ZULAUF CONSULTING

INVESTMENT COMMENT

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IN THIS ISSUE

POSITION SUMMARY

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

* Indicates a new position or change in view

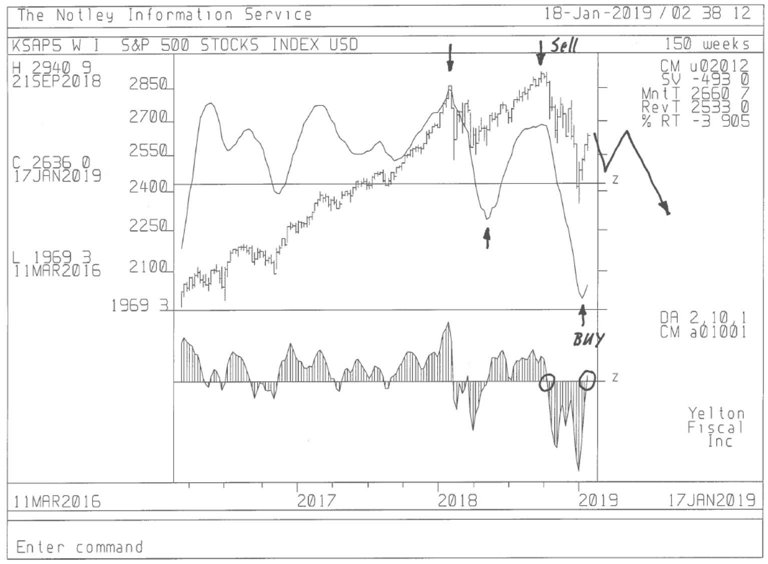
Highlights

- Global equity markets have bounced into the price and time target zones that we outlined in our previous report. A successful retest of the lows is now expected.
- However, bearish fundamental forces are expected to force global equity markets lower in the spring/summer period.
- Continued but sharply reduced repatriation is temporarily offsetting the Fed's QT tightening and injects liquidity into the US credit system. That is expected to reverse again later this quarter and in Q2. Thus, the monetary tightening by the US central bank is expected to continue, irrespective of rate decisions.
- Sovereign bond yields may bounce or stabilize, as long as global equity markets remain in their erratic countertrend recovery attempt. Eventually, we expect US Treasury bond yields to soften further until economic policy stimuli begin which we anticipate after mid-year 2019.
- A face-saving US-China trade deal for both sides is possible. However, it will not solve the core problem of the two incompatible systems. China is at present in a weak position and could make some concessions to buy agricultural commodities from the US. This scenario would also help Trump vis-à-vis voters in the farm belt in terms of the upcoming election. However, China will not bend and not change its system. The problem goes beyond tariffs.
- We expect the world economy to continue weakening into the second half, however some indicators may rebound somewhat temporarily. At some point this year, policy makers will wake up to the seriousness of the problem and react. Economies with large exports as a share of GDP should be the weakest, but we also expect the US to slow.
- After the expected rejection by the UK Parliament, Teresa May must come up with a plan B that does not exist. Either the date of exit is postponed, or a hard Brexit may follow.
- The currency market remains tricky, and the different currencies vary more than last year. We recommend staying neutral in the forex arena and wait for better opportunities to open trading positions.

- While the commodity complex could also see some bounces, we remain bearish base metals. Crude oil is stabilizing in the range of $45-$55 for WTI.
- We expect gold to pause and correct short-term, as optimism is too high.

CHART 1

S&P500 Weekly



Source: The Notley Information Service, Taniscott Capital Inc.

Markets Make the News – Not Vice-Versa

Most investors think that news makes the markets. We think it is just the other way around. Media headlines usually depend on the general mood of markets. For instance, several economic indicators have been pointing to a slowing economy for months. However, they made the headlines only in December when markets slumped.

> From Q2 onwards, we would expect liquidity conditions to deteriorate again and potentially quite sharply.

As global equity markets hit an extreme in price and sentiment in late December in combination with one of the technically deepest oversold readings in a few years, the expected bounce followed. That medium-term recovery attempt is not over, but a short-term overbought technical condition combined with the fact that we achieved the price and time targets we called for suggest caution here. Normally, a sharp sell-off like the one seen in December leads to a quick rebound followed by a retest. We expect that retest into mid-February, and we expect it to be successful.

