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	Neutral
Brent Oil	Neutral	Bearish
Gold	Neutral	Bearish
EUR/USD	Bearish*	Bearish*
USD/JPY	Bullish*	Bullish*
USD/CNH	Bullish	Constructive

* Indicates a new position or change in view

HIGHLIGHTS

- The reaction by authorities around the world to prevent further transmission and spread of the Covid-19 virus has resulted in the wide-ranging shutdown of the vast majorities of our economies.
- This approach is reminiscent of the old expression "killing the patient to cure the disease."
- The global system has changed to a "war economy" and the downside will be much worse than most anticipate. This economic situation differs completely from the financial problems of 2009. It is much more extreme and severe, as it affects nearly every industry throughout the world.
- The oil price collapse due to the disagreement between OPEC and other major producers has added to the problem. The energy industry as a whole – not just shale - cannot operate far below breakeven for long.
- Infected credit markets have become illiquid, particularly the low-quality part.
- The deep decline of the world economy requires immediate and gigantic financial help to prevent a meltdown of our global economic system. Central banks and governments must underwrite the corporate sector to prevent this collapse. Dominos are now beginning to fall and the first backstops have been put in place. It is not nearly enough and will have to be increased over time. The risk of a market closure or a bank holiday continues to increase, particularly in Europe where the banking system is weakest, and its problems are compounded by the misconstructed euro.
- Many large investors with "sophisticated strategies" have been caught flat-footed and have been hit by redemption calls by large clients. Those money managers running huge amounts are being forced into asset liquidation, which in turn forces other investors into selling, thus leading to the cascade of selling. This has even infected the most well-regarded sovereign debt markets in recent days.
- We revisit our scenarios outlined in our last publication on March 16, 2020 and make some minor changes. Our tactical recommendation inside stays the same as before, as our major

big picture view has not really changed in its direction, only in its degree.

- This is not a time to be a hero. We recommend following strict risk management procedures. It would be difficult to believe that this is a great opportunity to make a quick profit, except for the shrewdest of short-term traders.
- We lay out our expectations for markets inside this report, and share what our current recommendations are for investors given the situation we are in. As details unfold, we will continue to update our readers.
- Please join us for our upcoming Q1 Webinar this Wednesday, March 25th at 10:00 a.m. EST to discuss our views. We will have a live Q&A for clients. If you do not have the registration link, please e-mail info@felixzulauf.com.

The Minsky Moment

We are not medical experts and must rely on others regarding Covid-19. But common sense leads us to believe that while this virus is very dangerous for people with a health handicap, the far-reaching shut down is most likely overblown for most of the general population. The Netherlands has taken a different approach; they only isolate those who are at-risk, quarantine them, and let the rest of the population get infected. After a few weeks their illness will have passed, and they are then healthy again and have developed an immunity. It is a strategy Boris Johnson wanted to apply in the UK, but health system experts warned against it because the medical system would not have been able to handle such a high number of infected people. The healthcare systems in virtually all Western economies are clearly unprepared and have not been able to handle a broad-based epidemic. In addition, COVID-19 has exposed major supply chain issues related to medical and safety equipment as well as certain drugs. Not to mention the world's reliance on China for key medications.

Our spoiled world has forgotten that life is risky, and that unexpected new threats can arrive unannounced. Thus, governments are not properly prepared with their medical systems. The corporate sector is not prepared either. It went into debt to buy its own stock and push it higher so that management could cash in their option plans. Now, the corporate sector is left with the weakest balance sheet when the unexpected arrives. As an example, the US airline industry is asking for $50 billion in help from the government, after it had bought back its own stocks for $45.5 billion over the last 10 years. And most individuals did not save any more (as central banks had made it very unappealing to do so with their financial repression policy, particularly in Europe with negative rates). Many people made the choice to go into debt to enjoy life, now, even though they could hardly afford it. This is so different than what was done by our parents' generation, who went through the Great Depression and World War and always took precautionary steps for unexpected events that could happen at any time. Theirs was the humble generation. What a contrast to today! Whenever the spoiled society suffers some problems, they cry for central banks and governments to help. And the central banks delivered, instead of making tough choices they simply kicked the can down the road.

