MARKETFIELD
ASSET MANAGEMENT

The Weekly Speculator

May 25, 2017

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Over the last six sessions global markets have had to digest claims of impeachable offences in the US and Brazil, a vicious terrorist attack in the city of Manchester (where this author lived for 8 ½ years) and the downgrade of the sovereign credit rating of the world's second largest economy. Although there have been pockets of volatility (particularly in Brazil) markets have absorbed each of these blows without any obvious change in trend and by Wednesday's close the MSCI World Index had moved up to record a new all-time high. The resilience of global markets, including the US has been impressive and tells us a great deal about the mood of market participants. Markets that are able to ignore excuses to move lower have a much better chance of trading higher, particularly as we enter the mid-year allocation period.

Clearly there were plenty of investors waiting for any sort of a pullback to deploy capital, and it is notable that the vast majority of indexes we track reversed higher before they reached obvious price or moving average support levels, suggesting a willingness to step in quickly as the brief sell off developed. The only two markets that displayed a different behavior were Brazil and China. China onshore market has been out of phase with global markets for several years (its offshore market by contrast remains tethered to the overall emerging market complex) and the dreary trading of recent sessions has little in the way of a message for the rest of the world.

Brazil on the other hand was much more interesting since we witnessed an entire correction in one session, with the IBOV dropping -8.8%, its largest single day decline since October 2008. The EWZ ETF (which combines currency and equity market exposure) fell an astonishing -16.3%, a level only surpassed once in the entire 17 year history of the ETF which includes the 2008 financial crisis and 2001 collapse of Argentina.

This is a reminder of the fact that although this is overall an extremely benign, low volatility environment, the desperation to keep up with the strength of broad indexes means that any significant downside shock generates a massive outflow of capital resulting in an unusually violent single day move lower. This seems to us to be the great danger behind the rush into passive investing, with the same allocations being divested at the same time by a large number of people.

With the long powerful bull market still intact, and in fact broadening into other global regions, this risk does not seem relevant at present for the overall US and global environment. However, whenever we finally transition from bull to bear market it seems reasonable to expect some spectacular intraday drawdowns will be generated. In our experience every investment cycle becomes a product cycle and in the end the universal popularity of the product sows its own demise. We expect this to be as true of passive investing in its various forms as any of the financial fads that have preceded it. We very much doubt that the next US downturn will involve anything like the financial system distress of 2007/8 but we would still expect to see single day market moves that rival anything we saw during that period even if the cumulative drawdown proves to be less debilitating, and for the bond market to see similarly disruptive moves.

As we state above, fortunately this is a problem for a later period of time, and for the time-being it seems rational to expect the popularity of passive investing to force broad indexes higher. It also seems likely to provoke an ever wider disparity of performance, since the only way that active managers can stay close to the index without being accused of simply hugging it or actually outperform will be to crowd into those areas that are delivering outsized performance. Meanwhile showing patience with under-performance, even in the face of improving fundamental conditions or a compelling valuation has become increasingly difficult, and would seem to be a losing strategy for any manager trying to hold onto AUM, while the decline in the issues value (be it nominal or even just relative) means that it will be receiving less of a benefit from passive index level flows. It therefore seems rational to expect an ever widening valuation gap between winning and losing sectors, and for the long bull market to end with the usual giddiness that accompanies a major market top.

Thus although the market dynamics may seem very different from the end of the 1990's technology boom, when individual traders and large active managers propelled the entire market entire higher by levitating the technology sector *stock by stock* the net effect is starting to look quite similar. Variations of a long book strategy that involves a large allocation to the SPX index (which is now 23% technology) and then adds a few select technology names on top seems to have become dominant in recent months, and we would expect this to continue through the remainder of the cycle.

For the time-being we would say that this is justified by both market and corporate performance, but we are moving up through the gears quite quickly and the NDX index remains on pace to deliver a 53% gain through 2017, which would exactly match its performance in 2009 (although still be only half the ludicrous 102% advance seen in 1999).

In other words we are probably heading for another investment cycle that ends in debacle, but this does not mean that it is yet time to exit the market, rather than understand the process by which excess will be generated and eventually expunged.

