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IN THIS ISSUE

"Irma La Cruelle" 1
The Big Controversy 2
Medium-Term Rise in Bond Yields 2
Global Liquidity Deterioration & USD 4
Expect Base Metals to Correct 5
Is Equity Correction Over? 5
Will World Economy Stay Strong? 7

POSITION SUMMARY

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

* Indicates a new position or change in view

Highlights

- As if a textbook expansion, rising sentiment and improved data have risen in step with base metals while the dollar plunged. Atypically, bonds have diverged from their historical correlation. But our indicators show a reversal may be imminent as technicals, fund flows and inflation are all pointing to higher yields.
- The Treasury's release of massive dollar liquidity has weakened the US currency from a temporary technical correction to a dramatic slide in recent months. Now, as the treasury moves to replenish its account with the Fed, a sharp deterioration of USD liquidity is on the horizon- such a huge move as this is likely to have global implications, across all asset classes.
- Equities hit their medium-term low and have been rallying since. However, another leg in the correction is pending with liquidity and FX as a likely catalyst.
- US Markets, especially the multinationals, will be hurt by a rising dollar but so would the highly exposed Emerging Markets while a weaker Euro would provide tailwinds to European equities who have been relatively underperforming.
- In virtually all previous cycles there was a classic formula followed. But this current cycle is anything but typical and will likely differ in industrialized nations due to structural weaknesses. However, China has followed the playbook and their economy and markets are showing the excesses of late cycles.

"Irma La Cruelle"

After Hurricane Harvey hit the Houston area, Hurricane Irma hit Florida and many Caribbean islands. This was not "Irma la douce" but Irma the cruel. We do hope that the damage was smaller than expected, but we understand that many people have been hurt badly and our sympathy, thoughts and prayers are with all the people in the effected regions. However, for those interested in "weathernomics" we have read that Planalytics' initial estimate on lost sales in the Consumer/Retail sector will be approximately $1 Billion. This represents revenue that is lost and

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WILL NOT later made up. For example, Restaurants will take the biggest hit as these businesses do not make up for lost traffic. 'Mom & Pop' restaurants can take a devastating impact due to store closures and spoilage of foods, and many are not insured.

Malls/apparel stores also take a big hit during the period around hurricanes. Consumers are focused on making 'need based purchases' right now - shopping malls/department stores and specialty apparel chains all see negative impacts to traffic and sales. Home Centers (Home Depot, Lowe's, Tractor Supply) likely had an increase in traffic before the storms, and will aid in the clean-up efforts.

The total economic impact will take place OVER TIME - not just immediately after the storms.

It is also noteworthy to mention that in the Energy sector, near-term economic impacts will be felt outside of Texas. Over 20% of all U.S. refineries are in the Gulf Coast region. Many of these have closed/shut down as a result of Harvey. This can impact production of hundreds of thousands barrels of crude oil production per day. Reduced production can result in an increase to gas prices in the coming weeks. A rise in gas prices can lead to less discretionary income for those impacted. This can also result in less spending on apparel/Back to School items in the near term.

The economic damage for individual people and families are of course difficult on a personal level, but for the national GDP statistics it will be marginal. Any softness in the short-term will be compensated for in the medium-term. We are finally past the peak of the Atlantic Hurricane season, which is typically early September. Hopefully no more storms this season!

The Big Controversy

In recent months, economic optimism around the world has grown with data confirming some improvement. Instep with this advance and rising confidence, base metal prices have risen strongly and the US dollar has plunged, fully in line with textbook expansion. During that period with rising base metal prices, however, government bond yields of major industrialized economies have fallen. 10-year US Treasury yields have retraced virtually half of the preceding rise from its June 2016 low to the March 2017 high. Normally, base metals and bond yields are great bedfellows and march in synch with each other and not in opposite direction. The question therefore is why is it so and what will be the resolution.

Instep with this advance and rising confidence, base metal prices have risen strongly and the US dollar has plunged, fully in line with textbook expansion.

One of the reasons seems to be a benign inflation development that roots in the structural deflationary forces of demographics and overcapacity on a global basis. However, recent manufactured goods prices in Asia – the world's major manufacturing place – have stopped deflating and have risen somewhat. Thus, we must expect some upticks for imported goods prices from Asia. As a rule of thumb, imported goods prices enter the CPI with a weight of approximately one third. Thus, we must expect CPI inflation to creep somewhat higher in coming months.