Citizens may at some point realize that their pensions will not be financeable when they need them. Citizens will also realize that what central banks have been doing over the past few decades was counterproductive

This is the first time that citizens are realizing that most governments around the world have not done their job and that the health care systems are simply not prepared when an unexpected health problem of this magnitude arises. Citizens may at some point realize that their pensions will not be financeable when they need them. Citizens will also realize that what central banks have been doing over the past few decades was counterproductive and they may lose trust. And employees may find out that their corporate leaders were primarily looking after their self-interests, and not that of the stakeholders. In other words, we expect a growing mistrust by citizens vis-à-vis the political and economic establishment due to what has been and is happening in the world. Trust in our establishment and in our authorities has entered a structural bear market.

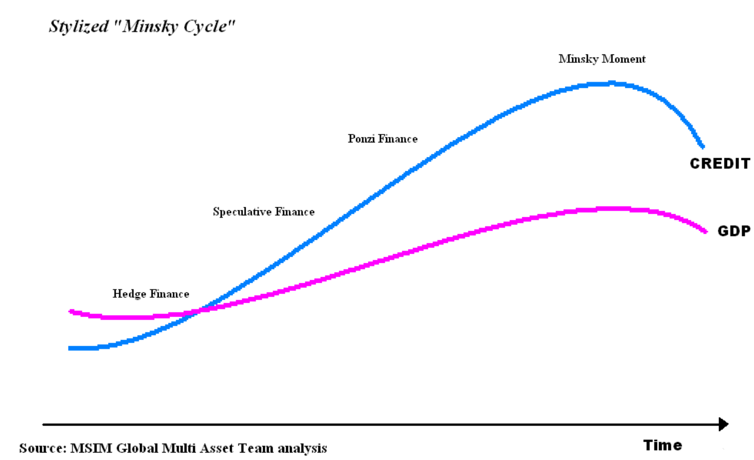
This will result in a decline of broad-based prosperity and of freedom, both economic and social. We are now laying the foundation for the coming secular reflation that could propel us closer towards this unfortunate outcome.

We have been critical, and remain so, of the easy money policy that has been in effect for years. And our reasoning is that it weakens our system structurally because easy money leads not only to debasing currencies, but to credit booms and busts which each time require more help. Thus, the intervention and manipulation by governments and central banks becomes greater with each cycle and eventually leads to a planning economy or serfdom. This will result in a decline of broad-based prosperity and of freedom, both economic and social. We are now laying the foundation for the coming secular reflation that could propel us closer towards this unfortunate outcome.

Hyman Minsky (1919-1996) was a great US economist whose work we read in our younger years. His book

CHART 1

Stylized "Minsky Cycle"



Source: MSIM Global Multi Asset Team analysis.

"Stabilizing an Unstable Economy" is great reading and could help one understand what is going on at present. His doctoral advisor was Joseph Schumpeter, a member of the Austrian School of Economics, who is famous for his work on "creative destruction and innovation". In contrast to present day academic economists, these two understood business cycles.

One of Minsky's main points was that when easy money prolongs and exaggerates a business cycle and credit grows out of proportion to the underlying real economy, there will come a moment when this imbalance must be balanced again. Chart 1 shows this with a simplistic illustration. At the beginning of a cycle, finance is sound and conservative behavior is the norm. As the business cycle expands, finance becomes speculative and eventually leads to Ponzi schemes. Fraudulent schemes are part of this. It usually is an exogenous event that triggers the beginning of a correction. We call that the "Minsky Moment." The expression was coined by our former colleague from UBS, Paul McCully, who after UBS became the former chief economist at PIMCO.

A New Era

The reaction of governments, medical experts, media and people to Covid-19 triggered the Minsky Moment in this cycle. The virus is not the cause of the looming economic crisis itself, but it is the trigger. This is an important point. Those who think the world will quickly return to how it was before, once the virus disappears by late spring or mid-year, do not understand the implications of the Minsky Moment! It changes the world for longer than just a few months, due to the structural damage done in the meantime. The dominos are now falling throughout our system, even as the central banks try to backstop it. Negative cash-flow will bankrupt many companies and lead to the loss of livelihoods by many. Their attitude to economic life may change for the rest of their life. This will impact everyone, entrepreneurs, large and small business owners, managers, employees and investors. There will be no exceptions.

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We may elaborate more on this later, but for investors it means that the deflationary or disinflationary period with ever lower bond yields is ending, while short rates will stay down for long as part of the intensifying repression that lays ahead. We will see much more government involvement in the future, more financial repression and central bank and fiscal authority involvement and major reflation leading eventually to a secular shift toward rising inflation. But first, we need to get through the downturn and the repair period in the real economy and the markets.

