THE CAPITAL OBSERVER

SPECIAL REPORT : It looks like the "expected recession" is over before it even started

the technical analyst
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A DC&C publication,
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THE CAPITAL OBSERVER

A Monthly Macro and Asset Review
Featuring MJT's Timing Methodology

SEPTEMBER 2019

03 Executive Summary

04 / It looks like the expected "recession" is over before it even started: monetary, fiscal stimuli to push economic recovery into Q2 2020, at least - In the July 2019 Capital Observer issue, we looked into the possible case of global and US growth bottoming in Q2 and Q3 this year, respectively. We took the IMF's word for an H2 recovery because The Capital Observer decided to test the IMF's thesis of global GDP bottoming, and subsequently growing, as from the middle of 2019. The theme of moderate global growth, and subsequent rise in risk assets, is also supported by rising central bank provided liquidity. The G5 aggregate central bank M2 Money supply and balance sheet has been very supportive of global growth, and the rise in global financial risk assets. . The central banks have gone beyond increasing global money supply (M2 and Monetary Base) – the major central banks are also easing monetary policy, and have been on the race to the bottom in lowering policy rates. With the double-barrelled approach of increasing systemic monetary liquidity, and declining costs of funds, global risk assets should catch massive bids before long. These positive global conditions, described above, have been building over the past several months, but many investors have likely overlooked these factors as they focus on the falling US and Global PMIs, the global trade backdrop (as the US-China trade spat shows no signs of immediate solutions), the inversion of global yield curves, and lower commodity prices. The fact remains that according to almost all surveys, investors are positioned for mid-cycle, others late-cycle and still others recession, and very few appear prepared for global and US growth over the next 4 quarters. Investors' fears are undoubtedly driven by what they believe to be the possible worst case to be brought about by those negative developments. US economic activity is usually led by a bevy of indicators including the Citigroup Economic Surprise Index and even the S&P 500 Index. All of these lead indicators have already been on the upswing, which makes likely a Q3 2019 US GDP higher than that of Q2. Finally, fiscal policy is again coming to the rescue of the economy and the financial markets. Spending and borrowing have been great for economic growth and the financial markets. So all that money being thrown on the economy should charge up US GDP growth.

10 / Timing and Tactical Insight - Equities should continue to climb a wall of worry - Year to date, equity markets have climbed a wall of worry. Many of them have since recuperated much of their 2018 sell-off. Despite this strong performance, many residual risks are still present, or only starting to fade. Hence, the market positioning is still very defensive, and the defensive sell-off / cyclical rally that we saw last week could be just the beginning of a larger move, from defensives to cyclicals, as these residual risks continue to dissipate and cyclicity re-accelerates. Time-wise, we may still see a last period of retracement on equities into late September / early October and Defensive assets/sectors may attempt a slight comeback. But from the start of Q4, we then expect a strong cyclical equity rally into early next year, perhaps extending into the Spring.

4 / It looks like the expected "recession" is over before it even started: monetary, fiscal stimuli to push economic recovery into Q2 2020, at least

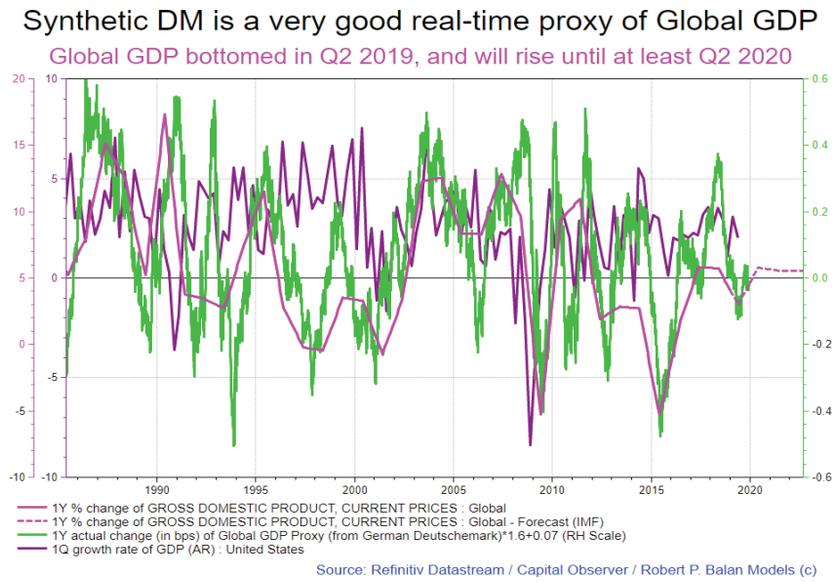
In the July 2019 Capital Observer issue, we looked into the possible case of global and US growth bottoming in Q2 and Q3 this year, respectively. This is what we said then:

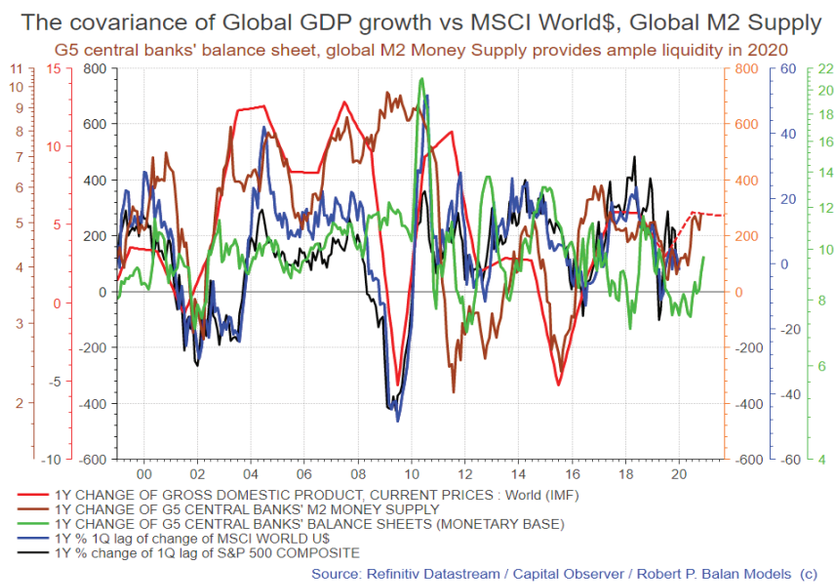
The Capital Observer's outlook has always been that there will be global growth during the second half of the year, and that trend will extend into Q2 2020. IMF has provided the broader rationale for growth; but we have our own set of reason for optimism during that period. We needed a real-time proxy to test whether or not the IMF has judged the economic backdrop correctly. It looks like the international agency has done the analysis well, and their forecast of a second half global GDP growth looks spot on.

The IMF said in their April 2019 report: ***Global growth is expected to soften from 3.6 percent in 2018, to a projected decline to 3.3 percent in 2019. However, after the weak H1 2019 start, growth is projected to pick up in the second half of 2019.***

We took the IMF's word for an H2 recovery because the Capital Observer decided to test the IMF's thesis of global GDP bottoming, and subsequently growing, as from the middle of 2019. We have previously created a real-time proxy of global GDP growth by taking elements from the German Deutschemark and from the Hong Kong Dollar. This synthetic currency has back tested very well, and has been out-of-sample for more than five years. It mimics global GDP very well, and as proxy, it has the advantage of providing real-time "updates" to global GDP. We show the results at the first graph on this page (green line).

We took the IMF's word for an H2 2019 recovery because the global GDP proxy did bottom on June 15, 2020, and has been rising since then, according to our projections for global growth. The IMF has since then issued an update in July 2019, saying:





Global growth is forecast at 3.2 percent in 2019, picking up to 3.5 percent in 2020 (0.1 percentage point lower than in the April WEO projections for both years)

The international agency reduced their 2020 growth forecast by 0.1%, "*as the United States further increased tariffs on certain Chinese imports and China retaliated by raising tariffs on a subset of US imports*." With US President Donald Trump and President Xi Jinping of China set to meet in September, this month, the primary risks to the IMF global growth projections are set to be addressed affirmatively. Our global GDP proxy should provide a good read on what the global outlook will be as we go along, and The Capital Observer will provide periodic updates.

The theme of moderate global growth, and subsequent rise in risk assets, is also supported by rising central bank provided liquidity. The G5 aggregate central bank M2 Money supply and balance sheet has been very supportive of global growth, and the rise in global financial risk assets (see 2nd chart bove). The G5 central banks are the US Federal Reserve Bank (FRB), the European Central Bank (ECB), Bank of Japan (BoJ), The Peoples' Bank Of China (PBoC) and the Swiss National Bank (SNB).

These monetary aggregates usually lead GDP growth and the price of risk assets by 5 to 6 quarters. The central banks have gone beyond increasing global money supply (M2 and Monetary Base) – the major central banks are also easing monetary policy, and have been on the race to the bottom in lowering policy rates. The most recent examples are of course the ECB, which will be on easing mode over the next 12 months, the PBoC, which just cut Required Reserve Ratios to free more cash to be lent out by commercial banks, and of course the FRB (Fed) which cut rates in July, and are expected to cut rates further during their September meeting next week.

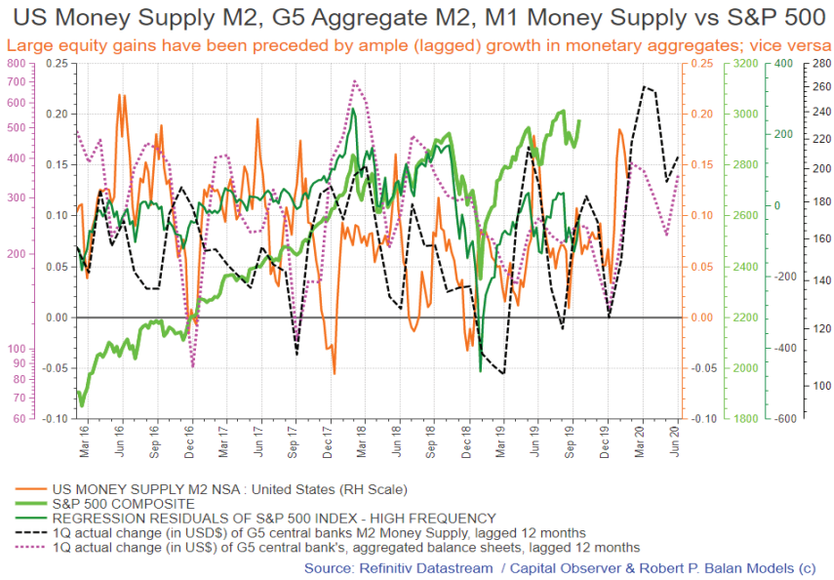
With the double-barrelled approach of increasing systemic monetary liquidity, and declining costs of funds, global risk assets should catch massive bids before long. Equity prices should rise smartly, and bond yields should soar. US risks assets are especially receptive to monetary inflows from the G5 and FRB itself (*see 1st graph on this page*).