Regarding the latter we do expect the FOMC to start to meaningfully tighten monetary conditions, even if the size of interest rate increases will seem small compared to other cycles. It seems that having already hiked in March another 25 bp increase will be delivered in June, and we currently expect to see similar moves in September and December, which would put us on pace for a 1.75% FDTR by the end of 2017. We recognize that the FOMC claims to be still in a "data driven" mindset but we expect the data to be quite good enough to keep this pace up through the rest of the year, and if there is any acceleration of inflation we may see something a little more aggressive. Added to this will likely be some shrinkage in the FRB's balance sheet, meaning that we could be in a quite different monetary and liquidity environment by the end of 2017.

If this deterioration of liquidity and its pricing were to be combined with another sharp move higher by the equity market we would probably start to become much more cautious about the investment environment, particularly if repatriation of foreign capital invested in the US started to become more prevalent. Indeed after 9 years of taking excess liquidity for granted it is

possible to imagine an investment landscape for the US that looks quite different in a few quarters time. Thus while in our opinion it is premature to sound the alarm it is not too soon to start thinking about how the final stages of this cycle may play out and what the signs would be that the terminal phase has been entered.

S&P 500

After last Wednesday's 1.82 % selloff in the SPX that filled the two late April opening gaps the large cap index closed Thursday's trading session up 8.69 points or +0.37%. That close marked an important short term higher low at 2,352.72 in the index and it has since followed through to the upside over the past four trading sessions. Yesterday the SPX marked a new record closing high at 2,404.39. That said, the index has not yet broken out of its three month consolidation pattern but buyers are once again are knocking at the door of key resistance and eating through overhead supply which we continue to believe will lead to a resolution of the price consolidation to the upside. MACD has quickly hooked higher in positive territory reflecting the quick turn in price. We now mark first support at 2,350 and second at the double bottom at March/April lows at 2,320.

NASDAQ 100

Like the SPX, the NDX has made an equally impressive recovery from last Wednesday's drubbing to go on to register a new record closing high yesterday as well. The high tech index closed yesterday's trading session at 5,730.30 up 26.96 points or +0.47%. The technical condition of the NDX continues to outshine both the SPX and RTY (to a much larger extent) by exhibiting superior relative strength and upside momentum as witnessed by MACD. The momentum oscillator has also hooked higher and has remained firmly in positive territory. We now mark first support at the rising 50-day ma and second at the March 27th low at 5,316.02.

Russell 2000

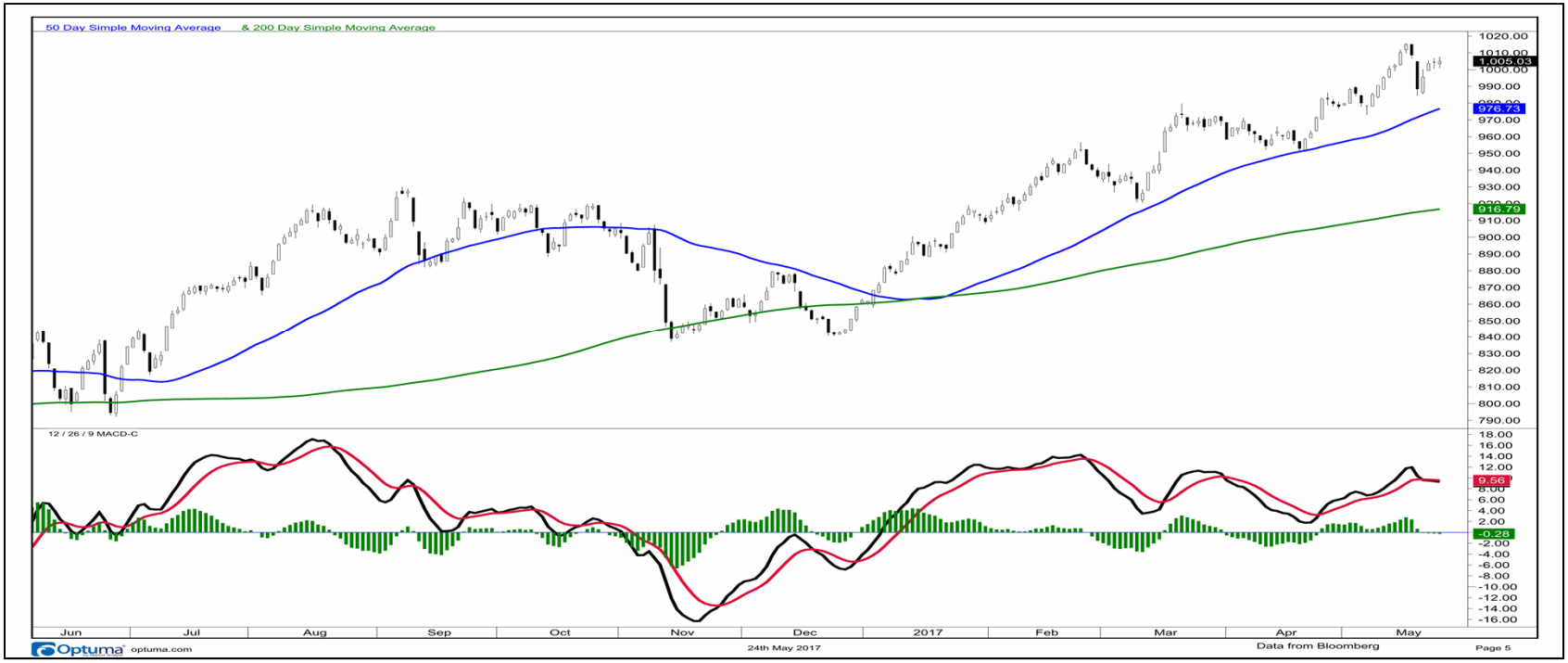
The RTY fell just short of reaching first support last Thursday before it reversed to close slightly higher on the day. Even though the small cap index has been able to trade back to near the middle of its five month trading range in concert with five consecutive closing highs it has yet to recover all the ground lost in last Wednesday's -2.78% sell off. MACD has begun to turn but as of yesterday's close the momentum indicator remains in negative territory. These two technical features remind us of the RTY's continued relative weakness compared to the other equity indexes we track in these pages. We continue to mark first support at 1,340 and second at the rising 200-day ma (1,321.83 as of yesterday's close).

