ZULAUF CONSULTING

INVESTMENT COMMENT

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IN THIS ISSUE

POSITION SUMMARY

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

* Indicates a new position or change in view

HIGHLIGHTS

- China Paper leaks, Hong Kong Community elections, UK parliamentary elections and coming changes in the German political landscape are all evidence of a political environment undergoing major changes.
- Some upticks in selected economic series from depressed levels have raised hopes of an improvement in the world economy. We believe these hopes are misplaced, and we continue to expect very low growth around the world, as fiscal stimuli remain lower compared to what is needed.
- Short rates are being cut around the world, which we expect to continue as a trend. Bond yields have bounced and could bounce some more, particularly in European markets. However, we doubt this is the beginning of a cyclical rise of US T-bond yields, yet. We see more downside potential than upside risks in yields for the next 3-6 months.
- The US dollar remains in its choppy correction, which is not over yet. EM and particularly Asian currencies remain weak, however.
- Global equity markets differ considerably in performance. Asia and many EM markets (with a few exceptions in local currency terms) remain weak and vulnerable to further declines. The US and European markets may feel the tightening liquidity because of the banking sectors' balance sheet reductions towards yearend. The current short-term corrections may last 1 - 3 weeks before markets may attempt to resume the medium-term rally into early 2020. The quality of the current decline and the ensuing recovery attempt will be important for the future directions of markets.
- Commodities continue to disappoint its fans because the world economy is simply not as robust as they expected it to be. Not even a correcting US dollar could trigger upside activity.
- Gold has fallen into a deep oversold condition, and sentiment has turned bearish. A short-term trading bounce has begun and needs to cross $1500 to gain medium-term credibility and momentum. Traders should nibble on the long side with tight stops.

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Greater China Issues

In Hong Kong, the pro-democratic forces gained a majority in 17 of the 18 District Council elections. More importantly, the voter turnout jumped from 47% in 2015 to 71% in 2019, a new record. It seems that freedom becomes an issue once the risk of losing it appears. The pro-democratic camp gained 347 seats, while the pro-Beijing camp gained 60 seats and independents gained 45 seats. In the real world of politics, however, this does not change the power in Hong Kong, as Beijing will always control the majority in the Legislative Council (where elections will be held next year). Though the message to Beijing is clear, Beijing will hardly make new overtures to change the system. The result may also be important in view of the election of a new president in Taiwan to be held on January 11, 2020.

US President Trump signed the Hong Kong Human Rights and Democracy Act into law a few days after the election, without much enthusiasm, and though Congress wanted it. It is a counterproductive step regarding a potential trade deal and will certainly not change anything in Hong Kong, except that the US Navy cannot use its harbor any longer. We assume that Beijing will become tougher with Hong Kong, as soon as its economic situation allows. As with many other issues, China will not bend.

We find the leakage of the "China Paper" to Western journalists even more interesting, as it shows that someone from the inner circle of the Communist Party had an interest in sharing with the world what is going on in the province of Xinxiang. The native people are the Uyghurs, a Turk tribe; and also Muslims like in the neighboring nations of Kazakhstan, Tadzhikistan and Uzbekistan. China is dominated by the Han Chinese, who are preoccupied with bringing other tribes like the Uyghurs into line with the goals and ideals of China's Communist Party. The paper offers a rare insight into what the leaders of China's Communist Party have decided. They want these people to forsake their religion, and Chinese forces there have been ordered to show "no mercy" to those who do not comply. Out of the 10 million Uyghurs, 1 million of them are being held against their will in an "education camp" where they are indoctrinated with China's Communist Party ideology and goals and prescribed behavior. Many families complain that relatives have disappeared or, reportedly, have died. Chinese officials live with many Uyghur families in order to continually spy on them 24 hours a day. It is simply an example of how brutal China is with all those who do not yield and conform. The individual counts for nothing while the Party's power counts as everything. This should be taken seriously by China's trading partners, because it shows once China has a goal, China marches towards it without any consideration of others at any cost.

It is unclear whether the leak from China is because someone does not agree with their policies towards the Uyghurs, or whether its intention is to weaken the power of President Xi. We suppose it is the latter.

The news about these camps is not new. What is new, however, is that a highly confidential paper from within the upper ranks of China's Communist Party has been leaked to the outside world. It is unclear whether the leak from China is because someone does not agree with their policies towards the Uyghurs, or whether its intention is to weaken the power of President Xi. We suppose it is the latter.

