INVESTMENT COMMENT

ZULAUF CONSULTING

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IN THIS ISSUE

POSITION SUMMARY

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

* Indicates a new position or change in view

HIGHLIGHTS

- Global equity markets have sold off sharply. We think a short-term low is near, but we doubt this is the end of a medium-term decline. For active traders, there may be an opportunity to play the bounce. But for long-term investors, we recommend staying cautious and do not get back into the market. In this publication, we will explain why.
- The world economy will most likely show negative Q1 growth, provided that China accurately reports the reality of its situation with regard to the coronavirus outbreak. We continue to believe that the world economy's first half will be very weak. At the same time, we expect authorities around the world to take measures to help prevent a lot more damage. But it will take time until we see economic improvement show up in the numbers, which we expect may begin sometime in the second half and carry well into 2021.
- 10-year government bond yields have declined substantially again, and a few of the developed countries' government bond yields have reached new historic lows. For example, we see this in the US and Australia. We believe that yields are near their cyclical lows in terms of time, but they could overshoot on the downside. We would not buy them any longer at these levels, but we are also not a seller yet. Stay put until things stabilize in the bond market.
- The US dollar was overbought and is correcting short-term with the help of President Trump talking it down, as we expected. More verbal intervention will follow, and it is likely that the Fed will act simply to show its presence. Depending on how powerful its action is, the Fed could soften the US dollar. It cannot fix the current problem by printing money. Thus, we doubt we will see very aggressive easing that would push the greenback into a cyclical decline. We see Asian currencies more vulnerable than European ones.
- We expect equity market indices around the world to either having hit a short-term low on Friday or early this week. Almost all the signs one wants to see at a short-term extreme were present, so a temporary bounce should be likely.

- However, it is Important to note that a climax type of reversal is still missing. The economic uncertainty will remain high and growth weak into mid-year, and therefore more corrections are likely after a bounce. If we were to see a deep climax low, it would be tested again within 2-6 weeks. Thus, we do not favor trying to buy until all the signs give us more conviction. The degree of the decline will depend on how fast the damage to the world economy can be stopped and the situation begins to normalize. We have been warning about this problem doing more damage, and the market is moving in the direction as we predicted it would.
- We still think it is too early to turn bullish again on a medium-term basis, and that we should let the dust settle. Our recommendation to tighten risk management, in case the decline was more severe, should have been of help to our subscribers.
- We remain bearish on economic sensitive commodities, which is in line with our bearish macro scenario.
- Gold rallied sharply the day of our last publication into our target zone. A new short-term sell signal has triggered weakness and our medium-term indicators are close of turning down. Gold is not acting well and breaking $1610 is a bearish sign. We made a mistake to improve our rating in our last report and go neutral again, at least for medium-term traders. However, our multi-year outlook is bullish for gold, although there could be a sloppy period of several months with back testing and broadening the base. We see the risk on the downside in the medium-term to the range of $1420-$1450, while the longer-term upside potential is that we could see new historic highs.

Panic Is in the Air

It seemed like the market suddenly read our February 5, 2020 investment report, in which we explained that the damage to the Chinese and world economy would be more severe than the consensus expected. And once the dam broke, there was no stopping it. In this age of passive investing, TINA (there is no alternative to stocks) and ultra-low cash (cash is trash), once investors sell, they sell the whole market. The selling hurts the major indices and selling begets more selling. We have seen indiscriminate selling, which is equivalent to wholesale liquidation. An optimist would say that this is a healthy cleansing process of previous excesses. We see the risk that this downturn is the beginning of something more serious.

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Ironically, the only market trading near this year's high is China. The Shanghai A Share Index is down only 4.2% from this year's high, after having been down 14%. And the CSI Small Cap 500 Index even went to a new high! We suspect that the government is actively intervening, even if only verbally, to prevent selling. So much for markets reflecting reality…

European markets are down sharply, as the coronavirus has now spread to Europe where Italy in particular has been hit with many coronavirus cases. The industrial region of Lombardy has shut down many plants, operations, public events, etc. We expect this to spread to other regions as well and impact a big part of the world, particularly the urban centers. In Switzerland, all public events with more than 1000 spectators have been canceled by the government. The famous automobile show in Geneva was cancelled, and some sports games (i.e. hockey) are being held according to schedule…but without spectators. Clearly there will be damage to all of these industries and economies.

Virtually all indices of the major economies around the world are now down for the year, and decisively so. Major indices in North America, Asia and Europe have lost approximately 15% from their recent highs, and most did so within less than two weeks of trading. It is natural that markets rise and fall, but the speed of this dramatic drop is surprising. Some investors have forgotten this fact, and the talking heads on TV were all completely lost calling for the Fed to step in.

