ZULAUF CONSULTING

INVESTMENT COMMENT

March 29, 2018
VOLUME 27, NUMBER 6

IN THIS ISSUE

POSITION SUMMARY

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

* Indicates a new position or change in view

Highlights

- Fears of rising protectionism are making the headlines and are shaking markets, in combination with the rising risks from the revolving door at the White House.
- We believe protectionism is a real factor, not only because of the Trump Administration, but also because of other external forces.
- Interest rates in the world remain low and real rates in most cases negative. However, the Fed, the most important central bank of the world, keeps tightening. LIBOR has doubled in the last 12 months, reflecting tighter liquidity conditions.
- Other central banks will follow the US, but it will be a slow process. While the global liquidity condition remains generous, it is deteriorating at the margin.
- The big risk we see is a US dollar recovery, driven by large Asian short covering. It could bring on temporary fears of a relapse to deflation and a pause in the rise of inflation.
- Markets are performing as we had outlined in previous publications. The rise in bond yields is fading, and we expect yields to soften. We also expect economic data around the world to undershoot expectations in coming months.
- Base metals should soften, although crude prices could make new recovery highs and overshoot in coming weeks for geopolitical reasons and in view of the present tight supply/demand situation.
- The medium-term equity market decline has led to some deep short-term oversold conditions in selected areas. With technology now breaking down, we may enter the later stages of this medium-term decline. At best we see a trading range for most markets. This type of environment will be attractive for traders, and disappointing for investors, for the next several months.
- Gold must clear the upper limits of $1300 for a more sustainable move to the upside to occur. While the potential is there, we expect this outcome would be difficult to achieve if the US currency begins a recovery.

Rising Protectionism Is A New Long-Term Trend

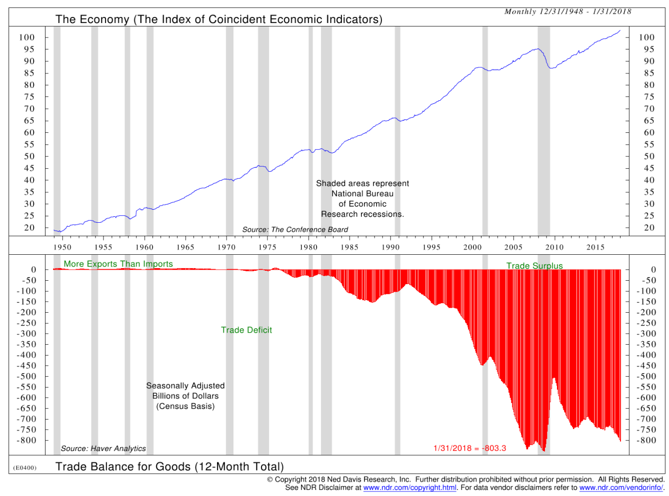
While there are many risks worrying the market, the fears about a potential trade war have been making the headlines lately. We firmly believe that global trade is beneficial for all, but we also understand that if the international community is unable to do it on a level playing field that there are large groups of losers. And losers, or those who fear to become losers, have begun to revolt. This backlash is what put Trump in the White House, made Brexit possible, and has weakened former dominant political parties in Europe to marginal forces without much power. We outlined in our special report back in January 2018 the reasons why rising protectionism will be inescapable in the long-term. However, we think the current noise is only the warm-up period and will not hurt the world economy in the short-term to any important degree. We expect a longer-term impact to arrive later, from the next recession onwards.

President Trump is right to request a level playing field in trade, which has not been the case for decades. The US spread the idea of free trade and preached it since World War II and guaranteed the safety of the trade lines around the globe. After the war, the Western world under the leadership of the US built the Bretton Woods fixed exchange rate system. The US allowed Japan and Europe to have undervalued currencies for a long time, to help them reconstruct their economies. The US knew that trade would improve the economic situation and political ties and strengthen the US hegemony in the Western world. In 1971, Europe had grown to the point that the US was discontinuing the fixed exchange rate system based on the US dollar and its backing by gold, because the US would have lost too much gold. At that time, the decline of the US dollar started.

The US trade account began to deteriorate from the second half of the 1980s onward (chart 1). In

CHART 1

US Economy and Trade Balance



Source: Ned Davis Rsearch, Inc.

the period under Fed Chairman Greenspan and President Clinton, the US began to run growing deficits in its trade account with many other countries because the US policy of chronically stimulating demand by fiscal and monetary means led to overconsumption, underinvestment and excessive indebtedness inside and by the US. Its competitiveness declined.

