ZULAUF CONSULTING

INVESTMENT COMMENT

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IN THIS ISSUE

POSITION SUMMARY

MARKET	CYCLE	MEDIUM-TERM *Up to 3 months*
S&P	Late Cycle	Bearish
30y Long Bond (price)	Neutral	Bullish*
Brent Oil	Neutral	Bearish*
Gold	Neutral	Bearish*
EUR/USD	Neutral	Bearish*
USD/JPY	Neutral	Bearish
USD/CNH	Neutral	Bullish*

* Indicates a new position or change in view

HIGHLIGHTS

- The weakening of the political center in most of Western economies supports the view that economic policies will become more profligate and fiscally lax.
- The global business cycle is expected to continue expanding beyond 2018, with a recession risk unlikely to begin before late 2019. While we expect surprises in general to be on the downside for the next two quarters, we think structurally the US economy may surprise on the upside over the next 4-6 quarters while China should surprise on the downside.
- While world trade continues to recover, the new tariffs introduced by the US targeting steel and aluminum imports will contribute to a deteriorating global trade environment.
- At this time of the cycle, one would normally expect major trends to be rising for commodities, bond yields, and equities favoring cyclical sectors and to be declining for the US dollar.
- However, we expect trends to be rather the opposite over the next few months, as already expressed in recent reports, namely set-backs for commodities, equities and softening of bond yields and a strengthening US dollar.
- The step by step withdrawal process of monetary stimuli around the world will make for a more volatile market environment that favors trading-oriented investment styles over buy and hold strategy.

Trade Conflicts Will Arrive – The Domino Effect

Last week, the Trump Administration introduced tariffs on steel (25%) and aluminum (10%) imports. This will hurt US trading partners, particularly Canada, Brazil, South Korea, Mexico, Turkey, Japan, Russia, Germany, Taiwan, Vietnam (ranked in declining order). China ranks only 11th, as it has already slashed steel exports to the US by 2/3. China was fully aware they would become a target, and took proactive measures to minimize the impact. As protectionism is a two-way street, the EU

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has already announced that it will retaliate. Asia may do so, too. China was relatively quiet but said they would reduce imports of US soybeans. A high ranking Chinese official will visit the White House soon and our understanding is that China wants to go slow and not add fuel to the fire at this moment.

The message is to manage risks even more closely when investing in export driven nations, as they will suffer more than large net import nations in the world we see ahead.

Of course, steel and aluminum amount to only 2% of world trade - but it starts the process. While the US administration may simply attempt a level playing field, it is a risky approach because once protectionism starts, the ball gets rolling and it will be difficult to stop it. Trump's reaction to the EU's retaliation threat of tariffs for US goods like Harley Davidson and blue jeans led him to reply that he thinks about a 35% tariff on EU cars. We have written extensively about this coming threat, and we do believe it is a trend that will continue and intensify over time. Trump is basically fulfilling a promise to his electorate from his campaign. For investors, the message is to manage risks even more closely when investing in export driven nations, as they will suffer more than large net import nations in the world we see ahead.

We explained the causes and roots of rising protectionism in our special report "From Globalism to Nationalism and Populism" dated January 18, 2018 (please let us know if you need us to resend a copy).

We outlined why we think the trend to rising protectionism will continue for many years. So far, the steps undertaken by Trump have been minor. The recent step, however, is important and Trump announced at his press conference that more steps will follow. He said the game by other nations to exploit the US for their own benefit must stop and his administration will do more to stop it. If the US wants to balance its trade account by protectionism, the world will enter a troubling period.

We understand the Trump Administration's motives and reasoning, but everything else being equal - protectionism raises inflation, lowers productivity, growth and prosperity for all. Thus, more protectionism may be good news for those few companies and employees of companies that are direct beneficiaries, like US steel and aluminum companies in the short run. But over the long run, the economic situation will get worse, not better. In our view, the WTO has failed to assure a level playing field over the last 30 years, as it allowed too many unfair practices to continue in trade. And this failure could now backfire and start a process that will be difficult to stop. It is like a domino effect, once the first one falls all the ones in line behind will go down too. There is no way to stop once it starts, which creates a high-risk environment for the world.

