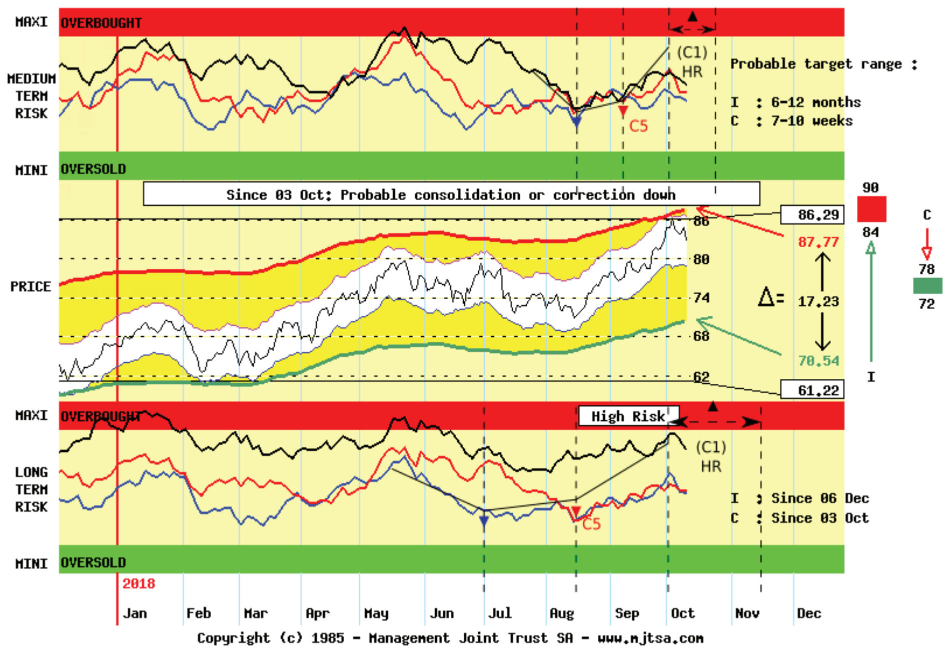
27 / MJT - TIMING AND TACTICAL INSIGHT

In search of the neutral rate Graal

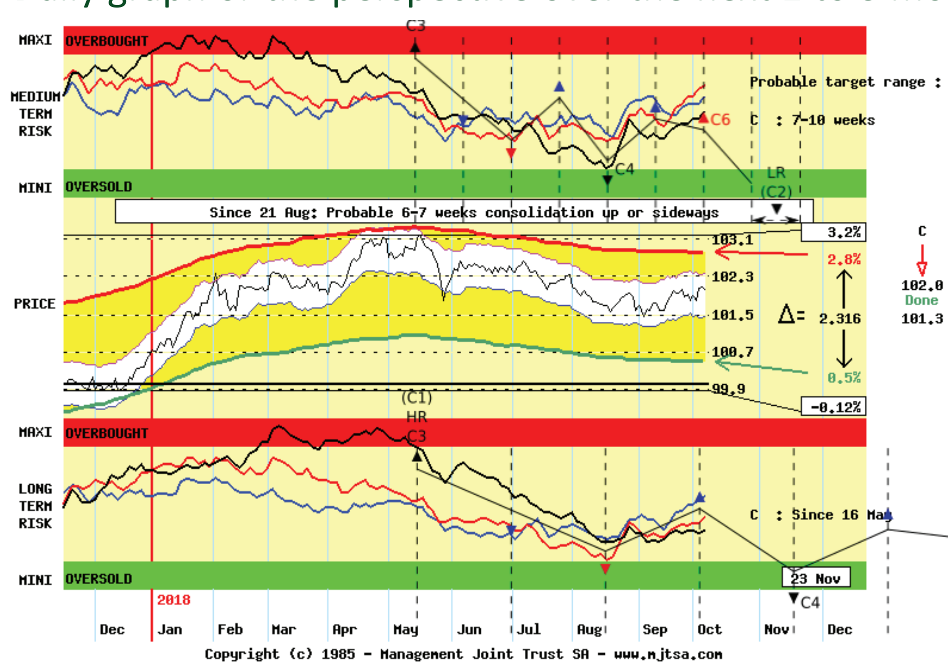
There's been a lot of talk in recent weeks about the natural neutral rate of interest rates. Fed Chair Powell is telling us that it is probably a few more rate hikes way. Yet, it is a trial or error process, and historically the FED has had a tendency to overshoot. As in January, following this past week's acceleration up in long term yields, equity markets have started to correct. This market weakness may constitute an early warning, i.e. for financial markets at least, the neutral rate is perhaps not that far away.