…Leading to Medium-Term Rise in Bond Yields

To not miss the forest for the trees, we have eliminated the short-term price noise and used our smoothed time weighted momentum indicators only to get a clearer picture. We are comparing the price of copper and the yield for 10-year US treasury bonds. In the monthly smoothing (chart 1), you can see that both smoothed momentum indicators have advanced strongly since early/mid-2016. This makes perfect sense and represents what we call a cyclical advance – or at least a mini-cycle. The important message is that both long-term smoothings are late in

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their cyclical advance from the first half of 2016 and may roll over within the first few months of 2018 and thereby giving a sell signal. This would most likely go hand in hand with a global economic slowdown. According to these indicators, we expect the world economy to begin a slowdown sometimes next year.

In chart 2, you see the same series smoothed but on a weekly basis, which we use for medium-term or 3-6 months moves. As you can see, copper has risen sharply and is in the late stage of its medium-term advance that started in Q2 of this year. We expect this indicator to roll over shortly and think that copper is topping now for the medium-term with lower prices to follow. Bond yields, in contrast, show an aborted rally attempt. However, in our interpretation, we expect now a catch up by bond yields to copper. Such a delayed move is often short but sharp. In other words, yields for 10-year US treasuries will rise and so will yields for most other government bonds around the world over the next few weeks. This move has started a few days ago.

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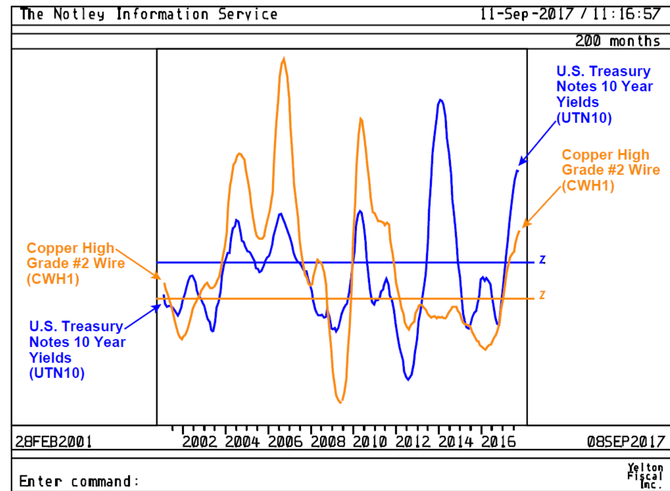
Two fundamental factors may contribute to such a rise. First, the Treasury announced it will borrow over $500 billion in Q4. This is a monumental amount and will put some upward pressure on yields. Second, we detect that the deflationary influence from Asian export prices of manufactured goods (is abating and prices are drifting upwards. This may be felt in rising import prices that represent approximately one third of the CPI. Thus, we have inflation, fund flows and technicals working together in the same direction.

CHART 1

Copper & 10-year T-Bond Yield

(Monthly Momentum Smoothed)

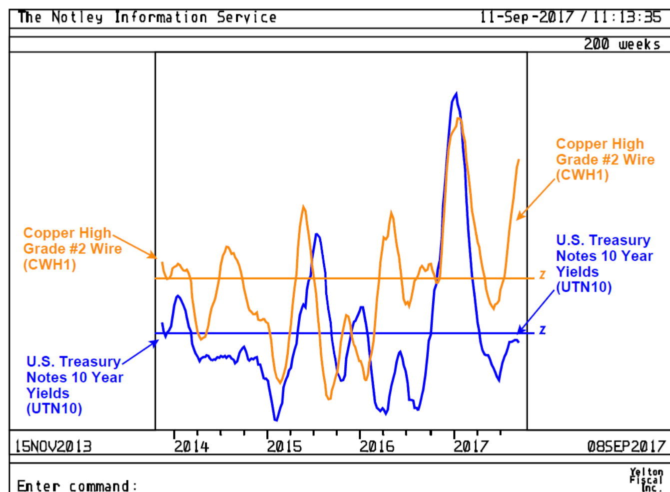


Source: The Notley Information Service, Taniscott Capital Inc.

CHART 2

Copper & 10-year T-Bond Yield

(Weekly Momentum Smoothed)



Source: The Notley Information Service, Taniscott Capital Inc.