President Xi did not gain many friends when he removed many party members from their positions in the fight against (so-called) corruption, which had very little to do with corruption and much more to do with cementing his own power structure. Moreover, Xi Jinping is of Northern Chinese descent. In general, Northern Chinese are stereotypically known to be more bureaucratic and power oriented, while the Southern Chinese are more trade oriented and more open to the world. It is no secret that many businesspeople are unhappy with how Xi handled the trade situation with the US. There may be more dissatisfaction in China

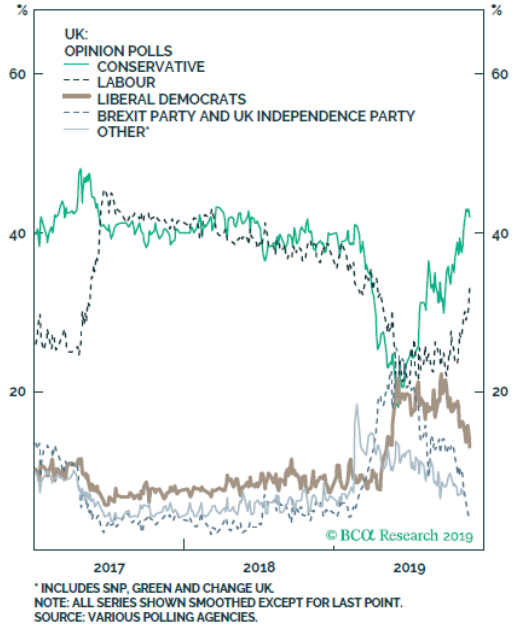
than we in the Western world yet understand. It could be a factor for more economic stimulation, as soon as the circumstances allow it. At present, the balance of payment remains too weak for a major stimulation, as it would weaken the currency, and potentially quite sharply. This could ignite inflation in a time when the CPI is rising and food prices are rising, particularly for pork.

If the US introduces tariffs on December 15, 2019 as announced, it would be another blow to a deal between the US and China for the near future.

Moreover, it also shows that Xi also needs a trade deal but cannot bend due to internal Chinese politics; this is also partly true for President Trump. And because the US did not hesitate to challenge China with steps like the Hong Kong Human Rights and Democracy Act, President Xi Jinping must show strength and retaliate. Now, Trump says he does not need a trade deal and can wait because China needs it much more. Such behavior will hardly lead the two parties closer to a deal. In our view, however, China has tried to turn the tables and to maneuver itself into a better position to dictate the terms of a trade deal. It helps Xi that he is elected for lifetime - even though it may be a farce. Any deal will not be of substance but more of a ceasefire in an ongoing conflict that, in our view, will intensify in the long-term. If the US introduces tariffs on December 15, 2019 as announced, it would be another blow to a deal between the US and China for the near future, which is what Wilbur Ross (US Secretary of Commerce) said to the media yesterday.

CHART 1

UK Political Polls



Source: BCA Research

UK Elections on December 12

In the UK, the Tories are expected to gain a majority in the parliamentary elections on December 12, 2019. Recent polls are shown in chart 1. The Brexit Party is attacking only Labour Party seats. Moreover, the Independence Party will most likely steal seats from Labour, too, which makes it easier for the Tories to win a majority. Finally, Brexit can take place before end of January 2020. We expect the pound to extend its current rally into yearend.

Thereafter, a Tory government must negotiate a new trade agreement with the EU. While this may look easier than the divorce process of Brexit that will be behind us by the end of January 2020, we know how stubborn the EU can be in protecting its economic interests. Let's hope that Germany will have a more important say in how to deal with one of its best customers. The other option the UK could have is to join the trade zone with the US, but only after the transition period with the EU. The UK could certainly use it as bargaining leverage with the EU, and the Trump Administration would back them.

Pending Changes in German Politics

The German Social Democratic Party elected a left-wing duo as its new leaders. Norbert Walter-Borjans and Saskia Esken defeated the current finance minister Olaf Scholz and Klara Geywitz. The latter duo represented the establishment and moderate wing, while the two elected are clearly from the left wing. Saskia Esken has little leadership experience, while Norbert Waltert-Borjans was finance minister of the state North Rhine-Westphalia from 2010-2017. He became famous for buying stolen CD's using the banking data of German residents hiding money outside Germany. And as finance minister, he was several times disciplined by the Court for mismanaging his budget.

