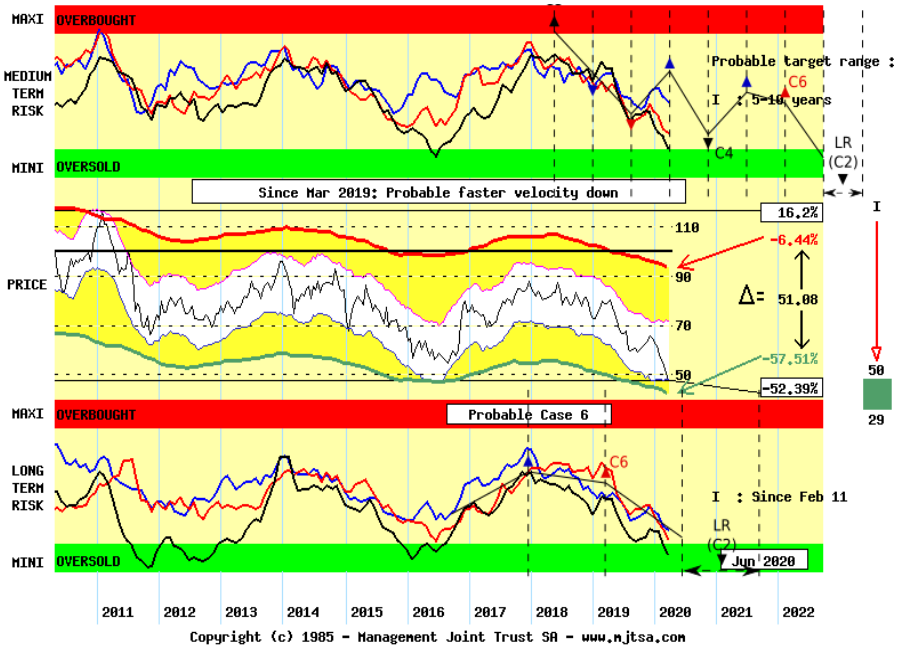
Oil prices are often the main driver of the medium term Inflation Expectations presented above. Similarly to their analysis, **we would probably favor a scenario where Oil continues its downtrend into midyear at least and probably even into late H2 2020 (as shown on our long term oscillators – lower rectangle). Our I Impulsive targets to the downside (right-hand scale) suggest that prices may reach down to 15 USD/barrel on Brent (perhaps even below on WTI)** Here also, we do leave the door open to a more positive scenario, where following a downside retest into late Q2, Oil prices manage to reverse up during the Summer.

US TIPs vs US Treasuries ratio
Bi-monthly graph or the perspective over the next 1 to 2 years



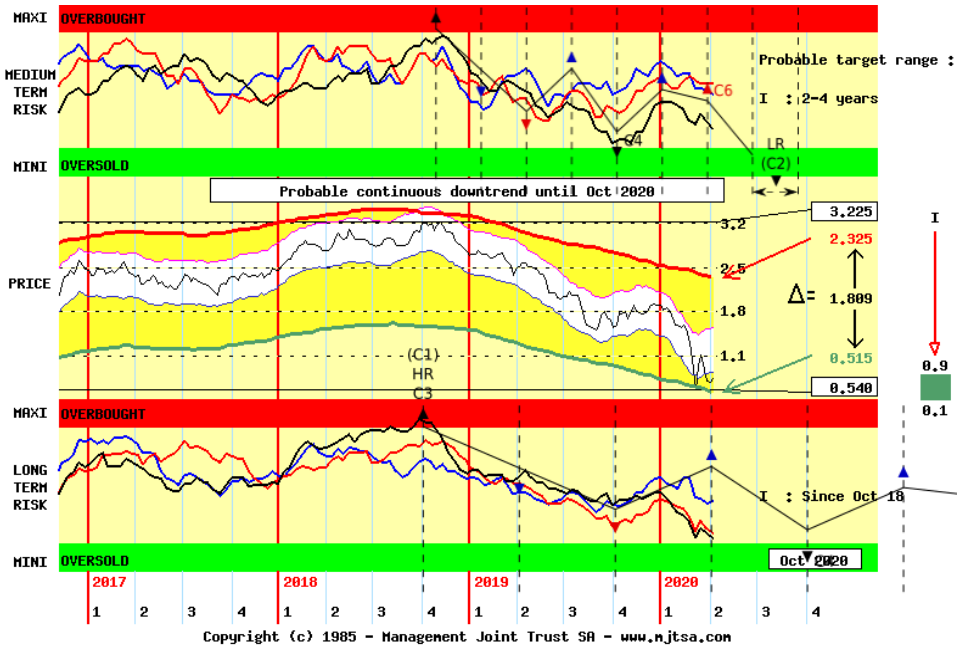
We now switch to our longer term bi-monthly graphs, which seem to confirm further downside risk for inflationary/deflationary ratios into late this year. Indeed, **US Inflation Expectations seem to have broken through long term support in March and according to both our oscillators (lower and upper rectangles) could continue to move lower into late this year. This would probably imply further downside pressure for Oil, which as we mentioned above is very much related to this breakeven ratio, as well as to the fate of most Cyclical themes (vs Growth or Defensive ones)**. On the target front (right-hand scale), the downside potential may not lead us much lower than the lows made in March, but would suggest that these will probably be retested at least between now and year-end.

Copper to Gold ratio
Bi-monthly graph or the perspective over the next 1 to 2 years



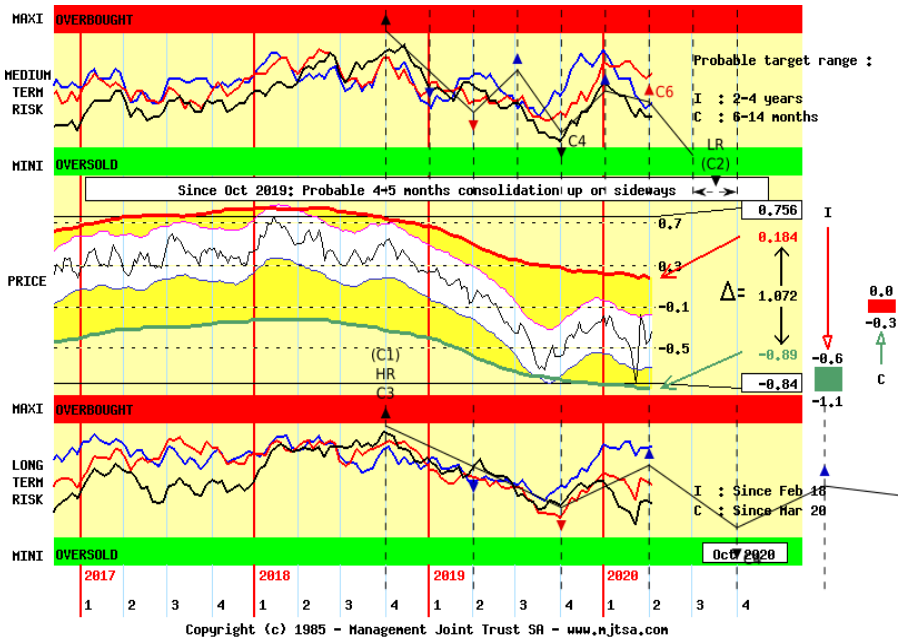
Another Inflation/Deflation ratio which captures cyclicity is the Copper to Gold ratio. On this bi-monthly graph, both oscillator series (lower and upper rectangles) are suggesting that **the ratio probably remains under downside pressure into late this year. Our I Impulsive targets to the downside (right-hand scale) are pointing to possibly 20% more downside risk for the ratio over the next few quarters. This does not bode well for a durable pickup in cyclicity, at least not until late this year.**

US 10 Year Treasury Yield
Weekly graph or the perspective over the next 2 to 4 quarters



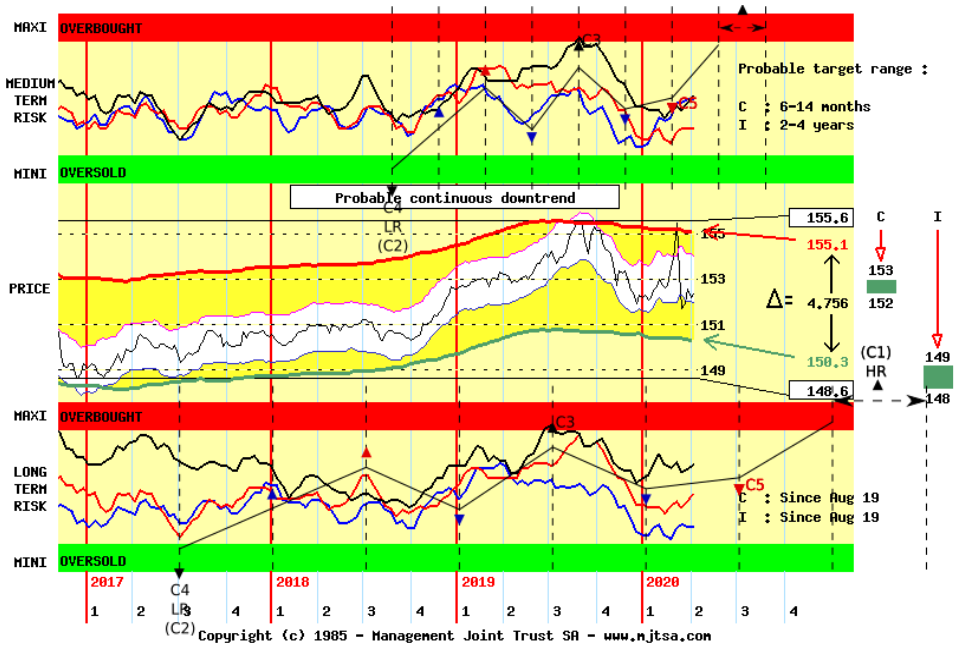
Having considered the various portions of the US yield curve as well as Inflation Expectations, Oil, or the Copper to Gold ratio, we conclude that cyclicity will probably remain weak into midyear at least (which seems rather obvious given the current economic disruption), but perhaps even until late this year when considering our bi-monthly graphs. In the meantime, we would probably expect a Summer bounce which may materialize from late Q2 into July/August. We transpose this scenario on the US10Y Treasury yield and it does seem to fit quite well. Indeed, **on our medium term oscillators (upper rectangle), we would expect an intermediate Low Risk position from late Q2 (which could justify a Summer bounce), while on our long term ones (lower rectangle), the current downtrend sequence seems to extend lower into October (suggesting a possible downside retest during the Fall). Our I Impulsive targets to the downside (right-hand scale) would point to further risk, probably towards 0.2% over the next few quarters.**

10 Year German Bund Yields
Weekly graph or the perspective over the next 2 to 4 quarters



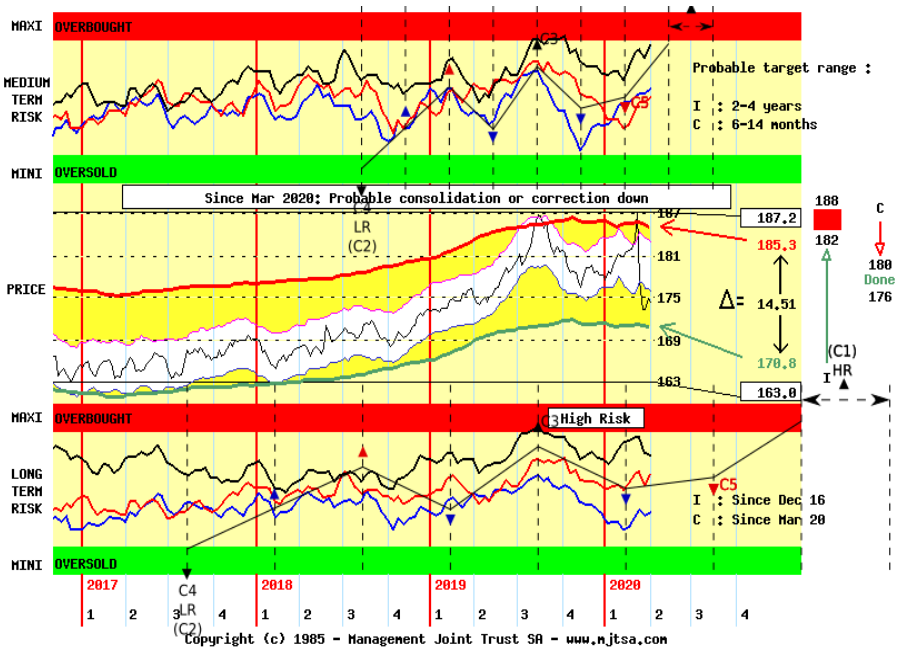
In Europe, on the German 10Y Bund yield, we would consider a similar scenario with **our medium term oscillators (upper rectangle) reaching a Low Risk position towards midyear (triggering a potential Summer bounce), while our long term ones (lower rectangle) do seem to extend lower into late Q3 / early Q4. Our I Impulsive targets to the downside (right-hand scale) are still pointing to lower levels and to a possible retest of last Summer's lows, somewhere in the -0.6 to -1.1% range**. Note: in order to turn move positive, the 10Y German Bund yield would need to break above 0% as suggested by our C Corrective targets to the upside. We believe this is rather unlikely over the next few months given our cross-asset scenario.

