THE IFA's Wealth Gram

LA TRIBUNE MENSUELLE DES MEMBRES DU GSCGI
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ANALYSES & PLACEMENTS

So the Fed raised policy rates 25 bps: this tightening regime should not last very long

...Extract from the March Capital Observer, a DC&C publication featuring MJT's timing methodology

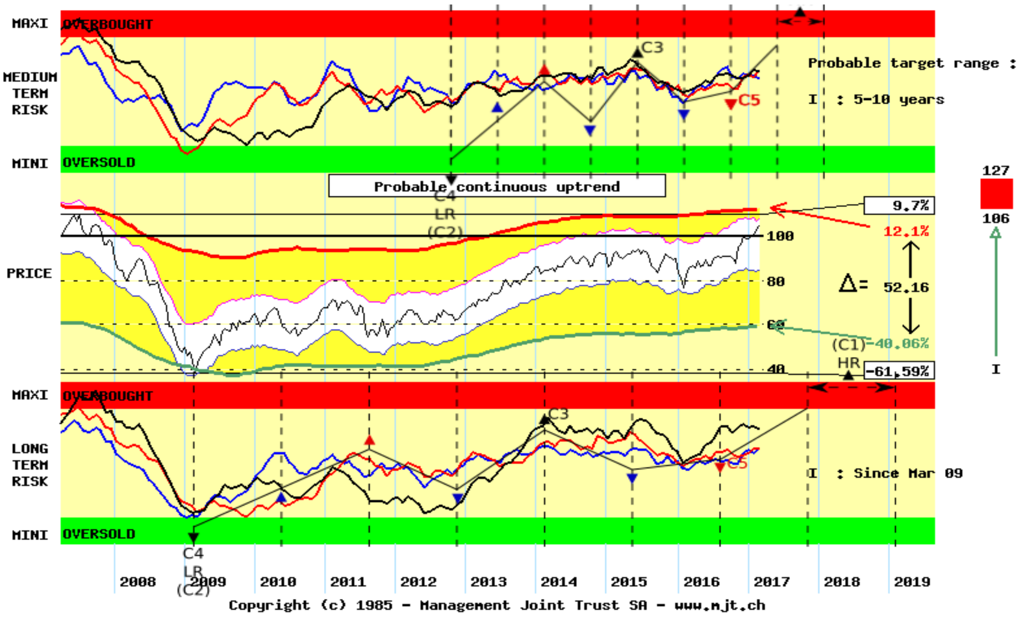
So the Fed raised rates 25bps, an outcome that was pre-ordained as long as a week ago, after the February jobs data exceeded expectations and following a round of Fed speak in the week prior to the blackout period. The only drama left of the FOMC meeting was what signal the Fed sends with the statement, the nuances expressed during the press conference, and the rearrangement of the so-called "SEP dots." The Fed did not disappoint the monetary policy hawks with the overall message signalling general confidence in the economic outlook while providing assurances that the Fed is neither behind the curve nor intends to fall behind the curve. The Fed took the optimal route, giving itself room to tighten policy at a gradual pace if they so desire. Given the Fed's pent-up desire to normalize policy, and given the cover that they were provided by the labor data set, two further hikes this year is indeed gradual as viewed from the Fed's perspective and many market participants. But basically, the slightly accelerated tempo just puts the Fed back to where they started in 2016, except that *(after the debacle of the December 2015 tightening)*, the Fed expects this "gradual" tightening regime to actually work out this time.

MJT Timing and Tactical insight:

The FED's move to hike this week was labelled a "Dovish hike" as it gave little guidance as to where rates were headed in the long run. Concomitantly, with Oil on the correction path, many analysts are viewing these developments in the yield curve as a "Bearish flattening" *(the short end rising faster than the long end)*. We believe that this situation is transitory.

S&P500 vs Treasury Notes 10 Years Contract (Mar)

(Bi-monthly chart or the perspective over the next 1 to 2 years)



We use this equity to Bonds ratio as a revealing agent of reflationary and dis-inflationary periods. Following the lows made in Q1 2016, the long term trend is heading up again. The sequences on both our oscillators series (lower and upper rectangles) point to further acceleration in the reflation path until tops are made towards late 2017 or into H1 2018. The potential for Equities versus Bonds during this period (targets, right-hand scale) suggests an outperformance that could reach 10% to 20%.