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Supply chains will be re-patriated and brought back to locations close to the region of the end market consumers. For example, China makes 95% of antibiotics and 70% of the base materials for pharmaceuticals in the US. This type of dependency on global trading partners will not be tolerated any longer, for safety reasons. The globalization from the past few decades will now lead to accelerating de-globalization, and consequently to increasing costs and lower productivity. Nationalism will also rise in a more pronounced way with tighter border controls, even after this pandemic ends. In the future, we will see more activist politicians than free-market orientated ones. Politics will move more towards socialism, trying to hand out goodies to keep the people quiet. The net effect will be a decline in prosperity, safety and freedom for individuals as well as the corporate sector. The era of travelling will slowly pass, as people will stay closer to home. All these things will not become immediately apparent, as it will be a slow process. In this sense, the world we knew has ended and a new era has begun.

This is very important to understand for investors, particularly those who think the present situation compares to 2009 and is a simple repeat. In our view, it is definitely not. This market will challenge us for longer than in 2009, and it will be more painful. Most likely, what we have seen is only part one, and it does not seem finished to us. Part two will occur over a period of several months when the Covid-19 fear abates and the world believes we are back on track toward what the world was like before the pandemic. The surprise will then follow when it is realized that the fundamental damage to our economies is such that equity markets will have another long drawn out downleg into a bottom, most likely in 2022. We will keep you posted.

Once a bottom is in, investors must then increase equities and inflation protective measures and reduce nominal assets. This is a slow process and may take 1-2 years.

Inflation will lead to the better performance of real assets than nominal assets. We are now going through that transition mechanism, which could last anywhere from several quarters to a few years. Equities will look completely discredited once this bear cycle is over. Investors should stay liquid, trade medium-term if you have the ability, and wait for the great opportunities that will arrive once the bear market disappears again. Once a bottom is in, investors must then increase equities and inflation protective measures and reduce nominal assets. This is a slow process and may take 1-2 years. Until the new secular trends begin in earnest, we strongly recommend investors to start thinking about how they want to position themselves best for the new era. Do your homework!

The War Economy

The "precautionary" steps governments are dictating have led to a change of our economies into a "war economy" (chart 2). Only essential production and services are kept running, people must hide at home and work from home if possible. Only those who must

CHART 2

The World Is Closed For Business

Source: The Economist

keep the essential parts of the economy running (medical, agricultural, food, basic finance, etc.) are kept open, while the rest are closed or sharply curtailed. It is no fun. It will lead to major casualties in the corporate sector around the world. We would not be surprised to see the GDP of our economies sliding 20%, which is depression level.

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This economic situation therefore differs decidedly from 2009, which was a crisis in real estate and finance. This time, the broad economy is affected as cash-flows in the entire corporate complex (with a few exceptions) decline and go negative in many ways. The corporate sector in many countries has entered this new situation by running large financial deficits (they must borrow to pay their bills, investments, dividends, etc.). According to some sources, the US corporate sector was running a deficit last year of $500 billion, the UK of £45 billion, France of €75 billion, and Germany of €100 billion. Some others like Italy or Japan were running surpluses, due to their deflationary bias. If we cautiously assume that due to cash flow drying up, the needs of the corporate sector may at least double this year. We are talking about big numbers. If we understand that China's corporate and local government sector has run a cash-flow deficit of 8% of GDP for years, we can imagine that they also need vast amounts of liquidity. So far, the total amount being talked about around the world is slightly below $5 trillion (yes, that is 5,000 billion!). In our view, it will not be enough and more must and will follow.

We expect the world economy in terms of GDP to decline close to 20%, which is a depression, not a recession.

The liquidity shortage must be solved by the central banks, as the private sector may be unwilling to do so by buying new debt. For this reason, central banks and governments have announced large amounts to help. We think that in addition, central banks must quasi-underwrite the corporate and sovereign bond market. It is a sort of "mini-nationalization" of the debt markets to support them and keep our system functioning. We assume and already see in some countries that certain payments have been suspended, like taxes, interest on debt, etc. The costs of all of this will be enormous. But it will be lower than letting the system go down completely. All of this is already part of the new world and one step deeper into the more powerful repression that is beginning. As we have seen in the last crisis, the US central bank was the only one trying to reduce and "normalize" its balance sheet during the ensuing expansion. It was a short-term affair and was terminated quickly with a far smaller amount than intended. In other words, do not believe that the central banks will ever "normalize" again. Hello, new era!

