



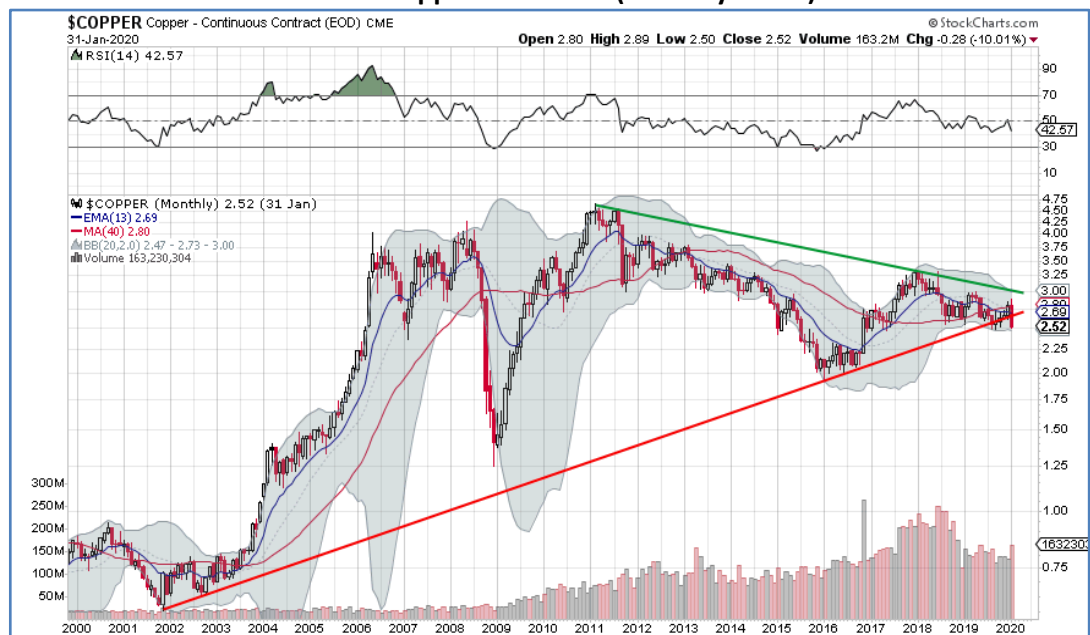
rare is to register returns above **+30%**. But with a little help from the Fed US and major global equity markets made it.

As 2020 started with a host of new problems and dangers (Middle-East/Iran issues, coronavirus in China and outbreak globally, a likely economic slowdown in China and Europe) amid a not so robust economic growth during the Election Year in the US, the potential for heightened volatility both in economic data and market returns is there. What we deem as likely is either a subpar year-end performance result in equities, even if we trade higher during the first few months of 2020, or an outright negative one. If we are, alternatively, hit with a deeper than expected correction first, then we will have to reassess our outlook as the time comes.

Bond markets seem to price economic weakness. US Treasury yields have been declining considerably in the past few weeks approaching the lows of July 2016. Ten-year Notes yields had traded to as low as **1.37%** back then. Today they are just below **1.60%**. The initial reaction is that investors flee towards bonds when they smell economic weakness ahead or some type of problems. However, in most such cases we witness re-allocation of flows into fixed income and out of equities. The present situation is not one of them. We have seen rallies in both equities and bonds amid slower economic growth globally and despite the Chinese virus outbreak. Yet, equities continue their march higher unphased by any concern aided by ample Central Bank liquidity. Most European bond yields remain glued at or below zero and that will likely not change anytime soon.

Most commodities have been trading water for many years now. Recently, and as the virus issue became apparent in China a sharp price pullback has occurred. Crude oil (Light Sweet – WTI) has suffered a swift setback from the early January high of **\$65** while Natural Gas has been registering multi-year lows. Commodities demand out of China is taking a beating and that cannot be understated. Question is for how long it will persist. But perhaps one of the most important economically sensitive commodity, Copper, is on the brink of violating an 18-year trend. It would be a negative sign if prices continued to deteriorate towards **\$2.20** and **\$2.20**.

**Chart 2: Copper since 2000 (Monthly Prices)**



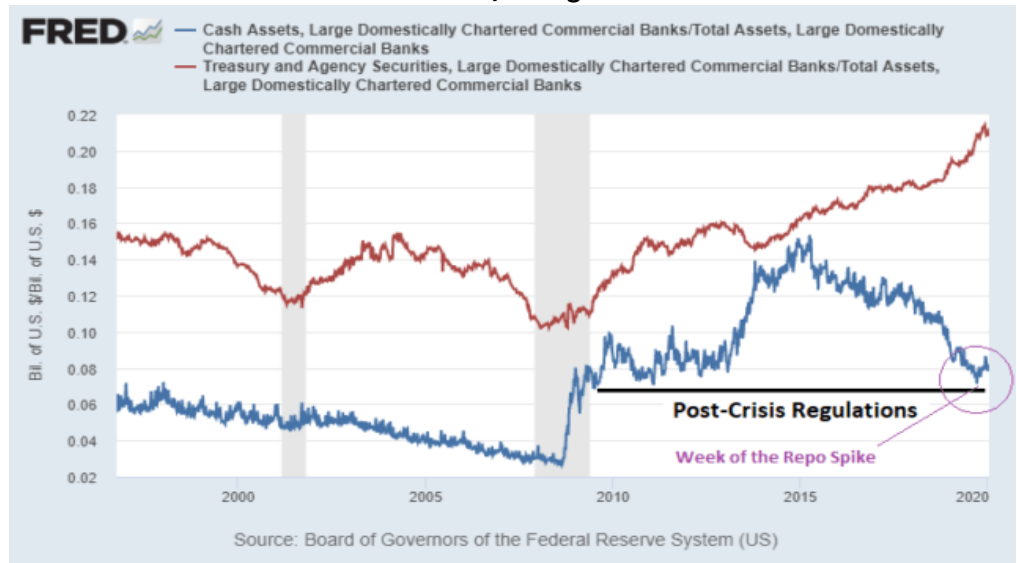
Source: Stockcharts.com, Data as of Jan. 29<sup>th</sup> 2020

## Fixed Income

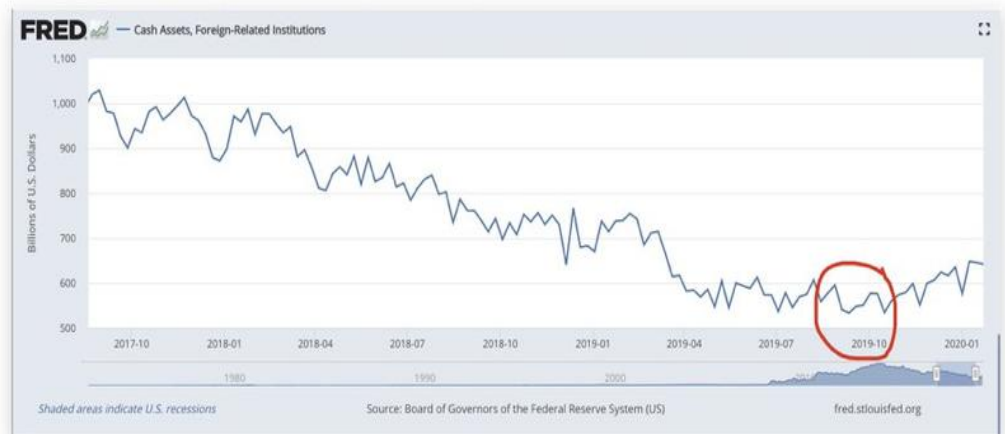
### The Repo Market Issues Rule the Day

Since the early days of the REPO market crisis last fall we argued in our then analysis that the US Fed’s intervention was not an outright QE at least like the ones enacted between 2008 and 2014. No doubt the end result may be additions to the Central Bank’s balance sheet but the mix of the holdings may be somewhat different. For many participants this IS NOT QE while for others IT IS. The important thing to understand is why the Fed had no choice but to intervene. The rest could be interpreted at will but again perception can be misleading many a times.

