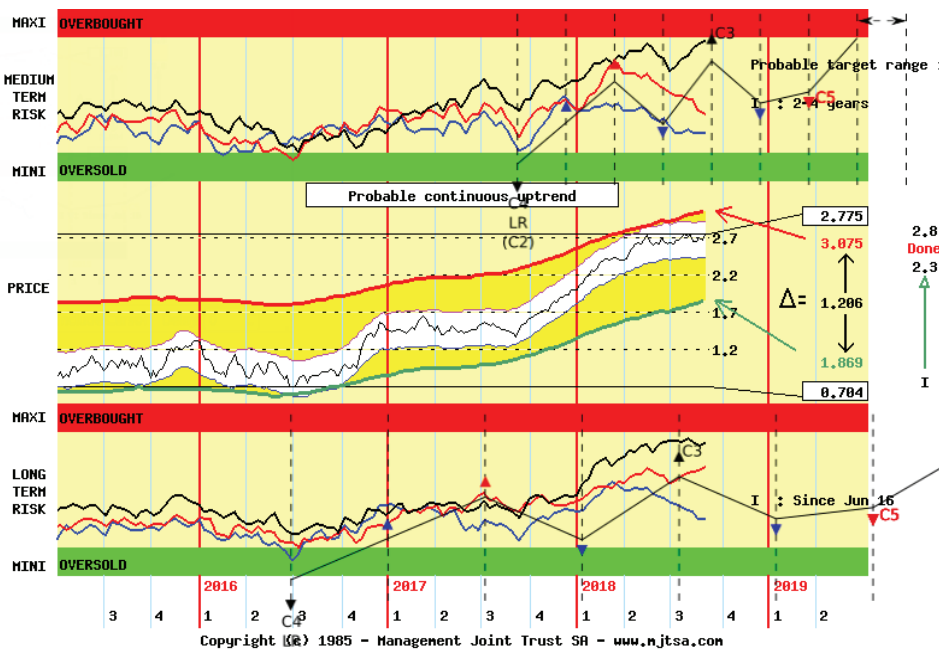
Flight to Safety is accelerating

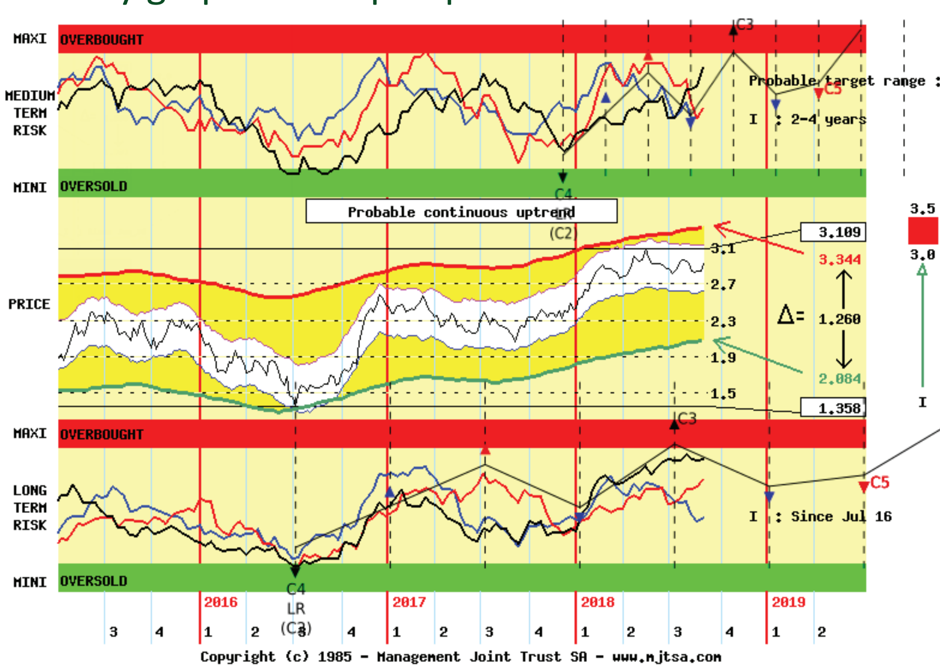
Since May, the rise in US Treasury yields has stalled. This is rather surprising given strong US GDP growth, a tight labour market, a Fed, which seems committed to several more rate hikes, and further increases in the supply of US Treasury Bonds. Consolidation or Distribution? In this article, we consider why US Treasury yields may getting ready to roll over and review what this implies for other asset classes such as developing and emerging equities and currencies.

