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POSITION SUMMARY

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

* Indicates a new position or change in view

HIGHLIGHTS

- The cancellation of the meeting between President Trump and President Xi in Mar-a-Lago may mean that the two parties have more difficulties to sign a trade deal than many are assuming.
- It remains unclear how Brexit will be executed, if at all. Will there be a postponement, a final hour deal, or a hard Brexit?
- China will in our view not return to the high growth it has enjoyed for so long.
- The world economy will continue to slow in the coming months. We expect that Europe will be the hardest hit.
- The consensus opinion on the USD has moved towards weakness, which we think is wrong. We still believe the US currency will perform better than generally believed. The caveat emptor would be an early termination of QT by the Fed.
- Bond yields have fallen to new lows for this mini-cycle in Europe and Japan and have also softened in the US. Some bounces may be possible after this decline, but the upside risk in yields over coming months is small due to the global economic slowdown and the cyclical softening of inflation.
- Global equity markets remain in their medium-term recovery attempt. The US and China remain the two best performers. US liquidity situation supports further advances short-term. Europe remains a laggard, and we do not expect this to change.
- Commodities are the least attractive asset class for the time being. Gold is an exception, as it benefits from rising uncertainty and overpriced other assets.

We held our Q1 webinar on March 5, 2019 in which we outlined our macro big picture and what to expect from different asset classes and currencies for the rest of this quarter and moving into Q2. You can request the replay by contacting info@felixzulauf.com.

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How the World Economy Works

Today, most mainstream economists use their GDP models based on monetary and fiscal policy inputs. They do not pay attention to demographics, which is in our view one of the most important variables for the growth trend. It was not necessary during the boom phase of the 1950s-1970s, as the world population grew strongly in the industrialized world. Thus, during that period, there was a tremendous tailwind which analysts and investors took as normal. Then came the disinflation years, with high nominal and real interest rates to squeeze out inflation from the system. While population growth slowed, economic growth was helped by declining interest rates and the increasing use of debt to pull final demand forward.

After WWII, the US as the hegemon of the Western World provided stimulus to the rest of the world. That is how a hegemon with the benefit of owning the major reserve currency should act, and how he protects his hegemon position and keep the satellites happy. In the early years, the US was still running trade and current account surpluses. Thus, it could afford to let Germany and Japan to keep using their cheap currencies to build up their export economies. Over time, the US slipped into external account deficits as Japan, Germany and Europe were accumulation increasing surpluses. When the Berlin Wall fell and the integration of China and the former Communist World into the world economy began to gain traction, it provided another boost for the world economy via globalization.

But Europe, Japan, and finally China exported goods in a major way at a high rate to the US where the consumers bought them on credit (thank you, Fed, for keeping monetary policy too easy for too long). This created imbalances in the export nations by rising surpluses in trade and current accounts, and in the US by rising deficits in those accounts. As it also moved jobs and income from the Western world to China and its satellite nations, it was too good to last. A new middle class with consumption power was created in China with its economic rise, while the middle-class in Western Europe and the US suffered income stagnation over a long period of time. The result was the election of President Trump, Brexit and the decline of the formerly dominating political parties in Western Europe. The tremendous globalization over the last 30 years seems to therefore be over, and we have outlined many times in our reports that we expect that movie to run backwards for the next 10-20 years. The US will simply not play that role any longer to the same extent. Thus, the largest importer of the world is terminating that mechanism by moving away from multilateralism, which the US itself proclaimed for decades (to cement its hegemon position) and is taking the world towards unilateralism. In this new world, power dominates over legal rights. It is very bad for smaller nations, particularly those depending on exports, but it may be RELATIVELY good for the large net importers like the US.

We firmly believe that free trade is a good thing, and if executed with fair rules it raises prosperity for most people.

Do not read us wrong – we firmly believe that free trade is a good thing, and if executed with fair rules it raises prosperity for most people. And free trade logically leads to globalization. But if the rules are wrong or not obeyed, and the result is disproportionately favoring some nations over others, problems start to rise, and a backlash begins. That is where we stand today.

US/China Trade Deal

While we do not agree with everything President Trump says or does, he does make a compelling argument and good points regarding his criticism of trading partners like China or Europe/Germany. We also firmly believe that whoever will follow Mr. Trump as president, whether a Democrat or Republican, will continue this policy against their trading partners.