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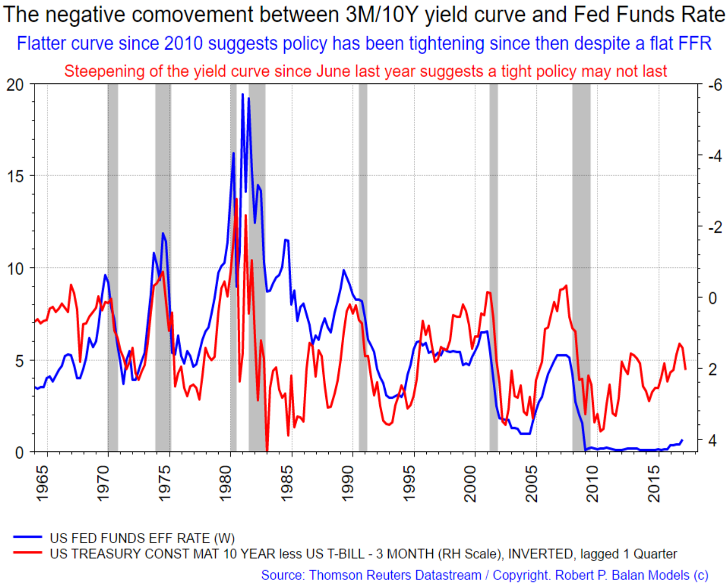
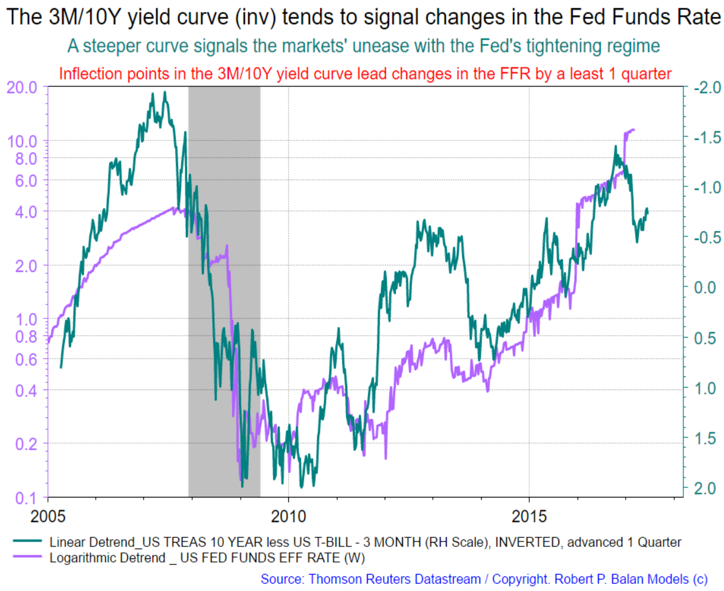
But we ask: "gradual" relative to what? And what makes them so sure *(otherwise, they would not have raised rates)* that there will be no repeat of the post-December 2015 climbdown? We have serious doubts that this long, so called "gradual" tightening regime will gain much traction in the light of developments happening in the yield curve space and in some of the underlying data that matters.

One feature of the bond markets that was brought about by the repression of the short-term rate since the Great Financial Crisis (GFC) is that most movements in the 3M/10Y yield curve now occur at the long end of the curve. Prior to the GFC, it was the other way around due to the sensitivity of short-term Treasury bond yields to adjustments in monetary policy.

Nonetheless, the negative comovement in the changes between the 3M/10Y and the Fed Funds Rate has remained – and is a testament to the flat nature of the short end rate – most of the changes in the curve is accounted for by the long rate which is a strong discounter of future events. And the crucial element in the relationship is that changes in the yield curve tends to lead the changes in the policy rate, exactly due to the anticipatory characteristic of the now more active long rate *(see top chart on right)*.

We routinely use the 3-month Treasury bill rate as a proxy for the Fed's policy rate *(the Fed Funds Rate, FFR)*. Therefore, it makes sense that if you juxtapose the yield curve against the FFR, changes in the yield curve provides a view of what to expect from the FFR future moves, with a lead of at least one quarter *(see chart on right)*.