10Y Japanese Government Bonds 3M Futures (June)
Weekly graph or the perspective over the next 2 to 4 quarters



We now switch to the two most defensive government bond markets, i.e. the Japanese and the Swiss ones. The March sell-off is historic in terms of scope given the short term time frame in which it materialized. This highlights the acute deleveraging pressures that were then rocking through financial markets. **This sell-off however did find support towards the lower end of our C Corrective targets to the downside (right-hand scale) and we now believe that these levels could continue to provide strong support going forward and a strong base for JGBs to resume their long term uptrend. Over the next few quarters, we would expect JGBs to first rise again into late Q2 / midyear as shown on our medium term oscillators (upper rectangle) and then probably continue higher into next year (lower rectangle).**

10Y Swiss Government Bond 3M Futures (June)
Weekly graph or the perspective over the next 2 to 4 quarters



Swiss Conf Futures saw a similar drop-off in March and pretty much also found support towards the lower end of our C Corrective targets to the downside (right-hand scale). **We now expect them to resume their uptrend into midyear on our medium term oscillators (upper rectangle) and then possibly once again from late Summer into next year.** We hence believe that all major benchmark bond yields could remain under downside pressure into late Q2, and then, following a Summer bounce, perhaps even towards the Fall and eventually next year.

Concluding remarks

We've considered the various portions of the US yield curve, inflation expectations, oil, other inflationary/deflationary ratios such as Copper/Gold as well as Government Benchmark Bond yields in the US, Germany, Japan or Switzerland. All seem to point to further downside pressure on yields from late April into late May / June. In the US, we expect all tenures from the US3M to the US10Y to converge down towards 0% and hence the whole front of the US yield curve should flatten out. The US30Y-US10Y spread on the other hand may rise, yet, we believe it is following opposite dynamics, as it is more influenced by more longer term inflationary trends. Hence the US30Y yield may drop, yet more slowly than the US10Y one. Fundamentally, we believe this weakness we expect on yields has 2 main underlying factors. The first one is related to the huge uncertainty around the actual damages the lock-down is inflicting to the various economies. The second is driven by the FED's likely intention to keep yields under downside pressure until the economic situation and credit markets stabilize ("unlimited QE"). From late Q2, we could then envisage a Summer bounce in yields, yet following that, long term graphs on ratios such as US TIPs vs Treasuries or Copper/Gold do seem to point to a downside retest into Q4.

47 / Gold uptrend carries on. Gold continues to be a primary defensive asset even after the COVID-19 crisis blows over: US and global growth slows, and inflation is stoked by tremendous amount of global money supply

The last time we discussed the role of Gold as a defensive asset was in the March 2020 issue of Capital Observer. This is what we said then:

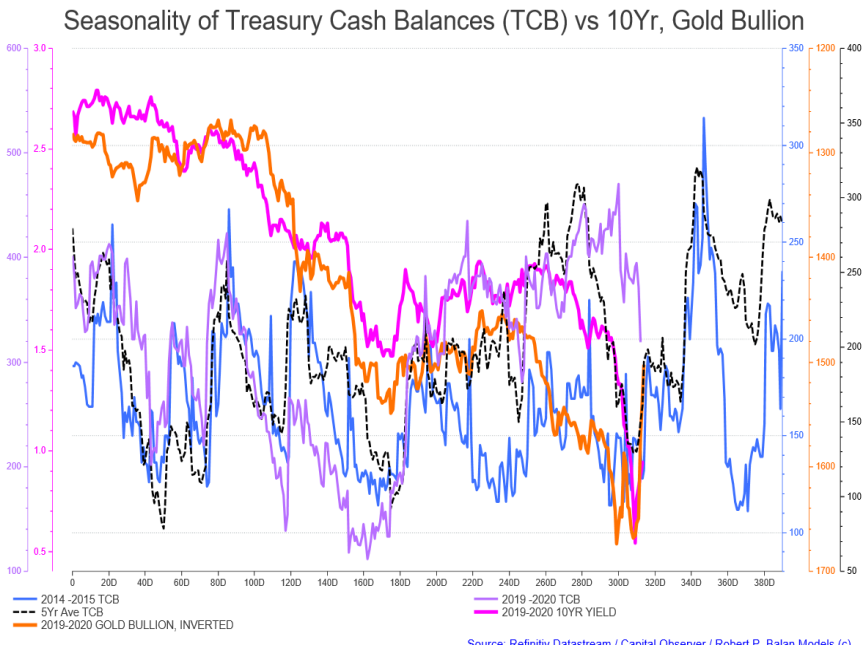
There was no question the gold market has seen heavy inflows recently, thanks to investors wanting to hedge portfolio risk against the negative impact of coronavirus and the oil market bust. The rise of gold was in perfect rhyme with the 10yr yield's plunge to near-zero pct. Spot Gold started a sharp rise from circa 1460 at year end to 1680 on March 9.

There has always been a good inverse correlation between Gold and the 10yr yield (see 1st graph on this page), and this in a sense is how bonds and gold become "defensive assets" in a tight partnership, e.g. rising bond and rising gold prices go together, and its true for the opposite direction, as well.

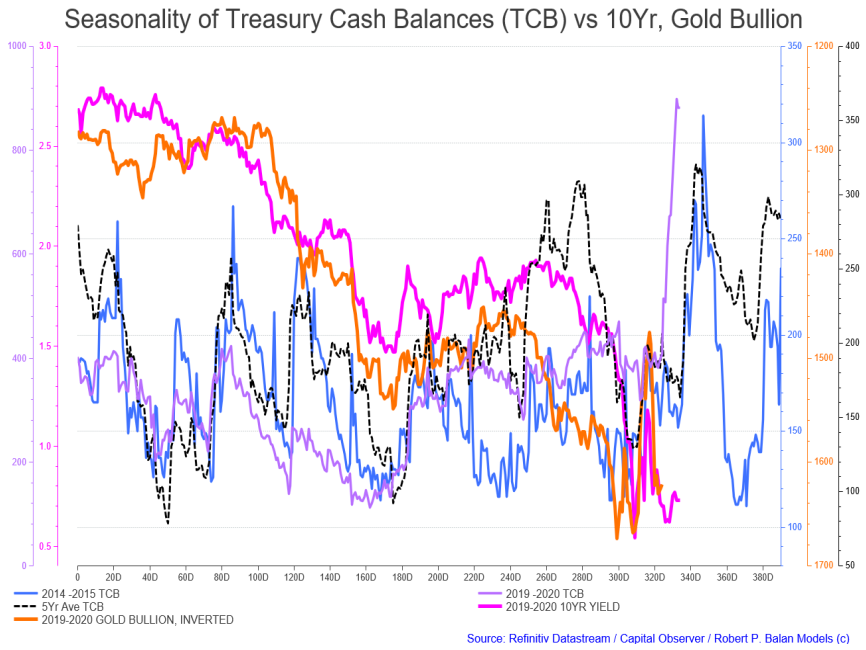
The amount of monetary resources the Fed and the government of Mr. Donald Trump have unleashed to ameliorate the negative impact of the COVID-19 virus epidemic has indeed taken some of sheen from these defensive assets. But bond yields fell again after further stimulus measures were announced by the Fed to help the high yield sector of the bond market, prompting gold to soar to new highs at circa 1750 area this week.

However, bond yields are expected to rise further out, until late April-early May time frame, as liquidity inflows abound on a seasonal basis, on top of the stimulus coming from the Federal Reserve and the US Treasury (*see 2nd graph on this page*). That has pushed the Treasury Cash Balance (TCB) to a historic high of $899 billion, as the US Treasury prepares to fund the stimulus programs mandated by the US Congress and signed into law by President Donald Trump (*see 2nd graph on this page and 1st on the next page*).

Original chart in the March 2020 edition of The Capital Observer



This is how the chart shown above looks now

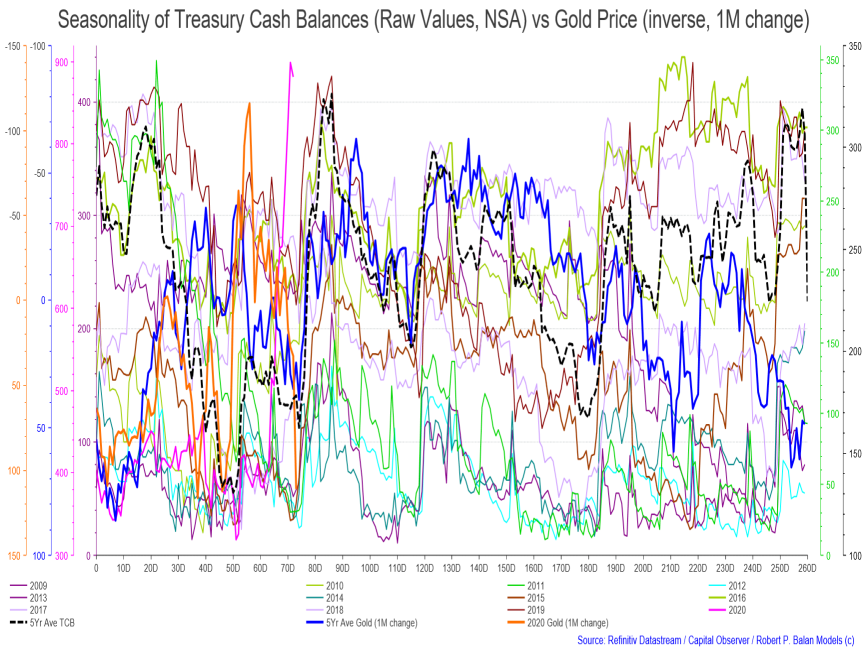


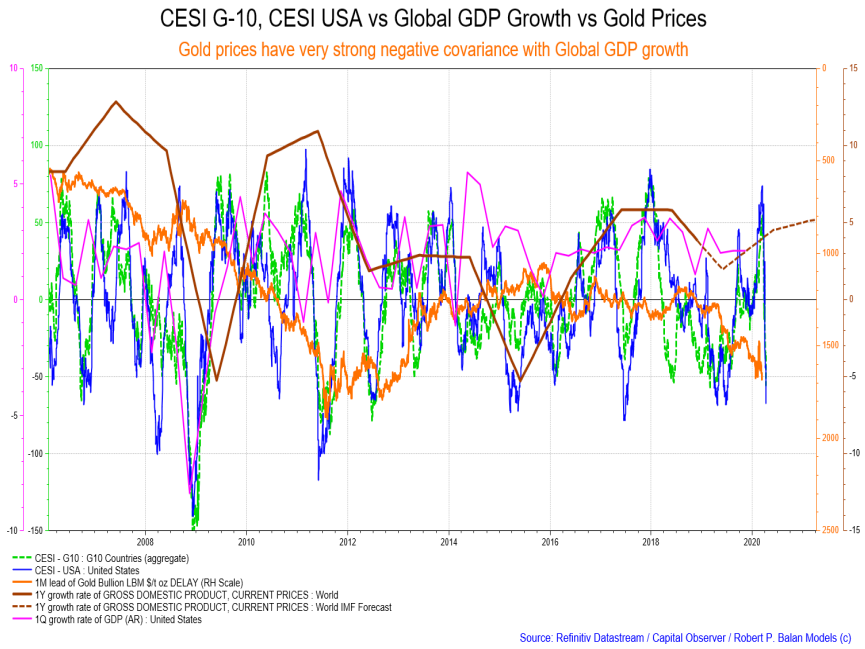
There is a historic inverse (lagged) relationship between the TCB and gold prices. This new TCB build-up to new historic highs could start undercutting some Gold support for the rise in prices within the next few days (*yellow line, see 1st graph on this page)*

To the extent that investors' sentiment has improved due to these amelioratory program, could bring some headwinds to Gold prices in the short term. **But this should not detract from the longer-term utility of Gold as a safe haven asset, with its immense relative price strength versus other major assets in the face of global economic uncertainty.**

Even with the risk of temporary weakness on account, the metal's dominant intermediate-term rising trend should be restored as US and global growth falters – there is strong inverse correlation between US and global GDP growth and the price of gold, with a slight time lag (*see 2nd graph on this page*). **Put another way, if US and global growth dies during Q2 and Q3 2020 (as we expect), then there is tremendous potential for Gold to outperform at that time**. We discussed the growth outlook for the US for the rest of the year in another article in this issue of The Capital Observer.

After the COVID-19 pandemic struck with full force, Gold has seen its biggest demand since the 2008 credit crisis. Gold, unlike people and the global economies, is immune to the virus. It is the currency of last resort and avoids the concern that paper currencies could be a medium of transfer for the virus. **At this stage of the pandemic scare, Gold has outperformed other safe haven assets like the Japanese Yen or Swiss Franc. That outperformance continues today. That's a trend we expect to see as long as uncertainty around the full impact of COVID-19 on the global economy remains.**





Even if the pandemic eases in the coming weeks, economic shocks and supply-chain disruptions related to it will likely linger for months to come, thus ensuring gold's enduring safety bid. **But it's also likely that after a brief pullback and period of consolidation, gold will benefit from the latest emergency steps taken by the world's leading nations to forestall a global recession which added significantly to the global money supply.** The threat of inflationary condition being stoked by the almost unimaginable amount of money thrown into global economy has become highly likely to happen.

