ZULAUF CONSULTING

INVESTMENT COMMENT

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

* Indicates a new position or change in view

HIGHLIGHTS

- Financial markets are now beginning to focus on politics in Europe. Islamic terrorism and Merkel's dogmatic stance on the refugee question right after the strong electoral gains of the nationalist AfD party (Alternative für Deutschland) in several German states may further increase the popularity of anti-establishment groups and parties throughout Europe and also increases the odds for Brexit. A UK exit from the EU would most likely accelerate disintegration of the Greater Europe project.
- Trump's strong performance is reflecting the degree of anger by the US electorate against the political establishment of both parties – as is the case in Europe. Moreover, continued terrorism in the Western world increases nationalist and anti-establishment feelings that play into the hands of Trump. Over the next few months, the pre-election debates will have an increasing influence on financial markets.
- A key question for investors is whether the growth slump and downward pressure in globally traded goods prices is over and whether the stabilization of the Chinese currency is sustainable, or not.
- A dovish Fed stance could mean a postponement of the overdue adjustments in financial markets, as it has taken the wind out of the sails of the greenback.
- Global equity markets are hitting a short-term high similar to early November. Although medium-term indicators allow more time to rally, the upside potential remains very limited from here due to rising uncertainty, an unbalanced world economy and overbought markets.
- Bond yields for perceived quality borrowers may zigzag sideways with an upward tilt, but the upside remains limited in our view.
- The US dollar's correction is not quite over yet, but the big part in terms of magnitude most likely is. Policy divergence between the US and the rest of the world has peaked, but we never expected a stronger greenback based on normalizing US policy but rather due to problems arising elsewhere.

- We consider gold an attractive investment in this fragile world of growing uncertainty, although a pause after the sharp rise in recent weeks is overdue. Setbacks offer good buying opportunities.

Politics Moving Into the Limelight

Politics seem more fragile than ever in Europe, and the presidential race in the US also seems to surprise many. The establishment is under attack by a dissatisfied electorate as the broad public continues to suffer a steady erosion of prosperity. This is the result of broadly misguided policies by the establishment and the apparent disregard of the interest of the broader population by the current leadership, at least in the eyes of the public. From the public's perspective, the social contract between the rulers and the ruled has broken down. As a result, members of the establishment are fighting an uphill battle in politics, and outsiders are in vogue in both political parties in the US. Donald Trump is the outsider with a nationalist twist, and he played his campaign strategy smartly. The public seems to give him credit despite his sometimes vulgar behavior. The world outside the US laughs about him as it laughed about Ronald Reagan as a candidate at that time. In any case, he may be able to introduce change from the current president and run a more business-like policy. The risk for the world is that the US under Trump would take a protectionist stance in trade, which would hurt the world economy if the biggest net importer of the world clamped down on "free" trade. His opponent seems to be Hillary Clinton, but she is challenged much more seriously by the left-wing Democrat Sanders. Again, Sanders is the outsider and Clinton is the representative of the establishment. She has a reputation for lacking integrity, which is exactly what the electorate does not accept any longer. Although she will most likely get the Democratic nomination, it is unclear whether she can win against the outsider Trump, particularly if Trump in the final phase of the election cycle portrays a more statesmen-like presidential persona. In any case, uncertainty regarding the future political course will rise in the US and the rest of the world. Unlike other races for the presidency, this time it is the candidate of the establishment against the outsider who is unknown for his policy, given that he is a newcomer to politics though with a reputation as a shrewd, selfish and unpredictable businessman. This political uncertainty will impact financial market behavior because markets and business don't like uncertainty.

Europe is entering very dangerous political territory. First, it was the euro and its deflationary straightjacket for the majority of the EMU members that led to rising dissatisfaction among the public. The Greek bailout and other bailouts made others dissatisfied, and then the breaking of virtually every important rule of the Maastricht Treaty (European Monetary Union) contributed to deepening rifts between increasingly dissatisfied parties. And finally, it was the naive behavior of Chancellor Merkel regarding the refugee problem. She basically welcomed the refugees and then wanted to dump them proportionately in the EU, a policy that met with stiff opposition. After the terror attacks in Paris and Brussels, people link the terrorism to the refugee problem, as Muslims seem less willing to integrate into European culture and society. Moreover, the fear is that this is not only a financial but also a social and security problem.