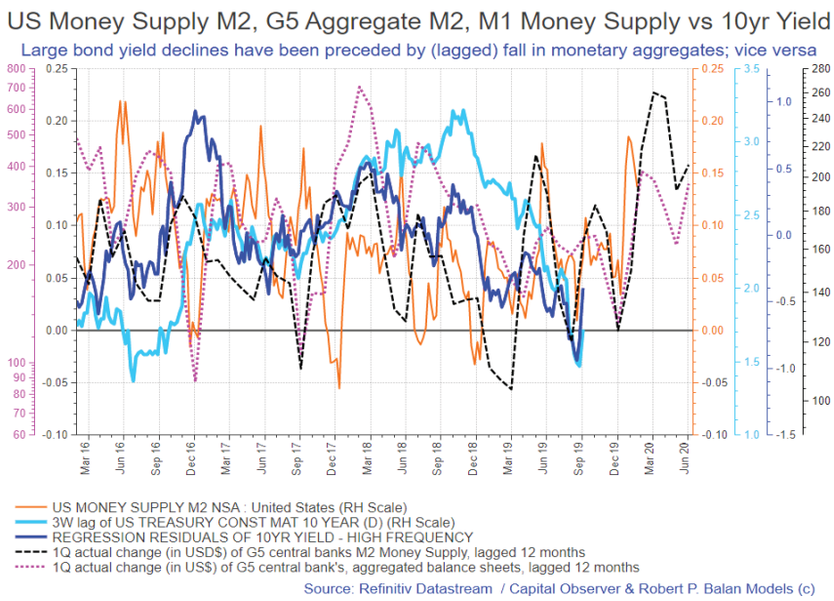
And the price/yield of safe haven bond assets rise/fall when monetary liquidity levels decline (after a lag). And the inverse is also true – the price/yield of safe haven bond assets fall/rise when liquidity conditions improve (after a lag); *see 2nd graph on this page*

That is exactly the reason why at The Capital Observer it is imperative for us to validate the potential for global growth in 2020. Over the past 12 months, global equities are up just 1%, the S&P 500 is just up 4%. After the challenges of the past year, it is imperative to ask whether conditions are going to get better, or worse relative to a year ago. **We believe that the situation will turn around. Important asset allocations require a prior knowledge of likely global growth trends over the next year. That is why we are offering our own rationale for global growth during the period from Q3 2019 to Q2 2020.**

These positive global conditions, described above, have been building over the past several months, but many investors have likely overlooked these factors as they focus on the falling US and Global PMIs, the global trade backdrop (as the US-China trade spat shows no signs of immediate solutions), the inversion of global yield curves, and lower commodity prices. The fact remains that according to almost all surveys, investors are positioned for mid-cycle, others late-cycle and still others recession, and very few appear prepared for global and US growth over the next 4 quarters. Investors' fears are undoubtedly driven by what they believe to be the possible worst case to be brought about by those negative developments.

But what if those perceptions are wrong, and we can show proxies that recently negative macro developments are on the mend?



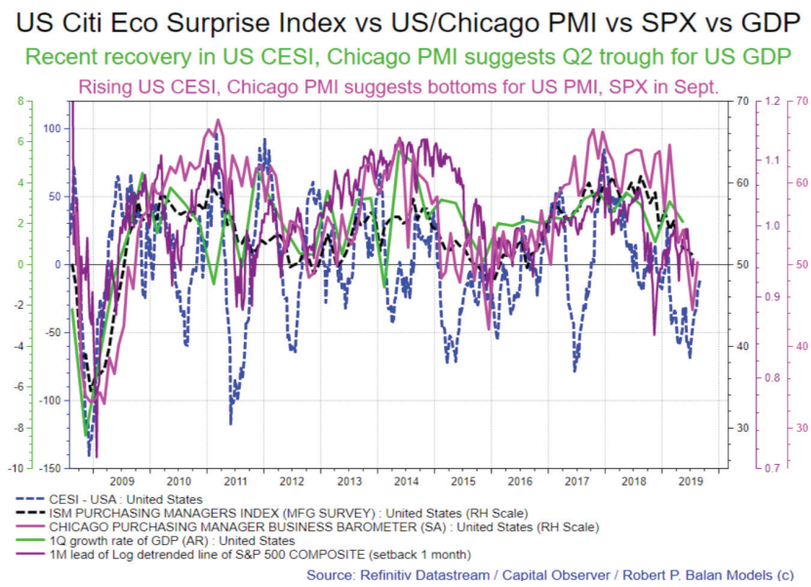


The US Manufacturing PMIs have turned around:

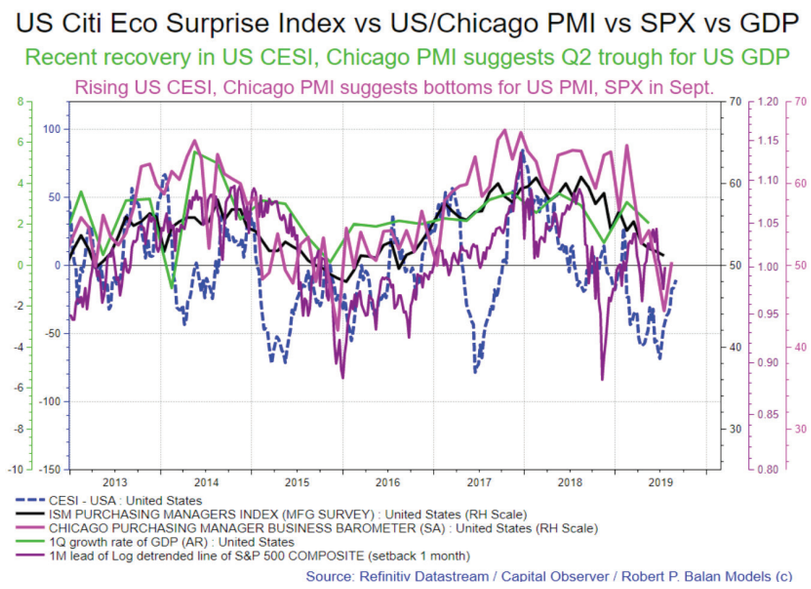
On the heels of rebounds across various regional Fed surveys, Chicago's PMI survey rebounded from recession-signaling lows in July, jumping from 44.4 to 50.4 (back into expansion) in August. New orders rose and the direction reversed, signalling expansion. Order backlogs also rose and the direction reversed, signalling expansion. And business activity has been positive for 8 months over the past year.

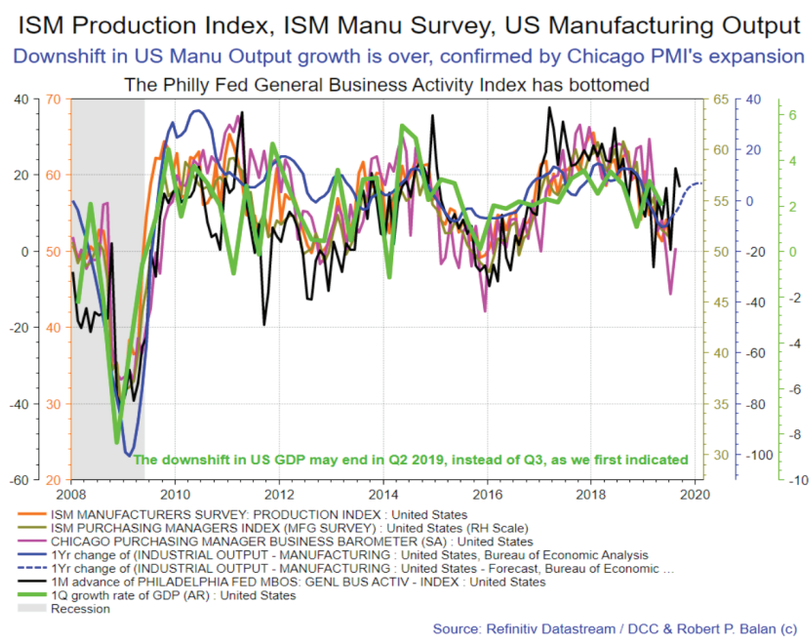
But best of all, the Chicago PMI teams up with the rising Citigroup Economic Surprise Index to indicate the high likelihood of a seeing a September bottom for the US PMI. And in addition to that, the combo also confirms that the bottom of the US GDP has been seen in Q2 earlier this year. (see 1st and 2nd graphs on this page)

The turn around in the Chicago PMI also confirms the lead indications from the internals of the US ISM and manufacturing output data. If we juxtapose those internal data with the upturn in the Philly Fed General Business Activity Index, which has bottomed, then we come to conclusion that the downshift in US manufacturing output growth is over – the inflection points higher in the data, and upturn in the ISM production Index is likely just a month away. *(see 3rd graph on this page and 1st graph on next page).*