The usual narrative about the slope of the yield curve that you read in the media has not been "upgraded" by the fact that the Quantitative Easing (QE) programs conducted by the Fed as a response to the GFC has changed the nuances in the relationship of many financial variables. The narrative remains the same. "Raising short end rates does not shift long-term yields. As a result, the yield curve becomes flat and in some cases, inverted. This is important as an increase of spreads usually indicates that investors are optimistic about the growth rate of the economy while, on the other hand, a narrowing of spreads implies a weakening economic outlook." This interpretation is not essentially incorrect, but it misses the important nuances in the signalling process provided by the yield curve on monetary policy. Steepening of the yield curve does not necessary imply that investors are optimistic about the economy – the shift in the orientation of the slope from flat to steep merely means that investors begun to anticipate that the tightening regime should not last very long or is not going to last long if the steepening happens at the start of a tighter policy regime. And that curve steepening opens a can of worms insofar as economic growth is concerned, and investors have no reason to cheer a steeper curve if its implications to credit supply and to job creation are properly understood.

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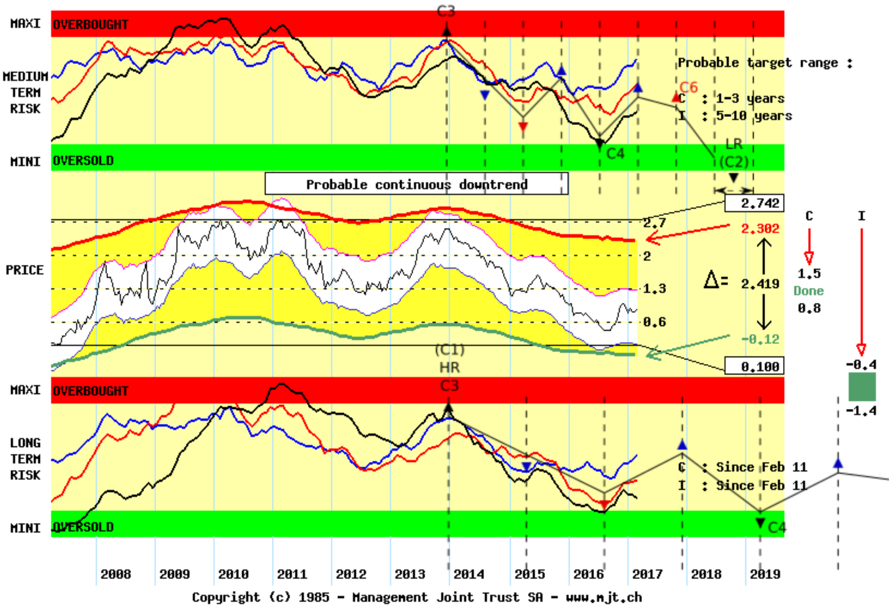
MJT Timing and Tactical insight:

USD Swap Rate 10 Years - USD Swap Rate 2 Years

(Bi-monthly chart or the perspective over the next 2 to 4 quarters)



The curve has made a first leg up during H2 2016 and could theoretically already be rolling over (our medium term oscillators, upper rectangle). Yet, the pronounced bottom made mid 2016 on our long term oscillators (lower rectangle) rather suggests that an important reversal has been made. We hence build the case that steepening could continue during H2 2017, i.e. a slight flattening on the current top into late Q2 2017 (upper rectangle) and then a second leg up in steepening during H2 2017 (lower rectangle). Our current understanding is that the maturing business cycle will probably limit the potential for many rate hikes on the short end, while commodity led inflation should remain strong during H2 2017, lifting the long end of the curve.

One implicit reason for the Fed's resuming the tightening regime is that growth will be "stable" – but this assumption may be tested in a few weeks when Q1 2017 GDP growth will be reported *(on the 28th of April 2017)*. It is looking a little grim, if the Atlanta Fed's GDP Nowcast is to be believed. Its real GDP growth *(seasonally adjusted annual rate)* Nowcast in the first quarter of 2017 is at 0.9%.

