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	Neutral
Gold	Bullish	Bullish
EUR/USD	Neutral	Neutral
USD/JPY	Neutral	Neutral
USD/CNH	Bullish	Bullish

* Indicates a new position or change in view

HIGHLIGHTS

- There is a widespread belief that this current decline may only be a short cyclical correction within a new secular bull market for global equities. In our view, the odds are high that this bear cycle may be the final part of a still ongoing secular corrective process from 2000 that is expected to end only after this cyclical decline will be over.
- The bulls are making the case that expansive monetary policy around the world is driving a new secular equity bull market higher as monetary inflation should lead to further asset inflation.
- The bears fear that expansive monetary policy simply intensifies the deflationary process leading to weaker corporate earnings and eventually undermining equity markets.
- While it is not important for investors from a tactical viewpoint whether secular bull or bear, it may be for strategic reasons, as an ongoing secular bear, particularly in the later part, could bring painful surprises for the bulls but also great opportunities for those prepared.
- The global cyclical bear market remains intact in our view and the recent rally attempt is countertrend in nature and technically relatively weak.

Secular and Cyclical Thoughts

The bulls claim that the rise to new highs in selected equity indices, particularly in the US, proves that the secular bear market that began with the peaking of the TMT bubble in 2000 ended at the lows of 2009. They point to higher highs in selected indices like the S&P500 or the Dow Industrial Average. At first glance, this seems plausible as the highs of 2015 were considerably above the highs of the previous cycle peak in 2007. However, closer inspection shows that the US indices were the exception and not the rule in the world. Among major European markets, only the DAX made decisive new highs but the DAX differs from virtually all other indices as it is a total return index and includes all reinvested dividends. The DAX price index is not widely followed but its price is now clearly below the peak of

2007. While a few selected national indices around the world rose to new highs above the previous cycle high, they all have a high weighting in consumer staples or defensive growth stocks while more balanced indices failed beneath the previous cycle highs. The same is visible in Asia. Japan is an exception as it peaked in late 1989 and suffered a serious secular bear market decline from 40'000 to 8'000 and is one of the very few markets in the world that on our own technical trend and momentum system appears in a new secular advance. However, Japan is in our judgement in a cyclical bear market within a potentially new secular bull cycle. Most emerging equity market indices remain in a cyclical bear market within an ongoing secular bear cycle or correction that started in 2007.

The thesis of the current cyclical bear market being part of an ongoing secular correction makes the most sense if the world faced another deflationary crisis, where the previous mantra of continued easy money leading to a normalized economy resulting in ever higher equity prices falls apart. This scenario would conceivably lead to a complete crisis of almost religiously imbedded beliefs that economic progress continues forever and equity prices always rise in the long-term and that market timing is an attempt that is an impossible, unnecessary and invaluable attempt.

The bull case points to the low interest rate environment justifying those high valuations. But we recall that Japan's market once traded at almost triple digit times when interest rates kept declining but that valuation collapsed when earnings declined. Hence, we believe the bull thesis requires at the very least stable if not rising earnings. Our case, however, is that due to the deflationary process often described, corporate earnings are under pressure and will lead to a cost cutting process that will undermine others' earnings and income and eventually weaken the economy as a whole. It is conceivable that the resulting economic weakness will only be noticed very late in the game. Moreover, this is a process in slow motion until recognized by the majority that will be only in the latter stages of this cyclical correction. Historically, most damage is done in the last six months of a bear market decline.

CHART 1

S&P 500

Source: Bloomberg Finance L.P.

CHART 2

Value Line Geometric

Source: Bloomberg Finance L.P.

CHART 3

DAX

Source: Bloomberg Finance L.P.

The USD Bull Run Is Interrupted by a Temporary Correction

In a deflationary crisis, the US dollar usually strengthens and therefore we believe that the current medium-term congestion/correction of the US dollar against several currencies is in our view not a cyclical trend change, but rather a temporary interlude to reduce excessive speculative positions in view of a softer US economy than originally anticipated. We also believe that the next advance of the greenback will be dominated by a renewed increase in capital flows from other parts of the world into US dollars due to the fact that in a deflationary world, the largest importer is hurt the least and last while the largest exporters are hurt the most and first. EM, Asia and Europe are the big net exporters while the US is the big net importer of this world. Moreover, all else being equal, a deflationary crisis strengthens the currency in which most global debt is denominated outside that economy (US in this case), which again is the US dollar. We have intensively written about our belief that capital flows of the last 10 years and more are reversing, and do think that process is well underway but it goes in waves (for copies of previous reports on this topic, please contact info@felixzulauf.com).