Brent Oil (USD/barrel)
Daily graph or the perspective over the next 2 to 3 months



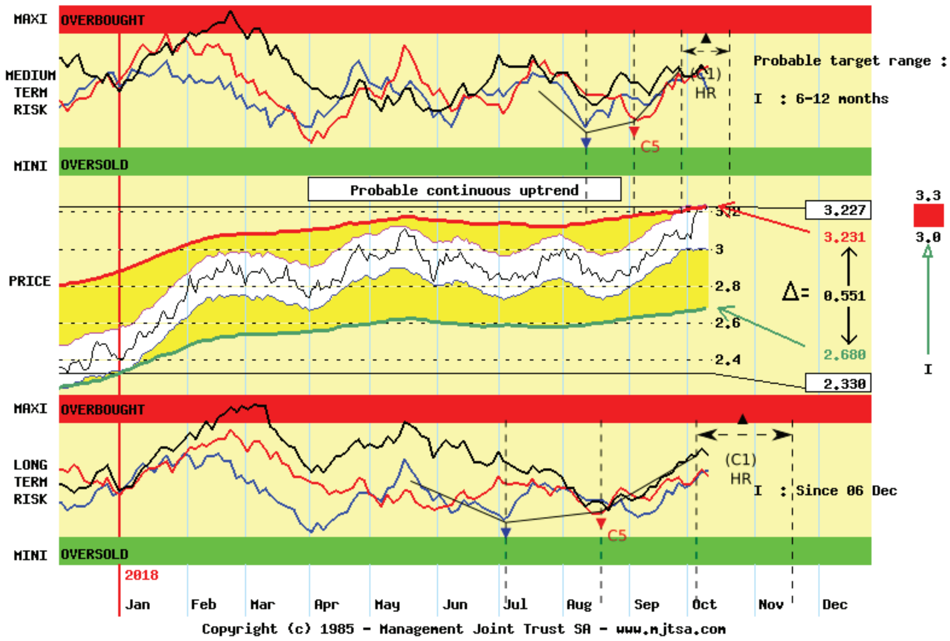
Since mid 2016, there's been a strong co-movement between oil, inflation perspectives and US long term yields. We hence start this article on yields with the analysis of Brent. Last month, we expected it to retest up and make marginal new highs, probably until early October. The break-out has been slightly stronger than we expected. Yet, we would confirm our early October timing for a top and a subsequent correction to the downside. Indeed, the sequences we show on **both our oscillator series (lower and upper rectangles) have now entered High Risk situations. On this Daily graph, these would usually trigger between 2 to 3 months of correction to the downside.** On the target front, we've pretty much reached our I Impulsive targets to the upside between 84 and 90 USD/barrel (right-hand scale). **The C Correction targets to the downside we can calculate would imply a correction of minus 8 to 14 USD/barrel at least over the next few months** (or minus 0.5 to 0.8 times our historical volatility measure "Delta", here at 17.15; middle graph, right-hand side). **Hence, we expect oil to top out soon and correct down into late Fall.**

TIP - iShares TIPS Bond ETF / IEF - iShares 7-10 Year Treasury Bond ETF
Daily graph or the perspective over the next 2 to 3 months



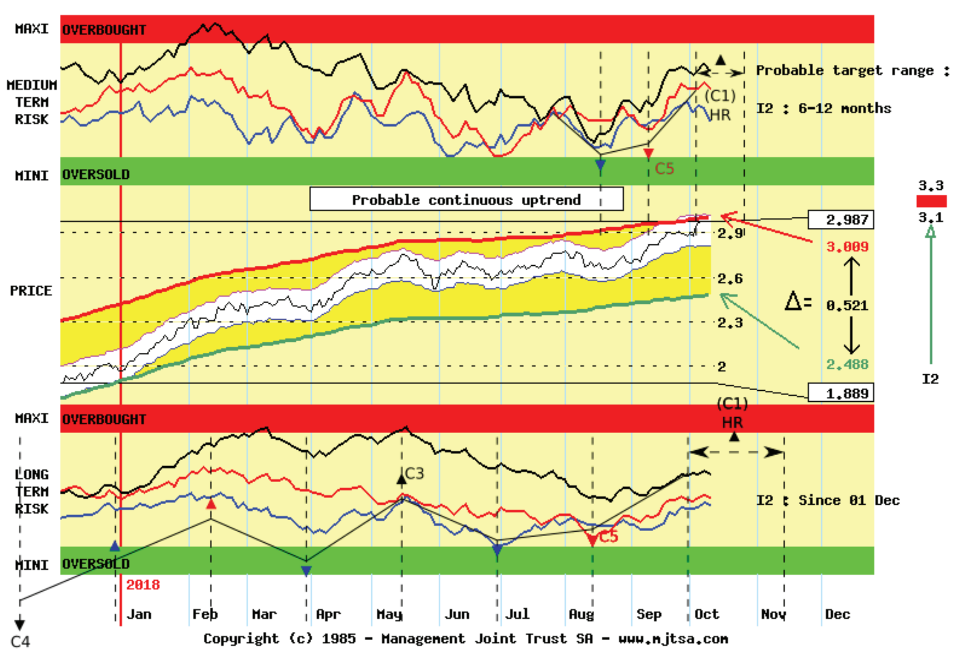
Inflation is a typical residual phenomenon in a maturing business cycle. What is important however is to determine if inflation expectations are continuing to be revised up, or if their upside momentum has started to stall. The TIPs vs Treasuries ratio tends to confirm the latter. Indeed, it topped out in May and has been consolidating down since. Its September bounce was also far weaker that the recent upside break-outs on Oil and in long term US Treasuries. According to both our oscillator series (lower and upper rectangles), **this relative weakness should continue into the Fall, and we expect the TIPs vs Treasuries break-even ratio to resume lower soon, probably until late November in first instance.** In early September, the ratio rebounded on the support of our C Corrective targets to the downside (right-hand scale). During the next leg down, it may break below them. **If such is the case, we see little chance that Oil and long term US Treasury Yields continue their acceleration to the upside.**

