Simons Research

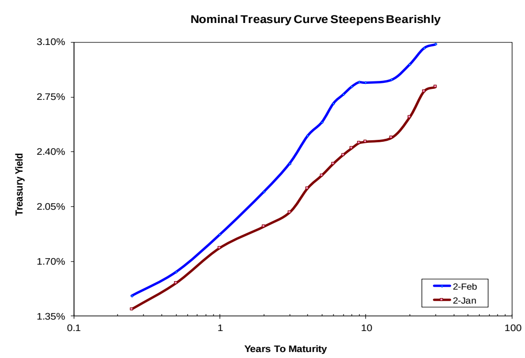
The Macro Environment For Financial Markets

One of the mysteries of the January rally was whether equity markets were discounting the same thing twice. They appeared to be, but the parabolic increase appeared to be accelerating at the end of last week, not to be poised for this week's breakaway gaps lower. The markets does not owe you a warning. Now we have to deal with the real possibility central banks will be tightening monetary conditions enough to increase risk-aversion but not enough to lower inflationary expectations. Those who complained of low volatility will get their wish in 2018 and will not like it. The causal chain now is:

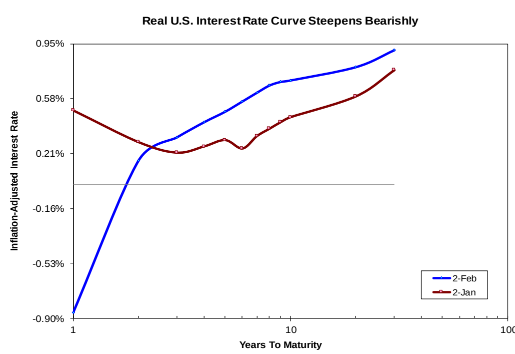
1. The market is pricing in March and June 2018 rate hikes;
2. Inflationary expectations are on pace to reach their next target of 2.26% for the ten-year;
3. The secular flattening trend in the U.S. yield curve has turned into a bearish steepening for the time being;
4. Short-term borrowers are accepting rollover risk rather than term-out borrowing in the bond market;
5. Swap spreads are rising; and
6. CDS costs have jumped, but more as a reflection of equity markets than of changes in credit conditions.

Key Market Indications

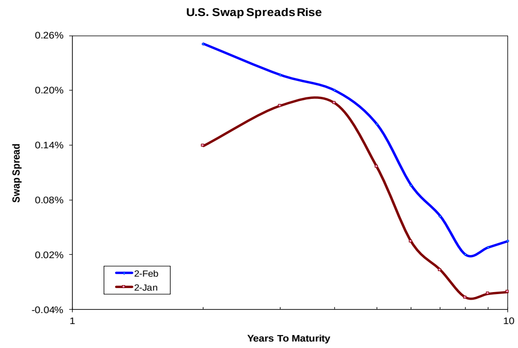
Ten-year UST are heading toward the next technical target of 3.05% by mid-year. With inflation expectations rising, the U.S. tax cut and the Federal Reserve shrinking its balance sheet, the fundamentals have turned negative for bonds.



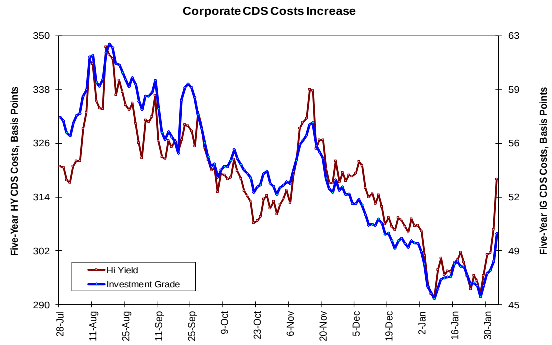
The pseudo-real yield curve shifted lower at the short end of the yield curve as nominal inflation breakevens rose faster than did nominal rates. Longer-term implied real rates are moving higher; this does not impose a direct threat to equities yet, but neither is it bullish.



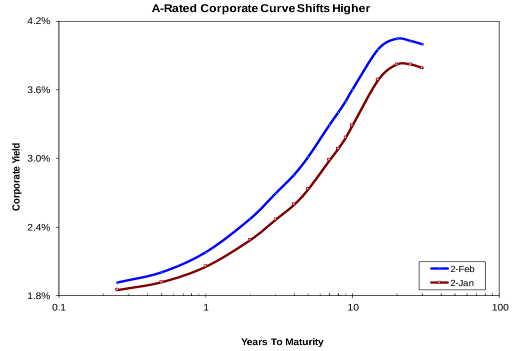
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose across the maturity spectrum. The rise at the long end present a danger to the long end of the corporate bond yield curve.



CDS costs jumped as the equities decline led to correlation trades. As the economic data continue to improve and liquidity remains ample, these spreads reflect equities far more than they do credit conditions.



The A-rated corporate yield curve steepened bearishly. As UST yields are rising and credit spreads jumped with the equity selloff, the risk/reward for these markets has improved after almost a year of decreasing value.