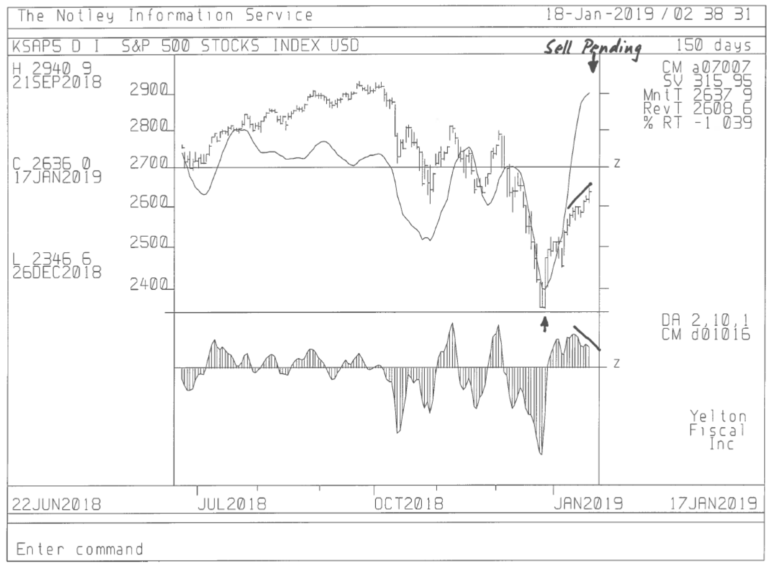
Our view is based on both fundamentals and technicals. While the Fed will in our view most likely pause regarding rate hikes, it will continue to reduce its balance sheet as planned. This is a negative monetary force that is of overriding importance. However, in the short-term two factors are offsetting this tightening. The repatriation of funds from overseas of over $100 billion injects liquidity into the US credit system. Moreover, the US Treasury has built up its account at the Fed to over $300 billion, probably in view of a potential shutdown of the government. This way, the government can still pay some bills. As the government does not borrow much money during the shutdown, it could run down its account at the Fed to pay bills. If it did, it would result in a net injection of liquidity into the credit system. Of course, this would only be temporarily liquidity positive, as the offsetting rebuilding of the account and borrowing by the Treasury would be liquidity negative later. And the repatriation will also have run its course. Thus, from Q2 onwards, we would expect liquidity conditions to deteriorate again and potentially quite sharply.

At the same time, our medium-term technical work suggests continued recovery attempts are likely until the indicators are neutral again from their deep oversold readings (chart 1). However, our short-term technical work suggests investor sentiment swung back from deep pessimism in late December to optimism again (chart 2, next page). Put/call ratios have corrected their spike seen during the latter stage of the decline, and sentiment surveys have all bounced back. Thus, we are dealing with a short-term overbought market within a medium-term still oversold environment. It would be textbook like to see a successful retest of the lows, and it is not important whether that secondary low is slightly higher or lower than the previous low. Some stocks will most likely fall below the first low like Automatic Data Processing (ADP), while others may not reach the lows and make a higher secondary low, like Amazon (AMZN).

> A perfect script would give us a successful retest by around mid-February followed by another high around mid-/late March.

CHART 2

S&P500 Daily

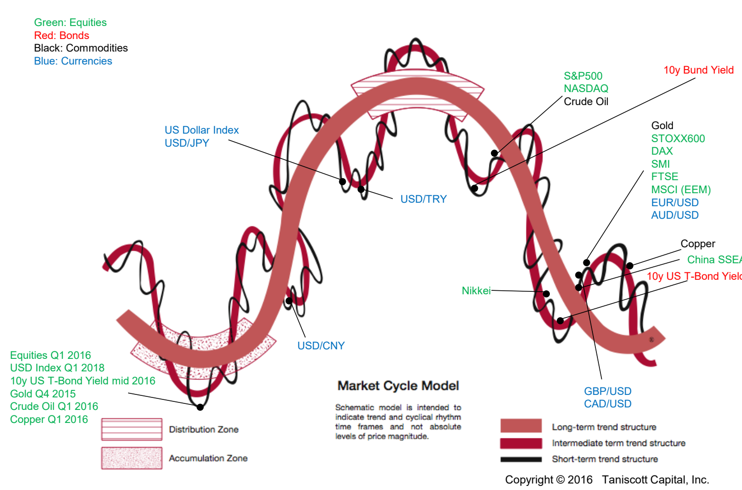


Source: The Notley Information Service, Taniscott Capital Inc.