Zoomed-in View



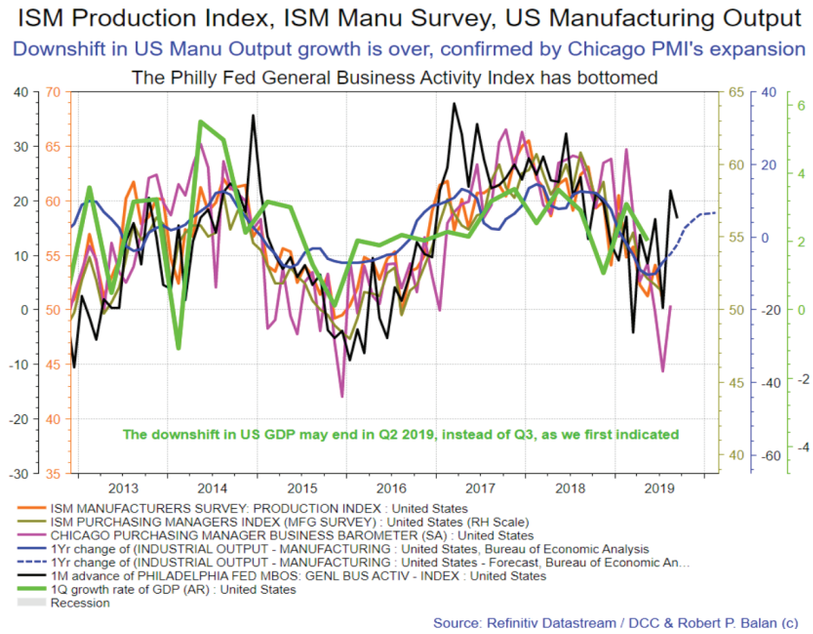


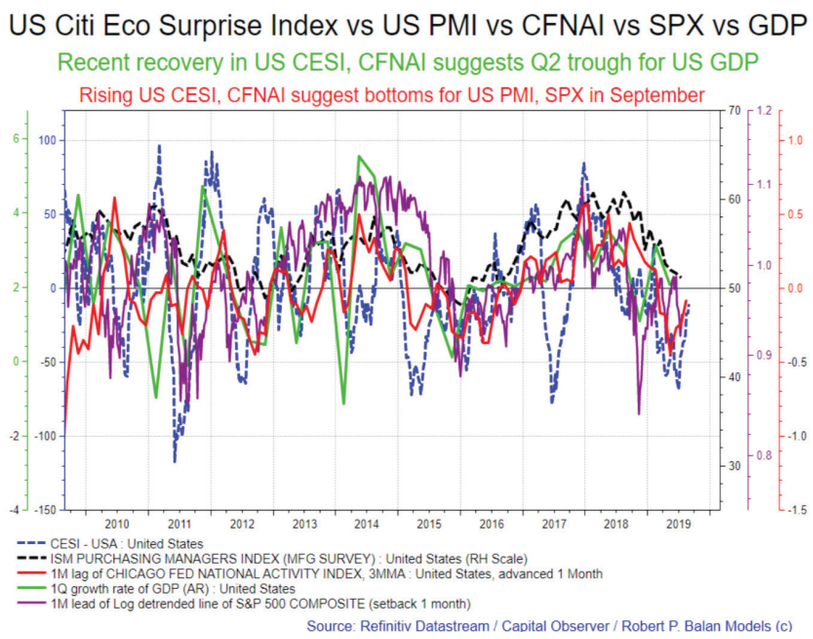
US economic activity is now on the mend – growth and manufacturing on the upturn

The CFNAI is a weighted average of 85 existing monthly indicators of national economic activity. It is constructed to have an average value of zero and a standard deviation of one. Since economic activity tends toward trend growth rate over time, a positive index reading corresponds to growth above trend and a negative index reading corresponds to growth below trend.

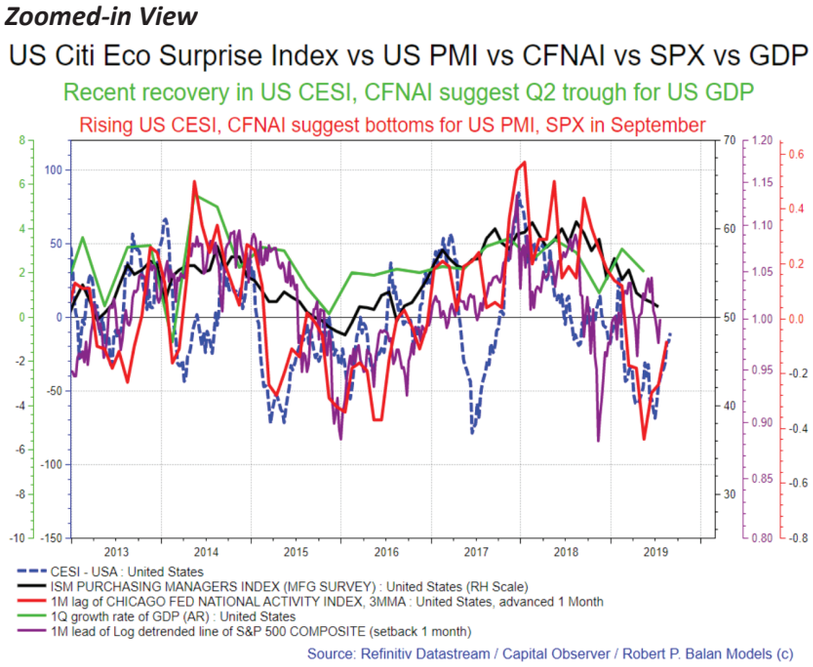
In its current state, the CFNI is heading towards neutral, and eventually a positive reading which suggests economic growth on the upswing. **US economic activity is usually led by a bevy of indicators including the Citigroup Economic Surprise Index and even the S&P 500 Index. All of these lead indicators have already been on the upswing, which makes likely a Q3 2019 US GDP higher than that of Q2.** *(see 2nd and 3rd graphs on this page)*

Zoomed-in View





Zoomed-in View

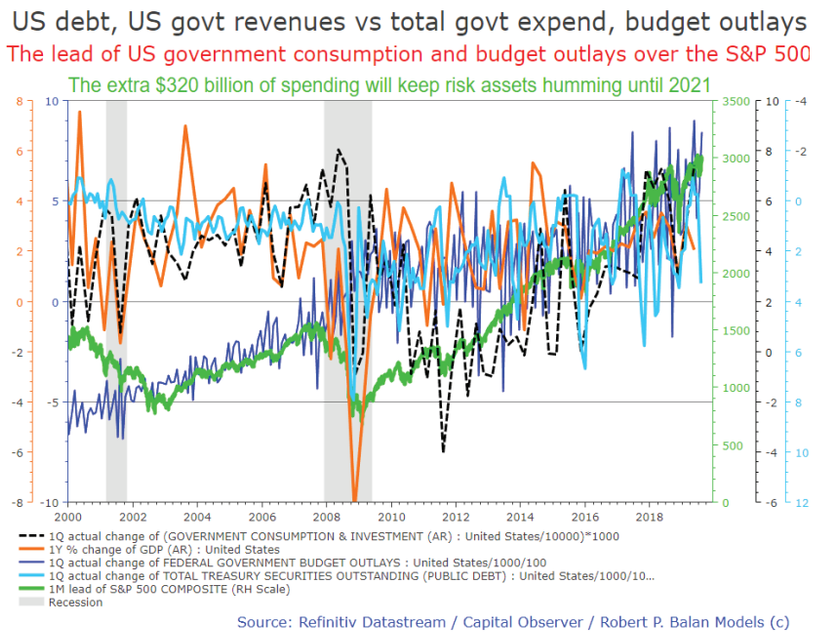


Fiscal policy set to reignite the economy and financial markets

Finally, fiscal policy is again coming to the rescue of the economy and the financial markets. Think about this: Trump and the Democrats agreed on a new, $4.407 trillion 2-year fiscal budget, which among other things approved discretionary spending of $160 billion for each of FYI 2020 and FYI 2021.

That's a lot of discretionary spending (and a lot of Treasury borrowing). **Spending and borrowing have been great for economic growth and the financial markets. That extra $320 billion of discretionary spending will keep risk assets humming until 2021. And in the process, all that money being thrown on the economy should charge up US GDP growth.**

(see graphs on this page)



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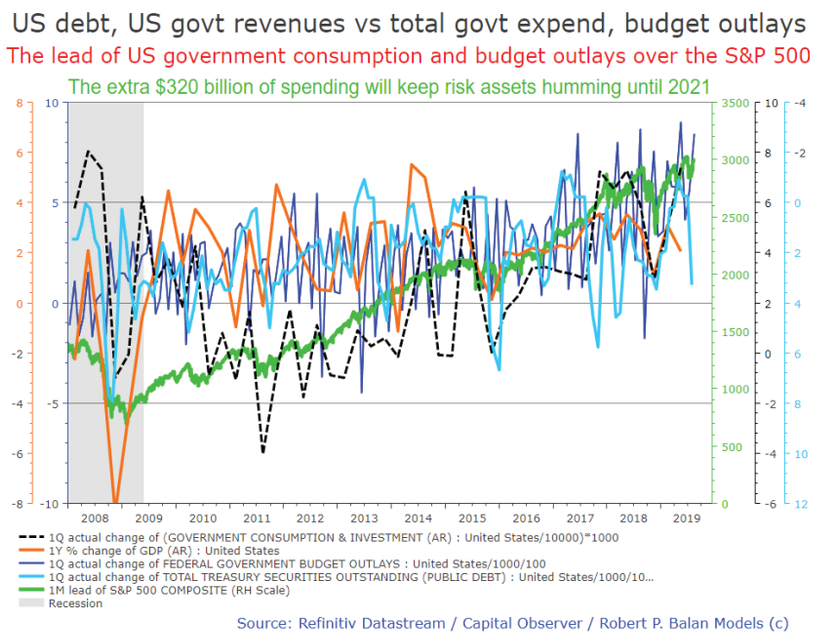
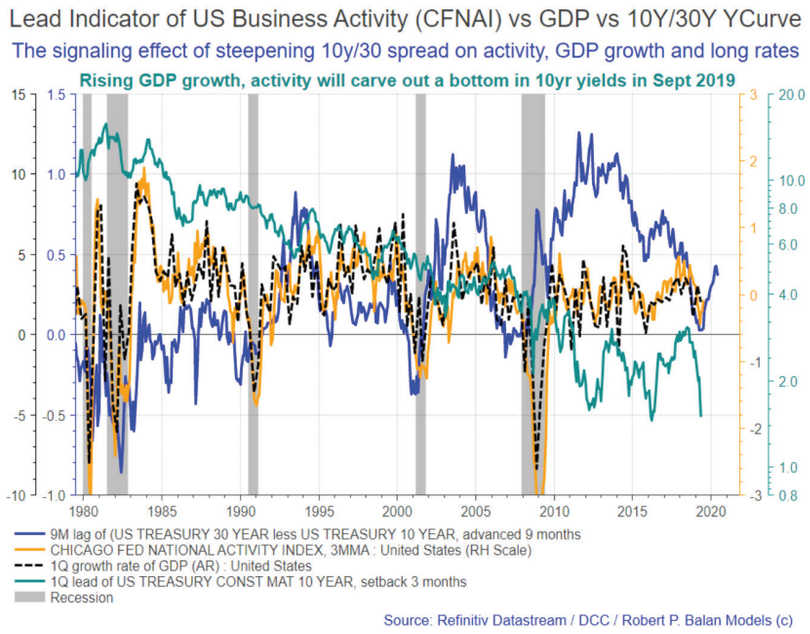