The easy money and its stimulation of final demand, primarily consumption, created a great environment for emerging economies like China to rise due to cheap labor (chart 2, next page). And China exploited the US and others over the last three decades, often using unfair trade practices. But Europe is also protectionist, and both Asia and Europe are pursuing highly mercantilist trade policies. Former US presidents simply did not address it, or requests to discuss these issues were declined by their trading partners. Trump is different – he wants to establish a level playing field in trade, and this leveling of the field creates tensions.

Trump Has Clear Goals, and Needs Cabinet Members To Support Him

Despite Trump's erratic behavior at times, he in general seems easy to read. He has stayed on point with his campaign messages and has tried to execute on his promises. Trump wants a better US economy, and

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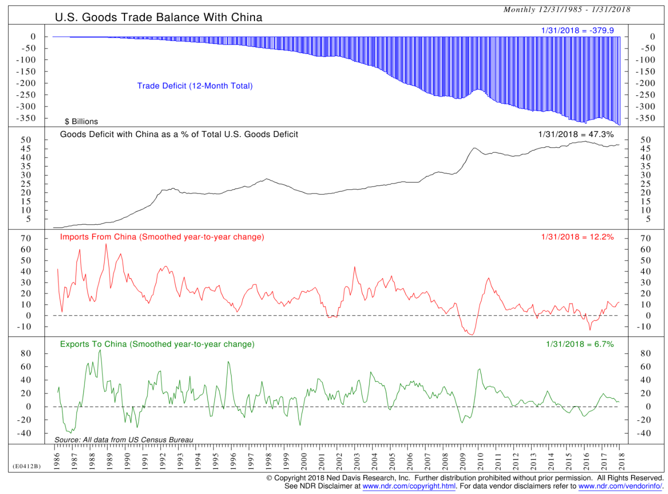
to achieve this goal he must reduce the leakage of the trade account. He wants less imports and more domestic production. And he wants to back this up with reduced taxation and increased government spending. Those cabinet members who are not fully supporting him must leave and are replaced. It is also clear that he needs team members who support bullying others to achieve his goals, and the new Secretary of Foreign Affairs and security advisor certainly fit the bill. The media around the world blames Trump for these steps, but he wants change and needs hardliners to back him. So far, this is all part of politics and bargaining and no serious threat, yet. But at some point, risks could tip over and get out of hand.

CHART 2

US Trade Balance With China



Source: Ned Davis Rsearch, Inc.

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As outlined previously, we believe that due to demographics in the OECD and large emerging economies like China and other constraints, economic growth will continue to slow on a secular basis to disappointingly low numbers over the next 10-15 years. Combined with other rising constraints like increasing debt and regulation, it leads to intensifying competition in a stagnant world economy. This will be showing up more clearly during and after the next recession. We see current trade developments simply as the foreplay to truly rising protectionism because it is so far only the first attempt to change things. Today's consensus believes that current steps will chip off not more than 0.1% of growth. That is most likely true but, in our view, the wrong way of looking at the problem.

> The real issue with China is the one regarding intellectual property rights, and the lack of a trustworthy legal framework.

Trump threatened others but then rightly reduced the threat to open the door for discussions. The question is now whether others will cooperate and reduce their tariffs. That is the real question. We think China will behave more intelligently than Europe as they simply have more farsighted people running their country. However, China will not simply bow to US requests, as they are now in a strong position and full of self-confidence and we expect them to retaliate moderately to signal others that China will fight back. The real issue with China is the one regarding intellectual property rights, and the lack of a trustworthy legal framework.

The EU could be a problem for other reasons, as revenues from tariff finances a large part of the EU budget. And with the UK as the second largest payer leaving, they may not be willing to weaken those revenues further. Moreover, Germany and its former D-Mark bloc countries are losing the blocking minority of 35% in the EU with the UK leaving. The UK was always the strongest voice favoring free trade, market-oriented solutions and freedom. Brexit gives the Mediterranean bloc led by France – a highly government control oriented nation – overriding power, and they can now dictate. Germany, one of the largest exporters of the world, has no say any longer. Most observers are not aware of this paradigm shift, and how it changes the EU's future character by 180 degrees. We are therefore very concerned that Europe will not be able to deliver what the Trump Administration would like to get accomplished.

