ZULAUF CONSULTING

INVESTMENT COMMENT

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IN THIS ISSUE

POSITION SUMMARY

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

* Indicates a new position or change in view

Highlights

- At the 19th National Congress of China's Communist Party, President Xi Jinping delivered a bold speech lasting 3 ½ hours in which he outlined his priorities for the next 5 years, as well as China's long-term aspirations to become the biggest and most powerful economy and military power. To our knowledge, no other Chinese leader in modern history has ever expressed this view.
- The details of President Xi's intentions are not clear yet, but his target goals are: strengthen his power and that of the party, increase the party's influence in all aspects of life, increase the government's influence in the corporate economy, make the economy highly innovative, eliminate corruption, build a prosperous society by assuring continued economic growth and spreading it to rural regions, improve the quality of SOE and restructure the financial sector, and finally cement China's increased status as a major empire.
- There have been several elections recently in Europe and Japan. While Japan's election result was a confirmation of the status quo, European elections show a continued trend toward more populism and a continued decline of established parties' influence.
- The world economy continues to grow with few short-term problems. We expect inflation to creep higher in China/EM economies and in the industrialized world.
- Central banks are moving step by step away from their ultra-excessive easy money, and short rates are either bottoming or rising. Bond yields are in a medium-term rise that has more to go.
- The US dollar benefits from the US central bank's lead in the rate hiking cycle. We expect the recovery of the US currency to continue against virtually all other currencies on a medium-term basis.
- Equities have been melting up, in contrast of our expectation of a correction. The bull market trend remains intact worldwide and may only peak during the first half of 2018. In between, we do expect a correction as part of a long-term topping process. We expect a new bear cycle to begin at some point during the first half of 2018.

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- Gold's medium-term recovery attempt peaked around $1350 in early September. The weak short-term rebound and a firming US currency may point to more corrective action. Only a break above $1350 would turn the gold picture positive in a sustainable way.

19th National Congress of China's Communist Party

China's Communist Party counts nearly 90 million members, and it holds its National Congress every 5 years with participation from over 2000 delegates. In even years, it usually elects the new leader while in uneven years it confirms the incumbent leader. The key body is the Central Committee, which consists of about 200 full members and another 100 alternative members. The Central Committee elects the General Secretary, Politburo (approximately the top 25 leaders) and the Politburo Standing Committee (PSC), which consists of the top 5-9 leaders. Those top leaders are selected through an intense negotiation process among the incumbent PSC and former leaders.

At each National Congress, roughly 60% of the members of the Central Committee are replaced by new people. This also explains why Chinese leaders usually only in their second term have the full authority to execute their will in full while in their first term a large number of representatives of the former leader are still involved in the decision-making process.

China is run as a parallel political system in which the ruling Communist Party operates alongside – and in reality above – the state. The political power in China lies in the hands of the politburo and particularly its Standing Committee. President Xi Jinping has already been one of the most powerful Chinese leaders before this Congress but now, he will be the most powerful Chinese leader since Mao Zedong. He also now has the military under his direct control.

While his predecessor Hu Jintao (President 2003-2013) started the big infrastructure program and the gigantic credit boom, Xi Jinping carried this monumental program on to the present day, although fixed asset investments growth has slowed over recent years. During his term, China tried once to restructure the financial sector but when a slowdown resulted in 2014/2015, the Chinese leader once again emphasized growth over restructuring.

In his long speech he outlined, for the first time, China's aspiration to become an Empire with the biggest economy of the world and a most powerful military. In addition, he stated in high self-confidence China's goal to become a powerful influence on world affairs. This was definitely new news, although some observers, ourselves included, expected this eventually. Xi also wants the leading Chinese companies to close the gap to Western and Japanese companies in terms of innovation, sales, productivity and profits and eventually rise above them. These two factors combined with our expectation of unsatisfactory economic growth of the world economy will, in our view, eventually lead to a major conflict between the rising power and the still dominating military power of the USA. By the way, our interpretation was that Xi's speech was full of pronounced nationalism.

The other goals, although not announced in detail, were already part of the previous 5-year plan – goals like improving the environment and restructuring the financial sector.