In the diagram in chart 3, you see where we think equity indices are positioned. Not all stocks are in that position. Most are either in that position or one short-term cycle (black line) leading or lagging. While we must accept markets as they unfold, a perfect script would give us a successful retest by around mid-February followed by another high around mid-/late March. At that time, the medium-term technical indicators would have worked off their oversold condition and be neutral or even slightly overbought. This would imply that markets would be ready for the next phase of exhaling. Until then, a Yo-Yo market will remain with us. If monetary conditions develop as we expect, the next decline may then begin and last during Q2. This remains our working hypothesis. We firmly remain of the view that this will not be a waterfall event like 2008. Instead, we are expecting interventions by policy makers much earlier, which will stretch out the bear market in time, perhaps over a few years and shape into a mini-bear followed by mini-bull sequences. Once we see that the first mini-bear is terminating – which we expect from

CHART 3

Idealized Cycle Diagram



Source: Taniscott Capital Inc.

mid-year onwards - we will certainly update you and recommend where to invest for the pending mini-bull cycle. In our view, we are not there, yet. Thus, investors should keep their powder dry while traders may trade the short-term swings.

Misreading Jay Powell

In recent conversations we were asked how we read Jay Powell, the new Fed Chairman. Some believe he is a Wall Street guy and wants to appeal to his former buddies by steering the same policy as Greenspan or Bernanke, which means reflating asset prices. We disagree, and now after the release of the FOMC meeting transcripts from 2013, we have proof.

> Continued QT will lead to a second leg down in the US equity market, another leg down in overseas equity markets, a stronger US dollar and lower Treasury bond yields for this mini-cycle.

Jay Powell was the one Fed member constantly warning Fed Chairman Bernanke about overstaying easy money by continuing QE and not raising rates. This is important information, as it suggests the Fed will try to behave differently. It may wait longer with rate cuts and may also continue QT for longer than the consensus expects. Powell seems to understand that an asymmetrically easy monetary policy as guided by Greenspan and Bernanke creates big problems longer-term. Thus, he may accept a bit more pain than his predecessors before easing. It all comes down to our scenario of more mini-cycles in the markets than before. While the Fed still sees two more rate hikes, we doubt it. But we may see a continued QT for longer than many believe, which we think will lead to a second leg down in the US equity market, another leg down in overseas equity markets, a stronger US dollar and lower Treasury bond yields for this mini-cycle. Once the US Fed changes policy, all these trends will reverse.

World Economy Continues To Slow

In many discussions and research reports we hear the argument that special developments like the trade conflict or Brexit are responsible for the slowdown of the world economy. We disagree decisively. Those factors may add to the problem, but they are not the cause of the economic slowdown. In fact, trade between the US and China probably benefitted in recent months ahead of feared tariff increases.

> China's economy is not only in a cyclical slowdown, but also in a structural downshift to much lower growth and growth potential for the future.

Our view is that the main cause lies in the pronounced slowdown of the Chinese economy. And that slowdown is the result of several factors but two of them stand out. First, we believe the major transformation from an agricultural to an industrial economy and from a rural to an urban society is complete. It follows that investments in infrastructure that have been huge are slowing. As fixed asset investments (FAI) still account for over 40% that slowdown impacts the whole economy to a large extent. Just keep in mind that virtually 65 million housing units are empty in China according to recent reports, which represents a vacancy rate of 20%. The need to build more is minimal. While some may continue building, they risk ending up as malinvestments.
The other factor is that President Xi has abandoned the free market approach initiated originally by Deng Xiao Ping and pursued by his followers. Xi put his anti-corruption policy above everything else and initiated a wave of numerous mergers of state-owned enterprises that

are in most cases not profitable and rely on vast amounts of debt. The big part of the sharp increase of credit in recent years is wasted money with those giant zombie corporations. This is another factor that is backfiring and reducing China's growth rate.