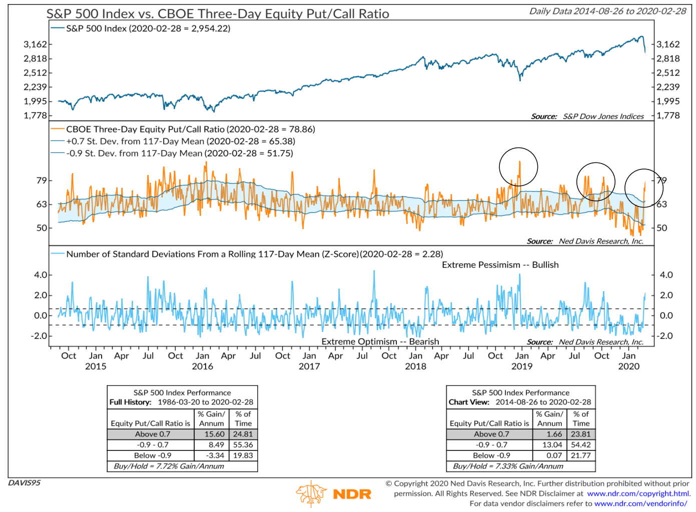
We are looking for a climax low, which would mean down sharply and a reversal to close up sharply for the day on heavy volume. Such climax lows are usually retested successfully within the next 2-6 weeks.

These sharp selloffs on large volume usually lead to a panic low within a few days. At such a low, we usually see extremely high put/call ratios (chart 1), optimism declining to pessimism in investors' surveys, volatility indices skyrocketing, fear appearing, media stock market headlines on the front pages of newspapers, as well as politicians and central bankers or ex-central bankers commenting. Investors demonstrate an urgency to sell because of rising uncertainty about how economic fundamentals will work out. This is even compounded by the fear about our own health, which makes this decline kind of a double whammy.

Our internal target was for the S&P500 to decline to its own 200-day moving average (3025), or around 3000. This is where the market traded last Thursday, and slightly below that on Friday (February 28, 2020). Often that 200-day moving average offers some support, although it is usually slightly undercut. Moreover, this price level offers some support as

CHART 1

S&P500 vs. CBOE 3-Day Equity Put/Call Ratio



Source: Ned Davis Research Inc.

lengthy consolidations took place there last year. Once the 200-day moving average area is broken, our next target is the 55-month moving average. This stands around 2500 for the S&P, and around 7000 for the NASDAQ100 and would measure approximately 25% off from their respective highs. Markets are now between these two target zones.

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According to our friend Walter Murphy, this 11-day decline from an all-time high is the sharpest in the history of the market even including the 1929 decline. Our longer-term trend and momentum work also suggest that markets have seen their highs for the year and will not revisit them. Moreover, we are leaning toward a true bear market resolution and recommend that only traders – and there will be plenty of volatility offering trading opportunities – should reenter. We firmly believe the investment community is underestimating the downside potential over the course of the next 12-24 months. Our subscribers who are sophisticated traders may have an opportunity to trade around a short-term bounce in equities. However, we suggest waiting for the climax reversal and then buy the retest, even if the retest does not quite reach to the absolute intraday lows again. It is the safer way.

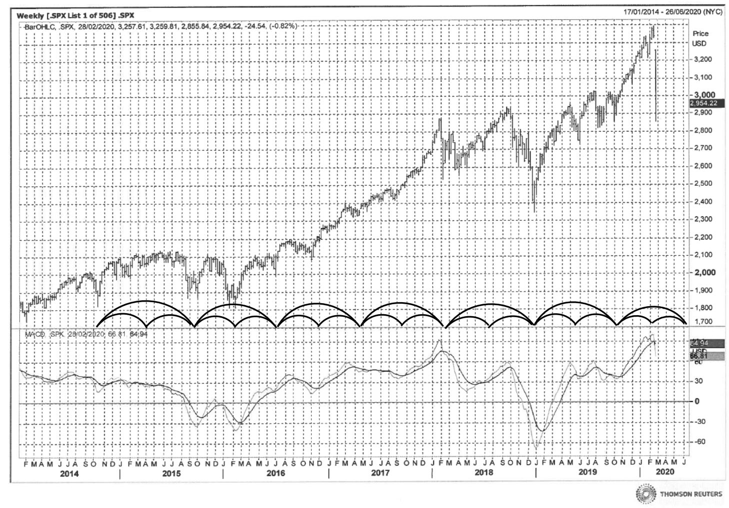
These bouncing attempts should run out of steam quickly, as our medium-term trend and momentum work still suggests that the correction is in its early stage and nowhere near an end.