Politics Become Important in Setting Economic Policy

Italy held its parliamentary elections over this past weekend, and the final results were not in yet at the date of publishing. However, the preliminary results show the three blocks - conservatives, anti-establishment and socialists - each having about 1/3 of the parliament. Details will follow. But so far, it looks like the result is a hung parliament, which will make it virtually impossible to push through any serious reforms. We expect the Italian tradition to continue – Italy is on a pregnancy cycle, as it had a new government every 9 months since WWII. We also doubt any new government will be strong enough to introduce necessary reforms. The big question is whether the anti-establishment parties can govern and ask the Italian people to vote on euro membership.

The polls show Italians favoring the euro as their currency at 50%, by far the lowest in all EMU member nations. The young generation wants to exit from the euro, to have a better chance to compete in the world that would bring back jobs for them. But the older want to hang on, as they fear their pensions paid in lira would become worth less than in euro.

But Italians want to stay in the EU, because they get financial support and exiting would exclude the young Italians from participating in European education and science projects, etc.

Finally, Germany Has a New Government – The Same as Before

In Germany, the members of the Social Democrats agreed to a great coalition with the Conservatives (CDU). It will be a weak government, as the voters wanted change and now the same parties entered a coalition government as before the election. However, there will be a much weaker majority (56% of parliamentary votes compared to over 80% before). The opposition parties will be stronger and louder. Moreover, if the new government executes the program agreed between the two coalition partners, we expect many members of the Conservatives to vote against certain issues, particularly in questions like European integration. Many members of the Conservative Party are angry with Merkel that she gave important departments like foreign affairs and finance to the Social Democrats and the interior department to the Bavarian sister party CSU. Thus, we think this Merkel government will face more than just the opposition parties in parliament but at times face opposition from the inside. As a result, we doubt this government will last 4 years and rather assume it will fall before 2 years are over. The coalition has agreed to loosen fiscal policy, which is in line with what we see in virtually all industrialized economies.

> We will see rising government spending and rising deficits.

Moreover, Merkel is not the strong leader of Europe any longer. Her reputation is damaged, and she missed the right time to step down. She will not even be taken seriously inside the EU, where the French President is now dictating the path. We assume it will eventually be questions about European integration that will terminate this government because the truly conservative group inside the conservative party will oppose many suggestions made by France.

These two decisions in Europe are fully in line with previous trends that are dominating, namely a weakening of former dominating people's parties slightly right and left of the center. The pressure on those parties has risen to the point where policies become more profligate – others would say fiscally lax or pro-growth. We will see rising government spending and rising deficits. It may have a marginal pro-growth impact for a while for the world economy. But eventually, it will force interest rates higher and eradicate the fiscal push.

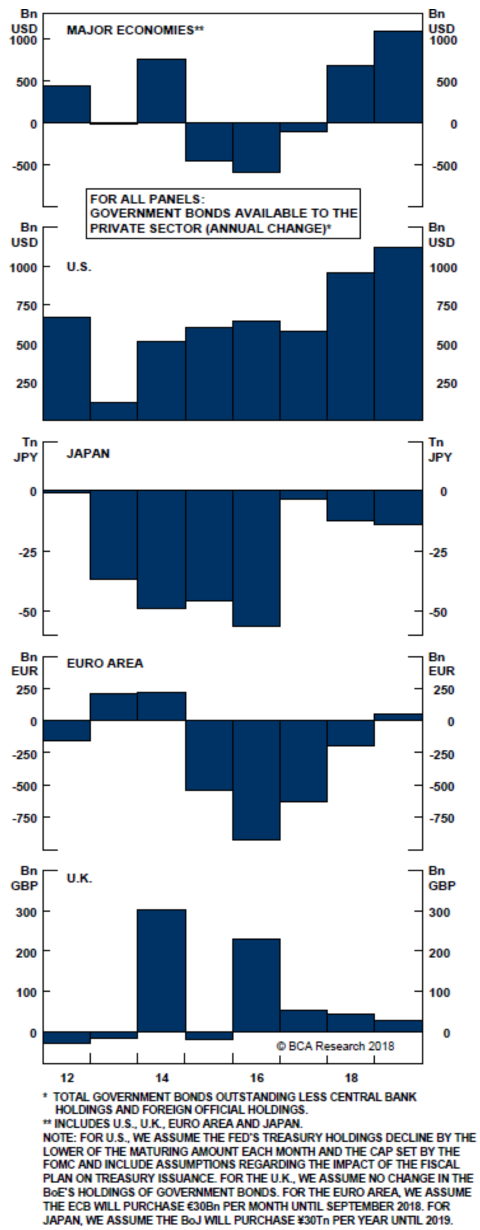
Looser Fiscal Policy May Push Bond Yields Higher – But Not Now