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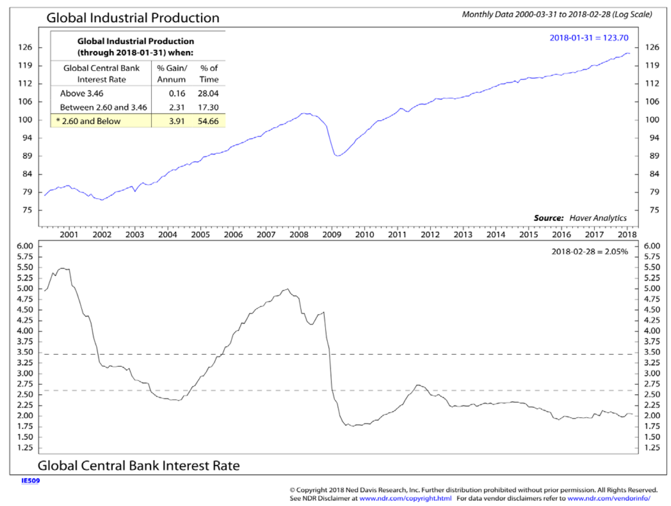
We do not expect an immediate and harsh protectionist step to break down global trade, as was the case with Smooth-Hawley in 1930. But we think the markets are in our view taking the problem too lightly, as this is a new trend that will become very powerful over the next 10-15 years. Markets have no tools to price rising political risks – that is the problem and the real risk.

CHART 3

Global Industrial Production & Central Bank Real Rates



Source: Ned Davis Rsearch, Inc.

Still Very Low Real Interest Rates, But…

Conventional economic analysis suggests that the economy prospers when interest rates are low and is restrained when they are high. Today, interest rates around the world are indeed low, as more than half of economies in the world still enjoy negative real rates (chart 3). They are even still negative in the US, where rates have been hiked several times. Thus, the consensus does not see any problem on the horizon. And it may be that the current business expansion that had so far three pronounced mini-cycles may stretch out and add another one. We need to monitor this and will certainly write about this topic more in future publications. At present, we simply notice a global economic slowdown in growth rates, but it does not seem to be a serious problem, yet.

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The consensus scenario remains for decent growth, higher trending inflation and rising rates and bond yields. But at the same time, the consensus expects rates to not rock the boat because the level is still low from a historical perspective. We have expressed our view in our recent report, that we disagree with the consensus for the next few months. Read on.

...USD Rates Outside the US Are Rising Strongly

The problem at present seems to be that part of the USD credit market is indeed tightening, as expressed not only in the rising short-term domestic rates like T-Bills but in the even more sharply rising rates for Euro- and Asiandollars (chart 4). What does it really mean? Some take it as a warning of rising problems in the banking sector, but we doubt this interpretation. Interest rates are the price for money, and for some reason the price for US dollar loans outside the US is rising sharply – more sharply than inside the US. In fact, LIBOR has doubled over the last 12 months. Be aware that a large amount of USD denominated debt overseas and even in the US is linked to LIBOR.

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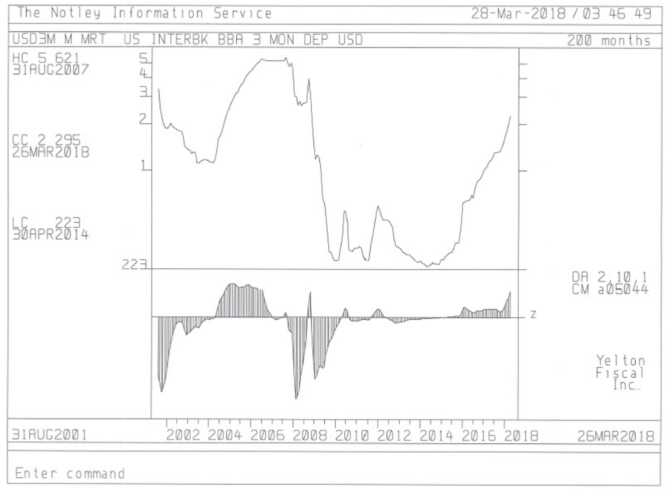
As the US dollar has declined last year, there have been large capital flows from US banks to banks in Europe and Asia on the order of over $500 billion - with the largest part most likely ending up funding the Chinese corporate sector, that was looking for new funding sources due to tighter money at home. The currency exposure was also working in their favor, as the US dollar declined, and they could even see a potential currency gain.

CHART 4

USD 3-Months LIBOR Rate



Source: The Notley Information Service, Taniscott Capital Inc.