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On top of these conflicts comes the UK vote on whether or not to stay in the EU, scheduled for June 23 of this year. The UK also seems to have a problem with the lack of Muslim integration. Moreover, the big losers of globalization and slower global growth in the UK are lower-class white males. As a result, the outcome of the voting will be uncertain. So far the polls are close, with those in favor of exiting slightly ahead for the first time. The recent terror attack in Brussels may have pushed them ahead, and it will, in our view, be a close race, but we see slight odds in favor of exiting as another demonstration against the ruling class.

The UK is a net contributor to the EU budget, comparable to the size of the Netherlands or Italy and about one-third the size of Germany. Brexit would create another crisis in the EU, with all the diverging opinions from the different national governments on several important topics. Big projects are usually launched at the height of prosperity or right after a crisis. The latter have much more chance of succeeding than the former because from its height, prosperity can only decline, leading to dissatisfaction because treaties written in the best of times usually assume the good times will roll on – and then comes disappointed. The risk is high that a Brexit could lead to a disintegration of the EU and a crisis forcing a complete overhaul of its goals and institutions. Dividing opinions will grow among EU members, even if the UK stays in, but the process would be much slower. In any case, there will be rising uncertainty regarding the future political scenario in Europe and the US in coming months.

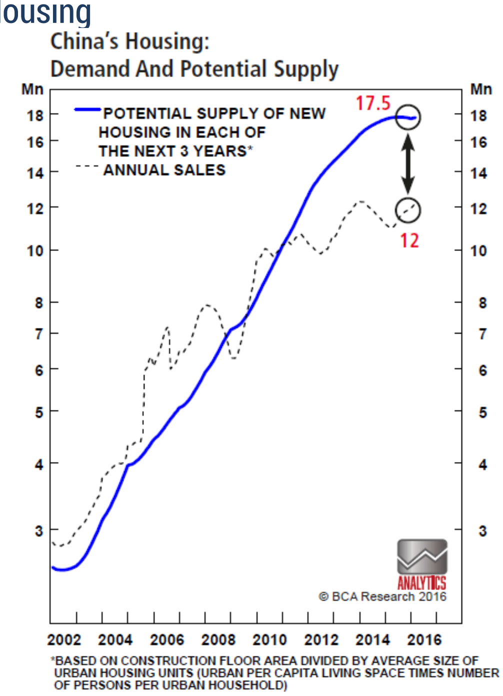
China Stabilization at the Surface Postpones Next Major Adjustment

The key question for investors is whether the growth decline in emerging economies is over or not. If not, the prices of globally traded goods will remain weak, putting downward pressure on corporate profits, and this risk-on rally will be only temporary in nature. If, however, the EM universe recovers sustainably, a resumption of cyclical bull trends could set in.

At present, we have no indication from fundamentals to believe the former-, although markets are playing the latter scenario. While PMIs have ticked up lately in a slight majority of economies, order backlogs, leading indicators, yield curves and credit impulses don't yet support the thesis of a turn for the better. Some point to the Chinese real estate market as a leading indicator of improvement, and indeed the aggressive monetary easing led to sharply higher prices of up to over 20% in selected tier 1 cities for the last 12 months. While the authorities are now tightening the rules for real estate, we doubt the Chinese real estate market is signaling a sustainable upturn. First of all, the construction of 17.5 million residential units per annum over the next

CHART 1

China's Housing



Source: BCA Research

three years compares with a normal rate of 12 million units of sales per annum (chart 1). Hence, we think China is already overbuilding again, and the same is true in the non-residential market. All China has done, in our view, is to try to get the economy going again by easing monetary policy aggressively. Indeed credit according to some sources has grown by 40%, of which some is probably adding non-paid interest to loans that are in fact non-performing. The rest of the corporate world and economic activity have responded only timidly. Higher construction activity, however has helped to stabilize the economy. In sum, we believe that the whole attempt in China has postponed the problem rather than solve it.