VXO

After the brief excitement of last week we find ourselves back in an ultra-low volatility environment with the VXO index collapsing to 8.97 at Wednesday's close, only the second sub-9 close since 2014. The wider followed VIX closed at 10.02, once again confounding investors who chased it higher last week, when it briefly traded above 16.

The worst that can be said is that at current levels volatility compression is no longer a source of further gains, and the broad SPX index is still to comprehensively pierce the 2,400 level. However, this does not seem like an insurmountable combination and we see no reason to expect a sudden transition out of this low volatility environment for the time being.

Morgan Stanley Emerging Markets



The MXEF participated in last Wednesday's selloff in the equity markets but as we reminded readers in our last note a significant number of emerging markets and equities were closed prior to the US markets open and lower closing levels and it did not surprise us to see Thursday's responsive recalibration in the MXEF (most of which was caused by Brazil's sharp decline). Despite last week's two day -2.64% sell off, the index remains in its uptrend and the price action can still be considered constructive as witnessed by the turn higher last Friday establishing a higher low above key support at its rising 50-day ma. We remain favorable disposed towards emerging markets and the MXEF's ability to rally to higher levels. We continue to mark first support at the rising 50-day ma (976.73 at yesterday's close) and second at the April lows at 950.

10 Year Treasury Note

The long end of the curve continues to be well bid despite the fact that risk assets across the world are at multi-year and all-time highs. The 10-year yield closed at 2.25% on Wednesday, roughly halfway between rising support at the 200-day (2.15%) and the falling 50-day ma (2.33%). These two levels bear watching for the direction of the next significant move, and we still favor a test of the 200-day followed by a move back up to the top of the longer term trading range as the likeliest scenario, but a break of support would potentially open up the way to 2.0%.