If the US central bank continues to hike rates – and it has indicated at least two more hikes this year – to "normalize" monetary policy, rising LIBOR rates could begin to squeeze dollar borrowers domestically and overseas. That in turn could lead some of those borrowers to switch into other currencies where rates are not as high and not rising, which could trigger the dollar to begin recovering. Thus, if the US dollar begins to recover from its decline that began over a year ago, Asia and Europe may be forced to buy more of those dollars back or hedge their USD exposure. In addition, if US multinationals send their cash they hold overseas back to the US, even if they already own US dollars, it would tighten the supply of overseas-US dollars and force the US dollar up in the exchange markets. We point to this potentially very important situation, because the amounts involved are several hundred billion US dollars and therefore very large.

A Potential US Dollar Recovery Attempt

Interest rate differentials are rising in favor of the US dollar. The ECB will not hike rates for the rest of this year and Japan will hardly hike to a large extent. In China, rates had doubled for over a year and they peaked in late 2017 and 3 months rates have softened since then from 4.00% to 3.10%; 10-year China Government bond yields have peaked at 4% in November and are declining since then, currently trading at 3.75%

(its low was at 2.75% in late 2016). Thus, trends of rate differentials are now working in the greenback's favor.

Our technical reading of the US dollar is that it is bottoming on a medium-term basis

Our technical reading of the US dollar is that it is bottoming on a medium-term basis (chart 5). Moreover, our longer-term work also suggests an important low is not far away. While it could briefly shakeout early bulls for a few days, we think it will not be confirmed by all currencies. The yen may be the strongest in our analysis, and most likely the last one to reverse (down for the yen, up for the dollar).

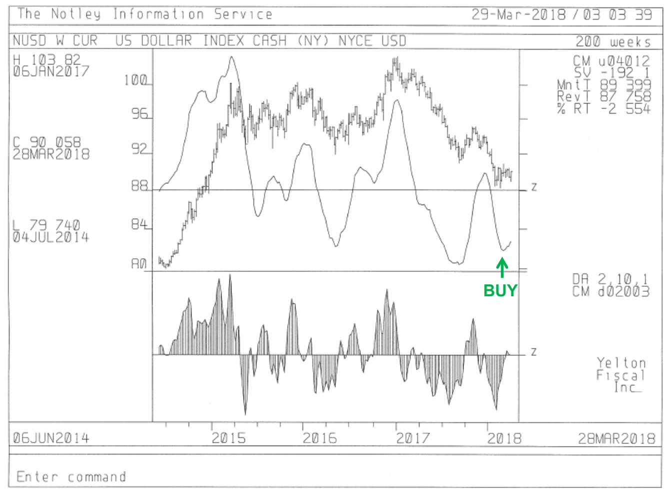
A dollar recovery, and particularly if it lasted many months and would be pronounced, would be important to the outlook of inflation in many countries. All other factors being equal, it would reduce inflation in the US from where it would be otherwise and increase inflation in other parts of the world. This is important as we believe Asia is now exporting rising inflation, China in particular. And rising Asian inflation is a major factor driving inflation higher worldwide.

And What It Means for Bond Markets

A rising dollar would therefore reduce the risk of 10-year Treasury yields breaking through the 3.04% level, the high of 2014, and postpone that risk for a later date when either the greenback weakens again, or the economy strengthens, or both. Thus, the currency markets will be very important to watch in coming months. While there may be another short-term attempt for higher bond yields if the US

CHART 5

USD Index Weekly



Source: The Notley Information Service, Taniscott Capital Inc.

currency relapses, we assume that bond yields worldwide will soften over the next few months. Although this is a medium-term trend counter to the rising long-term trend, we expect it to last for several months. Sentiment in the US bond market is very bearish at present and so is positioning.

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Moreover, anecdotal evidence suggests that our former Barron's round-table colleagues, the current and former "bond king", are bearish bonds, which is predominant consensus thinking. Thus, be prepared for some counter trend movement to begin soon, perhaps from a slightly higher level but below the 3.0% for 10-year Treasuries.

Commodities Could Also Be Impacted

We have pointed out in some recent reports that China is slowing down the real estate sector and addressing some of the financial excesses. This will certainly mean slowing demand in construction related base metals. Moreover, in line with the slower growth in the world economy for the next 3-6 months, we reaffirm our view that we expect base metals to soften. They have started to do so some weeks ago.

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Crude oil shows a different demand/supply picture and is presently still well supported by tight supply due to the OPEC/Russia production cuts. Moreover, the world economy continues to grow and therefore demand is growing even if growth slows at the margin. Thus, in an environment where base metals lose some appeal, at least for some time, the market could focus on crude oil again. This is particularly true if President Trump steps away from the Iran nuclear deal, which could heat up Middle East tensions again. Thus, we see the possibility for a brief overshooting – even into the low $70s. We would not chase such a rise because we doubt it will be sustainable.