Central banks are doing the right thing at this moment of crisis but will eventually have to increase the amounts involved. We are pleased to see that the Fed has opened USD swap lines with several central banks. They should also do this with China, as China is under severe pressure because of its large debt denominated in US dollars. Chinese corporations will need more USD funding. Moreover, there are many borrowers in the EM and frontier universe that will be desperate for US dollars. If they cannot get them, it will lead to major bankruptcies that will also impact our Western credit system. We also expect the IMF to eventually get involved. This is to make sure the major backstops for our system are in place. Even with them in place, the world economy will suffer badly. We expect the world economy in terms of GDP to decline close to 20%, which is a depression, not a recession.

Major Liquidation Process at Work

At present, markets are still in the liquidation process, as investors have been wrongly positioned, or levered and are forced to liquidate. A lot of the aggressive and very big money is managed based on academic theories that are rooted in the Modern Portfolio Theory. "Risk Parity" is one such strategy where a portfolio is mixed based on their measured risk. This risk is simply past price volatility - and may be adjusted for newer input. Thus, if a market advances steadily in a smoothed fashion due to the assumed Fed put (it never exists when needed), volatility or risk in this sense is lowest at the top. Once prices begin to decline and price movements become more volatile, risk measured that way goes up. And as risk goes up, these investors, according to their own theory, must sell. And their selling begets more selling, as more selling leads to ever higher volatility. We leave it up to our readers whether such a strategy makes sense or not. In our view, it is simply another example of all the fair-weather approaches.

We are taking the assumed that some gigantic investors are cancelling mandates due to financial stress in their home country. Think about oil producers having huge cash-flow problems. Hence, these "sophisticated" money managers may then be forced to liquidate. And as they do, selling begets selling and this pushes volatility up, which is the way they measure risk. We measure risk according to the intrinsic value of an asset and its future cash-flow production, and not by how much the price moves. In our view, the highly academic approach that works under fair weather conditions never works when it starts raining, or even worse, when it is pouring. In every cycle we have "professional experts" who create such turmoil. In 1998, LTCM was run by Nobel Prize Winners who are still famous for their option-pricing models. Of course, these investors are part of the Ponzi financing that comes late in the cycle according to Minsky. And when their risk needle points higher, they must liquidate ever more in a cascading fashion. At that time, dominos start to fall and the problems in the financial markets affect the real economy. That is happening now.

Conventional investors are selling because they feel uncertain and do not understand what is going on. As a risk procedure, they move to cash, which is also logical and understandable. As we explained in previous reports, this is why we have never given up and continue to believe in cycles -, both in the economy and in financial markets. Only enter the kitchen if you can stand the heat. The volatility we are seeing is not for the faint-hearted.

Revisiting Our Three Scenarios

In our last report, we explained our three scenarios. We are making the following adjustments to the odds of each:

A)Depression with 1929 style market meltdown (raising from 20% to 30% odds)
B) Final bear market washout terminating a multi-year bear cycle with new highs ahead (reducing from 30% to 20% odds)
C) Multi-year bear market with the final low beyond this year (unchanged at 50% odds)

We are slightly increasing the odds for the depression scenario and reducing the odds for the bear market washout with immediate new highs.

We are raising the odds of a depression and a corresponding severe bear market, although we still find it less likely than our preferred working hypothesis.

The industrialized economies could all decline more than 10% and we think as much as 20%, which is more than ever before since the last depression. Thus, we are raising the odds of a depression and a corresponding severe bear market, although we still find it less likely than our preferred working hypothesis.

In contrast to 1929, the world is not on a gold standard and can create as much money as is needed to economically save the world.

We have decreased the "ending of the bear market in this decline" scenario because we see the domino-effect in the real economy, which will change the world. A market decline like that of 2008/09 which is on everybody's mind is hardly the correct comparison, because that was a financial sector crisis that was fixed by the central banks' bazooka but did not impact the service sector by much. For short- and medium-term tactics, the three scenarios do not call for a different solution short-term. This time, the process is affecting the whole economy without any sector escaping. Keep in mind that the world carries much more debt relative to the economy's size than ever before in modern history. The damage done will leave an unforgettable impression on all economic subjects for the rest of their life and may change their behavior towards exercising more caution.

The appetite for equities at the low will be such that you will not want to buy them. That will be the bottom. We expect this to arrive either in late 2021 or more likely in 2022.