US 10 years Benchmark Bond Yield
Daily graph or the perspective over the next 2 to 3 months



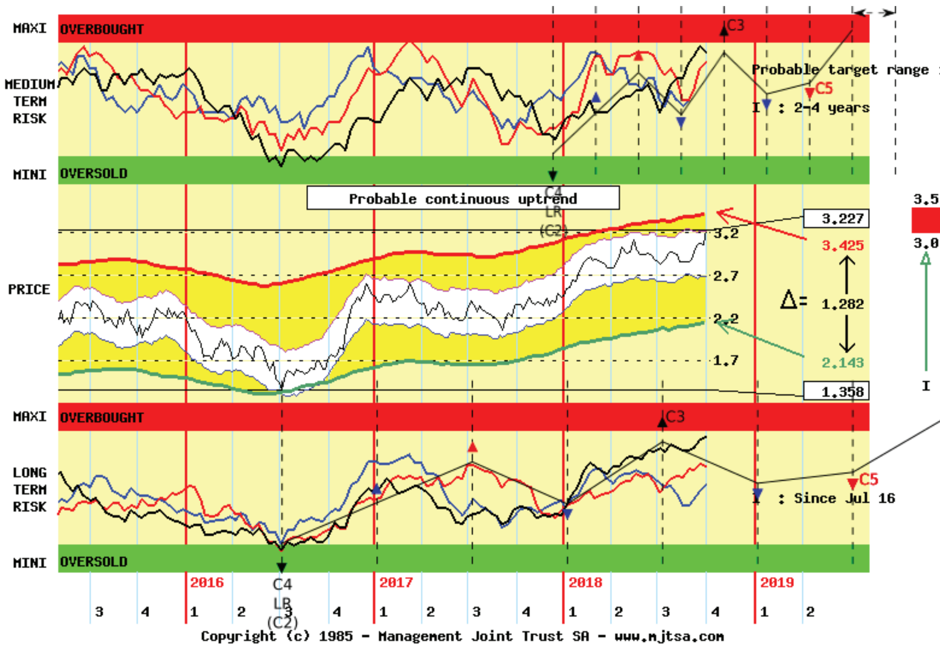
With market espectations on future inflation being rather subdued (consolidating TIP/Treasuries ratio), the recent acceleration up in US long term yields must be driven by a strong upward revision in real rates and ultimately in what the neutral rate of interest rates actually could be. That said, both our oscillator series have now entered High Risk zones (lower and upper rectangles), a situation that usually triggers 2 to 3 months of consolidation to the downside. Hence**, over the next few weeks, we expect the current acceleration up in long term yields to die out and start to reverse down**. Our I Impulsive targets to the upside (between 3.0 and 3.3%) are suggesting that the upside potential is also pretty much exhausted, and that **the risk/reward is now disadvantageous. In addition, the short position on US Treasuries is now at extreme levels and the market is probably quite vulnerable to a reversal, potentially followed by a rapid short covering spree.**

US 3 years Benchmark Bond Yield
Daily graph or the perspective over the next 2 to 3 months