Will Gold's Current Attempt to Break Topside Work?

Perhaps the world is realizing that President Trump is trying to change a few important things in the world, with the implication that the highly unstable multi-polar geopolitical situation leads to more risks than before. Moreover, Bitcoins' recovery attempt after the fall failed badly, and may be telling many who considered it a better alternative to gold that perhaps it is not.

We could see gold trying to break $1380, which would be necessary if we are to see a sustainable advance. But time is running against this run, if the US dollar recovers as we expect it to in coming months.

For gold to break the upper levels in the $1300's in a sustainable way, the world needs low interest rates and rising inflation, which we are currently seeing both. Moreover, a cocktail of geopolitical risks is also an important ingredient, which is present, too. Thus, we could see gold trying to break $1380, which would be necessary if we are to see a sustainable advance. But time is running against this run, if the US dollar recovers as we expect it to in coming months. Our long-term investment stance remains neutral on gold, but we see the long-term upside potential that will someday be realized. Do not chase gold here.

Highly Volatile Equity Markets – But Meager Potential Return

After the biggest point loss last Friday, Monday showed one of the biggest point gains in the major US indices, followed again by a large loss on Tuesday. Those looking for volatility got it. But what does it all mean?

Our view was that markets had entered a high level, potentially even an early stage of a long-term top, from where corrections may arrive more frequently. While European indices declined sharply from their tops, the US lost much less on a relative basis, and the emerging markets varied. Even if one is bearish leaning here for the whole cycle, our view remains that a topping process could take much more time. Whether this would then be only a congestion period and extend again remains an open question at this time. However, as risk managers, one should focus more on risk management. The potential upside reward seems unattractive compared to the downside risk. We have often shown charts with historic valuations, and they all carry the same message: valuation is historically very high. Buying high valuations leads to low returns and vice-versa. And this high valuation is true after one of the longest economic expansions ever.

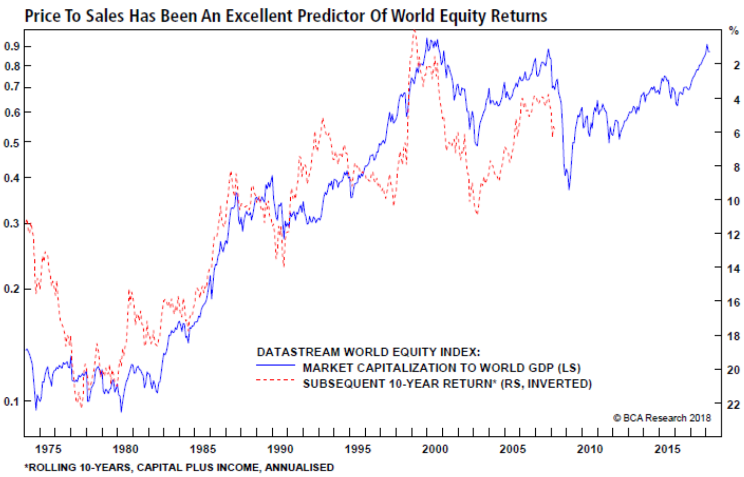
Valuation is historically very high.

Chart 6 shows the MSCI World as a percentage of world GDP (blue line, left scale) and the dotted red line shows the subsequent 10-year return inverted (right scale). Of course, we know the subsequent return only in hindsight. But when looking at this chart, you see the perfect fit over more than four decades. The current valuation suggests a meager return in the 1-2% area per year for global equities for the next 10 years. We assume that most investment experts and investors would hardly agree with this suggested result. And many would find explanations why it is wrong. But 44 years of history through rising or falling inflation and interest rates, business expansions and recessions, even wars, the chart was very accurate. That is a powerful argument in favor of its predictive value.

We are expecting high volatility, and therefore great opportunities for short- and medium-term traders and stock pickers but believe that passive buy-and-hold investors will have a disappointing year.

CHART 6

World Market Capitalization & Future Equity Returns



Source: BCA Rsearch, Inc.

Now, the suggested return per annum for the next 10 years amounts to what we just saw in one trading day, four days in a row, up and down. In other words, daily price swings of the major indices now amount to what will most likely be an annual return for the next 10 years! At these levels, even bonds (at least in the US dollar area) look better - and the world agrees that bonds are an unattractive place to invest. This is telling, and equity investors should think seriously about it. We are expecting high volatility, and therefore great opportunities for short- and medium-term traders and stock pickers but believe that passive buy-and-hold investors will have a disappointing year.

