



A LOOK AHEAD

December 2017

Geopolitical tensions (North Korea, Saudi Arabia) and the beginning of monetary tightening by the Fed could not stop equities from rallying. Most equity markets are expected to finish the year with double-digit gains while volatility sits at record lows. Simultaneously there has been a sharp increase in equity valuations with U.S. equities now being more expensive than in 1929 (they were only more expensive in 2000). How long will the rally continue and what about the economic recovery being one of the longest on record? On the following pages we will try to find answers and provide you with a roadmap for the first half of 2018 and beyond.

A Look Back – Key Messages Last July

Equities

Our expectation that U.S. equities had entered a correction that could last into early Q4 was wrong. The correction took place, but was only shallow and very short-lived. Since the August low, the S&P 500 has rallied more than 9%. Especially September and October were very strong months, which is a very unusual time for rallies.

While we were expecting a correction, we were also saying that we did not believe in a major top and that we expect one more rally attempt into mid 2018.

Interest Rates

As expected, U.S. 10yr treasury yields moved higher in the second half of 2017 although they did not reach the highs from March 2017 at 2.61.

Currencies

Back in July we said that we have good reasons to believe that the multi-year US dollar bull market is over and we recommended selling any rally in the greenback.

As the dollar index looked increasingly oversold, we were expecting a countertrend rally, which took place between September and November. While we were bullish on the Euro, it has not yet reached our target at 1.24. Already last December, we turned bullish on GBPUSD. Our 1.34 target was reached in September (+10% from the December lows)

Commodities

On the back of expected dollar weakness, we were calling for a significant rebound in commodities. Indeed, the CRB index rallied by 8%. We were particularly bullish on copper (+11%) and expected miners to outperform the broad market. Our bullish target of USD 50-52 in oil has clearly been exceeded.

Gold

We were bullish for gold but by saying that a move above USD 1300 would pave the way towards USD 1490/1520 (to be reached by late 2017/early 2018) we were too bullish. Since that call, gold has rallied 7.5%.

A Few Thoughts

"Low interest rates justify higher valuations" is among the most cited reasons for the ongoing rally in global equities. This is certainly true as long as the stream of expected future cash flows is held constant (discounting future cash flows at a lower rate results in a higher price). But despite strong earnings growth in 2016 and 2017, corporate profits are still at the same level as they were back in 2014. Also, it should not be forgotten that share buybacks were a key driver of that earnings growth in the last few years. Certainly, the loose monetary policy of central banks around the world was a key driver of this rally that is already in its ninth year and therefore the third longest in history. But with U.S. equity valuations at the highest level since 2000 and the Fed as first central bank in tightening mode, we ask ourselves how long this rally can last. Before we look at the technicals of the

markets we would like to share with you some of the potential risks in the coming year.

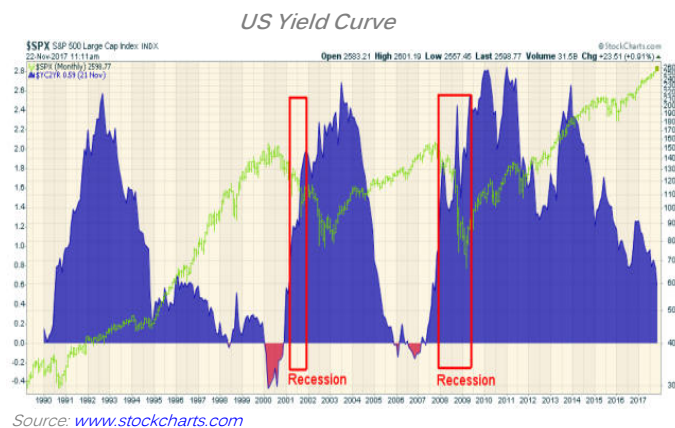
U.S. Stock Prices vs. U.S. Corporate Profits



Source: www.realinvestmentadvice.com

US recession

The current US economic recovery is the third-longest in the past 240 years, but at the same time one of the weakest. There are only two other economic expansions that were longer – one nine years long and one 10. Despite massive stimulus, real GDP growth has averaged only 2.2% since the recovery began in 2009. This compares to 4.6% between 1996 and 1999 and 3% between 2003 and 2007. Continued acceleration in the economic cycle is consensus despite the Fed being in the midst of a tightening cycle and real GDP growth running at only 2.2% this year. But signs that the US economy is weakening are rising: Tax receipts for example are lower than they were in late 2015 and credit card and car loan delinquencies are on the rise. Also, 10 of the last 13 rate hike cycles ended in a recession. Most important, one of the most reliable recession indicators, the yield curve (spread between two and 10 year US treasury yields), has reached the flattest point since November 2007. While it is not inverted yet (an inverted yield curve has preceded each of the past five recessions), it is in direct contradiction to the booming equity market. In other words, the bond market remains very sceptical that the tax reform will boost the economy and does not share the optimism of equity investors.