**Chart 3: Cash Assets at Commercial US/Foreign Banks & Fixed Income Securities**



*US domestic banks have been accumulating US Treasuries since early 2015 reducing their cash levels*



*Cash levels at foreign-related institutions were also at multi-year lows by mid-September 2019 when the REPO crisis became apparent*

Source: US Fed

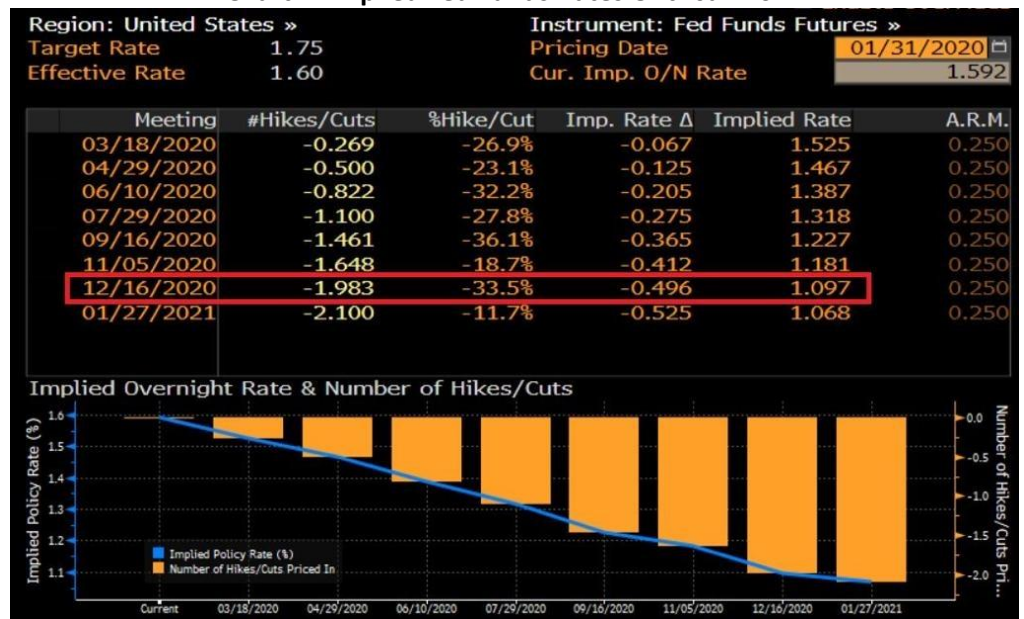
The real problem behind the REPO crisis is that the Fed had to deal with what was a near “lost control” of the short-term interest rates. During the autumn of 2018 events (of Quantitative Easing and the up-move in Treasury yields) it was rather obvious that monetary policy was quite a bit restrictive than the US economy could handle. The run up of 10-year Treasury yields to almost **3.25%** was a gift to many bond participants including domestic banks. Knowing that policy was very strict, they accumulated even more Treasury bonds/Notes looking for lower yields into the future as the Fed would have to succumb to economic (and market) pressure folding its tightening policy and make a U-turn. Note that US domestic banks had already quite a bit of Treasuries as they actually had been accumulating since early 2014 (note that

the US Fed backed off its QE officially in its FOMC meeting of December 2014).

But the REPO market did not get any help from foreign bank liquidity either. The lower panel on **Chart 2** clearly shows that foreign-related institutions were a bit low on cash as well since 2017, for other reason perhaps. The end result was one and only: both the US and foreign banks were unable to offer liquidity in the REPO market and the US Fed had no option but to fill in the blank.

The rapidly falling stock market during Q4 of 2018 and the Trump administration's continued calls for lower interest rates finally yielded results. However, the US Government had done nothing to address the ballooning budget deficits. That very fact coupled with the gradual departure of many foreign buyers of US Treasuries since 2014 left a big void to finance the US debt needs. As the banks had quite a bit of capital tied to Government Bonds/Notes there was little liquidity left for the normal REPO and short-term operation's needs. The US Fed had no choice but to keep pumping liquidity on a daily basis into the REPO market. Otherwise the short-term interest rates would have spiked quite a bit above its targeted Fed Funds rate nullifying the previous rate cuts. What was supposedly a solution for the near-term and would be phased out eventually was made a permanent operation. Perhaps that is the main reason many call it finally a QE as the intervention was made nearly permanent.

**Chart 4: Implied Fed Funds Rates Until Jan 2021**



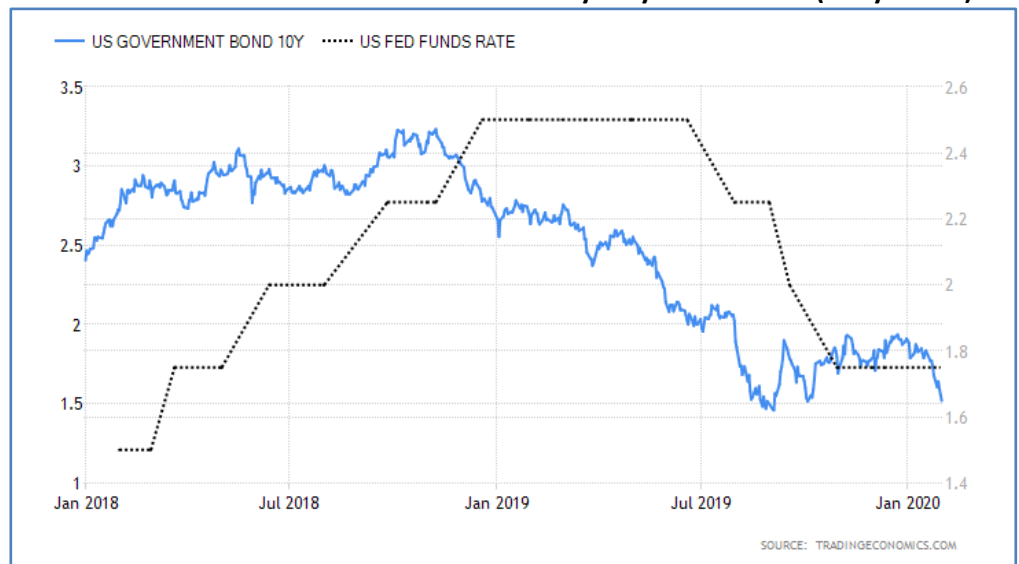
*The Fed Fund futures market implies more rate cuts by the end of 2020 towards the 1% level*

Source: Bloomberg

At the dawn of 2020 US Treasury yields have plummeted to levels not seen since the summer of 2016 (low of **1.37%**) and traded towards **1.55%**. Investors seem to either seek refuge in the fixed income market from something sinister (economic, geopolitical or other) or are forecasting weaker economic growth dead ahead. As the above **Chart 4** shows, the Fed Futures market implies more cuts as we head into the end of 2020. The question, however, is whether the recent worsening coronavirus situation out of China pushes the Fed and other Central Banks to act pre-emptively once again. On February 3<sup>rd</sup> the Reserve Bank of Australia (RBA) holds a policy meeting and given the role China plays for the Australian economy a rate cut may be a precursor to many more moves from other monetary policy makers. A pause would reflect less Central Bank panic.