The signalling effect of the US yield curve: the 10yr yield should rise

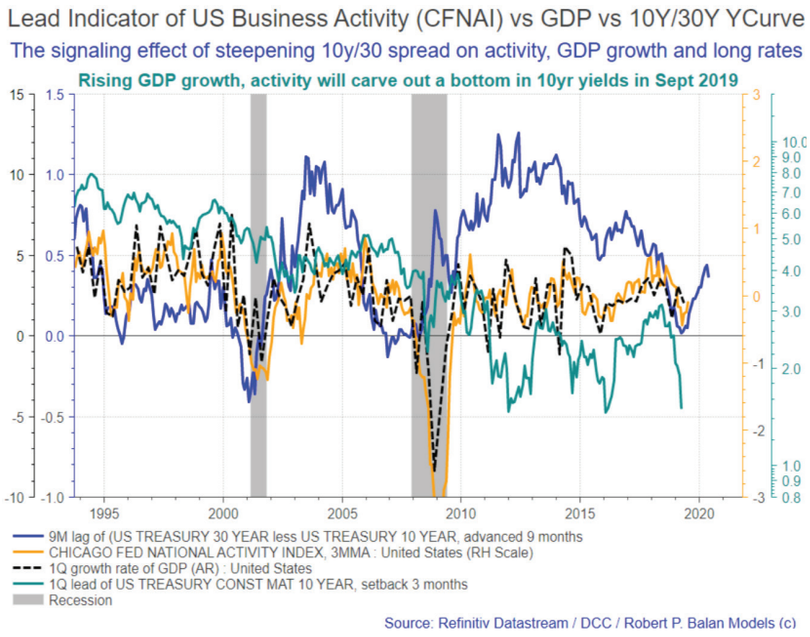
The inversion of the US front yield curve (3Yr/10Yr) has been taken as ill-omen by investors, as a portent of subsequent recession (after 4 to 5 quarters). Therefore, it follows that a steepening of the yield curve SHOULD be taken as positive for growth and financial assets, and that is happening at the back-end of the yield curve, in the 10Yr/30Yr spread. And the good portents are happening now.

The signalling effect of steepening 10y/30 spread on activity, GDP growth and long rates should be part of the positive news for the next 3 to 4 quarters. With economic activity (CFNAI) and GDP set to turn around soon (as soon as September this year), the 10yr yield should respond to better economic circumstances -- rising GDP growth, activity will carve out a bottom in 10yr yields in Sept 2019.

(see graphs on this page)



Zoomed-in View

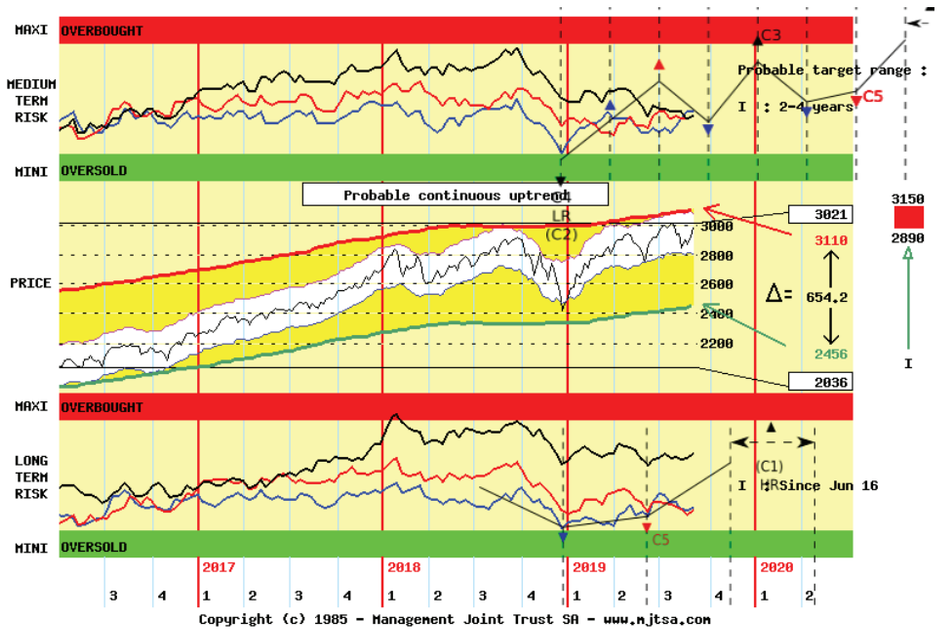


10 / MJT - TIMING AND TACTICAL INSIGHT

Equities should continue to climb a wall of worry

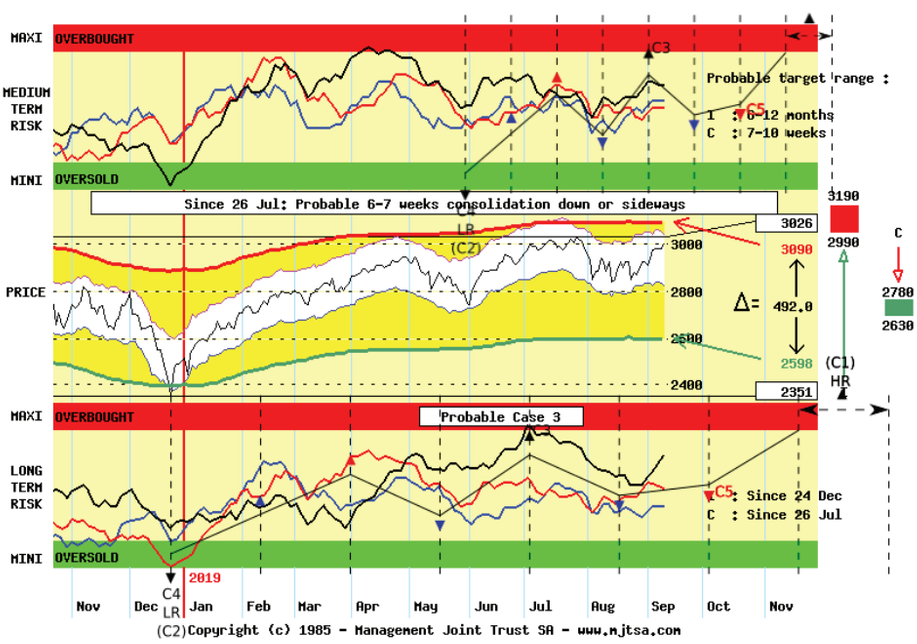
Despite all the worries about the ongoing US-China Trade War, a continuous deterioration of economic data in the US, Europe and China, and a painful Brexit process, so far this year, equity markets have climbed a wall of worry. Most of them have recovered much of their 2018 sell-off. In this article, we detail why we expect this recovery to continue.

S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



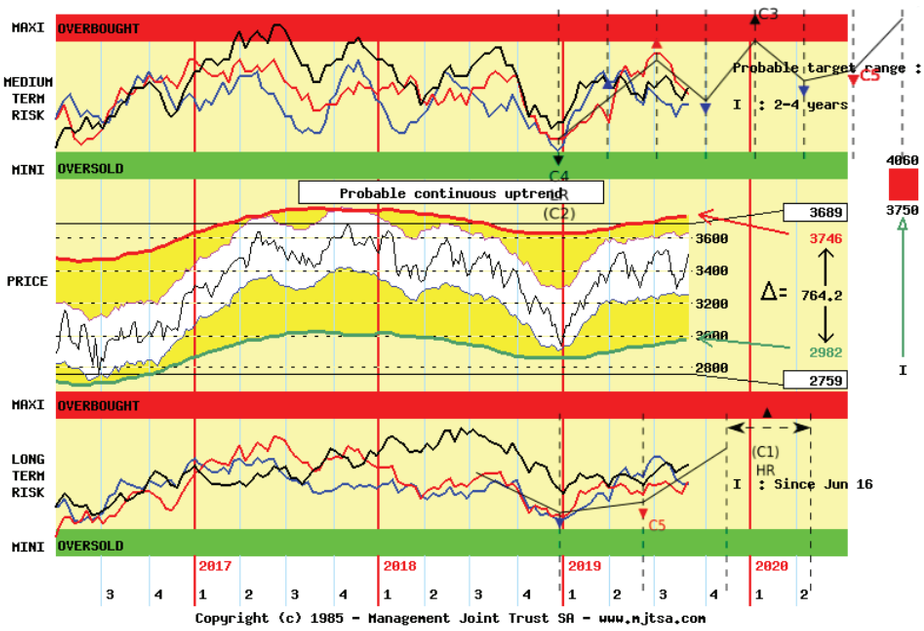
Following the strong sell-off late last year, both our oscillator series (lower and upper rectangles) are now back in uptrend sequences on the Weekly graph of the S&P500. **Both suggest that the index probably continues higher into early, perhaps Spring next year.** Shorter term, our medium oscillators (upper rectangle) do suggest a short period of retracement that could still materialize over the next few weeks. Yet, from early Q4, the S&P500 should then resume higher towards year-end at least. On the target front (right-hand scale), **our I Impulsive targets to the upside indicate that the index could reach into the 3'150s over the next few quarters.**