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



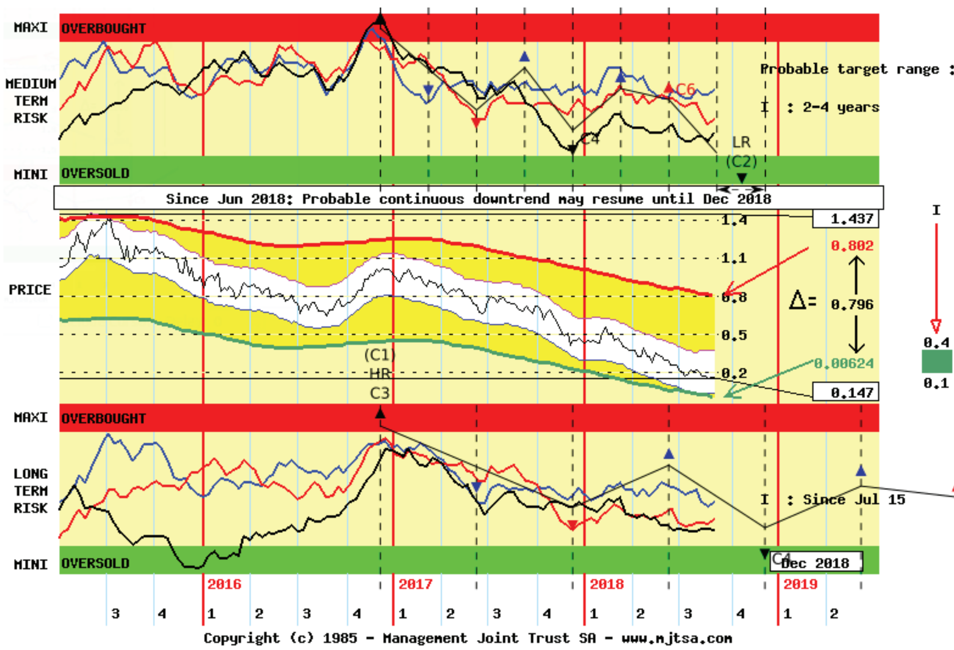
US 3 years Treasury yields have pretty much stalled since mid Q2, this despite an acceleration in Treasury issuance on the 2 to 5 years tenures (+ 1 billion USD a month on each on the 2Y, 3Y and 5Y issues). Indeed, while our I Impulsive targets to the upside between 2.3 and 2.8% have been achieved (right-hand scale), both our oscillator series (lower and upper rectangles), also seem to have reached important intermediate tops. Both sequences suggest that **a 6 to 12 months consolidation to the downside may be coming. During this period, US3Y Treasury yields may correct between 60 and 100 basis points** (0.5 to 0.8 times our historical volatility measure "Delta", here at 1.206%; right-hand side, middle rectangle).

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



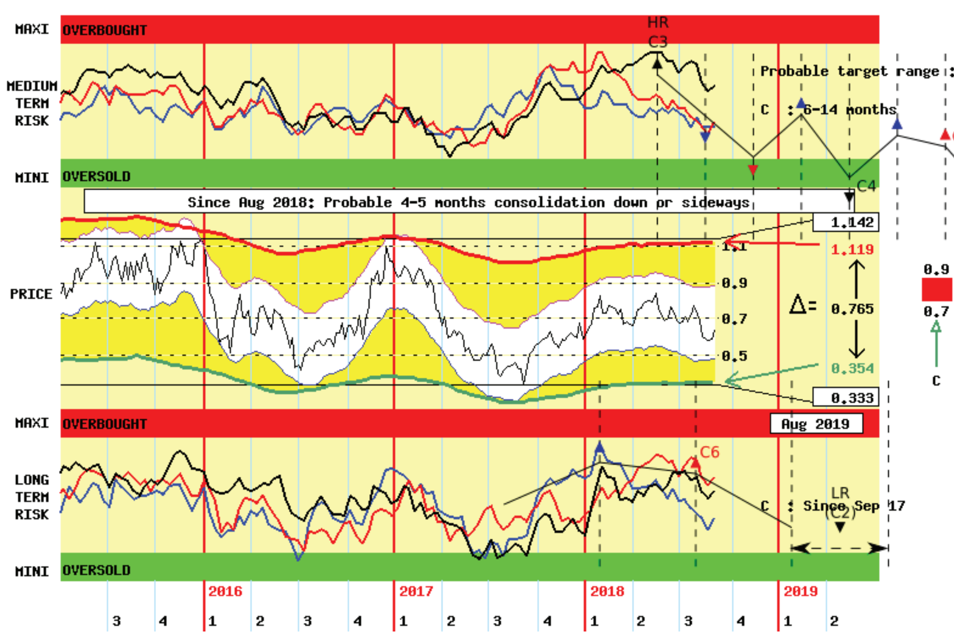
On US10Y Treasuries yields, the sequences we show on both oscillator series (lower and upper rectangles) could also be topping out soon. Our long term oscillators (lower rectangle) may have already done so this Summer, while our medium term oscillators (upper rectangle) would suggest a last upside retest until early Q4. On the target front, the lower end of our I Impulsive targets to the upside was achieved above 3.0% in May. The higher end, around 3.5%, now seems very aggressive, given the limited time left to achieve these. **At best, we expect marginal new highs within the next few weeks and then 6 to 12 months consolidation to the downside. During this period US10 Year yields could retrace between 65 and 100 basis points** (0.5 to 0.8 times our historical volatility measure "Delta", here at 1.26%; right-hand side, middle rectangle).