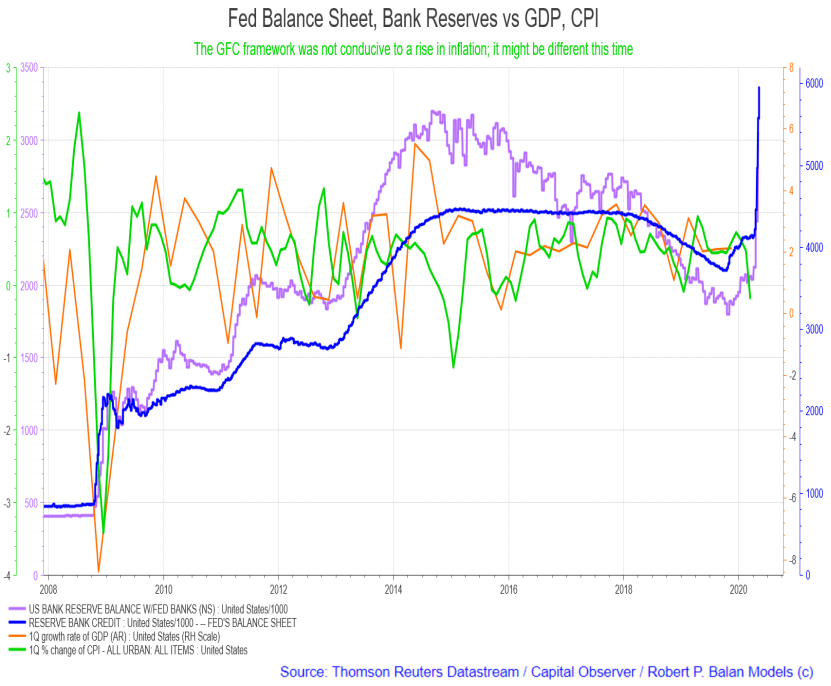
Nonetheless, it is valid to ask why inflation should become an issue during the current QE stimulus by global central banks, when it has not been a problem after the large-scale asset purchases of the central banks after the Great Financial Crisis of 2008. Large-scale money printing was done during the GFC, but it did not stoke inflation. **Why would inflation become a threat this time around? Why then would it be different this time? Simple answer: the GFC was different; the situational framework during the GFC was not conducive to a rise in inflation. This time is NOT different;**

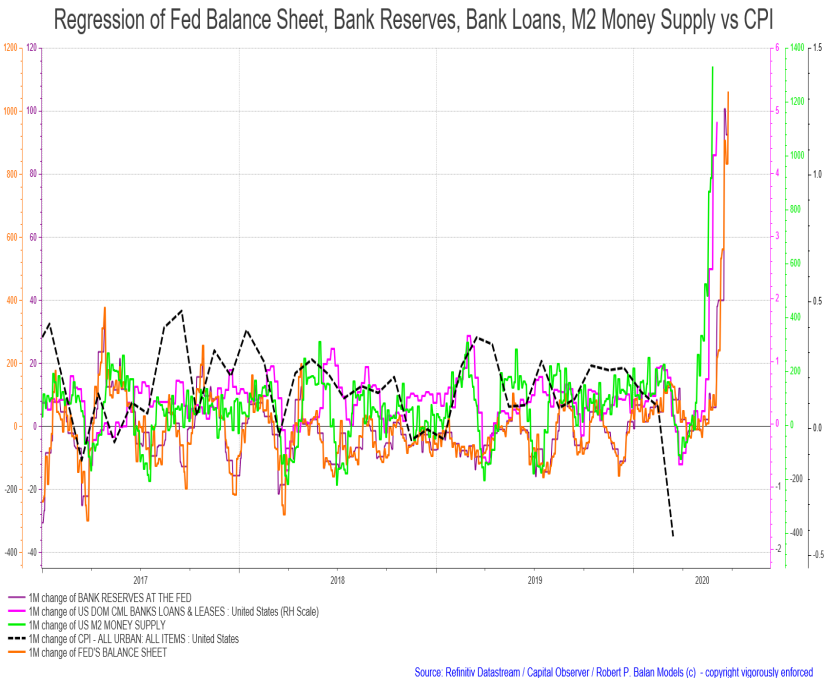
the conditions this time were similar to other times when too much money supply ignited inflationary tendencies. The situational framework during the current crisis is conducive to a rise in inflation. *(see 1st chart on this page)*

There were some really unique circumstances about the GFC crisis which tempered inflation. **The Global Financial Crisis, as the name suggests, was a financial crisis. The crisis began, ended, and ran through the banks and shadow banking system which was over-levered and undercapitalized**. The housing crisis, and the garden-variety recession it may have brought in normal times, was the precipitating factor. The other contributing factors to this huge fail (the fall of Bear Stearns and Lehman, IndyMac, and WaMu, and the near-misses by AIG, Fannie Mae, Freddie Mac, Merrill, Goldman, Morgan Stanley, RBS) were all tied to high leverage, low capital, and a fragile financial infrastructure. **The subsequent reaction function of Congress, the Federal Administration, and especially the Federal Reserve were targeted largely to shoring up the banks and fixing the plumbing. And it worked.**

Moreover, the Federal Reserve took an unusual step early on and started paying Interest on Excess Reserves (IOER). With this step, the Fed was essentially paying banks to not lend, essentially. Sure enough, the Fed was creating huge amount of money ex nihilo by merely executing computer keystrokes. But the effect of the IOER was akin to the Fed shipping boxes of money to the banks and saying "we will pay you not to open these boxes".

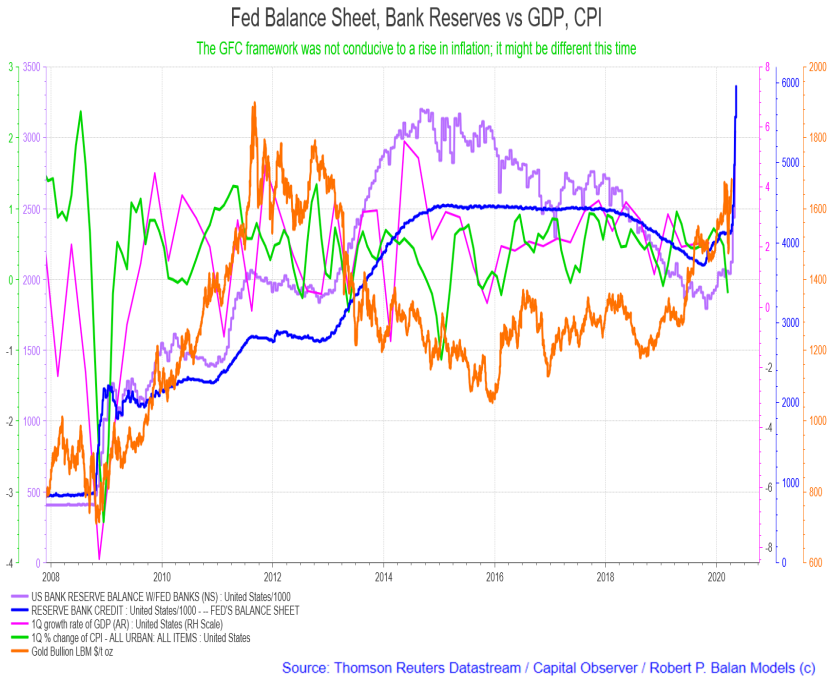
The capital and liquidity constrained financial institutions took the line of least resistance, as it made more sense from them to take the riskless return from IOER instead of lending at the back of those bank reserves and taking on more risk. **So therefore, M2 Money Supply never grew faster than 10% despite a massive increase in the Fed's balance sheets (essentially, the Monetary Base). That is not the case today. The Fed's balance sheet is exploding, the banks are lending freely, and the M2 Money Supply is likewise exploding. It is likely that the CPI will rise sharply as well as a lagged consequence** (see 2nd graph above).





Here is the situational difference between the COVID-19 crisis and the GFC: instead of incentivizing banks to cling to their reserves, this time around the Fed is actively using moral suasion to push banks to make loans – and indeed they have done so with gusto. Also, the federal government is putting money directly in the hands of consumers and small businesses. The banking system is working as intended (which was not the case during the GFC). That's the part that's not at all different this time from the other times that inflation was stoked by infusion of large amount of money into the system in a rapid pace. This time, inflation will be a significant issue further out. If high inflation rears up its head as we expect, Gold will outperform. The combination of slow global growth and tremendous amount of money supply

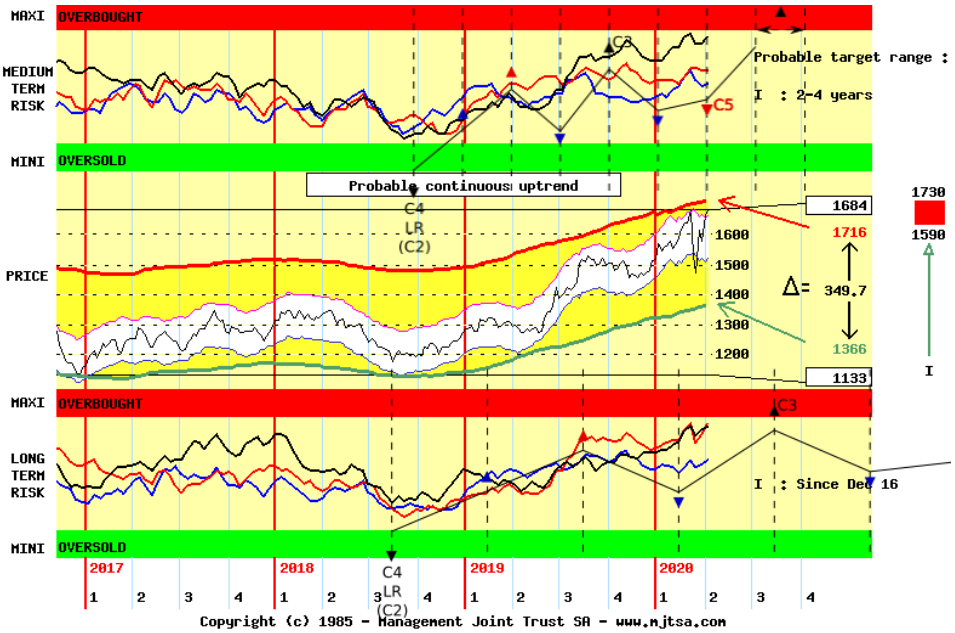
sloshing within the system (generating inflationary pressures) will be fantastic for gold further out (*see 1st graph on this page*).



51 / MJT - TIMING AND TACTICAL INSIGHT
Defensive assets should benefit from a period of residual risks

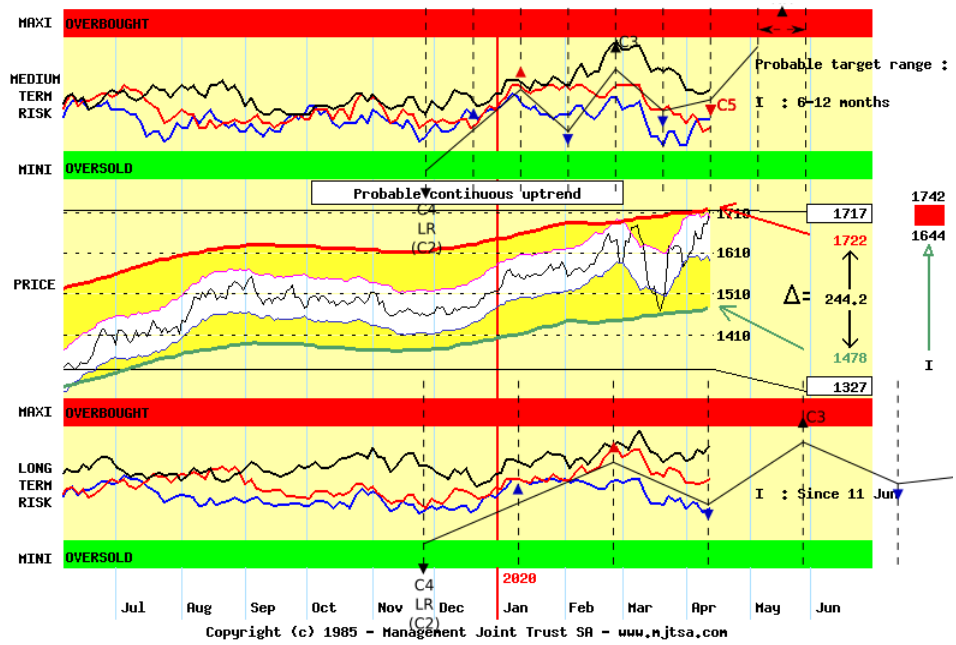
Acute periods of risk as we experienced in March are bad for all assets because of the massive deleveraging they provoke. Periods of residual risk however usually benefit defensive assets while risk assets retest down. These are usually accompanied by strong monetary accommodation as is the case today, or was the case for example from late 2008 into 2012 or during H1 2016. As mentioned in another article of this issue of The Capital Observer, we expect a new risk-off period to materialize during May, perhaps into June, Defensive assets will certainly outperform, yet will they perform on an absolute basis? A lot will depend on how deep and broad this new period of downside retest is and if it is likely to trigger some widespread deleveraging once again. In this article we review defensive assets on both an absolute and relative basis in order to evaluate the likelihood and opportunity of a period of residual risk vs the more damaging one of a renewed period of cross asset deleveraging.