S&P500 Index
Daily graph or the perspective over the next 2 to 3 months



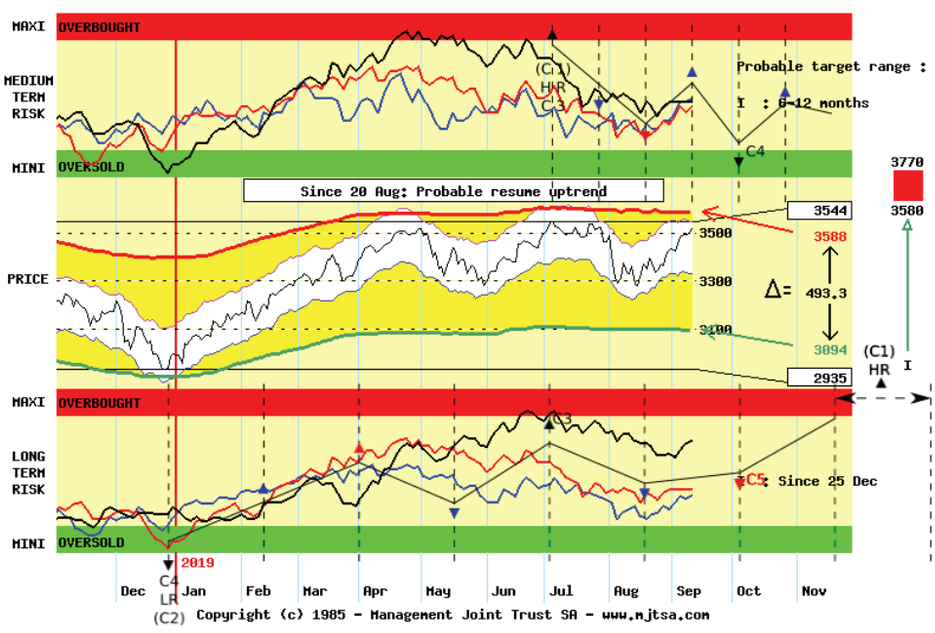
On the Daily graph, the S&P500 is also still in uptrend sequences on both our oscillator series (lower and upper rectangles). Both suggest that **following a short period of retracement until late September / early October, the S&P500 should then resume its uptrend towards year-end**. On the target front, our C Corrective targets to the downside (right-hand scale) suggest corrective risk back below 2'800, possibly below 2'700. Although we cannot exclude such a drop, the time left to achieve it is rather short. Looking into year-end, **our I Impulsive targets point to upside potential towards 3'200.**

EuroStoxx 50 Index
Weekly graph or the perspective over the next 2 to 4 quarters



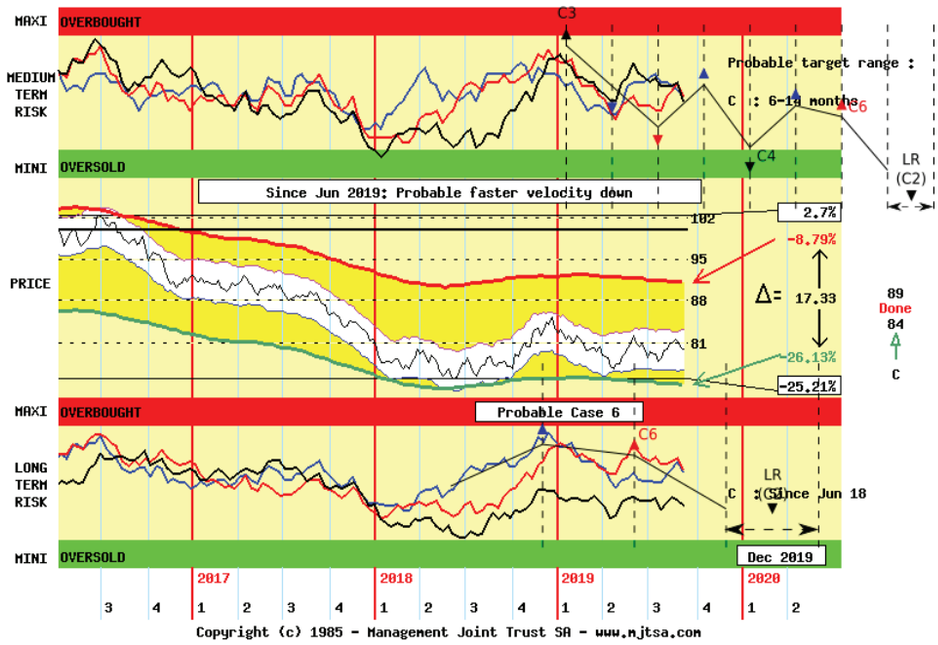
Similarly, in Europe, the EuroStoxx 50 has staged an impressive recovery since the beginning of the year. It is for now still shy of its 2017 highs, yet our I Impulsive targets to the upside (right-hand scale) indicate that it could make an attempt above them over the next few quarters. On the timing front, both oscillator series (lower and upper rectangles) suggest that **the uptrend may continue until early / Spring next year. Shorter term, our medium term oscillators (upper rectangle) point to a few weeks of retracement before the uptrend accelerates up.**

EuroStoxx 50 Index
Daily graph or the perspective over the next 2 to 3 months



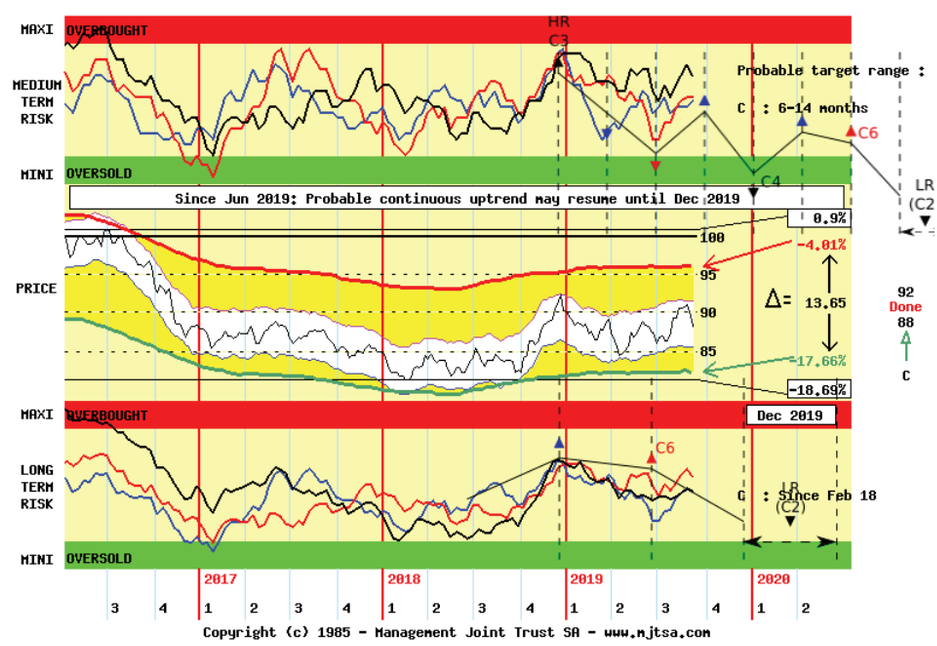
The Daily graph of the EuroStoxx is similar to the one on the S&P500, although the risk of our C Corrective targets to the downside is not shown anymore. If we had to, we would calculate these into the 3'300 – 3'200 range. Such a retracement is still possible, but the time to achieve it is quite short. Following that, **from late September / early October, both oscillator series (lower and upper rectangles) suggest that the uptrend on the EuroStoxx 50 resumes, probably towards year-end. The I Impulsive potential shown by our targets to the upside (right-hand scale) is in the 3'580 – 3'770 range, or probably above its 2017 highs.**

US Defensive Sectors vs the S&P500
Weekly graph or the perspective over the next 2 to 4 quarters



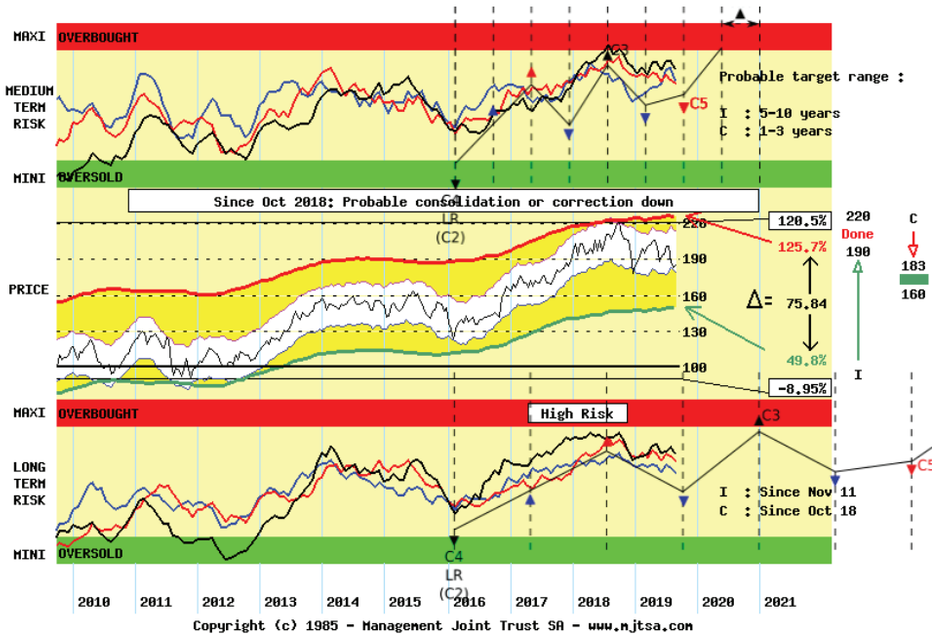
Mirroring the bullish indications on the equity graph above, the ratio of US Defensive sectors (we use an equal weighted portfolio of Staples, HealthCare, Utilities, Telecom and Real Estate) vs the S&P500 index seems to be **resuming its downtrend on both our oscillator series (lower and upper rectangles). From early Q4 at the latest, we then expect US defensive sector to accelerate lower vs the S&P500 into early, possibly Spring next year.**

European Defensive Sectors vs the Europe Stoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



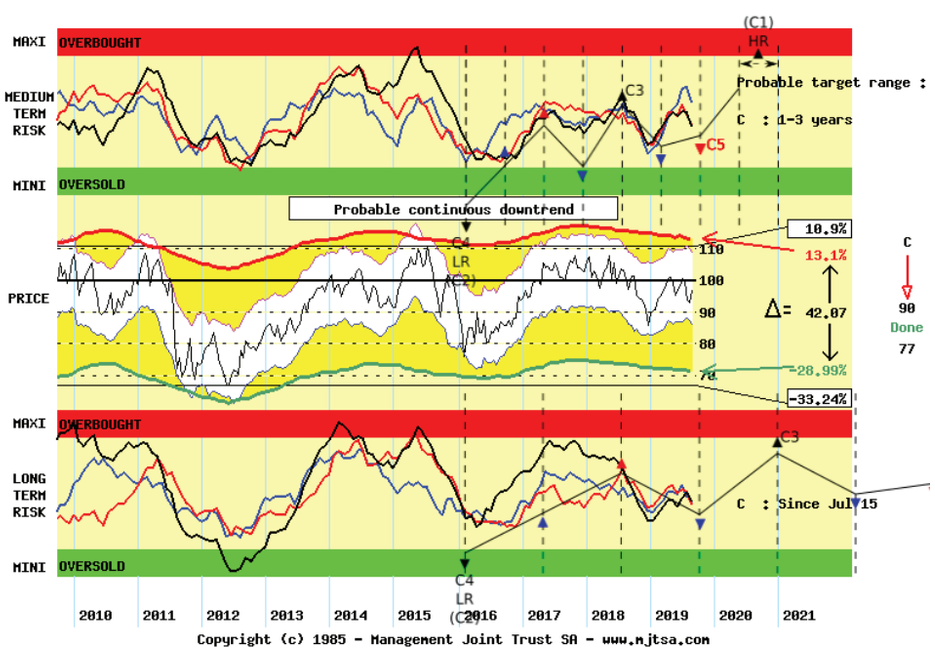
Similarly, in Europe, European Defensive sectors (we use an equal weighted portfolio of Food & Beverage, HealthCare, Utilities, Telecom and Real Estate) are also due to underperform going forward vs the Europe Stoxx 600 Index. Indeed, following their recent strong Summer rally, **we expect them to gradually reverse down on both oscillator series (lower and upper rectangles). From early Q4 at the latest, their downtrend vs the EuroStoxx 600 could then accelerate lower until early / Spring next year.**