Another reason for concern is a development, which may or may not be linked, to this grim growth outlook being projected by the Atlanta Fed growth model -- a sudden collapse in loan growth in general, and in the crucial Commercial and Industrial Loan segment in particular. It is a collapse which has the normally staid Wall Street Journal describing it as an «ominous economic signal.» Total loans and leases by U.S. commercial banks are currently rising at an annual pace of about 4.6%. which is down from a 6.4% pace for all of 2016, and from the peak rates of circa 8% during mid 2016. This is the slowest pace of debt creation since early 2014. The WSJ noted that «is at odds with the idea of a stronger economy and rising sentiment,» as deceleration has been broadbased among business, real estate and consumer lending. The decline in growth rates and in nominal volumes have been particularly sharp in the Commercial and Industrial loan category, which has unexpectedly fell to just 4.0% as of the latest week, relative to the pace of growth of 10% during the first half of 2016. The falloff was circa 50% lower than the 7% growth posted earlier in the year. The current loan growth is the lowest pace since July 2011.

Simply put, the banks did hit the brakes on lending, and it has something to do with the improvement in their Net Interest Margins (NIMs). The current improvement in NIMs has something to do with the steeper yield curve which we saw from June 2012 to January 2014. It takes a while before the steeper curve translates into wider NIMs, which started to expand since Q2 last year. In a sense, the current fall-off is a stronger response into that widening, and bank lending drought will continue for some time, perhaps until at least late Q3 this year. But the flatter yield curve between July 2015 and September last year should bring relief to the loan situation shortly. The lags between the yield curve and actual changes in micro-data are long, at least 5 quarters even 7 quarters in some cases, so it is easy to overlook the rationale for a micro-event that is happening now. There is no "efficient economy hypothesis" for yield curve related financial phenomena.

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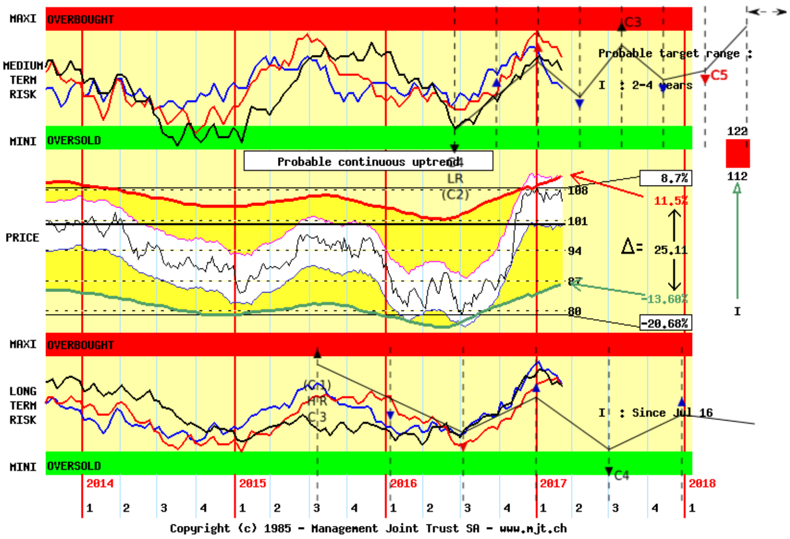
MJT Timing and Tactical insight:

KBE – S&P Bank ETF vs S&P500 Index

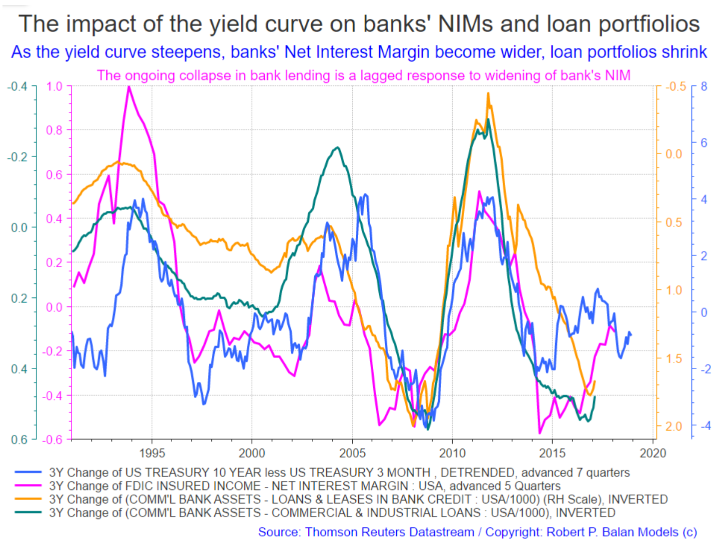
(Weekly chart or the perspective over the next 2 to 4 quarters)



Banks are a great proxy for the trajectory of the yield curve. As it steepens, margins on their lending business improve, allowing them to shift some resources to less risky fee generating businesses. This is why they are often considered late cycle movers. Indeed, their Weekly relative chart to the S&P500 has been following the Yield Curve closely since it bottomed in mid 2016. As with the Yield Curve, we expect a mild retracement of their outperformance towards late Q2 2017, before they accelerate up again in H2 2017.