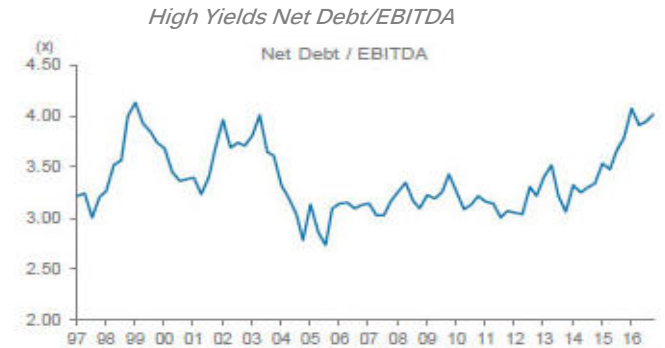
Source: www.stockcharts.com

Corporate Debt

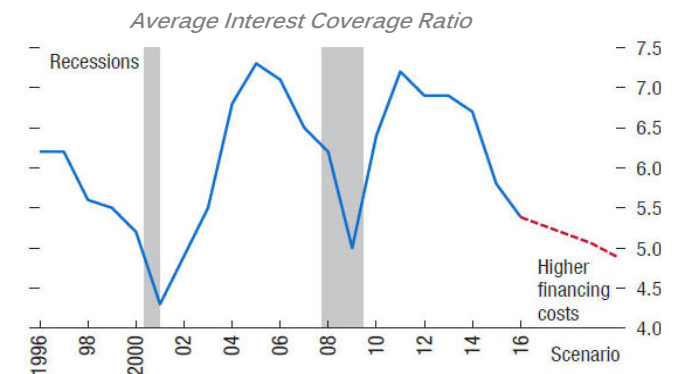
In their Global Stability Financial Report from April 2017, the IMF warned of the seemingly unstoppable growth in global corporate debt (remember, most of the share buybacks were financed by the debt issuance). For example the debt pile of Russell 2000 members (small caps) has increased fivefold since the end of 2009. Also, currently the ratio of debt-to-EBITDA for companies in the S&P 500 (excl. financials) stands at 2.33x, the highest point in at least 20 years.

The IMF also said that the number of firms with very low interest coverage ratios is already high. Interest coverage for the smallest 50% of US companies is near record lows. Firms accounting for 10% of corporate assets appear unable to meet interest expenses out of current earnings. A sharp move higher in rates or – more likely – lower earnings caused by a weakening economy could trigger an avalanche of defaults. The sell-off in high yield bonds in

November has given a taste of what might happen if investors rush for the exit. For all the reasons mentioned above, we do not want to own highly indebted companies such as Telsa or Netflix, only to mention the most prominent.



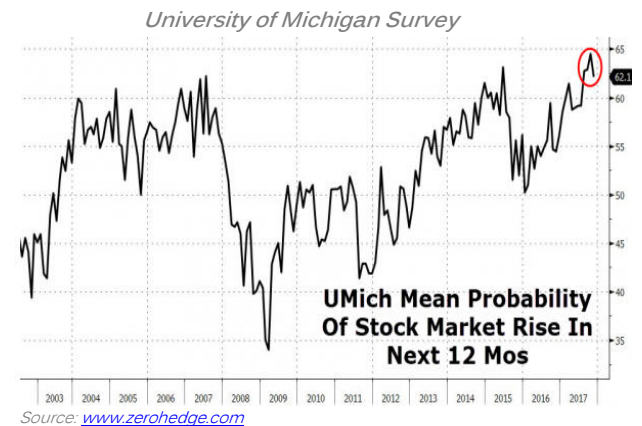
Source: www.imf.org



Source: www.imf.org

Investor Confidence

Individuals have never been as hopeful as they are currently that the stock market will continue to grind higher. According to the University of Michigan survey, consumer sentiment for November showed a 62% expected probability that stocks would rise in the next 12 months. The August reading of 65% showed the highest optimism since beginning of the survey in 1999.