Xi Jinping will not only continue to tighten the reigns in all aspects of life, but he wants the corporate sector under more state control. This is clearly a disappointment for all those who expected a transition to a more open society and to a more market based economy. It would be interesting to learn what thought process led Xi to come to this conclusion. Was it that he sees certain malfunctioning in the market based democracies on the political and/or economic side as we witness since the Great Financial Crisis? Or was it primarily his goal to cement the power of the Communist Party as an efficient control instrument and insurance against domestic economic and social risks? From our perspective, the goals of a more efficient and innovative corporate sector and a more tightly controlled environment for individuals and corporations with more state involvement seem contradictory.

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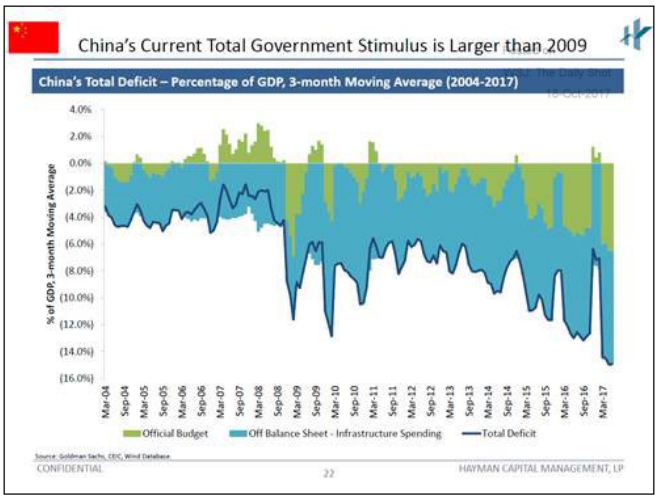
China has been able to create a lot of wealth and to create a new middle class that is doing well by most accounts. But the wealth is still very unevenly spread and a small circle close to the leaders of the Communist Party has amassed a disproportionate share of the country's wealth. The officially published Gini factor for China is 0.47 (1 means only one person owns all the wealth while 0 means all own the same amount), while non-government calculations show a factor of 0.62-0.67. For comparison here are a few examples of the Gini factor in selected nations: Sweden 0.25, Germany and Switzerland 0.28, Japan 0.33, Russia 0.41, Singapore 0.42, USA 0.47, Nigeria 0.51, Brazil 0.59.

The Potential for a Minsky Moment in China

The other matter of great interest is the announced restructuring of the financial sector. As is well known, China has accumulated gigantic amounts of debt during the last 10 years. Official statistics in China are questionable, which is also true for debt numbers. As an example, the government shows China's official budget deficit as running between 2%-6% of GDP over the current cyclical expansion while unofficial estimates by several independent economists run between 6%-14% of GDP (chart 1). While nobody knows the exact number, the truth is probably closer to 10% on average. This estimate simply represents the annual addition to its government debt, but private debt is also excessive although precise and trustworthy numbers are lacking. The following table shows the change in non-financial debt outstanding as a percent of GDP over the last 10 years (official numbers):

CHART 1

China: Large and Increasing Budget Deficits



Source: Hayman Capital Management, LP.

TABLE 1

Nonfinancial Debt to GDP

	4Q 2007	Now
Canada	220.7	295.5
U.S.	228.4	250.8
China	144.9	257.8
Germany	180.9	180.1
Japan	307.5	372.6
G20	212.2	240.0

Source: Bank for International Settlements, Gluskin Sheff

Likely, China's debt is much higher than expressed in these figures, as China has a reputation of only showing the world what it wants it to see.

If China's economic growth continues at 6%-7% in real terms, debt will increase further and disproportionately, as it takes now almost 5 yuan of new debt to achieve 1 yuan of nominal GDP growth. China's leaders obviously understand that they must restructure the financial sector, or they will eventually run into a brick wall. However, any attempt to restructure will automatically slow the economy, as new debt creation and economic growth are highly interlinked.