The impact of the yield curve-NIM dynamics does not stop with the banks' credit-creation process. If we go back to First Principles and identify the crucial data sets which influence the jobs market in the core, there nothing more primary in this regard than credit extended by commercial banks, the steepness of the yield curve, and the banks' consequent Net Interest Margin (NIM) – and now this foundation of the current job phenomenon is under attack. To understand how this comes about, we have to follow the narrative from the outset *(see chart on right)*.

Collectively, if banks' non-performing assets are high, their NIM will go down if the interest earning assets are steeply reduced by non-performing assets, and vice versa. A steeper yield curve provides better conditions for the banks' NIM to rise, which reduces the need for larger portfolios for riskier loans - hence loan levels fall when the yield curve steepens. The linkage to the job sector flows from the steepness of the yield curve to the amount of lending then to the jobless insurance claims and the unemployment rate. Put another way, when the yield curve steepens, commercial lending volume falls, and the tighter credit situation impacts hiring and payroll growth after a lag, with concomitant effects on unemployment and jobless insurance claims.



Developments in lending usually take several quarters to manifest in the jobs market, so it may be that we have a few more months of jobs growth. But it is increasingly becoming clear that the upswing phase of the current Business Cycle is starting to show signs of aging. Under these conditions, we do not expect the Fed to be able to tighten policy for as long and as quickly as they have indicated in their current Summary of Economic Projections (SEP) dot plots.

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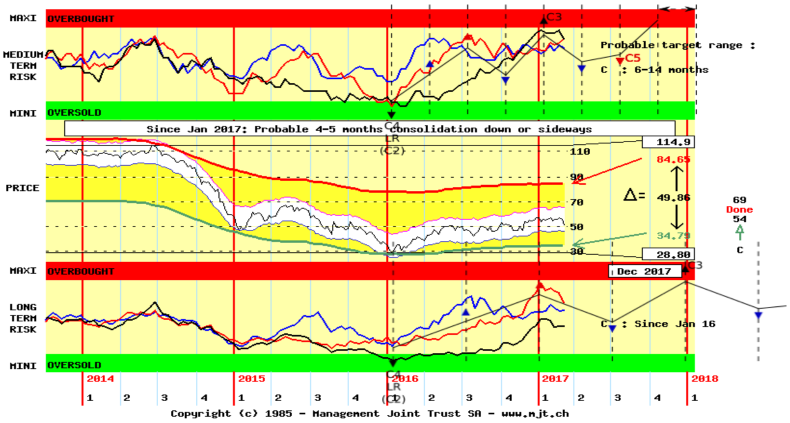
MJT Timing and Tactical insight:

Brent Oil

(Weekly chart or the perspective over the next 2 to 4 quarters)