Source: www.zerohedge.com

In early November, the CBOE Volatility Index (VIX), widely considered the best gauge of fear in the market, fell to its lowest level on record. Speculative short positioning in VIX futures has reached an all-time high. The message is clear: investors are not worried about a major correction at all. This complacency is astonishing, considering geopolitical tensions (North Korea, Saudi Arabia), an unpredictable U.S. president, margin debt at an all-time high, a tightening Fed and record high equity valuations.

CBOE Volatility Index 1990-2017

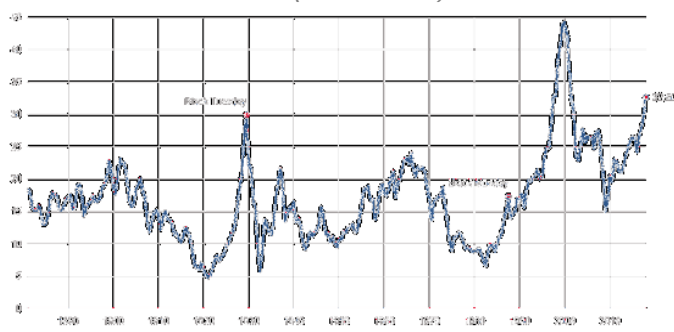


Equity Valuations Matter

In all our recent issues, special attention has been paid to equity valuations (that get more extreme every time we write about them). We are totally aware that markets can stay overvalued much longer than any of us can imagine, especially during a central bank-sponsored bull market. But in our view, the bottom line remains always the same: this time is never different. Instead of rewriting the story, we have decided to only update the numbers. We strongly recommend first time readers to read this chapter carefully, as all of the valuation methods mentioned below present an invaluable tool for the long-term success.

The **Shiller P/E** or **CAPE ratio** was developed by Nobel Prize winner Dr. Robert Shiller and Dr. John Campbell. It divides the S&P 500 by the 10-year average of inflation-adjusted earnings. It therefore captures earnings over one or two business cycles instead of only one year. While earnings over only one year have frequent ups and downs, the 10-year average better reflects sustainable earnings.

Shiller PE (1800-current)

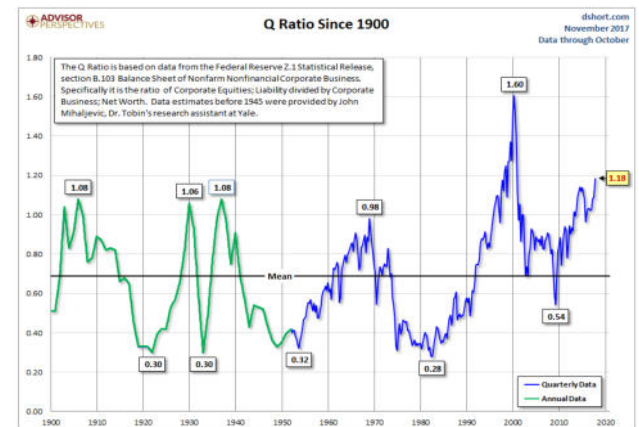


Using data going back to 1900, the median value for the CAPE ratio is 15.64, which compares to today's ratio of 32.6. Not only is today's ratio more than 80% above its historic norm, it is now higher than in 1929.

Yes, the current Shiller PE is much lower than its 1999 peak but if today's historically high profit margins are adjusted to 1999's levels, the ratio today is much closer to its 1999 peak. If stocks were to revert to their long-term median value, that would imply a decline of more than 40% from today's prices.

Tobin's Q ratio, which compares stock-market values with the real-world prices of corporate assets, is another indicator that signals overvaluation. A ratio above 1 means that the market is worth more than the replacement costs of all the companies. The current ratio of 1.22 is way above historic average, which is around 0.65. While it is still far below the extremes from 2000 (1.61), it clearly signals that the market is overvalued.

Tobin's Q Ratio



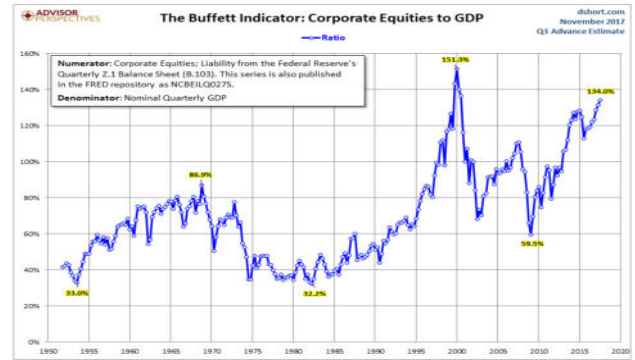
Last but not least, the **Buffett Indicator**. According to Warren Buffett, it is "probably the best single measure" of the total market valuation at any given time. The indicator compares total market capitalization to GDP and currently shows that investors have only paid more for stocks at the peak of the tech bubble in 1999. The current level of 134 implies a more than 60% overvaluation in stocks relative to their median value. Similar to the CAPE ratio, a fall back to the long-term historic norm would be equivalent to a fall in stocks by roughly 40%. As a side note: Berkshire Hathaway currently holds a record amount of cash (36% of its assets).