Whatever the reason when 10-yr yields move below the Fed Funds rate monetary policy is deemed “restrictive” and therefore the Fed may be forced to lower its key interest rate yet again. That was exactly the turning point with the last interest rate hike in December 2018 that “broke the camel’s back” (see **Chart 5** below). As bond yields moved below the Fed Funds rate in late 2018 it was a race to just play catch-up with market reality. Hence, the Fed’s rate cutting campaign in 2019. As market rates moved below Fed’s Fund target yet again in early January 2020 we should be prepared for another rate cut later this year. That is exactly what the market prices at the moment as per **Chart 4** on page 4. Unless we have an about face in market interest rate moves and yields rally substantially from current levels the expectation would be for more cuts. What would be a reason for yields to head up again? A deeper than expected equity market correction due to coronavirus issues/growth scare that sends the Fed cutting more aggressively and rather earlier. The re-allocation of funds from bonds and back into equities could prompt such a move and open the gap between market rates and Fed Funds.

**Chart 5: US Fed Funds Rates and US Treasury 10-yr Note Yields (Daily Prices)**



*Once the 10-yr Treasury Note Yield falls below the Fed Funds rate monetary policy is deemed restrictive*

Source: TradingEconomics.com

The virus outbreak in China will for sure detract some from the domestic GDP figures but it is rather early to assess the full impact not only internally in China but also globally. If global Central Banks respond to such a situation aggressively via rate cuts and more liquidity/QE schemes then we must be prepared to witness some “silly” moves in many asset prices as sloshing liquidity always finds its way into risk markets. Equities are the prime suspects for such a liquidity party. The important question we ask ourselves today is this: **will the US Fed wait a little bit to see how the situation in China develops and act only if it deteriorates or will it act in anticipation of any (negative) event?** There is no clear answer, of course, at the moment. But for sure, in order to avoid a market panic (as the Fed clearly targets the markets for a few years now) it may provide ample liquidity or even start QE4 officially. As the title of the current report denotes, we do believe that 2020 will be a year to behold. Volatility should be plentiful, and investors will be reminded yet again that there is risk involved in the markets. There is no free lunch.

## Equities

The abundant Central Bank liquidity sent investors chasing aggressively **beta** yet again. That coupled with the fact that the vast majority of traders was leaning bearish after the August corrective shake-out and the seeds for a huge short-squeeze were already planted. **Chart 6** presents the price gain in % terms of the major global equity indices for the entire 2019. Just amazing in an otherwise turbulent year with so many trade war headlines, Brexit shenanigans and amid slowing earnings growth.

**Chart 6: Major Global Equity Indices (Daily Prices)**



*Major global equity indices had an amazing year in 2019. US equities led the way higher*

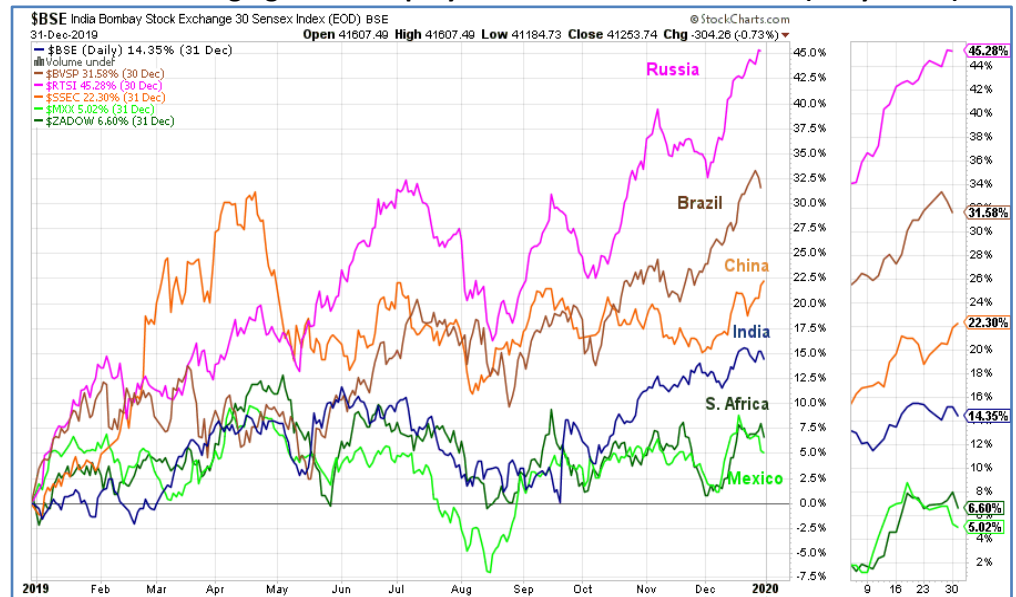
Source: Stockcharts.com, Data as of Dec. 30<sup>th</sup>/31<sup>st</sup> 2019

The best performing market amongst the developed ones was that of the US. The large-cap index S&P 500 closed **29.97%** higher (at **3231** from its 2018 close of **2507**). The technology heavy NASDAQ indices, Composite and NDX, fared even better returning between **36%** and **38%**, respectively. The main European equity markets scored big gains as well and between **+25%** and **+28%**. France was the best performing market with a **+27.77%** return. Germany (**+25.48%**) and Switzerland (**+25.95%**) followed closely behind. The two main Asian equity barometers, NIKKEI-225 (Japan) and Hang Seng (Hong-Kong) trailed a bit with a gain of **+18.20%** and **+10.53%**, respectively. The widely followed protests in Hong Kong were having quite an impact for sure curbing retail sales and exports. As we will discuss later on most of the gains in many developed markets came from P/E multiple expansion as earnings growth slowed noticeably or even halted. Central Bank interventions and another interest rate cutting cycle aided the expansion of multiples.

The true performers, however, were Russia and Brazil from the Emerging Market (EM) space. Russia was a comeback story after years of underperformance while Brazil benefited from the new government and reforms agenda. China was up **+22.30%** despite the “negative” trade war headlines and negotiating back-and-forth tactics. India was up a respectable **+15%** amid some slowing economic action while Mexico (**+5.02%**) and South Africa (**+6.60%**) were little positive in an overall bullish year, showing mediocre to bad figures. It was evident that a falling USD was of help to these EM markets. Not surprisingly. The big question as we start 2020 is whether the positive momentum from 2019 can carry forward. For EM equities the stage is set for more gains in the scenario of a stable or falling USD as most of the price appreciation was not derived from valuation expansions. When multiples expand due to “external”

factors such as monetary policy the danger is always the inability of follow-through from economic activity so that earnings (E) play catch-up with prices (P). When there is no meaningful earnings growth we get swift pullbacks as fundamentals matter in the longer run.