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While the world economy is doing well, at present, the US economy may have to digest the hit of Harvey and Irma in the short-term. Assuming real growth near 2% and inflation around 2%, we arrive at nominal growth of near 4%. Even if one deducts some for the secular and structural downward bias of CPI inflation, 10-year treasuries can easily rise back to the previous high of 2.65% again. We see this near the upper end of the longer-term range within a multi-year bottoming process.

Global Liquidity Deterioration and the US Dollar

Global liquidity is predominantly US dollar liquidity. While the US treasury ran down its account with the Fed to pay bills, it injected these large amounts of liquidity into the US dollar credit system. The release of that huge amount of US dollar liquidity weakened the US currency from a temporary technical correction to a pronounced slide in recent months. Now, with accounts run down, the Treasury announced that it will borrow over $500 billion in Q4 to pay bills and replenish the account at the FED. That part of the amount that will be placed with the FED represents a liquidity withdrawal from the system and because the amount is very large – our guestimate is anywhere between $100-200 billion, we assume it will have a decisive effect on markets.

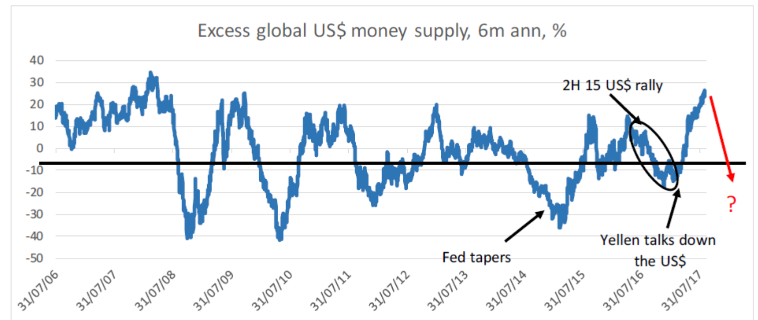
A sharp deterioration of USD liquidity for the next 2-3 months should strengthen the US dollar.

Deteriorating liquidity was an important driver of the dollar rally into late last year (chart 3). The sharp rise of liquidity during this year was the driving factor behind the weak US dollar – as well as rising equities

CHART 3

Excess Global USD Money Supply

(annualized over 6 months)



Source: Bloomberg, The MacroStrategy Partnership.

and other risk assets, primarily in the EM universe. If our thesis is right, a sharp deterioration of USD liquidity for the next 2-3 months should strengthen the US dollar. At present, momentum and sentiment are extremely depressed and the market is positioned short. Thus, we expect a recovery of the US dollar until the process described above is over.

Of course, this means that the euro as well as virtually all other currencies will correct against the US dollar. Be prepared for a highly volatile forex market environment over the next few months. China is also loosening up its tight regime they implemented to support the weak currency, as it has strengthened considerably in recent months. The reserve requirement for banks' forex forward transactions of 20% has been eliminated. This step is taken to create a valve to relieve some capital from the domestic system because inflationary pressure is building as the increasing capital created must stay. Thus, some controlled capital export is allowed again.

This has two implications. First, it helps to correct the recent strength of the Chinese yuan – which plays into the hands of a stronger dollar. Second, it may inflate some selective assets again overseas in the very short-term although we see it as a minor positive factor for non-Chinese assets. While limited in dimension, the change of heart by the Chinese

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authorities may help sentiment in asset markets more than real prices.

But our essential point is that global USD liquidity, the predominant liquidity of the world, will deteriorate and that should become a problem for asset markets, as liquidity precedes asset prices and asset prices precede the economy. Thus, the risk is rising for those assets that have risen strongly in recent months driven by the liquidity injection by the US Treasury.

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…Expect Base Metals to Correct

As a result, we think that commodities, base metals in particular, should soon begin a medium-term correction after the strong advance, for liquidity and technical reasons.

Moreover, we believe that even gold must undergo some correction although it is lagging base metals and may therefore correct with a time lag, as well. So far, we have received a short-term sell signal for gold within its medium-term advance but medium-term indicators have not turned down, yet. As sentiment is excessively optimistic, we would take some chips off the table for trading accounts. If an attempt to continue rising after this correction fails, we would turn more cautious.

Is the Equity Correction Over?

