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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	Bullish	Neutral
EUR/USD	Neutral	Bearish
USD/JPY	Neutral	Bullish
USD/CNH	Neutral	Bullish

* Indicates a new position or change in view

Highlights

- The German election results were in line with our forecast. As expected, the established parties of the coalition government lost big, and virtually every other party gained. This result of this election suggests that the new Merkel led government will, at best, be a very weak one. Further European and Eurozone integration will become unlikely if the Free Democrats (FDP) join for a coalition government. If they do not join the government, a minority government would result but would hardly last long. We expect the new German government to be the weakest since WW II. This is a stark contrast to the dominating position of Merkel over the last 12 years, which was also the dominating force in European politics.
- In the US, we are all waiting for a resolution by Congress regarding fiscal policy steps. It is unlikely that the final legislation will surprise the markets in a positive way, since the impact of any potential legislation has likely already been priced in.
- The future of the world economy depends primarily on China's pace and policy steps, as it continues to be the main driver of global economic growth directly and indirectly.
- The Chinese consumer boom continues, and is pushing inflation rates higher worldwide. We anticipate that this will lead central banks to step away from their excessively easy policy of recent years.
- With reduced QE in many countries, balance sheet tapering in the US, and upward drifting inflation rates - bond yields continue to drift higher. Sell-offs by risk assets could temporarily counter this trend, but we assume higher bond yields during Q4 on a global basis.
- We expect further deterioration of global USD liquidity pushing the US dollar to recover, while the euro will likely suffer from the German election outcome and a dampened German attitude to further integration.
- Global equity markets are priced for perfection. While a process of topping may most likely stretch further into 2018, we still believe another short-term sell-off into an October low will be seen first.

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- In the environment described, the performance of individual sectors and stocks will vary widely. In general, high growth stocks (FANG) are more vulnerable than value or cyclical stocks. On a medium-term basis, we expect Europe and Japan to outperform the US equity indices due to our expected currency moves.
- Gold is correcting short-term, as we had expected, but our medium-term indicators have not yet given a sell signal. If the next rally attempt fails to break the early September highs, we will most likely turn more cautious medium-term.

German Election Outcome Will Prevent Further Eurozone Integration

While world media reports Merkel's victory on the German election, we do not perceive the election outcome in such a constructive light. We have a contrary view, and our interpretation of the election data leads us to predict a negative impact on the future of EU integration. Merkel's Conservative Party (CDU) has slumped in the election from 41.6% to only 31%, the lowest since 1953! And the Social Democrats (SPD) lost another 5.2%, down to 20.5%, the lowest on record. This result is in line with our expectations that the established government parties will lose and the smaller parties will gain. The third largest party is now the "Alternative für Deutschland" (AfD), a political right wing party that is now in parliament for the first time. They campaigned against Merkel's misplaced refugee policy, the continued European integration process and in favor a national sovereign state or "Germany First". This party attracted over 22% of the votes in former East Germany, and shows how dissatisfied people have been with the German government. Many protest votes have been placed for this party, perhaps because the mainstream media and mainstream politics tried to redline them. The Free Democrats (FDP), a market oriented conservative party that dropped out of parliament last time because they did not stick to their own principles as part of a coalition with Merkel's CDU, is now back in parliament with 10.7%. Furthermore, the Green Party (GP) gained also marginally to 8.9%. And the Left (Linke), the succession party of the former communist party of East Germany, gained marginally to 9.2%.

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Before the final election results were available, the Social Democrats, the coalition partner of Merkel's Conservatives for the last legislation, announced that they are not available for another coalition. They believe their role as a junior partner cost them too many votes. This means that the only coalition possible to build a majority government is one with the Conservatives (CDU), the Free Democrats (FDP) and the Greens. This is not so easy, as there are clear political differences between those parties. The Greens are a left leaning party in favor of further European and euro integration, favoring socialist and state driven economic policies; their major topic is protection of the environment, which is reflected in Merkel's energy policy that is costing the taxpayers hundreds of billions in subsidies. The FDP, however, is favoring an energy policy that is based on free market mechanism, not subsidies. And most importantly, the Free Democrats campaigned on preventing further European integration if that means mutualization of debt and financial subsidies and transfer payments to other nations. They campaigned for national responsibility in the Eurozone, not further integration and burden sharing (which usually means Germany must pay). This point is essential, as the Free Democrats have dropped out of parliament in the last election because they did not execute when in power as junior partner of Merkel's CDU what they had promised before in their campaign. They will therefore not repeat the same mistake of campaigning for one thing and when elected doing the opposite.

