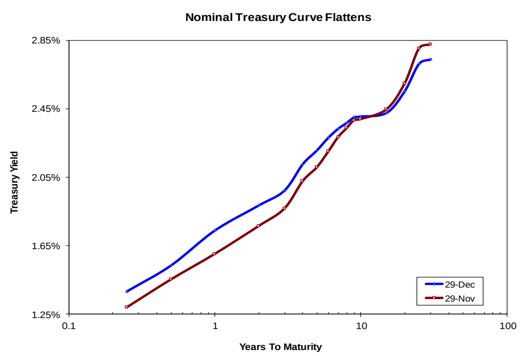
The Macro Environment For Financial Markets

Bull markets end under a combination of rising optimism and rising short-term rates. We have both, but until there is a compelling alternative to risky financial assets, simple inertia is going to propel the global economy higher. Yes, rising optimism, even on these pages. What we are witnessing to a remarkable extent is the reinstatement of a social compact that the best thing a government can do is allow its citizens to accumulate wealth. That has been missing for too long. The causal chain now is:

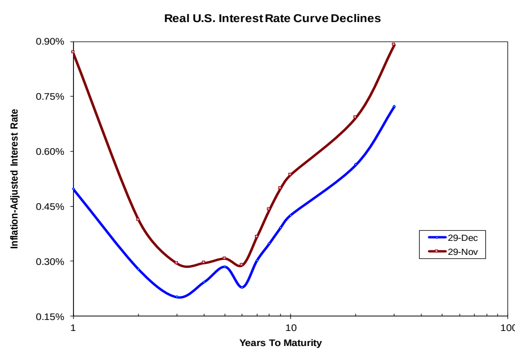
1. The market is pricing in March and June 2018 rate hikes;
2. Inflationary expectations are moving toward resistance at 2.04%;
3. The secular flattening trend in the U.S. yield curve continues;
4. Short-term borrowers are accepting rollover risk rather than term-out borrowing in the bond market;
5.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

Key Market Indications

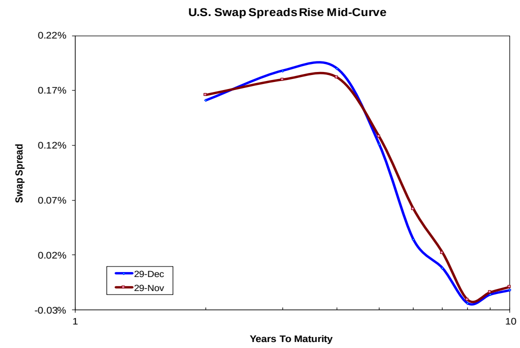
If the 36-year bull market in UST is going to end in 2018, it will end via rising non-U.S. rates ending a carry trade into the U.S. Rising short-term rates will not shake out the must-own long-bond holders such as pensions, life insurance firms and endowments, nor will central banks liquidate their portfolios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



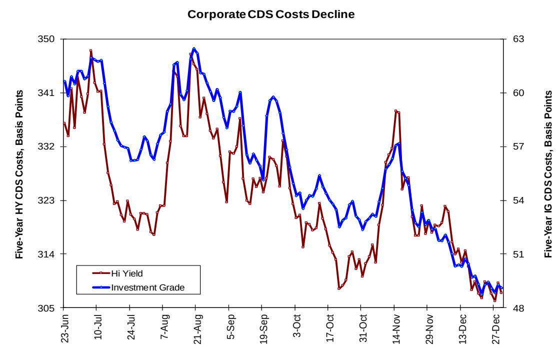
The pseudo-real yield curve shifted lower across the maturity spectrum as nominal rates remained tame and inflation breakevens rose.



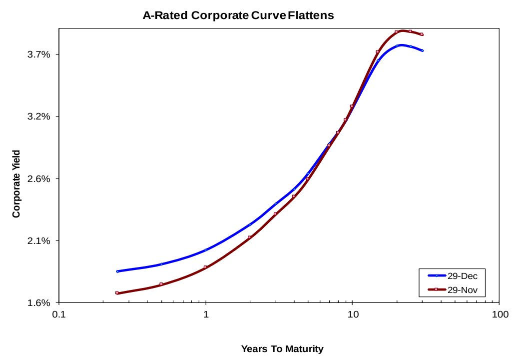
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose mid-curve but declined past five years. These declining spreads are still supportive for both corporate bonds and for equities.



CDS costs remain near their lows. 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
Natural Gas and Grains remain in downtrends and Livestock is neutral, but all other physical commodity indices are in structural uptrends. Both ten-year UST and the dollar index are in downtrends and the S&P 500 has entered a trading range.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 2 - 5
BBerg	29	Trending	0.400	6.5%	0.06%
BBerg Grain	29	Trending	-0.101	9.2%	-0.05%
BBerg Ind. Metl	29	Trending	0.462	13.5%	0.81%
BBerg Pre. Metl	29	Trending	0.372	8.1%	0.25%
BBerg Softs	29	Trending	0.236	13.0%	0.30%
BBerg Nat. Gas	29	Trending	-0.002	23.8%	-0.11%
BBerg Petroleum	22	Trending	0.268	15.8%	0.52%
BBerg Livestock	9	Sideways	0.066	10.6%	
Dollar Index	29	Trending	-0.275	4.9%	-0.06%
S&P 500 Index	6	Sideways	-0.084	3.8%	
EAFE Index	29	Trending	0.255	6.5%	0.09%
EM Index	24	Trending	0.329	7.9%	0.26%
Ten-year UST (price)	28	Trending	-0.034	4.0%	-0.06%