A glance at the chart of the US dollar index (see chart 8 on page 4) shows many similarities of the current cycle that started after the last crisis with the previous cycles. We have lettered alphabetically the different steps in the two chart patterns to show what we mean. Of course, it would be naive to assume every cycle is similar and to base an investment policy on such a chart but, it is noteworthy how closely the different steps in these three cycles move in lockstep. In our view, another US dollar advance will be due once the current congestion/correction is over and that will be once deflationary pressures intensify again – and those surprises are expected from outside the US. However, it is unclear how long this corrective wave E will last, and whether it will be shallow and drawn out versus short and sharp. But we believe once this wave E correction is over, the problems in the world markets will return and intensify.

CHART 4

DAX Price Index

Source: Bloomberg Finance L.P.

CHART 5

FTSE

Source: Bloomberg Finance L.P.

CHART 6

EURO STOXX 50

Source: Bloomberg Finance L.P.

It remains our view that China (and other China dependent economies) will then unleash another wave of deflationary pressure, once the current attempt by China to support its economy by intense monetary stimulation either fails or leads to a weaker yuan, at the very least. The still high inventories in Asia – and actually also in the US – will in our view trigger another episode of deflationary pressure in the world economy for which global financial markets seem unprepared. Moreover, it is a bit like Soros' theory of reflexivity in that a deflationary world not only strengthens the dollar but a stronger dollar also reinforces the deflationary process. It also makes sense from a relative monetary policy view, as the US central bank is the least expansive of all central banks although this is only a minor and certainly not our major point. The point here for bulls and bears is to monitor currencies very closely as they will signal the start of the next episode.

Central Banks Are Lost

It seems to us that central banks around the world are somewhat lost about what else to do to help with economic improvement. They seem to realize that their policies of recent years - be they ZIRP, QE, or even negative rates - failed to revive growth. We have argued many times in our reports that all these policies – aside from acting as lender of last resort in an acute systemic crisis – are counterproductive. The cheaper the financing costs, the more capacity around the world expanded. This is not necessarily at home, but elsewhere (China and EM boom). Hence, the more intense the deflationary forces became for many tradable products. And the lower the yields on fixed-income investments were pushed by central bank action, the more the savings rate of private households tends to rise. It was therefore predictable that the outcome of central bank policies of recent years would fail, because counter to prevailing theories it would expand the supply of tradeable goods. Instead of the intended increasing of demand, it would rather lift the savings rate and therefore limit or even weaken final demand. This was even true despite the

CHART 7

Nikkei

Source: Bloomberg Finance L.P.

biggest drop in the price of energy in many years. And as we can see, growth rates of the global economy continue to erode and have continued falling for years.

While monetary policy is failing, fiscal policy would work. However, after increasing public sector debt to unsustainable levels, fiscal policy makers may have – finally – learnt the lesson of too much debt and practice now

CHART 8

US Dollar Index

Source: Bloomberg Finance L.P.

fiscal restraint (while still running deficits but less than a few years ago). The EU even polices its member states. China is already running deficits of 10% of GDP although the official number is much lower and while they may talk about more fiscal stimulus, they simply don't have that option any longer. The question is whether policy makers can or will move toward fiscal stimulus if all other remedies don't work? We detect some slippage in selected countries with Canada moving first recently and some slippage on a state level in the US, perhaps in view of elections. Japan is certainly at a point where it needs some fiscal help but has not moved yet while Europe is probably forced into some fiscal slippage due to rising costs for refugees and related security.

But we don't see the big fiscal stimulus coming anytime soon. More likely, growth around the globe will remain lackluster but as we have written several times, we will not see a 2008-like weakening – as most bears believe - but rather a continued erosion that will prevent policy-makers from launching large fiscal programs. This way, the world economy keeps sliding in slow motion into another deflationary crisis. It is a process new to expert economists and strategists. For that reason markets take any hint that a collapse is not taking place as a reason to rally – as was the case in recent weeks. In our view, the bulls' argument that the current resilience of economic indicators and avoidance of a repeat of 2008 so far is dangerous. In our scenario, the current process eventually will lead to a recession but will only be recognized as such once markets are decisively lower. The risks are building from a pricing to a profit-ability problem.

Nobody knows how low equity markets could decline in such an environment, but it could eventually threaten the imbedded belief that our capitalist system really works (which on a side note, the system is not truly capitalist any longer, unfortunately). This is very similar to the disillusion we saw at the low in the mid-1970s. Such disillusions arrive when the world gets hit with something completely unexpected, and that people are unprepared for. While a major yuan devaluation has been avoided so far – and the world obviously assumes China is no threat any longer, we still believe it will be the most logical outcome as all other options are more painful for China.