Finally, there are demographic factors that come into play, as China's population growth is fading and the population is aging rapidly. If one combines just these three factors, China's economy is not only in a cyclical slowdown, but also in a structural downshift to much lower growth and growth potential for the future. If our thesis is true, it is easy to understand why Prime Minister Li Keqiang said the other day that China will not opt for a big flood-like stimuli but rather target selected projects. In the context of our understanding this makes sense, while building another 30 million housing units would not.

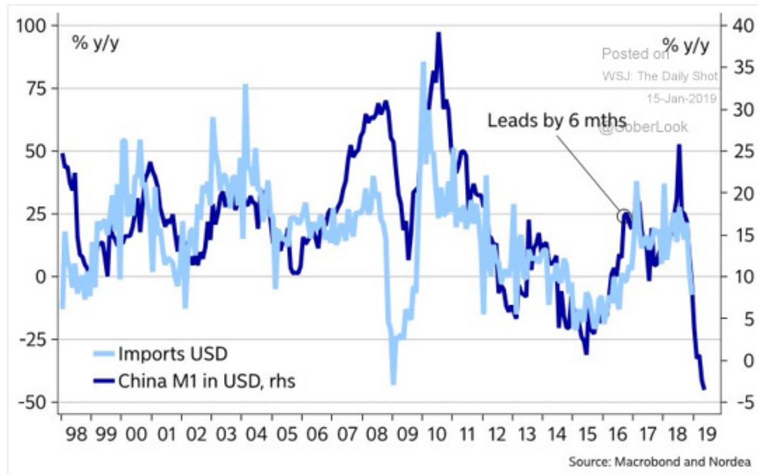
The problem therefore remains that the Chinese economy continues to slow, and that slowdown will last longer than most expect despite monetary easing and targeted infrastructure projects. Chart 4 shows the weak money growth and how it leads imports. The core of the Chinese stimulus will be tax cuts, primarily VAT to stimulate consumption.

We doubt that this will help economies in the EM universe or in Europe much, as those trade primarily in capital goods/commodities and medium-term goods for re-exports. That is why we continue to believe that the economic news will continue to point to a slower pace for the world economy for all of 2019, even if a month or two will see indicators bouncing a bit.

It is conceivable that the sentiment-based indicators like PMI or ISM may have overshot on the downside for the last 2-3 months. Those indicators have a high correlation with the stock market, as the mood of interviewed purchasing managers swing with the stock market. Chart 5 shows such an indicator. We would therefore not read too much into them if they bounced some in the next few months, as this would be totally normal.

CHART 4

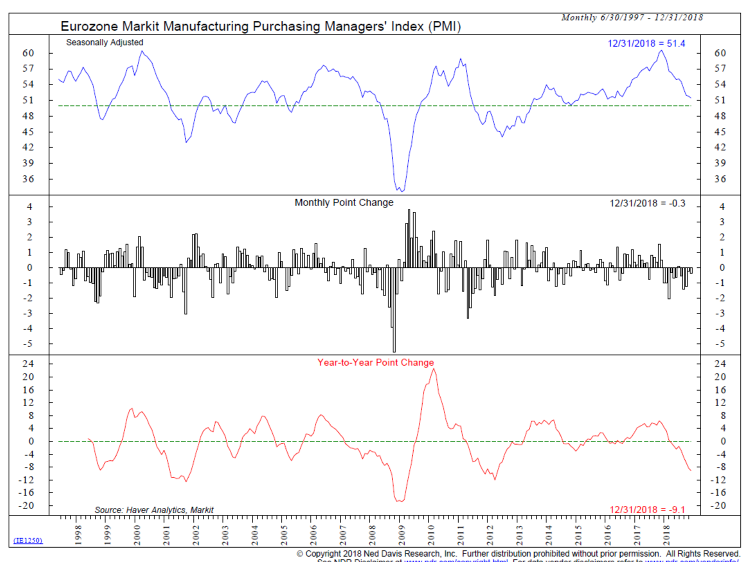
China: Weak Money Growth Leads Imports



Source: Macrobond and Nordea

CHART 5

Eurozone PMI Manufacturing Index



Source: Ned Davis Research, Inc.