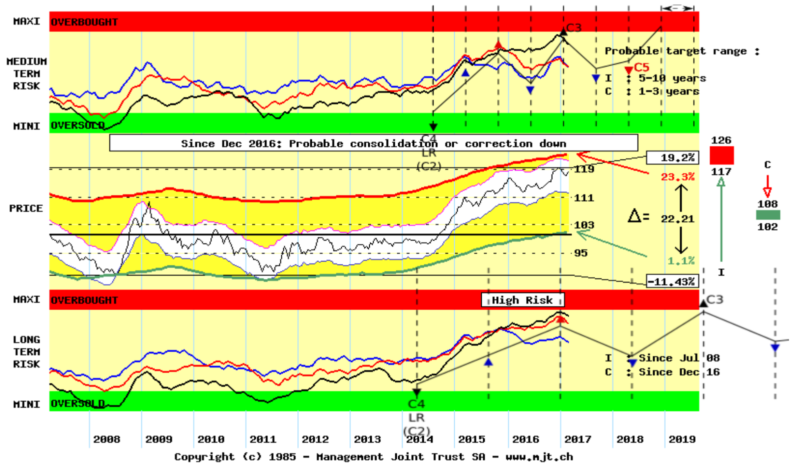


Oil has been the key reflation asset during "Reflation I" (2016 into Q1 2017) and will prove crucial again in fomenting "Reflation II" (H2 2017 into 2018). Oil is now consolidating down following the tops recently made on both our oscillator series (upper and lower rectangles). We believe it should resume its uptrend from late Q2 2017 to go test the upper end of our "C" corrective targets up during H2 2017 (USD 69 per barrel; right-hand scale). Above those levels, the next price targets range is between USD 90 and 100 a barrel.

Trade Weighted Dollar (TWD) – simulated using effective weightings

(Bi-monthly chart or the perspective over the next 2 to 4 quarters)

This is the Dollar the FED monitors as it is the one the US consumers actually feel. On this long term chart, both oscillator series (lower and upper rectangles) have confirmed a potential top. "I" impulsive targets up (right-hand scale) had been achieved. The "C" corrective potential down indicates that the correction down could now range from minus 10% to minus 20%. As this correction down potentially accelerates into H2 2017 (while, as we mentioned above, oil moves up again), inflation expectations should also increase (i.e. the worst kind of inflation, not dissimilar to what was seen during 2007). Long term rates should follow suit, while the short end could be capped by the maturing business cycle.



Conclusion

We've reached the eye of the storm as far as reflation goes. During this transitory period, we expect some retracement of reflation trades until late Q2 2017 *(possibly from late April onwards)*. Following that, a second leg up in the reflation trend should materialize in H2 2017 *("Reflation II")*, fuelled by a new rise in oil prices, a weakening Dollar, higher inflation expectations and a maturing business cycle. It will ultimately cap the potential for shorter term rate hikes, lift long term interest rates and result in further steepening of the yield curve during H2 2017.

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Education in mining engineering, computer science, finance, and training in economics led to a commodity analysis career during the commodity boom of the early 1970s. Robert switched to global macro focus in the early 1980 with specialization in foreign exchange. Robert wrote a very high profile daily FX analysis while Geneva-based in the mid-1980s *(the first FX commentary with a real global readership)*. He worked for Swiss Bank Corp and Union Bank of Switzerland as head of technical research and as proprietary trader in London, New York, and subsequently head of proprietary trading in Toronto, from late 1980s to mid-1990s. A stint at Bank of America as head of global technical research *(in London and New York)* followed in late 1990s to early 2000s. He returned to Switzerland in 2004 as head of technical research and strategy, and FX and commodity market analyst for Swiss Life Asset Management in Zurich. He joined Diapason Commodities Management in 2008 as senior market strategist, and subsequently as Chief Market Strategist. He is now part of the team of Diapason Currencies and Commodities UK and a key contributor, as Macro strategist, to the Capital Observer publication (http://www.thecapitalobserver.com). Robert wrote a book on the Elliott Wave Principle in 1988, which was hailed by the London Society of Technical Analysts as "the best book ever written on the subject". Robert is a member of the National Association for Business Economics (NABE), USA.

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Jean-François is the CEO of Management Joint Trust SA (MJT - www.mjtsa.com), a company founded in 1969 in Geneva Switzerland, which provides institutional market advisory services based on proprietary algorithms. The methodology uses Timing oscillators, Trend analysis and Price Targets calculations to monitor risk/reward and cyclicality as well as project likely market scenarios over time frames ranging from longer term charts to intrahour. Coverage includes circa 5'000 instruments over all asset classes *(stocks, indexes, ETFs, commodities, bond indexes and interest rates)*. On the institutional advisory front, MJT specializes in intermarkets scenario building as well as asset and sector rotation analysis across the business and market cycles. Jean-François started his career in investment banking *(Paribas, then Deutsche Bank in London)*, joined MJT in 2003 and was awarded the International Federation of Technical Analysts' Bronwen Wood Memorial Award in 2013 *(for the best CFTe certification diploma paper in the world during 2012)*. Under his supervision, MJT's research was nominated in 2015 and in 2017 *(this year)* as Finalist in The Technical Analyst Awards "Best Specialist Research category". Jean-François also acts as Lead technical analyst for The Capital Observer publication (http://www.thecapitalobserver.com).