A look at chart 1 (see next page) shows how the supply of government paper will increase in the major economies. This comes right at a time when the US pushes the economy forward with a tax cut, and central banks begin to tighten policy. The Fed will not only buy less paper but is now a net seller of Treasuries. The ECB will most likely end its QE program by September of this year and stop purchasing bonds that has depressed those yields to historically absurd levels. It is likely that the numbers for the UK supply are too low, as the May government is coming under pressure and changing its policy toward pro-growth policies and run larger deficits thereby increasing the supply. Japan's deficit may be somewhat smaller this and next year because the economy has gained momentum and tax revenues are rising. Japan has been the leader regarding fiscal stimulation, which has now peaked while others, the US and Europe are only beginning.

While we agree with those questioning the rise in inflation for structural reasons, we believe inflation is rising for cyclical reasons. This rise may be slow, but it will continue and in combination with an improved labor market and increasing fiscal stimuli, central banks are trying to begin leaning in the other direction. This will lead to tighter money relative to what it was before. This change at the margin is important for financial and asset markets.

CHART 1

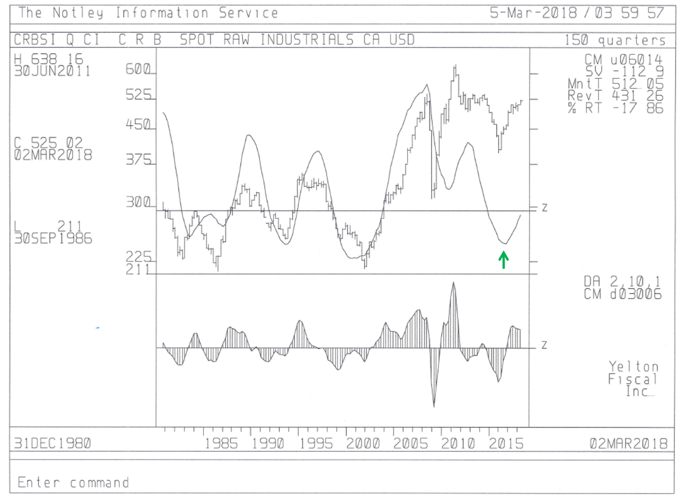
More Supply of Bonds Coming



Source: BCA Research, Inc.

CHART 2

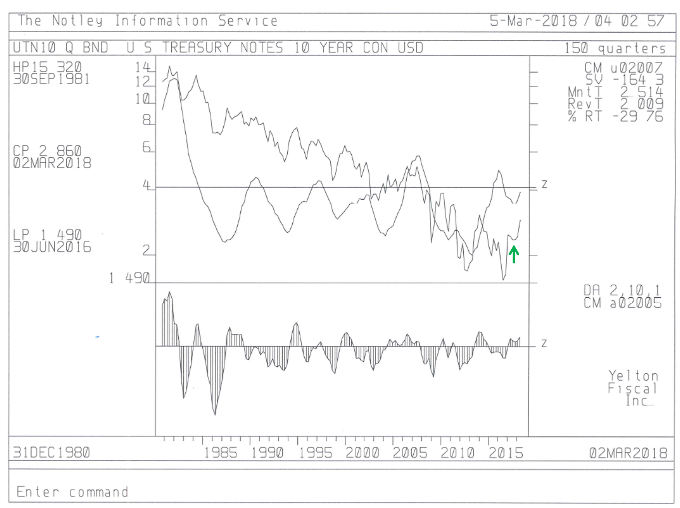
CRB Raw Industrials



Source: The Notley Information Service, Taniscott Capital Inc.

CHART 3

10-Year US Treasury Yield



Source: The Notley Information Service, Taniscott Capital Inc.