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



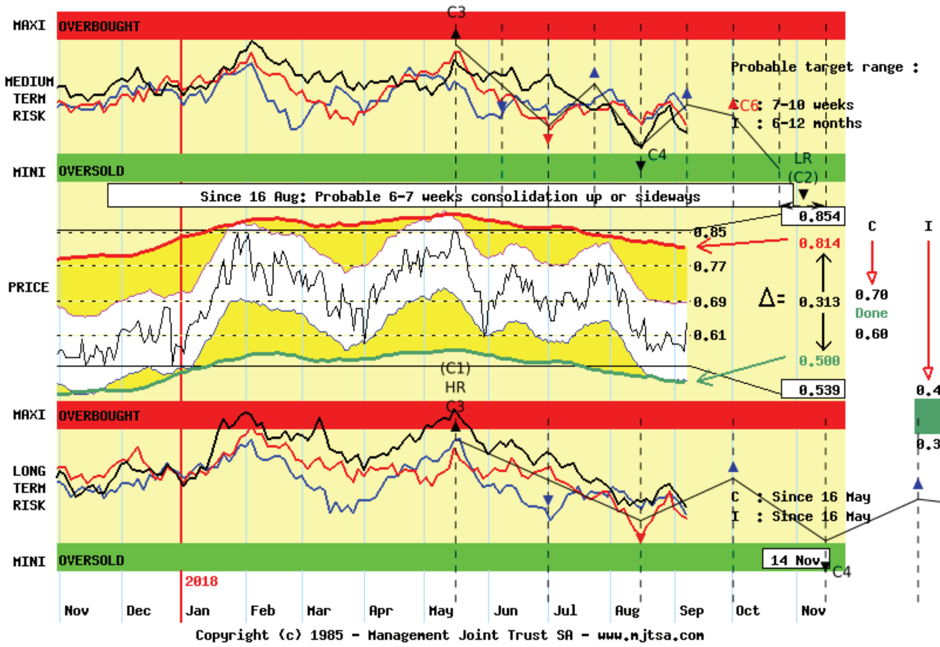
In general, we see little upside potential left on both US10Y and US3Y tenures, if any, and we expect them to start correcting down soon, probably towards Spring next year. This is an important trend reversal to the downside for US Treasury yields, while the FED is still raising rates, and it should continue to flatten the yield curve. That said, on this 10Y-3Y spread, most of the downside potential is probably behind us (I Impulsive targets to the downside; right-hand scale). It is rather the market timing perspective, which is interesting here: both oscillator series (lower and upper rectangles) and our automatic messaging are suggesting that the US10Y-US3Y continues to flatten until December. **This, in our view, implies that, until December, the FED sticks with its current tightening course, and that the steepening risk until then is limited.**

US 3 years minus US 3 months Benchmark Bond Yields
Weekly graph over the perspective next 2 to 4 quarters



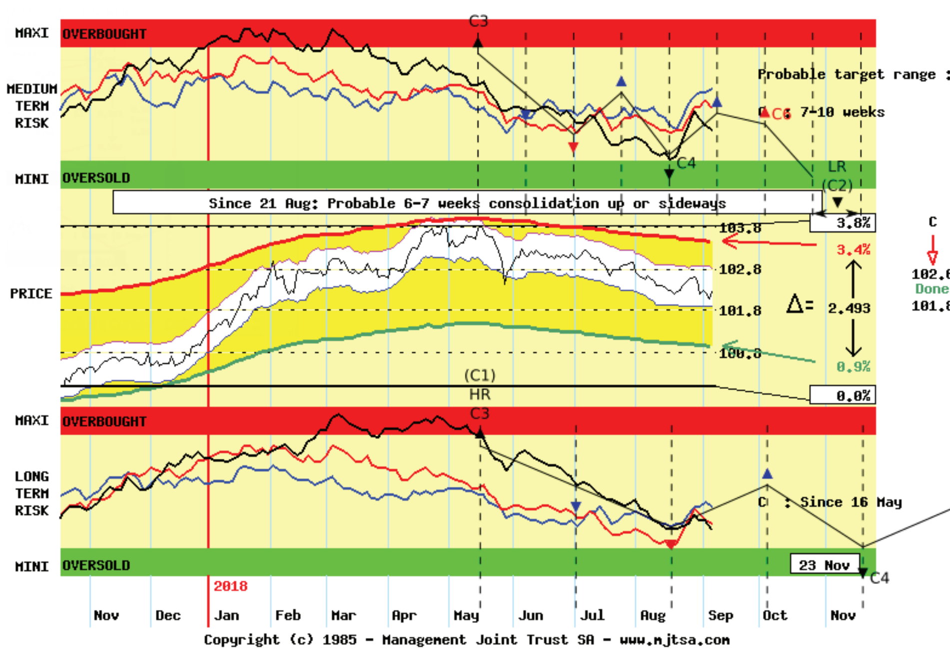
The Shorter term end of the curve is in our view more interesting. Indeed, **the 3 Years minus the 3 Months Treasury spread is much more reactive to reflation/deceleration dynamics than the US10Y minus 3Y one**. For example, it shot up late last year as an increase in US Treasury issuance met with a pick-up in US Inflation and Growth expectations. The move was particularly strong as the spread steepened by 50 basis points and this despite the headwind of a 50 basis points increase in the US 3M yield (rising Fed Funds Rate). The spread eventually saw a first top in January, just prior to the Equity market correction, and then another one in May. It has since been reversing down. **Both our oscillator series (lower and upper rectangles) are now suggesting that it could accelerate down lower, probably into Spring next year at least**. On the target front (right-hand scale), our C Corrective targets to the upside were recently achieved, and **the I Impulsive targets to the downside we can now calculate are pointing towards inversion, possibly also by Spring next year**. This is 60 basis points below current levels (1.3 to 1.7 times our historical volatility measure “Delta”, here at 76.7 bps, subtracted from the late 2016 highs at 1.142, i.e. downside targets for the Spread between 0.15% and minus 0.15%). **We believe it reflects a significant deceleration in inflation dynamics and a potentially widespread flight to the Safety of US Treasuries**.

