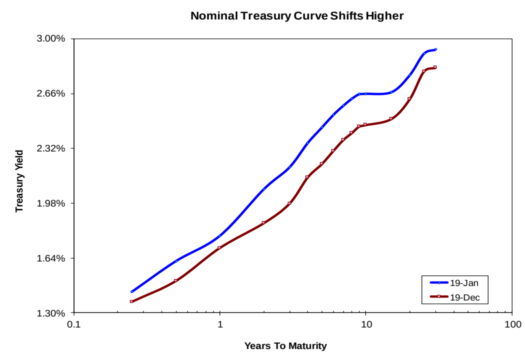
The Macro Environment For Financial Markets

Per Occam's Razor, if the simplest explanation for the runaway bull market in equities is higher prices attract buying, then we are in an equity bubble. Remember, bull markets end when the news is the most bullish, and that certainly describes the present situation. The timing is uncertain, but the long history of central banking suggests we can count on the Constitution Avenue crowd to tighten things until they break. The causal chain now is:

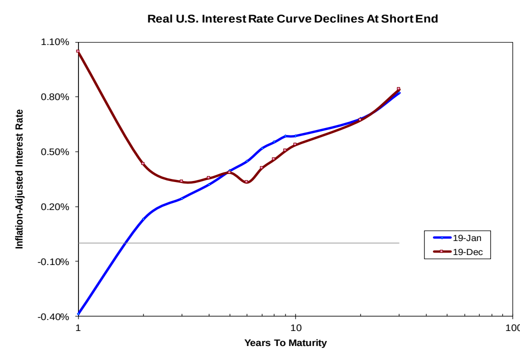
1. The market is pricing in March and June 2018 rate hikes;
2. Inflationary expectations are on pace to reach their next target of 2.26% for the ten-year;
3. The secular flattening trend in the U.S. yield curve has ended in the short-term;
4. Short-term borrowers are accepting rollover risk rather than term-out borrowing in the bond market;
5. Swap spreads are rising; and
6. CDS costs remain in their secular downtrend, but have stopped declining.

Key Market Indications

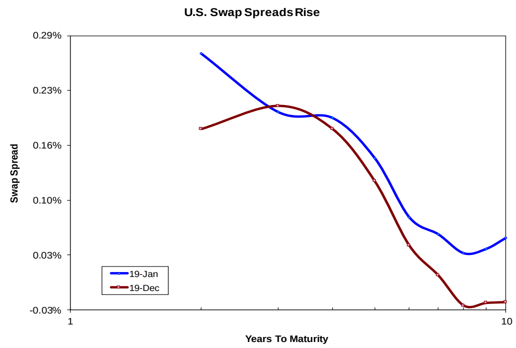
Depending on the thickness of your pencil, we broke through support on the ten-year UST and will be heading toward the next technical target of 3.05% by mid-year. With inflation expectations rising, the U.S. tax cut and the Federal Reserve shrinking its balance sheet, the fundamentals have turned negative for bonds.



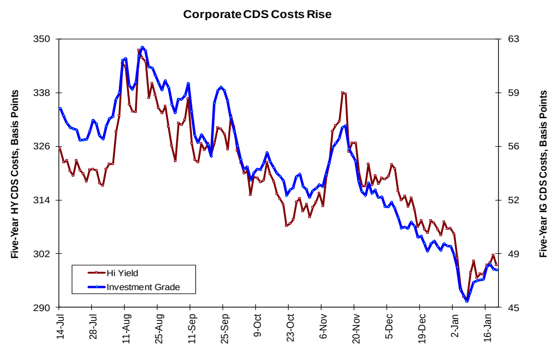
The pseudo-real yield curve shifted lower at the short end of the yield curve as nominal inflation breakevens rose faster than did nominal rates.



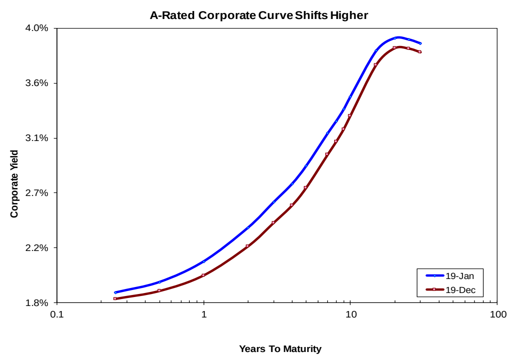
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose at both ends of the yield curve. The rise at the long end present a danger to the long end of the corporate bond yield curve.



CDS costs rose slightly over their recent lows, but remain well within their downtrends. Unless equities decline and produce correlation trades, there is no reason for CDS costs to rise.



The A-rated corporate yield curve shifted higher across the maturity spectrum. As UST yields are rising and credit spreads already are just over post-crisis lows, the risk/reward for these markets remains poor.