The Free Democrats also made it clear if they could not integrate their most important points into a coalition agreement, they would rather

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prefer an opposition role than joining a coalition at any price, or the price of being punished at the next election and dropping out of parliament again. This means if they cannot be integrated into a coalition, Merkel had to enter a minority government. Such a government would not last very long and new elections would be called sooner than most believe, now. Such a call would be the end to the political career of Angela Merkel.

The Greens are more willing to join a coalition as their current leaders are less dogmatic than former key persons. All they need is some agreement on the environment, but we believe the Greens are much more flexible there than the Free Democrats on misplaced European integration.

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The essential point is that either the new German government – be it a 3-party coalition or a minority government - will be much less willing and able to integrate further. The French President will not be able to accomplish his goal and what he proposed last night is already outdated and not worth the paper it is written on. We suspect that there will be fault lines appearing over time in the Eurozone regarding further integration. It is also important to understand that for the first time in modern German history, there are seven parties in parliament, which is more than ever before. These factions will make decision making with any weak government even harder. This reflects the trend in other countries, and is a result of the dissatisfaction of voters with their governments. The impact of this will make it harder to govern not only in Germany, but beyond the borders as it will be more difficult than before; it will slow, if not completely stop, the European integration process. It is again the political – and to some degree also the economic – establishment that is getting the bill presented for ill-guided policies that have been always sold to the public as if there were no alternatives.

We think sovereign spreads will widen again as the fragility of the euro system will increase. After the French election, markets had wrongly bet on a deepening of the European integration process assuming the German election was an easy one. This is now highly unlikely.

In the short-term, markets may not fully understand the complexity of the situation and what it means for the euro. But in the medium-term, this will weaken the drive to integration and strengthen the nationalist movements underway on the Continent. As we mentioned in our last report in a short preview of the German elections, this will not be positive for the euro in the medium-term. Moreover, we think sovereign spreads will widen again as the fragility of the euro system will increase. After the French election, markets had wrongly bet on a deepening of the European integration process assuming the German election was an easy one. This is now highly unlikely.

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China Drives the World Economy, Not the US

We continue to believe the high growth of the Chinese economy is the main driver of the world economy, as it acts as a catalyst for the EM universe as well as for Europe and Japan. The interdependence with the US is much lower and the US economy depends almost exclusively on domestic factors. And we are waiting for a fiscal package by the Administration/Congress.

It remains our working hypothesis that China will tighten in 2018 due to rising inflation and monetary and credit aggregates will then slow down decisively and impact the Chinese - and through the transmission of global trade - the world economy.

Chart 1 shows the BCA central bank monitor and indicates that virtually all central banks are in need to tighten policy (indicators above zero call for tightening). As central banks move their policies accordingly, it will be an additional damper for global economic growth sometimes from 2018 onwards.

Tighter US Dollar Liquidity Strengthens the US Dollar

We have pointed to a coming recovery of the US dollar in the last few reports. The German election outcome will be the next factor contributing to the dollar's recovery attempt.

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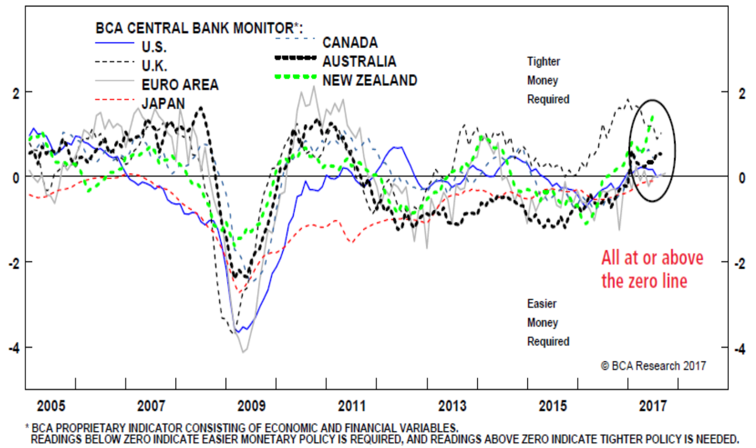
We think EUR/USD peaked at 1.21 and we are looking for 1.14 target for a first stop. We will then reassess as the variables might change. Please keep in mind that trend is more important than level in our forecast.

