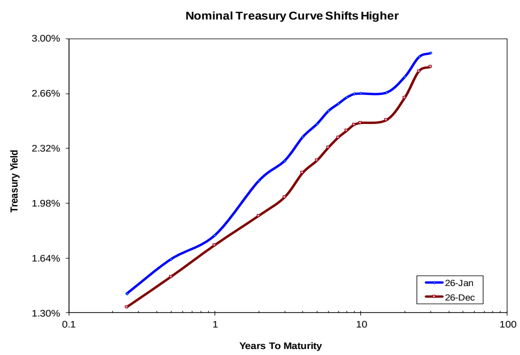
The Macro Environment For Financial Markets

The problem with putting several hundred self-important people in a room at Davos is they feel compelled to generate click-bait by saying stupid things. I am talking to you, Steve Mnuchin. Even the resulting uproar in currency markets was not enough to derail the upside blowoff in global equities. Nothing is this good, but you might as well enjoy it while it lasts. The causal chain now is:

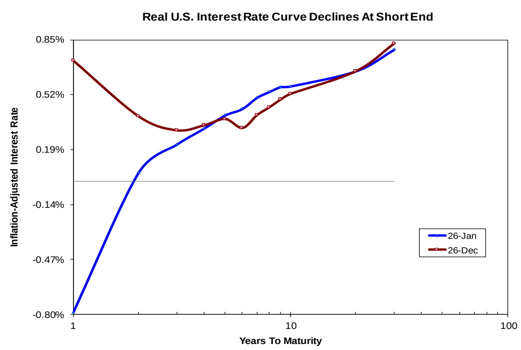
1. The market is pricing in March and June 2018 rate hikes;
2. Inflationary expectations are on pace to reach their next target of 2.26% for the ten-year;
3. The secular flattening trend in the U.S. yield curve is resuming;
4. Short-term borrowers are accepting rollover risk rather than term-out borrowing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

Key Market Indications

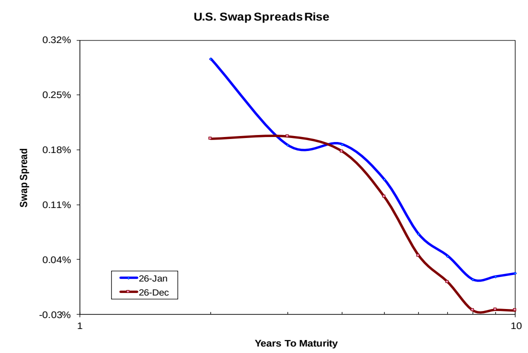
Ten-year UST broke through support on the ten-year UST and will be heading toward the next technical target of 3.05% by mid-year. With inflation expectations rising, the U.S. tax cut and the Federal Reserve shrinking its balance sheet, the fundamentals have turned negative for bonds.



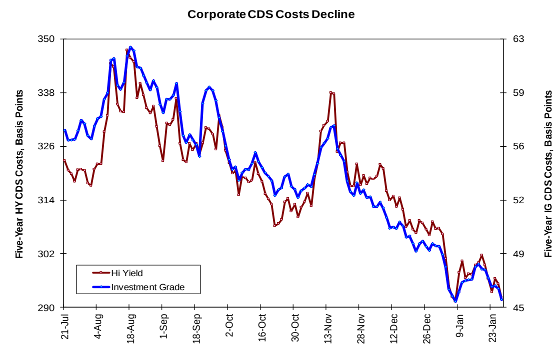
The pseudo-real yield curve shifted lower at the short end of the yield curve as nominal inflation breakevens rose faster than did nominal rates.



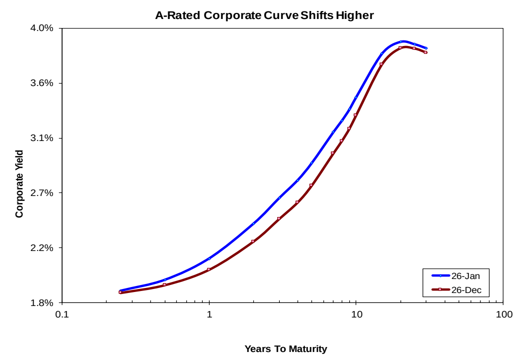
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose at both ends of the yield curve. The rise at the long end present a danger to the long end of the corporate bond yield curve.



CDS costs resumed 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

The main Bloomberg index along with Grains, Precious Metals, Natural Gas, Petroleum and Livestock are in structural uptrends amongst the physical commodity markets. Within financials, both ten-year UST and the dollar index are in structural downtrends and the EM index remains overbought.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 29 - Feb. 2
BBerg	29	Trending	0.514	5.8%	0.13%
BBerg Grain	25	Trending	0.249	7.8%	0.07%
BBerg Ind. Metl	14	Transitional	0.127	14.4%	
BBerg Pre. Metl	29	Trending	0.397	8.0%	0.12%
BBerg Softs	29	Trending	-0.055	14.1%	
BBerg Nat. Gas	22	Trending	0.180	24.4%	0.43%
BBerg Petroleum	29	Trending	0.423	11.7%	0.43%
BBerg Livestock	24	Trending	0.106	9.5%	0.10%
Dollar Index	29	Trending	-0.501	6.2%	-0.06%
S&P 500 Index	4	Sideways	0.117	7.6%	
EAFE Index	4	Sideways	0.007	11.4%	
EM Index	29	Trending	0.971	6.9%	0.26%
Ten-year UST (price)	29	Trending	-0.331	3.5%	-0.06%