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



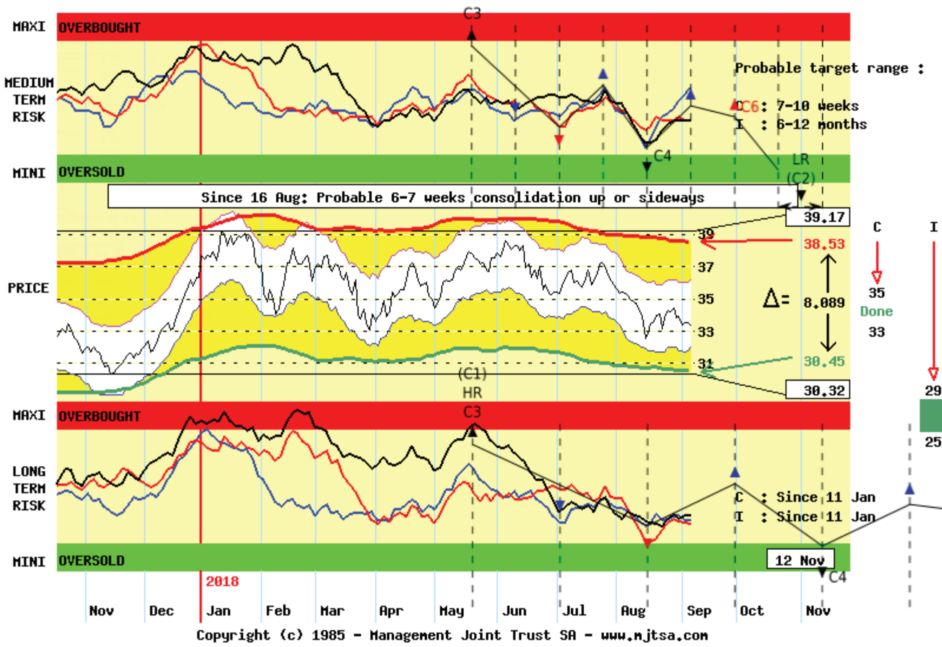
The Daily graph of the US3Y-US3M spread is in our view very telling. Indeed, since January, it has been a great proxy for the risk-ON / risk-OFF cross asset sentiment: it shot up with inflation expectations and equity markets in January, corrected down with equities into late March, followed their strong relief rally until mid May (marginal new highs), corrected down with the Italian political Crisis, saw another relief rally early June, before it retested lower late June as the Chinese devaluation started to accelerate, bounced in July with Emerging markets and cyclical assets, and followed their renewed sell-off into mid August. **It is currently attempting to bounce again** and according to both our oscillators series (lower and upper rectangles) **could hold up until late September, before it resumes lower into October and then towards mid November**. Our downside targets (right-hand scale) suggest that once it breaks below 0.6%, the spread could then move lower towards the 0.4 – 0.3% range. **This would probably reflect a strong risk-OFF shift, possibly between late September and November, and imply strong flows to the Safety of the very liquid 2 to 5Y US Treasury market.**

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



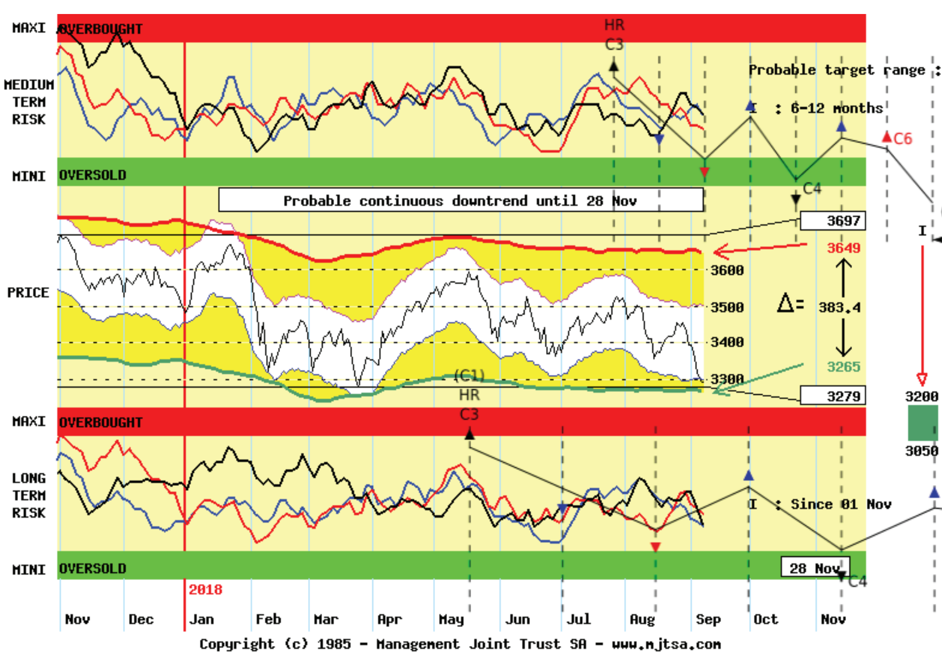
Not surprisingly, changes in inflation expectations, which we measure here using the TIP to Treasuries break-even ratio, are telling a similar story. Indeed, on both our oscillator series (lower and upper rectangles), they are attempting to bounce from the intermediate bottoms we identify mid August. **The rebound is quite weak, yet could hold up until late September, before the TIP/Treasury ratio resumes lower into mid/late November. Here also, if we break through our C Corrective targets to the downside (right-hand scale), the ratio could see a rapid sell-off.**