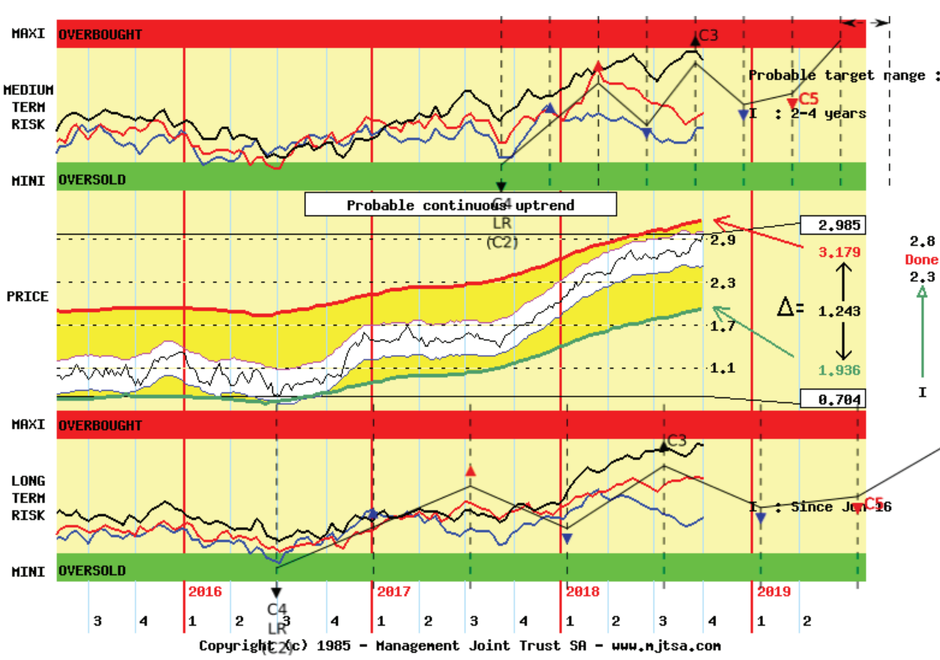
The graph on the 3 years tenure is quite similar. Here too, both our oscillators series (lower and upper rectangles) are entering High Risk zones. As mentioned above, these usually are followed by 2 to 3 months of consolidation to the downside at least. On the target front, US3Y yields are beyond their I Impulsive targets to the upside and would have only another 25-30 bps to rise before they exhaust our extended I2 Impulsive 2 targets (right-hand scale). Although, US 3Y yields closely follow US target FED rates up, it is nevertheless very rare that a market price/yield move can make it above our I2 extended Impulsive 2 targets to the upside. Hence, **the upside potential, even on this short term tenure is getting exhausted. Either, the FED is obliged to halt its rate hiking process earlier than it thinks, or US3Y yields may start to diverge and gradually lose momentum vs the Fed Fund rates. We believe it is probably a bit of both.**

US 10 years Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



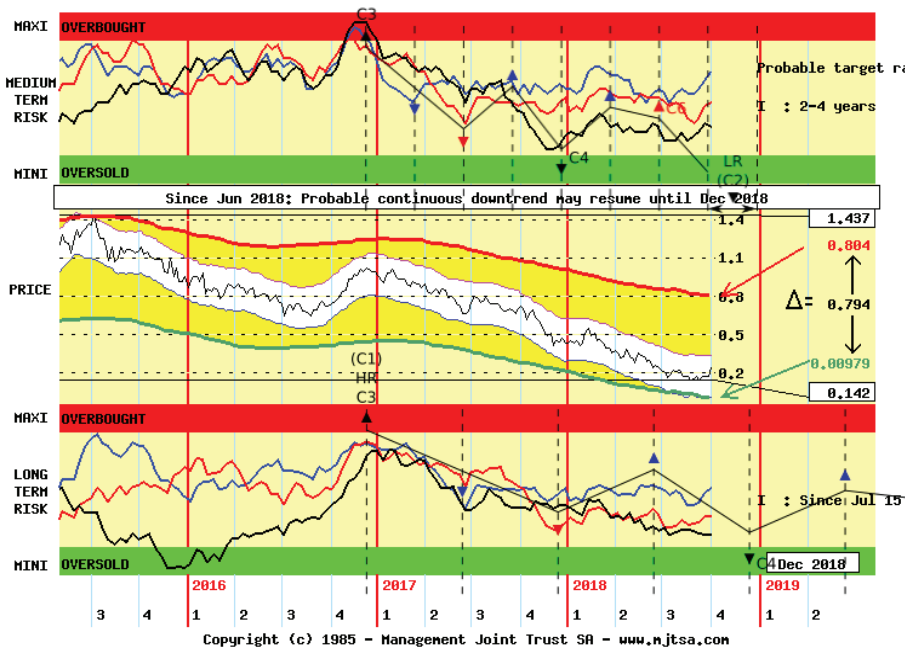
We now turn to the longer term Weekly graph of US 10Y treasury yields. Our long term oscillators (lower rectangle) are suggesting that an important intermediate top is already overdue. These yields should hence soon start to retrace probably into early, perhaps mid next year. **The sequence on our medium term oscillators (upper rectangle), on the other hand, is still rising for now, yet it probably doesn't have much longer to go (max 1 month), before it also hits a potential inflection point to the downside and starts to correct.** On the target front, we are now in the middle of our I Impulsive targets to the upside. This may still justify an acceleration up towards 3.5% to the max, but not necessarily. This compares to the circa 60 to 100 bps retracement potential we can calculate over the next few quarters (minus 0.5 to 0.8 times our historical volatility measure "Delta", here at 1.282; middle rectangle, right-hand side). **To summarize, we believe that the current leg up since last September could top-out soon, and that its remaining upside potential is rather small vs the downside retracement risk that lies ahead.**

