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12 / **US Economy Expands; Prices Spike Higher Amid Signs Of Accelerated Buying Due To Trade Issues and the Fed presses on the brake**- September PMI survey data added to signs that the US economy continued to expand at a good rate in the third quarter, albeit with the pace of expansion down on that seen in the second quarter. However, the finer details paint a slightly troubling picture as suggested by the Citi US Economic Surprise Index. The one component that raises concern is the price index. The price index fell 5.2 percentage points to 66.9 in September from 72.1 in August. Despite the ease, the price index has been above 50 for 31 months. The continuing high level of this index suggests manufacturers remain under difficult pressure from rising input costs. The combined survey results suggest that the pace of economic growth continued to run close to a 3% annualised rate over the third quarter. This would mark a slower rate of economic expansion than the second quarter, albeit with the economy still enjoying robust growth. That would be less that the 4.00% plus GDPNowcast forecast of the Atlanta Fed. The combination of strong labour conditions and brisk demand is the biggest risk to the US economy as the Fed threatens to pre-empt subsequent expected inflation which could be generated by those pressures. We know that the US economy is on a roll, prices are rising, and that will induce the Fed to keep adding pressure to the brakes. However, the history of the Fed has not been stellar in this respect, and there is a chance that, as in all tightening cycles after WW II, we could be headed for a difficult 2019 if the Fed goes through with what it promised to do with the policy rates.

16 / **Timing and Tactical Insight - Financials Markets are anticipating a mature business cycle -** Financial markets are a discounting machine. They usually anticipate developments in the business cycle many months in advance. In a way, despite the current strong momentum in US economic data, for markets, perception of future developments is the reality. Rule of thumb is that they can look ahead as much as 6 to 9 months. Typically, as business cycles mature, Commodities are the last asset class to top out. Oil was just making new highs, yet we believe it may have now reached its peak for this cycle. Other pro-cyclical commodities such as Copper, Lumber or Cotton, already topped out this Spring, and have started to correct down, probably until early next year at least. Concomitantly, main equity indexes have now started to break down. Beneath the surface, market breadth had been deteriorating very quickly (along with equities in most of the rest of the World). For example, Small Caps recently turned down vs the market, while Consumer Discretionary sectors, which are negatively impacted by higher interest rates, such as Housing and Autos, are already well off their Q1 highs. At the same time, however, Defensive sectors are starting to stabilize. We are watching them carefully as we currently see them breaking out to the upside vs the market. We expect them to outperform probably towards Spring 2019 and beyond. These developments are typical of late cycle behaviour, at a market top, and slightly ahead of a top in the business cycle.

23 / **The Fed shifts to restrictive policy stance, push yields sharply higher and steepen the yield curve; preparing for a fallout on risk assets** - The labor market is, on the surface, sufficiently strong to convince Powell and the rest of the FOMC to keep to a more restrictive policy path. The recent steep wage growth practically had the Fed mortified; the wage data is starting to tell an alarming story to the Fed. Year-over-year growth edged down from 2.9% to 2.8%, but the annualized pace over the last three months has been a healthier 3.76%. Add to that the gains in the ISM NonManufacturing and Manufacturing surveys, and you get a Fed with an itchy trigger finger, despite a tame 2.2% core inflation. The impact of the shift in Fed policy: expect more rates hikes in the months ahead as the early reads on the third quarter, primarily October survey data, indicate that the economic momentum continues, although at a more moderate scale. For the Fed, this is not any more a time for dithering. That has made several members of the FOMC to reconsider their previously dovish stance. That the yield curve is steepening in the wake of a Fed policy shift to a much tighter stance is about as good a story as the Fed could hope for. But as we will see, this apparent boon (from the Fed's point of view) could quickly turn into a nasty symptom of distress. Steepening of the yield curves has corresponded to the start of growth decline that culminated in recessions. Tightening cycles impact employment and activity that slows economic growth. The Fed then turns dovish, and cut rates, as growth spirals lower. But steepening PRECEDES the growth decline, and the reaction function of the Fed (to cut rates) after GDP starts falling hard. the Fed's attempt to control "inflation to make growth sustainable" in each and every one of the tightening cycles since World War II has resulted in recession. They always over-tighten. Always. There is no reason to believe that it will be different this time around.

27 / **Timing and Tactical Insight - In search of the neutral rate Graal -** 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.