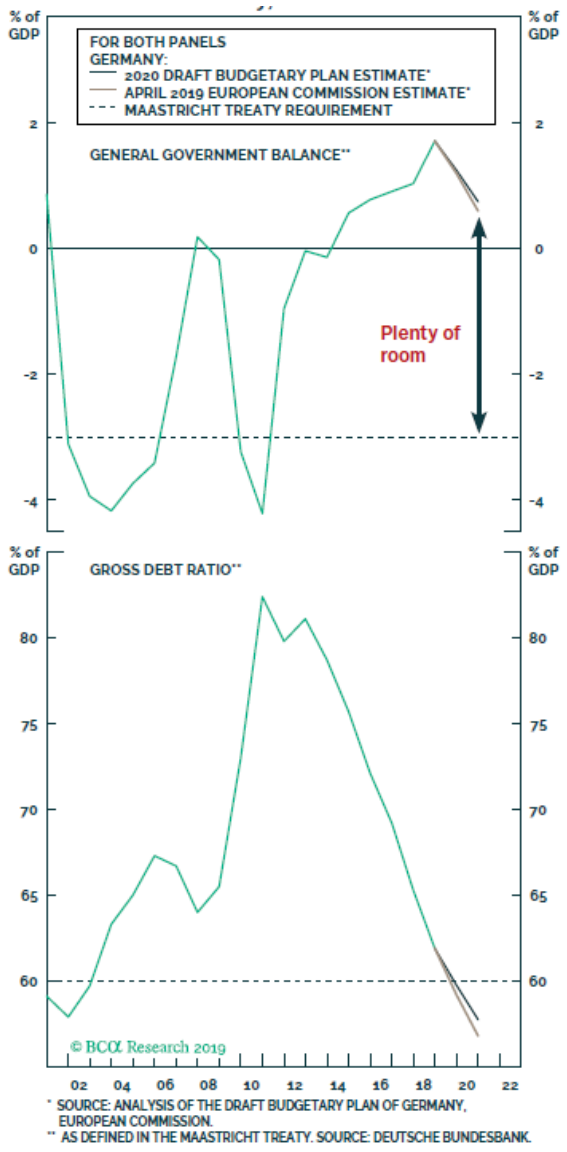
> The options for forming a strong government are virtually zero. As a result, the current coalition government may agree to become more aggressive in its fiscal policy, instead of risking another weakening of their power.

The new leadership duo favors a decisive left-wing economic and social policy and they have already called for more investments to protect the environment as well as for increasing welfare for the poor and middle class. It would all be financed by running deficits and assuming more debt as well as by more taxing of the rich.

The Conservatives have already reacted by saying the coalition Agreement will not be changed. The whole situation may lead the SPD to pull out of the government because they blame their coalition partner for the substantial losses among voters over recent years. If this happened, the Conservatives could try to form a new coalition with new partners. The problem is that it would either be a minority government or a very weak coalition, weaker even

CHART 2

German Government Budget and Debt Situation



Source: BCA Research

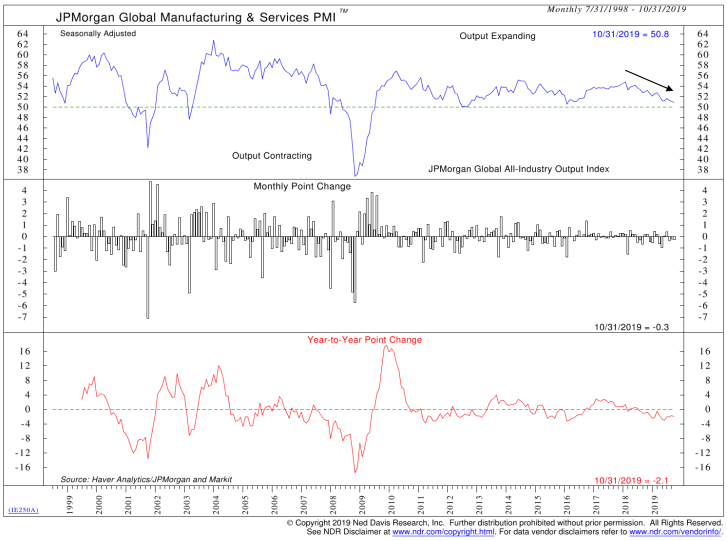
than the current one. Moreover, the Greens would likely be the coalition partners, and their policy does not differ much from the left wing of the SPD. Thus, new parliamentary elections could be the most democratic option. However, even this may not solve the problem of a weak government, as most likely the formerly dominating people's parties like the CDU/CSU and the SPD would even gain less votes than last time. In contrast, the Greens and particularly the left wing "Linke" (former Communist Party of Eastern Germany) and the right wing AfD would gain decisively. And the Conservatives refuse to work with the Linke or the AfD while the SPD refuses to work with the AfD. Thus, the options for forming a strong government are virtually zero. As a result, the current coalition government may agree to become more aggressive in its fiscal policy, instead of risking another weakening of their power. Chart 2 (previous page) shows that Germany would have plenty of room to stimulate via fiscal policy. Germany is an economy highly dependent on exports; and if China does not reaccelerate and Chinese imports remain weak, which we continue to expect, it would make sense for Germany to help its economy via fiscal boosts for the domestic economy. We would, however, favor lower taxes (supply side) instead of misguided investments with negative returns. The consequences of such a policy will be discussed here once they become more realistic. But all these problems in EU member states do not pose a threat for the euro's existence because, in virtually all member nations, the constituencies are backing it, and despite the widespread public opinion that the ECB's monetary policy is highly misguided.