Gold Spot (USD/oz)
Weekly graph or the perspective over the next 2 to 4 quarters



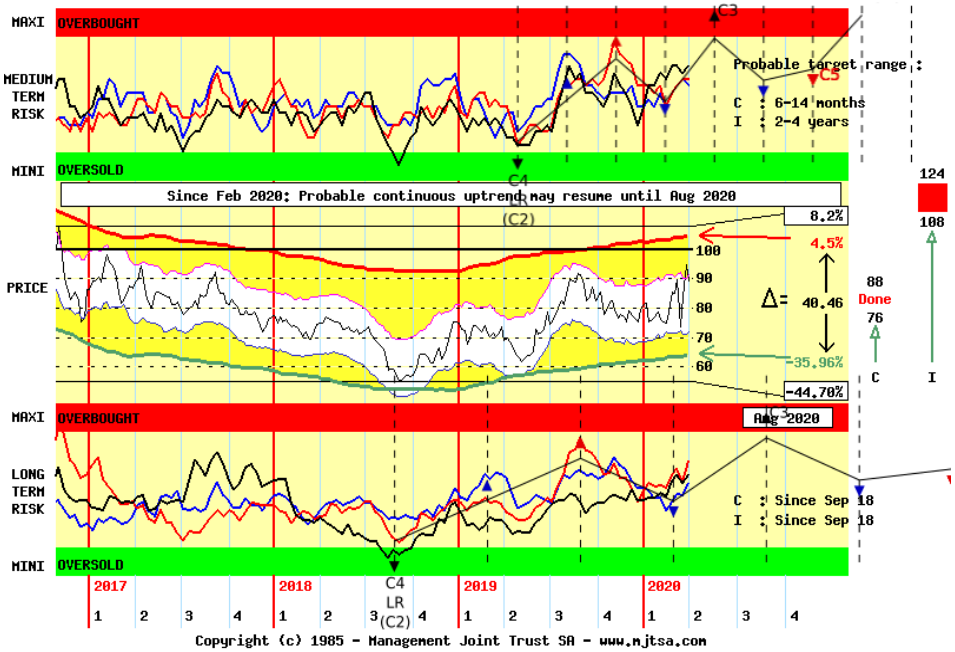
Following its brief, yet strong sell-off in March, Gold is currently making new highs for this cycle. Both our oscillator series (lower and upper rectangles) suggest **that this uptrend, probably continues into midyear, possibly into the Summer.** The potential shown by **our I Impulsive targets to the upside may seem pretty much exhausted (right-hand scale), yet as mentioned in the February issue of The Capital Observer, our bi-monthly graph (not shown here) is still pointing toward 2'000 as a possible upside target.**

Gold Spot (USD/oz)
Daily graph or the perspective over the next 2 to 3 months



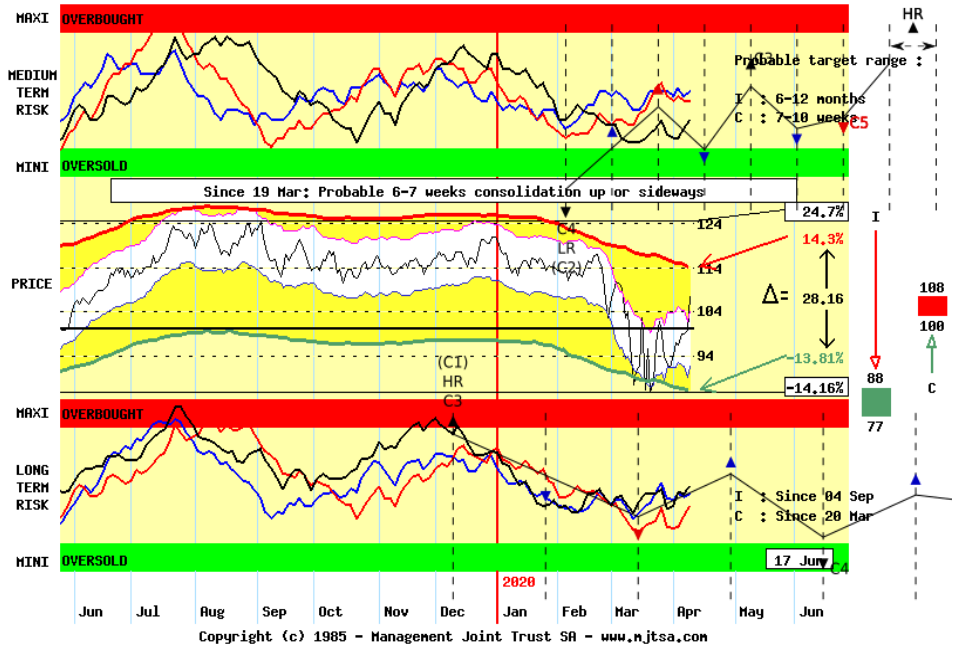
On a Daily basis, Gold is breaking out to the upside. Our oscillator series (lower and upper rectangles) would support this acceleration as they are both in **resume uptrend situations which extend into mid/late May at least**. Here again, our I Impulsive targets to the upside are pretty much exhausted (right-hand scale). If we were to **calculate our I2 Impulsive 2 extended targets to the upside, they would point to the 1'889 and 1'986 range** (or 2.3 to 2.7 times our historical volatility measure "Delta", here at 244.2 – middle rectangle, right-hand side – added to the lowest point of the graph at 1'327 USD/oz). We would consider these targets as achievable over the next few months.

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



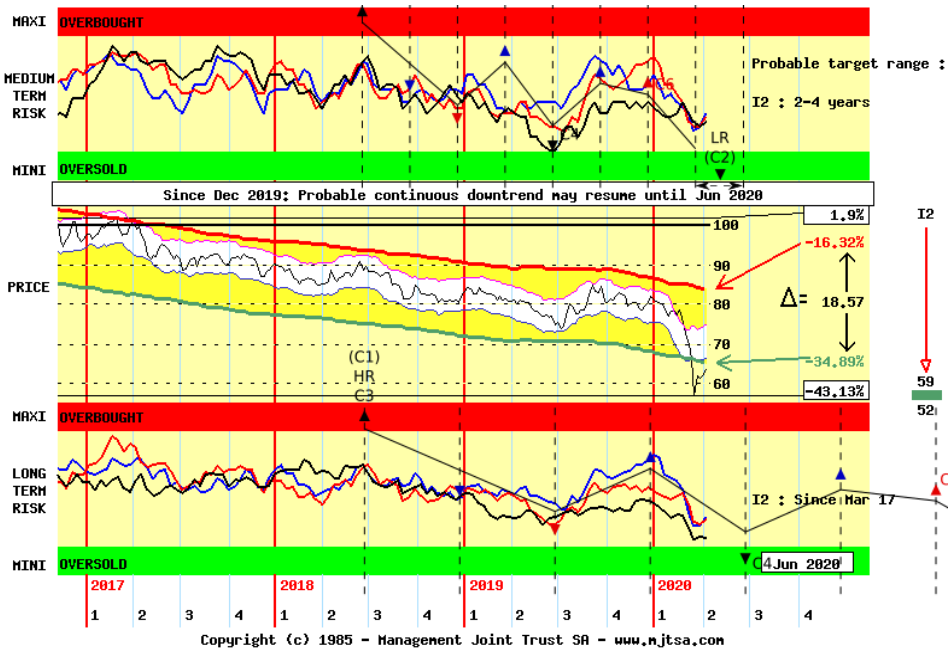
Goldmines (GDX ETF) are also looking strong, especially when compared to the S&P500 Index on a relative basis. Both oscillator series are also pointing to **a period of re-acceleration to the upside which extends into May on our medium term ones (upper rectangle) and towards the Summer on our long term ones (lower rectangle). Our I Impulsive targets to the upside (right-hand scale) are pointing to 20 to 30% of outperformance potential over the next few months.**

Goldmines vs Gold
Daily graph or the perspective over the next 2 to 3 months



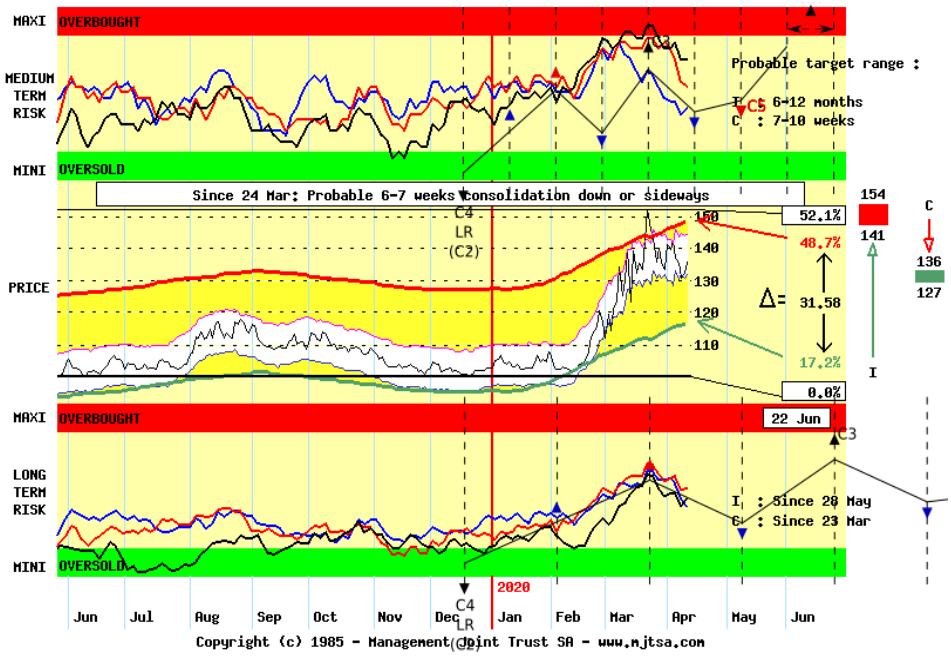
Vs Gold, Goldmines (GDX ETF) are usually more cyclical. Hence the ratio usually rises and falls with risk assets. According to the sequences we show on both oscillator series (lower and upper rectangles), **we would expect the recent outperformance of Goldmines to stall towards late April / early May. Goldmines could then underperform Gold again into early/mid June**. Will the ratio eventually make new lows? The answer probably depends on how strong the outperformance of Goldmines vs Golds is over the next couple of weeks. If the ratio manages to break clearly above our C Corrective targets to the upside (right-hand scale), then the retracement down during May will probably be a corrective one and will probably not make new lows. If however, the ratio stalls around current levels (i.e. if it cannot break above its 108 resistance on this graph), then the downtrend is theoretically still in place and the ratio will then probably retest its March lows.

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



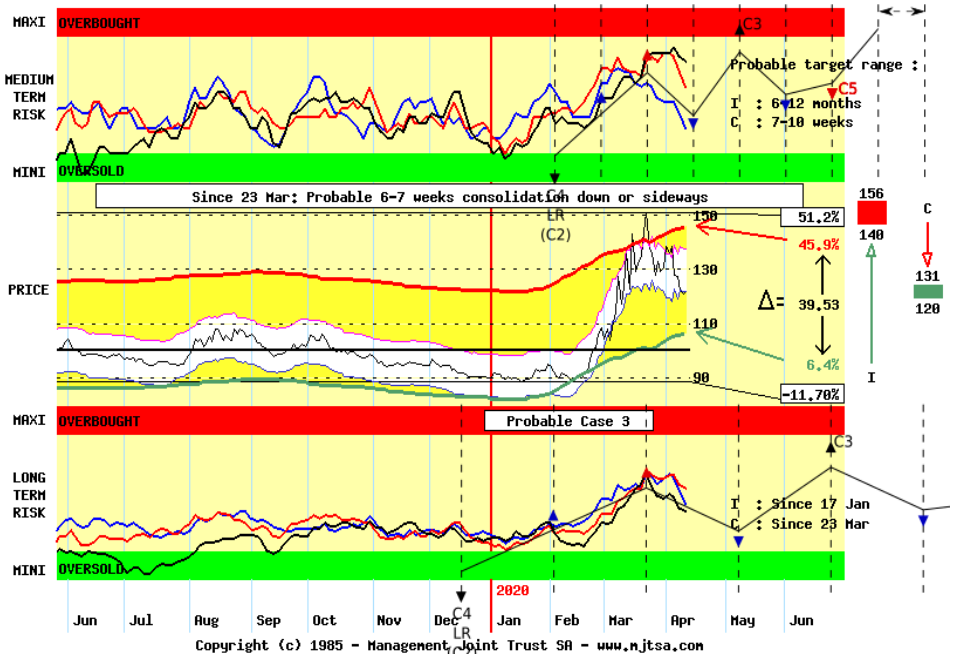
Similarly, Silver usually outperforms Gold when Gold is rising, risk assets are rising and when monetary policy is very accommodative. This may be the case short term, perhaps over the next week or so. **Yet, the ratio could then suffer a downside retest while risk assets retest down during May and perhaps even into June**. Following that, both oscillator series (lower and upper rectangles) would suggest that **a more significant bounce materializes on the Silver to Gold ratio from June into the Summer**. In the meantime, however, our I2 Impulsive 2 extended targets to the downside (right-hand scale) indicate that the ratio could make marginal new lows towards late Q2.