Our case remains that the monetary overhang in the Chinese economic system is simply out of line to a large degree with other economies, even those at the same stage of economic development. Hence, the desire by wealthy Chinese to export capital as a diversification will not disappear. That is the reason for our bearish cyclical stance on the yuan. Our hunch is that recently released trade statistics by China on one side and by Hong Kong and other Asian economies on the other, did not match; in fact, they revealed a much greater discrepancy than before. In plain English, capital export is now primarily done via the trade account in the form of faked billing as well as by takeovers of foreign targets by Chinese companies and less via the capital account.

We honestly don't know how long China can sustain the current situation or postpone the inescapable adjustment. But lowering interest rates and expanding the supply of money dramatically and keeping the currency stable are hardly a recipe for long-term stable conditions. Something will give, but we don't know exactly when.

The monetary overhang in the Chinese economic system is simply out of line to a large degree with other economies.

We are aware of the risks of our stance, of course, because the longer China can keep things together in the current state, the higher the risk of a pop of inflation. In China, we already have seen asset prices rising, but consumer prices could follow. Conceptually, the more inflation rises and interest rates are kept low, the higher inflation rises and the higher the risk that interest rates eventually bounce back. That would be unpleasant in a highly leveraged economy as China is today. Moreover, the longer the Chinese can preserve the current status, the greater the risk that the rest of the world could also all of a sudden see a bounce in inflation, not least with the base effect of oil kicking in sometime this year. Hence, the question of how long this situation will last has important implications for global financial markets. According to our cyclical (monthly) oscillators, most EM currencies have given long-term buy signals near late September's lows that may suggest this interlude could last a bit longer than we originally expected.

CHART 2

US Dollar Index

Source: Bloomberg Finance L.P.

However, oscillators can be misleading in trending markets. Moreover, as long as fundamentals for those currencies remain bearish, it is hard to see more than two medium-term trend corrections against the primary trend. At present, we are in the late stage of the first medium-term correction for some and for others already in the late stage of the second recovery attempt.

We doubt that China can walk away without any backfiring from previous and current policies. If our analysis is right and capital exports pick up via the trade account, financial markets will realize it sometime during the second half of the year. The US central bank may not hike rates (which we expected) as the markets had assumed, and this may give the whole EM complex a bit more breathing room until the bearish fundamental factors return to markets.

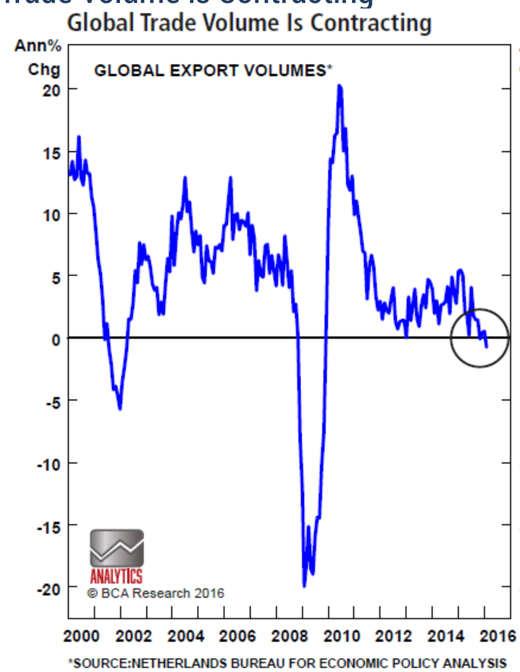
In our last report we showed the chart of the US dollar index (chart 2) and named the different moves and compared them with the previous two cycles. The US dollar index is still in its E wave, as we had indicated, and as soon as its medium-term trend reverses to the upside, the risk-on period in global financial markets will in our view come to an end. That is the key factor to watch.

Global Growth Remains Very Slow

The world economy continues to grow, but at very slow rates (chart 3), and leading research organizations have continued to cut their forecasted growth. This is all in line with our expectations. As long as authorities provide the wrong remedy and central banks try to address structural problems by easy money that simply cannot solve those problems, the world economy will not improve in a sustainable manner but may creep along until imbalances break it up again. A continuation of this course only makes matters worse over time. Interest rates that are too low or even negative encourage borrowing more and more from future demand in the real economy. This policy may prevent pronounced economic weakness now, but it implies much bigger problems down the road.