False Green Shoots?

George Soros's theory of reflexivity comes to mind when looking at the performance of markets in recent months. While economic fundamentals have in general weakened, there were a few upticks, as we had announced earlier. Many of these upticks are found in indicators that are influenced by the stock

CHART 3

Global Manufacturing & Services PMI



Source: Ned Davis Research, Inc.

market. Purchasing managers indexes (PMI) (chart 3) are a survey of these managers and they correlate better with the stock market than with the real economy. Thus, investors should not rely heavily on them to form an investment policy. But, of course, rising stock indices can influence the psyche of entrepreneurs, managers and consumers in a positive way. This is why stock indices, like monetary indicators, are part of the leading economic indicators (LEI). But stocks and even certain monetary aggregates are not the leading indicators they once were, because we are now operating in a manipulated world and financial markets have become the receiving end of those manipulations, while the trickle down to the real economy does not work to the same degree as it used to.

At present, the US economy would most likely be in recession without the growing government deficits lending support. The breadth of State Leading Indexes (chart 4, next page) has turned down (upper clip) and is at the weakest point since the last recession. And Europe remains in very slow growth mode, as its exports to China and its satellites remain weak. And Japan is not growing well - but what is new there? And the EM universe is in trouble. There are many riots in Latin American countries due to dissatisfied citizens. Brazil may be the exception, as it has started to ease monetary policy decisively. Asian economies

are weak relative to expectations and to their own economic history of the last 20 years.

We doubt the world economy will improve without any major fiscal help. And we doubt that baby step interest rate cuts will do the trick.

We doubt the world economy will improve without any major fiscal help. And we doubt that baby step interest rate cuts will do the trick. In our view, fiscal stimuli are needed. But to our surprise, it is still relatively quiet. Of course, there are individual nations providing support by running larger deficits, but there are no major programs to lift the spirit of consumers or corporations. Therefore, the best we can see is a continued slow world economy. And because this world economy is saddled with the biggest debt ever, it is evocative of how risky it is when planes fly low with a heavy load and are losing speed.

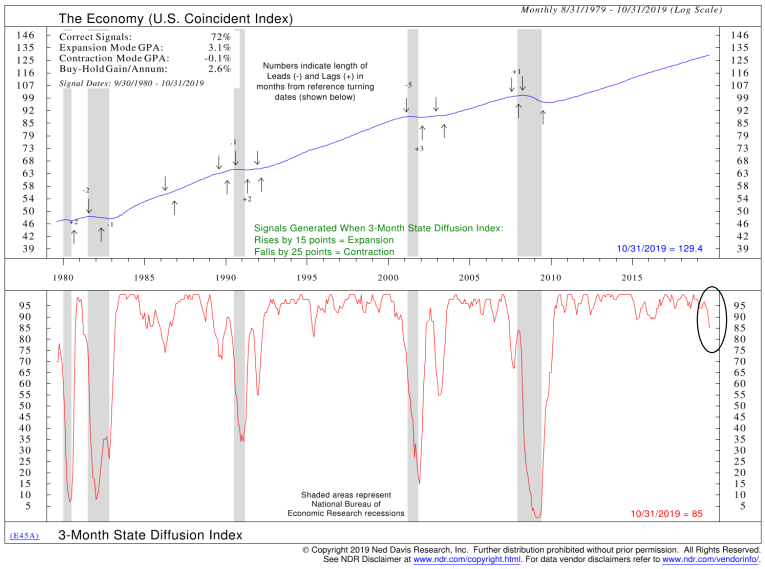
We have pointed out in these reports that we are expecting corporate earnings to weaken further into perhaps mid-2020, based on our indicators tools. We would only change this view if we saw new important information that would lead to a different assessment. In this regard, our view differs from the consensus which expects economic improvement in 2020.