In chart 2 and chart 3, we show the price of the commodity index and 10-year US treasury yields and in chart 4 (see next page) the US Dollar Index on a quarterly basis. As you can see, they move up and down together (USD in juxtaposition) and the primary trend for this cycle remains up. That is the longer-term view well into 2019. And this would be the normal course in a normal cycle.

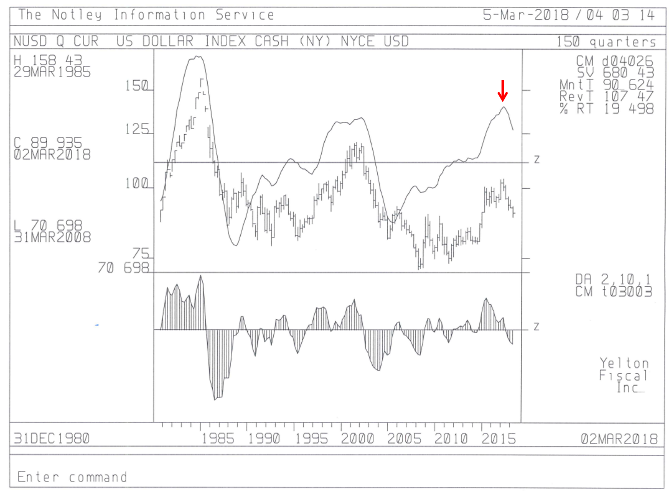
However, China is a main caveat here, as China is the only exception to restrain economic policy by trying to reduce some built up excesses. We have argued in previous reports that China will try to tackle some of the imbalances and slow the economy during 2018/19, and to stimulate again in 2020 for a better 2021/22 when they celebrate the 100-year anniversary of the Communist Party and hold the next National Congress and election of their leaders. The recent developments underline that President Xi is not losing any time and his crew is working hard on restructuring the financial sector, targeting particularly the shadow banks. Real estate construction is already slowing, and prices are down on a broad basis for the first time in some years.

China is the only exception to restrain economic policy by trying to reduce some built up excesses.

Moreover, China has hiked interest rates for some time and tightened liquidity conditions. Recently, the insurance regulator has taken control of Anbang Insurance Group, a leading insurance company with over $300 billion in assets and a former leader in buying foreign assets by leveraging up. We expect more moves in this direction and expect China to surprise the world by overdelivering in terms of restructuring. The net result, however, will be a pronounced slowdown of the Chinese economy that has already begun in the investment and production part of the economy. President Xi is attempting to become President for lifetime and he needs to succeed with restructuring. He seems to use the time window when the US provides stimulus to the world economy to execute his restructuring.

CHART 4

USD Index



Source: The Notley Information Service, Taniscott Capital Inc.

We have argued many times that China has been the locomotive for world economy in the current cycle. Emerging economies, Europe and Japan depend highly on the Chinese economy. If China slows, as we expect, a slower pace will follow in those economies, too. In fact, we already see the slowdown in the Citicorp Economic Surprise Indices for China (chart 5, next page) and the G-10 economies (chart 6, next page).

We expect more moves in this direction and expect China to surprise the world by overdelivering in terms of restructuring.

Thus, a slowing Chinese economy may slow their imports and exports by the export dominated economies from Europe to the emerging economies. On top of these already baked slowing trends for the world economy, we are now facing central bank policy to remove step by step part of the stimulus provided earlier. Chart 7 shows the S&P500 together with the total of Treasuries and mortgage backed securities (MBS) held by the Fed. It shows that the Fed's intended course will tighten liquidity.

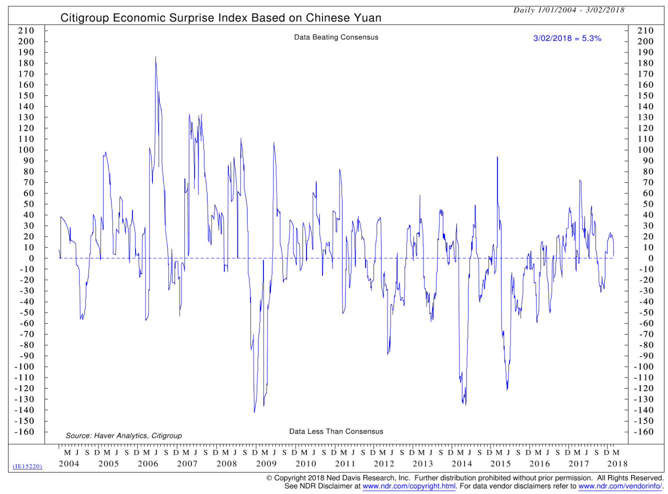
US Dollar Bottoming for a Medium-term Rally