Keep in mind that the underlying problem is economic in nature. The world economy will be damaged in Q1, remain soft in Q2, and will hardly recover before the second half of this year.

In one of our recent reports, when pointing to a coming medium-term correction, we said that the shape and form of corrections can hardly be forecasted. We recommended to use stop loss or other procedures in case the correction would be deeper than our working hypothesis. This is now the case. We also mentioned that this late in the cycle, with markets as stretched as they were on the upside, stochastic processes of exogenous nature could materialize any time.

CHART 2

S&P500 with 40- & 20-Week Cycle



Source: Thomson Reuters

Apart from fundamentals and technicals, we look at other things to help guide our investment outlook. One of these factors are trading cycles. The 40-week trading cycle has topped in February, and at the same time the 20-week trading cycle is calling for a bottom (chart 2). Thus, from a trading cycle perspective, bouncing attempts are due here.

Investors should not enter yet on the long side and should remain in cautious mode until the climax reversal is seen.

Markets make the news, so therefore we expect we will soon hear comments by officials where they will offer pacifying action which will give markets an excuse to bounce. These bouncing attempts should run out of steam quickly, as our medium-term trend and momentum work still suggests that the correction is in its early stage and nowhere near an end (chart 3, next page). The 40-week cycle is due to bottom in July. It is therefore conceivable that markets will make an important short-term low here followed by a recovery attempt. Recoveries are usually front-loaded, and then fade again. This may be a good environment for gifted short-term traders, due to the high volatility and big moves both ways intraday. But investors should not enter yet on the long side and should remain in cautious mode until the climax reversal is seen. We believe that a medium-term buying opportunity may arrive closer towards mid-year, and not before.

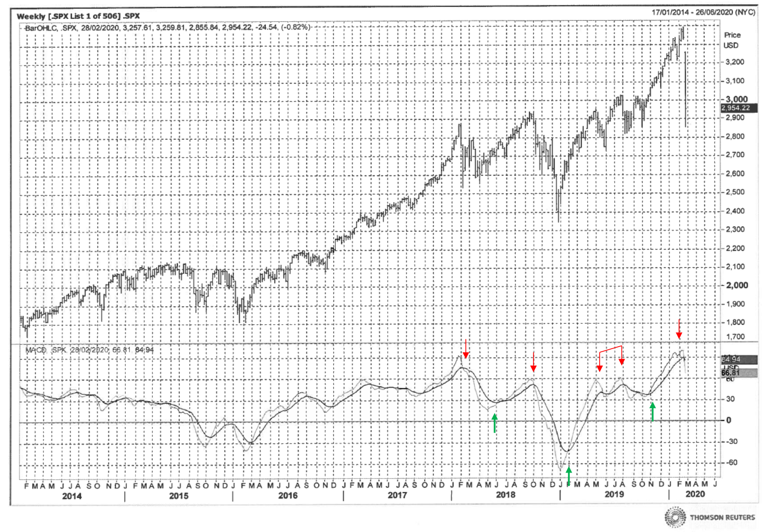
Some of the leaders of this long bull market have held up better than the market. They will therefore be the leaders in any bounce. While technology sector indices have declined slightly more than the indices, not much damage has been done so far to them. The belief in them seems still unshaken. Once the cyclical bear market will be ending, that belief will have vanished. We also noticed that large caps outperformed small caps and growth outperformed value. Thus, so far there is no sign of a leadership change visible, yet, in global markets.

Weak Fundamentals

We have been concerned for the last few years that China has entered a fundamentally very challenging situation that will reduce growth structurally. Our reasoning has been bad demographics, excessive debt, and an unsustainable growth in infrastructure on which growth relied. Moreover, we thought that the classic North Asian development model to grow via mercantilism and debt was at risk, as the US would not tolerate it any longer. Late last year, the swine flu pushed prices for pork and pork substitutes substantially higher, and the Chinese CPI is now over 5%, which puts real income growth in negative territory for the first time in many years. This of course happened before the coronavirus problem and weakened the economy. And on top of this, the coronavirus broke out, which shut down a big part of both the Chinese and the world economy. While the resumption rate is reported to be increasing again, it still means that the Chinese economy is badly damaged. On Saturday

CHART 3

S&P500 Weekly & MACD



Source: Thomson Reuters

China reported its PMI indices. For manufacturing it fell from 50.0 to 35.7, far below the expected 45. Output fell from 51.3 to 27.8. These are far worse than during the financial crisis in 2008 when manufacturing PMI slumped to 38.8 and the services PMI never went below 50.