Heterogenous Currency Markets

The US dollar is a counter-cyclical currency. Whenever the world economy strengthens, it usually weakens, and vice-versa. At present, the US dollar is correcting against the euro bloc currencies and marginally only

CHART 4

Breadth of US State Leading Indexes



Source: Ned Davis Research, Inc.

against Asia, while strengthening against Latam currencies. The current choppy correction in the US dollar is in our view technical in nature, as positions are being squared in view of the year end. Moreover, the consensus view of an improving world economy contributes to this perception, which would weaken the US dollar. And the Fed's maneuver of a change of policy in September and October helped this perception to grow.

Our view is that the US dollar remains the best of the major currencies as long as the Fed does not enter a major easing process. While the Fed is buying T-Bills from the banking sector, this is not the usual QE, as it does not create new bank deposits that are being used in the real economy. In contrast, the money the banks receive are simply new reserves that are deposited with the Fed and stay there. Of course, the liquidity injection has a positive influence on financial markets and influences investors' psychology. But that money does not become effective in the real economy. However, this injection has helped to avoid a major liquidity squeeze that would have strengthened the dollar. We still expect the European banking sector in particular to reduce its balance sheet into year-end in order to be in line with the capital adequacy requirements. Part of this will mean no rollover of US dollar

loans that could eventually hurt financial liquidity and would support the US dollar.

Our view is therefore that this choppy correction of the US dollar will be over in a few weeks.

Our view is therefore that this choppy correction of the US dollar will be over in a few weeks. If the EUR/USD breaks 1.1150 to the upside, it could potentially run to 1.14 (chart 5). At present, we do not see more than that. We do not expect the USD to weaken much from here against Asian currencies like CNY, SGD, TWD or KRW. To the contrary, we expect these economies to be under pressure to ease monetary policy ahead of the US, and therefore we expect these currencies to weaken again against the USD. Latam currencies have slumped and we expect them to continue to weaken on a medium-term trend basis.

Attractive Treasury Bonds

If our assessment is right, the medium-term recovery attempt of global government bond yields could be already over. At least, in the US, which we consider the most attractive bond market for the time being. We do expect another medium-term decline of yields, potentially back to the lows or even below. This means that the price of bonds could reach back to the highs or even slightly higher (chart 6 shows the 10-year Treasury bond yield).

We are less enthusiastic for European and Japanese bonds, as the yield level is already sharply mispriced and excessively low. While yields may weaken there too, we recommend preferring US Treasury bonds.

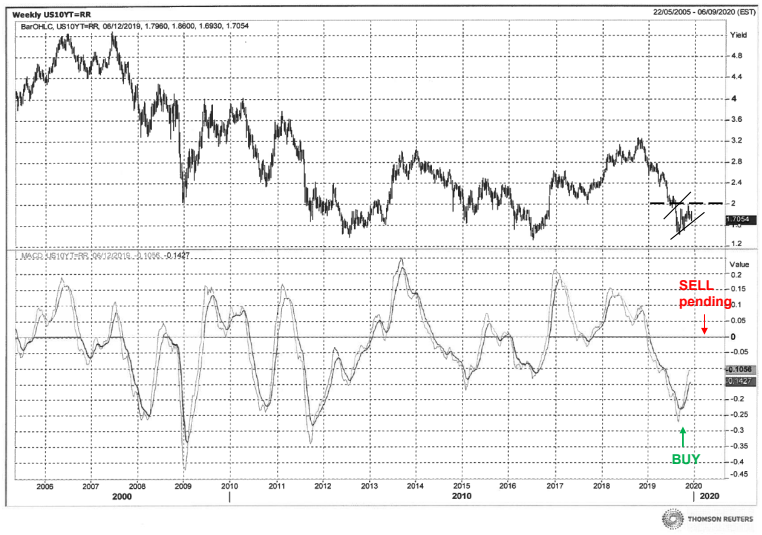
CHART 5

EUR/USD Weekly & MACD

Source: Thomson Reuters

CHART 6

US 10-Year T-Bond Yield & MACD



Source: Thomson Reuters

We see bond yields in the late stage of a cyclical and secular decline

and bottoming on a cyclical and secular basis. Our outlook is for bond yields to begin a cyclical rise sometime in 2020, once the coming medium-term decline is over.