Market Structure

Only Softs and Livestock are in trending structures amongst the physical commodities, and neither is economically significant. Within financials, both ten-year UST and the dollar index are oversold and the EM index is overbought.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 22 - 26
BBerg	4	Sideways	0.003	6.8%	
BBerg Grain	17	Transitional	0.056	7.1%	
BBerg Ind. Metl	5	Sideways	0.016	15.9%	
BBerg Pre. Metl	8	Sideways	0.030	9.0%	
BBerg Softs	29	Trending	-0.090	14.8%	0.30%
BBerg Nat. Gas	10	Sideways	0.054	24.7%	
BBerg Petroleum	4	Sideways	-0.043	12.5%	
BBerg Livestock	21	Trending	0.139	9.5%	0.10%
Dollar Index	29	Trending	-0.409	5.4%	-0.06%
S&P 500 Index	4	Sideways	0.052	9.2%	
EAFE Index	4	Sideways	0.037	8.2%	
EM Index	29	Trending	0.843	6.7%	0.26%
Ten-year UST (price)	29	Trending	-0.427	3.6%	-0.06%

Performance Measures

This week's eyebrow-raiser has to be sugar; this is getting back toward prices seen in the 1980s. Terms of trade for agricultural producers have been negative globally. The runaway rally in the energy markets is going to leave a lot of stranded bulls once the inevitable OPEC production quota cheating begins. The decline in the USD and in short-term implied real rates has worked to the benefit of gold.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.30%	3.38%	7.33%	1.19%
Grains Sub-Index	0.73%	0.71%	-13.70%	-15.40%
Corn	1.11%	0.25%	-13.36%	-15.84%
Soybeans	2.90%	1.88%	-5.98%	-12.15%
Wheat	-2.39%	-0.36%	-22.84%	-17.44%
Energy Sub-Index	-0.16%	7.77%	23.89%	4.64%
Petroleum Sub-Index	-0.40%	6.43%	38.27%	16.81%
WTI	-0.55%	8.27%	36.67%	13.13%
Brent	-0.66%	6.35%	44.04%	20.41%
ULSD	-0.62%	4.69%	36.23%	20.88%
Gasoline	0.60%	4.85%	31.45%	11.89%
Natural Gas	0.58%	12.29%	-12.30%	-26.08%
Precious Metals Sub-Index	0.75%	4.22%	5.25%	6.85%
Gold	0.84%	4.36%	5.99%	9.85%
Silver	0.44%	3.71%	3.02%	-1.27%
Industrial Metals Sub-Index	0.29%	1.13%	19.43%	20.94%
Copper	-1.38%	-1.47%	16.17%	19.13%
Aluminum	2.16%	1.23%	14.77%	17.61%
Nickel	0.81%	4.84%	32.86%	29.36%
Zinc	0.98%	4.78%	25.63%	24.29%
Softs Sub-Index	-3.18%	-1.31%	-6.02%	-23.77%
Coffee	-1.23%	0.82%	-15.11%	-27.78%
Sugar	-6.53%	-9.15%	-10.79%	-36.91%
Cotton	0.96%	7.25%	22.29%	15.55%
Livestock Sub-Index	2.93%	2.54%	-3.26%	5.39%
Cattle	3.23%	1.94%	-5.97%	5.09%
Hogs	2.33%	3.37%	1.75%	6.36%

Currencies turned mixed this week; the strongest performer by far was the MXN, which rode the back of strong flows into its equity markets. How long will China allow the CNY to run higher? Their best ways of weakening it, buying USD and JPY securities, do not seem to meet the Party's policy goals at the moment.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.16%	3.23%	6.14%	14.61%
Chinese yuan	1.02%	3.13%	5.43%	7.31%
Japanese yen	0.26%	1.91%	1.08%	3.69%
British pound	0.95%	3.53%	6.42%	12.28%
Swiss franc	0.47%	2.30%	-0.75%	4.51%
Canadian dollar	-0.27%	3.08%	0.90%	6.60%
Australian dollar	0.99%	4.33%	0.54%	5.74%
Swedish krona	-0.04%	4.41%	3.11%	11.14%
Norwegian krone	0.72%	6.18%	2.41%	7.44%
New Zealand dollar	0.48%	4.37%	-1.07%	1.21%
Indian rupee	-0.32%	0.30%	0.69%	6.71%
Brazilian real	0.28%	2.96%	-1.49%	0.17%
Mexican peso	2.16%	3.10%	-5.80%	17.82%
Chilean peso	-0.83%	1.97%	7.48%	8.62%
Colombian peso	0.30%	4.19%	5.37%	3.39%
Bloomberg-JP Morgan Asian dollar index (spot)	0.44%	2.16%	4.03%	6.81%

In the absence of negative news, money continues to shift into global equities. The EM index in general and Latin American markets in particular were the strongest performers as lower USD borrowing costs are a direct boon to these markets.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	1.02%	5.24%	13.81%	26.86%
North America	0.89%	4.99%	14.41%	26.01%
Latin America	2.89%	12.14%	13.86%	30.13%
Emerging Market Free	2.02%	9.15%	17.31%	41.31%
EAFE	1.25%	6.16%	12.84%	29.67%
Pacific	1.30%	5.69%	15.27%	27.39%
Eurozone	1.58%	6.60%	12.47%	33.11%

CTAs continued their strong start to 2018, indicating they 1) embraced the risk-on environment and 2) are crowding the trade on each other. Amazingly, global hedge funds lost money; the real question is "how?"

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	2.02%	5.29%	13.67%	8.41%
Newedge Trend	1.35%	3.26%	9.77%	7.15%
Newedge Short-Term	1.77%	4.28%	4.05%	-0.06%
HFR Global Hedge Fund	-0.10%	2.30%	4.64%	7.57%
HFR Macro/CTA	0.07%	3.93%	6.06%	7.10%
HFR Macro: Sytematic Diversified CTA	0.11%	5.25%	12.02%	11.31%

Futures trading involves the substantial risk of loss and is not suitable for all investors. Each investor must consider whether this is a suitable investment since you may lose all of or more than your initial investment. Past performance is not indicative of future results.