US 3 years Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



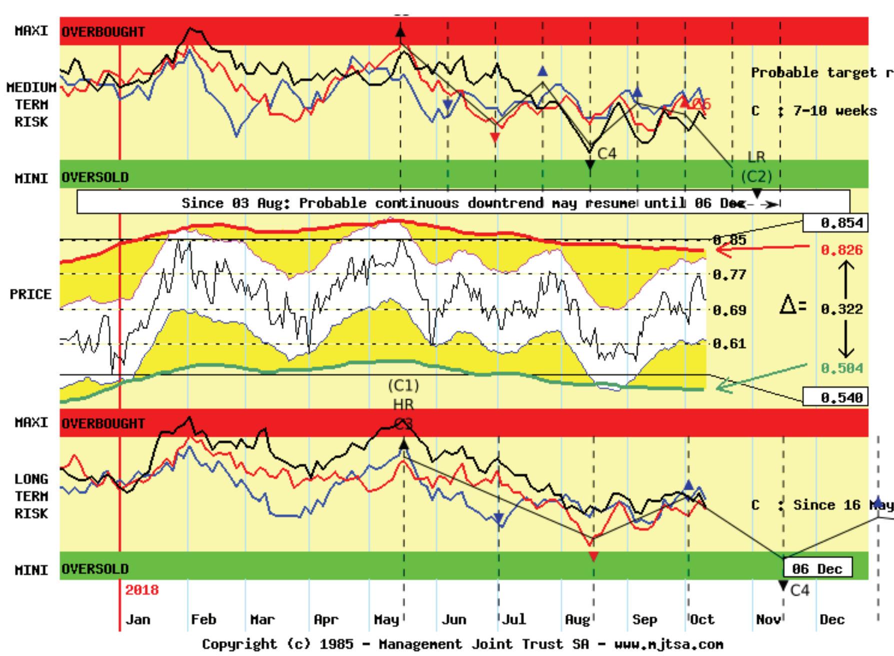
Similarly, on the 3Y tenure, the sequence on long term oscillators (lower rectangle) should have already topped out. In addition, here, our medium term oscillators (upper rectangle) also seem **ready to top-out and start reversing down**. Furthermore, the higher end of our I Impulsive targets (right-hand scale) has been reached, and hence the uptrend since mid 2016 is probably close to exhaustion. **As with US10Y yields, we expect US 3Y yields to retrace between 60 and 100 bps over the next few quarters** (minus 0.5 to 0.8 times "Delta", here at 1.243%; middle rectangle, right-hand side).

US 10 years Benchmark Bond Yield - US 3 years Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



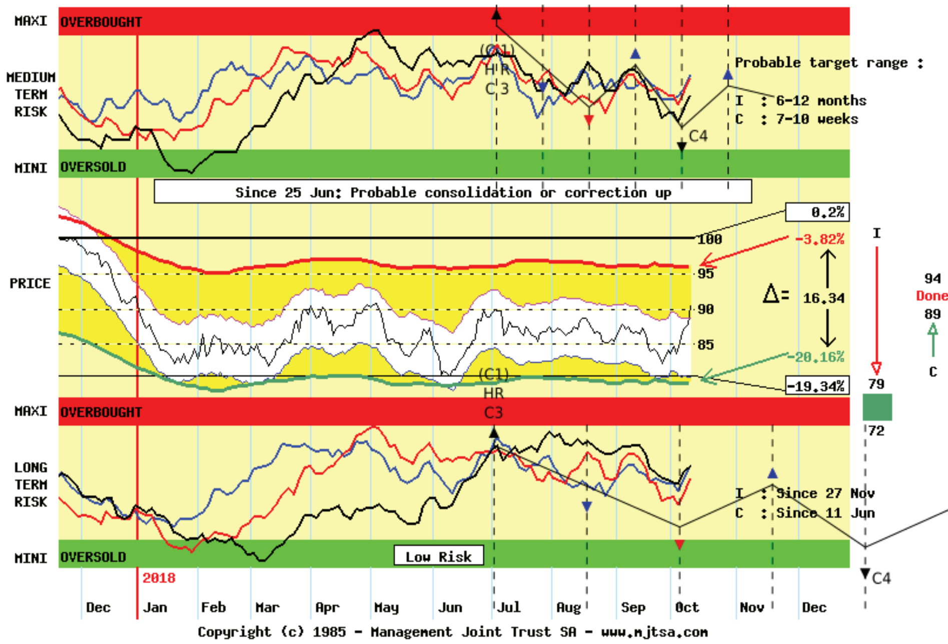
From our comments above, it may appear that the US3Y yields is closer to topping out that the US10Y Yields. Yet, we believe this discrepancy should be reversed over the coming weeks. **Indeed, while, since mid September, the US10Y-US3Y spread did see a light steepening bounce (plus 10 bps), both our oscillators series (lower and upper rectangles) are still suggesting that it will then probably resume lower until December at least**. On the target front (right-hand scale), the spread has pretty much reached its I Impulsive targets to the downside. Yet, it could still retest slightly lower once again. **This would bring it very close to inversion, probably by year-end, and whatever John Williams, NY's FED President, is saying about it "not being a deciding factor in terms of thinking about where 'we' should go with policy", yield curve inversions in the past have usually been bellwethers for an economy on the brink of deceleration.**