A Trading Range at Best for Equities

Some markets have corrected more than others (charts on page 11 & 12). Europe has remained the weakest performer, and those markets are now deeply oversold from a short- and medium-term perspective. But they need to rally strongly soon to move away from important potential breakdown points. A weaker euro here could do the trick. European markets have been loved by the value investors because it is the cheapest region. However, this is due to the different weightings (much less tech and much more banks). On a sector by sector comparison, the difference is quite small. Europe runs a political risk as the political establishment in the majority of nations runs in a different direction than what their constituencies want. In Europe, we will most likely soon see the first anti-establishment government being installed in Italy. This is a result of the establishment parties having messed up and not solving problems. Thus, the revolt against the political establishment in Europe will grow further until the situation changes, which means rising political instability. This can hardly be good news for the economy in the medium-term. In addition, the trade problem will be unfavorable for Europe because the EU – the European trade bloc that dominates the region – will certainly come under attack or must tolerate more competition. That is the reason why European indices look so weak on the long-term charts.

Specific US Factors Created Outperformance

There are some specific factors for the tremendous outperformance of the US market. Unlike Europe where buybacks are minimal, US corporations have bought back large amounts of shares. In addition, many companies went private, particularly during this bull cycle, because increased regulations for public companies after the financial crisis made it less attractive for them to remain public. Thus, the number of publicly listed companies in the US has virtually halved over the years. This trend, along with the fact that there are less shares outstanding due to corporate buybacks, has reduced the supply of publicly traded equities at a time when the central bank made money the cheapest it has ever been. Moreover, passive investing has become the new investment strategy of choice and dominates the market - there are more funds outstanding than publicly listed equities. Therefore, funds are ending up all buying the same stocks, namely the index components. And successful companies outperform and so do their stocks, which creates a momentum by itself. In turn, this leads to ever cheaper financing of the successful companies, and they are therefore increasing their market share. This is particularly visible with the "disrupters". In 1977 the largest 100 publicly traded companies made 48% of the total S&P500 profits, in 1997 they made 51% and in 2017 it amounted to 84%! And Amazon's net worth rose $33 billion in 2018 alone, which is more than the individual market cap of 63% of all S&P500 companies. In other words, the concentration into a few major companies is largely responsible for the great outperformance of the US. And that is what is usually seen near a major market top.

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Technology Coming Under Pressure

The big question now is whether those rising stars or let's call them the new "nifty fifty" – technology and FAANG type of stocks - will continue to outperform or begin to lose relative performance. The Uber crash by a self-driving car and a rising death toll is certainly impacting several related companies, those which provide the components from software to semiconductors. The Facebook "scandal" is certainly raising the risk of future regulation for all social media companies. And that company's stock does look very risky in our view. And Tesla seems to be running on loose governance principles and stretched financing. It is therefore no surprise the technology or FAANG sector broadly speaking is now coming under attack.

Our medium-term targets of approximately 2400/2450 for the lower end of a trading range for the S&P500 still stands.

We mentioned in previous reports that the medium-term correction would approach its ending, once the former leaders fall briskly. It seems that process has started but may have more to go until it is done. Our medium-term targets of approximately 2400/2450 for the lower end of a trading range for the S&P500 still stands. Importantly, we did not see strong breadth thrusts on any of the bounces, which is a sign that the selling has not climaxed, yet.

The message for portfolio managers simply is: check out your stocks, get rid of underperformers, stick to the outperforms and monitor them for potential breakdowns. Risk management is increasingly important this year.

We are now seeing the selection process of the leading theme of this bull market. Some stocks will end up with "broken chart patterns," while others may keep their trends in both absolute and particularly relative terms intact. Selectivity will increase, and one by one will begin to correct – some more and some less. This is usually a process one sees in the early stage of a cyclical topping process. We are leaning in that direction, but do not want to block ourselves with a fixed preconceived idea.