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In 2021, the Communist Party will celebrate its 100th anniversary and President Xi Jinping wants a China in good shape at that time to prove the Communist Party has been doing a great job. Thus, he must make sure to stimulate the economy from 2020 onwards to achieve that goal, which in other words means, China must attempt the financial restructuring in 2018/19. As China has been the dominating driver for the world economy and global trade, the next two years will likely bring a much slower world economy and increasing economic and financial risks, not only for China but for the whole world.

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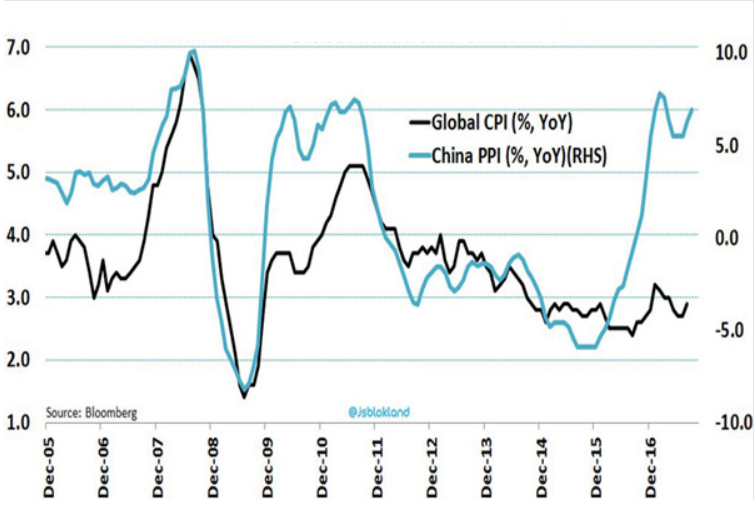
As President Trump will likely achieve a modest fiscal reform that could support the US economy in 2018 – which is less related to China's economic pace than Europe, Japan and the emerging economies – inflation will most likely rise further into 2018. China's inflation today will be the rest of the world's inflation tomorrow due to China's rising export prices that become the rest of the world's rising import prices (chart 2). This may force more central banks to step away from their excessively easy monetary policy over the next 12 months. The Fed is leading this process, the Bank of England and Bank of Canada are following and more will follow (see Eastern Europe).

CHART 2

Global Inflation and China's PPI Inflation



Source: @jsblokland, Bloomberg

The ECB will likely cut its QE program decisively later this year and may hike rates next year if inflation rises as we expect.

Most experts are relatively relaxed regarding these challenges in China and elsewhere simply because so far everything has worked out well at the surface and investors are very pleased by rising asset prices of all sorts. We are not as relaxed for the following reasons:

1. The boom in China has changed over the last few years from an investment driven to a consumption driven boom.
2. Fixed asset investments (FAI) keep slowing down despite the Chinese led investment project "One Belt, One Road", which is large but represents a little less than 2% of Chinese FAI.
3. The consumption boom is driven by too much stimulation of demand combined with the closed capital account that prevents investments outside of China.

Thus, Chinese individuals are reducing their savings and buy goods of all sorts, as they want to protect against rising prices. While official CPI numbers are rising but at a still relatively low level, Chinese consumers feel inflation is much higher. Home prices continue to rise despite increased restrictions and in 3rd tier cities, where the restrictions are low, double digit percentage increases continue.

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A consumption boom will eventually change the import/export situation in a negative way, and begin to hurt the external accounts through deteriorating trade. At some point over the next 2-3 quarters, we expect China's balance of payment to deteriorate with the result that foreign exchange reserves at the Bank of China could begin to melt. Hence, Chinese authorities may be forced to tighten credit and hike interest rates at some point. For reasons outlined that China will most likely stimulate its economy in 2020, the later China begins the restructuring the more problematic it is as the risk of bad timing could then backfire.

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We doubt that central planners like the Chinese leaders are not thinking about this. Consequently, we expect them to tighten from mid-2018 onward, at the latest. This could eventually lead to a Minsky moment, which is when the speculation of a credit driven boom eventually leads to declining asset values and the system begins to adjust – downwards. It is interesting that the current but outgoing head of the Peoples Bank of China warned about the risk of a Minsky moment just a few days ago due to excessive corporate debt and briskly rising private household debt. He said China would do what is necessary to avoid a Minsky moment, which in our view means tighten credit early.