US Slowdown but No Recession, Yet

The signs for a slower US economy are also evident. The housing and automobile cycle have already peaked. Capital equipment spending in the oil & gas industry is slowing, too. Moreover, the rate of growth in the capital equipment sectors keep slowing for the last few quarters despite the tax cut and the repatriation of funds from overseas. While the consumer has an improving income situation, the negative wealth effect from declining equity markets and a soft housing market may lead to a rising savings rate after it had declined over the last few quarters.

Brexit – Greater Europe RIP

This Tuesday, the UK Parliament voted the Brexit Agreement with the EU down with the biggest spread between yes and no votes ever in history. This outcome is along the lines of what we predicted in previous reports, and it virtually blocs any effort to receive major improvements from the EU. The signal against the proposed agreement is overwhelmingly clear. The motion launched by the labor party for a confidence vote against the Prime Minister Teresa May on Wednesday was rejected by a narrow margin, as the Tories have no interest in new elections. Thus, the situation is that the British people have voted in favor of Brexit, but parliament voted against this proposed agreement which the EU declared as the final and not further negotiable version.

A hard Brexit may still happen.

The finality of this vote leaves two remaining options open: (1) there is no Brexit at all - which would negate the peoples' vote to exit, or (2) a hard Brexit. While business and particularly the EU and the British remainers are against a hard Brexit, it may happen by default. Perhaps the UK and the EU may agree to postpone the exit date by three months, to permit more time for officials to sit down and renegotiate again.

In our view, this vote by the UK parliament is a much bigger blow to the EU than vice-versa. But the EU seems very dogmatic and eager to demonstrate to existing member countries that exiting is costly and not an attractive option. Thus, a hard Brexit may still happen. What would it mean? The trade between the UK and the EU would then be executed based on WTO rules. This is the basis for the trade between the EU with several trading partners in the world, including China. But the fact would be that the EU would be decisively smaller than before Brexit, and the importance of the EU would decline. We had forecasted the Brexit vote, and ever since then said that the odds of a hard Brexit were very high. Of course, the transition period could create some chaos, but the situation and the trade would normalize after a few months. Moreover, the UK could then set policy based on their own interests and could position itself favorably. For that reason, we disagree with those who fear that a hard Brexit could be very damaging to the UK. It could perhaps be the beginning of a less dogmatic EU, and it could even be the beginning of an EU shrinking process. Perhaps the EU leaders need such a blow to become more pragmatic and give up their dogmatic project of centralized Greater Europe. Stay tuned!

Europe Continues to Weaken

Half of Europe's growth in recent years was directly and indirectly due to exports to China. As China is slowing - particularly infrastructure and capital expenditures - Europe's exports to China and the EM universe (EM depends highly on China) slow as well. Germany is the main European economy. At present, German new orders have weakened considerably (chart 6, next page) and point to further slowing GDP. While Germany is at full employment, German industry has chosen to outsource production to Eastern European economies like Poland, Hungary or Czech Republic where wages are considerably lower. For that reason, wages in Germany are surprisingly low despite some recent upside pressure.

Interestingly, we see CPI and PPI inflation rates in the industrialized as well as emerging economies softening. When corporations cannot raise prices, it is a sign of too much capacity that is not fully utilized. Hence, we expect capital spending to disappoint on a global basis this year until fiscal programs are enacted to stimulate growth.