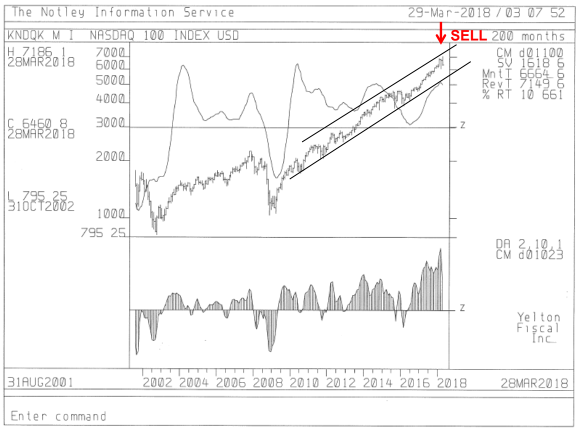
The message for portfolio managers simply is: check out your stocks, get rid of underperformers, stick to the outperformers and monitor them for potential breakdowns. Risk management is increasingly important this year. Talented traders can trade with these swings in the market, but this is the most difficult thing to do.

Finally, we see the emerging markets as between the US and Europe. As emerging markets are less liquid, we would reduce our exposure there while the consensus is still very upbeat. We would still favor the US over other regions in local currency terms, for the special factors mentioned and for those who must or want to be in the markets. Cash does not hurt any longer as short-term rates are now equivalent to the S&P dividend yield – for the first time in many years.