US 3 years Benchmark Bond Yield - US 3 months Benchmark Bond Yield
Daily graph or the perspective over the next 2 to 3 months



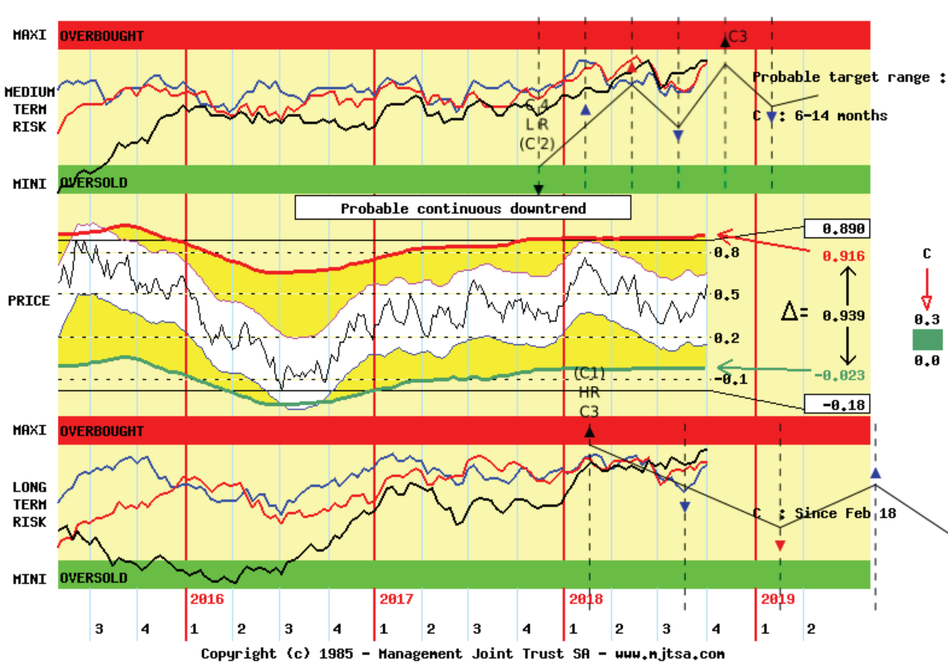
Last month, we did spend a bit of time on this graph as we believe that the shorter end of the yield curve spread, in this case the US3Y-US3M, has been a great proxy to monitor risk-ON and risk-OFF phases since the beginning of the year. For example, and similarly to today, in January, the spread did shoot up as treasury yields were rising rapidly. However, once the late January/February equity market correction started to accelerate lower, it then reversed down into March. We believe this could be happening again today. Indeed, although the rebound since early September has been stronger than we expected, both our oscillators series (lower and upper rectangles) are suggesting **that the spread should soon start to reverse down again, probably into mid/late November. Interestingly, equities had started to sell-off over the past week, which was also the case late January, right before the spread started to retrace and equity markets sold-off. The move should now continue lower towards late October, and then possibly into mid/late November.**

S&P Utilities Sector vs S&P 500 Index
Daily graph or the perspective over the next 2 to 3 months



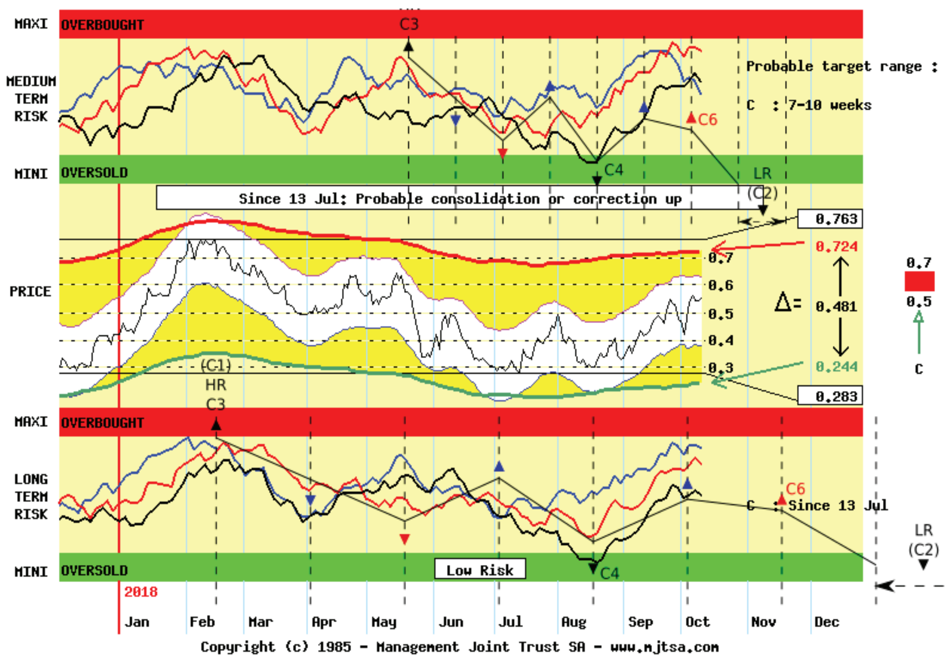
We now look at the other end of the spectrum, and to the Utilities sector, which is a typical equity bond proxy sector (defensive profile, regular and above average dividends). In this graph, we compare the sector to the S&P500 Index, and it appears that these relative dynamics since the beginning of the year are indeed quite similar to the ones of US Treasury (i.e. a first low was registered towards late January, then a retest into mid May/June, and finally more recently, a sell-off since early September). That said, this relative sector ratio may now be reacting slightly in advance. Indeed, **since last week, Utilities have started to turn up vs the market.** Both our oscillator series (lower and upper rectangles) suggest that **this rebound could last until late October, perhaps November at least. Theoretically, it is difficult to imagine a worthwhile outperformance of Utilities, while Treasury yields continue to accelerate up. Something must give in, and in our view it could be the uptrend on Treasuries.**

