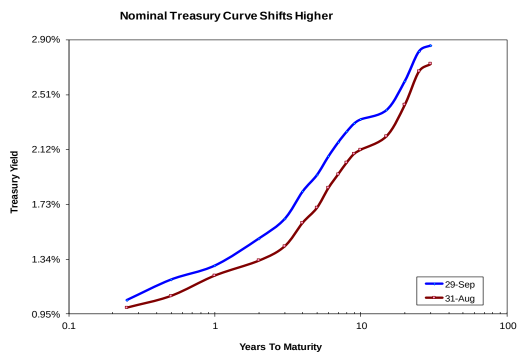
The Macro Environment For Financial Markets

The so-called Trump Trade died in all markets save U.S. equities by February. It is resuming now under the impetus of some tax reform proposals whose likelihood of passage is significantly less than 100%. To quote myself, "Sell hope." The USD is rising, the yield curve is flattening, financial liquidity will be declining and growth is unlikely to accelerate without touching off higher inflations. Still, investors are willing to push valuations higher. One only wonders where these valuations would be if policymakers were operating smoothly. The causal chain now is:

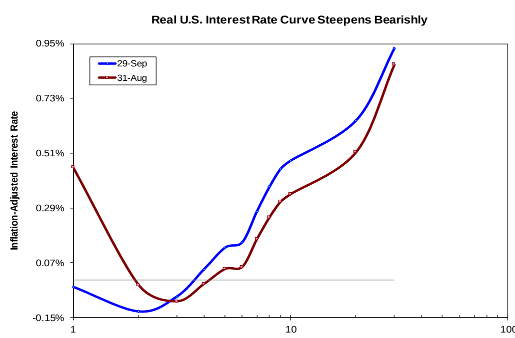
1. The market has been forced to start pricing in a December rate hike along with the shrinkage of the Federal Reserve's balance sheet;
2. Inflationary expectations continue to rise;
3. The secular flattening trend in the U.S. is resuming;
4. Short-term borrowers are close to terming out short-term debt into the bond market;
5. Swap spreads are shifting higher; and
6. CDS costs have stopped rising, but are unlikely to decline significantly further.

Key Market Indications

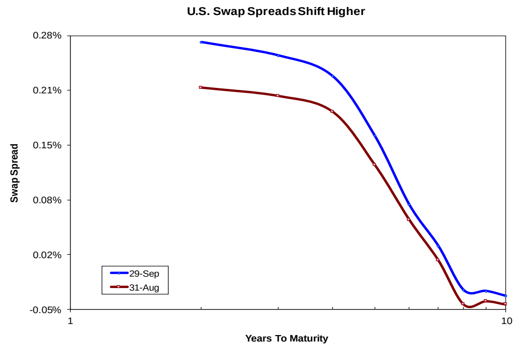
The yield curve began flattening in November 2013, meaning this is close to a four-year trend. It still remains a bullish flattening even though long-term rates are once again approaching their critical support level of 2.40%.



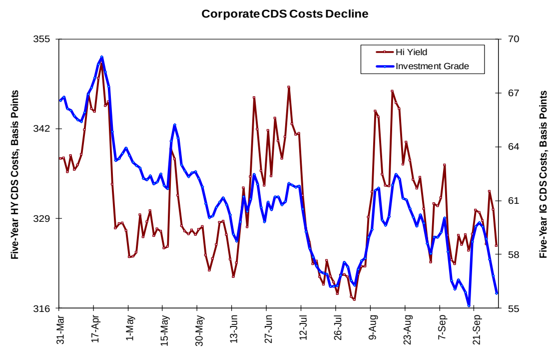
The pseudo-real yield curve steepened bearishly, rising at the long end of the yield curve and declining at one- and two-year maturities. It remains negative for maturities between two and four years. This curve was common during 2015-2016 period of accelerated global QE, but it is quite surprising to see during a period when the Federal Reserve is beginning to unwind QE and other major central banks are leaning in that direction.



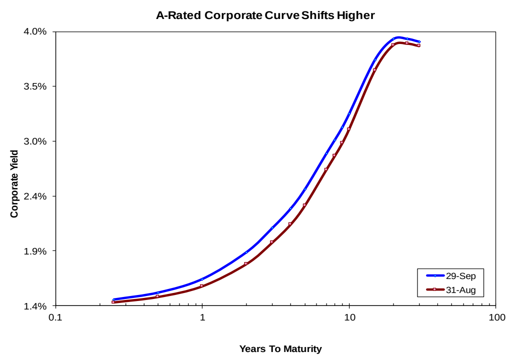
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose across the maturity spectrum, with the largest shift at the shortest end of the yield curve. Markets are anticipating a steady climb in short-term rates and are not anticipating a further decline in long-term rates.



CDS costs fell for both the investment-grade and high-yield indices. The combination of correlation trades against equities, a lack of contagion from the previous week's Toys 'R' Us bankruptcy and no deterioration in the economic data put the investment-grade index back at resistance. The potential for further declines in credit spreads is limited, however.



The A-rated corporate yield curve shifted slightly higher over the past month. This remains a bull market with limited upside potential.