Another way of looking at the huge overvaluation of US equities is to look at a simple price to sales ratio. By this valuation, the US stock market has not been more overvalued since 2000.

These numbers tell us, that investors buying US equities at current levels and just holding them will very likely suffer poor returns over the next decade. Based on the Shiller P/E or

CAPE ratio, the U.S. market is expected to return -2.7% over the next eight years. The Buffett Indicator indicates a return of -1.8% over the same period! (the complete opposite for example is Russia, one of the cheapest markets worldwide (Shiller PE 5.6) There, the expected future annual return is at 27%!) While these return estimates have historically a strong correlation with real returns, markets can stay overvalued a very long time. It is all about timing and therefore it is worth to have a look at the technical picture of the markets too.

Buffett Indicator (Market Cap to GDP)



Source: www.advisorperspectives.com

Equities

Back in July 2016 we set a price target for this bull market at 2'550 which we expected to be reached in the first half of 2018. Trading at 2'687, the target has been exceeded by 5%, earlier than expected. From an Elliott wave perspective, the S&P 500 is trading in the final 5th wave. In other words, the advance is very mature and in its final stage.

Past major market tops have been characterized by multi-month distribution patterns. Prior to the the financial crisis of 2008, the market traded more or less sideways for eight months before it broke down in January 2008. In the final stage of the Dotcom bubble, the S&P 500 moved sideways for six months.

Both tops had something in common: weakening market breadth. During the months preceding the final top, the participation in the rally was continuously fading. Fewer and fewer stocks helped to lift indices to new highs. Examples are the percentage of stocks trading above the 200 day moving average or the percentage of stocks making new 52-week highs that both kept falling in the months ahead of the final top. Another warning signal came from the volume of advancing minus declining stocks. It was already falling before the actual high in the index. Yes, there were enough signals that should have warned investors that something was going very wrong.

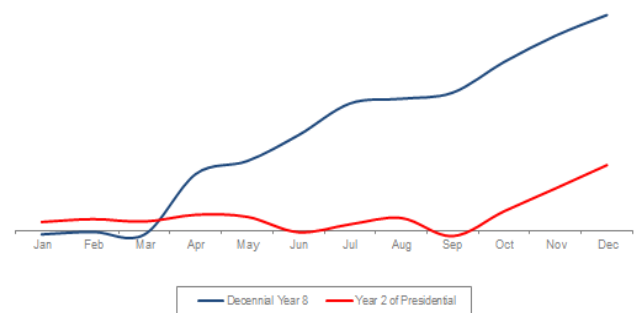
Today's Situation

Near the end of a bull market, very often it is small- and mid cap stocks that fail to make new highs and where market breadth starts to deteriorate first. Today, small- and mid caps both did not confirm the highs in the large caps anymore. and in small caps the percentage of stocks trading at a new 52-week high is constantly falling. This could be an early warning sign that we are getting closer to a top. But the fact that breadth and momentum still looks fine in large caps (e.g. Dow Transport confirmed the highs in the Dow Jones Industrial) makes us believe that a major market top is still months away.

Regular readers know that cycle analysis is one part of our work. Unfortunately, for next year both cycles (presidential and decennial) are of no help as they strongly diverge. What they both indicate is a relatively weak Q1. A near-term pullback is also

indicated by the weekly RSI: The recent highs in small caps, the Nasdaq 100, the DAX, EuroStoxx50 and the SMI were not confirmed by the RSI anymore.

Cycles 2018



Source: Bloomberg, CV Invest Partners AG

Following a pullback into early Q1, we continue to expect the markets to edge higher with a potential (major?) top in May.