> There are already reports that 13% of the companies in China have gone bust.

Chinese small and medium sized companies (SME) are the backbone of the economy; they represent about 2/3 of GDP and employ about 80% of the total workforce. However, this sector is extremely undercapitalized and at risk if they have no cash-flow for 6-8 weeks. There are already reports that 13% of the companies in China have gone bust. We have repeatedly pointed to the fact that the corporate and local government sector (depending on tax revenues and land sales to finance their infrastructure projects) are not only cashflow poor but keep running a negative cashflow of around 8% of GDP for years. The partial shutdown of the Chinese economy not only disrupts the global and national supply chains in many industries but runs the risk of a cascading bankruptcy wave. For this reason, authorities are responding, albeit late, but late is better than never. The central bank has eased policy, and authorities have ordered banks to make loans even if they are risky. Now, high loan growth may then not translate into high economic growth, as these loans are rather bailouts to stabilize the system. We also hear that Chinese companies may be forced to lay off 20% of their workforce and cut wages by 20%-30% to overcome their cashflow problems. In other words, this is serious economic stuff and not only a virus problem.

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A colleague of ours has done more in-depth research on the funds needed to stabilize China, and concludes that it probably needs new credit on the order off 25% of GDP (US borrows between 17-20%, which is already a high number). If these assumptions are true, and we do not doubt them, it means that China must most likely also rely partially on foreign funding, as it cannot finance all their needs internally. This will force China into more repression but also more dollarization and dependence on the US Fed in the future. In other words, China has a very bad structural problem and is trapped. And this is really where the Fed may help the US banking system to channel several hundred billion dollars to China, via the interbank market. We will see…

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We think the Fed will ease policy, but more important than cutting rates is providing the liquidity to flow wherever it is needed in the world, including China. The poor Chinese banks are being forced into a terrible trade to go short US dollar and long domestic credit risk. And China is forced to increase its already very high debt even more. Good luck with that trade for the long-term!

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Central banks can provide the necessary liquidity to fix a balance sheet problem, but they cannot increase final demand, not even if they cut rates aggressively. In general, final demand is weakening for obvious reasons and private household savings rates will probably rise. The corporate sector is partially disrupted and operates at reduced capacity depending on where in the world it is. Moreover, supply chain disruptions are increasing because not only is China affected but other Asian and now European regions are as well. Disruption may also spread to the US economy, although the US economy is less interconnected with the world economy than others. But Americans are travelling worldwide too, and travelers from all over the world visit the US.

We mentioned that Q1 for the world economy will most likely be negative, although we are not sure what numbers China will release (probably not a realistic figure). Moreover, we think Q2 will also still be affected. Thus, the first half of the year will be weak, in line with our original expectations, but even worse in magnitude. Recoveries will begin sometime during the second half of 2020 and will last well into 2021. But the world economy will hardly achieve 2% real growth this year, which in the past always equaled a global recession. This is the real threat for global equity markets. And this is why equity markets are declining in line with deteriorating economic fundamentals, not because of a health issue.

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The good news is, however, that this is the shock that was missing to push authorities around the world into fiscal policy stimulus for which we have been waiting for some time. Thus, fiscal policy easing will be coming worldwide. Some countries like China, Hong Kong and Malaysia have already decided on it. More will come through in our view. Europe will follow, too. However, we think there may be too little too late and a bear market cannot be avoided.

Risky Politics – Feeling the Bern, and Brexit

It has not gone unnoticed that Bernie Sanders is doing extremely well in the Democratic debates and leads the polls among Democrats by a substantial margin. While only a minority see Sanders winning the Presidential election, we would not underestimate him especially given his popularity among younger voters. He comes across authentic in the debates because he really believes what he preaches. Of course, he would do a lot of damage to the US economy, as he would lead the US down the European way into deep socialism.

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While Sanders is the outsider, keep in mind that half of all US citizens could not afford to pay an unexpected bill of $400 out of their pocket, because they are only able to live hand-to-mouth. For them, Sanders makes a lot of promises that sound appealing. His spirit - as much we think it is baloney - is in line with the current “Zeitgeist.” He represents the same ideals that are so popular with the “yellow vests” in France. He appeals to the young generation which has no money and feels betrayed by the Establishment. We should not underestimate how much this could impact the Stock Market.