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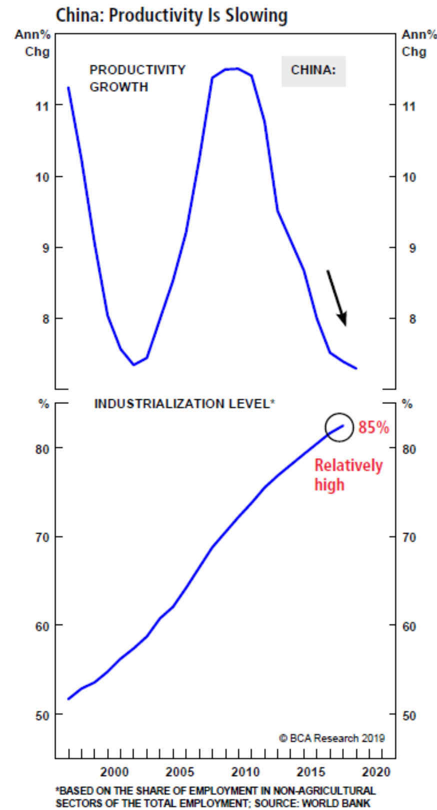
The trade deal between the US and China was originally expected to be completed before the end of February. Then, the Trump administration extended the period of not hiking tariffs as the bargaining went on to the end of March. The two presidents should have met before the end of this month at Mar-a-Lago. A few days ago, that meeting was cancelled. It seems that the two parties are having difficulties with reaching a substantive agreement that would actually be enforceable. That is what we said from the very beginning.

China cannot and will not bend on the main issues of intellectual property rights, as it needs the US high technology as a base to develop it further. Any nation that wants to become the largest and most powerful economy, which President Xi said a few months ago, needs that technology. China could agree to buy more US goods, and substitute goods from other regions with US products. However, while this purchase of American goods may help the US – and China – if a trade deal can be reached (at least for some time), it certainly would not be good news for the rest of the world. Other countries and regions, Europe in particular, would suffer. And even if the US and China strike a deal, we would not expect it to hold for long, as the Democrats will make it an issue in the 2020 election and Trump cannot let them take it out of his hands. Thus, he will increase pressure on China in 2020.

CHART 1

China: Productivity is Slowing



Source: BCA Research

Will China Return to High Growth Again?

China has risen from a very underdeveloped economy to an industrialized titan. Its growth has been mindboggling and any regular visitor to China would be impressed. We were there for the first time in the late 1980s, when there were virtually no cars on the streets. We are impressed too. The growth has been driven by the transformation process from an agricultural economy/rural society to an industrialized economy and urban society. Today, 85% of China's work force is active with jobs outside of agriculture. We therefore believe that the transformation process is virtually complete. If this assumption is true, economic growth will be more in line with demographics and productivity gains. And that is where the problem is.

The consensus still believes that the growth numbers published by China and its targets of 6%-6.5% are real. We differ for the following reasons: economic growth is largely the result of population growth (demographics) and productivity growth. China has increased productivity tremendously as a result of the transformation from an agricultural to an industrialized economy. But as we explained above, that transition is largely complete, and therefore productivity growth is in steep decline as shown in chart 1. Even more importantly is the

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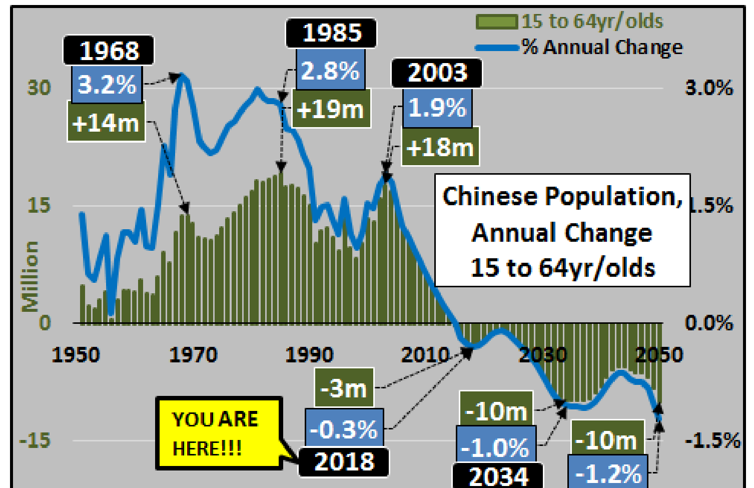
demographic challenge. Have a look at chart 2, which shows the number of 15-64-year olds in millions (green bars) and its growth rate year over year (blue line). As you can see, the number of that age group went negative for the first time in 2008, and that negative development will intensify over the next 30 years. Now, have a look at the same growth rate of the 15-64-year old (blue line) together with the official real GDP growth rate in chart 3. One can easily see the correlation of demographics and growth and if one looks a bit more critically, one could even see that the growth has stayed higher than demographics suggest. In our view, there are two factors responsible for this. First, the official number may be too high. We think that China is growing perhaps at 3%, not 6% as published. Secondly, China used debt to a bigger extent than all other industrialized economies to push growth. A quick look at chart 4 (next page) shows that GDP has increased from $0.4 trillion in 1991 to $13 trillion in 2018, while debt has grown from $1 trillion to $44 trillion during the same time. This means that debt to GDP rose from 40% to 340%.

