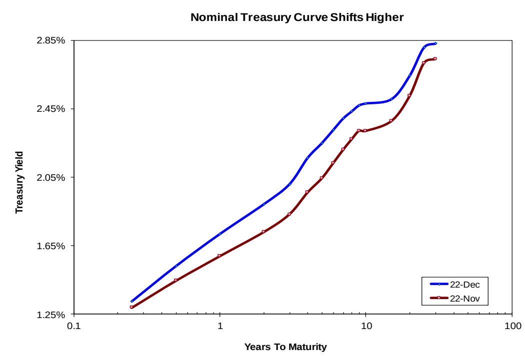
The Macro Environment For Financial Markets

The last time the U.S. had a combination of fiscal stimulus and a contractionary monetary policy was during the late 1980s. It was a time of slower growth, a rising USD and decent equity returns. We have no idea how it would have ended naturally as it ended with the first Persian Gulf War. This one will sail higher until the rest of the world declines to export their savings to us to finance our consumption or until an expanding trade deficit triggers protectionist impulses. The causal chain is:

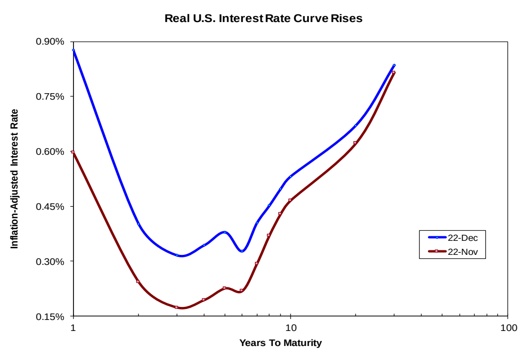
1. The market is pricing in a March 2018 rate hike;
2. Inflationary expectations are moving toward resistance at 2.04%;
3. The secular flattening trend in the U.S. yield curve continues;
4. Short-term borrowers are accepting rollover risk rather than term-out borrowing in the bond market;
5. Swap spreads are inverting bullishly; and
6. CDS costs have resumed their decline.

Key Market Indications

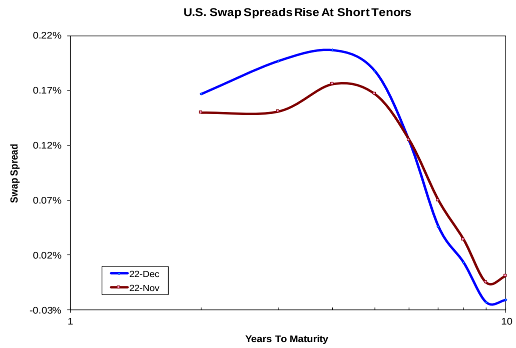
The selloff in ten-year UST projects to 2.64% on the first leg. The bond market woke up to the realization federal borrowing is going to rise at the same time the Federal Reserve will be shrinking its balance sheet. What were these savants doing all year? As bond yields keep failing from lower highs, it will be very interesting to see if this fails and ends the bull market dating back to September 1981.



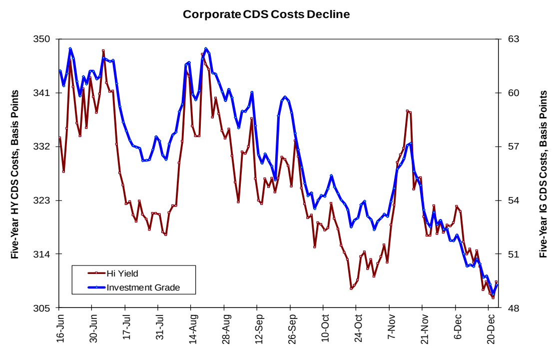
The pseudo-real yield curve shifted higher across the maturity spectrum. The shift will start to weigh on risky financial assets soon into 2018.



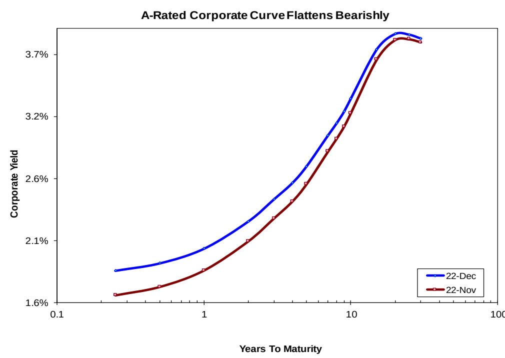
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose at the short end of the yield curve as further short-term rate increases appear likely. Long-term spreads declined, however, which is still supportive for both corporate bonds and for equities.



CDS costs declined once again. Unless equities decline and produce correlation trades, there is no reason for CDS costs to rise.



The A-rated corporate yield shifted higher. As UST yields are rising and credit spreads already are at post-crisis lows, the risk/reward for these markets has turned poor.