We think the repatriation of capital by US multinational companies from overseas may have a positive impact on the US dollar, not only by the change from foreign currencies into dollars (which is estimated to only about $200-300 billion) but also by transferring dollars from the Eurodollar system into the US system. This may create financing shortages in Europe and should reduce the money supply of the Eurodollar system. Similar developments are going on in Asia, of course. Such a process may strengthen the US dollar, which is now oversold on a medium-term basis. We mentioned in one of our last reports that we expect the greenback to rally from late Q1 onwards. While the next 1-3 weeks may see some relapsing US dollar weakness, we see this as part of a bottoming process and expect a decent rally for several months.

> The scenario we outline is completely different from current consensus, who expects an overheating economy, rising bond yields, a weaker dollar and rallying equities (cyclicals).

CHART 5

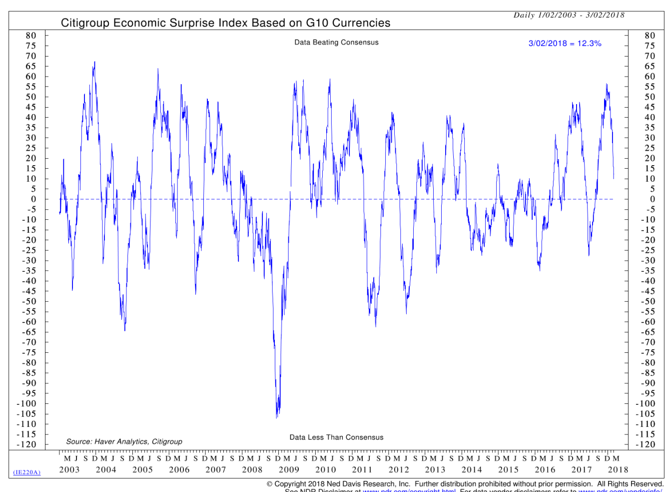
CESI China



Source: Ned Davis Rsearch, Inc.

CHART 6

CESI G-10 Economies



Source: Ned Davis Rsearch, Inc.

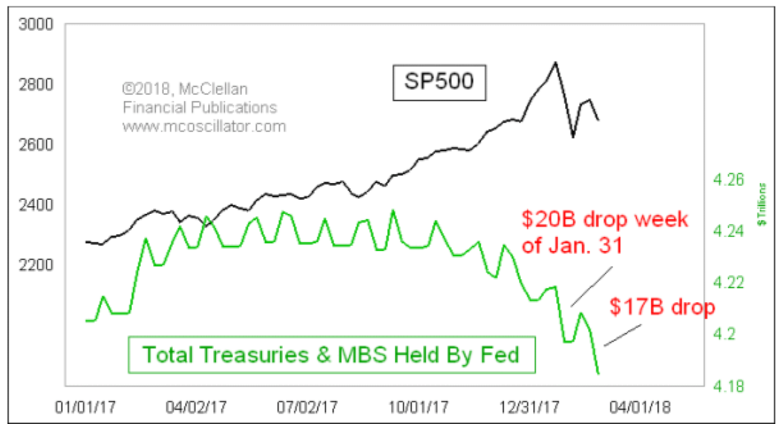
A recovery of the US dollar goes hand in hand with softer commodity prices, which go hand in hand with a slower Chinese and world economy (at least outside the US). This should bring relief to global bond markets, the USD denominated bond market in particular.

The scenario we outline is completely different from current consensus, who expects an overheating economy, rising bond yields, a weaker dollar and rallying equities (cyclicals). But as the legendary Bob Farrell said: “When all the experts and forecasts agree – something else is going to happen”.

Our point is that the risks for the next few months are exactly the opposite from the consensus. We see bond yields softening from resistance at around 3% for 10-year Treasuries. While yields in other markets are more depressed due to bigger manipulation, they may hardly have any downside. We see long-term bond yields in a secular bottom that is not complete yet and the bottoming may last longer. All major currency denominated bond markets remain in this secular bottoming process from where we will see a break topside – but not in the next few months but rather later.