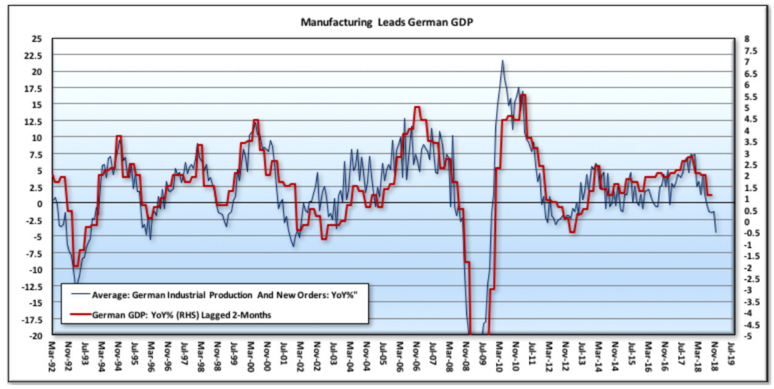
Angela Merkel's successor as President of the Conservative Party is calling for tax cuts. While it is not clear yet whether she wants to target consumers or corporations, the coalition partner is against it. It will result in a hefty debate, but we assume that taxes in Germany will be cut for 2020. In fact, we assume that we will see more fiscal stimuli coming through in Western Europe during this year for next year, particularly if the economy disappoints as much as we expect.

> We expect capital spending to disappoint on a global basis this year until fiscal programs are enacted to stimulate growth.

The question is what the ECB will do. It has just terminated its QE program – right when the economy started to weaken – and it will hardly remove its negative interest rate regime. Although this is what they should do, as it hurts the banking industry and therefore also the economy. But tell this to dogmatists! We assume that the ECB will eventually turn around and revive its QE program, and perhaps include even corporate bonds. This will not work for the economy, but it will at least provide increasing liquidity to the system and benefit asset prices. The timing of this will most likely arrive in the second half when economic disappointments force the central bank to act. The ECB may even use a hard Brexit as an excuse to restart the QE program.

CHART 6

Germany: Orders Point to More Weakness



Source: Exelauno Capital

US Treasuries Need A Pause

Based on our thesis of continued but erratic rebounding attempts by global equity markets into late this quarter, it is also likely that US T-bond yields may rebound some. The short position in the Treasury futures has been reduced but the market is still short (chart 7, next page). Moreover, bullish sentiment has bounced back during the decline in yields from 14% bulls in mid-November 2018 to 53.9% now (chart 8, next page). While this is not extreme, yet, and may eventually go higher, as net shorts will turn into net longs, we expect this mini-cycle decline in yields to end with high optimism and a net long position by speculators, perhaps by late summer of this year.

US Dollar Is Holding Better Than Most Expect

The consensus believes that the recent economic slowdown is a temporary blip. It also sees the Fed easing due to this temporary slowdown and a weaker stock market. And a weaker dollar would accompany those trends. Well, we think the forex market is much trickier than most other asset markets because currencies are ratios of one currency against another one.

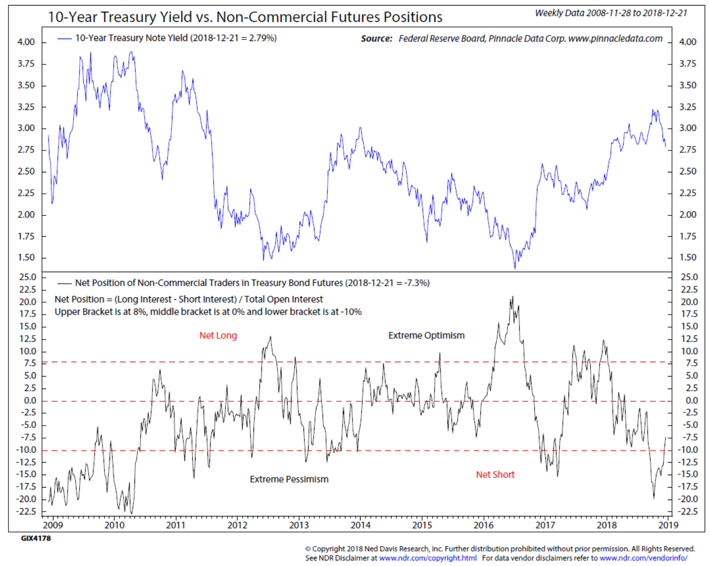
The US dollar remains the main currency in trade and settlement of economic transactions. The second largest economy (China) is not an open economy and has capital controls in place, which makes it impossible as an alternative currently. Whenever the US central bank tightens monetary policy, the US dollar usually strengthens because the rest of the world is hardly tightening ahead of the US. There may be occasional exceptions, but we are simplifying here for explaining purposes. Whenever there is a global bear market in asset prices, the global credit system does not create enough US dollars to satisfy demand relative to other currencies. And vice-versa, if the world economy expands, the global credit system usually creates more than necessary dollars. That is why the US currency usually weakens during global business expansions and strengthens during contractions. However, the US dollar is fundamentally a weak currency because the US economy runs a chronic current account deficit of currently $450 billion. In other words, the US must attract net $450 billion of capital flow towards the US for the US dollar to stand still.