What Does It Mean for Investors?

The world economy is showing decent growth, at present. However, this may change during 2018 going into 2019/20. Investors will therefore first be confronted with rising inflation and rising yields and thereafter, once the world economy begins to slow, with declining yields for quality investments (if their level is near normal, which is not the case now) and with widening quality spreads. Investors should then see the fallouts of the current long cycle and its immense credit excesses. It is doubtful that the world will see a soft landing - as soft landings usually only happen in "strategy papers" but never in the real economy.

At the beginning, a slowing world economy could also help the US dollar, as the US economy would have some fiscal support in 2018 that other economies would not have. And US real interest rates would remain above others for some time, except when China tightens. It remains our view that the US currency has one medium-term recovery attempt left lasting well into 2018 before the outlook for the greenback turns weaker.

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Our longer-term cyclical concern for global equity markets remain and fit well into the picture we painted about China and its impact on the world. The equity bull cycle is in its late stage and the topping could last well into the first half of 2018. We had assumed that a medium-term correction this fall would be the warning crack within the topping process. However, this correction was shallow in most markets or hardly visible in major indices in the US and some selected emerging markets.

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Late in the cycle, the following phenomenons are usually visible:

- the dominating theme and its leading stocks either take off for a very powerful run ending with a buying climax, or
- the dominating theme and its leading stocks begin to underperform relative to the major indices while major indices continue climbing, or
- cyclical stocks usually outperform as late in the business cycle the anticipated profit growth by the market rises over proportionately, and
- breadth usually begins to deteriorate and refuses to confirm new highs by the indices, and/or
- momentum indicators refuse to confirm rising indices and new highs.

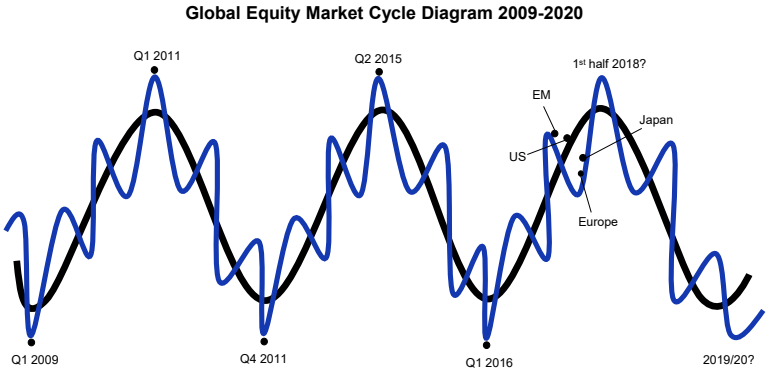
The equity bull cycle is in its late stage and the topping could last well into the first half of 2018.

So far, we have seen several of the large cap thematic stocks like Apple or Amazon beginning to underperform and the same is true for the NASDAQ 100 Index. However, this underperformance is not yet serious and could be overcome quickly by a new rise in equities. In our view, many of these stocks are extended and could correct, while those that have corrected – particularly in relative terms – could quickly rejoin the bull run.

We are also seeing cyclical industrial stocks outperforming the indices as shown by sub-indices as well as individual stocks. Financial cyclicals are usually not part of the outperformers late in the cycle but this time, many financials are more related to the level of interest rates and rising rates are a positive for them

CHART 3

Global Equity Market Cycle Diagram 2009-2020



Source: The Notley Information Service, Taniscott Capital Inc.

– at least as long as short-term rates are rising more slowly and the yield curve remains positively sloped.

Breadth has confirmed the advance in the major markets, as well as on a global scale. Normally, a warning break is the beginning of deteriorating breadth and a future rally attempt would then lack the confirmation of breadth. Such non-confirmation usually lasts 3 months or longer. As we have explained in previous reports, breadth confirmation could be the fooler in this cycle, as passive investing has become dominant and distorts breadth in a positive way.