Hopium Is Losing Its Influence on Equities

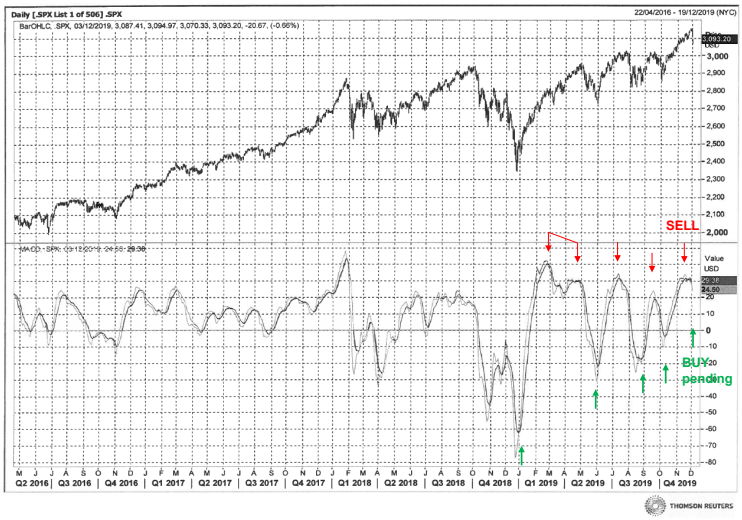
We did expect a correction starting sometime in November. Instead, markets rallied further and created some technical divergences. They rallied on hopes that the US and China would soon sign a trade deal. Such a trade deal would have lifted spirits among managers and entrepreneurs and improved the economy (reflexivity). Yesterday, President Trump and Wilbur Ross (US Secretary of Commerce) poured cold water on an imminent trade deal. As the hopes are disappearing, markets are back dealing with realities. Hopium is vanishing!

President Trump and Wilbur Ross (US Secretary of Commerce) poured cold water on an imminent trade deal. As the hopes are disappearing, markets are back dealing with realities. Hopium is vanishing!

Now, markets must deal with an overbought technical condition, disappointing earnings and an uncertain economic outlook. Not only may further tariffs be introduced by the US against China this month (or more likely early 2020), but new tariffs are being introduced against Brazil and Argentina (steel) due to

CHART 7

S&P500 Daily & MACD



Source: Thomson Reuters

sharply weaker currencies and France (luxury items) to retaliate for the introduction of a digital tax targeting US internet giants. The EU and the US stated earlier that they will work out a deal, but the 90-day period has passed without a deal. All of this agrees with what we have been writing for the last few years. Globalization has entered a correction period for the next 10-20 years. This will not lead to a complete breakdown of trade like in the 1930s, because we are in a multipolar world where there are enough countries trading with different countries. Cheating will become widespread, too, as the three blocks will be unable to completely dictate to others how to behave (although they will try). However, trade may shrink, and economic growth will slow and so will corporate earnings and eventually prosperity for the average Joe. Equity markets are not discounting this, today, but rather assume that the world will go back to how it was before these conflicts.

We outlined in our last report that once the current medium-term rally is over, we will see a correction. If fiscal stimulus were to be applied during 2020, and our view remains that it will, there is a chance that global equity markets could add another mini-bull cycle, once that correction has run its course. Thus, we see any upcoming medium-term correction as a potential opportunity to warm up for equities and turn bullish. But at this point, we rather see more downside than upside in the markets.

The market peaked only 2 days ago, on December 2 (chart 7, previous page). Short-term sell-off or corrections usually last 2-3 weeks, which would bring us to the third week of December. This is when tax-loss selling in the US usually ends and markets recover in thin volume into a January/February high. The problem will occur at the next short-term sell signal, in early 2020, when it could occur in combination with a medium-term sell signal (chart 8). Moreover, the long-term (monthly) MACD could then also roll over and signal a long-term sell recommendation that would potentially arrive with higher prices but at a lower indicator reading. This would be a very bearish constellation and warn of a sharp decline ahead. It would perfectly fit into our expectation of a good medium-term low around mid-year.