S&P 500 Weekly



Source: www.stockcharts.com

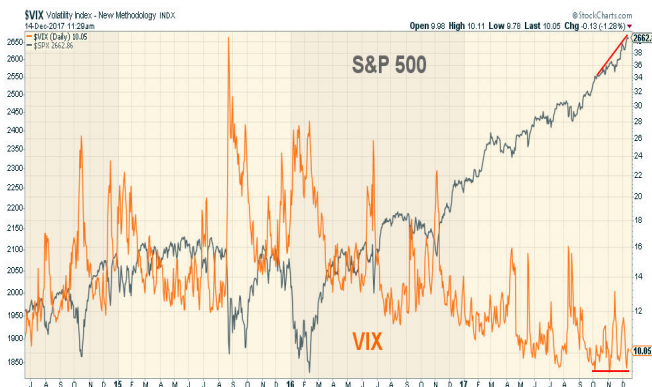
Remember, bear markets lead recessions by about 8 months. So even if a US recession is still many months away (late 2018 or 2019?), the stock market could start to anticipate it already by next summer.

As explained before, weakening breadth always precedes major tops. Between now and then, we will closely watch economic indicators and market breadth. Beside that we will keep a close eye on the following "indicators":

Volatility

Ahead of major market tops, we often see a divergence in the VIX. This is when equities make new highs on higher volatility. In recent months we have seen the S&P 500 making new highs while the VIX staid more or less flat. If the S&P 500 AND volatility moves higher in the coming months, we would get an additional signal of a pending top.

S&P 500 vs. VIX



Source: www.stockcharts.com

Treasury-Bund spread

For the last 30 years, the spread between 10-year US treasury notes and German 10-year bunds has worked very well as an early warning signal of a pending major market top. The spread peaked in May 1999, 10 months ahead of the March 2000 peak for the S&P 500. In June 2006, the spread peaked 16 months ahead of equities. Then in April 2010, it peaked 12 months ahead of the April 2011 high. Now most recently, the spread peaked in December 2016, a year ago. Therefore and if the indicator works once more, a top in equities in the first half of 2018 is likely.

Treasury-Bund Spread



Source: www.stockcharts.com

Technology

The FANGs (Facebook, Amazon, Netflix, Google) have been massive outperformers this year. This has been reflected in the performance of the S&P 500 index, which was up 17% as of end of November. Excluding these names, the benchmark would have returned "just" 11%. Therefore, any weakness in technology stocks and especially the FANGs could signal that the market is tired and about to top out (in the Nasdaq 100, we are already seeing weakening market breadth)

Initial Jobless Claims

The chart below shows the 4 week moving average of US initial jobless claims (inverted) versus the S&P 500. Ahead of the 2000 and 2007 top, initial jobless claims started to rise while equities were still rallying. That divergence gave an early signal of a weakening economy.

Initial Jobless Claims 4 week MA vs. S&P 500



Source: www.stockcharts.com

Sotheby's

The stock of Sotheby's (BID), one of the world's largest brokers of art, jewelry, real estate and collectibles, has been cited as a good predictor of the business cycle. In 1999 and 2007, peaks in the stock were followed by recessions a few months later. A break below the 12 month moving average and a bearish crossover in the monthly MACD would signal, that the stock has peaked and that equity markets were to follow soon thereafter.

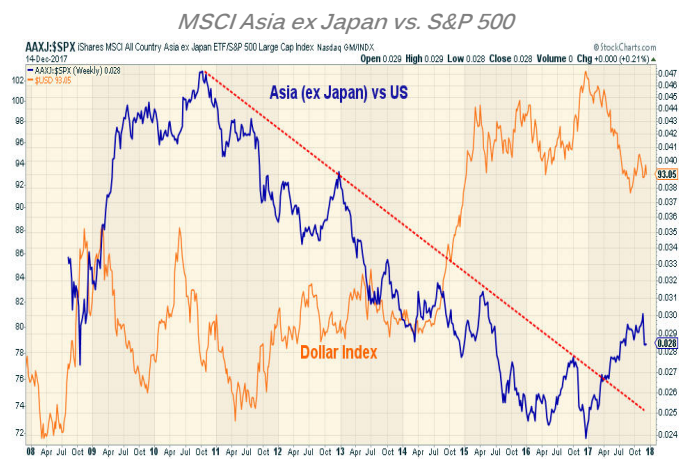
Sothebys Holdings (BID) Monthly



Source: www.stockcharts.com

Underweight US Stocks

As explained above, the US market is one of the most expensive markets in the world, trading at a Shiller PE of more than 30. Asian and European markets are trading at much more reasonable ratios (e.g. Germany 20.5, France 21). But cheaper valuations are not the only reasons why we recommend to underweight US stocks in 2018. For more than seven years, Asia has underperformed the US. One reason has clearly been the dollar rally. But in early 2017, only a few months after the peak in the dollar index, the MSCI Asia ex Japan has broken the seven year old trend of underperformance. We expect this trend to continue in 2018 and therefore recommend to overweight Asian equities. Our expectation of a weakening US dollar fits perfectly to our view.