3M Standard & Poors Fut. (Dec) / Treasury Bonds 30 Years Future (Dec)
Bi-Monthly graph or the perspectives over the next 1 to 2 years



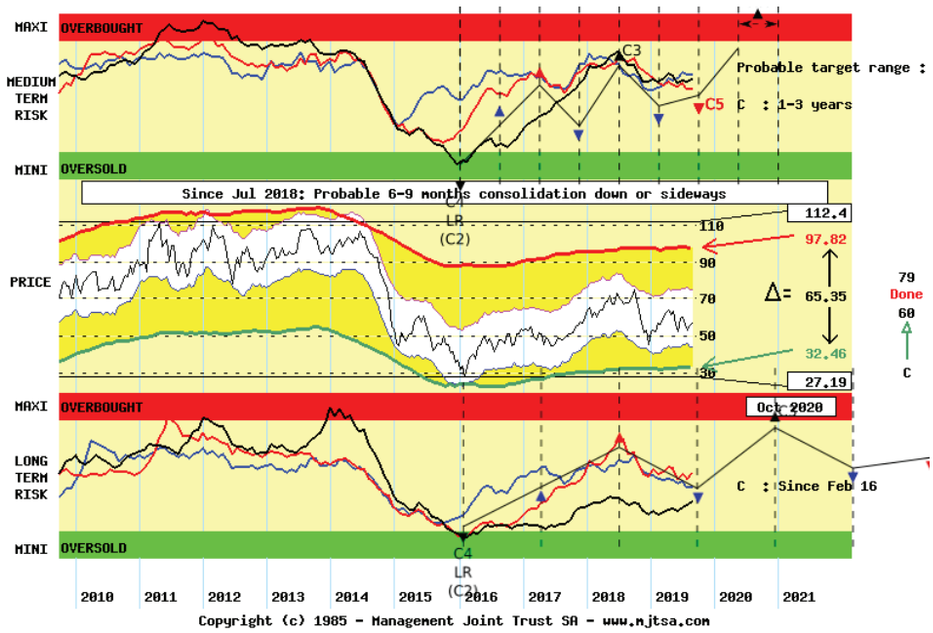
Given the bullishness we express above, and the rebound on yields we expect in other articles of this issue of The Capital Observer, we believe it is worth considering the long term perspectives for the Equity to Bond ratios. Indeed, these have been coming down quite strongly since markets sold-off late last year. On this graph comparing the S&P 500 3M Futures with the 30Y US Treasury Bond Futures, we can note that although the ratio was very Overbought last year, a new uptrend sequence seems to be developing on both oscillator series (lower and upper rectangles). **It could lead the ratio towards new highs in H2 2020. The corrective period since late 2018 seems almost finished and the inflection point to reverse back to the upside may be quite near.**

Euro Stoxx 50 Future (Sep) / Bund Future (Dec)
Bi-Monthly graph or the perspective over the next 1 to 2 years



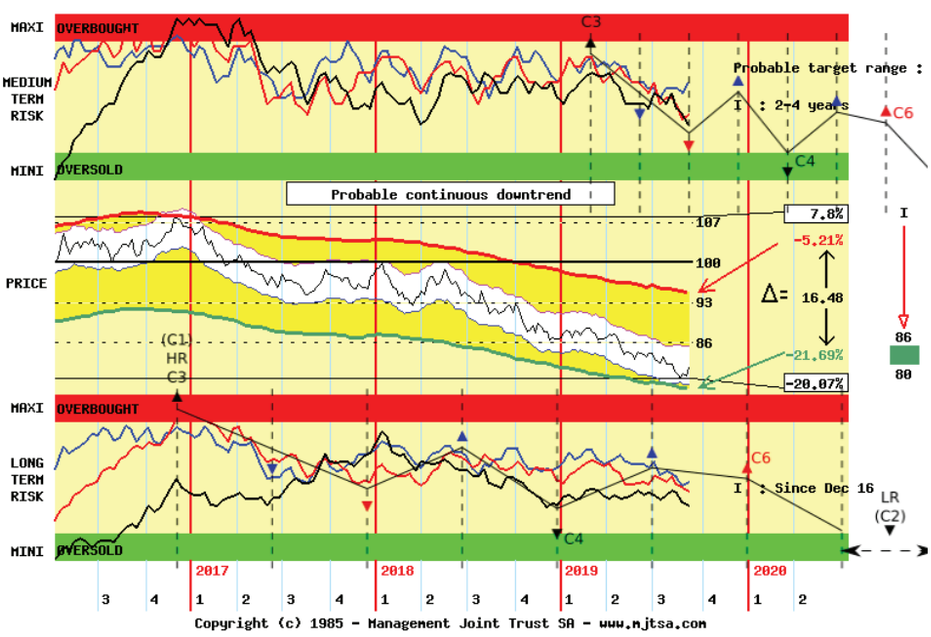
In Europe, the picture comparing the EuroStoxx 50 Futures with the Bund Futures has been rather sideways over the last 10 years. Yet, although the uptrend on the ratio is less clear than in the US, the inflection points are rather similar. Indeed, both oscillator series (lower and upper rectangles) do suggest that **a new uptrend sequence may be underway. The ratio may indeed find support over the next couple of months and start to move higher towards H2 2020**. This would probably imply quite a strong recovery in Europe.

Light Crude Oil, WTI (USD/barrel)
Bi-monthly graph or the perspective over the next 1 to 2 years



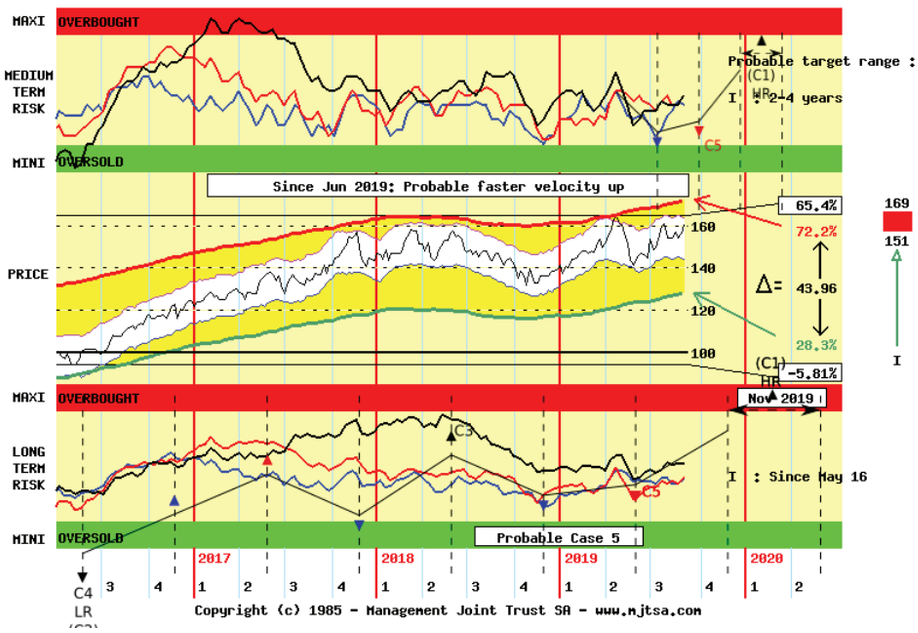
Rising Bond to Equity ratios in the US and Europe do point to the likelihood of an economic recovery (even a late cycle one). We hence turn to the long term graph of oil to confirm this view as such an economic recovery would certainly boost Oil demand and hence Oil prices. **This graph of WTI has been correcting down for more than a year on both oscillator series (lower and upper rectangles). We expect it to resume its uptrend soon, probably towards H2 2020. The resistance of the upper of our C Corrective targets to the upside (right-hand scale), around 80 USD/barrel, could be retested by then.**

US Cyclical sectors vs the S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



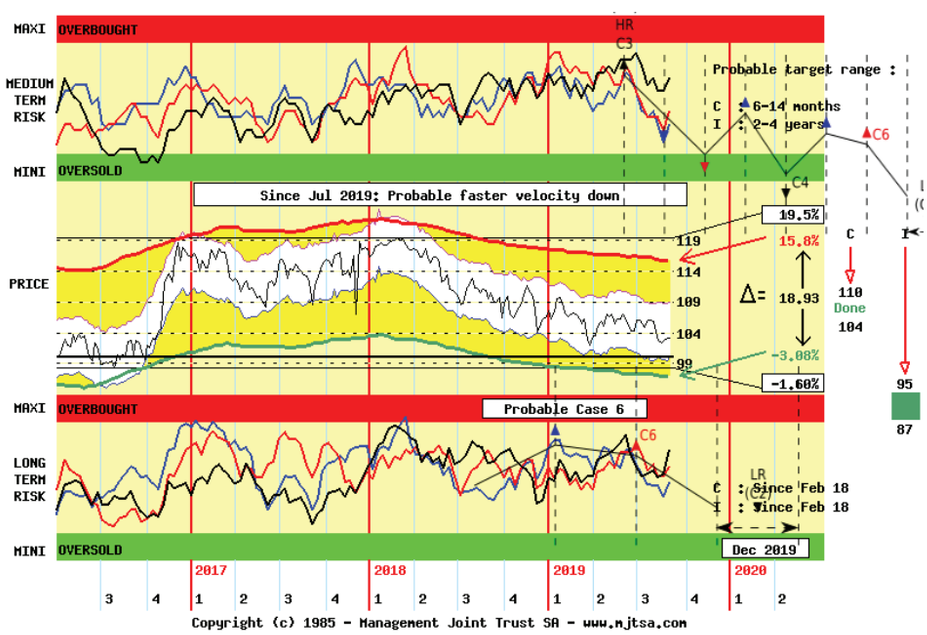
We now turn to US Cyclical sectors vs the S&P500 Index. The equal weighted portfolio we use contains US Industrials, Materials and Energy. It is compared to the S&P500. Since early 2017, these profiles have sustainably underperformed the S&P500 as such cyclical plays often have lower cash flow visibility than the general markets and are hence considered short duration equity plays. Indeed, this graph is very similar to the US10Y-US3Y yield spread graph presented in another article of this issue of The Capital Observer. Similarly to it, **it seems Oversold on our medium oscillators (upper rectangle) and is probably getting ready to bounce. Yet, this bounce may be relatively short lived, probably until year-end / early Q1, as shown on both oscillators series (lower and upper rectangles). Following that, we expect US Cyclical sectors to underperform the S&P500 during H1 2020. This does not necessarily mean that these sectors would fall, but simply that they could be giving up the lead to growth oriented sectors, following their strong re-rating during Q4 this year.**