> We think that China is growing perhaps at 3%, not 6% as published.

Now, this trend can hardly be continued in future years and the Chinese government has realized it. Prime Minister Li Keqiang said in his speech at the recent National Congress that Chinese must prepare for more difficult times ahead. At another occasion, he remarked that debt cannot grow to the same degree as in the past. Based on demographics and the level of debt, we assume that China's growth will decline step by step to levels comparable to other industrialized nations over the years. The Chinese government will be challenged to steer this transition.

CHART 2

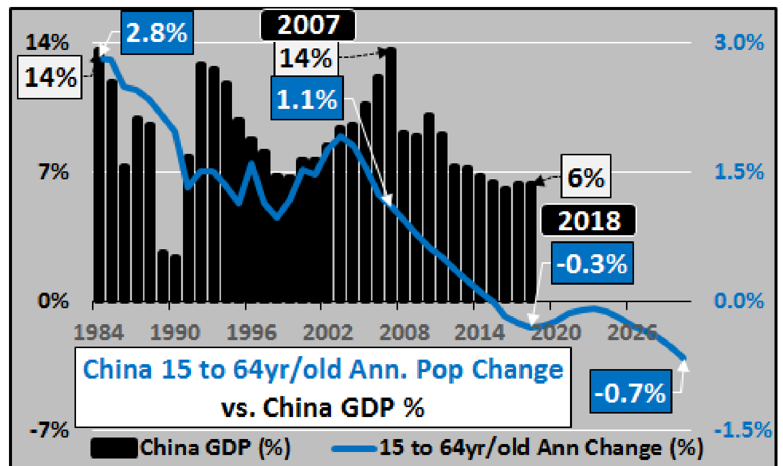
China: Population Growth of 15-64-Year Old



Source: Econimica

CHART 3

China: Population Growth & GDP Growth



Source: Econimica

In view of these assumptions, it becomes clear that China wants some sort of trade deal with the US to get its hands free on the trade front to accompany the internal transition as smoothly as possible. But it also clear that China will not bend to any other nation, and that its aspiration to become the biggest economy of the world remains the government's

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top goal. While we have no doubt that China will eventually succeed, the road could become bumpier than most economists assume.

Continued Global Economic Slowdown

As the Chinese economy has been the main driver of growth for the rest of the world economy – except in the US – its continued slowing will impact the world economy. The Asian satellite economies and the EM universe will continue to slow as will Europe, about which we are most concerned both in the short-term and long-term.

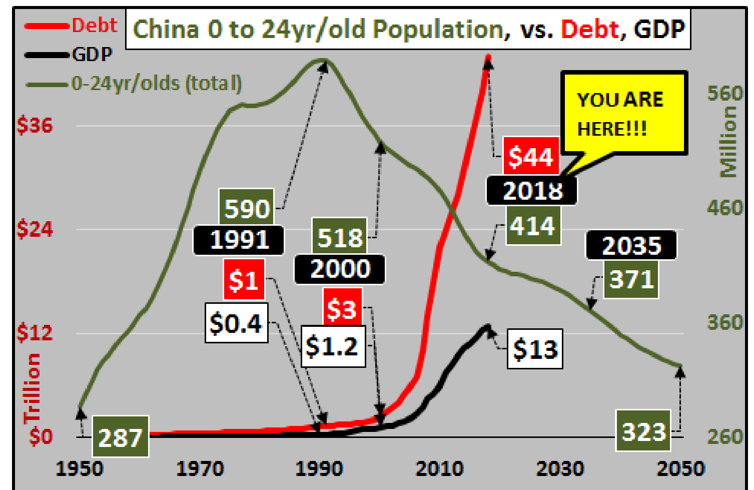
There are several weak months ahead of us for China, and it will impact the rest of the world.

At present, we notice a decisive rise of inventories in Asia, the US and Europe (where the data is less clean). We assume this is involuntary inventory accumulation as a result of the slowing of final demand. Thus, the world economy will need to adjust production to softer demand levels, which virtually guarantees more slowing ahead of the world economy. As Asian exporters have started to cut prices again, it all suggests that inflation will rather soften over the next 6-9 months on a global basis.

