3/ Executive Summary

12 / **The brewing EM Crisis is a handiwork of the US Dollar; it will get worse, before it gets any better** - Emerging Market economies are in serious trouble. Increased US borrowing, which is helping power the US economy and its stock market for now, is hurting many other countries' currencies. Current EM problems can indeed merge into a much larger global debt crisis, just like the subprime crisis became a global financial crisis. The pain in the EM universe is widespread. Argentina is on the brink of total economic collapse. Turkey's currency has been steadily falling, recently exacerbated by Trump tweets. China's Shanghai Composite Index has fallen by more than 20% from its peak early this year, as the domestic currency devalued rapidly. News is plentiful about other Emerging Market (EM) currencies falling against the US dollar. China's yuan has declined by almost 10% against the dollar since February. The Indian rupee just also just hit a record-low against the dollar, though the pace cannot be compared to the Argentine peso or the Turkish lira. Many other EM currencies have been doing poorly in recent months. It seems that the whole world is fibrillating while the US economy is pumping ahead. However, the main problem, just like with the previous crisis, is too much debt all around the world. Last time, it was mostly about too much household debt in the US. This time around, it could be about too much borrowing, on a larger scale, in all sorts of places, from sovereign debt in EM, to corporate debt and household debt in both EM and DM. Emerging Market debt (including China) grew from \$21 trillion in 2007 to \$63 trillion in 2017. That, combined with the forced monetary tightening that is taking place in developed economies, could develop into something serious. Ultimately, the gorilla in the room is China. China, just like Japan before it, has been running, and growing, on selling to the rest of the world. It has also been using stimulus on a scale no other country has done until now for so long, and successfully, without being a DM economy. China hasn't had a recession for decades, and it has been able to achieve annual growth rates of more than 10% for many years (see chart below). Most of this success has been achieved through various stimulus activities, pushing total Chinese debt to over 300% of GDP according to reports of the Institute of International Finance. Most of the growth in China has been achieved through: (1) selling to the rest of the world, and (2) heavy stimulus measures after the financial crisis of 2008. Back in 2007, almost nobody thought what started as the subprime crisis could turn into a global debt crisis. Almost nobody fears what is now an Emerging Market crisis- which is in reality a debt crisis in the making for those countries- could turn into a much bigger global debt crisis again. But the ingredients seem to be there. And further US Dollar gains, which we expect to last until Q1 2019, will be there to makes matters worst for the Rest of the World.

17 / **Timing and Tactical Insight - Flight to Safety is accelerating -** 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.

24 / **The signalling effect of oil inventories suggests further support for crude oil and E&P into late summer early autumn but the trend is extended** - U.S. crude oil production is at the 11 million barrel per day level, deemed high by pundits, but the lack of sufficient pipeline networks in regions like the Permian basin and other areas has prevented stocks from exploding. At the same time, demand for gasoline and distillate products because of buoyant economic conditions has supported the price of the energy commodity, and refineries work overtime to keep pace with demand. Energy prices generally rose after those reports. You should not fear the build in petroleum and oil inventories. The build of inventories is a natural consequence of improving demand for oil crude oil and products. It is inventories being stockpiled in anticipation of near-term consumption. Moreover, the builds lag actual demand and consumption trends and therefore are not really part of the oil discovery process. The message: do not fear inventories; they can also be signs of good times. There is no single factor which will explain oil prices. The oil market is an economic system where changes in one element almost always affect all the other elements. Unfortunately, the system has no starting or ending point. At times, crude prices lead product prices. At other times, product prices lead crude prices. Nonetheless, it is clear to us: changes in spot product prices due to changes in product demand generally leads to changes in oil prices (and E&P equity prices). We came to this conclusion by modelling the relationship between the change in product prices and the change in crude values.

28 / **Timing and Tactical Insight - Last upside retest for Oil, before it follows other risk assets lower -** On our long term Bi-Monthly and Weekly graphs, Oil has probably reached an important intermediate top. The correction to the downside that follows should last at least into early next year, and potentially into the second half of 2019. The downside potential may be as low as the mid/high 50s USD/barrel on Brent, and the low 50s on WTI. We also expect Energy sectors in the US and Europe to enter a correction phase to the downside. The risk is probably between minus 10 and 20%. We also believe that these sector should under-perform their respective markets, at least into December, possibly year-end. Shorter term, until end September / early October, Oil may attempt a last upside retest. It may make new marginal highs on Brent (mid eastern political risk), yet probably won't on WTI. October and November should then see both benchmarks move lower into mid/late November in first instance.