CHART 7

S&P500 and Total Treasuries and MBS Held by Fed



Source: McClellan

We expect the US dollar to bottom out within the next 1-3 weeks.

We expect the US dollar to bottom out within the next 1-3 weeks and start a medium-term recovery against major and emerging currencies on a broad basis. The biggest caveat we have is for the Japanese yen, where we expect announcement to hike JGB yield targets and which may support the yen somewhat longer. We could see 103 in USD/JPY before a reversal.

Will Important Levels Hold?

When equity markets weakened suddenly in late January, only very few saw it coming. But all those who did not see it coming thought that it was another dip to buy. Our view differed, as we said we expected a bounce – but followed by another decline. We have not changed our view, and still believe there is more risk regarding time and price in this correction.

Many markets are near important levels. At present, the 10-year US Treasury yields could stop their rise around the 3% level and soften again. The US dollar may relapse short-term to minor new lows but should start a recovery from later this month on. As part of this scenario the commodity complex should soften, and equity indices should correct more.

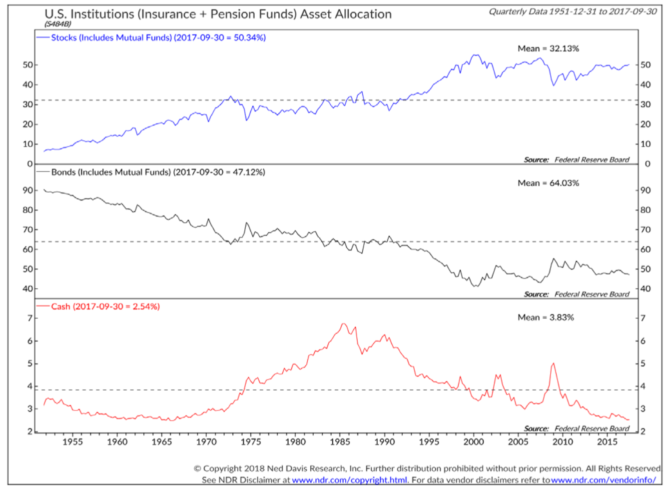
All these indices have in our opinion topped medium-term and the medium-term correction has further to go.

European indices are already back to their February and late August 2017 lows and some have even broken below slightly. In contrast, the major US equity indices are still trading above their February lows. The S&P500 trades in the middle between the highs and the February lows while the NASDAQ still trades near its highs. Japan is between the US and Europe, as it is trading close to the February lows like Europe but still clearly above the late summer highs. All these indices have in our opinion topped medium-term and the medium-term correction has further to go. As Europe has fallen the most and is closest to oversold, it may be the first to hold. This may then have to do with a change in the currency market, as the euro could begin a medium-term correction while the US dollar begins to rally.

While point projections are not reliable, we still think that the DAX could fall into the low 11,000 from their current level at 11,900. We also see the S&P500 correcting into its support zone around 2400/2450. The Nikkei could decline into its support in the low 19,000 from its current level of 21,182. Thus, we disagree with all those recommending buying the dip.

CHART 8

Asset Allocation US Institutions



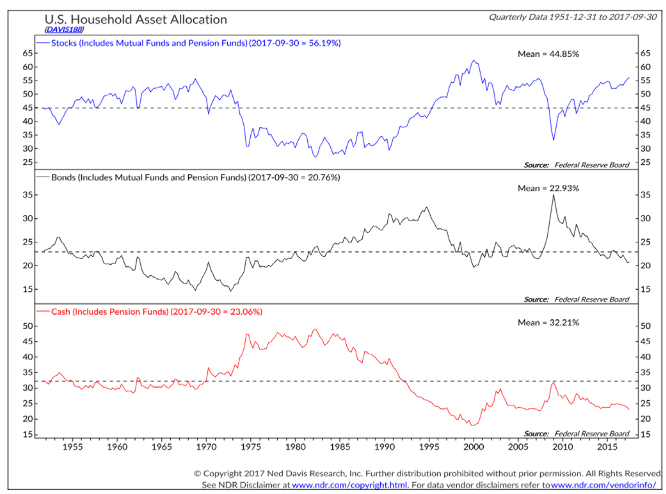
Source: Ned Davis Rsearch, Inc.

