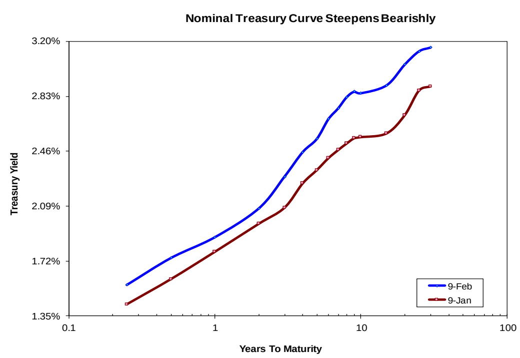
The Macro Environment For Financial Markets

To repeat from last week, those who complained of low volatility will get their wish in 2018 and will not like it. To state the obvious, the gains over the past year were not sustainable, but there really did not seem to be any viable alternatives. What we have now is a recognition the end of the QE era must be accompanied by an end to financial suppression. The real question must be what central banks will do to protect their massive holdings of sovereign debt; they are unlikely to sell and impair their solvency. Worse, governments are going to find out fiscal stimulus will not be financed at negative real interest rates. Old habits die hard, especially in a dysfunctional political environment. The causal chain now is:

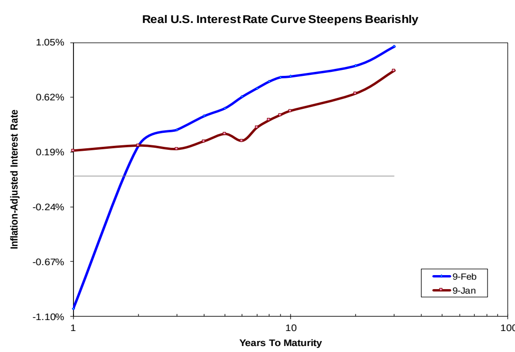
1. The market is pricing in March and June 2018 rate hikes;
2. Inflationary expectations are on pace to reach their next target of 2.26% for the ten-year. This rise has been slowed by the equity market downturn, however;
3. The secular flattening trend in the U.S. yield curve has turned into a bearish 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

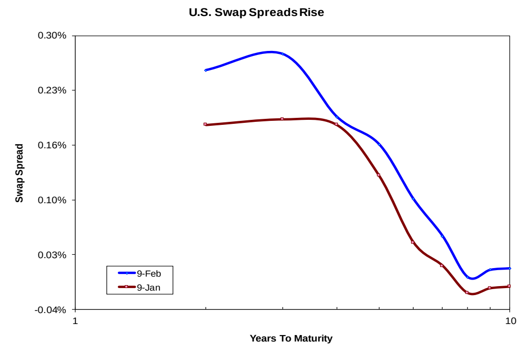
Ten-year UST are heading toward the next technical target of 3.05% by mid-year. With inflation expectations rising, the U.S. tax cut, another round of expanded federal spending and the Federal Reserve shrinking its balance sheet, the fundamentals have turned negative for bonds.



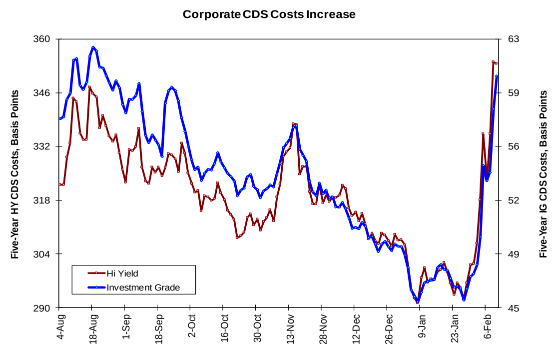
The pseudo-real yield curve shifted lower at the short end of the yield curve as nominal inflation breakevens rose faster than did nominal rates. Longer-term implied real rates are moving higher; this does not impose a direct threat to equities yet, but neither is it bullish.



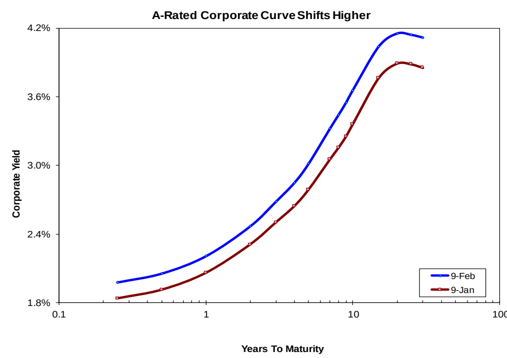
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose across the maturity spectrum. The rise at the long end present a danger to the long end of the corporate bond yield curve.