**Chart 7: Emerging Market Equity Indices since Dec. 31<sup>st</sup> 2018 (Daily Prices)**



Source: Stockcharts.com, Data as of Dec. 30<sup>th</sup>/31<sup>st</sup> 2019

*In Emerging Market equities Russia was the clear winner with an incredible 45% advance. Mexico and S. Africa were barely positive*

The dawn of 2020 finds global equities, but mostly the developed market ones, in such a delicate position. Prices have rallied sharply during 2019 on hopes of a positive resolution in the Sino-American trade negotiations while earnings growth has virtually slowed to levels not commensurate to the price gains. As mentioned earlier most of the performance came from P/E expansion were prices rallied amid steady/lower earnings. The liquidity injections by the Fed, and rate cuts by other Central Banks, have spilled oil into the fire. Market participants have begun to discount yet another up economic cycle at the mere signal that Central Banks are there to add liquidity. But why investors do not interpret the ample liquidity from the US Fed as negative or at least as the existence of problems under the hood? As we mentioned in the Fixed Income section the huge budget deficits in the US required abundant liquidity on the part of the Fed to fill the missing blank in the REPO market and also execute pure “debt monetization.” It is rather obvious that the US Fed is a lender of last resort not only to ailing banks during an economic crunch but also to the US government.

*Is the US Fed repeating the 1998-1999 policy “mistake” of ample liquidity? While this time the problem is a bit different, the end result ( a bubble in equities) may be the same*

Investors are bidding equities higher as the only viable alternative to achieve their targeted performance goals with bonds yields in Europe at zero (or below) and US 10-year Treasury Note yields below 2%. In the process US equity indices are having a melt-up kind of look reminiscent of the 1998-2000 dot.com bubble era. True, many price charts do look parabolic as many of the technology stocks have the same pattern like the ones of late 1999 and early 2000. Back then liquidity injections by the Fed to stave off the **Year 2000** looming bug coupled with enormous bets on the limitless technology boom created a positive feedback loop where price gains lured more investors into the technology stocks. The buying stampede was so fierce with investors piling into those stocks as there was no tomorrow. The fact that huge capital flows out of Asia (after the 1997-1998 currency crisis in the Asian Tiger economies) entered into the US equity market perhaps made matters worse.

We appear to be in a similar situation at the moment as trade war escalation fears

may have directed capital out of Asia again while European capital flows may also be targeting the US. The still **10+ trillion** worth of bonds in Europe trade in negative yields may have made many local managers to chase for yield elsewhere. A falling EUR does not help matters either. Their natural choice is US assets, of course, as there is no other market so liquid to absorb demand.

As we look into Q1 of 2020 and further beyond for equities we see a rather *potentially* dangerous market. It is very likely that the upside momentum will not subside easily as we have witnessed so many times in the past. The “buy-the-dip” mentality is too far entrenched into investors’ and traders mind that they will not give up easily buying any dip. **This momentum in markets will stop ONLY AFTER a corrective dip will not reward the buyers.** When people who pile into equities after a pullback are punished with losses only then will start to change their attitude. At the moment it is a bit early to see such a change after a minor corrective blip. The coronavirus event is a potential destabilizer and a wild card but unless it spreads around the world indiscriminately killing thousands of people it will not be the real force behind the equity indices. It looks more likely that stocks will continue to take cue from the US Fed’s loose policies and shrug off the weaker earnings reports for now. Once we see some liquidity draining from the system then a bigger correction may be underway.

Many analysts have been comparing today’s equity market behavior, especially the US one, with that of late 1999 and early 2000. While price chart patterns look eerily similar for many stocks or indices these two periods are not even remotely identical in terms of economic figures. The US economy is kind of trapped into a perennial easy liquidity environment provided by the Fed while the current administration is targeting the stock market almost directly. It is no secret that Trump wants a roaring market environment as he heads into November’s Presidential Election and wants to achieve it at any cost. Unfortunately it looks like the Fed has accommodated quite a few of his needs. Kicking the can further down the road is not a good recipe but it has served the incumbent rather well. From an investor’s perspective such a liquidity driven market environment highlights the potential risks and nothing more. Just because a market is rising due to another engineered liquidity event should NOT make investors shun the risk taking activities. It should, however, make them be on their toes and be prepared to act quickly if the liquidity ebbs. In other words, investors should NOT be negative during such an advance but rather know well enough that liquidity driven rallies can be unsustainable in nature and when the tide turns the reversal and decline can be very swift. It is therefore imperative for professional investors with overweight equity exposure to procure specific defense plans in the event the party ends early. Hedging long exposure is the most natural response of all if one does not want to increase cash levels. Career risk is a great motivator to follow the crowd and be part of a herding type mentality.

*Investors should not be too negative during liquidity driven rallies. However, should be fast to react and EXIT when the tide turns lower*

As we discuss with more detail in the APPENDIX section write-up on Melt-Ups and Blow-Offs we firmly believe that the rate of ascent the equities have witnessed is quite steep but not too parabolic as of yet. We cannot forecast whether they will get as parabolic as in 1999/2000. In the US equity market, for instance, we do have the parabolic look on the charts of many individual stocks but the indices may require some more aggressive rate of ascend. An up-trend ends in a blow-off and parabolic move when it accelerates even more at the very last stage. It does not just grind higher and higher. It accelerates until there is no more buyers at such elevated prices, shorts are ruined, the amateur late stage buyers are adamant about their predictive abilities, almost all market participants embrace a “new paradigm” for equities and in general people buy at higher prices just because everybody else is doing the same. They buy because price is going higher without any regard to fundamentals, earnings

or other valuation metrics. Are we there yet? Not exactly, even though we have seen a few signs here and there. If we were to risk a forecast we would say that a correction of no more than 5% to 10% is welcome and will likely reset the momentum play. After that a true blow-off COULD develop. It does not have to, but it could. Therefore, we should be on guard for the conditions that make this unsustainable rally ripe to end. As the music is still on we must dance, right?

In sum, equity valuations are not as stretched as in late 1999/early 2000 but we should not compare the current market environment with one that huge excesses were the name of the game. Why should we reach obscene valuations once again in order to get a wakeup call? Valuations are always a measure of discounting future cash flows into present value using a discount rate. It looks once again we may be falling into the usual trap of extrapolating eternally P/E's using the so called Fed model that posits that the earnings yield of the stock market index (i.e. the reciprocal of the P/E ratio) should approximate the yield of the 10-yr US Treasury Note. If we assume that the forward P/E for the US equity market (say the S&P 500 index) is around **17x** at the moment, then this valuation metric would imply equal valuation with a 10-yr US Treasury Note at **5.88%**! In other words, the equity market P/E is way cheaper when compared to the 10-yr Note yield. If we try to equalize these two valuation metrics, i.e. calculate the equivalent P/E at **1.57%** of the current Note yield then the model would "justify" a P/E of **63x** earnings. Well, that means the S&P 500 should be trading at meteoric highs then based on its **\$181/share** forecast of 2021 earnings (just do the math  $63 \times 181 = ?$ ). Under this approach every price level is in theory cheap for US equities and then investors should only bid stocks up. Stocks are almost risk-free. Are they?