SOX - Philadelphia Semiconductor Index vs S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



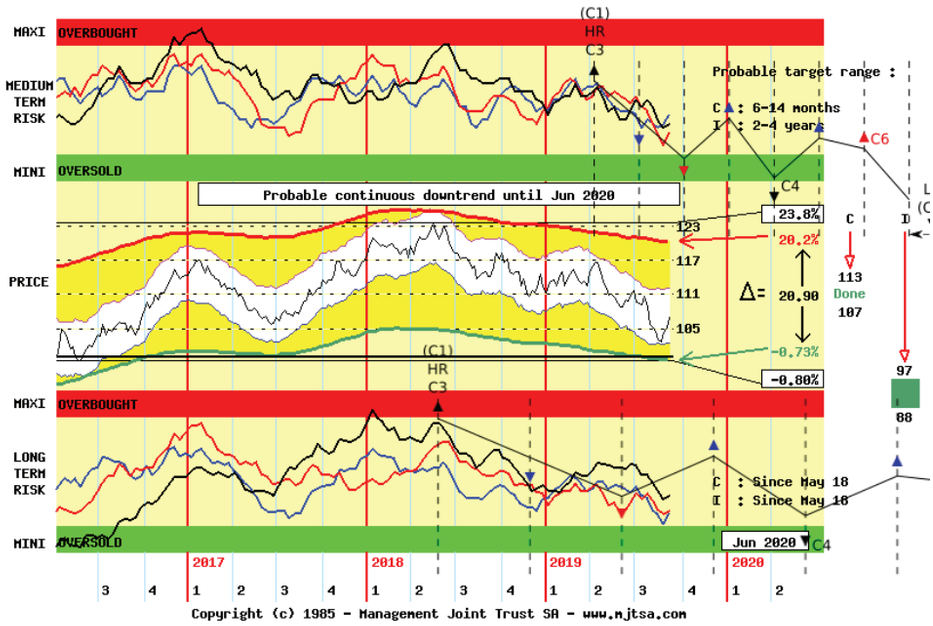
Some sectors may present a bit of both worlds, being highly cyclical, but rather Growth than Value. We take Semiconductors as an example of such profiles and compare them here to the S&P500. **Our long term oscillators (lower rectangles) built a base with ascending lows this Spring and could now continue to move higher towards early / perhaps Spring next year**. Our medium ones (upper rectangle) could see a slight retracement over the next few weeks, but should then accelerate up (i.e. outperform the S&P500) towards early next year. There is still a bit of price potential left on our I Impulsive targets to the upside (right-hand scale) and the move looks very dynamic, especially as we are talking about relative performance above the S&P500.

US Financials vs the S&P500 Index
Weekly graph or the perspective over the next 2 to 4 quarters



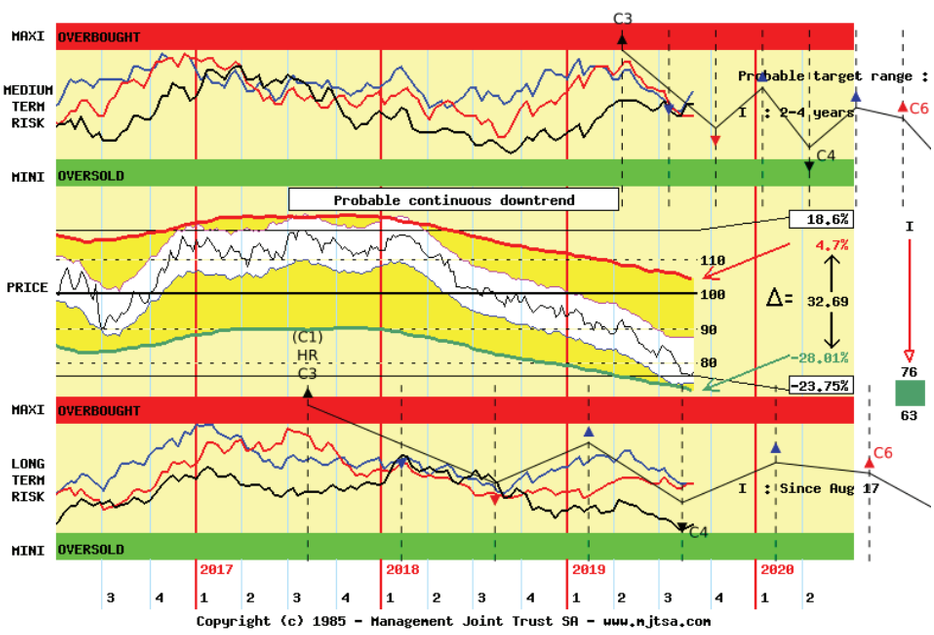
US Financials may also profit from a bounce in yields, yet compared to other US cyclical sectors, they appear rather weak on a relative basis. Indeed, according to both our oscillator series (lower and upper rectangles), **their ratio vs the S&P500 may take more time to find support during Q4, probably into mid Q4, before a potential bounce finally materializes into Q1**. The downtrend on US Financials vs the S&P500 is also less Oversold than for other US Cyclicals. This could leave more risk to the downside. Hence, we would probably wait for more confirmations into Q4 that the potential economic recovery and bounce in yields, we expect, are sustainable, before Overweighting them.

European Cyclical sectors vs the Europe Stoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



In Europe, the cyclical bounce we expect is probably also starting to materialize, at the latest, from early Q4 (the equal weighted portfolio we use here contains the European Automobiles, Natural Resources, Chemicals and Energy sectors). Both our oscillator series (lower and upper rectangles) do indeed suggest that this **relative bounce could take place from early Q4 into late Q4 and perhaps early Q1. It probably corresponds to a strong and rapid re-rating of European Cyclical sectors, which are very Oversold vs the market**. Following that, European cyclical sectors could start to underperform again vs the Europe Stoxx 600, probably during much of H1 2020. Yet, on a standalone basis, they will probably continue higher a while longer, just not as strongly as the general market.

European Banks vs the Europe Stoxx 600 Index
Weekly graph or the perspective over the next 2 to 4 quarters



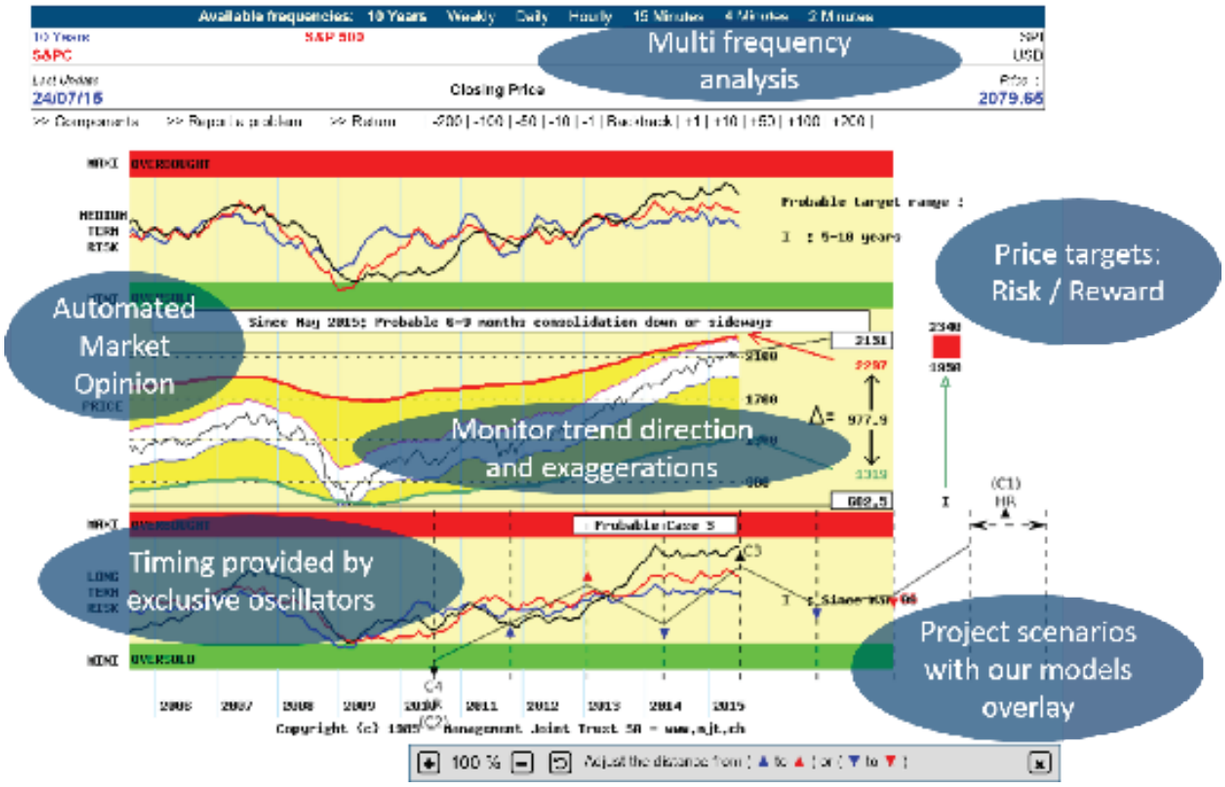
Finally, we look at European Banks vs the Europe Stoxx 600. Along, with other cyclical sectors these did start to bounce quite aggressively last week, both on an absolute and relative basis. On this ratio, our medium term oscillators (upper rectangle) suggest some downside retesting until early Q4 before a bounce materializes into Q1 next year. On our long term oscillators (lower rectangle), the bounce has already started, and European Banks may now continue to outperform until early next year. **Our view, is that along with equity markets, some retracement is still possible until late September / early October. From then on, equity markets, as well as highly de-rated sectors such as European Banks, could indeed outperform into early next year.**

Concluding remarks:

Year to date, equity markets have climbed a wall of worry. Many of them have since recuperated much of their 2018 sell-off. Despite this strong performance, many residual risks are still present, or only starting to fade. Hence, the market positioning is still very defensive, and the defensive sell-off / cyclical rally that we saw last week could be just the beginning of a larger move, from defensives to cyclicals, as these residual risks continue to dissipate and cyclicity re-accelerates. Time-wise, we may still see a last period of retracement on equities into late September / early October and Defensive assets/sectors may attempt a slight comeback. But from the start of Q4, we then expect a strong cyclical equity rally into early next year, perhaps extending into the Spring.