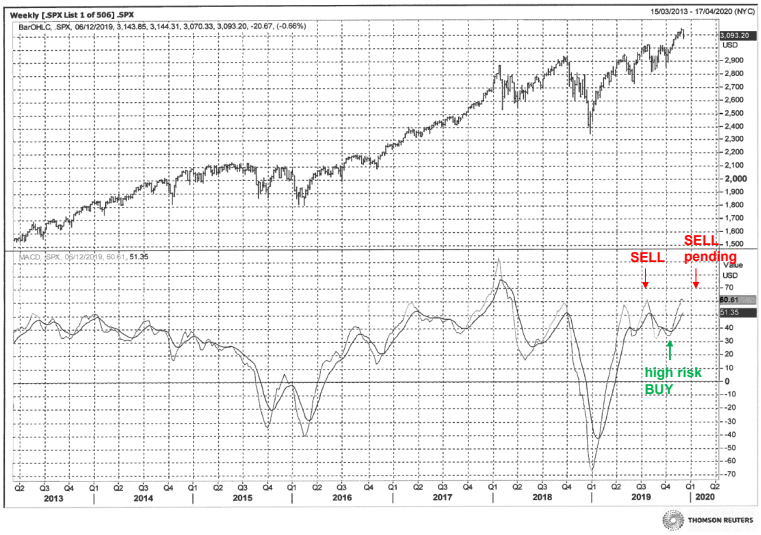
The problem will occur at the next short-term sell signal, in early 2020, when it could occur in combination with a medium-term sell signal.

While we have urged investors to go with the flow, particularly the outperforming stocks and sectors, we also recommended tightening risk management. This still stands because market tops, even of medium-term significance, usually need time to evolve. We expect a down-up sequence to terminate this medium-term advance. And even if the second high would be lower, the outperformers would do relatively well.

In any case, we expect a medium-term topping action with a down-up-down sequence and recommend investors to keep risk management very tight. The risk is that the next medium-term sell-off could be deep into spring/summer 2020. We do not share the

CHART 8

S&P500 Weekly & MACD



Source: Thomson Reuters

consensus view, which - at least until 2 days ago, - was that the market simply climbs higher and higher without much interruption. We have seen some extremely bullish comments appearing last week, particularly by simple chart readers who took the breakout as a signal that the sky is now the limit. In times when algorithms rule in global stock markets, breakouts are often a false signal and often terminate a move. This is very different from how it was in previous decades. We have seen excessive put/call ratios near the high, and investors surveyed also showed high optimism. We think a medium-term top is in the making in global equity markets into Q1.

We have urged investors to go with the flow, particularly the outperforming stocks and sectors, we also recommended tightening risk management.

Be aware that markets outside the US have as a rule not climbed to

new highs. And those indices that did so were pushed by a low single digit number of stocks that dominate the indices while the broad market lagged. Advance/decline lines are not a good indication in times of digital pricing and program trading. We therefore warn against using them as in former times for confirmation of a trend.

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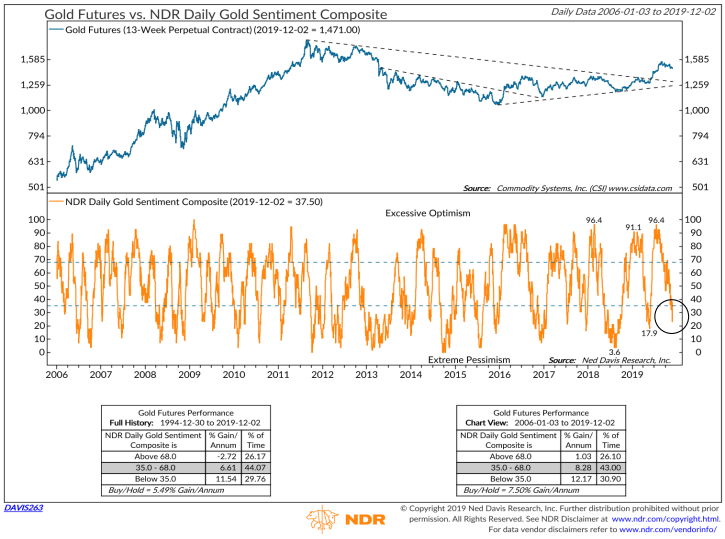
Asian markets have been extremely weak, particularly Hong Kong. The economy there is in recession, for obvious reasons. But China has performed poorly as has Singapore. Markets with very weak currencies like Brazil or Australia have performed better.

We therefore temper our call for overweighting economic sensitive sectors and stocks and favor a more balanced selection.

We notice that the outperformance of Europe is relapsing, and this goes hand-in-hand with the relapsing of cyclicals and value stocks. Selected financials may be the exception that confirms the rule. While defensives have improved lately, we particularly like to stress health care. When these sorts of stocks perform better, the economic background is usually shaky. We therefore temper our call for overweighting economic sensitive sectors and stocks and favor a more balanced selection.