But once the US Fed changes policy and begins to ease, the US dollar will weaken – even if other central banks ease too.

China's yuan cannot supersede the US dollar for a long time. The euro was created to become an alternative to the US unit. Today, the euro is 20 years old and we can say that the euro is no serious alternative. It is a currency behind which no sovereign nation stands. It has many other pitfalls that simply makes it a misconstruction. We assume that the euro will stay alive for another few years, but that will eventually change. The euro simply cannot stay in its present form for long. The truth also is that the euro is not a Deutsche Mark 2.0 but rather a French Franc, as its central bank runs a chronically easy money policy. But due to Germany's high current account surpluses,

CHART 7

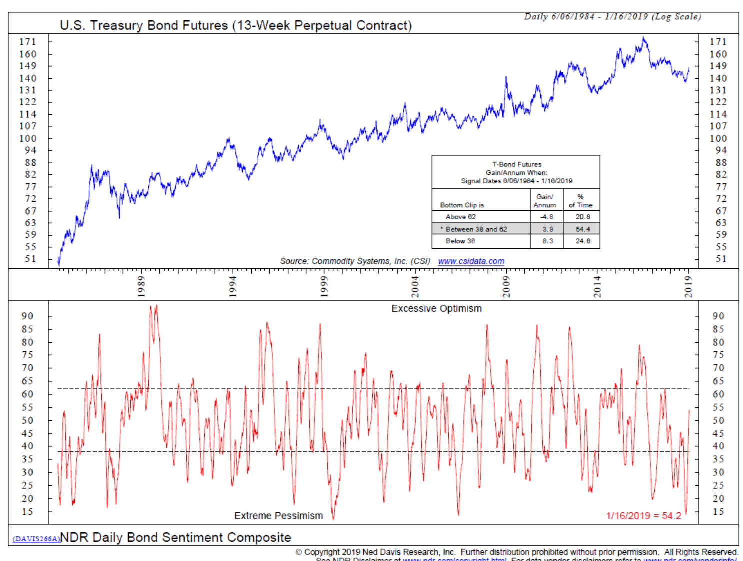
10-y Treasury Yield & Futures Position



Source: Ned Davis Research, Inc.

CHART 8

NDR Daily Bond Sentiment



Source: Ned Davis Research, Inc.

it looks strong on paper. Negative interest rates, the threat of a hard Brexit, the potential to restart QE again are hardly attributes of a strong currency. At present, fundamentals like growth and rate differentials support the US dollar. Chart 9 shows the spread of the industrial production of Germany and the US, which speaks clearly for a weaker euro and a stronger dollar.

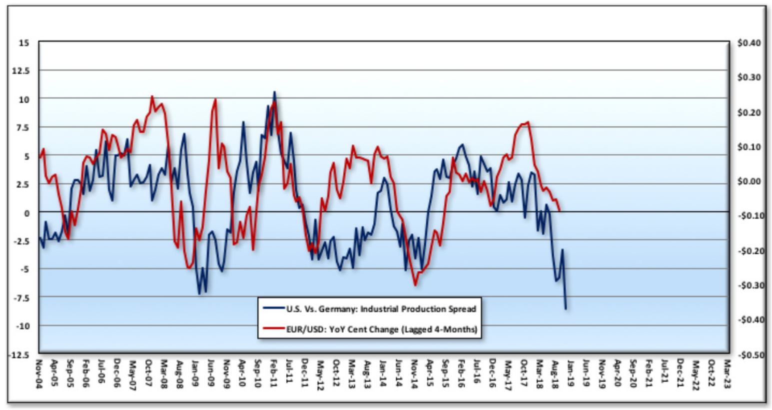
But once the US Fed changes policy and begins to ease, the US dollar will weaken – even if other central banks ease too. This is because the size of the US dollar market is so much bigger than the size of any other currency market that the sheer size of it overwhelms others. We call it the bathtub/espresso cup effect.