Long-term momentum is peaking, but we do not see decisive non-confirmations, yet. A further rise in the major indices without long-term momentum indicators confirming would be a caution signal, which we expect to arrive during the first half of 2018.

Our essential point is that global equities are in their late stage of the cycle that has lasted since 2009 via 3 different mini-cycles (chart 3). Europe and Japan had their corrections and have started another medium-term rally, of which the first shot higher is almost over. After a pause or short-term correction, we expect those markets to continue their rise and favor Japan over Europe.

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The US market differs as those indices have not corrected, as you can see on chart 4 that shows the last of the three mini cycles that are part of the whole bull cycle from the 2009 low. It is unclear whether they will have a delayed correction before another upside attempt, or not. That is why we recommend staying with the outperforming sectors (Table 2 + 3), groups and stocks but weed out underperformers and tighten risk management procedures.

TABLE 2

Relative Performance Outlook by Economic Sectors

US sectors

Overweight	Neutral	Underweight
Financials (XLF)	Energy (XLE)	Consumer Cyclicals (XLY)
Industrials (XLI)	Health Care (XLV)	Consumer Staples (XLP)
Materials (XLB)		Real Estate (IYR)
Technology (XLK) →		Telecom (IYZ)
	←	Utilities (XLU)

TABLE 3

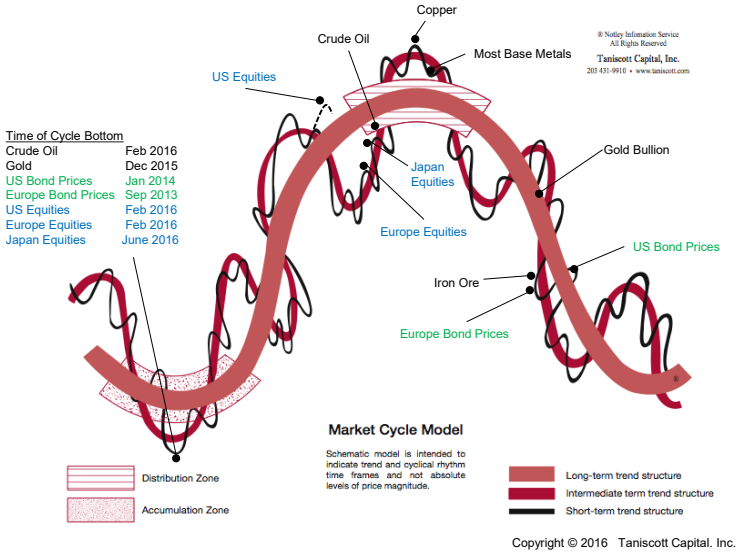
Relative Performance Outlook by Economic Sectors

European Stoxx sectors

Overweight	Neutral	Underweight
Basic Resources →	Autos	Media
Chemicals	Banks	Personal & Household Products
Financial Services →	Construction	Retail
Industrials	Food & Beverage →	Telecom
Technology	Health Care → ←	Utilities
←	Insurance	
	Oil & Gas	
	Travel & Leisure →	

CHART 4

Market Cycle



Source: The Notley Information Service, Taniscott Capital Inc.

Gold Remains Unattractive Until the Minsky Moment Arrives

Gold peaked in early September around $1350 and then began its correction. While it is short-term oversold and could bounce, gold's bouncing attempt has been disappointing so far. Only a break above $1350 would lead to a more sustainable long-term bull run.

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At present, the expected rate hike in the US and elsewhere and a rising US dollar are forces working against gold. Moreover, if equities remain in bull trends, investors do not see any need to reallocate capital to the yellow metal, yet. And sentiment still shows too much optimism.

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Once the cyclical forces in the world economy and in global equity markets change for the worse and a potential Minsky moment arrives in China, capital will be reallocated from equities to gold. However, we are not there yet and investors can therefore still wait to commit large amounts to gold. Next year, we expect the fundamental framework to improve for gold when it begins to deteriorate for equities. But the price of gold could trend lower until that moment triggers the next bull cycle.

Felix W. Zulauf
October 24, 2017

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