*The Fed Model in valuing equities appears very simple yet it fails many tests. It gives "unreal" upside estimates in low interest rate environments. Why isn't working in Japan or Europe?*

Of course, this Fed Model approach does NOT explain why with Japanese 10-yr interest rates pegged to almost zero for more than a few years equities (based on the NIKKEI current levels) are still trading some **40%** below their all-time-high of late December 1989. That is 30 years from that historical top. We do not want to compare apples with oranges here, as Japan has faced strong deflationary pressures for quite some time while the US escaped its own during the 2007-2009 crisis. The way Bank of Japan handled the twin market collapse (equities + real estate) when compared to how the US Fed reacted is like comparing night with day. However, the Japanese experience is a perfect example of why the Fed Model approach cannot be trusted without a serious "quantitative filtering" first<sup>1</sup>. Why is the Fed Model suitable for US equities and not for Japanese? How could we price using the same approach European stocks with negative yields on the 10-yr bonds in many countries? There is no good universal answer. Hence, the Model's validity is at the very least questionable.

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<sup>1</sup> By *quantitative filtering* we refer to any mathematical adjustment needed to yield a more down-to-earth estimate for the targeted market valuation yardstick. The introduction of **Equity Duration** may approximate a bit better the real life time span of a company's equity and therefore make the 10-yr Treasury yield inappropriate to be used for valuation purposes. We do understand that as companies are going concerns with an average life span of more than 10 years they would be valued differently if some other "discount rate" was applied. Let's not forget also that even when we use the traditional **CAPM Model** to calculate the **Cost of Equity**, the *Equity Risk Premium* is derived from data that go back way more than 10 years. Indeed, when interest rates are very low cash flows from equities that yield way more than bonds should have higher value. The simplistic Fed Model approach, however, does not take into account other very important aspects of the valuation process. Should we also care about the leverage of the firm? How about the reduced free float from share buybacks financed with debt? What about the dividends paid with (cheap) debt as well? Are they sustainable? And yes, we believe that any Fed Model related valuation metric takes us to the *twilight zone*. Lest we forget what happened in 1999-2000. Deja vu!

To simply make a bold statement here we believe that equity markets ARE NOT trading at the moment based on any fundamentals. Any effort to justify valuation metrics such as Price-to-Earnings, Price-to-Cash Flows or Price-to-Sales is futile at this stage. Investors using these metrics here believe what they want to believe and simply are curve-fitting the data as we would say in statistical jargon. This is not to say portfolio managers must avoid equities all together and head to green pastures. Not at all. Where else could returns be derived from in a low interest rate environment? But is one thing to trade the markets based on momentum/hype and another holding a portfolio of assets which seem to defy basic rules of valuation calculation. When trying to extrapolate indefinitely current momentum and equity prices investors will always find current valuation cheap. Just good to know what to do when the music stops.

As the US market strategist of RIA Advisors, Lance Roberts, pointed out recently:

*“The “bullish bias” is not dead as of yet, and investors will be quick to try and “write off” the impact of the “virus.” After a decade of “macro-events” not stopping the bullish charge, the belief the market is “bulletproof” has become so deeply ingrained into investor mentality it won’t be dislodged until it is far too late to matter. Is this “the” event that triggers the next “bear market” and “recession?” Maybe. Maybe not. We won’t know for sure until after the fact. But this is why we manage risk in the short-term, so that we can navigate the “twists and turns” of the market without careening off the cliff.*

We agree 100% ...

## Commodities – Precious Metals

### Crude Oil (Light Sweet Western Texas Intermediate – WTI)

The energy complex has been hit hard in the past few weeks and especially after the Iranian missile attacks on the heels of the assassination of an Iranian military general in Bagdad (Iraq) in early January. Prices rallied towards the resistance area of **\$64-\$66** and reversed sharply lower. The recent coronavirus outbreak in China has made matters a lot worse for crude oil as demand is dwindling in the region. Previous support from the summer correction at around **\$50** has held prices for now. Should prices move decisively below that support the next target is at **\$45** and then at the late December 2018 low at just above **\$42**. We can clearly see that most of the action of the past 10 months is between **\$50** and **\$64-\$66**. A close outside the range would be notable.

Chart 8: WTI since April 2017 (Weekly Prices)



*WTI Crude Oil has been range-bound between \$50 and \$64-\$66 for the past 10 months. A outside the range may give another directional move*

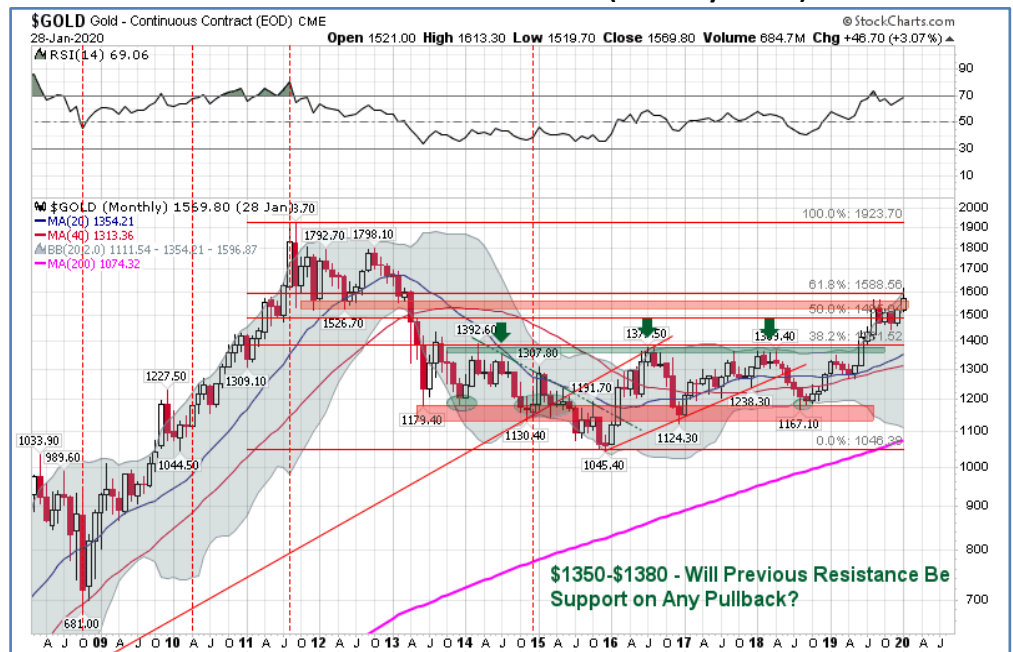
### Gold, Platinum, Silver & Palladium

*Gold has been trading positively for a few months now after creating a wide multi-year basing pattern going back to 2013. That consolidation had an upper price resistance range at the **\$1350-\$1380** area. Purely technically it is imperative that gold prices stay comfortably above the area that should now act as support. For now, resistance has been found at the breakdown area of April 2013 between **\$1530** and **\$1550**. Note also that the half back retracement (50% of the decline) is at **\$1485**. If gold prices can push cleanly above **\$1550** and also clear **\$1588** (61.8% Fibonacci) they will have a shot at **\$1750-\$1800**.*

The above paragraph written in early October 2019 is still more than valid. Gold is encountering stiff resistance in the **pink** zone (between **\$1530** and **\$1585/88**). This price range, as can be seen from **Chart 9** on page 12, represents the area where prices probed twice between late 2011 and mid-2012 before rebounding towards the peak. Also, the **\$1588** level is the Fibonacci 61.8% retracement of the entire decline from

the September 2011 top (\$1923) to the December 2015 low (\$1045).