In contrast to 1929, the world is not on a gold standard and can create as much money as is needed to economically save the world. While the decline of GDP will reflect a depression, the outcome will differ from the Great Depression. In our view, governments and central banks must and will get involved to a greater degree than ever before––with lasting consequences. Most likely, the debasing of our FIAT currencies will accelerate over the next generation and lead to new and most likely even bigger problems. Most people usually lose out in an inflationary world. Thus, a social backlash could escalate in future years. If you do not know how this looks like, take a look at Argentina as an extreme example.

Among our scenarios, we clearly favor scenario C – a market with wild but tradable medium-term swings for a few years (still 50% odds). Our working hypothesis is that once this current decline terminates towards mid-year, a medium-term recovery will follow which we expect should last approximately 3-6 months. We then expect the recovery rally to give way to a second decline that will most likely be less impulsive and sudden, but a gradual decline. It should fully discredit the "buy & hold strategy" and the passive investment approach when the bottom is reached. The appetite for equities at the low will be such that you will not want to buy them. That will be the bottom. We expect this to arrive either in late 2021 or more likely in 2022.

This timeline is not carved in stone, but we want to give subscribers an idea of what our scenario could look like for the future. We will continue to advise our subscribers as things shift, and keep you informed as we see ourselves progressing through the various stages.

Once we gain conviction that the bear market is ending in approximately late 2021 or in 2022, we expect that there will be another bull market that will lead us to new highs. We see high odds that this will happen. Take this as a big positive from someone whom others often call a skeptic! We look forward to having more positive news for our readers, but we will all have to go through a painful time before we get there.

The Likely Path of the Markets

Thursday, March 12, 2020, was the day the New York Stock Exchange showed the largest number of declining stocks (4037), the biggest declining volume (2,090,383,352) and the highest number of new 52-week lows (3216). Although during trading last week the major indices declined sharply again, these extremes were not reached. Despite the weak closing on Friday that must have moved more former bulls to the bear camp, we consider this a first ray of sunshine, as it shows that selling pressure is slowly lessening. Moreover, our short-term oscillators are beginning to marginally diverge from further declining indices. And a new short-term buy signal by our momentum work is pending any day; in some selected European markets it has already arrived. Sometimes, we look at Elliott's wave theory, although it is highly subjective. But it is another tool with which to understand the mass psychology at work in the markets. Of a theoretical 5-wave decline from the top, we see the major indices either late in wave 3 (the majority of the major indices in the US and Europe) or late in wave 5, depending on the indices. Short-term fear and risk indicators are at their most extreme in many years. This suggests that we are close to entering a countertrend move (wave 4) that will most likely be sideways with high two-way volatility. The final medium-term low we expect only when wave 5 down ends, which we expect sometimes between May-July of this year.

Bear cycles are corrections of previous bull cycles. You should not expect a 10-year bull cycle which showed one of the most extreme valuation excesses in 100 years to be corrected by a one-month decline. Markets need much more time after such a devastating decline to build a base. And base building means high volatility sideways trading. Our view is for a three-step decline, or an A-B-C as technicians call it. The A wave down is highly impulsive and markets could lose up to 50% of their value. It is followed by a B wave recovery due to extreme oversold conditions and some lessening of the perceived problem (in this caseCovid-19). Then follows the C-wave decline that lasts longer and is drawn out (chart 3, next page). During this decline investors realize how big the structural damage is and they lose interest in equities and sell.

You should not expect a 10-year bull cycle which showed one of the most extreme valuation excesses in 100 years to be corrected by a one-month decline. Markets need much more time after such a devastating decline to build a base. And base building means high volatility sideways trading.

Building a bottom is hard work, and we prefer to leave that part to others and to concentrate on buying when the time is ripe. For medium-term operators, we expect this low may come between May and July 2020. But we also think that longer-term investors need to buy at this upcoming Covid-19 related low so that they can sell at the next phase of the A-B-C, probably around the turn of the year. We would like our investors to be ultra-defensive in what happens then as the "going-out-favor-process," or the C wave decline into the final bottom. It will be nerve wracking and painful, financially and emotionally.

We will report to our clients on when we think it is time to get your feet wet and tip toe back into the investment waters.

A good historic low is usually retested. 2009 was an exception, but for those who do not trust us, they could read our interview in Barron's from March 7, 2009. The interview was recorded on March 6, 2009 which was the day of the low. We expressed our view that at least 25%-40% would be seen on the upside in the next 3-6 months, but we were not sure what would follow thereafter and whether or not we would still go lower. Tactical maneuvering counted then, as it will this year.