As expressed in our last report, equity markets hit a short-term low and have been rising since. While some indices, primarily (but not only) the major ones in the US, have even hit new highs, we still see a second part of the correction pending. More importantly, however, currency moves may lead to moves in different directions in the global equity arena.

Our view was - and remains - that Europe has most likely hit a medium-term low, as we laid out in our last report. Our expected correction of the euro will be a relief for European equities as a strong euro hurts corporate earnings in the aggregate. Even if European equities fell back once more at the next short-term decline, Europe should outperform the US market over the next several weeks, measured in local currency terms – and after a decisive underperformance in recent months.

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For the US equity market, the message is different. The large cap multinational companies that benefitted from a weaker US dollar and drove major cap indices to new highs in the latest rally, should correct on grounds of a firmer dollar. More importantly, the deterioration of global dollar liquidity should be a big negative for US equities, as an asset class. But we also think that the EM markets will be exposed to the deteriorating US dollar liquidity and could correct after the recent sharp rise.

While we do see that trend indicators remain bullish and the US advance/decline line has not yet diverged from the major indices,- which keeps

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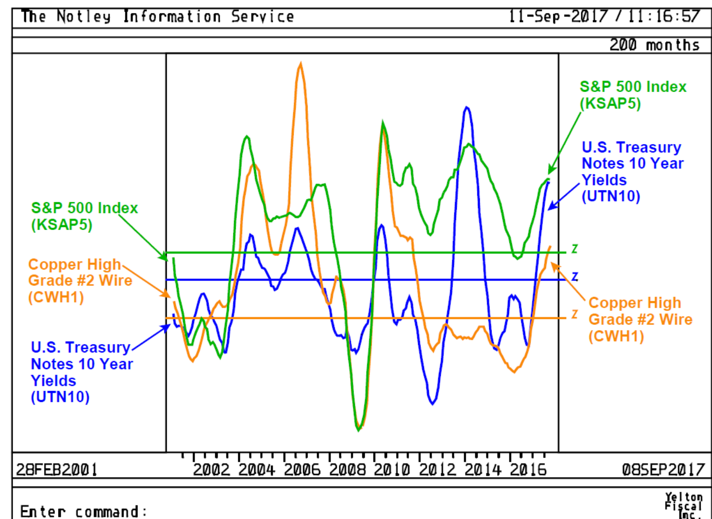
technicians bullish – we do believe that the risk of another short-term decline over coming weeks and into an October/November low is still on table. Thus, we would remain very cautious and apply tight risk measures for equities worldwide.

Let's look at our smoothed momentum indicators again in chart 4 showing the mini-cycle in form of those lines with bond yields, copper and the S&P 500. As you can see, the overlay of those three series shows a very advanced stage in the current mini cycle with a reversal to the downside pending in coming months. Of course, this is part of the big picture view only and short-term timing and adjustments must then be made. Once all these indicators reverse to the downside (we expect it during the first quarter 2018), we will be facing the beginning of a mini-cycle correction if not a full-fledged bear market. As those indicators are all at an advanced stage, markets are already on borrowed time.

CHART 4

Copper, 10-year T-Bond Yield & S&P500

(Monthly Momentum Smoothed)



Source: The Notley Information Service, Taniscott Capital Inc.

It has been an extremely powerful growth cycle in China with all the excess of the late cycle stage present.

In virtually all previous cycles, the sequence of events was a booming economy, full employment and rising inflation leading to rising rates and tighter monetary policy, deteriorating global liquidity followed by falling equity prices. This current cycle is anything but a normal cycle and may therefore differ in the industrialized world due to structural weaknesses. However, it has been an extremely powerful growth cycle in China with all the excess of the late cycle stage present. One should therefore focus on the dominating region for this cycle as almost everything else will be derived from there. This was true on the upside and will be true on the downside as well.

Moreover, the current rising optimism for the world economy in view of the recent improvements will lead more central banks to step away from their excessively easy monetary policy. The Fed was leading the tightening cycle but some other central banks have raised interest rates, too. Japan is silently tapering its QE and the ECB must reduce its current QE from later this year on, as the size of available government paper in the secondary market is shrinking sharply and creates mounting hurdles to purchase much more.

This all means that excessively expansive monetary policies around the world, the main driving factor for rising equity prices, will be removed step by step on a global basis.