**Chart 9: Gold since Late 2007 (Monthly Prices)**



*Gold has broken-out of a multi-year base between \$1150 and \$1350. It needs to stay ABOVE that for the bullish scenario*

Source: Stockcharts.com, prices as of Jan. 28<sup>th</sup> 2020

The main message is still the same as we maintained throughout the 2H of 2019. As long as prices stay above \$1350-\$1380 the multi-year consolidation (2015-2019) and break-out is valid. Prices could work their way higher if they can manage to break above \$1588-\$1600 meaningfully/sustainably. But they should get moving upwards soon or something may be fishy. The price consolidation between \$1550 and \$1450 that lasted throughout the autumn of 2019 should have provided enough time to absorb supply and digest the rapid 1H of 2019 rally. If we do not break-out soon watch for failure and acceleration lower after we break below \$1536-\$1550.

**Chart 10: Platinum since 2005 (Monthly Prices)**

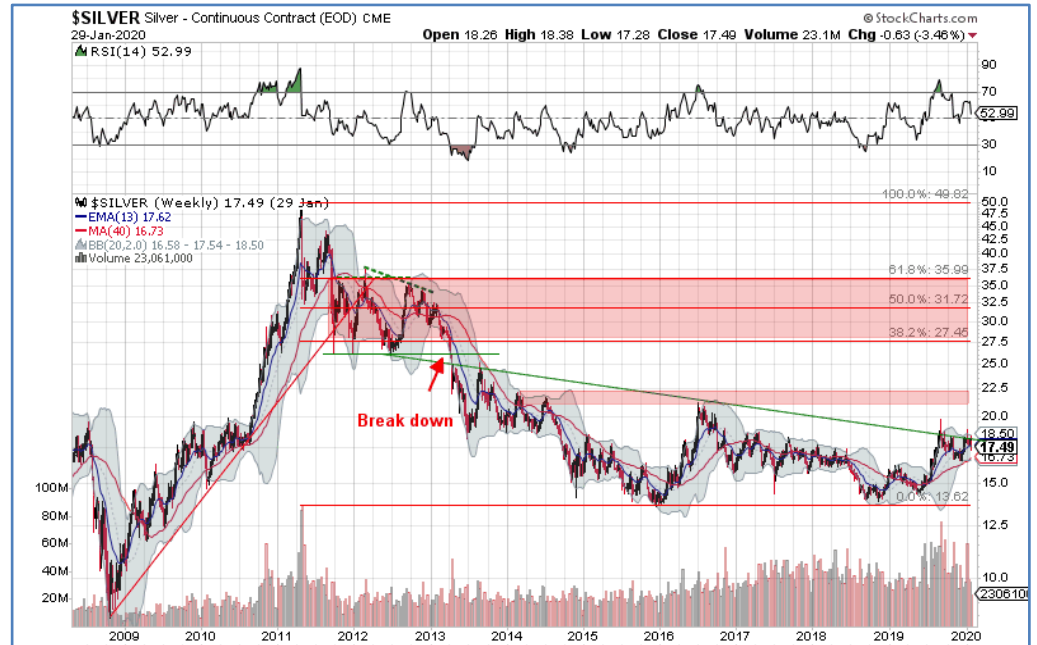


*A push above \$1030-\$1050 would be positive for Platinum*

Source: Stockcharts.com, prices as of Jan. 28<sup>th</sup> 2020

Platinum prices have been trying to find a bottom and likely build a base since late 2015 at around **\$800 (+/- \$50)**. The June-August 2019 up-move bumped against resistance at the **\$1000** level (**green** down sloping trend line since the 2011 top at **\$2000**) and failed. The base-building between **\$800** and **\$1000** continued during the fall months of 2019 as all precious metals stalled for a breather (see **Chart 10** on page 12). Once above **\$1030-\$1050** (**green** horizontal zone) prices should move swiftly towards **\$1215-\$1360** (area of the 38.2% to 50% retracement of the 2011-2018 decline). We should not go below **\$880-\$900** and stay for more than a week or two if we are to rally higher.

**Chart 11: Silver since May 2008 (Weekly Prices)**



Source: Stockcharts.com, prices as of Jan. 29<sup>th</sup> 2020

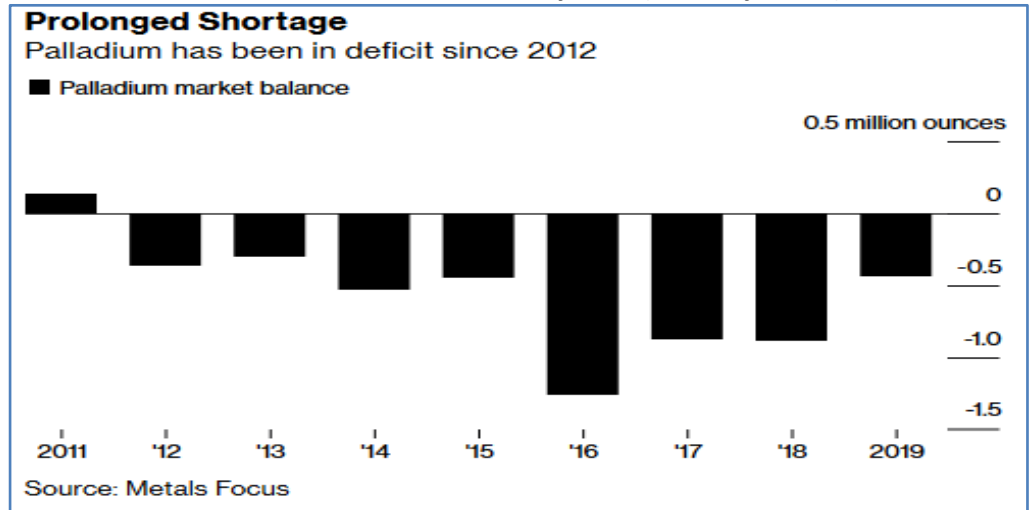
*Silver has attempted to break above \$19.50-\$19.75 during 2019. A push above that resistance may lead to gains towards \$21-\$21.50. Support near-term is at \$16.20*

Silver is usually called a “poor man’s” gold and for good reason. People who cannot afford to buy/hold gold often resort to having silver instead. So apart from its industrial use silver is a precious metal as well sensitive to investors’ risk appetite when precious metals are in demand. In many cases silver follows gold in its travails but sometimes with a lead and sometimes with a lag. In the most recent blow-off top of 2011 (see **Chart 11** above), for instance, Silver led precious metals and topped in late April (the 29<sup>th</sup>) just shy of **\$50/oz.** while gold continued higher for more than 4 months to finally peak on September 6<sup>th</sup> at **\$1923.70/oz.** In the most recent rally of 2019 as silver followed gold higher it has bumped on multi-year resistance (see **green** down-sloping trend line since 2013) at around **\$19.50-\$19.75**. A rally and close above this area of resistance will likely unlock silver’s price towards the next higher resistance zone between **\$21.20** and **\$22.50**. Only a rally/close above **\$22.50** would confirm that a more powerful move towards **\$27.45** (i.e. the 38.2% Fibonacci of the 2011-2016 decline) is unfolding. For the abovementioned scenario to be valid prices should not violate support at **\$17.20** and **\$16.20**, respectively. Should support at **\$16.20** is lost, something else, for sure not bullish (or outright bearish), is likely underway.