The other problem is the rising potential for a trade conflict between the EU and the UK. The EU wants to force the UK to accept EU law as binding and rejects free competition. And Boris Johnson made it clear that the UK will not give up sovereignty after they have just regained it. Trade between the two parties is intense. A hard Brexit would bring chaos, damage and anger to Europe, one of the most important economic regions in the world – at least in the short-term (we have mentioned repeatedly, that in the longer-term a hard Brexit could be good for the UK, but bad for the EU). It could potentially disrupt supply chains, too. Some may think this is all strategic positioning for the talks, but we fear the EU is extremely dogmatic and would rather accept a trade war than give in.

Here is a short summary of our view of the different asset markets:

Bond Yields

Sovereign long bond yields are in their last decline towards a cyclical and secular bottom, which we expect to materialize in the first half of the year. Some overshooting could materialize. For example, 10-year US Treasury yield could drop below 1% (chart 4).

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As we expect fiscal stimulus to kick in around the world from the second half onwards, this would lead yields higher.

Forex

We still like the US dollar medium and longer-term because capital around the world is looking for a safe haven. Only if the Fed gets very aggressive and Bernie Sanders' odds of becoming President rise sharply would it turn global investors off and the dollar would decline sharply. In the meantime, verbal intervention and some added liquidity would soften the US unit temporarily and make for some choppy trading, particularly against the euro. However, we think EM currencies in Asia and Latam will trend weaker medium-term.

CHART 4

10-Year US Treasury Yield & MACD

Source: Thomson Reuters

Equities

We are looking for a selling climax, which means down sharply intraday and closing up sharply for the day with extremely heavy trading volume. This would be a decisive short-term cleansing of the situation.

We have been looking for a medium-term low in the equity markets around mid-year.

After such a climax reversal, as a trader we would buy the retest, which usually materializes within 2-6 weeks after the climax. Until we see such developments, we prefer to stay defensive. Keep in mind that the economic news will get worse during the first half instead of better. Thus, we do not believe there is any hurry to become aggressive on the long side, except for short-term traders.

We have been looking for a medium-term low in the equity markets around mid-year. While the low may arrive sooner, we would at least expect some retesting toward that time period, before a more sustainable rally developed. If this happens, it would give us much more comfort to buy then, rather than to step in here. Expect a highly volatile and choppy trading environment into mid-year.

We believe a cyclical bear market has started for global equity markets and that the first leg down will be completed towards mid-year. While we have focused and reported on US S&P500 index, this is a proxy for the rest of the world. In our view, a global bear market has started.

Commodities

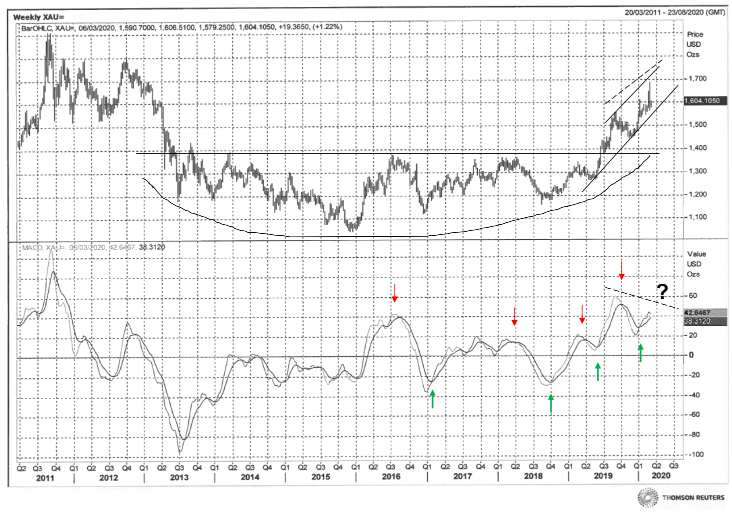
We remain bearish for economic sensitive commodities, like base metals or crude oil, for the time being. We see no reason to enter on the long side anytime soon in view of all the economic uncertainty and weakness. The commodity complex may bottom in synch with bond yields.

Gold

While we like gold for the long term (our system must debase currencies or collapse), we are concerned that it peaked in our expected time period and the break of $1,610 is a bearish development in the medium--term. What is happening in the credit and economic system is deflationary in nature, and that is usually hostile for

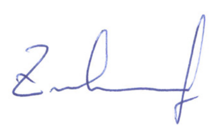
CHART 5

Gold Weekly & MACD



Source: Thomson Reuters

gold. We see the risk of a lengthy back testing towards risk in the low to mid $1400 zone, which will broaden the base for much higher prices in the next few years (chart 5). Stay tuned!



Felix W. Zulauf
March 2, 2020

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