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34 / **The equity markets take fright at the sharp rise in yields and Fed's policy communication folly; risk-parity fund managers will push markets towards "convergence to the mean"**- The S&P 500 has lost about 5% since last month's record high, but it's still up about 4% year to date. It's painful, but still far short of a typical correction (-10%). The proximate cause is the bond selloff (sharp rise in bond yields), there's no question about that, in our opinion. Last week's rapid run up in long-end Treasury yields is the proverbial talk of the market and judging by the market response, equity investor's earlier equanimity with rising yields ran out at above roughly 3.20% on the 10-year bond. The sharp rip higher in yields has been caused by the Fed's transition from pseudo-dovish to outright bullishness in the pace of policy tightening. As we discussed in another article in this issue of the Capital Observer ("The Fed shifts to restrictive policy stance, push yields sharply higher and steepen the yield curve; preparing for fallout on risk assets"), the Fed's shift into an overt tightening policy and is expected to make conditions restrictive, has finally struck a nerve in equity market investors. That is what has flipped the equity-rates correlation to negative and impacted large pools of money that are managed based on a risk parity strategies. So we are seeing the extreme volatility in the equity markets as position get adjusted. As the January debacle showed, sharply rising yields would tend to undercut the equity markets when the composure of the equity markets is shattered. In this case, Fed Chair Powell's injudicious comments implying restrictive monetary policy to come was the veritable straw that broke the camel's back.

37 / **Timing and Tactical Insight - Intermediate correction or significant break? Looking into the recent weakness of US, Emerging and other Developed markets -** The equity rebound during September was rather strong on the EuroStoxx 50, while in the US and Japan, the uptrend continued to make new highs. Emerging markets performed a dead cat bounce, as expected. Over the last week, however, all these markets have accelerated lower. Europe and Emerging Markets are resuming their downtrend, and the US and Japan are topping out. The current correction phase to the downside will probably complete a first leg down by late October. Following a bounce, it then potentially resumes lower again towards mid/late November. Initially, we had planned for 5 to 10% of downside potential on average into October, yet the sell-off yesterday has already fulfilled much of this. The next level of targets are a further 5 to 10% lower. For example, on the S&P500, breaking below 2'685, would probably imply further downside risk towards the 2'530 – 2'410 range. This is not something to be discounted. Indeed, on our longer term graphs, S&P500 and the Nikkei 225 ate still quite Overbought, while in Europe and in Emerging markets, the longer term trends are already heading down. Both could easily justify another 10% risk to the downside. Hence for now, we are calling for strong caution on equity markets into late October at least, and then probably into mid/late November. We will then reconsider, although our analysis suggests that the 2016-2018 equity bull market may have just ended.

45 / **Macro and micro factors are aligning to push the US Dollar even higher going into H1 2019: winners and losers in its wake** - Since early in the year, our thesis has been that the dollar is in a strengthening phase, and will likely remain strong over the near term for a number of reasons. One of which is expectation in the coming year that global growth will be uneven – the US will grow while the Rest of the World (RoW) will not. There are also other factors contributing to the dominance of the US currency at this time. And we go from the macro scale, represented by (1) the growth or non-growth of the Rest of the World vs US, (2) differentials in central bank monetary policies, (3) by differentials in regional capital flows, to micro scale represented by (A) domestic systemic liquidity proxied by the level of term (money) market rates, and (B) by the spreads of those short-term market rates. The effect of the distributed lag in the US Capital Account has made demand for bonds and Dollars stronger, the combined effect of which will weaken equities. Strongest Capital Account inflows happen during market and/or economic crises, so yields fall on demand for safe haven paper, strengthening the DXY-- that weakens equities. For most of H1 2019, get used to falling yields, stronger DXY and weaker equities. And perhaps a crisis, or two. The evidence convinces us that the US Dollar (DXY) is in a bull market which could last until late Q2 2019. This is happening during a time when the distributed lag of the Capital Account inflows begins to reassert as well – and its lagged impact is estimated to last until mid-2019. The winners will be US Dollar denominated assets over those of other regions, and the biggest losers are shaping up to be the Precious Metals asset class.

50 / **Timing and Tactical Insight - Strong Dollar dynamics and related trades -** The recent rise in US yields is mostly driven by real rates. Indeed, inflation expectations (breakevens) have rebounded a bit since mid August, but nothing like the acceleration we have just seen on Treasury yields. This is highly positive for the US Dollar over the next few months as proxied by the rising US to the rest of the world interest differential, while inflation remains rather tamed. A slight contra-trend may materialize though towards late October, early November. EUR/USD is on the other side of this equation, along with GBP/USD, or the Yuan vs the USD, as well as related trades such as Industrial metals or Gold. EUR/CHF is also quite interesting as a risk-ON / risk-OFF indicator in Europe. It should continue lower over the next few months along with the EuroStoxx 50. On the other hand, USD/JPY (which is usually defensive) has remained strong until just recently, yet may have just topped-out, together with other late cycle plays such as the Nikkei or Oil. Finally, Emerging markets currencies should continue to suffer over the next few months. This is especially true for the currencies of commodity producing countries, and we expect them to underperform their importing peers, probably into early next year.

56 / **Splicing the markets - Weighing up Cyclical Value vs Defensives -** Value and Cyclical trades have been on a roll over the last few weeks. Their out-performance synchronizes with the bounce we have recently seen on the yield curves. Yet, for now, vs Defensive trades, these positive moves are still counter-trend, and could potentially start to retrace over the next few weeks. Positive developments on the Brexit front, or new found resilience in Emerging Markets may gradually switch this defensive stance to a more positive outcome. Yet, for now, we continue to abide by it, until late October, early November at least.