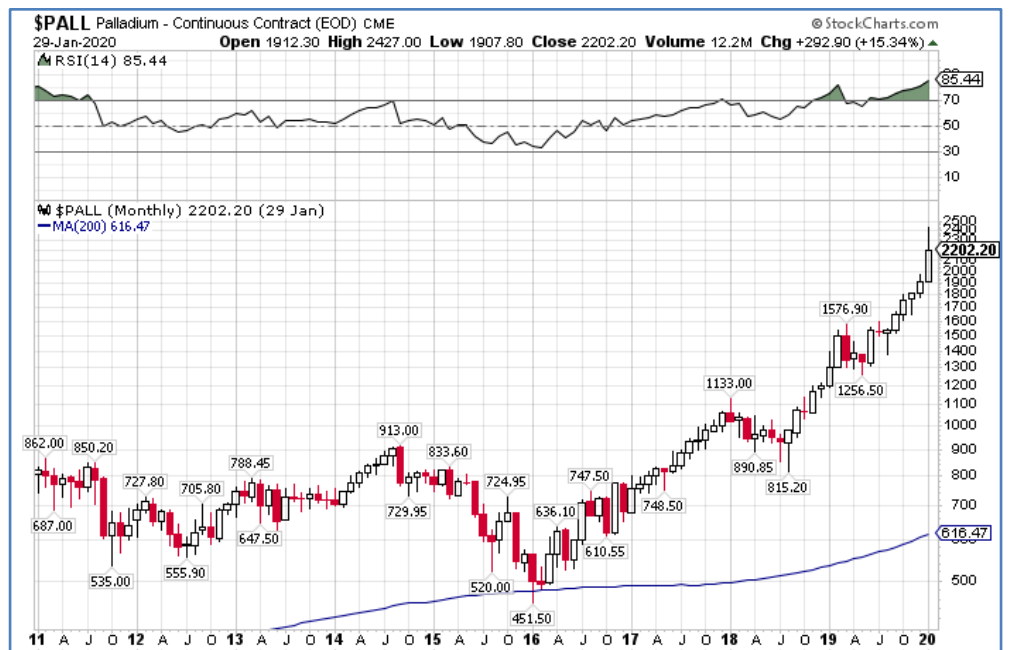
As precious metals caught a serious bid during the spring of 2019 with gold and silver benefiting noticeably there was another metal that perhaps stole most of the attention. It was Palladium. A series of factors such as supply shortages, hedge fund accumulation and strong demand from China has sent prices soaring. **Chart 12** (on page 14) above presents the blow-off type of move in the past few months. Palladium

is **300%** higher from its January 2016 low at **\$451**. This is how blow-off moves develop. A disequilibrium between short-term demand and supply tilts prices aggressively towards the deficit side. In this case the supply shortage coupled with aggressive buying by funds to basically move price higher/faster has yielded a near vertical move. In the case of commodities when real supply is involved these short squeezes have a magnified effect on prices. Once demand is exhausted or supply becomes balances prices usually retreats fast.

**Chart 12: Palladium since Early 2011 (Monthly Prices)**



*As supply/demand equilibrium became unsustainable prices rose sharply led by demand out of China and Hedge Fund aggressive buying*

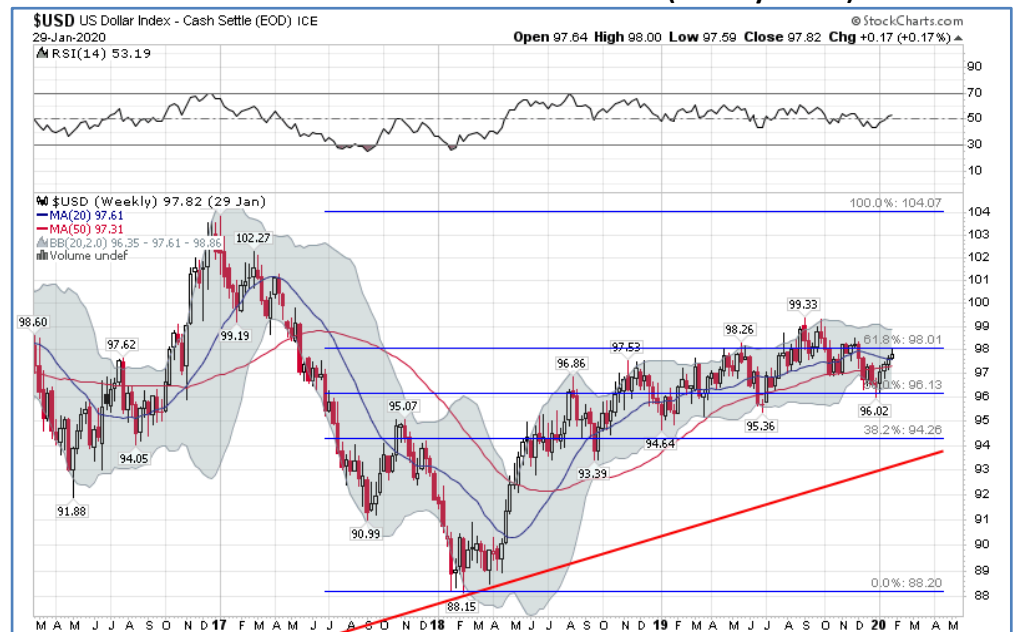


## Currencies

The US dollar Index peaked at the dawn of 2017 as the new Trump administration was sworn in. Trump was immediately quite vocal calling for a weaker US dollar as exports were being hurt. It was not until early 2018 when the trade war with China started to gather steam that the US Dollar Index bottomed and begun to rally. The advance has already stalled below the 2015-2018 peaks between **100.60/70** and **103.82**. If the US Fed continues to lower its interest rates as the Fed Fund futures market anticipates it may not be that easy for the US dollar to swim against the lower tide. However, if the US economy were to fall into an economic downturn (not necessarily a recession) it would not be a surprise to see the US currency being bought as it was the case in both previous recessions.

The below **Chart 13** shows initial support at **94**, then **92** (rising trend line since 2011) and finally at the 2016 low of just above **88**. The REPO market crisis since mid-September 2019 perhaps has altered a little bit the overall tone as the market is effectively short US dollars. The Fed has intervened to both address the lack of liquidity as banks have virtually disappeared from the REPO market and also provide the “scarce” US dollars even outside the country. The effort of the US Fed to be providing ample liquidity has perhaps made it difficult for the US dollar to rally. Will the Fed lose control of the situation leading to a USD upside thrust? Difficult to say. If the current status quo is maintained the normal USD trajectory should be down. A “clean close” above **99.50-100** would imply that something is “wrong” with the Fed’s intervention or it has lost control of the US dollar’s exchange rate. Unless that is the desirable scenario.