CDS costs jumped again 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

The various market dislocations took all but Natural Gas, Petroleum and Livestock out of trending conditions. It is hard to imagine only two weeks ago the EM index had a trend oscillator over 0.90. That overbought condition did not prompt the surprised reactions seen this past week.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Feb. 12 - 16
BBerg	16	Transitional	-0.393	8.7%	
BBerg Grain	6	Sideways	-0.012	10.0%	
BBerg Ind. Metl	19	Transitional	-0.207	17.0%	
BBerg Pre. Metl	15	Transitional	-0.216	11.3%	
BBerg Softs	7	Sideways	-0.056	15.1%	
BBerg Nat. Gas	29	Trending	-0.221	23.2%	-0.05%
BBerg Petroleum	29	Trending	-0.490	16.1%	-0.49%
BBerg Livestock	29	Trending	-0.148	10.4%	-0.04%
Dollar Index	10	Sideways	0.125	7.9%	
S&P 500 Index	4	Sideways	-0.027	34.5%	
EAFE Index	4	Sideways	-0.088	15.5%	
EM Index	4	Sideways	-0.082	22.5%	
Ten-year UST (price)	5	Sideways	-0.038	9.8%	

Performance Measures

The downturn in the energy complex was especially hard and contributed to shock in EM currencies, equities and high-yield bonds. The economically sensitive Industrial Metals turned lower, as did the Precious Metals; the latter was somewhat surprising given the alleged rise in inflationary expectations and the decline in implied real short-term rates. These downturns made it another bad week for the physical commodities. In fairness, any asset class can have a bad millennium.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-3.87%	-3.40%	2.96%	-3.14%
Grains Sub-Index	0.37%	4.66%	-3.71%	-13.99%
Corn	0.20%	4.70%	-6.33%	-14.56%
Soybeans	0.44%	2.43%	2.30%	-10.91%
Wheat	0.49%	6.85%	-7.08%	-16.60%
Energy Sub-Index	-8.98%	-10.03%	7.73%	-3.79%
Petroleum Sub-Index	-9.09%	-8.88%	19.60%	7.08%
WTI	-9.51%	-7.72%	19.92%	4.73%
Brent	-8.47%	-9.32%	24.04%	9.77%
ULSD	-9.60%	-10.59%	14.48%	9.04%
Gasoline	-9.02%	-8.63%	14.59%	3.35%
Natural Gas	-8.66%	-13.08%	-22.43%	-31.27%
Precious Metals Sub-Index	-2.00%	-2.63%	-0.25%	1.08%
Gold	-1.59%	-1.69%	1.59%	5.61%
Silver	-3.39%	-5.74%	-5.88%	-11.11%
Industrial Metals Sub-Index	-4.05%	-2.99%	8.14%	11.97%
Copper	-4.81%	-5.64%	3.38%	7.59%
Aluminum	-3.82%	-4.06%	2.88%	11.14%
Nickel	-3.48%	1.94%	21.06%	20.13%
Zinc	-3.26%	0.19%	18.54%	16.68%
Softs Sub-Index	0.23%	-4.52%	-6.87%	-24.49%
Coffee	1.19%	-0.26%	-17.02%	-23.69%
Sugar	-0.02%	-3.81%	0.08%	-35.95%
Cotton	-0.87%	-6.11%	12.60%	2.15%
Livestock Sub-Index	-3.36%	-0.01%	-0.84%	4.81%
Cattle	-1.95%	3.61%	3.56%	11.37%
Hogs	-6.36%	-7.26%	-9.09%	-6.51%

Only the JPY stood in the way of the USD gaining across the board. The greenback traded as both a haven asset and one whose expected interest rates are rising. As the dollar carry trade had been increasing in popularity over the past year, this affected the emerging market currencies especially hard.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.69%	2.64%	4.19%	14.99%
Chinese yuan	-0.04%	3.59%	5.89%	8.98%
Japanese yen	1.26%	3.54%	1.17%	4.09%
British pound	-2.06%	2.12%	6.33%	10.64%
Swiss franc	-0.77%	4.73%	2.67%	6.72%
Canadian dollar	-1.21%	-0.93%	0.95%	4.48%
Australian dollar	-1.49%	-0.14%	-0.95%	2.47%
Swedish krona	-2.20%	1.85%	1.20%	10.20%
Norwegian krone	-2.88%	1.74%	-0.07%	4.72%
New Zealand dollar	-0.62%	1.28%	-1.12%	0.95%
Indian rupee	-0.52%	-1.06%	-0.87%	3.81%
Brazilian real	-2.48%	-1.57%	-4.40%	-5.26%
Mexican peso	-0.57%	2.88%	-4.03%	8.82%
Chilean peso	-0.13%	0.68%	7.35%	7.00%
Colombian peso	-3.37%	-1.04%	2.09%	-2.73%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.27%	1.43%	3.94%	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	-5.52%	-6.06%	6.82%	15.78%
North America	-5.12%	-4.87%	6.65%	14.97%
Latin America	-5.94%	0.02%	7.36%	18.67%
Emerging Market Free	-7.14%	-5.11%	7.79%	26.64%
EAFE	-6.19%	-5.30%	3.79%	18.49%
Pacific	-5.67%	-5.24%	7.40%	16.54%
Eurozone	-6.63%	-6.53%	3.44%	23.61%

CTAs have promised for decades they are a diversifying asset. Not this past week. Hedge funds continue to demonstrate they are risk-on vehicles generally capable of positive returns only during bull markets in equities.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-10.34%	-7.12%	2.36%	-1.25%
Newedge Trend	-7.56%	-5.74%	1.33%	-0.14%
Newedge Short-Term	-4.87%	-0.90%	1.56%	-0.80%
HFR Global Hedge Fund	-1.61%	-0.95%	2.70%	5.34%
HFR Macro/CTA	-2.73%	-1.58%	2.72%	3.24%
HFR Macro: Sytematic Diversified CTA	-4.85%	-3.88%	5.15%	4.77%