CHART 3

Global Trade Volume is Contracting



Source: BCA Research

Overbought Equity Markets Due for a Correction

Markets were surprised by Yellen's dovish stance in her recent speech leading to speculations that the major central banks agreed on a plan to weaken the US currency to prevent a deflationary shock to the world. We understand this speculation and understand the rationale behind it, but we think that the Fed realized Q1 would show less than 1% annualized growth. If there was such a plan, it would simply postpone the inevitable, as easy money everywhere and markets believing in that remedy would lead to even greater excess in credit and financial markets around the world, which would eventually make the adjustment even more painful. Could it happen? Of course, central bankers left the straight and narrow path long ago and now seem able to omit no blunders.

In that sense, we not only understand the Pavlovian reaction of the markets to a softer Yellen speech, but we understand the reasoning of the bulls that alternative investable assets are becoming ever less attractive, thereby making stocks look good. If that scenario – which is not ours at present – were to materialize, markets would rally further, based on monetary factors alone and despite the absence of supporting economic fundamentals. While not impossible, we would not bet on it at present.

Corporate profits in the US are down for the last 12 months, and interestingly the main factor is not the strong dollar but rising wages that reduce profit margins. The economy is too slow to accelerate the wage increases, but they could remain steady. Moreover, if the world economy does not sustainably improve but simply creeps slightly higher – which is our scenario – and the weakness in EM and Chinese currencies return, global equity markets will be in trouble again. Investors are pretty fully invested and hold low levels of cash, but big money only sells once profits begin to weaken.

Global equity markets are overbought, as in early November of last year (chart 4). At that time, markets simply marked time until late December, when weakness set in again. We think something similar could happen here. Among global markets, it is simply a see-saw pattern, with those markets suffering from a rising currency performing relatively weak and vice-versa. Recently, US markets performed best on a relative basis (NASDAQ underperforming, however) and could mark time in a distributional manner. Europe underperformed and so did Asia, with a few exceptions. European indices contain in general more cyclical and financial components. Financials are the weakest performers and seem at risk of breaking down further. They often lead medium-term trend changes and market moves – either way.

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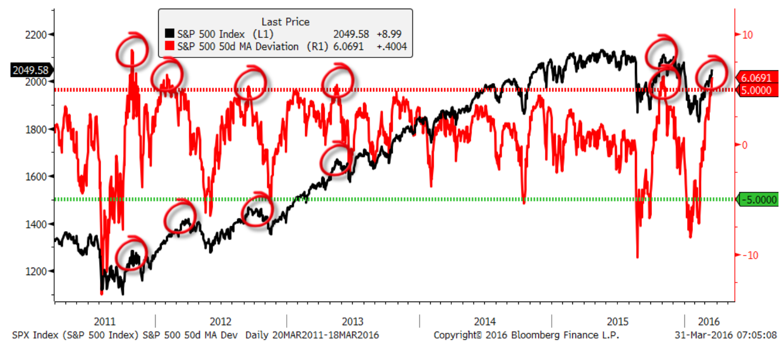
If, contrary to our expectations, markets correct only mildly and rallied on powerful breadth again, it would signal that this risk-on period would last longer. We will address this in future reports. For the time being, we await some pullback in coming weeks.

Stick to Long US Treasuries

We have taken a constructive view on long-dated US treasury bonds for a long time. While we are fully aware that these yields will rise on a secular basis, we believe the upside pressure will not occur until the final deflationary hit from yuan devaluation is felt first. But if that development was postponed and the West had a temporary uptick in inflation, supported by the base effect of the oil price and a weaker dollar, then yields could also bounce. We still believe that if it happened at all, resistance would be powerful in the upper 2% for 30-year treasury yields. Hence, we leave our

CHART 4

S&P 500 and Deviation from 50-Day Moving Average



Source: Puplava Fiinancial Services, Inc..

constructive assessment in place. But we still advise against other currency-denominated sovereigns, although they could decline even further, as JGBs have demonstrated.

Currencies Are Key

As expressed above, currency markets will lead the trend for virtually all other markets. Hence, it is important to monitor them very closely. And EUR/USD as well as USD/CNY are key, as these are the two biggest markets.

The euro is a currency with a chronic current account surplus, and therefore if there is no crisis, it has a firm bias. It weakens only if there are circumstances leading to large capital outflows that overcompensate for the large current account surplus. That is what Draghi tried when he initiated the large QEP strategy. However, the surprise effects are gone, and only new factors leading to a fundamental reassessment of Europe as a safe place can weaken the euro. Current interest rate differentials alone are not enough to do it. A Brexit, however, would certainly lead to large capital outflows, as fundamental doubts over the EU and the EMU would be raised.