We have outlined in our Q1 webinar on March 5th that the large credit increase in China in January was probably a distortion on the upside due to the Lunar New Year. Now, the February number has been released and was very weak and when smoothed, we get a clearer picture. Yes, credit is growing but not at such a high rate as the January number suggested and excited so many analysts. Thus, the earliest low

CHART 4

China: GDP and Debt Growth



Source: Econimica

point in this current mini-cycle decline of the Chinese economy would be late summer (Q3 2019). In other words, there are several weak months ahead of us for China, and it will impact the rest of the world.

If our thesis of further slowing of the world economy is right, we expect the Fed to ease relative to the current condition sometime from mid-year onwards.

The US economy is also softening, as the weak retail sales and the rising inventories suggest. While some believe the Fed has changed, we only see the Fed on hold so far, not more. But if our thesis of further slowing of the world economy is right, we expect the Fed to ease relative to the current condition sometime from mid-year onwards.

The ECB has already moved ahead of the FED, announcing more LTROs to come, which is a deviation from its former course to terminate its balance sheet expansion. Interestingly, European bank stocks declined

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immediately. It seems the ECB is trying again what did not work before and weakened the European banking system. Trying the same strategy again and expecting a different outcome does not speak well in favor of the ECB leadership. Negative interest rates in combination with a very flat yield curve reduces the opportunities for the banking industry to earn income from duration transformation. To us, the ECB behavior is a sign of how helpless they are in the current situation.

Short-Term US Liquidity Boost…

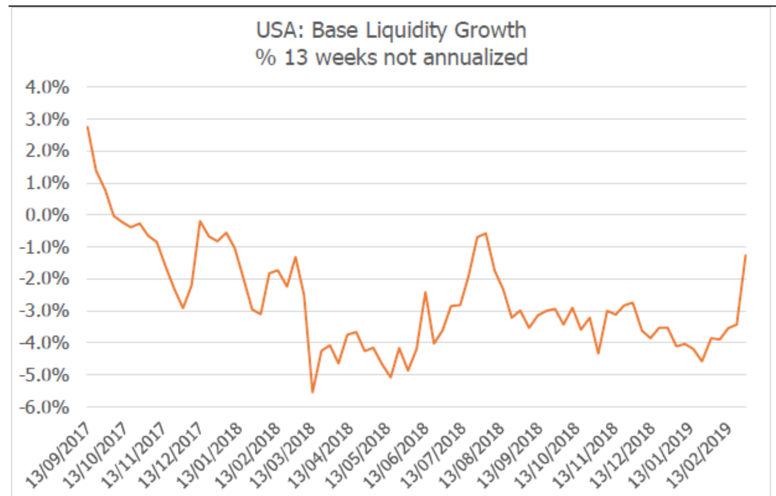
We repeat here what we said during our recent Q1 webinar. There is a temporary liquidity boost in the US credit system (chart 5). First, there were large repatriation of overseas profits that improved the US liquidity situation – but weakened the overseas liquidity. And second, there is now a sharp decline of the Treasury's accounts at the Fed. That money is released into the credit system as the Treasury reduces its balance to pay bills. This is a one-time off event, as is the repatriation. According to our sources, we assume this will change again and weaken the US liquidity situation during Q2 of this year. As that liquidity is injected into the system it improves the US liquidity situation. It also leads, at least partially, to a further outflow via the banking system into the global credit system – we assume temporarily. Thus, all markets may temporarily benefit but to different degrees.

…Keeps the Fairytale Story Intact

Thus, the current strong liquidity situation is bullish for US financial assets in the short run and helps to carry the global equity rally further. US bonds, which are also somewhat overbought, also benefit as the countertrend bounces will most likely be minor. We covered more on this in our Q1 webinar, please check out the replay for more details.

CHART 5

USA: Base Liquidity Growth



Source: AHE

While we are still bullish the US dollar, such a US liquidity boost could temporarily also prevent the US unit from rallying. You need to remain patient, but in another few weeks we expect we will see another rally attempt by the USD versus virtually all currencies. In this sense, we are leaning against the consensus who keeps expecting a weaker US dollar on a trend basis.

While we are still bullish the US dollar, such a US liquidity boost could temporarily also prevent the US unit from rallying.

Keep in mind that if globalization is turning into de-globalization, it strengthens the currency of the net importer of last resort and weakens the currencies of the largest net exporting nations. There are some mega trends operating that we should keep in mind.