Performance Measures

Year-end markets can produce some large returns. Only Grains did not produce strong returns. Natural Gas rose 13.6% on the week, making it something of a cryptocurrency in a pipe. Both Industrial and Precious Metals rose strongly as well. The consensus remains 2018 will be a strong year for physical commodities. We shall see.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	3.42%	2.06%	7.35%	1.70%
Grains Sub-Index	0.11%	-2.93%	-13.86%	-11.31%
Corn	-0.11%	-0.67%	-11.42%	-11.51%
Soybeans	0.32%	-4.30%	-0.95%	-8.13%
Wheat	0.03%	-2.52%	-26.04%	-12.52%
Energy Sub-Index	5.71%	2.31%	19.59%	-4.31%
Petroleum Sub-Index	3.73%	4.42%	33.93%	9.58%
WTI	3.52%	3.63%	28.98%	5.10%
Brent	3.82%	5.48%	37.86%	14.25%
ULSD	5.07%	5.81%	38.17%	15.01%
Gasoline	2.49%	2.11%	30.50%	2.79%
Natural Gas	13.61%	-4.70%	-15.36%	-36.37%
Precious Metals Sub-Index	3.71%	2.84%	4.39%	10.94%
Gold	3.08%	2.21%	5.02%	12.79%
Silver	5.61%	4.73%	2.59%	5.79%
Industrial Metals Sub-Index	3.86%	7.62%	21.65%	29.35%
Copper	2.55%	6.84%	20.77%	29.17%
Aluminum	5.78%	9.36%	16.85%	31.18%
Nickel	5.75%	13.00%	35.06%	25.58%
Zinc	2.61%	2.36%	21.73%	29.71%
Softs Sub-Index	2.43%	0.38%	5.65%	-14.43%
Coffee	3.26%	-2.48%	-4.04%	-16.02%
Sugar	2.67%	1.31%	6.40%	-25.38%
Cotton	0.92%	7.20%	17.26%	12.78%
Livestock Sub-Index	2.69%	0.40%	-4.49%	6.36%
Cattle	1.60%	-0.25%	-4.65%	9.13%
Hogs	4.70%	1.59%	-3.70%	2.79%

As bank books are closed on the year, we should not overanalyze. Only the COP declined against the USD this week. The overwhelming speculation is the U.S. is going to wait for other central banks to match its rate hikes. Remember, a year ago the sentiment was the USD was going to have another strong year.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.21%	1.33%	4.93%	14.44%
Chinese yuan	1.08%	1.69%	4.31%	6.90%
Japanese yen	0.53%	-0.67%	-0.45%	3.42%
British pound	1.12%	0.78%	3.89%	10.21%
Swiss franc	1.41%	1.06%	-1.89%	5.00%
Canadian dollar	1.26%	2.34%	3.44%	7.41%
Australian dollar	1.30%	3.16%	1.64%	8.17%
Swedish krona	1.64%	2.27%	3.47%	11.46%
Norwegian krone	1.39%	0.63%	2.21%	5.35%
New Zealand dollar	1.08%	3.15%	-2.75%	1.91%
Indian rupee	0.27%	0.70%	1.18%	6.62%
Brazilian real	0.76%	-2.07%	-0.29%	-1.77%
Mexican peso	0.46%	-5.57%	-8.22%	5.44%
Chilean peso	1.17%	4.58%	8.08%	8.25%
Colombian peso	-0.66%	0.36%	1.11%	1.41%
Bloomberg-JP Morgan Asian dollar index (spot)	0.62%	0.98%	3.56%	6.71%

The rally in physical commodities and a downturn in the USD helped propel the EM index to strong gains. Both the EAFE and the U.S. pulled back on the week.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.18%	1.77%	10.86%	23.07%
North America	-0.18%	2.05%	11.54%	21.08%
Latin America	1.92%	2.21%	13.09%	23.79%
Emerging Market Free	1.71%	1.78%	15.79%	38.37%
EAFE	0.95%	1.79%	9.25%	26.27%
Pacific	0.98%	1.91%	12.31%	24.96%
Eurozone	-0.34%	-0.23%	7.65%	28.59%

At the risk of sounding nasty, the Newedge CTA index and the HFR Global Hedge Fund index returned 0.70% and 5.86% in 2017. What can anyone say to make those returns look acceptable?

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.89%	1.20%	4.44%	0.70%
Newedge Trend	0.53%	0.62%	3.12%	1.66%
Newedge Short-Term	-0.06%	-0.54%	-1.22%	-7.60%
HFR Global Hedge Fund	0.00%	0.82%	3.08%	5.86%
HFR Macro/CTA	0.13%	0.11%	2.03%	1.87%
HFR Macro: Sytematic Diversified CTA	0.29%	1.70%	6.04%	3.90%