In view of all the damage done to the real economy, we seriously doubt this will be the V-shaped recovery that so many have in mind, particularly those looking at previous lows. Our view remains that the May-July period should bring at least retests or even considerable undershooting of previous lows, though not confirmed by the internal statistics. In other words, even if the major indices should slump considerably lower, let's say to 1800 for the S&P500, we would expect these lows to be unconfirmed by the technicals.

We are confident we will find a low-risk entry point to get long again, but would not hurry except for very short-term oriented shrewd and experienced traders. We will let you know when we think there is less risk to make a move to get back in the markets.

What To Do

We recommend staying defensive until the dust has settled. **Equity markets** will likely swing wildly for several weeks, if not months, to find and build a bottom. This decline has done so much damage that an immediate sustainable rise is the most unlikely scenario. Of course, the value of a great company will go up again sometime in the future. All we are interested in is to buy that good company or the market when the price is exhausted on the downside, when the selling and liquidation is done and the investment community has moved from fully invested to high cash and defensive positions – and not before. We seriously doubt the market is there already. In our view, there must be a healthy relation between the previous bull cycle and the bear cycle. You cannot clear in one month the longest business cycle expansion and one of the most powerful bull markets in history lasting 10 years. This simply does not make sense. For those who have moved defensive as we have recommended, stay defensive. Wait like a sniper for the right moment. We intend to signal when it is okay to re-enter markets on the long side for at least the medium-term investor.

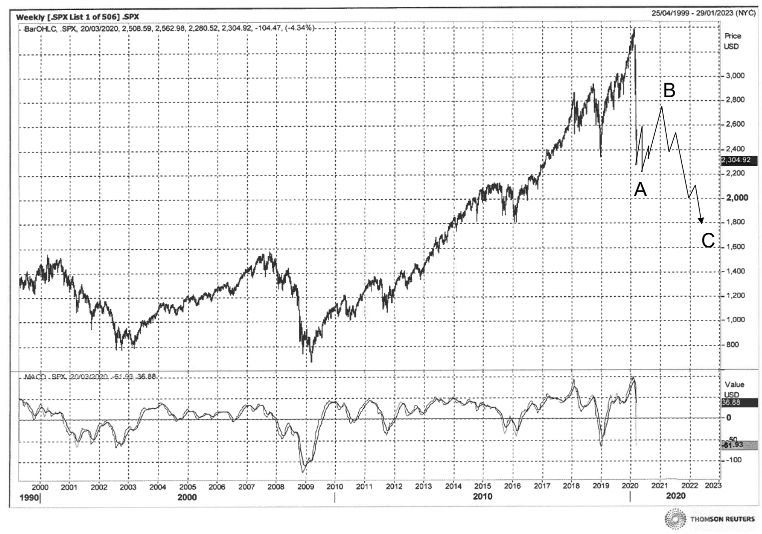
For those who have not sold, or not sold enough and think they are still too much exposed to the market risk, wait for bounces in coming weeks and use them to sell. We doubt the S&P500 will break 2700 into mid-year (chart 3). It could get close or even above briefly, but the 2600-2700 zone would be the zone where we would raise cash. We see 2600 as a realistic chance to reach but are not sure about 2700. We would still weed out sectors and stocks that have performed worse than the market on the way up into the January peak and on the way down. These are the real losers and will need much more time than the general market to repair their fundamentals. Please apply similar consideration to other markets.

The more difficult question is for investors in the **fixed-income markets**. High quality corporate bonds trade in close lockstep to the sovereign markets, although spreads are widened. We expect a cyclical and secular bottoming to be in a terminal stage and would use bounces in corporate bond prices to sell, particularly longer maturities. As we expect more central bank support to arrive in coming months, we would continue to hold short to mid-term maturities as defensive cash equivalents.

The high yield/low quality segment swings in synch with the equity market. The whole corporate bond market is illiquid at present, but central banks will

CHART 3

S&P500 & Expected Future Course



Source: Thomson Reuters

come in and lend support. Do not assume that this market will be back on a bullish track immediately. It will be a limited support but not a bail out. Thus, we would only hang on if the quality of the borrower is fine. This crisis will eventually normalize in the economy - most likely later than most assume, - and therefore bonds beaten down due to illiquidity but where the borrower's quality is okay may recover. In terms of duration, we intend to move step-by-step away from long to shorter duration, as we see this as a cyclical and secular bottoming process and yields trading near the cycle lows. A year from now, we expect medium to longer-term yields to be somewhat higher but short rates lower.