Gold Spot (USD/oz) vs the S&P500 Index ratio
Daily graph or the perspective over the next 2 to 3 months



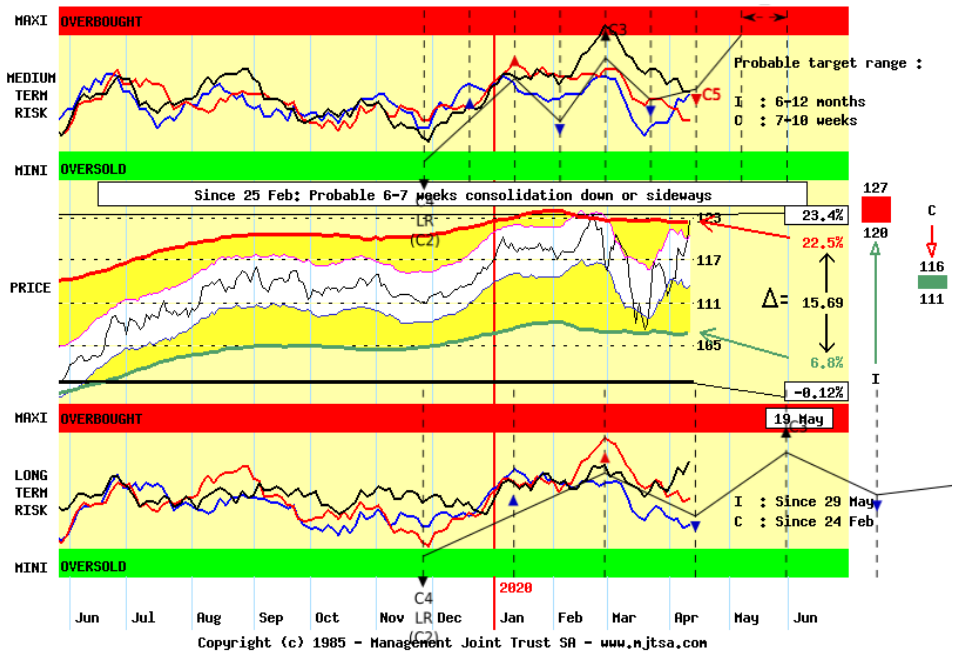
Following its correction down from the 4th week of March, the Gold to the S&P500 ratio is currently attempting to resume its uptrend. We believe this new leg up should be confirmed over the next couple of weeks as the rebound on equity markets dies out and Gold continues to accelerate up into late May at least. Our I Impulsive targets to the upside suggest **that the ratio could reach to between 10 and 20% above current levels by then (right-hand scale).**

30Y Treasury 3M Futures (June) vs the Mini S&P 500 3M Futures (June)
Daily graph or the perspective over the next 2 to 3 months



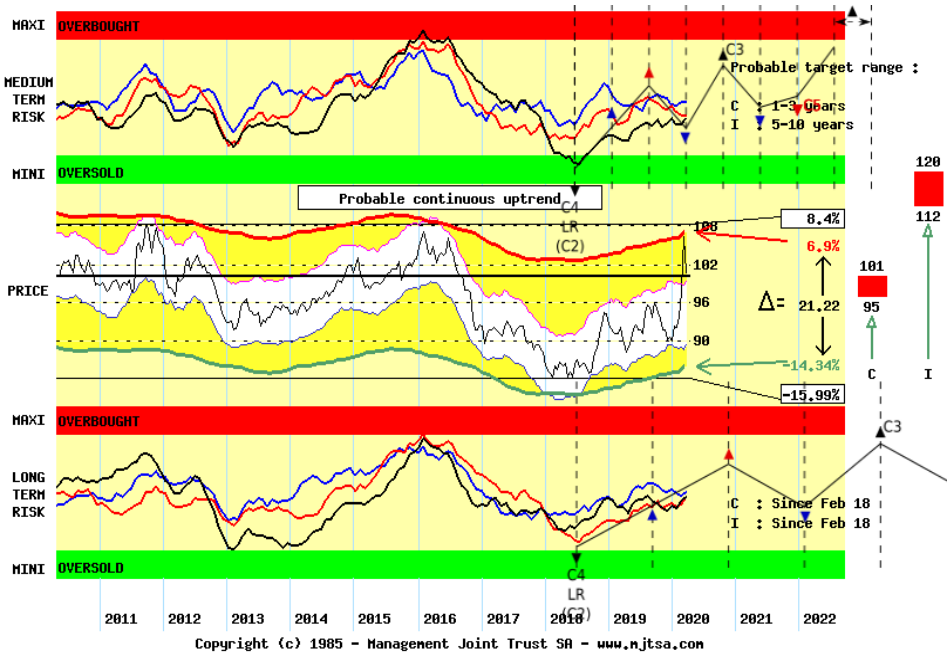
Long term US Treasuries (30Y Futures) are showing a similar profile vs the S&P500 although they **are finding it more difficult than Gold to reaccelerate up vs equities. Nevertheless, we believe this should also be the case by late April / early May at the latest** according to both our oscillator series (lower and upper rectangles). 30Y Treasury Futures **could then also outperform the S&P500 Index by 10 to 20% into late May / June** according to our I Impulsive targets to the upside (right-hand scale).

Gold vs the 10Y Treasury Note 3M Futures (June)
Daily graph or the perspective over the next 2 to 3 months



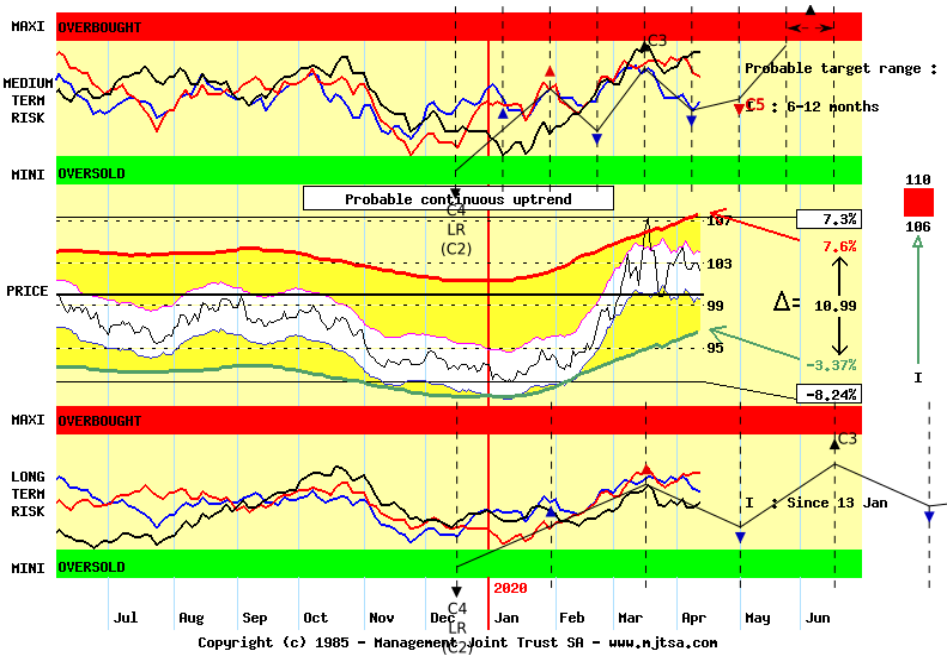
We now compare both defensive assets, Gold vs 10Y Treasuries. **Gold does seem to have the upper hand here and according to both our oscillator series (lower and upper rectangles) should continue to outperform into mid/late May at least.** Our I Impulsive targets to the upside (right-hand scale) are pointing to 2 to 5% of upside potential over the next couple of months and hence to **new year-to-date highs for the ratio during May.** Note: the performance differential we expect between these two defensive assets over the next couple of months is actually not that compelling and as mentioned above both could widely outperform risk assets over the period.

European Defensive sectors vs the Europe Stoxx 600 Index
Bi-monthly graph or the perspective over the next 1 to 2 years



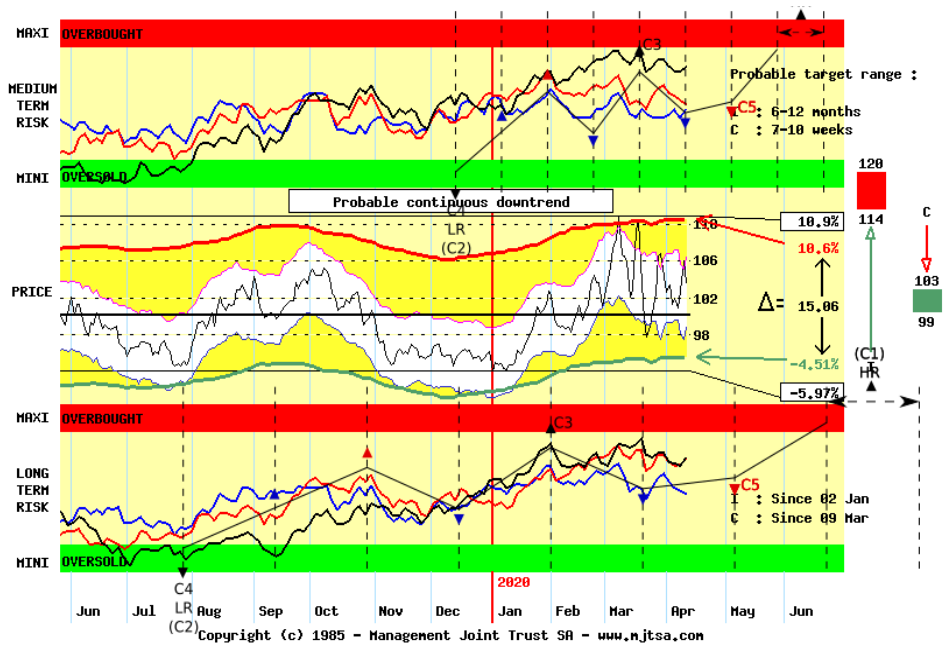
We now shift to equities and first consider defensive sectors in Europe vs the Europe Stoxx 600 index. Our equal weighted portfolio excludes Real Estate which may suffer from delinquencies over the next few months and includes European Healthcare (SXDP), Food & Beverage (SX3P), Telecoms (SXKP) and Utilities (SX6P). **Its ratio vs the Europe Stoxx 600 still appears very strong on this bi-monthly graph, probably into late this year according to both our oscillator series (lower and upper rectangles). The ratio did break above our C Corrective targets to the upside in March (right-hand scale), which could justify between 10 and 15% of further outperformances for European Defensive sectors vs their reference index over the next couple of quarters**. Such defensive strength does not necessarily imply falling equity markets but does point to a rather defensive environment fraught with residual risk and usually accompanied by lower interest rates (i.e. a rather disinflationary environment).

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



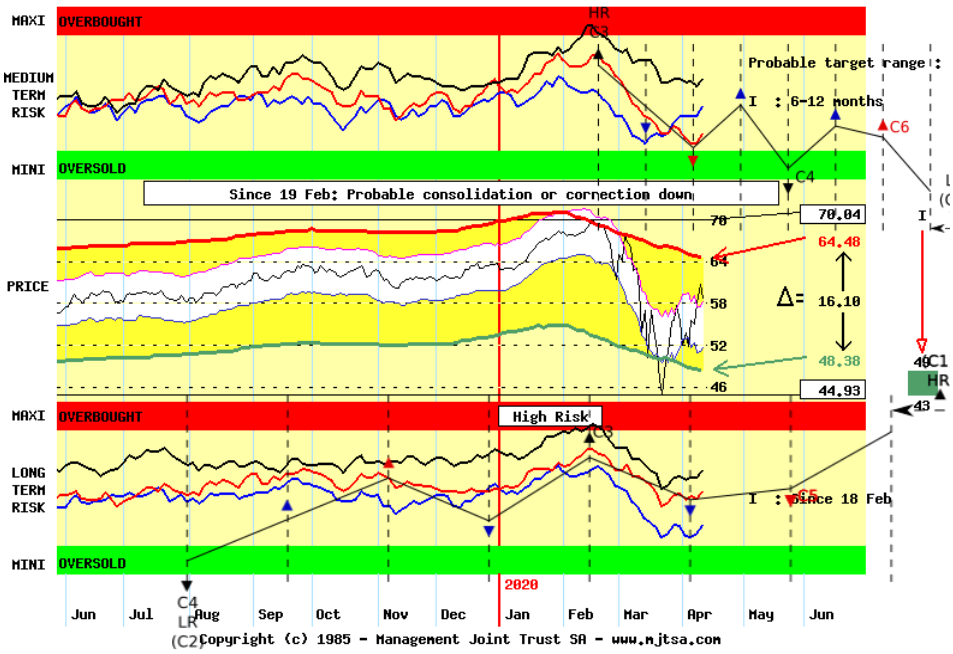
In the US, we consider a similar portfolio which excludes Real Estate but includes Healthcare (XLV ETF), Staples (XLP ETF), Utilities (XLU ETF) and Telecoms (XTC Arca Index) on an equal weighted basis and compare it to the S&P500 Index on a Daily basis. **The ratio made an intermediate top mid March, has since been consolidating at high levels, and according to both our oscillator series (lower and upper rectangles) could soon resume its uptrend, between now and late April, possibly towards late May / June**. Our I Impulsive targets to the upside suggest that **it could outperform the S&P500 Index by 3 to 8% over the next couple of months**. Again, this spells quite a defensive environment into June.

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



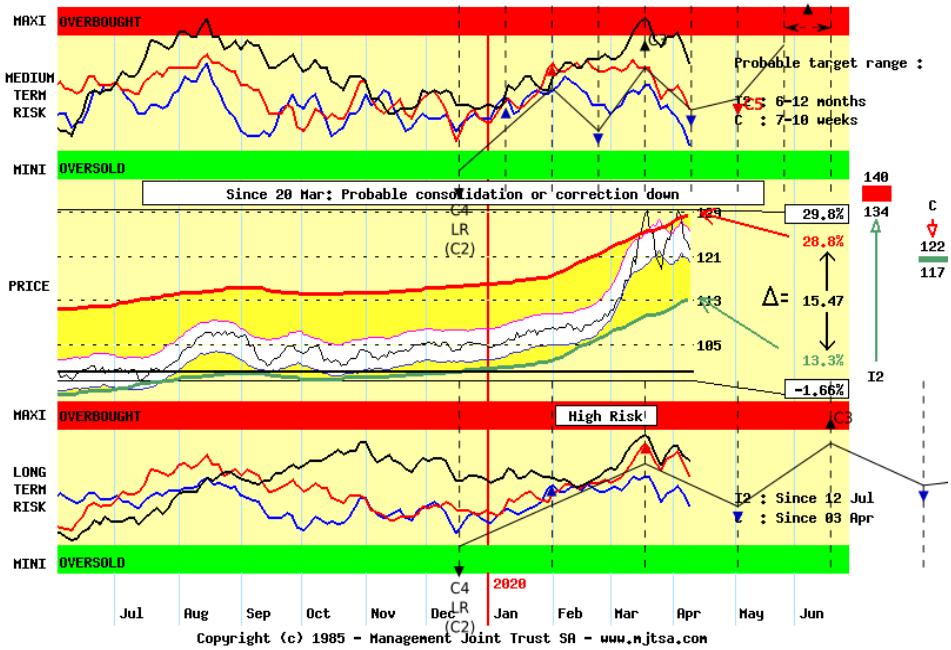
We consider US Utilities (XLU ETF) as an example of one of the sectors we particularly like into late May on a relative basis vs the S&P500. **The ratio is currently in a high level consolidation which, according to both our oscillator series (lower and upper rectangles), should resume its uptrend from late April into late May, perhaps even June. Our I Impulsive targets to the upside (right-hand scale) suggest that it could reach 7 to 13% above current levels by then**. Note: the fact that since mid March, the ratio has held above the lower end of our C Corrective targets to the downside (right-hand scale) is quite supportive of a continuation of its uptrend over the next couple months.