XME - SPDR S&P Metals & Mining ETF
Daily graph or the perspective over the next 2 to 3 months



Searching for "Analogues" (other asset which currently show similar profiles), we can find quite a few. For example, our oscillator sequences on the **US Diversified Mining sector are very similar** (lower and upper rectangles). Also here, **we expect the sector to hold up (if even) during September, before it moves down again between late September and mid November**. Prices have found support on our C Corrective targets to the downside (right-hand scale), yet once these break, **our I Impulsive potential to the downside is compelling, probably between minus 13% and 25% over the coming months.**

DJ Euro Stoxx 50
Daily graph or the perspective over the next 2 to 3 months

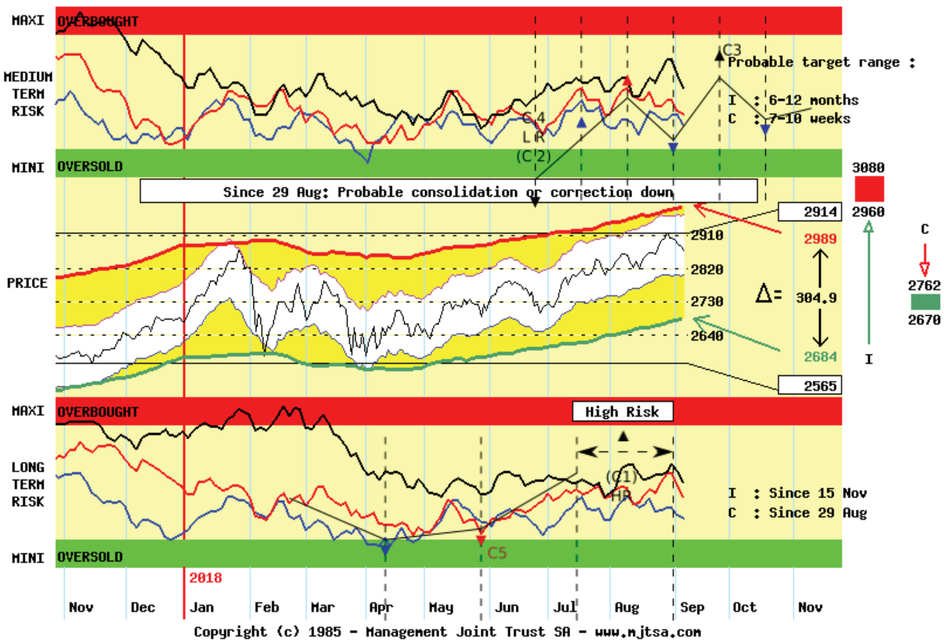


European Equity markets show a similar pattern, **yet even weaker**. Indeed, last week, the EuroStoxx 50 broke below its August lows. Going forward, a slight bounce may materialize over the next couple of weeks (medium term oscillators; upper rectangle), yet, on both our oscillator series (lower and upper rectangles), **we then expect the EuroStoxx 50 to probably sell-off again, from late September at the latest, into mid/late November.** Our I impulsive targets to the downside (right-hand scale) would suggest between 3 and 8% of downside potential into November.

Initial remarks:

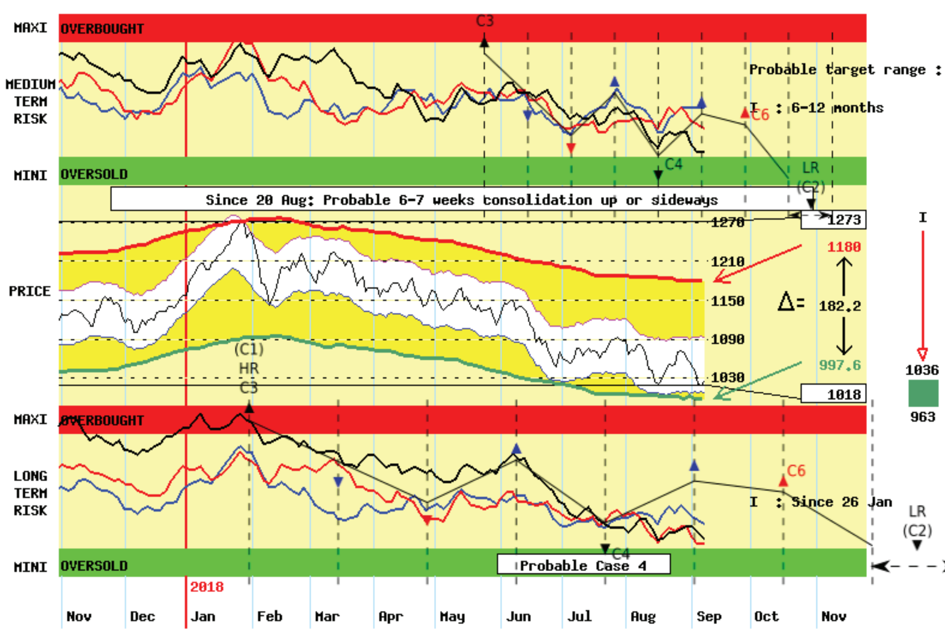
Both the examples above (US Diversified Mining and the EuroStoxx50) are interesting as they seem to be caught cross-currents between stronger US equity markets and Emerging markets, which have sold off aggressively over the last 6 months. Indeed, US Diversified Mining is a US sector with a strong sensitivity to Chinese demand, while Europe is a developed market with increasing Sovereign risks on its Southern and Eastern borders. We believe most developed markets ex the US show similar "median" features. Their current price patterns are also quite similar to the US3Y-US3M Treasury spread mentioned throughout this article. They may follow its potential breakdown into the late Fall.