Market Structure

Industrial Metals moved into a structural uptrend while Natural Gas and Softs remain in downtrends. All of the equity indices are un uptrends, while both ten-year UST and the dollar index are in downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 26 - 29
BBerg	29	Trending	0.076	6.6%	
BBerg Grain	5	Sideways	0.041	6.8%	
BBerg Ind. Metl	29	Trending	0.328	13.4%	0.81%
BBerg Pre. Metl	29	Trending	0.035	8.5%	
BBerg Softs	29	Trending	-0.003	13.5%	-0.28%
BBerg Nat. Gas	29	Trending	-0.363	22.1%	-0.11%
BBerg Petroleum	18	Transitional	0.141	16.3%	
BBerg Livestock	6	Sideways	-0.015	11.8%	
Dollar Index	29	Trending	-0.042	5.1%	-0.06%
S&P 500 Index	29	Trending	0.278	6.8%	0.12%
EAFE Index	29	Trending	0.172	6.9%	0.09%
EM Index	29	Trending	0.146	8.2%	0.26%
Ten-year UST (price)	27	Trending	-0.204	4.0%	-0.06%

Performance Measures

Year-end markets can produce some large returns. The Energy markets rose strongly and pulled the main Bloomberg index higher, and the economically sensitive Industrial Metals rose sharply as well. Then we have some smaller markets putting some mileage on, such as sugar with its 6.9% one-week return. The consensus, for whatever reason, is 2018 will be a strong year for physical commodities. This sounds very much like trading by hope.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.04%	-1.34%	8.28%	0.30%
Grains Sub-Index	0.33%	-2.31%	-8.58%	-9.85%
Corn	1.32%	-0.74%	-10.14%	-10.19%
Soybeans	-1.79%	-4.36%	3.64%	-7.69%
Wheat	1.58%	-2.20%	-18.28%	-9.79%
Energy Sub-Index	2.73%	-1.73%	20.69%	-7.14%
Petroleum Sub-Index	3.32%	0.55%	38.68%	8.04%
WTI	2.30%	-0.63%	33.64%	3.18%
Brent	3.35%	2.56%	42.24%	12.39%
ULSD	3.42%	0.95%	42.67%	13.45%
Gasoline	5.11%	-1.95%	36.53%	2.72%
Natural Gas	0.49%	-9.74%	-21.52%	-41.78%
Precious Metals Sub-Index	1.89%	-1.62%	0.51%	9.52%
Gold	1.72%	-0.91%	1.42%	11.90%
Silver	2.40%	-3.70%	-2.08%	2.92%
Industrial Metals Sub-Index	4.07%	1.63%	21.67%	25.23%
Copper	3.34%	1.58%	21.93%	28.07%
Aluminum	6.17%	2.64%	16.12%	24.67%
Nickel	4.74%	0.70%	32.72%	14.84%
Zinc	2.00%	0.89%	21.89%	27.24%
Softs Sub-Index	3.28%	-1.38%	6.80%	-14.77%
Coffee	-0.26%	-5.51%	-6.45%	-19.36%
Sugar	6.91%	-5.41%	7.44%	-22.76%
Cotton	2.60%	8.37%	16.50%	12.68%
Livestock Sub-Index	-0.56%	-2.77%	-3.98%	5.59%
Cattle	-2.00%	-4.72%	-6.17%	6.22%
Hogs	2.14%	0.93%	-0.04%	4.88%

As bank books are closed on the year, we should not overanalyze. However, the MXN and BRL took hits this week even as their equity indices rose, and those are unusual confluences. The USD declined against majors other than the JPY; the Bank of Japan is not eager to raise short-term rates now but the speculation is they will have to do so in 2018.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.96%	0.34%	6.37%	13.65%
Chinese yuan	0.49%	0.50%	3.92%	5.64%
Japanese yen	-0.61%	-1.83%	-1.73%	3.75%
British pound	0.32%	0.29%	5.37%	8.79%
Swiss franc	0.25%	-0.61%	-1.64%	3.81%
Canadian dollar	1.08%	-0.26%	3.96%	5.92%
Australian dollar	0.82%	1.21%	2.21%	6.82%
Swedish krona	2.24%	0.25%	5.19%	10.90%
Norwegian krone	0.78%	-1.98%	2.04%	4.75%
New Zealand dollar	0.41%	2.02%	-3.33%	1.72%
Indian rupee	0.00%	1.37%	0.86%	6.16%
Brazilian real	-1.05%	-3.38%	0.14%	-1.38%
Mexican peso	-3.20%	-5.63%	-8.28%	5.11%
Chilean peso	2.18%	1.77%	6.58%	8.57%
Colombian peso	1.26%	0.55%	2.26%	1.20%
Bloomberg-JP Morgan Asian dollar index (spot)	0.40%	0.47%	3.02%	6.07%

All of the major indices rose, which is typical at year-end in a bull market. Some reduced political uncertainty in Latin America in general, Chile in particular, helped the EM index.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.69%	2.07%	10.16%	22.28%
North America	0.37%	3.22%	11.27%	20.79%
Latin America	2.63%	-0.90%	13.24%	28.12%
Emerging Market Free	2.08%	-1.24%	14.68%	39.00%
EAFE	1.25%	1.42%	8.85%	25.22%
Pacific	1.48%	0.98%	11.51%	23.78%
Eurozone	0.68%	-0.98%	7.39%	28.42%

Both CTAs and hedge funds had positive returns on the week, as has been the case when equities rise.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.83%	0.71%	2.67%	0.50%
Newedge Trend	0.35%	0.36%	1.66%	1.40%
Newedge Short-Term	0.16%	-0.42%	-0.99%	-7.46%
HFR Global Hedge Fund	0.69%	0.75%	3.20%	5.75%
HFR Macro/CTA	0.55%	-0.17%	1.36%	1.59%
HFR Macro: Sytematic Diversified CTA	0.73%	1.39%	4.63%	3.55%

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.