Monetary and Trade Fundamentals Are Changing

Global equity markets have been trading at a historically high valuation due to the help of central bank stimulation. Now, the removal process is underway right at a time when the driving engine, China, is slowing down in earnest. This creates a completely different set-up from what investors have been used to in recent years. Moreover, investors' allocation to equities is at the level where they usually are at the peak of the cycle (chart 8 & 9). We do not have up to date data for foreign markets but as foreigners hold more US equities today than at the last cycle peak, we have no doubt their general allocation to equities is also around previous cycle peaks.

CHART 9

Asset Allocation US Households



Source: Ned Davis Rsearch, Inc.

> The monetary framework is changing.

The monetary framework is changing, as central banks will try to reduce or even remove the stimulus of recent years. While at first, these steps are timid, the change at the margin is important, as monetary liquidity is the lifeblood of the markets and when the rate of change weakens, it leaves its marks. Just have another glance at chart 7 to understand what we mean.

Moreover, the beneficial trade environment that allowed the great globalization over the last 30 years is changing, too. It is early in the change and many will not take it seriously. But we believe this is a new trend. Trump is not a Republican nor a Democrat. He is a US businessman and when facing a problem, he addresses it. Obviously, he faces rising trade imbalances with the US a loser. And he wants to change it his way. We do agree with him that others played unfair for many years. But if an unfair situation has been going on for too long, it is sort of grandfathered in the minds of many politicians. It would take great diplomatic skills to make global trade a level playing field again. We simply doubt the Trump Administration, nor the EU Administration, has those skills. China may be best, as they seem the only ones to understand what is at risk, but they are now very self-confident and hardly in a mood to cooperate easily, as would be required. They will play hardball but wrapped in the façade of good diplomacy.

The beneficial trade environment that allowed the great globalization over the last 30 years is changing, too.

Those investors and experts who do not see these two major factors changing may not understand how much is at risk in current markets. Our hunch is that the medium-term decline will go further, but will be followed by a recovery attempt. We could then see particularly the major US indices rise to minor new highs but doubt that the majority of national market indices will make new highs. In our view, we are now witnessing the process of a cyclical top building stretching into the second half. A bear market is expected thereafter. And a certain number of stocks has probably already seen their highs and others will follow during the next rally phase as many will not make it decisively above their recent highs, if at all.

We intend to change our medium-term bearish label in the table on page one to bullish when we think the recovery rally is about to start. We also intend to change the cycle assessment from late cycle to early bear near the next medium-term rally high. But we are not there yet. Stay tuned!

Economic sectors may in many cases perform just opposite to expectations. If our scenario of more correction is correct, the more defensive sectors that have underperformed for some time, may improve their relative performance during this remainder correction. However, we doubt they will be money makers in absolute terms. At the same time, many former outperformers may underperform. The exception may be the few top leaders from the technology, e-commerce, internet and defense field where a few of those stocks (the new nifty fifty?) may continue to perform well. They may only correct in a bigger way in the very late stage of this current medium-term market correction – as leading theme stocks usually do. In the recovery rally thereafter that we expect, they may go to new highs while the broad market – and particularly breadth – may lag.

Will Gold Shine or Disappoint?

We are painting at least a minor deflationary relapse for coming months. Whether this will turn into a major relapse with economic disappointment and bear market symptoms remains an open question at this time. Moreover, we want to take one step after another and not jump too far ahead.

Moreover, we dislike the non-confirmation by silver, as it has made constantly lower highs since mid-2016.

But if equity markets correct further, and 10-year Treasury yield cannot break above the low 3% level and the US dollar begins a recovery while the commodity sector weakens, we cannot see how gold would strengthen. We see the potential for gold for one further short-term attempt on the upside, but our medium-term trend and momentum indicators are already weakening.

Moreover, we dislike the non-confirmation by silver, as it has made constantly lower highs since mid-2016. And gold mining indices have already traded below the December and February lows. These are not bullish signs. Thus, we are more inclined to sell bounces than to buy weakness. In our view, gold will have its rebirth once the systemic risks come to the surface again. For that it seems still a bit early.

Felix W. Zulauf
March 5, 2018

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