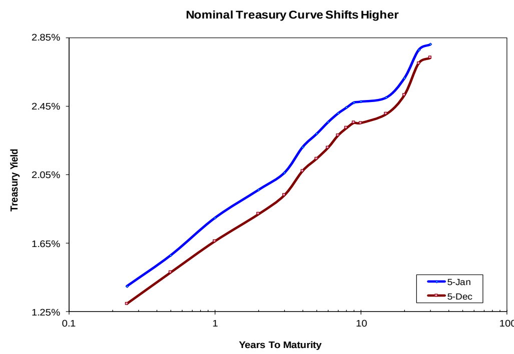
The Macro Environment For Financial Markets

What is not to like? Growth is up, employment is up, the regulatory environment is friendlier, the fiscal environment is more friendly, monetary policy is accommodative still…so everyone is nervous. We know every reason things are going to get better, but we do not know how they will fail. Eventually, they will, but until then, enjoy the good times. I have been saying a variation of this since the end of 2011, and I will change when the environment does. The causal chain now is:

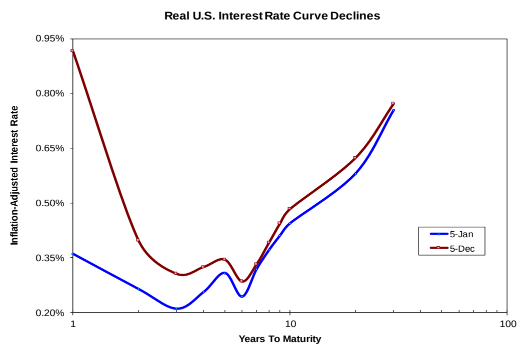
1. The market is pricing in March and June 2018 rate hikes;
2. Inflationary expectations have hit resistance at 2.04%, but their next target of 2.26% is not reachable in the short-term;
3. The secular flattening trend in the U.S. yield curve continues;
4. Short-term borrowers are accepting rollover risk rather than term-out borrowing in the bond market;
5. Swap spreads are inverting bullishly; and
6. CDS costs remain in their secular downtrend.

Key Market Indications

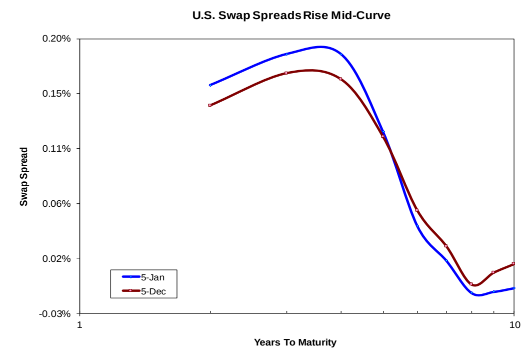
To repeat verbatim from last week: If the 36-year bull market in UST is going to end in 2018, it will end via rising non-U.S. rates ending a carry trade into the U.S. Rising short-term rates will not shake out the must-own long-bond holders such as pensions, life insurance firms and endowments, nor will central banks liquidate their portfolios into a declining market. Over? It will not be over until foreign central banks say it is over!



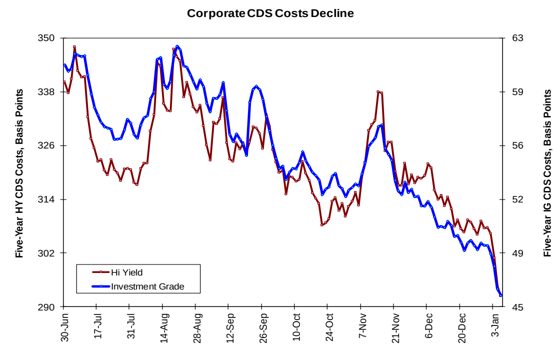
The pseudo-real yield curve shifted lower across the maturity spectrum as nominal rates remained tame and inflation breakevens rose.



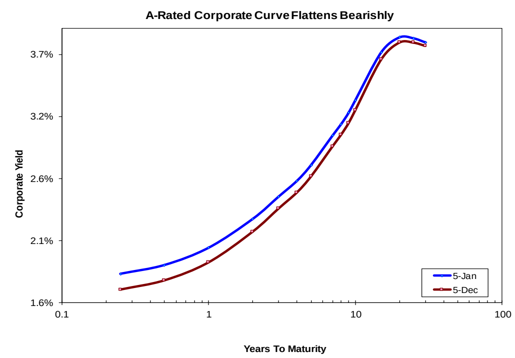
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose mid-curve but declined past five years. These declining spreads are still supportive for both corporate bonds and for equities.



CDS costs have made new lows within their current bullish move. Unless equities decline and produce correlation trades, there is no reason for CDS costs to rise.



The A-rated corporate yield flattened via higher short-term rates. As UST yields are rising and credit spreads already are at post-crisis lows, the risk/reward for these markets remains poor.