CHART 9

Gold & Bullish Sentiment



Gold Futures Performance
Full History: 1994-12-30 to 2019-12-02

NDR Daily Gold Sentiment Composite is	% Gain/ Annum	% of Time
Above 68.0	-2.72	26.17
35.0 - 68.0	6.61	44.07
Below 35.0	11.54	29.76
Buy/Hold = 5.49% Gain/Annum		

Gold Futures Performance
Chart View: 2006-01-03 to 2019-12-02

NDR Daily Gold Sentiment Composite is	% Gain/ Annum	% of Time
Above 68.0	1.03	26.10
35.0 - 68.0	8.28	43.00
Below 35.0	12.17	30.90
Buy/Hold = 7.50% Gain/Annum		

Source: Ned Davis Research, Inc.

Gold's Chance to Rally – While Oil Remains Soft

In our last report, we outlined our view on gold. If you looked at that cycle diagram chart, you saw that there is still an open potential for a medium-term rally to a new high. We are not sure whether the gold market will achieve this potential because we fear that the global liquidity situation is worse than what most investors assume it is.

Last week, bullish sentiment for gold (chart 9) dropped to 23% bulls, the lowest since 18% just before the rally from $1270 to $1550 began. Moreover, we think global uncertainty is rising again, as markets may begin to understand that the world that was will not come back (in terms of a stable political and economic environment). Thus, we recommend that traders take a long position for a trade. Gold needs to break $1500 to gain momentum. The correction has now lasted 13 weeks (for Fibonacci aficionados) and corrected from upper Bollinger band to its lower band. Moreover, while our medium-term momentum indicator is close to giving a new buy signal, this signal has already arrived for the short-term and for gold mining equity indices even for the short- and medium-term (chart 10, next page). We therefore recommend taking a trading long position with tight stops in bullion and the miners.

Crude Oil trades softly as do the base metals. These economic sensitive

commodities obviously feel the slow pace of the world economy. The Saudis are interested in having a firm oil price when they launch their Aramco IPO in coming days. It is therefore conceivable that further production cuts will be forthcoming to support the price of oil and keep it in the range of $45-$65, perhaps pushing it toward the upper end. US shale oil production is slowing, and we expect new fiscal stimuli next year in several major economies, not the least China. This should then help crude oil to trade somewhat higher. But for the time being, we expect it to continue on the soft side in the absence of any major production cut.

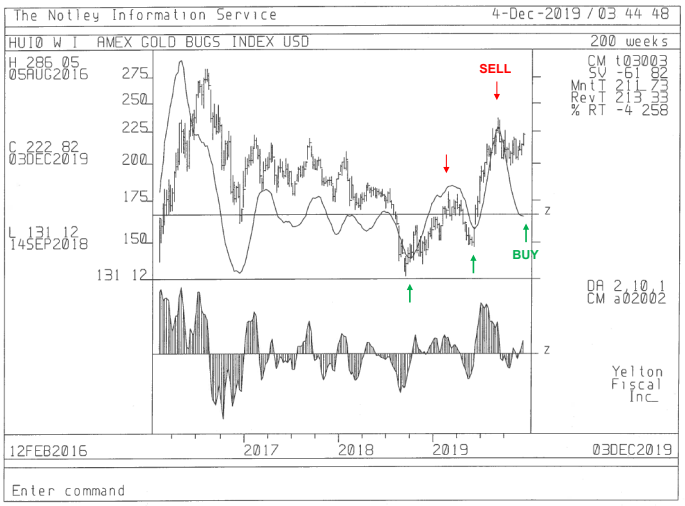
For investors, energy as well as base metals do not make sense on the long side, yet.

Our stance is bullish on Treasury bonds, neutral on equities with the potential to turn bearish at the next short-term high, neutral to bearish on economic sensitive commodities, bullish on a trading basis for gold and neutral on the US dollar. Our intention is to turn bearish on bonds sometime next year, most likely in the first half, potentially turn bullish after a medium-term correction in equities, and potentially turning more constructive on commodities and more reluctant on the US dollar. We expect next year to bring several major trading moves in different asset classes that could help investors to achieve good returns.

We invite our clients to participate in our upcoming webinar scheduled for December 17, 2019 at 10:30 a.m. EST where we will discuss the outlook going into 2020. If you need the registration link please e-mail us at info@felixzulauf.com for details. In the meantime, we wish all our subscribers and friends a very Happy Holiday Season and best of luck for good trading!

CHART 10

Gold Mining Index Weekly & Momentum Buy Signal



Source: The Notley Information Service, Taniscott Capital Inc.

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