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



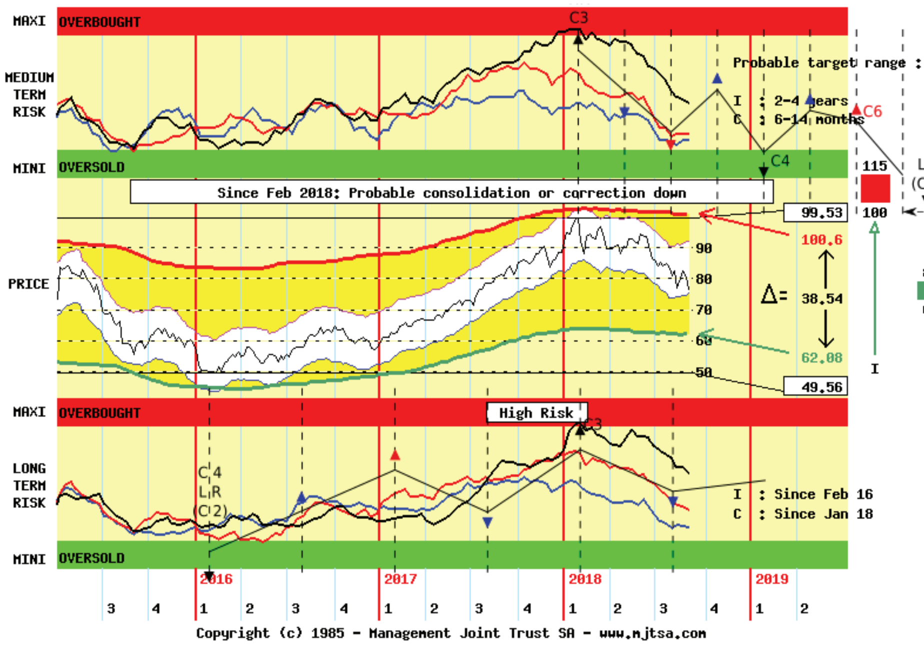
We now review the two ends of the spectrum. **We will start with the S&P500 Index**. For now, it is still uptrending with a risk/reward which is rather neutral (3 to 7% I Impulsive upside potential, vs 4 to 7% C Corrective downside potential). Yet, our long term oscillators have now reached a "High Risk" zone (lower rectangle) and such situations usually trigger 2 to 3 months of downside correction at least. On our medium term oscillators (upper rectangle), the uptrend may still push up slightly higher into late September. Yet, the time frame seems too short to consider a strong upside melt-up. Hence, **we are now turning very prudent on the S&P500. It may hold up until late September, but will probably join other markets to the downside from October into mid/late November. The first support levels are probably somewhere below 2'700.**

MSCI Emerging Markets Index
Daily graph or the perspective over the next 2 to 3 months