But once the US Fed changes policy and begins to ease, the US dollar will weaken – even if other central banks ease too.

At this point, we doubt the Fed will ease. As the US economy slows, they may not hike rates again. But the balance sheet reduction continues, which translates into tighter money. For as long as QT remains in place at the current rate, the US currency is fundamentally supported. Moreover, the repatriation of offshore dollars to the US convert offshore dollars to onshore dollars. While it improves the US domestic liquidity situation (which is not or less currency sensitive), the offshore dollar liquidity declines. This means that European and Asian banks are getting squeezed and must buy dollars to fund their dollar business. This is dollar positive. The one negative is that speculative positions are still high, although they have been reduced somewhat. That is why we expect a choppy forex market environment for a while longer.

CHART 9

Spread US/German Industrial Production & EUR/USD



Source: Exelauno Capital

In sum, as long as the US economy does not weaken considerably, the market will not assume a change in US monetary policy. In that case the US dollar will remain well supported. At the time when the US economy weakens more, or the US equity indices break below the December lows, the risk of a weaker dollar increases. We called for a neutral dollar position when the US Dollar Index broke 96.30. It declined to the low 95 area. A rebreak topside of 96.30 would open the door for further strengthening.

As long as the US economy does not weaken considerably, the market will not assume a change in US monetary policy. In that case the US dollar will remain well supported.

Gold: The Pause That Refreshes

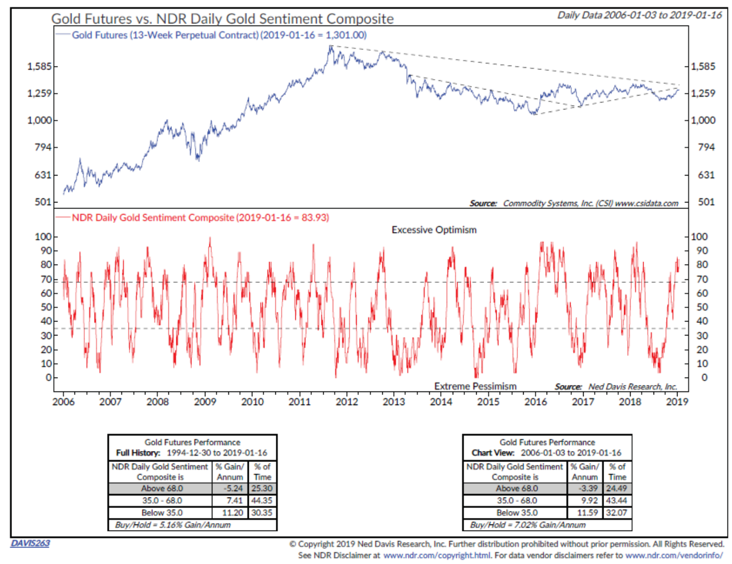
If our economic scenario plays out as suggested, it would mean that we would see increasing stimulation efforts to begin from early in the second half onwards. Such a scenario would be bullish gold and related assets. It would likely also be constructive for the commodity sector as whole and bearish the US dollar. For the time being, that remains our working hypothesis.

Gold could also have a multi-month setback or pause. However, it could be the pause that refreshes and become the springboard for the successful attempt to break $1375 to the upside.

At present, gold bulls have risen from 5% bulls at the August low when gold traded below $1200 to 84% now (chart 10), when gold trades over $100 higher. While we have no medium-term sell signal yet, our short-term technical work suggests caution is advised and some setback or at least a pause could set in. If our scenario plays out as described above, it would mean that gold could also have a multi-month setback or pause. However, it could be the pause that refreshes and become the springboard for the successful attempt to break $1375 to the upside. We tentatively expect this to happen in the second half of this year. For this reason, we have in our last report turned bullish on the cycle, but we keep our medium-term assessment neutral. The time to turn bullish should arrive sometimes within the next six months. Stay tuned!

CHART 10

Gold and NDR Sentiment



Source: Ned Davis Research, Inc.

Felix W. Zulauf
January 7, 2019

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