**Chart 13: The US Dollar Index since 2010 (Weekly Prices)**



Source:Source:Stooqcharts.com, prices as of Jan. 29<sup>th</sup> 2020

*The US Dollar Index appears trapped between a shortage of USD amid a REPO crisis and a willingness of the US government to see it lower*

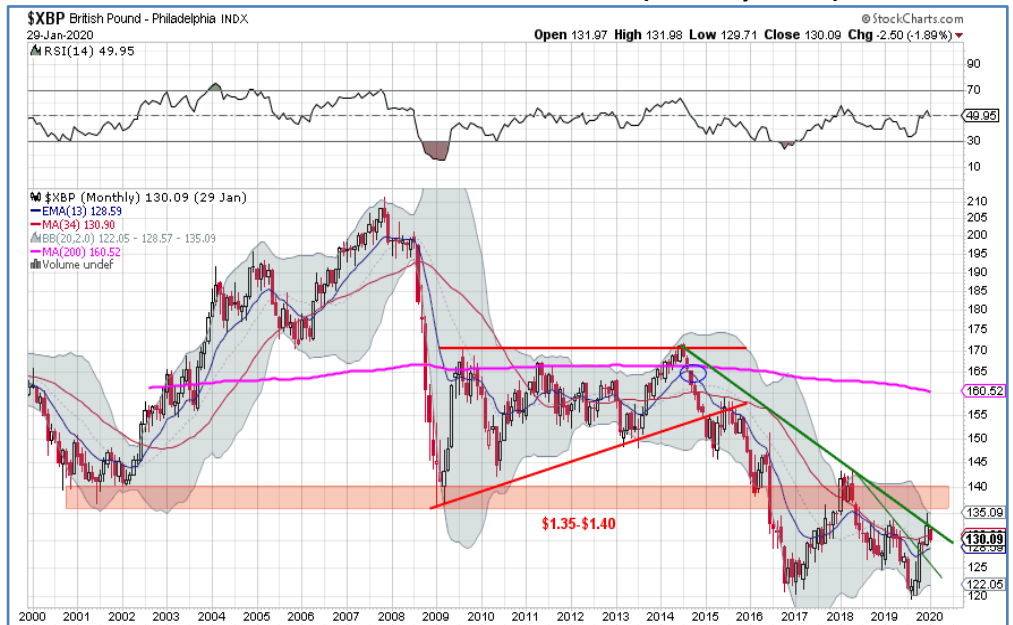
## GBPUSD & EURUSD

*The rally off the \$1.20 low of late summer seems convincing so far, barring any negative surprise of course. As long as it stays above \$1.2450 we may say that the previous medium-term bearish picture ended and we enter a neutral phase. Any rally up to \$1.33-\$1.3350 should reinforce this assessment. A rally and close above \$1.3350 would be very*

*bullish GBP longer-term. However, the price range between \$1.35 and \$1.40, which represents the initial area low immediately after the Brexit vote of June 23<sup>rd</sup> 2016, will represent formidable resistance.*

The GBPUSD pair rallied sharply in anticipation of Boris Johnson’s election victory in December and traded to as high as **\$1.3512** immediately after the exit polls showed an ample parliament majority for the Tories. The pound sold off almost instantaneously upon entering the resistance zone of **\$1.35-\$1.40** (as denoted by the horizontal ribbon). The fact of the quick reversal down strengthens our long standing opinion/analysis that the Brexit breakdown price range will offer stiff resistance. Once GBPUSD starts to trade comfortably above **\$1.35**, our longer-term targets are from **\$1.45** to **\$1.48** and then above **\$1.5250** towards **\$1.60**. Only a close below **\$1.25** would alter this bullish scenario for the pair. First support before that is at **\$1.28**.

**Chart 14: The GBPUSD Pair since 2000 (Monthly Prices)**



*The \$1.35-\$1.40 area presents a very stiff resistance barrier for GBPUSD. It was the area from which it broke down after the BREXIT vote on June 23rd 2016*

Source: Stockcharts.com, prices as of Jan. 29<sup>th</sup> 2020

**Chart 15: The EURUSD Pair since 2003 (Monthly Prices)**



*EURUSD remains weak as long as the ECB insists on its negative interest-rate policies. A rally of EUR will likely be a result of USD weakness*

Source: Stockcharts.com, prices as of Jan. 29<sup>th</sup> 2020

ECB's eternal QE has put a lid under the EUR's attempt to advance (**Chart 15** on page 16). We could very easily say that any EUR rally from now on will more likely be attributed to US dollar weakens and not due to EUR strength. We know it is very tough to distinguish which is which in an advance or decline but if the US dollar index declines, the EUR and other major FX pairs will get a bid no matter what. However, as long the pair trades below **\$1.1250** it is in a longer-term DOWN-trend and therefore caution is advised. Once above **\$1.1250** the next upside target is at **\$1.15**. Ultimate target but farfetched at the moment is the **\$1.20** area. A lot of things need to happen for the EURUSD to rally towards that level.

## Summary

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Global markets entered 2020 with a very positive attitude as momentum carried forward from Q4 2019 prices in both equities and bonds. Global equities, and US ones in particular, were quite a bit stretched showing melt-up characteristics while earnings had not kept pace with prices. P/E multiple expansion led to swift setbacks when higher expectations do not come to fruition or when an exogenous shock makes investors to re-price risk. The coronavirus outbreak may have just provided the needed catalyst to get some froth out of equities. Global growth will suffer if the virus spreads further out into more countries and global trade declines. Markets have not priced for such outcomes, even though we do not know how far the virus scare can affect the global economy. It has the potential to create havoc globally or alternatively to just be contained as was the case with previous outbreaks (SARS, Ebola, etc.). A **5% to 10%** correction in equities is not a big deal after such a bull run throughout 2019 and especially after the non-stop advance since early October. It will take a bit of air out of the bulls' sails but that would be healthy. What would be outright negative for equities? A decline below the price peaks of May and late July 2019. In other words a move lower that would negate the October break-out higher.

In US fixed income we see the seeds for more yield declines if equities correct deeply and investors continue to flee into bonds. It will be the rotation out of bonds and into stocks that will hint of a "short-term correction only" move down in equities. European bonds are still mostly in negative yield territory and therefore this is no space to add anything. Avoid. Emerging market debt carries the risk of a rallying USD and present some risk-off opportunities.

If we were to risk a bigger picture forecast for the next few years as we just augured a new decade we would say that as long as global equities correct orderly and any pullback is maintained above the breakout levels of last fall, we should not see panic interventions from Central Banks. If we do see them panic and flood once again markets with "unlimited" liquidity we may very well experience the very scenario we discuss in our APPENDIX section related to Melt-Ups and Blow-offs. If global Central Banks accelerate the liquidity/QE efforts we may very well witness the nearly vertical blow-off move that ended previous parabolic moves higher in equities, commodities or other asset classes. From that point on a market bust, or better said a crash, could emerge wiping out most of the 2019-2020 gains and then some. Such an event would be highly DEFLATIONARY and likely be countered with amazing response by Central Banks. An INFLATIONARY BOOM should naturally follow. In such a scenario bonds will initially benefit quite a bit as yields may approach the "zero bound" in the US but then will suffer the consequences of rapid inflation later in the decade. **This is a scenario to unfold ONLY if we do melt-up/blow-off in equities** (i.e. say in a 20%+ move above whatever correction low we see in the days/weeks ahead should the pullback continues). If we do not correct enough now but instead continue our move higher in a slow grinding way, the above mentioned scenario is nullified. We will have to redraw our potential path forward.

## Notes

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