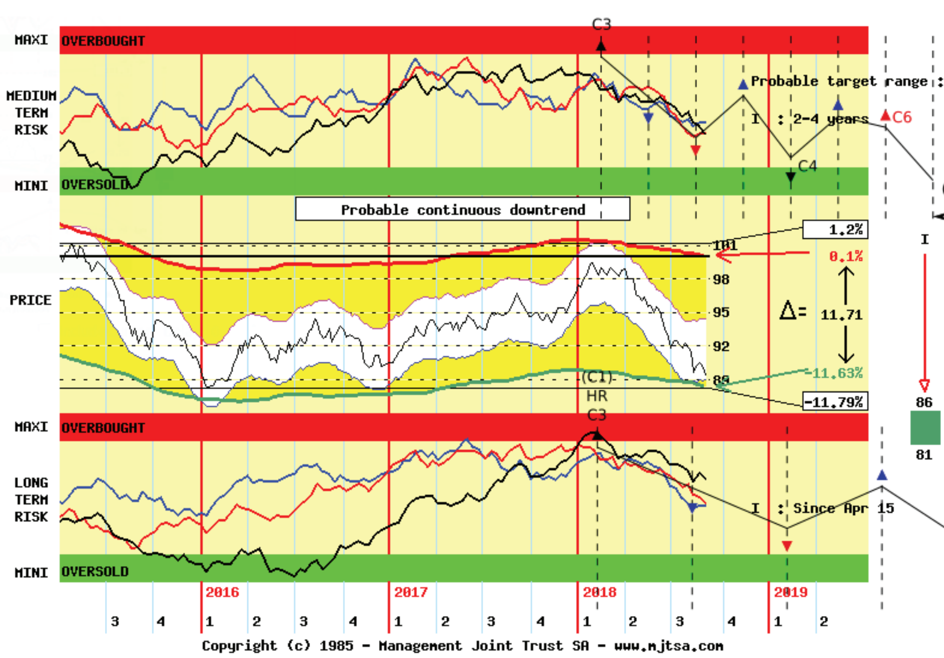
On the other hand, **the sell-off in Emerging Markets is looking more and more like a liquidation (minus 20% since January).** Indeed, the July and late August bounces were rapidly retraced, and going forward, on both our oscillators series (lower and upper rectangles), we expect **that the succession of weak bounces and rapid liquidations probably continues towards November/December at least. Shorter term, a new rebound is possible on our medium term oscillators (upper rectangle), yet we don't expect it to last much longer than a couple of weeks**. On the target front, our I Impulsive targets to the downside (right-hand scale) show up to 7% of further downside potential. Our Weekly graph (not shown here) may be suggesting much more into next Spring, especially if prices start moving below 940. Given the arguments above, **we remain very prudent on Emerging Markets. We expect them to resume lower again at some point between now and late September, potentially towards November in first instance.**

MSCI China
Weekly graph or the perspective over the next 2 to 4 quarters



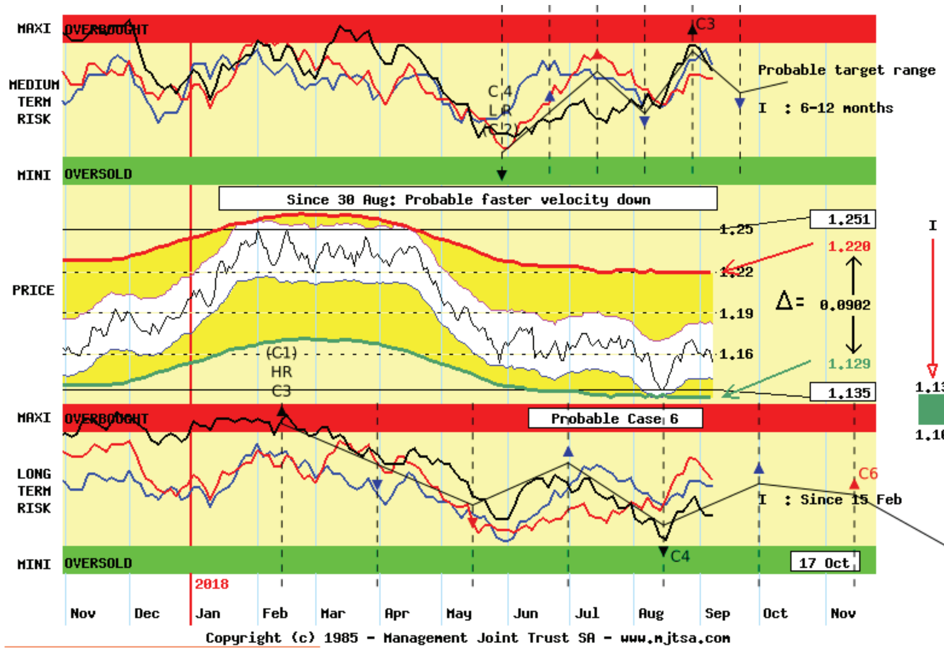
China accounts for more than 30 % of the MSCI Emerging Markets Index. Since June and the acceleration of the Yuan's devaluation, it has been weighing on the index, underperforming it by more than 10 %. Apart from Turkey, Russia, South Africa or Argentina, which are much smaller (even when combined), it is the main driver in the current Emerging Markets rout. Since January, the MSCI China Index has lost almost 25 % of its value. On our long term oscillators (lower rectangle), the uptrend sequence from early 2016 was effectively completed in early Q1 this year. **The « High Risk » top, which was then identified, usually triggers at 6 to 12 months of consolidation to the downside, more if the downtrend turns impulsive (Then 2 years of downtrend at least). In the current sell-off, the 6 months mark is already behind us, and we now expect China to correct down until early next year at least. Once/if prices break down below our C Corrective targets to the downside into impulsive territory (below 69 ; right-hand scale), the downtrend should then extend lower into late 2019/2020. Shorter term, our medium term oscillators (upper rectangle) could justify a slight bounce until late Q3 / early Q4, and then the downtrend resumes into year-end and early 2019 in first instance.**

EM Currencies portfolio vs the US Dollar
Weekly graph or the perspective over the next 2 to 4 quarters