US Utilities
Daily graph or the perspective over the next 2 to 3 months



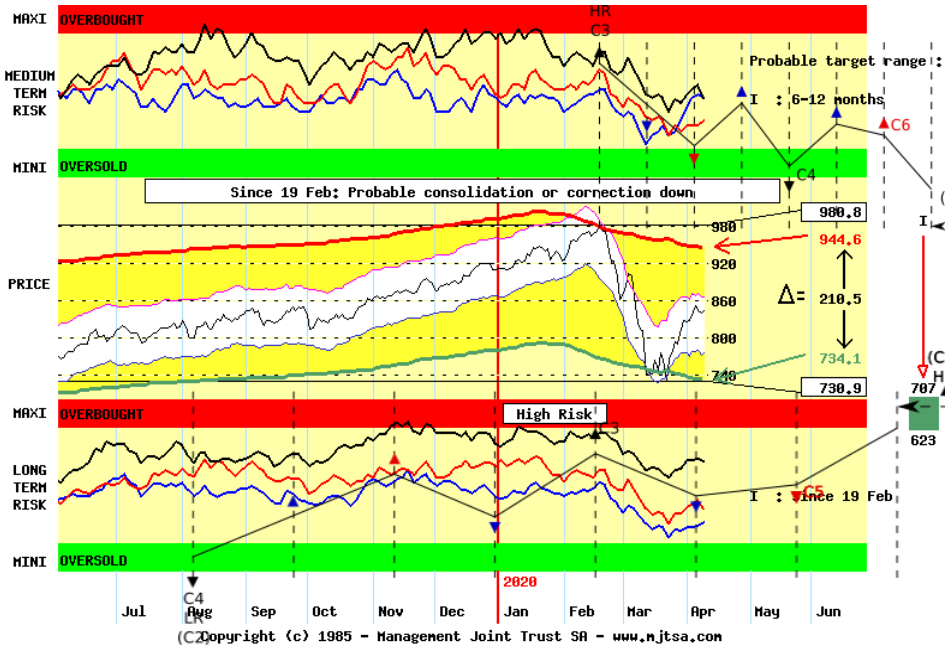
US Utilities on an absolute basis did suffer quite a strong sell-off in May (although less that other sectors due to their lower level of volatility). They have since been rebounding very dynamically. In fact, US Utilities have now broken back above the resistance of our C Corrective targets to the upside (not shown here, but we would calculate this resistance level as 0.8 times our historical volatility measure "Delta", here at 16.10 – middle rectangle, right-hand side – added the to the graphs lows at 44.93, i.e. at 57.8). Hence, **theoretically, from a targets perspective, US Utilities are back in an uptrend. In this context, we would favor the scenario we show on our long term oscillators (lower rectangle) where US Utilities retrace down into May, but without new lows, and then rise into the Summer** (rather than the more negative sequence we show on our medium term oscillators – upper rectangle).

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



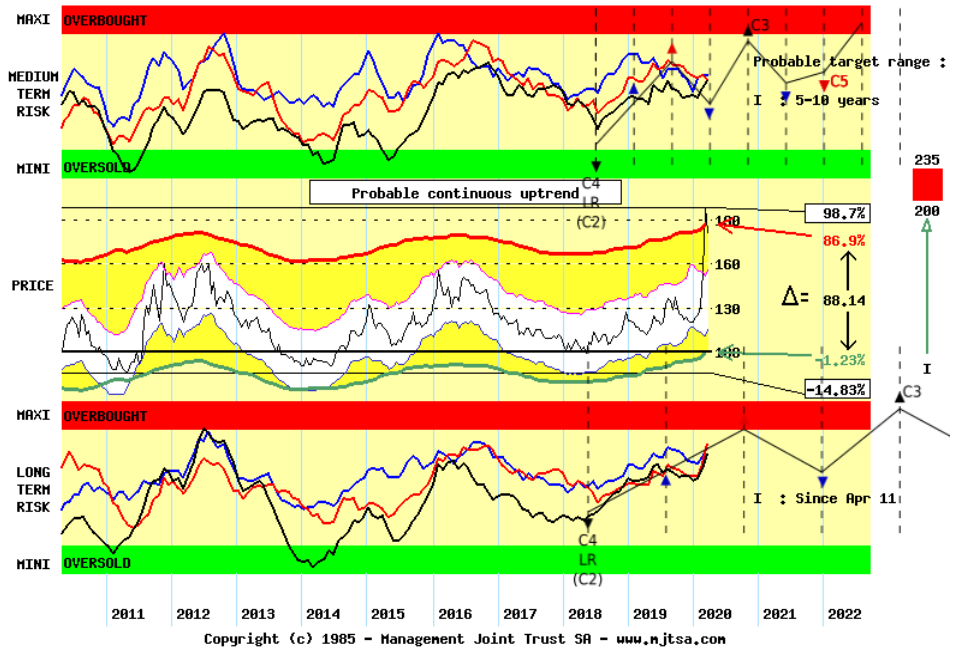
In Europe, we analyze European HealthCare (SXDP) vs the Europe Stoxx 600 Index. Both oscillator series (lower and upper rectangles) suggest **that the ratio made an intermediate top in March, and that it could soon resume its uptrend (between now and late April), probably towards late May and perhaps June. Our I2 Impulsive 2 extended targets to the upside are pointing to 10 to 20% of further outperformance for the sector until then.**

European HealthCare sector
Daily graph or the perspective over the next 2 to 3 months



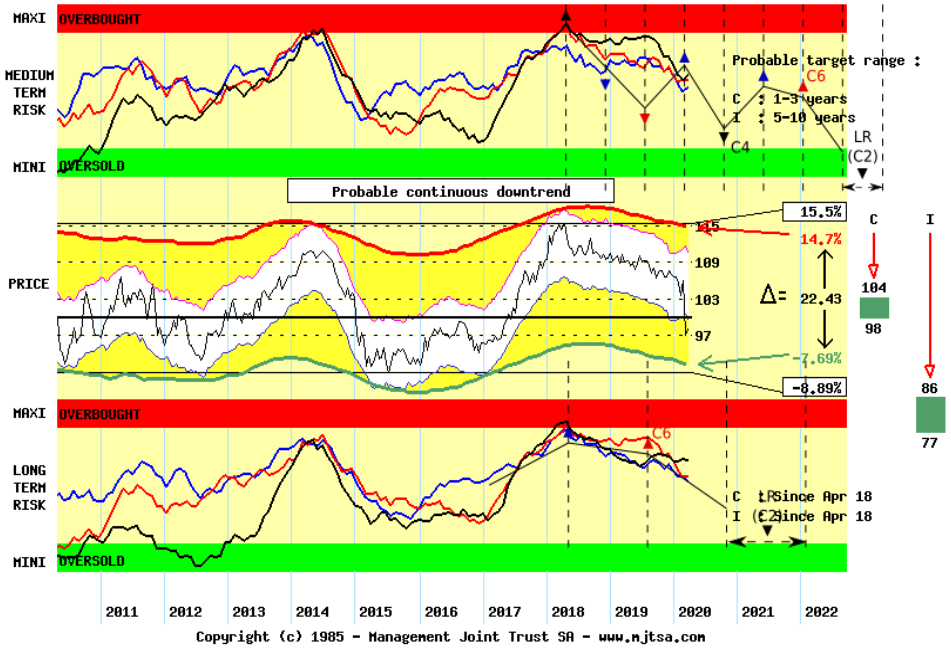
On an absolute basis, European Healthcare has also staged a nice rebound , yet **could soon meet strong resistance** towards the upper end of our C Corrective targets to the upside (not shown here, yet we can calculate this resistance as 0.8 times our historical volatility measure "delta", here at 210.5 – middle rectangle, right-hand side – added to the graph's lowest point at 730.9, i.e. at 899). This is still **2 to 3% above current levels. Then, from late April as shown on our medium term oscillators (upper rectangle), we expect European Healthcare to retrace down into mid/late May**. It could, but will not necessarily, make new lows as shown on our long term oscillators (lower rectangle).

20Y US Treasury Bonds ETF vs European Markets
Bi-Monthly graph or the perspective over the next 1 to 2 years



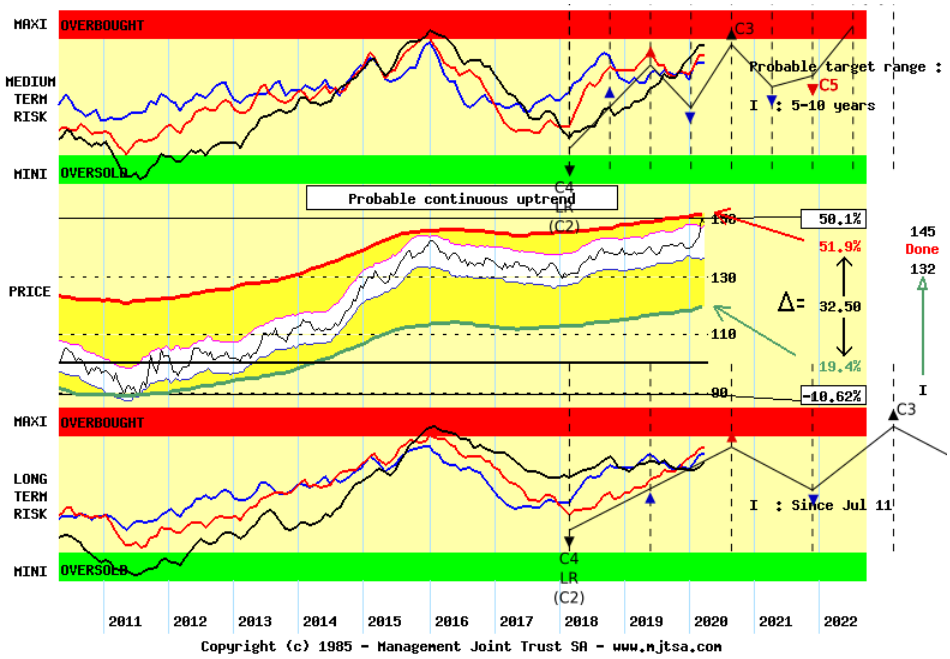
We now consider a long term cross asset graph that we already presented last month. It compares long term US Treasuries (TLT ETF) to European Equities (IEV). Both are denominated in US Dollars. The configurations on both oscillator series (lower and upper rectangles) resembles the ones presented on the long term graph of European Defensive sectors vs the Europe Stoxx 600 a few pages above. Similarly, they also suggest that **US Treasuries (a defensive asset) should outperform European markets (a more cyclical asset) into late this year. Upside potential as indicated by our I Impulsive targets to the upside could still be as high as 35%** (right-hand scale). **We believe that these projections do point to defensive strength into late this year, but they would also suggest that the environment remains very positive for US Treasuries and the US Dollar, probably as disinflationary forces linger on longer than most expect.**

German Bund Funds Futures vs US 10 Year Treasury Futures (both in US Dollars)
Bi-monthly graph or the perspective over the next 1 to 2 years



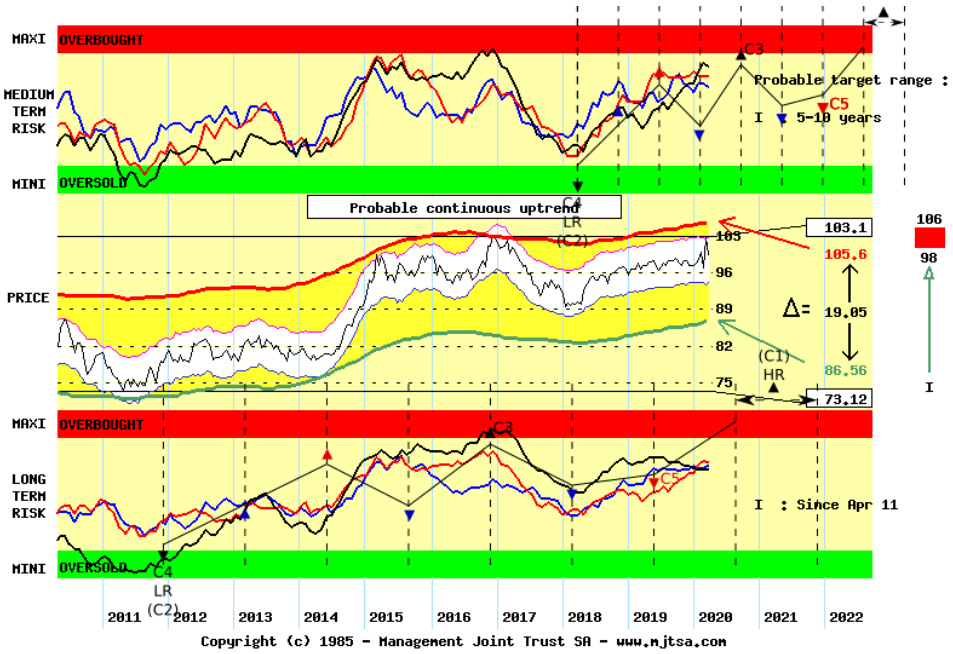
Another long term graph which in our view speaks for a stronger US Dollar and lower yields is the one comparing the performance of the 10Y Bund Futures vs US Treasury Notes Futures of the same duration. **This ratio goes beyond measuring the interest differential between the US and the EuroZone as it is denominated in US Dollars and hence integrates fluctuations in the EUR/USD exchange rate. When the ratio falls, Bunds and the Euro usually fall against Treasuries and the US Dollar. Both our oscillator series on this graph (lower and upper rectangles) indicate that the current downtrend probably continues until late this year. On the targets front (right-hand scale), the ratio has recently broken below the support of our C Corrective targets to the downside, opening the way towards our I Impulsive targets to the downside, some 10 to 20% below current levels.** Since Q4 2018, this ratio has been falling linearly along with the US to Europe interest rate differential and the EUR/USD exchange rate. US assets have benefited from stronger performance due to falling yields in risk-ON phases and from Flight to Safety flows in Risk-OFF periods. This trend should continue going forward, as the FED's "whatever it takes" "unlimited QE" approach to stabilize its economy may crowd-out any investments into other regions. This will work as long as the US manages to maintain its credibility in doing so.