Less clear is the situation in Europe where the MSCI EMU Index has underperformed US equities since 2008. In early 2017, they managed to break this multi-year trend of relative underperformance but renewed weakness puts a question mark behind the sustainability of this breakout. We give Europe the benefit of the doubt and view the current pullback as a normal backtest of the broken trendline.



By looking at the monthly charts of the EuroSTOXX 50 and the broader STOXX 600 below, it becomes obvious that both are sitting at critical levels, facing massive resistance. A monthly close above 3700 and 405 respectively would be very positive.

But as we see the risk of an important top in the US market early next summer, it is hard to image that European equities will not follow them. While we believe in relative outperformance, a sustainable breakout might be postponed.

Euro STOXX 50 Monthly



STOXX 600 Monthly



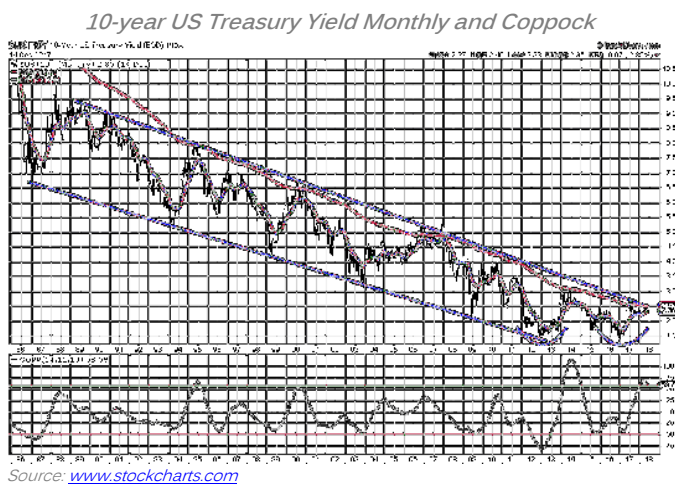
We should also not forget the Nikkei. In 2013, Japanese equities have entered a new secular bull market. Investors continue to remain very sceptical. But not only is the BoJ expected to continue its loose monetary policy for quite a while, Japanese companies are doing extremely well. Profit margins are at the highest level since beginning of this century, balance sheets look strong and the price-to-book ratio is at only 1.4.

Nikkei 225 Monthly



Interest Rates

10-year US treasury yields are still trading within a multi-decade downtrend. In early 2017, an attempt to breakout failed. Currently, yields are trading at 2.43, slightly below resistance at 2.53. This is where the 1989 downtrend line and the 96 month exponential moving average meet. The latter has capped every rally in the past 22 years. Next resistance is at 2.62%, the highs from early this year and then at 3%, the 2014 highs. Breaking the latter would signal the end of the bond bull market. But with the Coppock curve having turned bearish, medium to long-term the risk is rather to the downside. Clearly, the 2012/2016 double bottom indicates, that a major bottom is in and that the 35 year old bull market in bonds is about to end. But history has shown that such turning points last for many years and we do not expect this to be different this time.



High Yields

Special attention should be paid to high yield bonds (formerly known as junk bond, which is more appropriate). Back in 2015, a multi-month divergence in the RSI signalled troubles ahead.

In June 2015, high yields broke down and two months later, were followed by equities. That marked the start of the 2015/2016 correction in equities. Today, there is a very similar setup. Recent highs in the iShares iBoxx \$ High Yield Corporate Bond ETF (HYG) were not confirmed by momentum anymore. Should the ETF fall below USD 85.65 (the lows from July, August and November), we could see a sell-off in high yield bonds. Not only could liquidity become an issue but also corporates could get into trouble. Remember, many companies are highly leveraged and therefore extremely vulnerable to a spike in credit spreads. How distorted the high yield market has become is best shown in the 100 year bond issues of Ireland, Austria and Argentina. The latter defaulted 4 times in the last 35 years...



Foreign Exchange

In December 2016 the Dollar index reached 102.80, almost precisely the price target of its inverted head and shoulder pattern. The fact that this top matched the 7-year cycle peak and was not confirmed by the monthly RSI anymore made us turn long-term bearish in our December 2016 issue. Between then and September 2017, the dollar index lost more than 10%. We view the rally between September and November as a typical bear market rally. But we believe that the bigger trend is down and therefore expect the dollar index to break the 91 support in the first half of 2018.