Our medium-term timing model for the euro remains bullish, and bearish for the US dollar, with indicators for both currencies already in a very advanced stage. The cyclical model for the euro has been bullish for one full year now, since it hit 1.05. The previous decline was from 1.40 to 1.05, and a 38% retracement would bring it to 1.18. The first medium-term recovery attempt went from 1.05 to 1.17 and lasted five months, peaking in August 2015. The second recovery attempt started again from 1.05 in early December of last year. Hence, a feasible recovery target near 1.18 around late April or early May as an extreme is conceivable.

The ECB is not pleased by the stronger euro, and some members have tried to verbally talk it down by saying there is still some downside potential in negative yields, unlike Draghi whose remarks were taken as the end of the move. The more important issue will be the upcoming vote on Brexit. If the UK exits the EU, it will in our view have negative implications for the euro, as a disintegration process could begin in earnest. In that case, capital would shy away from all the weaker member countries and move to Germany within the euro or more likely even into US dollars. In the latter case, the euro could actually see dramatic capital outflows with a balance of payment crisis despite its chronic current account surplus. The vote is on June 23.

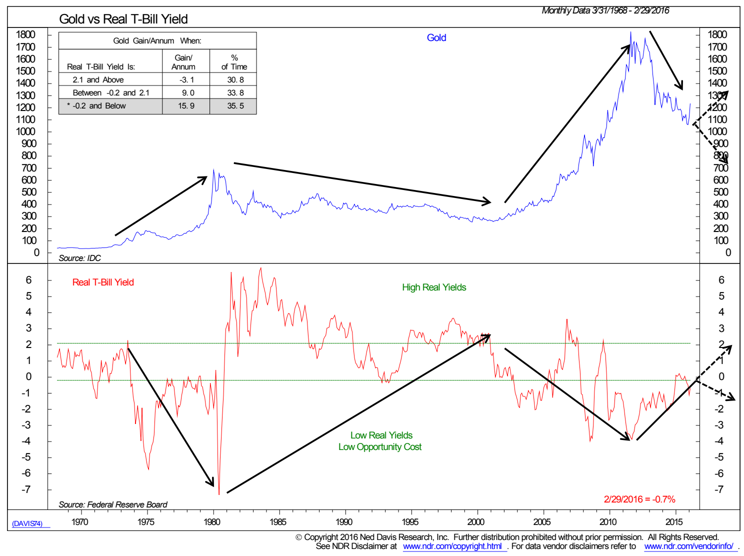
A weakening euro and therefore strengthening US dollar would most likely also strengthen the US greenback against most other currencies and bring markets in general back in line with our scenario.

Buy Gold on Weakness

Gold has risen almost $240 from the recent low. Our expectation was a quick move back to the $1,400 zone with which we stick. However, the first run seems virtually over, and sentiment has been hitting extreme optimism again. Corrections in coming weeks offer good buying opportunities again for another rally ahead. The case for gold is that central banking has left the straight and narrow path and opportunity costs in all major currencies are negligible. Moreover, negative rates or the introduction or tightening of punishing rules for holding cash or paying by cash will make savers move part of their money outside the banking system due to eroding trust. A glance at chart 5 of gold and real T-bill yields shows that gold performed well when

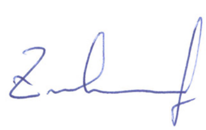
CHART 5

Gold vs Real T-Bill Yield



Source: Ned Davis Research, Inc.

real yields trended downwards particularly when the level was below 0%. And gold was declining when real yields rose, even in negative territory, perhaps because from those extreme negative yield readings, gold was already highly over-owned and over-bought. We are not sure whether the trend of real yields has truly reversed downward for the long-term, but it did for the last few months, and it may in our view last a few more months, particularly if CPIs pop. That's why we expect another leg up after the current corrective interlude, as gold offers a great hedge against the US central bank staying dovish longer. In our view, gold has at least another shot to the upside, at around $1,400, and that's why corrections are opportunities to buy.



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April 5, 2016

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