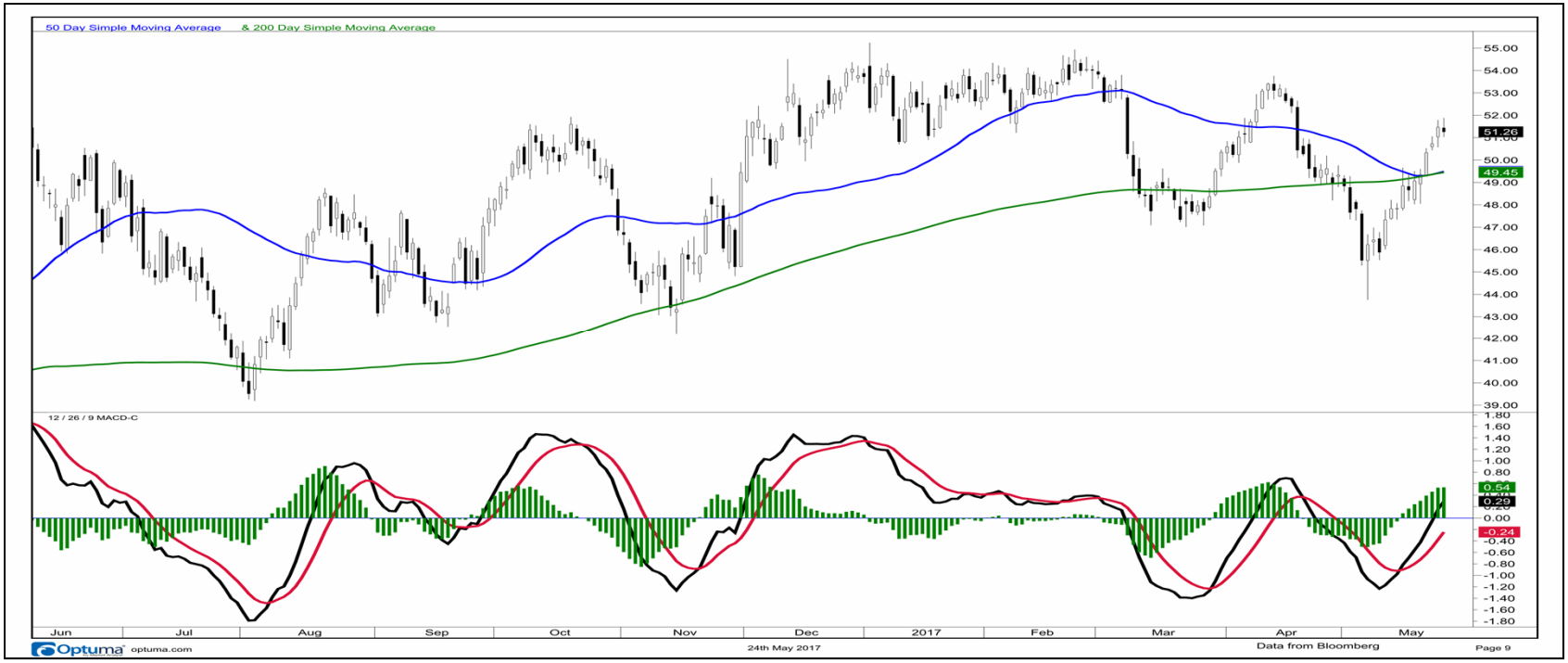
US Dollar

Last week's weakening of the USD continued well into the earlier part of this week before the DXY went on to find support at last November's low of 96.8. The index has since held steady above this level and should a full-on reversal of this decline occur we would expect some resistance to be found at the 99 level, where the 50 and 200-day mas are on the verge of intersecting. Our greater sense is, however, that we are witnessing the beginning of a long reallocation process away from USD denominated assets that may accelerate into quarter end. With MACD in the most negative territory seen in over a year, the DXY appears likely to remain vulnerable to a retest of support at the 96 level.

Gold

Gold has continued to enjoy the weakening of the USD and the metal has held on to its recent gains, trading in a fairly tight range over the last week between $1,245 and $1,265. Wednesday's close at $1,258.45 keeps the metal in touch with the high end of this range and a move above this level would suggest the metal is ready to move up and test much stronger resistance at $1,300.

Crude Oil



After briefly fighting resistance at the $49 level (where the 50 and 200-day mas crossed paths), crude oil resumed its May rally with strength that took us largely by surprise. The commodity appears to have found some resistance for now just below $52, though there could be more room for crude to inch further towards the upper bound of its long-term range at $55. With supply likely to be abundant at these higher levels, the odds are that long-term resistance here will prove formidable just as it has in the past. A pullback from this point on, on the other hand, should find some support at $49.

Copper

Although copper has managed to make some progress from when we last wrote, the metal still finds itself having difficulty getting through resistance at its 50-day ma. The significance of this indicator suggests that short-term trading flows are dominating price moves at the current time, though we would still expect an eventual test of this level to be successful. The key question from here on, however, is whether this scenario goes on to immediately materialize, or if prices will have to re-test support at the 200-day ma before going on to make further gains.

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