CHART 1

BCA Central Bank Policy Monitor



Source: BCA Research 2017

While our thesis of tighter US dollar liquidity helps the US dollar against virtually all currencies, the German election outcome may weaken the euro in other crosses – for reasons explained in the political section. The US Fed intends to hike in December and this will particularly be seen if Congress and the Administration can legislate a fiscal program in Q4 or markets can see that it will be forthcoming in early 2018. Those factors should also help the greenback to recover.

Heterogenous Equity Markets

We still believe that the global equity bull market is in its later stage as monetary policy will step by step become less supportive (see again chart 1). At present, the world economy has not slowed down and the big money will not liquidate equity investments as long as fundamentals do not deteriorate. Business and career risks are simply too high to risk moving too early. For that reason, we see primarily high rotation and diverging performance by sectors as well as individual stocks. It is an environment favoring stock picking and punishing passive strategies.

In recent days, the US indices and particularly the FANG type of stocks have started to correct more decisively and we expect this to continue. It means that NASDAQ is more vulnerable here than other major US indices (chart 2 & 3, next page). But we also expect the S&P 500 to

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correct into a low in the second half of October. Whether that will be the low for this medium-term correction for those indices and stocks must be answered as we get to that point.

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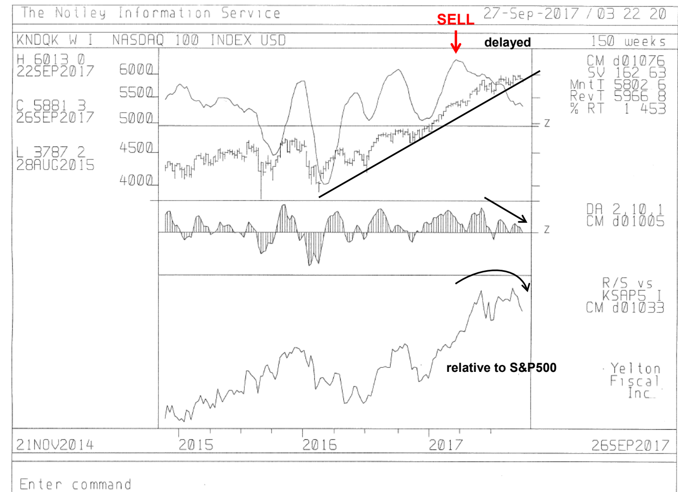
In contrast, most European indices have already corrected into lows in late August, and have bounced off those lows. We expect those markets also to soften into the second half of October but those late August lows have a chance to hold and broaden the base. If our thesis about the US dollar strengthening and the euro weakening is correct, we think chances are good that European markets will outperform US major indices for the remainder of the year in local currency terms (chart 4, see next page).

Japan has corrected into a low of early September and bounced strongly off that low. It may also correct a bit or pause but we see Japan outperforming the major US indices in local currency terms (chart 5, see next page). Japan is not only a cheap market but corporate Japan has shown rising earnings at a high pace for many years and it has an extremely solid balance sheet, which is not the case in the US. Moreover, Japan is highly underrated by the global investment community and we think foreign investors will come back to this market. Finally, the Bank of Japan is buying large quantities of ETFs of Japanese stocks, a major positive (we do not advocate this as sound policy but it helps performance).

CHART 2

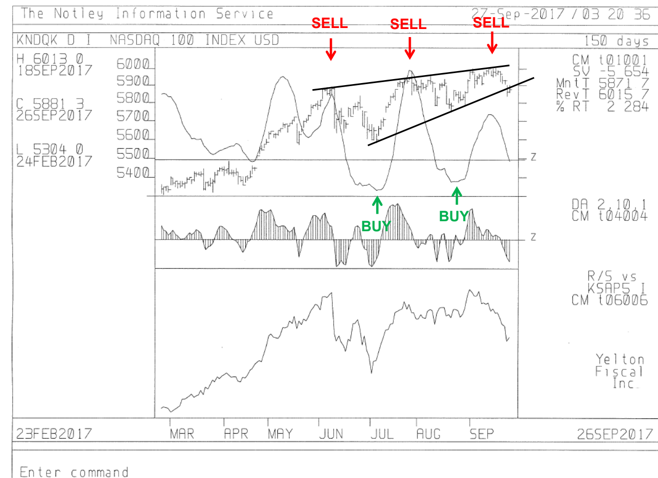
Nasdaq 100 Index - Weekly



Source: The Notley Information Service, Taniscott Capital Inc.