For the sovereign sector we have already mentioned in our last report that we would avoid lower quality borrowers. We would also move out of all European borrowers – even perceived high quality - denominated in European currencies, as we are still very concerned about the European financial system, the European Monetary Union and the euro. And it does not make sense to hold Japanese bonds here because yields are low, and we do not expect the currency to strengthen soon against the US dollar.

Our preferred bond market has been the US Treasury market. We mentioned that we intend as our next step to turn bearish on bonds. The move up in yields for the **10-year Treasury** from the low at 0.32% (closing low 0.49%) to over 1.00% within a few hours of trading was dramatic and probably indicates forced liquidation by some risk-parity managers. The move must be seen in the context of the previous decline from 1.97% in November to the low at 0.32% in March. We still believe there is a good chance that that low may be retested, or at least the closing low of 0.49%, if not broken. Keep in mind that the Fed must make Treasuries as unattractive as possible so as to channel the flow towards the corporate sector. Thus, some patience is needed for those staying long and waiting for a good selling opportunity. Major short-term resistance on the upside is around 1.15%-1.35% (chart 4). A break of 1.35% would surprise us and most likely mean that the low has been reached. But we still believe that top quality yields will come under downward pressure once again when the corporate sector begins to report Q1 earnings and bleak outlooks from early April onwards.

In our last report, we wrote about short-term whipsaws in the **forex markets**, but we explained that we stay bullish the US dollar on a medium-term trend. Unfortunately, we did not adjust the summary table on the front-page of the publication. Please forgive us - it has been a hectic period for us too and we should have clarified. While we saw and still see one more slingshot lower for the US dollar in these volatile markets, the medium-term low has been set and the medium-term if not the cyclical trend for the **US dollar** stays up until the Fed's bazooka gets so big as to weaken it. We think this is unlikely in the next few months (chart 5).

We have explained several times that there is a shortage in US dollars due to the high indebtedness by foreign entities, public and private. This shortage accentuates when the economy sinks, and cash-flows dry up. Keep in mind that USD denominated debt by non-bank borrowers outside the US had increased from $5.8 trillion by late 2008 to $12.1 trillion by Q3 2019, according to the BIS. If the US banking sector and foreign intermediary banks show

CHART 4

10-Year US T-Bond Yield Daily & MACD

Source: Thomson Reuters

CHART 5

USD Index Weekly & MACD

Source: Thomson Reuters

a low-risk appetite due to deteriorating economies around the world, the funding and refunding of outstanding US dollars get squeezed and someone is forced to buy US dollars in the open market. For this reason, the US dollar moves counter cyclical to the world economy. If the world economy weakens, the US dollar strengthens and vice-versa. A weaker world economy is deflationary and creates shortages of US dollars, while an expanding world economy does the opposite. In the current sharp decline of the world economy, the problem is accentuated to a larger degree and makes the US dollar super strong.

We would not be surprised if pound sterling fell back to its 1985 lows of 1.05 to the US dollar.

The Fed is slowly waking up to the currency problem but most likely underestimates its degree. The USD swap lines with other central banks is a good first step, but most likely not enough. In addition, uncertainty about the European monetary system still forces capital out of Europe into the US, and the same is happening with Asia, as China is far from being back to normal. Those exposed to the highest risks are all the emerging and frontier economies that participated to a large degree in the global credit boom and for a long time were free riders when the US dollar was easily available and looked cheap. Those central banks are now being forced to ease policy, which in combination with the other factors simply sinks their currencies. We have shown the chart of the Brazilian real and the Korean Won (clearly better fundamentals than Brazil) in a recent report and explained that we expected a decisive weakening which is now underway. Natural resource currencies like the Australian dollar, Canadian dollar, Norwegian kroner or Russian ruble are under severe downward pressure. We wonder how long the Saudis and Omanis can hold their currency pegged to the US dollar given the current stressful situation they are in.

GBP is one of the currencies that suffered a devastating slump not just a correction. The Bank of England moved quickly to support the credit system by offering a huge amount of financing. In contrast to many other major currencies, the UK has run a chronic current account deficit which at times was 5%-6% of GDP. It narrowed last year, and we estimate it amounts to 3%, now. This still means that the UK must attract a large amount of capital just to keep the currency stable. A weak currency given the current circumstances may not be all that bad for the UK, as in such circumstances the economy also weakens sharply. Moreover, the upcoming trade discussions with the EU may let the UK demonstrate that it could easily let the currency drop, if the EU played it tough. The EU has lost a lot of bargaining power due to a slumping economy on both sides of the Channel. Playing tough is easy during good times but difficult when times are rough. We would not be surprised if pound sterling fell back to its 1985 lows of 1.05 to the US dollar.