Market Structure

Livestock joined Natural Gas and Grains remain in downtrends, but all other physical commodity indices are in structural uptrends. Both ten-year UST and the dollar index are in downtrends. Both the EM and EAFE indices are in structural uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 8 - 12
BBerg	29	Trending	0.359	6.4%	0.06%
BBerg Grain	28	Trending	-0.005	9.0%	-0.05%
BBerg Ind. Metl	29	Trending	0.275	13.8%	0.81%
BBerg Pre. Metl	29	Trending	0.459	8.1%	0.25%
BBerg Softs	29	Trending	0.228	13.2%	0.30%
BBerg Nat. Gas	29	Trending	-0.084	26.5%	-0.11%
BBerg Petroleum	26	Trending	0.284	15.2%	0.52%
BBerg Livestock	29	Trending	-0.043	10.7%	-0.10%
Dollar Index	29	Trending	-0.257	5.0%	-0.06%
S&P 500 Index	4	Sideways	0.190	4.6%	
EAFE Index	29	Trending	0.540	6.4%	0.09%
EM Index	28	Trending	0.683	7.8%	0.26%
Ten-year UST (price)	28	Trending	-0.141	4.0%	-0.06%

Performance Measures

The decline in short-term implied real rates propelled the Precious Metals higher. While the Petroleum subindex gained and made new 2.5-year highs on various supply disruptions, Natural Gas declined despite the surge in spot NG prices. The economically sensitive Industrial Metals declined after closing 2017 strongly.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.28%	4.76%	8.09%	1.60%
Grains Sub-Index	0.72%	-0.27%	-16.34%	-11.72%
Corn	-0.18%	-0.32%	-16.49%	-13.42%
Soybeans	1.50%	-2.95%	-6.00%	-6.39%
Wheat	0.73%	2.91%	-26.64%	-14.92%
Energy Sub-Index	0.34%	4.96%	23.96%	-1.76%
Petroleum Sub-Index	1.69%	6.49%	39.79%	10.70%
WTI	2.61%	7.12%	36.67%	6.40%
Brent	2.24%	7.40%	45.56%	14.98%
ULSD	0.65%	6.49%	41.62%	16.43%
Gasoline	-0.12%	3.29%	31.92%	4.22%
Natural Gas	-4.59%	-0.58%	-15.18%	-32.65%
Precious Metals Sub-Index	2.02%	6.86%	9.57%	9.50%
Gold	1.97%	6.03%	8.93%	11.82%
Silver	2.17%	9.36%	11.50%	3.25%
Industrial Metals Sub-Index	-1.63%	9.67%	21.00%	24.98%
Copper	-2.36%	8.54%	21.04%	24.40%
Aluminum	-3.74%	9.47%	12.67%	25.76%
Nickel	1.40%	14.36%	39.63%	20.56%
Zinc	1.54%	9.12%	21.50%	28.98%
Softs Sub-Index	0.99%	2.71%	3.94%	-19.19%
Coffee	2.96%	4.88%	-4.75%	-17.98%
Sugar	0.57%	7.45%	3.30%	-30.20%
Cotton	-0.97%	5.93%	14.06%	6.63%
Livestock Sub-Index	-1.61%	1.95%	-4.82%	7.05%
Cattle	-2.42%	0.91%	-5.21%	8.23%
Hogs	-0.14%	3.85%	-3.56%	5.79%

The EM currencies in general and the Latin currencies in particular benefited from a strong risk-on environments and allocations into EM equities. The USD gained only against the low-rate CHF and JPY. Commodity-linked currencies such as the CAD and AUD gained against the greenback.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.20%	1.72%	5.96%	13.41%
Chinese yuan	0.28%	2.02%	4.83%	5.98%
Japanese yen	-0.32%	-0.40%	0.19%	2.03%
British pound	0.43%	0.95%	4.93%	9.28%
Swiss franc	-0.04%	1.30%	-1.10%	3.60%
Canadian dollar	1.28%	2.25%	4.39%	6.55%
Australian dollar	0.70%	3.38%	3.43%	7.17%
Swedish krona	0.31%	2.51%	4.03%	10.24%
Norwegian krone	1.90%	2.62%	4.22%	5.30%
New Zealand dollar	1.06%	4.32%	-1.60%	2.09%
Indian rupee	0.79%	1.60%	2.22%	7.24%
Brazilian real	2.58%	0.42%	1.85%	-0.94%
Mexican peso	2.50%	-2.13%	-4.57%	11.70%
Chilean peso	1.59%	7.93%	9.92%	9.28%
Colombian peso	2.76%	3.12%	6.16%	0.87%
Bloomberg-JP Morgan Asian dollar index (spot)	0.56%	1.65%	4.25%	6.30%

There really is no such thing as a January indicator. So saying, this week set a high bar for the 51 weeks remaining in 2018. In the absence of negative news, money plowed into global equities, and plowed very hard.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	2.38%	4.12%	13.82%	23.90%
North America	2.60%	4.54%	13.90%	22.88%
Latin America	5.02%	8.78%	17.99%	26.92%
Emerging Market Free	3.69%	7.76%	20.39%	39.68%
EAFE	2.45%	4.82%	12.63%	25.87%
Pacific	2.81%	5.30%	17.06%	25.17%
Eurozone	3.34%	3.48%	11.62%	29.80%

Both CTAs and hedge funds had a strong beginning to 2018, indicating they 1) embraced the risk-on environment and 2) are crowding the trade on each other.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.53%	2.99%	10.87%	2.74%
Newedge Trend	1.21%	2.10%	8.22%	3.15%
Newedge Short-Term	1.33%	1.87%	1.92%	-5.91%
HFR Global Hedge Fund	1.06%	1.97%	4.42%	6.74%
HFR Macro/CTA	1.57%	3.17%	5.08%	4.14%
HFR Macro: Sytematic Diversified CTA	1.96%	4.47%	10.75%	6.89%

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.