EURUSD

As the Euro accounts for nearly 60% of the Dollar index, being bearish on the dollar should almost automatically translate into a bullish view on the Euro. Indeed, the break of the RSI downtrend



in May gave a very bullish signal for the Euro, especially as it happened on the monthly chart. We expect EURUSD to move towards 1.23, the next strong resistance (trendline that connect the lows from November 2005, June 2010 and July 2012). Above that, 1.29 would be the next stop (upper end of a multi-year downtrend channel)

EURUSD Monthly



Source: www.prorealtime.com

EURCHF

In 2017, the Euro has gained nearly 10% versus the Swiss franc. While we have a bullish view for the Euro against US dollar, we do not expect the Euro to rally against Swiss francs. On the weekly as well as on the monthly chart, the Euro is heavily overbought. Coupled with a divergence in the weekly RSI, we expect the Swiss franc to strengthen in the first half of 2018.

EURCHF Weekly



Source: www.prorealtime.com

Commodities

Being long-term bearish on the dollar should be supportive for commodities. Following a strong rally of more than 15% between July and November, the CRB index retraced 38.2% of that move, a healthy correction caused by the countertrend rally of the US dollar. Since then we witnessed another sharp move to the upside and the CRB index is now about to take out the highs from early November. Next very strong resistance is at 196 (currently 193), the highs from June 2016 and January 2017. With the dollar in bearish mode and bullish weekly as well as monthly momentum indicators we expect a break of 196 to only be a matter of time and commodities to continue their rally in the first half of 2018.

CRB Index Weekly



Source: www.stockcharts.com

Crude Oil

By reaching USD 59, crude oil came very close to the highs of May/June 2015 at USD 60-62. On a weekly timeframe, crude is getting overbought but a divergence is still missing. Therefore we expect oil to rally and any pullback to be only short-lived. Also longer term we are bullish as on the monthly chart, crude is far from being overbought. And don't forget, geopolitical tensions in North Korea and especially the far east have the potential to spark a sharp spike in oil prices. The price target of the inverted head and shoulder pattern is at USD 85!

Crude Oil Weekly



Source: www.stockcharts.com

Copper

Despite a five wave move off the early 2016 lows, we do not think the rally in copper to be over yet. Clearly, after rallying more than 12% since December 5th, the metal looks ready for a pullback. Also, the recent new high was not confirmed anymore by a new high in the weekly RSI. This is another warning sign of a pending correction. While we would not chase copper at current levels, we do expect higher prices into 2018 as on a monthly timeframe, the metal is not overbought yet.



Gold

Despite a very unfavorable environment since beginning of September (-9%), gold in US dollar is still up more than 12% year to date. Rising real interest rates, a stronger dollar and a goldilocks economy are all factors that are negative for gold. It is also the case that gold currently stands in the shadows of cryptocurrencies (never buy stuff you don't understand!) and that money has flown into bitcoins and co. rather than gold.

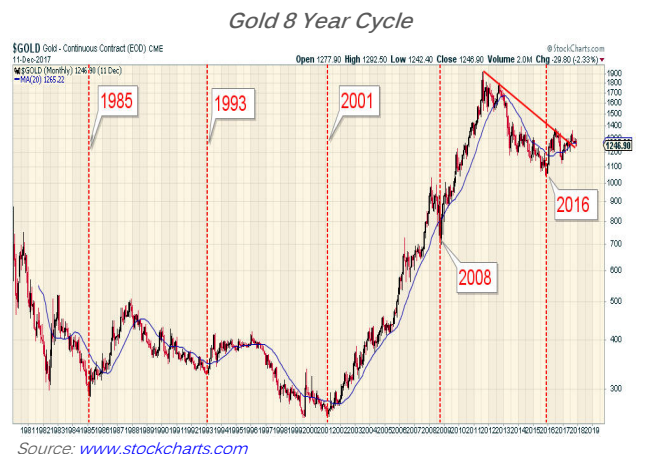
In expectation of a major top in equities in 2018, another downturn in the US dollar and a possible burst of the cryptocurrency bubble, we give gold the benefit of the doubt and continue to view gold as a good hedge should the "everything-bubble" burst. Buy Gold.

In previous issues we have talked about the significance of the 20 month moving average. During the 2002-2011 bull market, that moving average provided very good support. Between 2011-2016 bear market, the same moving average turned into resistance. The break above in early 2016 coupled with an 8-year cycle low was one of the main reasons why we turned bullish in our December 2016.