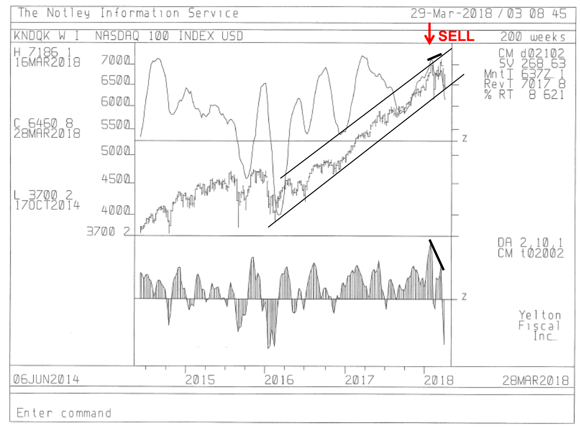
Felix W. Zulauf
March 29, 2018

Disclaimer

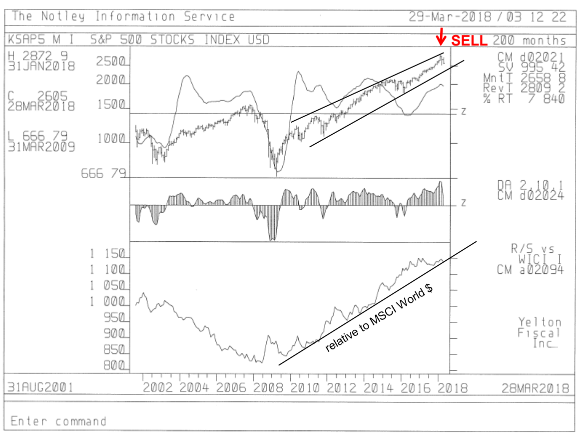
NASDAQ - Monthly



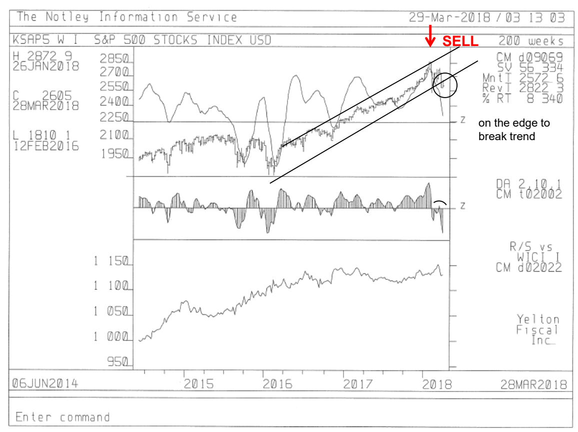
NASDAQ - Weekly



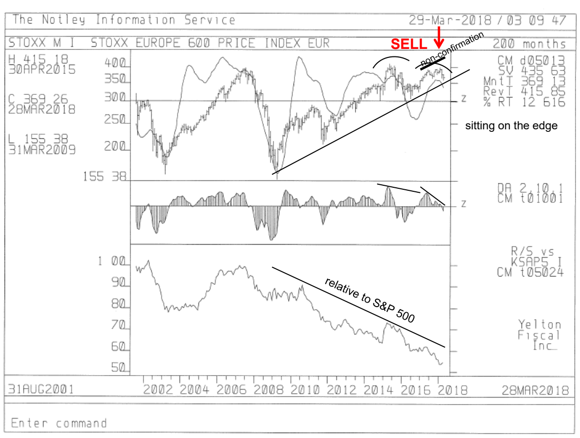
S&P500 - Monthly



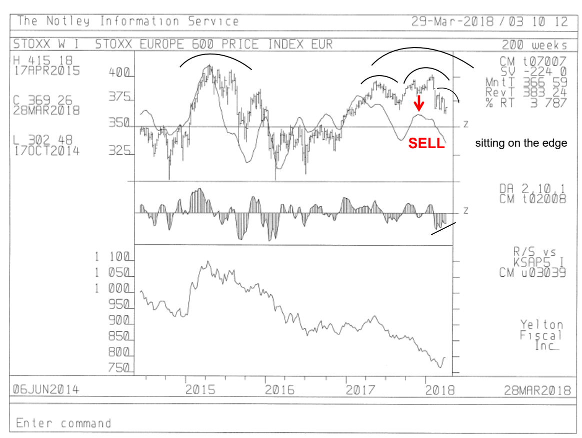
S&P500 - Weekly



STOXX - Monthly

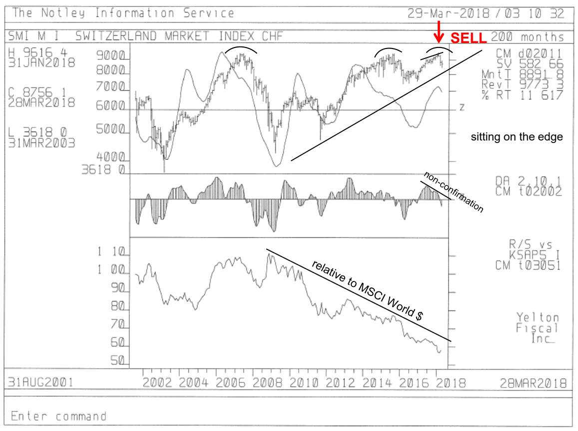


STOXX - Weekly

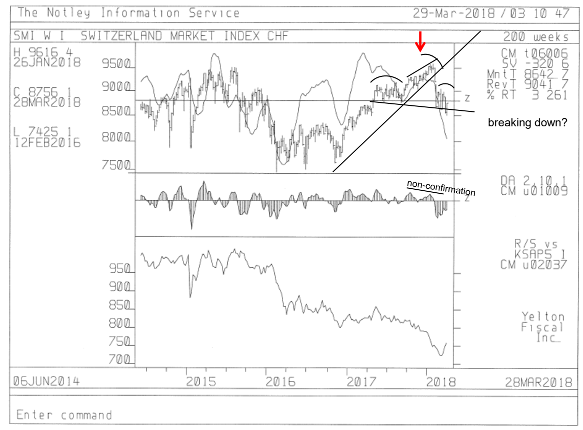


Source: The Notley Information Service, Taniscott Capital Inc.

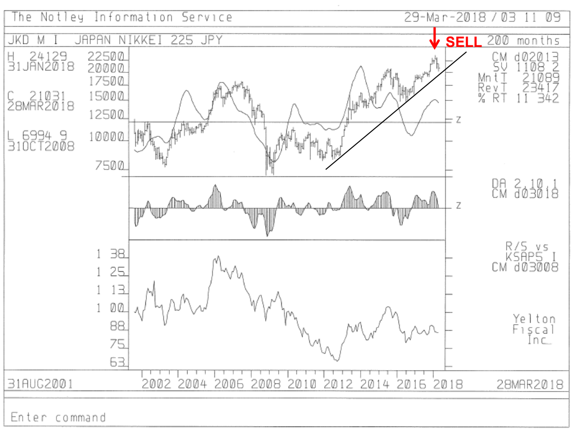
SMI - Monthly



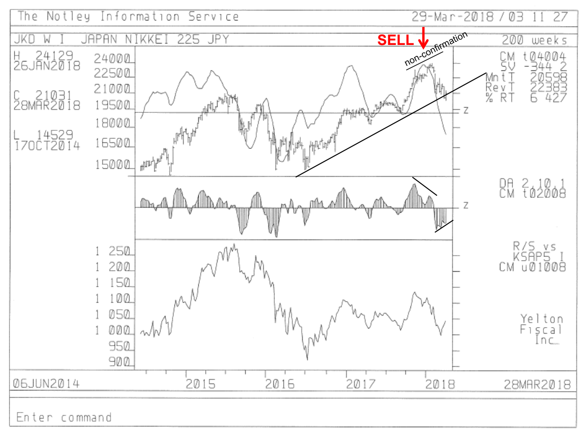
SMI - Weekly



NIKKEI - Monthly



NIKKEI - Weekly



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