The current short-term liquidity boost keeps investors believing that it

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reflects a robust world economy. As we have outlined in our reports and above, we believe the contrary. While we are not exactly sure how long the weakening of the world economy will last, we still believe it will last long enough and deepen enough to create problems for the corporate sector. The world economy and a large percentage of public companies' businesses are related to the cyclical swings of the world economy. And their profits swing with the global economic cycle. Thus, we still expect that earnings estimates must be cut, and more disappointments lie ahead.

This liquidity boost and the equity rally has nothing to do with Fed policy.

We view this rally in equities as a rally to correct a medium-term oversold condition, which is temporarily helped by a temporary short-term liquidity boost in the US. This liquidity boost and the equity rally has nothing to do with Fed policy. But we also see this as a rally against the deteriorating economic fundamentals of a sharply slowing world economy that will lead to earnings disappointments, particularly for cyclical companies.

We still prefer the US over Europe, Japan or the EM universe.

The US liquidity situation is clearly helping the US market the most, while others benefit also at the margin. This is one of the reasons why the US stock market continues to perform best among the major markets. We still prefer the US over Europe, Japan or the EM universe. Among the EM universe, we prefer

CHART 6

Shanghai Stoxx Exchange Composite Index

Source: Thomson Reuters

the Chinese market, as the monetary authorities are releasing more liquidity into the system and the government is providing some help on the fiscal side, including tax cuts. That tax cut will not do much for the GDP growth, but it will help the corporate sector.

While the Chinese stock market indices may be ahead of themselves and short-term corrections/congestions are due, the longer-term picture is promising. Our view of a slower economy and more and more stimuli over the years may be bullish for equity markets, particularly in view of the high cash amounts on the sidelines by Chinese savers. We have put our expected course of the Chinese index into chart 6. It is a view over the next few years not the next few weeks, and we are not married to the exact timing but more with the shape this index will follow. The high of 2007 terminated a strong long-term advance and what followed was a long-term consolidation as a triangle. Usually, within a triangle there are 5 moves before the breakout. So far, we have only seen 3 of 5 moves. Thus, we expect the current mini-bull followed by a mini-bear and finally the breakout that should lead to new historic highs. The current mini-bull has the potential to run to about 4500 on the Shanghai Stock Exchange Index, which would be an advance of approximately 50%, in local currencies. Thus, while we see the Chinese economy very

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differently from the consensus of economic experts, our view may also differ considerably regarding the course of the Chinese market (more bullish than the consensus). When looking at the chart, it reminded us of our first visit to the Shanghai Stock Exchange in 1994. At that time, the trading room was a back room in one of the famous hotels in Shanghai and the trading was anything but sophisticated. When visiting some companies in the early 1990s, those companies had no clue what accounting was, but all were talking about getting listed at the exchange. The Stock Exchange was closed in 1949 when Mao took over and brutal communism was introduced to China. It reopened in 1990 when China was still a very underdeveloped nation. How times have changed!

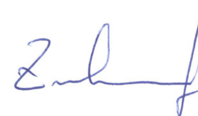
Gold – Prepare for Better Times

The yellow metal is also benefitting from the short-term liquidity push as described above. But once the US liquidity situation changes, the global liquidity situation should worsen once again until central banks begin to stimulate in earnest and more decisively. Thus, gold may add another short-term run towards the major resistance level of the mid- to upper $1300. We doubt it will break through anytime soon, but rather expect a correction or congestion below that resistance line when the US dollar puts on another rally attempt. Once that correction in gold terminates, we think a promising attempt at that resistance line will follow and a more decisive move to higher highs will begin. We also expect gold mining stocks to participate and perform very well.

This is in line with our thinking outlined in previous reports. The world economy is weakening and forcing fiscal and monetary authorities to act and support the system – they are so much afraid of a systemic break down (or losing the election). Thus, in contrast to those who expect a repeat of the 2008 waterfall decline in equities, we rather think it will be a highly volatile sideways affair that could even include new highs next year in some indices. However, we also think it will be highly selective on a regional, national, sector and individual stock basis. Thus, analytical skills to select individual sectors and stocks will be as important as timing skills. A buy and hold strategy applied on passive index instruments will only lead to disappointing returns.

We recommend accumulating gold on setbacks over the coming months.

We think the effort of the authorities to underwrite the system – which will eventually work through the balance sheet of central banks – will be very beneficial for gold as we will see more unconventional behavior by our authorities in future years. Moreover, we expect the conflicts of the two titans and others in trade and geopolitics to intensify in coming years, which should also be gold positive. Hence, we recommend accumulating gold on setbacks over the coming months. We will certainly report when we think the train will begin to accelerate. Stay tuned!



Felix W. Zulauf
March 12, 2019

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