Market Structure

Only Petroleum and Livestock are in structural uptrends within the physical markets; Precious Metals, Softs and Natural Gas are in structural downtrends. The EM index fell out of its structural uptrend and the dollar index exited its structural downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Oct. 2 - 6
BBerg	10	Sideways	-0.069	6.7%	
BBerg Grain	15	Transitional	0.018	13.6%	
BBerg Ind. Metl	7	Sideways	-0.004	16.4%	
BBerg Pre. Metl	29	Trending	-0.266	10.3%	-0.31%
BBerg Softs	29	Trending	-0.189	14.8%	-0.81%
BBerg Nat. Gas	28	Trending	-0.027	17.9%	-0.03%
BBerg Petroleum	29	Trending	0.218	17.7%	0.30%
BBerg Livestock	25	Trending	0.197	12.7%	0.45%
Dollar Index	28	Trending	0.094	6.9%	
S&P 500 Index	29	Trending	0.304	5.3%	0.04%
EAFE Index	29	Trending	0.174	7.1%	0.11%
EM Index	29	Trending	-0.128	6.0%	
Ten-year UST (price)	29	Trending	-0.315	3.7%	-0.15%

Performance Measures

Every time the petroleum complex rises, it feels as if other commodities should be rising as well, but this reaction is so 2004-2007. In reality, there was quite a bit of differentiation this past week as Precious Metals, Softs and Grains all declined while Industrial Metals and Livestock rose as groups. Are Lean Hogs really worth 5.9% more than they were a week ago, or is this simply another artifact of poor market liquidity.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.45%	-0.53%	-0.56%	-0.29%
Grains Sub-Index	-0.47%	1.19%	-5.46%	-5.48%
Corn	0.52%	0.08%	-9.28%	-5.96%
Soybeans	-1.61%	2.06%	0.98%	-2.45%
Wheat	-0.26%	2.25%	-6.40%	-7.24%
Energy Sub-Index	0.32%	3.21%	-0.84%	-2.87%
Petroleum Sub-Index	0.58%	5.83%	3.77%	2.08%
WTI	2.01%	7.75%	-0.46%	-2.90%
Brent	0.89%	8.01%	3.83%	3.05%
ULSD	0.10%	4.68%	12.50%	10.03%
Gasoline	-2.14%	-0.58%	2.96%	1.81%
Natural Gas	-0.43%	-4.03%	-13.07%	-15.64%
Precious Metals Sub-Index	-1.17%	-4.12%	-0.96%	-6.56%
Gold	-0.96%	-3.35%	2.30%	-3.35%
Silver	-1.79%	-6.32%	-9.45%	-14.61%
Industrial Metals Sub-Index	0.14%	-4.69%	8.56%	24.00%
Copper	0.38%	-5.15%	10.02%	31.11%
Aluminum	-2.77%	-2.05%	5.66%	23.13%
Nickel	0.71%	-12.96%	3.87%	-2.31%
Zinc	4.38%	-0.41%	13.93%	31.74%
Softs Sub-Index	-3.25%	-1.26%	-15.32%	-28.44%
Coffee	-4.74%	-0.69%	-12.89%	-22.75%
Sugar	-3.67%	-1.09%	-19.67%	-41.24%
Cotton	0.01%	-4.70%	-9.18%	0.88%
Livestock Sub-Index	0.59%	3.69%	2.82%	24.41%
Cattle	-1.83%	4.49%	2.82%	24.14%
Hogs	5.89%	2.32%	2.42%	24.32%

Only the CHF failed to decline against the USD this week. If we see fiscal stimulus in the U.S., a major "if" considering the players involved, it will combine with tighter monetary policy to end the USD's year-to-date decline.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.15%	-1.32%	9.73%	5.28%
Chinese yuan	-0.94%	-0.84%	3.57%	0.22%
Japanese yen	-0.46%	-2.49%	-1.31%	-10.20%
British pound	-0.79%	3.72%	7.75%	3.32%
Swiss franc	0.10%	-1.29%	2.91%	-0.22%
Canadian dollar	-1.07%	0.32%	6.85%	5.40%
Australian dollar	-1.61%	-1.47%	2.14%	2.59%
Swedish krona	-2.03%	-2.57%	8.83%	5.22%
Norwegian krone	-2.04%	-2.67%	6.75%	1.08%
New Zealand dollar	-1.65%	-0.66%	2.50%	-0.61%
Indian rupee	-0.74%	-1.92%	-0.56%	2.41%
Brazilian real	-1.19%	0.07%	-1.35%	3.07%
Mexican peso	-2.79%	-2.26%	2.48%	6.94%
Chilean peso	-2.31%	-2.17%	3.79%	2.92%
Colombian peso	-1.08%	-0.07%	-1.90%	-1.50%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.39%	-0.95%	1.65%	-0.15%

I quipped last week there was nothing worse than being bullish on emerging markets and hearing major asset managers echo your sentiment. Sure enough, the EM index fell under the weight of poor Latin American performance. Higher short-term rates in the U.S. and a stronger USD are a headwind for these markets.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.40%	1.96%	9.39%	18.83%
North America	0.64%	3.24%	7.81%	19.18%
Latin America	-2.21%	1.47%	11.01%	24.98%
Emerging Market Free	-1.82%	0.31%	13.37%	21.57%
EAFE	0.01%	2.82%	11.72%	19.31%
Pacific	-0.12%	0.90%	8.08%	14.51%
Eurozone	0.17%	3.44%	16.77%	29.38%

CTAs had another bad week, as did macro-oriented hedge funds. Unsurprisingly, the story of hedge fund liquidations continues as well. What do you expect when anyone off the street with an index fund is turning in better performance at lower cost and risk?

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.59%	-2.34%	-4.40%	-10.41%
Newedge Trend	-0.97%	-1.72%	-2.94%	-7.46%
Newedge Short-Term	0.21%	-0.36%	-2.54%	-8.89%
HFR Global Hedge Fund	-0.04%	0.88%	2.84%	5.57%
HFR Macro/CTA	-0.56%	-0.54%	0.37%	-1.95%
HFR Macro: Sytematic Diversified CTA	-0.60%	-1.11%	-0.69%	-5.69%