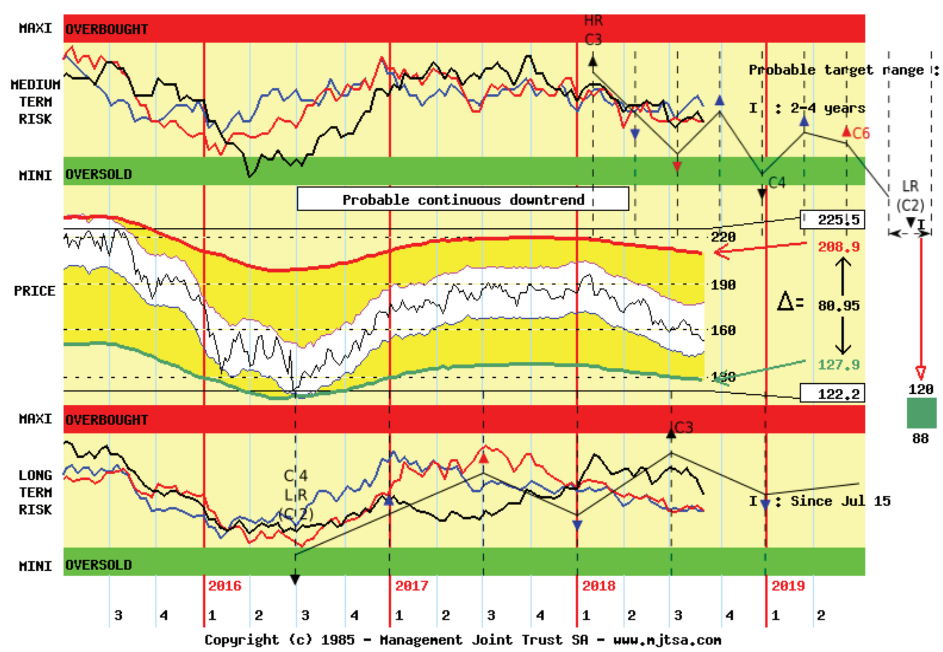
The current Emerging Markets sell-off is also a currency crisis. Indeed, it appears that high levels of Dollar denominated debt in emerging markets, coupled with expansionary monetary and fiscal policies, have recently collided with the FED's more restrictive monetary policies. The ongoing Trade War with China has added more negative pressure. These dynamics have created a negative feedback loops for Emerging Markets and their currencies. We hereby consider a weighted portfolio of the currencies of the Top 8 countries in the MSCI Emerging Markets Index (Chian, South Korea, Taiwan, India, Brazil, South Africa, Russia and Mexico). Together, they account for 85% of the index. Similarly to the MSCI China or more generally to Emerging Markets, our oscillators series (lower and upper rectangles) suggest that **the sell-off is still ongoing, probably into early 2019 at least. The damage in terms of prices is even greater that on Emerging Markets equities**. Indeed, this portfolio has already broken below its C Corrective targets to the downside (not shown here anymore) and is now eyeing **10% more downside potential into next Q1 2019**, in addition to the 12% it has already lost since January. **The current leg down in Emerging Markets may be only half way through.**

EUR/USD
Daily graph or the perspective over the next 2 to 3 months



We now turn to EUR/USD, for a view of the US Dollar against the Majors. **Here also, the Euro's retracement vs the US Dollar is looking more and more like a liquidation: its bounce since mid August is already retracing, our medium oscillators (upper rectangle) are already overbought again, and our long term oscillators (lower rectangle) suggest further downside pressure from late September, at the latest, and into November, at the least.** Our I Impulsive targets to the downside (right-hand scale) are also pointing lower, towards the 1.13 to 1.10 range over the next couple of months. These weak EUR/USD perspectives seem to match the weaker ones we expect on the EuroStoxx 50 mentioned above, and could imply that **Europe may be first in line to suffer from any contagion from the ongoing crisis in Emerging Markets.**

Europe Stoxx 600 – Banking sector
Weekly graph or the perspective over the next 2 to 4 quarters



The European banking sector probably crystallizes these fears. For example, and in addition to ongoing problems in the European banking sector, Spanish banks have an EUR 80 billion exposure to Turkey, French Banks EUR 35 billion or Italian bank almost EUR 19 billion. A default of Turkey for example could be a nasty trigger for a more widespread European banking crisis, which would probably spill over into the wider economy. Our Weekly graph of the European banking sector is now back in a downtrend, our I Impulsive targets to the downside are scary (25 to 45% below current levels), and both oscillators series (lower and upper rectangles) suggest that from late Q3, the trend may continue lower again until at least year-end. **Our view is that contagion leads to further contagion, and that if the debt default dominoes start to fall, the feedback loops will be negative for other Emerging Markets, for Developed markets and eventually for the US.**

Concluding remarks

US Growth and Inflation perspectives remain strong, yet since May, the uptrend on US Treasury yields has stalled. This is quite peculiar, especially on the short end of the US yield curve, as until quite recently 2 to 5Y tenures were rising faster than Fed Fund rates. Indeed, since May, following a strong push up from late last year, the short term end of the US yield curve (3Y minus 3M) has started to flatten. We believe this initially reflects increasing Flight to Safety to the US Treasury market as investors start to exit Emerging Markets. In a way, this may spell the first stages of Contagion. Today, many risk assets show a similar profile as the flattening US3Y minus 3M spread, and in particular European markets. Our models suggests that these, along with the spread, could resume lower again, probably from late September at the latest and into November. US markets may then follow as their uptrends now seem exhausted. Going forward, following a bounce towards year-end, we expect further weakness on these assets into the Spring. Depending on the damage done, deleveraging may then spread to most asset classes and geographies.