The Capital Observer editors team, London / Geneva, September 13th 2018
to view other issues, please visit our website at: http://www.thecapitalobserver.com

4/ Executive Summary

33 / **China's CNY, and Gold: linked at the hip, and hobbled by the US Dollar's ascendancy, China's growth implosion** - Gold's future is generally tied to the trend of the US Dollar, but for practical purposes, gold is currently tied at the hip with the Chinese CNY. And the CNY is hostage to the escalating trade war between the Trump government and Chinese President Xi Jinping. Much of that weakness is reflected in EM currencies, and the price of gold suffered alongside them. China may again choose to continue to devalue the CNY on a sustained basis. Consequently, Gold could continue to decline further. The trade war and its effect on the USD/CNY exchange rate remain the immediate determinant of Gold prices in dollar terms. Until either the trade war ends or the dollar falls, either of its own accord or due to a Fed reversal in policy, CNY is likely to go lower, followed in its wake by the gold price. We therefore expect gold to briefly shine over the next two to three weeks, but could thereafter resume the downtrend until Q1 2019, when presumably (according to our models) the US Dollar bull trend could pause. That would be a period more apropos to investments in the precious metals sectors and in the Miners' equities.

35 / **Timing and Tactical Insight - Gold is still stuck between a rock and a hard place -** The rebound on Gold since mid August is rather weak and bottom fishing it against its recent downtrend still seems quite uncomfortable. This is the case in US Dollar terms, but also in EUR or even CNY terms, as Gold is negatively correlated to the US Dollar, yet with a stronger volatility than these currencies. Going forward, we expect the US Dollar to remain strong, probably into Q1 2019 at least. This will put additional pressure on Gold, and in the current context, a capitulation below 1'000 USD/oz cannot be excluded. We would hence stay away from it for now, this despite the defensive cross asset shift we expect. It's a question of timing within the downtrend cycle. Gold is currently getting stronger vs Copper, which suggests the end of the reflation trade, yet it is also accelerating up vs Silver, which usually happens when both are precious metals are declining. In 2008 for example, Gold and Silver started to react up very late in the year, following the Lehman crisis and only once the TARP rescue program was put in place. Gold and Silver then accelerated up during the first years of QE, Silver more than Gold, and the Gold to Silver ratio declined. Our graphs suggest that this is unlikely to happen at least until next year. The fact is that Gold in a monetary phenomenon, it reacts to the cure (monetary easing), rather than the crisis itself. With the FED and the ECB still on the tightening path, Gold should remain under pressure for now. This will continue to be the case until these Central Banks start to flinch. Given our negative scenario on risk assets over the next few quarters, this is not implausible, yet it may take a few more months/ quarters to actually materialize.

41 / **Base metals face headwinds from China's slowing growth, firm US Dollar trend** - It was common to see headlines like "Copper rises on strong Chinese growth and China's industrial profits rise the most in four years on commodity prices"? It is easy to show that there is a mutually supportive cycle of Chinese strong growth fuels rising commodity prices, and rising prices fuels strong China growth. But since early Q2 2018, there has been a softening in commodity prices and the former explanation has dominated (e.g., "Chinese demand concerns hit metals and related stocks"). The recent Chinese slowdown in oil imports has been instrumental in undercutting oil and base metal prices. Ironically, it is not the failure of the country's long-term, export-led growth model that is to blame. The culprit is slowing domestic consumption. Retail sales this year have grown at their slowest pace in more than a decade. Wages in the private sector are growing at their slowest pace since the global financial crisis. Most of China's current woes are self-inflicted. Government expenditures in China have virtually collapsed since January 2016. With China being such a significant driver of the base metals price structure and with such a negative outlook, it is not a surprise that we expect base metals and commodities to mark time over the next few quarters, a new upwards cycle in global and US growth probably awaits in the later part of 2020. That could initiate a widely expected new cycle of boom times for resource materials at that point in time.

44 / **Timing and Tactical Insight - A Chinese hard landing is an increasing probability -** The sell-off in Chinese equity seems far from over. The downtrend is especially clear on the Chinese domestic market where the Shanghai Composite could continue to slide towards the 2'000 mark by early next year, and perhaps even lower, later on in 2019. All attempts to bounce during the Summer were rapidly retraced, and we now expect that from late September at the latest, Chinese equity markets could accelerate down again into November/ December. Chinese equities also seem very weak vs both other Emerging Markets and the MSCI World Index, and in general the sell-off in Chinese Equities looks more and more like a panic liquidation. The Chinese equity sell-off is also impacting all related themes. Industrial metals such as Copper or Zinc have started to accelerate lower, the US Diversified Mining, Steel or Coal sectors are gradually reversing down, and growth themes related to basic metals or China, such as Lithium or Alternative Energy, are also selling off. We see little respite for most of these themes until at least early next year, and probably until end 2019, and believe that their downtrends could see further acceleration during these periods. We would hence avoid any investment themes relating to China and Industrial metals over the next few months and probably the next few quarters, i.e. don't try to catch a falling knife.

51 / Splicing the markets - This time is probably not that much different - Given the long standing linear Bull market on US equities, a correction that could reach beyond minus 20% would feel like a surprising anomaly. Yet, such corrections have happened in the past and not so long ago in Europe, Emerging Markets or Japan. Financial crisis usually come from left-field and unexpectedly. This time may not be that much different and the current set-up, where longer term our oscillators on most markets are reaching important tops or are already descending, seems quite right for it to happen again.