US Dollar vs Commodity Currencies
Bi-monthly graph or the perspective over the next 1 to 2 years



We hence conclude this defensive section with a couple of long term graphs on the US Dollar. We first compare the US Dollar vs a basket of cyclical commodity currencies (an equal weighted basket including AUD, NZD, NOK, CAD, ZAR, BRL, RUB and CLP). **The timing is similar to the graphs we present above, with the US Dollar continuing to outperform until this Summer at least, perhaps even into the Fall on both oscillator series** (lower and upper rectangles).

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



The Dollar Index (i.e. mostly the USD vs the Majors) is a bit weaker as it has not made new highs above its late 2016 ones yet, but it is showing similar dynamics. Indeed, both our oscillator series (lower and upper rectangles) are suggesting that **it could continue to rise into late Summer / the Fall potentially reaching 106 by then** according to our I Impulsive targets to the upside (right-hand scale). Note: our medium term Weekly graph on DXY (not shown here) even suggests an acceleration towards 109 over the next 6 to 12 months is possible

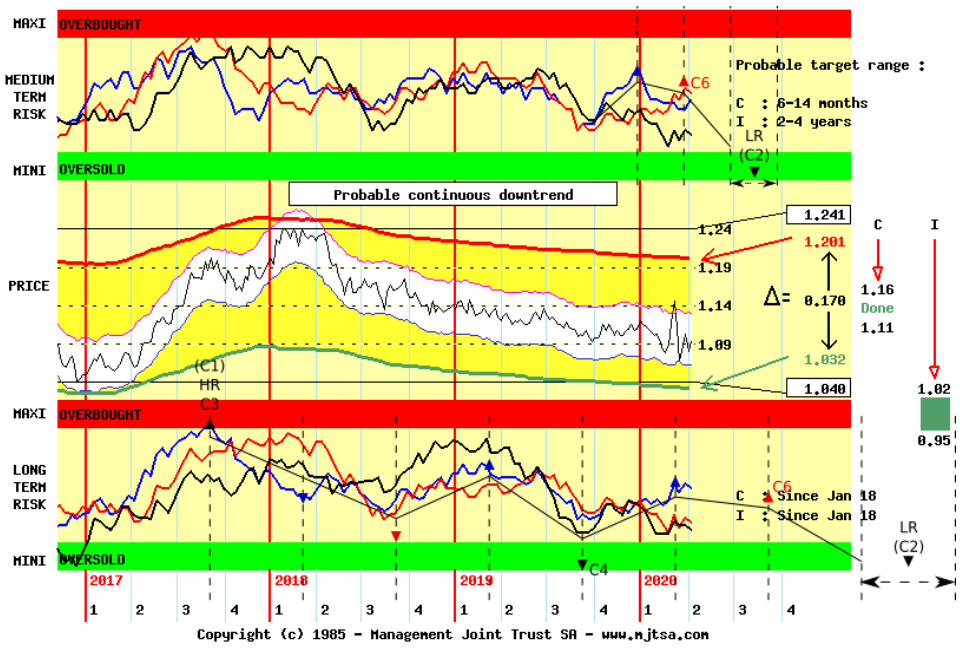
Concluding remarks:

Gold is currently breaking out. We expect its strong acceleration to the upside to continue into late May/June at least, perhaps until the Summer. It may reach 2'000 USD/oz by then. It may hence widely outperform equities which we expect could be retracing down at best over the next couple of months. Goldmines and Silver could also perform strongly, yet less that Gold in this defensive environment. Treasuries should also remain strong, yet underperform Gold, which suggests a period of residual risks rather than disorderly deleveraging as was the case in March. Over the next couple months, we also expect Defensive equity sectors to outperform their respective index. Some of the longer term graphs even suggest that this outperformance may last into late this year. This is also the case for US Treasuries vs European markets or the Bund, which potentially implies further downside for US yields as well as continued US Dollar strength. Indeed, when considering the US Dollar vs commodity currencies or developped ones, it seems to extend higher into the Summer at least.

60 / Splicing the markets: US Dollar update vs other Majors

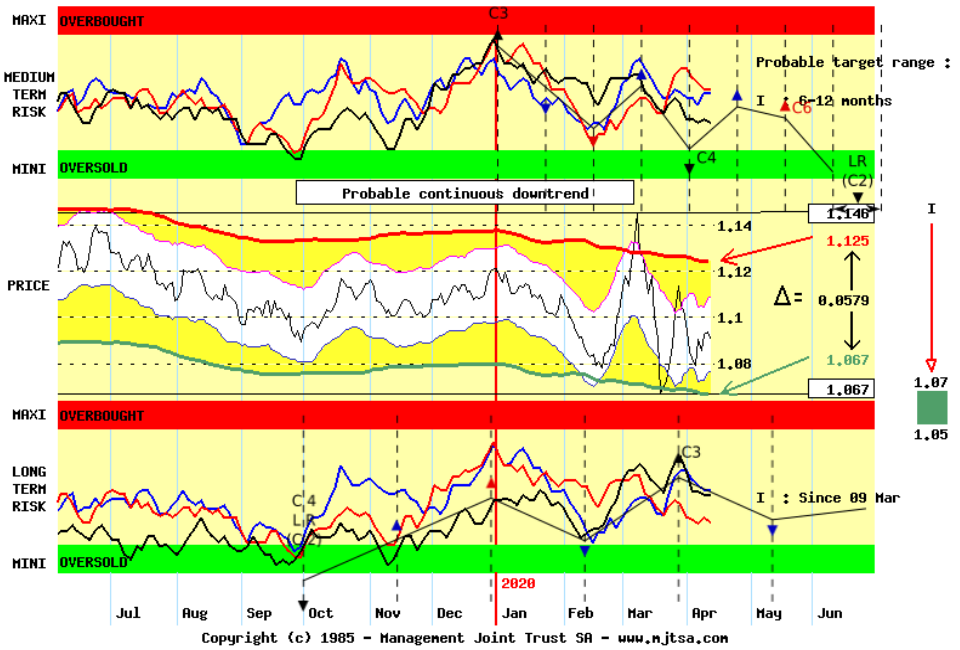
Last month we reviewed major currencies pairs vs the US Dollar in this Splicing the Markets section. Over the last 4 weeks, the US Dollar has continued to roller coaster and we believe it is worth reiterating this analysis in this issue. Our bias is that the US Dollar remains quite defensive vs the Euro and the Pound, but potentially also vs the Yen, which is less common.

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



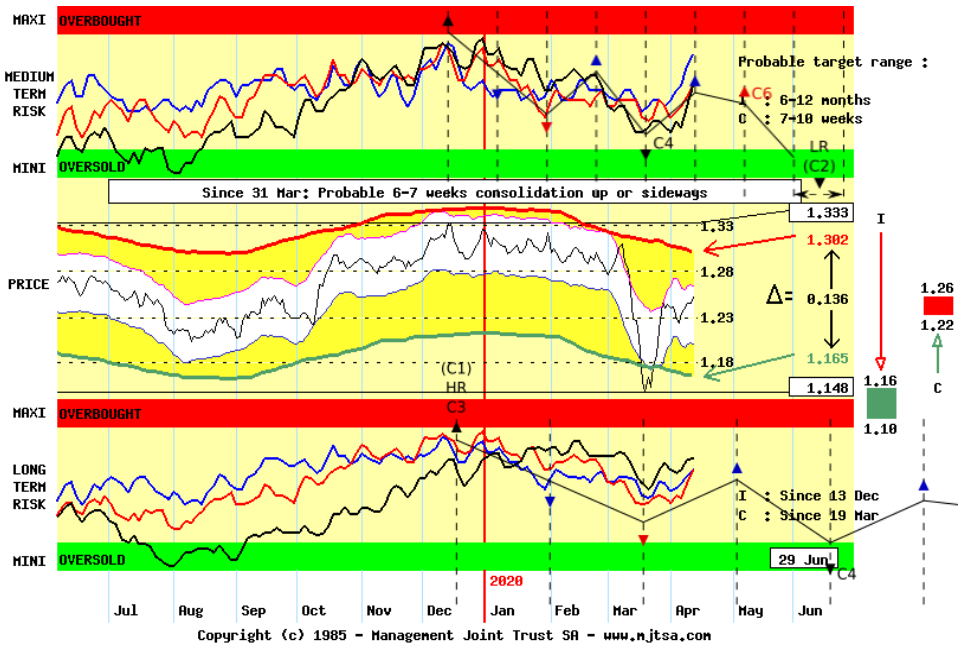
We believe the downtrend since early 2018 is still in place. Both our oscillator series (lower and upper rectangles) would suggest that the period of upside consolidation which started late Q3 last year on EUR/USD, probably ended with the early March spike as risk assets started to correct. **We now expect EUR/USD to drop into midyear** on our medium term oscillators (upper rectangle), **then potentially bounce shortly during the Summer, before resuming its downtrend once again towards late this year, perhaps even into early 2021** as shown on our long term oscillators (lower rectangle). Current prices are already below our crucial support, which was around 1.11. This leaves the door open for **further downside potential over the next 6 to 12 months, probably towards our I Impulsive targets to the downside in the 1.02 – 0.95 range** (right-hand scale).

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



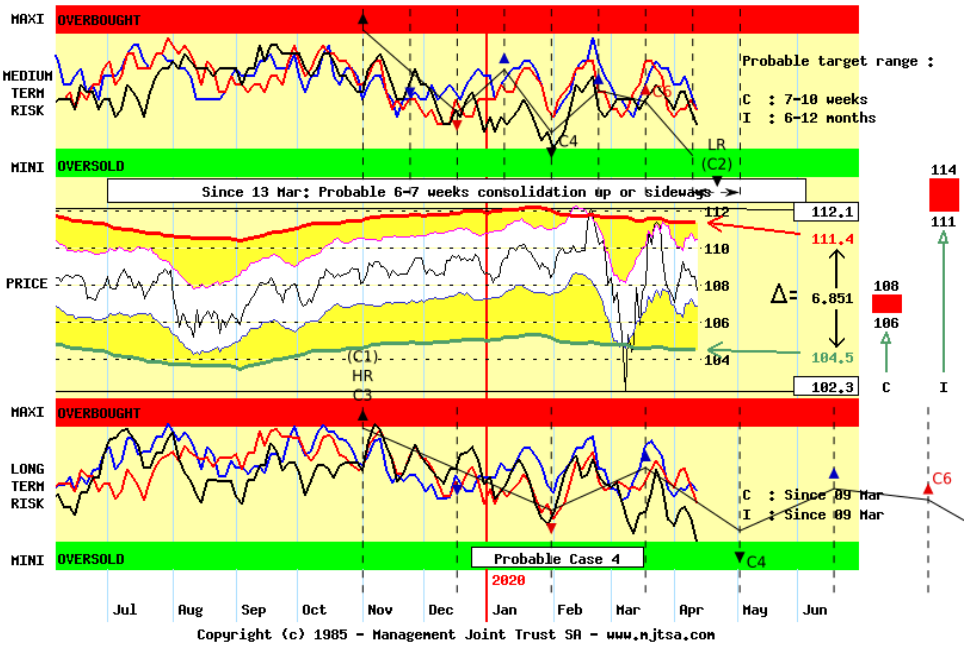
As shown on our long term oscillators (lower rectangle), the sideways consolidation period to the upside (sideways move with a final spike) since last October on EUR/USD has now probably come to an end. **We believe that EUR/USD is in the process of resuming its long term downtrend**. Shorter term, as shown on our medium term oscillators (upper rectangle), **attempts to bounce since late March and early April should eventually die out between now and early May. We would then expect a new leg down into June, possibly towards our I Impulsive targets to the downside in the 1.07 – 1.05 range, in first instance** (right-hand scale).