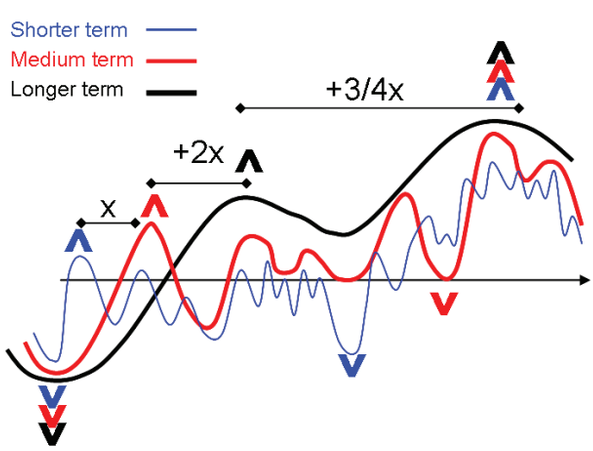
17/ METHODOLOGY

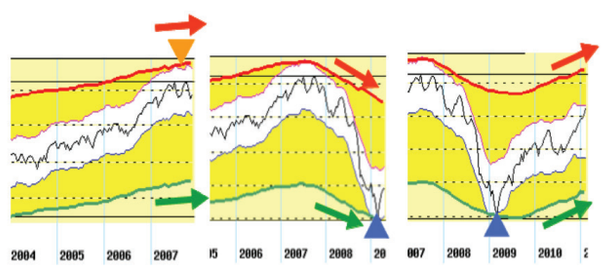
MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative charts, Opportunity filters, Multi charts monitoring screens and a Portfolio Simulation tool complete the functionality set. See below a description of What's on the Chart, a Methodological brief and an outline of the ideal Uptrend/Downtrend Models (read more on www.mjtsa.com)



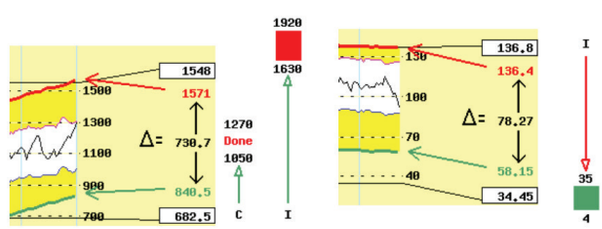
Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)

Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).

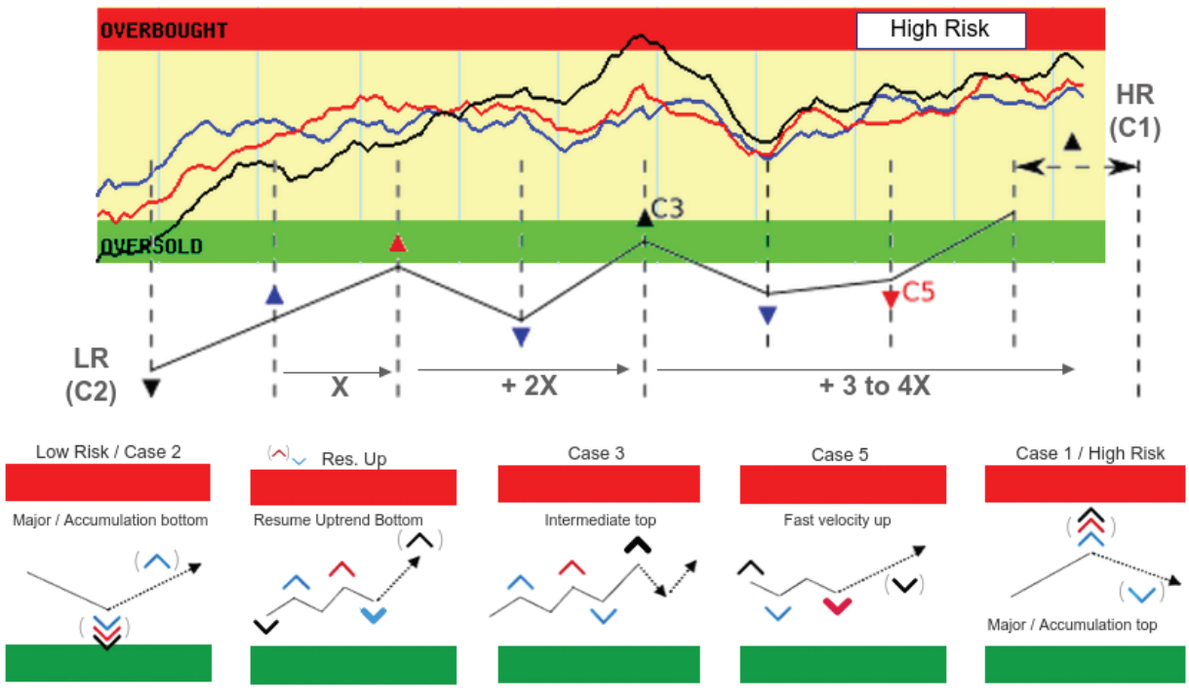




Price targets: based off historical volatility, they can highlight price potential or risk and, once achieved, define take profit or stop loss areas (e.g. below S&P500 in early 2011, Brent in October 2014).

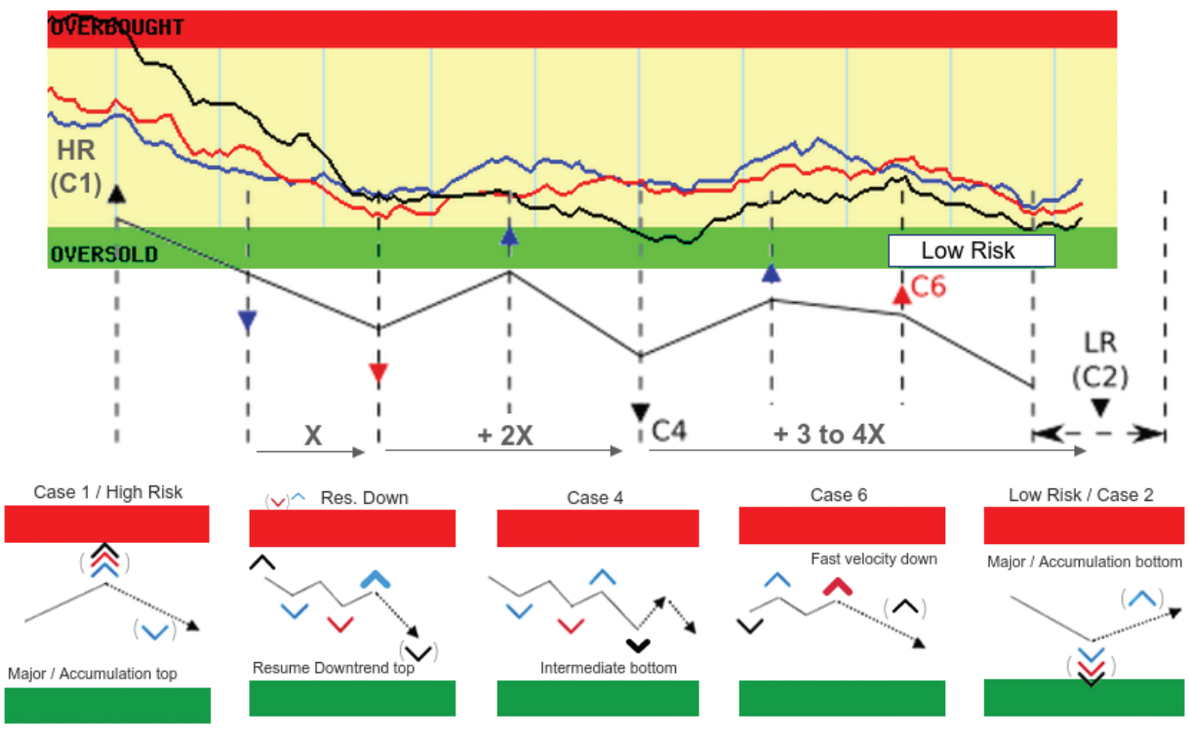


Ideal Uptrend Model



(left to right) from an oscillator black bottom (usually a Low Risk or a Case 2), the oscillators and prices will start moving up. An uptrend is confirmed once a red top can be made above a blue one. The correction down that follows delivers a buying opportunity ("Resume Uptrend") followed by an intermediate top (Case 3). A new period of consolidation down or sideways then starts, ending with a Case 5 acceleration up towards an important top (usually a High Risk or a Case 1). For each time frame, a fixed time unit separates each timing incidence, so that the distance between a blue and red top is usually X, the distance from the red to the black top is then 2X and the distance between the first and second black top is 3 to 4X.

Ideal Downtrend Model



(left to right) from an oscillator black top (usually a High Risk or a Case 1) the oscillators and prices will start moving down. A downtrend is confirmed once a red bottom can be made below a blue one. The correction up that follows delivers a selling opportunity ("Resume Downtrend") followed by an intermediate bottom (Case 4). A new period of consolidation up or sideways then starts, ending with a Case 6 acceleration down towards an important bottom (usually a Low Risk or a Case 2). For each time frame, a fixed time unit separates each timing incidence, so that the distance between a blue and red bottom is usually X, the distance from the red to the black bottom is then 2X and the distance between the first and second black bottom is 3 to 4X.

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