Moreover, we expect the negative rates will be eliminated in coming months, as they are counterproductive and the current economic pace

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does not justify it any longer. The strong euro may prevent such a move now but after a medium-term weakening, the ECB may remove the negative rates. In the US, a fiscal stimulus program by the Administration may invite the Fed to lean against it by tighter money than at present. This all means that excessively expansive monetary policies around the world, the main driving factor for rising equity prices in the current cycle, will be removed step by step on a global basis. We would be very surprised if this would not lead to market reactions at some point.

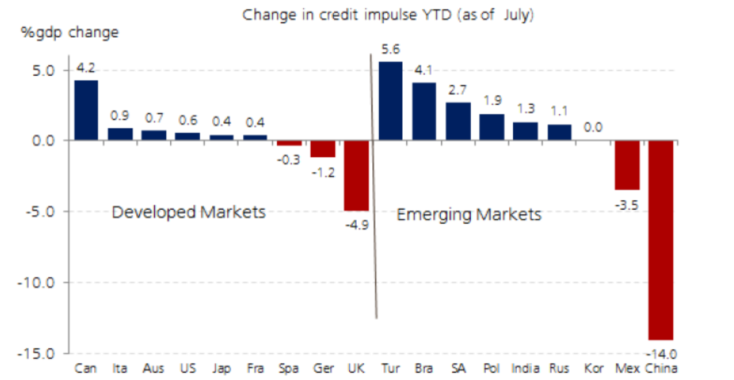
Will the World Economy Stay Strong?

Our working hypothesis has been, and remains, that the world economy will most likely begin to weaken during 2018 into a recession 2019/20. We also said that in theory, 2018 should be the ideal peak for the global equity bull market. However, since geopolitics and trade politics will be creeping up and the world economy is the most levered ever, we rather turn cautious/bearish one medium-term cycle ahead of the theoretical high. This is what we have outlined and we still stick to it, particularly now that liquidity deterioration should begin shortly. Once technicals and liquidity signal a brighter medium-term sky, we would soften our risk aversity.

China is, in our view, the most decisive factor for the current cycle, as it has been the driving force for economic growth throughout the world but particularly so in the emerging market universe, Europe, and Japan and to a much lesser degree in the US. We have pointed to slowing credit and monetary aggregates in previous reports and show in chart 5, the credit impulse (second derivative of credit growth) over the last 12 months. As you can see, the sharp drop in China is alarming and should over time slow the Chinese economy, which would lead to lower imports from the rest of the world. That is the process we expect to slow the world economy. China is the second largest economy of the world and its

CHART 5

Change in Credit Impulse (year to July)



Source: UBS calculations, Haver, BIS, FoF

slowing will overpower all other countries from 2018 onwards.

The Chinese Communist Party will hold its National Congress starting October 18. This is an important event that takes place every 5 years and where the leadership will be confirmed. We assume that Xi Jingping will be confirmed as the General Secretary of the Party and the political leader of the nation; he is already the most powerful Chinese politician since Mao. Once confirmed, he will consolidate his power by tightening controls further and continue removing those who could threaten his power.

This will be a monumental task as the $8.5 trillion shadow banking system alone represents almost 75% of GDP, which is about equal to the total business debt/GDP in the US.

Among the main topics will be the restructuring of the financial system in coming years. The most important task will be the integration of the shadow banking system into the banking system to regain control over the lending process by the central authority. This will be a monumental

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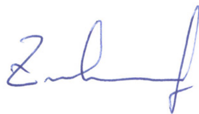
task as the $8.5 trillion shadow banking system alone represents almost 75% of GDP, which is about equal to the total business debt/GDP in the US. In China, this is simply the unregulated shadow banking system debt; it is a huge number and therefore a gigantic challenge. The bigger the amount to integrate, the higher the risk that credit creation will slow and considerably so.

While we will see continuous debt/equity swaps, as in previous cleanups, they are small relative to the size of the problem and will not eliminate the debt problem. We think China has reached a point where it simply cannot continue to grow at the same speed because the ratio of new debt to GDP is now around 5:1 and further high growth will push the banking system beyond its limit to finance it. Thus, we expect a tighter monetary framework to evolve as a side effect of the restructuring of the financial system. Such a monetary slowdown should eventually slow the economy further and the process should then unfold as we expect. This is a 2018-2020 story. Stay tuned!



Felix W. Zulauf
September 14, 2017

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