Without a crystal ball, we cannot pinpoint or forecast the exact time the system and markets will reach that point of extreme pessimism. However, our current view suggest that this is possible at the end of the current cyclical bear market at which point we could be there. Very often, we see in markets an alternation between one cycle and the other in terms of shape of the decline. For instance, the 2007-2009 bear was a waterfall like decline, while the 2000-2002/3 decline was more complex in the major indices (not in the NASDAQ, or the former darling stocks). We speculate that the current cycle could be complex again until the very last stage, when a shock could take place and a severe markdown would result. But if we are right in our major thesis, there could be false starts for a new cycle that may first look like a new cycle, but then fail again and thereby making the whole decline more complex and more painful. In this type of market environment, many investors get sucked in again at the wrong time. This is all highly speculative but we want to share our thinking with our readers.

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We are not writing about the bear scenario because we like to (and run the risk of being mistakenly looked as a perma bear), but rather because we want investors to prepare and use the opportunities for cleaning their portfolios (or sell short for more aggressive investors). We see this strength as an opportunity to eliminate the weak elements of your portfolio, to preserve capital and have cash available for upcoming opportunities on the long side when this bear cycle will be done. At that time, a new secular bull cycle may begin and it has a high chance of being accompanied by rising inflation and a lot more government involvement. Governments may then support the system by launching large fiscal stimulus and central banks will most likely underwrite it. But it may most likely need a crisis first to trigger those policy steps.

It follows that yields of perceived quality bonds should decline further, and most likely much further than rational thinking would allow. In an older report we expressed our view by using the title "Zero Percent Yields Are Not the Bottom." Although we have been deflationists since the early 1980s, even we were surprised that 10-year government bond yields could decline below zero percent. Japan has now joined Switzerland with negative yields for 10-year government paper and we think it may not be the last country doing so. In that sense, we believe long term US treasuries still make sense as we expect those yields to decline further in this cycle. US treasuries offer much better value than any other developed nation – but in an overvalued asset class from a secular point of view, and near the very end of that secular decline.

Medium and Short-Term Update

Global financial markets are still in the risk-on rally attempt - in synch with the wave E correction of the US dollar in that chart - that in our view is counter to the primary or cyclical trend. This view is based on the belief that recession risks have declined as economic indicators do not currently indicate one. More importantly, recent numbers show some stabilization rather than a further deterioration for the time being. Moreover, central banks in China, Japan and Europe are still printing a lot of money. While part of it will remain stuck as bank reserves at central banks' balance sheets, there may still be a net positive liquidity effect to some degree. Finally, markets were oversold on a technical basis and some recovery attempt was expected.

There will be important developments in the near future with the ECB and FED decision due in coming days. China's National People Congress, with about 3000 party officials attending, is also taking place and should offer a clue how the leaders want to deal with the economic slowdown. Such decisions may shape the short-term to medium-term outlook in financial markets.

We doubt the Fed will move in March, but it is unclear what the ECB will do. Draghi will certainly try talking down the euro, and perhaps push negative rates even slightly lower. He may even intensify, if only marginally, its QE program. It will be difficult to push the euro lower and if Draghi continues his counterproductive policies, it could even backfire. To us it looks like China has decided to go the way of monetary stimulation, which has not come unexpected. If pursued, it may postpone some problems in the banking and real estate sector but the downward pressure on the yuan should intensify again. As explained in previous reports, the wealthy Chinese want to diversify internationally. In our view, the constant outflow will not remain at reduced rates from previous months for long. This is due to making capital exports only temporarily harder for Chinese residents.

Markets have now rallied strongly, and many believe that the worst is behind us and the bull market may resume for the reasons mentioned above. Actually, this rally is technically much weaker than the one in Fall 2015 based on breadth and momentum. Moreover, short-term oscillators are already overbought and bullish sentiment has jumped back quickly, which is typical of bear market rallies. We believe short-to medium-term countertrend moves last between 6-10 weeks, not longer. Rallies have so far consumed about 4 weeks and may therefore not be complete, yet.

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It is impossible to forecast whether the E-wave correction will be mild or sharp. If the latter, the rallies in equities and commodities would continue further but in case of the former, the upside from here should be very limited. The current reading of those medium-term indicators would allow more time to rally. While we suspect markets have now entered what we thought would be good resistance zones, we don't have any clear indication yet to trigger the resumption of the decline at this time.