Do not rush to buy commodities, as we will have enough time to do so at cheaper prices. Crude oil has now fallen into the low $20s and is bouncing off. We doubt this is the low.

In summarizing our forex stance: Stay bullish on the US dollar against all currencies on a major trend basis. The strong dollar will only be over once the stock market has hit the cycle bottom, which most likely will not be this year but rather in 2021 or 2022. However, the US dollar strength of this month may lead to a short-term correction. But stay the course on the medium-term and cyclical trend. The greenback will go higher.

Commodities are declining sharply, according to our scenario and expectation. The world economy is in a free fall and demand is falling off a cliff. This is in our view the final decline of the bear market in effect since 2008. We do not know where the bottom is, but we will find out (chart 6). Do not rush to buy commodities, as we will have enough time to do so at cheaper prices. Crude oil has now fallen into the low $20s and is bouncing off. We doubt this is the low. Saudi Arabia wants Russia back at the bargaining table and must probably force prices even below $20 toward the $17 technical target. It gives many governments a chance to buy oil cheap to increase their strategic reserves. We expect this to end by late summer at the latest because the extreme policy forces a quick solution among producers, as it is so painful. It is conceivable that President Trump will try to broker a solution between the two parties in conflict regarding their production strategy.

As long as the US dollar remains strong, the commodity complex can hardly recover, as the world economy will hardly recover quickly to turn this crisis around. Stay defensive and patient.

CHART 6

Bloomberg Commodity Index

Source: Thomson Reuters

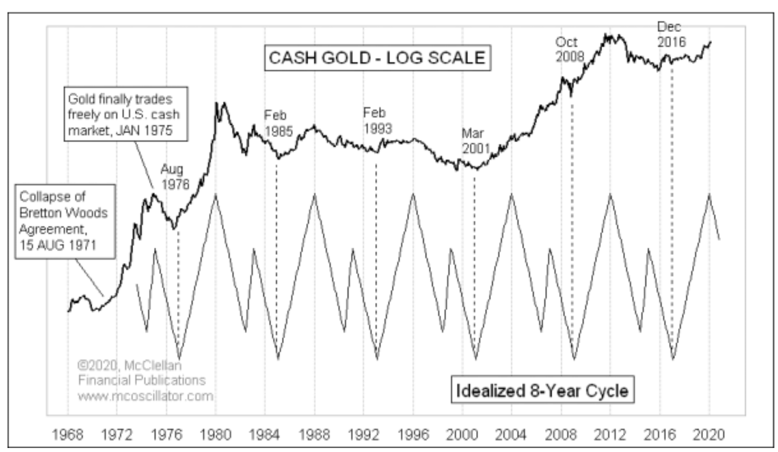
This Time Is Not Golden

Gold has disappointed all those who believe it offers a hedge against an economic crisis. But if the crisis is highly deflationary like this one, it hurts virtually all assets, including the yellow metal. Not only has bullion broken our $1610 stop loss level, gold mining stocks slumped in a devastating way. GDX, the gold mining ETF fell virtually 50% within 3 weeks from its high at $31.84 on February 24.

The short-term damage for gold is done and we will soon see a bounce. But for traders, it is a selling opportunity. If our big picture view is right, the gold complex will become a screaming buy at sometime within the next 2 years, as authorities will be forced to fill the reflationary pipeline with bigger ammunition than ever before. Our view goes hand-in-hand with our conviction that bond yields are in a cycle and secular bottom here. But gold fans' patience will be tested. We came across the 8-year cycle chart by

CHART 7

Gold & McClellan's Idealized 8-Year Cycle



Source: McClellan Financial Publications

McClellan (chart 7), which points to a lengthy correction. While such charts always look neat, they could be wrong, and if a new secular bull market develops as we suppose, it may very well be that the next mini cycle low in 2022 could be very similar to the one in 2007 (which was still in the early stages of the last bull market).

Our fundamental view for gold is bullish in the long-term, but current market action and technicals keep us from a buy recommendation yet.

Our fundamental view for gold is bullish in the long-term, but current market action and technicals keep us from a buy recommendation yet. Use bounces to lighten exposure if you still own gold and want to re-buy it at lower prices later. We are trying to guide you to find the next low-risk entry spot and great buying opportunity. Stay patient and stay tuned!

Felix W. Zulauf
March 23, 2020

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