Germany 10 years Benchmark Bond Yield
Weekly graph or the perspective over the next 2 to 4 quarters



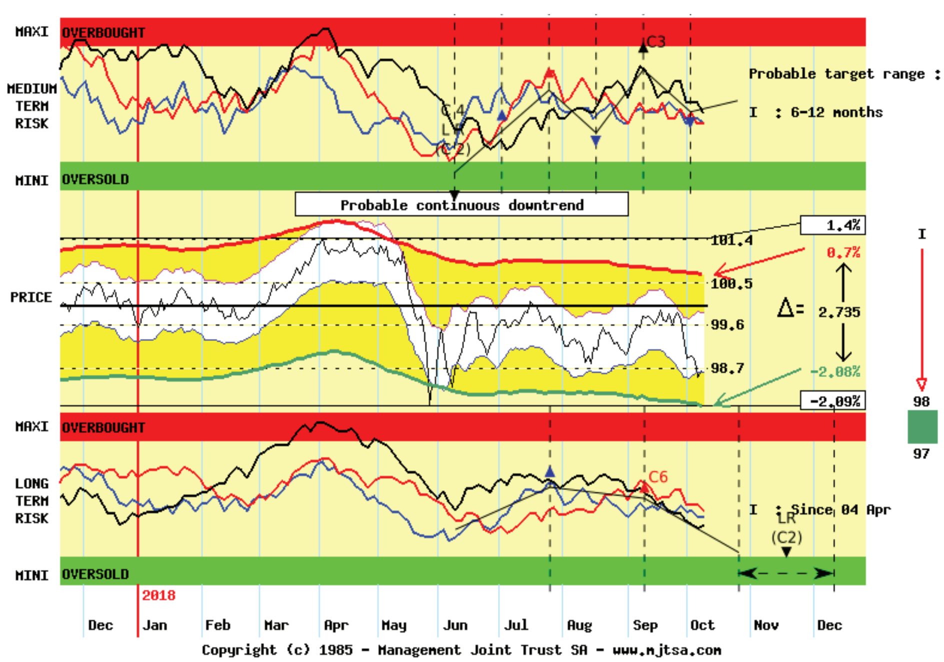
In this article, we've focused much of our comments on US Treasuries. Yet, in Europe, Bund yields have also been bouncing over the last couple of months. Indeed, the 10Y Bund yield, which topped out in January as the European Economic Surprise Index started to deteriorate, has moved up almost 30 bps since early July. Again here, as in the US, we believe this move up is probably coming to an end. Indeed, our medium term oscillators (upper rectangle) are suggesting that **the 10Y bund yield is topping out again soon, at lower price levels than this Spring. Such divergences are usually followed by strong sell-offs. In this case, we expect the next leg down to last probably into early next year as both oscillator series (lower and upper rectangles) are suggesting.**

Germany 10 years Benchmark Bond Yield
Daily graph or the perspective over the next 2 to 3 months