The US dollar remains in its correction, and we also see most EM and also natural resource **currencies** (AUD, CAD) bouncing, in certain cases sharply. They have been deeply oversold and many short-, medium- and even longer-term oscillators are turning up for them. This action fits in very well with what is going on in commodities, bonds and equities, too. Markets are therefore agreeing with the consensus for the time being. The indicator picture allows more bounces or correction against what we consider a fundamental and structural bearish trend. But we are not at a point to call and end to this interlude, yet.

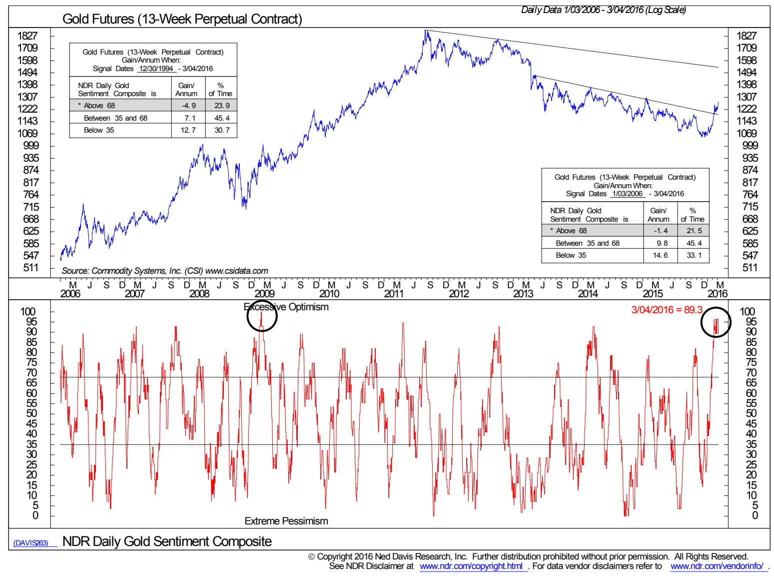
Commodities have rallied between 10% and 40% within the last few weeks from deep oversold readings. Moreover, monthly oscillators have entered buy zones and we suppose many active in those markets have turned bullish again. Bullish sentiment has also jumped higher, but only into neutral territory. While we understand that production cuts have been announced and will be executed over time, which is a big plus, we doubt this is already the start of a new commodity bull cycle and rather see the advance as part of a very lengthy bottoming process that may even include further lows along the way.

The big risk we see is in health care, that is breaking down in relative terms which is a warning for the immediate future.

Gold has rallied strongly, and bulls have risen to 97% the highest since early 2009 when gold traded around $900 and was in the early stage of its run to $1900. It has also broken multi-year downtrends. We see this high optimism as a trend confirmation on a medium- and potentially even longer-term basis. We remain constructive on the medium-term, but would not be surprised to see some short-term setbacks soon in view

CHART 9

Gold Futures



Source: Ned Davis Research, Inc.

of the strong recent advance.

The **yields** of 10-year and longer duration government bonds of perceived quality borrowers, such as the US or Germany, made a spike low at the time of the equity market low. Many fear that yields could rise further due to the spike low in February, which usually shows one-sided emotion. While we see the risk of a further rise in yields, we see heavy resistance around 2.00% and 2.85% for 10- and 30-year treasuries. But yields could back and fill for some time until the next downleg sets in. Moreover, if our scenario is right, quality spreads will then begin to widen again – this should happen on a global basis.

Global **equity** markets have rallied and are now short-term overbought, but are only in neutral territory on a medium-term basis. Hence, we expect soon at least a short-term setback. If this setback doesn't gain traction on the downside, it could mean that the whole corrective process will stretch out further in time. But markets in general have rallied to about the levels we think offer heavy resistance. Hence breaking through here – even if our scenario would be wrong – is less likely.

The rally so far has lacked breadth and it was primarily a sharp recovery attempt by beaten down sectors. Energy has stabilized and natural resources in general have bounced sharply. We would certainly not be buyers of those sectors here after the sharp bounce. Financials remain underperformers but industrials have improved, particularly in the US where the softer US dollar may have helped. Technology remains a market performer here and the more defensive sectors like staples or utilities are going through some short-term correction. Utilities in Europe look decidedly weak, however. The big risk we see is in health care, that is breaking down in relative terms which is a warning for the immediate future. It is an area where institutional money is largely overweight and we would definitely be sellers here.

The risk to our scenario is time in that China can stabilize its situation – at least at the surface – somewhat longer than we think is likely. Interesting times ahead, stay tuned.

Felix W. Zulauf
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Disclaimer