Market Structure
Grains, Livestock and Natural Gas remain within structural uptrends amongst the physical commodities. Within financials, ten-year UST turned oversold.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Feb. 5 - 9
BBerg	4	Sideways	-0.059	8.9%	
BBerg Grain	29	Trending	0.265	8.1%	0.07%
BBerg Ind. Metl	16	Transitional	0.029	15.6%	
BBerg Pre. Metl	13	Transitional	-0.105	9.9%	
BBerg Softs	29	Trending	-0.171	14.4%	-0.23%
BBerg Nat. Gas	26	Trending	0.026	23.4%	0.43%
BBerg Petroleum	10	Sideways	-0.054	14.9%	
BBerg Livestock	27	Trending	0.183	10.1%	0.10%
Dollar Index	4	Sideways	0.021	8.3%	
S&P 500 Index	4	Sideways	-0.154	10.7%	
EAFE Index	4	Sideways	-0.108	10.2%	
EM Index	5	Sideways	-0.135	11.5%	
Ten-year UST (price)	29	Trending	-0.573	3.8%	-0.06%

Performance Measures

Natural Gas gained 8% last week and lost 10.3% this week. The rally in the Petroleum index has stalled out for the time being on the rise in U.S. production, but it will take a global recession to put this back into a bear market. Precious Metals were unable to mount a rally even though risky assets sold off and implied short-term real rates fell; such is the power of expected higher nominal short-term rates.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.82%	1.48%	7.67%	2.39%
Grains Sub-Index	0.91%	2.67%	-5.89%	-11.52%
Corn	1.43%	3.03%	-7.93%	-12.60%
Soybeans	-0.66%	0.94%	0.62%	-8.52%
Wheat	1.33%	3.83%	-10.47%	-13.13%
Energy Sub-Index	-4.41%	3.57%	19.07%	5.77%
Petroleum Sub-Index	-2.09%	3.69%	29.75%	18.01%
WTI	-1.02%	6.70%	30.45%	15.67%
Brent	-2.15%	2.37%	34.20%	19.75%
ULSD	-3.45%	0.62%	25.58%	20.72%
Gasoline	-2.79%	3.67%	23.00%	15.28%
Natural Gas	-10.34%	3.80%	-9.41%	-24.98%
Precious Metals Sub-Index	-2.07%	-0.11%	4.86%	4.80%
Gold	-1.44%	0.88%	5.65%	8.65%
Silver	-4.17%	-3.22%	2.33%	-5.61%
Industrial Metals Sub-Index	-0.84%	1.45%	16.43%	21.84%
Copper	-0.33%	-1.19%	9.64%	19.58%
Aluminum	-2.16%	0.19%	14.54%	17.99%
Nickel	-1.60%	7.26%	30.41%	29.71%
Zinc	0.62%	4.44%	26.29%	26.20%
Softs Sub-Index	-1.26%	-7.27%	-9.11%	-24.85%
Coffee	-3.77%	-6.16%	-17.86%	-24.85%
Sugar	2.05%	-9.51%	-6.54%	-37.94%
Cotton	-3.92%	-0.80%	9.80%	2.39%
Livestock Sub-Index	0.73%	2.43%	-0.23%	7.46%
Cattle	1.23%	4.18%	-0.56%	11.17%
Hogs	-0.31%	-1.35%	-0.20%	1.03%

As incredible it may seem to those who remember all of the EUR's existential crises, it has traded as a haven currency in 2018 while the JPY turned lower on the Bank of Japan's desperate attempt to halt the rise JGB yields. The Peoples' Bank is likely to move to arrest the CNY's rise at some point.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.29%	3.35%	5.12%	15.84%
Chinese yuan	0.44%	3.05%	6.68%	9.26%
Japanese yen	-1.44%	1.92%	0.50%	2.39%
British pound	-0.30%	3.89%	6.77%	12.70%
Swiss franc	0.11%	4.33%	4.24%	6.58%
Canadian dollar	-0.97%	0.67%	1.13%	4.81%
Australian dollar	-2.21%	1.29%	-0.46%	3.56%
Swedish krona	-0.44%	3.36%	2.47%	10.74%
Norwegian krone	-0.55%	5.11%	2.14%	6.72%
New Zealand dollar	-0.68%	2.74%	-1.74%	0.16%
Indian rupee	-0.81%	-0.91%	-0.56%	5.17%
Brazilian real	-2.21%	1.32%	-3.27%	-3.03%
Mexican peso	-0.56%	5.08%	-4.16%	10.57%
Chilean peso	-0.22%	0.61%	8.02%	6.73%
Colombian peso	-1.01%	3.18%	4.27%	1.28%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.22%	1.44%	4.21%	6.50%

In risk-off periods, correlations rise. The reduction in risk exposure affected all of the major indices equally badly. Once again, diversification during a selloff is an expensive way of trading currencies.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-3.40%	0.78%	11.43%	23.22%
North America	-3.79%	2.33%	12.19%	22.66%
Latin America	-3.14%	7.96%	14.26%	27.20%
Emerging Market Free	-3.29%	4.54%	16.02%	37.94%
EAFE	-2.74%	3.41%	9.85%	26.17%
Pacific	-2.13%	1.53%	13.81%	24.87%
Eurozone	-3.06%	1.43%	8.19%	30.21%

While both hedge funds and CTAs lost money on the week, the surprising aspect is how they did not lose more given their recent embrace of the "risk-on" trade. This suggests they maintained strong short-bond positions.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.17%	6.60%	13.91%	9.63%
Newedge Trend	-1.22%	4.41%	9.50%	7.86%
Newedge Short-Term	0.47%	5.93%	6.03%	3.18%
HFR Global Hedge Fund	-0.62%	2.52%	4.92%	7.96%
HFR Macro/CTA	-0.67%	4.19%	6.51%	7.59%
HFR Macro: Sytematic Diversified CTA	-1.27%	5.33%	11.69%	12.48%