Performance Measures

Natural Gas returned 8% this week on the astonishing news it gets cold in the U.S. at the end of January. Who knew? Of greater significance, only cotton and hogs declined during the week. The combination of rising equities, rising growth and lower implied real short-term rates boosted physical commodities almost cleanly across the board.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.58%	3.10%	8.13%	4.26%
Grains Sub-Index	1.86%	2.48%	-10.47%	-12.21%
Corn	1.16%	1.75%	-11.09%	-13.17%
Soybeans	0.87%	2.58%	-4.31%	-9.86%
Wheat	4.35%	3.39%	-16.45%	-12.28%
Energy Sub-Index	4.79%	7.80%	22.89%	9.17%
Petroleum Sub-Index	3.59%	6.82%	32.66%	22.26%
WTI	4.50%	9.55%	31.47%	18.32%
Brent	2.83%	5.82%	37.49%	24.80%
ULSD	3.60%	4.21%	30.71%	27.40%
Gasoline	3.33%	6.35%	26.59%	18.75%
Natural Gas	7.99%	9.38%	-4.67%	-23.67%
Precious Metals Sub-Index	1.68%	3.00%	5.71%	9.56%
Gold	1.46%	3.40%	6.31%	13.00%
Silver	2.41%	1.84%	3.97%	0.48%
Industrial Metals Sub-Index	2.08%	0.42%	17.95%	23.27%
Copper	0.39%	-2.97%	10.41%	16.71%
Aluminum	1.57%	-0.71%	17.25%	21.65%
Nickel	7.36%	6.97%	33.08%	42.29%
Zinc	1.91%	4.93%	27.09%	27.55%
Softs Sub-Index	0.73%	-2.31%	-4.47%	-23.96%
Coffee	3.25%	-0.72%	-13.20%	-25.05%
Sugar	0.86%	-11.77%	-9.86%	-36.85%
Cotton	-3.50%	2.47%	17.33%	8.80%
Livestock Sub-Index	0.32%	0.30%	0.16%	6.77%
Cattle	1.58%	0.99%	-0.29%	8.23%
Hogs	-2.22%	-1.49%	0.55%	4.25%

The Bible says Samson slew 10,000 with the jawbone of an ass; the same comment can be made for Steve Mnuchin. It might be nice if you are reversing two decades of Treasury Department policy not to be contradicted by the President the next day. Oddly, such moves often end, rather than begin, periods of USD weakness as central banks are forced to adjust.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.68%	4.80%	5.91%	16.34%
Chinese yuan	1.20%	3.42%	6.73%	8.78%
Japanese yen	2.02%	4.28%	2.39%	5.48%
British pound	2.18%	5.88%	7.91%	12.41%
Swiss franc	3.26%	6.10%	1.98%	7.23%
Canadian dollar	1.50%	3.08%	1.11%	6.35%
Australian dollar	1.44%	4.94%	1.31%	7.63%
Swedish krona	2.35%	6.10%	3.84%	12.35%
Norwegian krone	2.25%	8.05%	2.63%	8.44%
New Zealand dollar	1.00%	4.40%	-2.26%	1.45%
Indian rupee	0.50%	0.79%	1.32%	7.13%
Brazilian real	1.54%	5.13%	-0.30%	0.85%
Mexican peso	0.79%	7.44%	-4.87%	14.73%
Chilean peso	1.09%	2.77%	7.64%	8.03%
Colombian peso	1.35%	5.41%	7.28%	4.51%
Bloomberg-JP Morgan Asian dollar index (spot)	0.80%	2.45%	4.53%	7.62%

To repeat verbatim: 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	1.89%	6.98%	15.84%	27.76%
North America	2.12%	7.13%	16.62%	26.72%
Latin America	5.49%	16.50%	20.37%	31.47%
Emerging Market Free	3.29%	12.03%	20.88%	42.40%
EAFE	1.50%	7.45%	14.33%	29.53%
Pacific	1.32%	6.52%	16.75%	27.44%
Eurozone	1.66%	8.07%	13.11%	34.48%

CTAs continued their strong start to 2018, indicating they 1) embraced the risk-on environment and 2) are crowding the trade on each other. Global hedge funds managed to make small gains. To quote Harry Caray, "too bad there weren't 11 men on base."

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	2.41%	7.96%	15.90%	10.10%
Newedge Trend	1.66%	5.43%	11.46%	8.35%
Newedge Short-Term	1.35%	5.61%	5.34%	1.15%
HFR Global Hedge Fund	0.63%	2.78%	5.18%	8.03%
HFR Macro/CTA	1.09%	4.58%	6.96%	7.63%
HFR Macro: Sytematic Diversified CTA	1.68%	6.32%	13.40%	12.71%