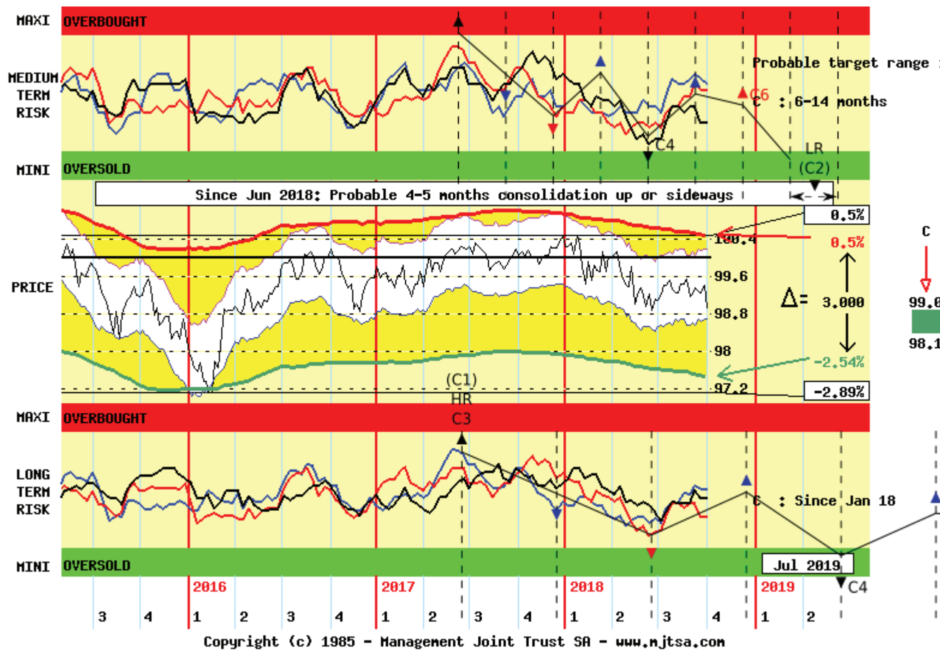
Turning to the Daily graph, both our oscillators series (lower and upper rectangle) made an important intermediate low mid August and started to react up. **Our preferred scenario is that the 10Y Bund yield is now getting ready to reverse down** as shown on our long term oscillators (lower rectangle). This is in line with what we describe above on the Weekly graph. Alternatively, yields could retrace slightly during October and then start to accelerate up again, first into November, and then into next year (medium term oscillators, upper rectangle). We believe it is much too early to consider this scenario and that for now the prevailing downtrend since February is still in place. **Furthermore, for now, the 10Y Bund yield is still below our C Corrective targets to the upside (right-hand scale), which would confirm that the current bounce is still only a counter-trend reaction. This should remain the case as long as 10Y Bund yields remain below 0.7%.**

iShares Euro Government Bonds 7-1 ETF / iShares Government Germany UCITS ETF
Daily graph or the perspective over the next 2 to 3 months



In Europe, the Sovereign Credit market seems to be deteriorating again. Indeed, as we expected last month, European Sovereign Bonds on average have started to underperform the higher quality German Bunds again. Both our oscillator series (lower and upper rectangles) have confirmed a top mid September, which we believe marks the end of the counter-trend bounce since late May. The current move lower could now potentially last into November / December at least, and according to our I Impulsive targets to the downside (right-hand scale), the sell-off could be similar in scope to the one that was experienced in May. **Further rises in Sovereign credit spreads in Europe will most probably trigger Flight to Safety flows towards the German Bund, thereby adding further pressure to the downside on their yields.**

LQD - iShares iBoxx $ Investment Grade Corp. Bond ETF / iShares Aaa - A Rated Corp. Bond ETF
Weekly graph or the perspective over the next 2 to 4 quarters



Back to Corporate Bond Spreads and the US, we now look at the overall US investment grade universe vs Aaa-A rated US corporate bonds . Indeed, **there is growing concern in the market, that the issuance of lower quality investment grade has exploded over the last few years and that many of these companies run the risk of being downgraded to junk once the credit cycle turns.** Higher Treasury yields are certainly putting additional pressure on this corner of the market and over the last few weeks, it seems that it is starting to break down. Indeed, both our oscillator series (lower and upper rectangles) are suggesting that the sell-off could now accelerate lower, probably into Spring / Summer next year. **These developments if they materialize are bound to trigger strong Flight to Safety flows towards the Aaa-A end of the market and into Treasuries, thereby putting a cap on their upward progression.**

Concluding remarks

Last month, we expected Treasury yields to retest to the upside until late September / early October. The strength of the upside break-out did however surprise us. For now, we still think that over the next few weeks, these dynamics could reverse and resume down again. US Yields have entered High Risk positions on our Daily graphs, while they are probably close to longer term intermediate tops on our Weekly graphs. Oil shows a similar profile, while other related trades such as TIP/Treasury break-evens, US Yield curve spreads or German Bund yields could also be getting ready to resume their downtrend, probably from now into mid/late November. Looking into 2019, we still expect that a significant period of retracement could materialize on Treasury yields, and that this correction to the downside may extend over the next 6 to 12 months. Our projections are that US Treasury yields could retrace between 60 and 100 bps across the curve during this period. Credit is another element that could add additional downside pressure on Treasury yields and Bund yields. Indeed, over the next few months, we expect credit spreads to continue their rising trend, possibly into early next year at least. This should trigger Flight to Safety flows towards Treasuries and higher corporate rated issues, put a cap to the upside on benchmark bond yields and gradually lead them to reverse down.