CHART 3

Nasdaq 100 Index - Daily



Source: The Notley Information Service, Taniscott Capital Inc.

Many of the EM markets traded higher in recent months and hit highs during the last few months and weeks. They are now exhausted on the upside and the key for them is tightening US dollar liquidity (as shown in

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our last report) and a recovering US currency. Deteriorating US dollar liquidity and a stronger US currency is historically bearish for the EM equity universe.

Our fear was that markets could have a deeper dive from a summer high into a fall low. What we have seen so far, however, is only a rotational correction. We like to wait until this current short-term correction is behind us in October to call for a decrease of short- and medium-term risks. We continue to see markets trading in a topping process that could stretch further into the first half of next year, when we expect global equity markets to roll over for this cycle. As chart 6 (see next page) shows, the number of new 52-week highs among national indices from the whole world keeps declining, which is a message of less and less participation in the bull run, a precursor of a final top. In the meantime, it is high rotation but no net liquidation yet by the big money. They will only sell once they see deteriorating fundamentals or if a geopolitical event would darken the economic outlook. Until this short-term correction is over, value will outperform growth and cyclicals will outperform defensives.

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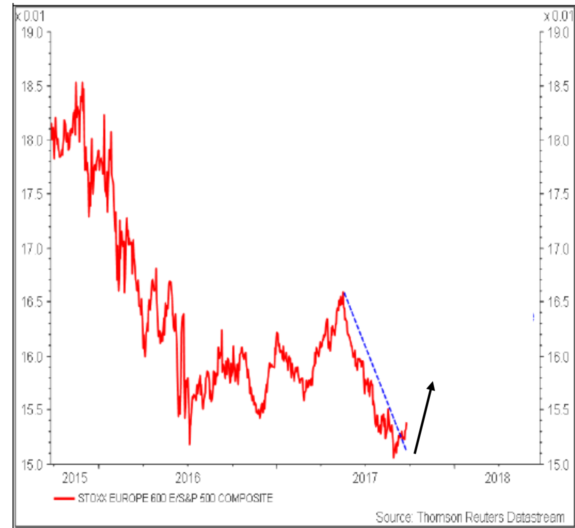
Neutral on Gold

We turned neutral on gold in our last report and stated that a short-term sell signal will most likely lead to some correction in coming weeks. This correction is upon us, as gold has stepped down to around $1300.

CHART 4

Stoxx Europe 600 relative to S&P500



Source: UBS, Pinnacle Data, Datastream

CHART 5

Nikkei 225 relative to S&P500

Source: UBS, Pinnacle Data, Datastrream

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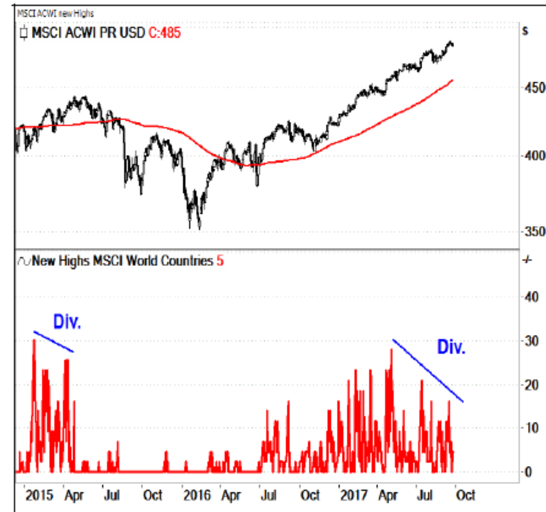
A new short-term buy signal is pending in about 1-2 weeks' time. Our hunch is that gold may not break the recent high and if it does not, it will fall back again as long as the US dollar liquidity tightens. Trading sentiment is still too bullish and with central banks willing to gradually move away from excessively easy money, the case for gold is dampened.

Gold attractiveness will rise again once the world economy rolls over, systemic risks are laid open again and central banks will move to "save" the world by buying every asset (even of low quality) that risks bringing down the system. Call us neutral on gold here. Our next step will most likely be to turn more cautious again.

CHART 6

MSCI World Markets New 52-Week Highs



Source: UBS, Pinnacle Data, Datastrream

Felix W. Zulauf

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