On December 12th, gold reached USD 1235, the 50% retracement of the December 2016-September 2017 rally. But thanks to the strong move of the past few weeks, it becomes very likely that we will see a monthly close above the so important 20 month moving average (currently at 1265).

The fact that 2017 will turn out to be another great year for gold makes us feel very optimistic for 2018, especially considering all the negative factors mentioned above.



Conclusion

Since 2009, equity markets have been steadily rising against a backdrop of extraordinarily loose monetary policy. Now, as the Fed has started to tighten, markets continue to move higher. Especially the valuation of the US equity market is very rich. It has only been more expensive once, in 2000 ahead of the dotcom bubble. While valuations play a very important role for the long-term success, markets can stay overvalued for quite some time. We believe the rally in world equities and especially US equities is in its final stage but a major top should still be a few months away. Following a short pullback in January, we expect a final rally into May, our earliest timing for a top. Especially the second half of 2018 could turn out to become very disappointing. The biggest threat in our view is a weakening of the US economy.

We expect European and especially Asian equities to outperform US stocks. Not only are they much cheaper, they have also broken multi-year trends of relative underperformance.

In US 10 year yields we might see a test of 2.51 and then 2.62 in the coming weeks. But only a break above 3% would signal an end of the multi-year bull market in bonds. We do not expect this to happen in the first half of 2018. Rather we expect lower yields especially as the Copped curve has turned bearish.

We will keep a close eye on high yields as a risk factor for equities. A break of the iShares iBoxx \$ High Yield Corporate Bond ETF (HYG) below USD 85.65 could trigger a sell-off that is likely to weigh heavily on equities.

It remains our view that the dollar index has peaked in December 2016. The September-November rally was a typical countertrend move. As the bigger trend is down we recommend to sell any rally in the dollar. Therefore we also expect a higher Euro, where next resistance at 1.23 could be reached. Since beginning of February, the Swiss franc has lost nearly 10% versus the Euro. With a negative divergence in the RSI, the trend looks increasingly mature. We expect EURCHF strength to be over.

From July until November, the CRB rallied more than 15%. Dollar strength and overbought readings have led to a well deserved correction. But on the back of renewed dollar weakness we expect commodities incl. crude oil and copper to rally into summer 2018.

Considering all the factors that currently weigh on gold (rising real interest rates, rebound in the dollar, goldilocks economy) it is astonishing that the metal has not lost more. Despite losing 9% since early September, gold is still up more than 12% year to date. Our base case scenario of renewed weakness in the dollar and a weakening economy should help gold in 2018. We view gold as a good hedge should the "everything-bubble" burst.

"A key to successful investing lies in selling when we're closer to the top, and buying when we're closer to the bottom"

Howard Marks, Oaktree Capital Management

Disclaimer

This document has been prepared by CV Invest Partners AG. It is not considered as financial analysis regarding the SBA directives aimed at guaranteeing independence in financial analysis. As such, these directives do not apply to it. The information contained herein is based on sources believed to be reliable, but no assurance can be given that such information is current, accurate or complete. This document is for information purposes only and shall not be construed as an offer, invitation or solicitation to enter into any particular transaction or trading strategy. This document does not take into account the investment objectives, financial situation or particular needs of any particular investor. Investors should obtain individual financial advice based on their own particular circumstances before making an investment decision on the basis of the recommendations in this document. Opinions and references to prices and yields expressed are subject to change at any time without notice. CV Invest Partners AG may from time to time, on their own behalf or on behalf of third parties, engage in transactions in the financial instruments described herein, take positions with, perform or seek to perform investment banking or other services for any company mentioned herein or any of its parents, subsidiaries and/or affiliates. This document is intended only for the recipient named. It may not be photocopied or otherwise reproduced, or distributed without the prior permission of CV Invest Partners AG. The delivery of this document to any US person shall not be deemed a recommendation of CV Invest Partners AG to effect any transactions in the securities discussed herein or an endorsement of any opinion expressed herein. CV Invest Partners AG may furnish upon request all investment information available to it supporting any recommendations made in this document. This document is not for distribution to Private Customers in the United Kingdom and investments mentioned in this report will not be available to such persons. Email transmission cannot be guaranteed to be secured or error-free as information could be intercepted, corrupted, lost, destroyed, arrive late or incomplete, or contain viruses. The sender does not therefore accept any liability as a result. If you are not the intended recipient of this message, please immediately notify the sender and delete this message. Any disclosure, copy and/or distribution thereof is prohibited.

© 2015, CV Invest Partners AG