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



Cable is much more risk-ON / risk-OFF than EUR/USD. It has indeed reversed up quite remarkedly since equities bottomed early in the 4th week of March. **The bounce which travelled back 10 figures is now reaching the resistance of the upper end of our C Corrective targets to the upside around 1.26 (right-hand scale). We expect it to stall around these levels, perhaps slightly above, over the next couple of weeks as GBP/USD gradually resumes its downtrend between now and early May** (similarly to what we expect on equities). **We then expect GBP/USD to drop back down into June, possibly retesting into our I Impulsive targets to the downside in the 1.16 – 1.10 range** (right-hand scale).

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



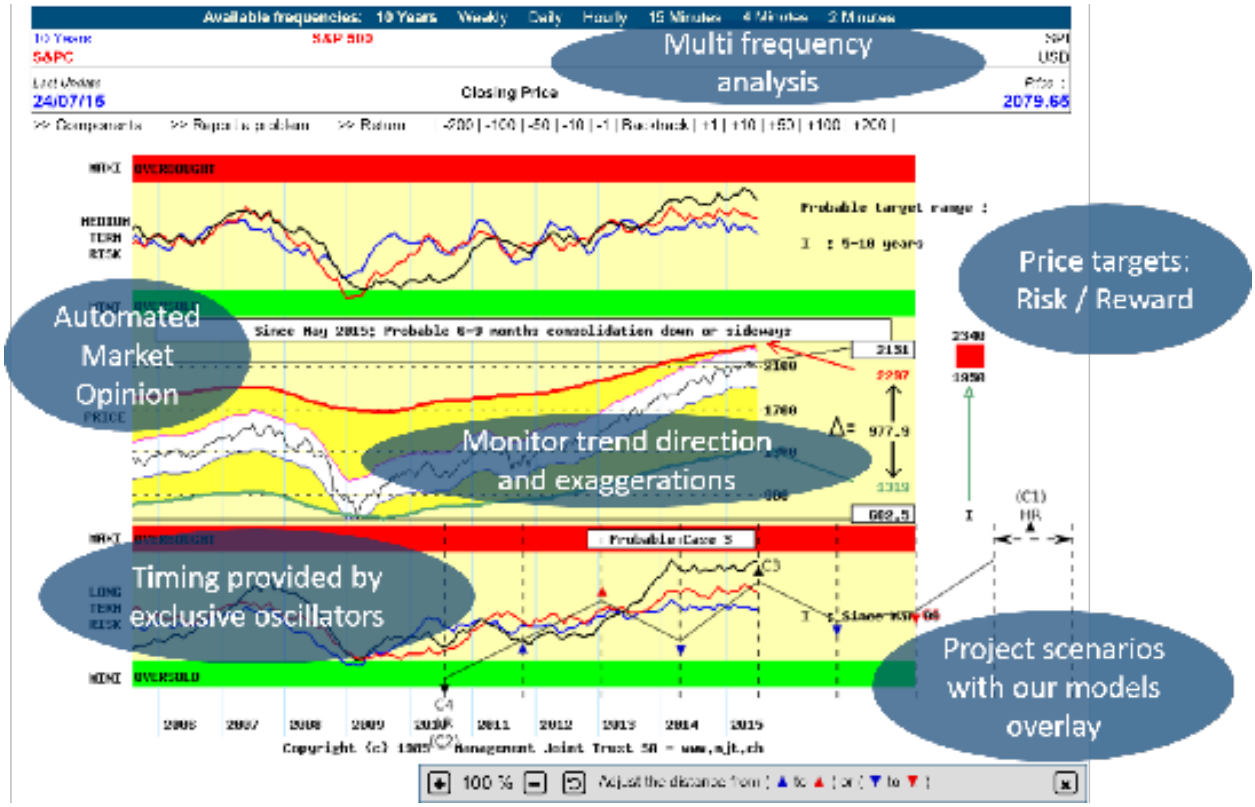
Risk-ON / Risk-OFF correlation seem to have gone astray on USD/JPY. Since the 2nd week of March and the powerful US Dollar deleveraging rally which took place as equities and credit instruments were crashing, USD/JPY has moved countertrend to risk assets. This is highly unusual as in the past, USD/JPY would have typically fallen during financial deleveraging periods. Yet, **this COVID-19 crisis is particular, as the related lockdowns are endangering the very existence of many businesses. We're not talking about carry trades unwinding here, but rather about a huge pile of US Dollar denominated debt globally, of which large chunks could be on the verge of defaulting**. Business, Foreign Treasuries, Banks are all scrambling for US Dollars. The sequence we show on both oscillator series (lower and upper rectangles) suggest that **USD/JPY could remain weak for another couple of weeks while risk assets conclude their recent bounce (towards 106 - 105). As these then retrace down during May, we may then see renewed stress on US Dollar funding, and potentially a bounce in USD/JPY into June**. The deleveraging should be less acute than in March given that the FED is providing huge amounts of US Dollar liquidity, domestically to the US Commercial Paper market and internationally, through its additional FX Swap lines with a number of foreign Central banks. Nevertheless, we then expect USD/JPY to bounce back to **the higher end of its recent range (1.08 – 1.09)**.

Concluding remarks :

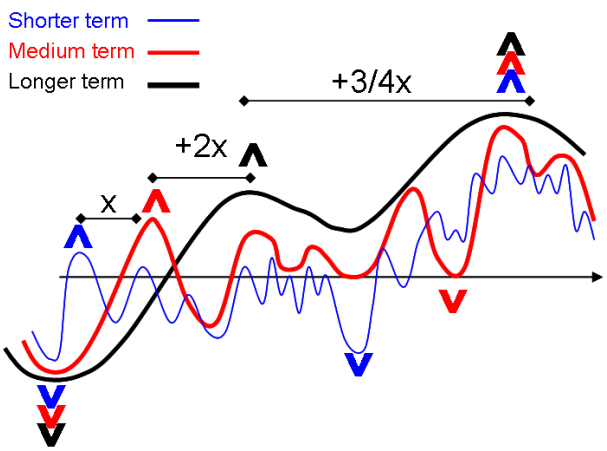
Many corporations around the world rely on US Dollar funding to match their US Dollar revenue streams. The lock-downs related to the COVID-19 pandemic are putting large chunks on this US Dollar denominated debt a risk. The world is hence scrambling for US Dollar and the situation will persist the longer lock-downs are extended. Despite the FED's efforts to mitigate this funding crisis, the US Dollar still appears very risk-OFF. We hence expect it to rise during the downside retest we expect on risk assets from late April into late May/June, most probably vs the Euro and the Pound, but potentially also vs the Yen. As we advance towards late Q2, the US Dollar may gradually become more neutral in terms of risk-ON / risk-OFF (vs JPY especially) as the funding shortage situation may then start to improve.

62/ 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)



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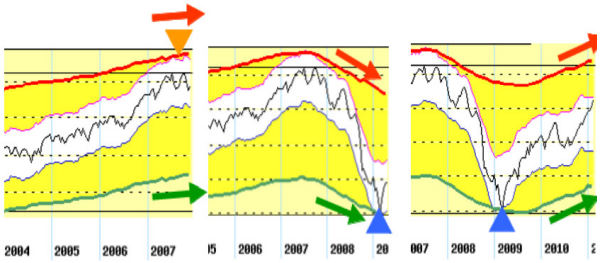
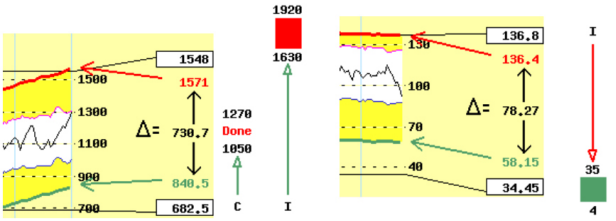
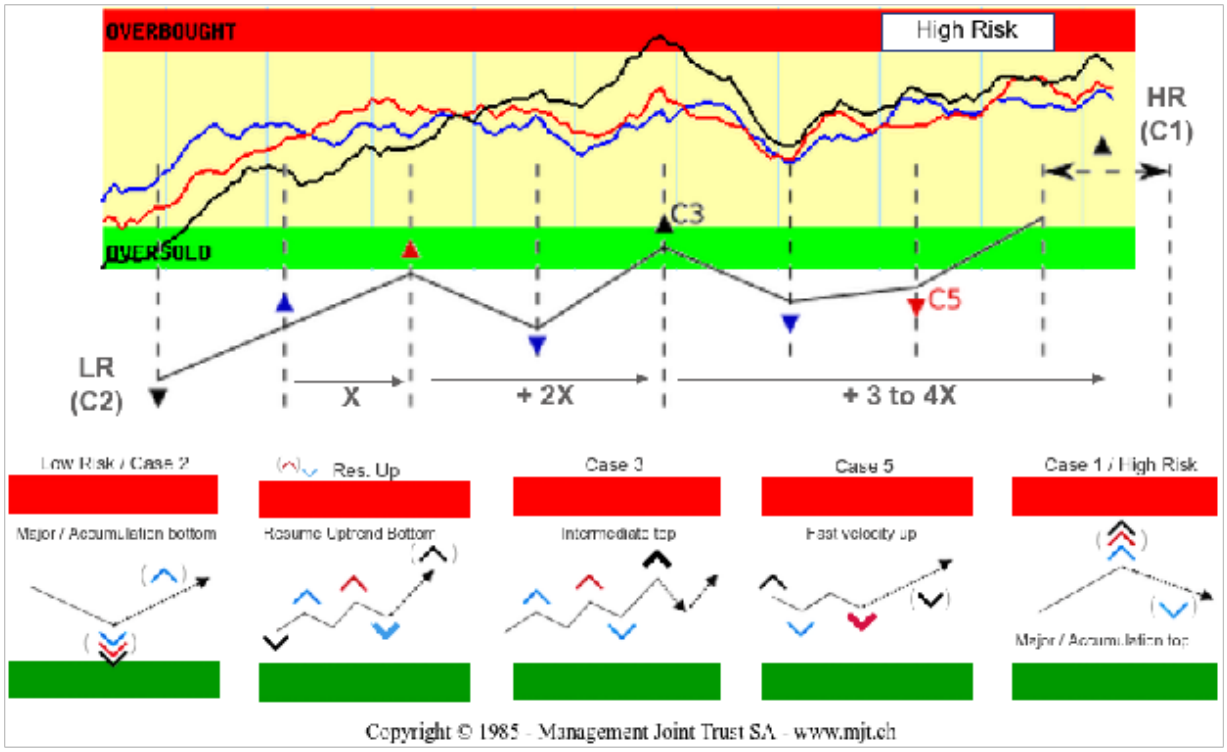
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



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).

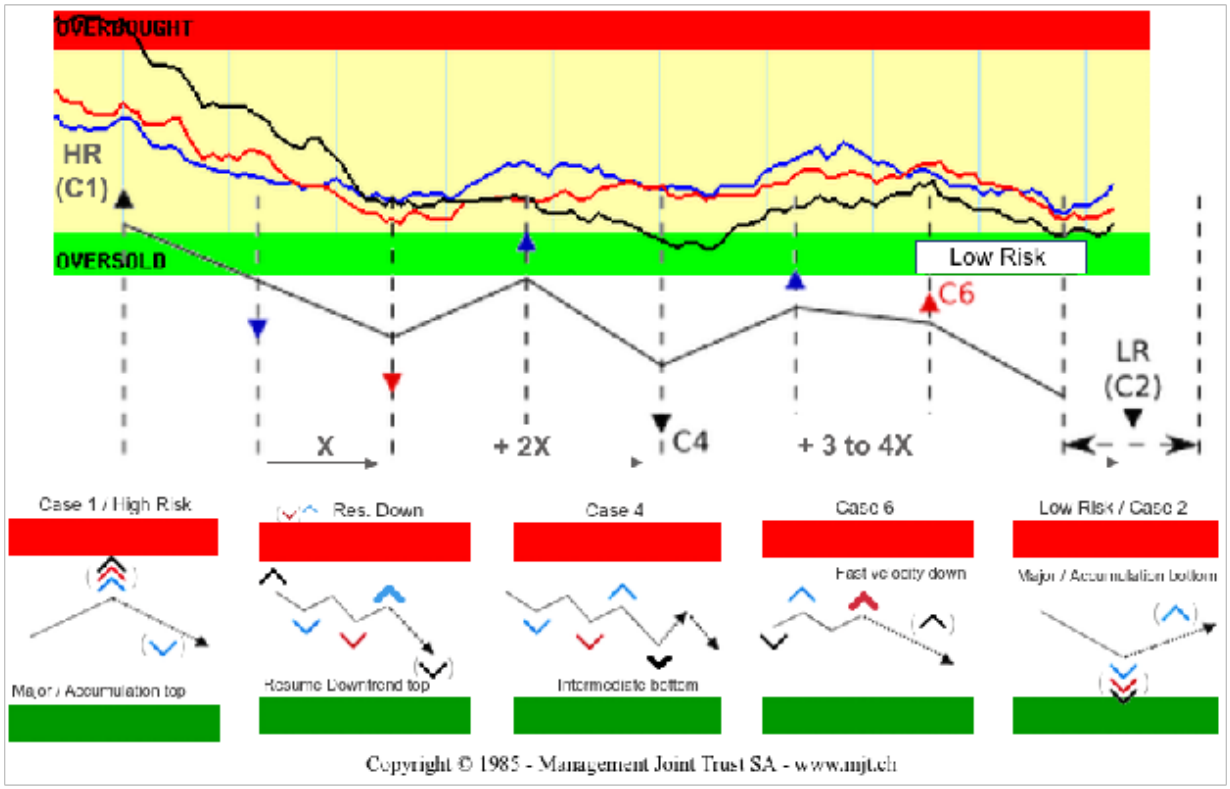


Ideal Uptrend Model



(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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