MARKETFIELD
ASSET MANAGEMENT

The Weekly Speculator

October 04, 2018

Michael Shaoul,Ph.D.
mshaoul@marketfield.com

Timothy Brackett,MSTA.
tbrackett@marketfield.com

We have been warning for several weeks that the long end of the curve looked to be poised for a breakout and the 30 year bond yield finally punched through key resistance at 3.25% on Wednesday and then surged to close at 3.335%, its highest level in four years. For the more closely watched 10 year yield there was a 7 year high recorded at 3.18%, but it is the long bond that ultimately determines the shape of the yield curve and by breaking higher the prospects for the future now look quite different.

With the barrier at 3.25% now removed we would not be surprised to see the 30 year close in on the 3.50% level quite quickly, and possibly 3.75%. Moves at the long end of the curve can be quite rapid and prone to overshoot, as we saw during the taper tantrum in 2013 and the pre-Brexit plunge and post-Brexit surge in 2016. We would expect the more closely watched 10 year yield to follow suit, although the current 10-30 year spread of 15 bp could widen to 20 or 25 bp. This would imply a 10 year yield at about 3.25-3.30% if the 30 year were to halt at 3.50%, and a 3.50% 10 year yield if its halts at 3.75%. If these numbers seem high then it should be remembered that back in 2011 in a much weaker economy the 10 year yield reached 3.77%. With nominal growth in the US finally breaking higher and the FOMC conceivably pushing the policy rate up to 3.0% by this time next year a 10 year yield above 3.50% hardly strikes us as outlandish.

It is also worth considering that the breakout by long term yields removes the risk of an imminent yield curve inversion. Although a number of FOMC members have indicated a willingness to set the policy rate without viewing

an inversion as a constraint there is absolutely no doubt that they would *prefer* an inversion not to take place, particularly given that inflation still remains contained in their favored PCE Deflator. In other words higher long term yields should be viewed as an enabler of tighter monetary policy, particularly if one extends the horizon into 2019.

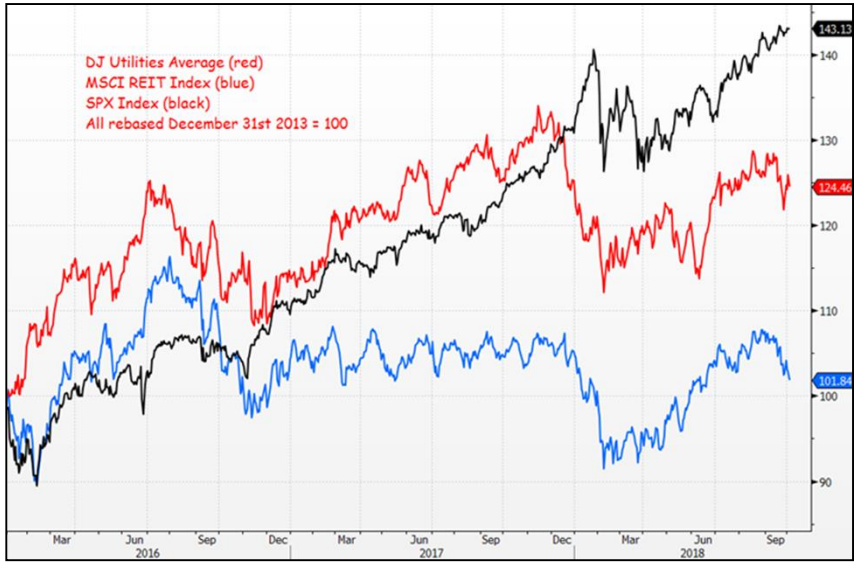
As to Wednesday's move itself, there was no clear catalyst for the surge higher. Although both the ADP Employment Report and ISM Non-Manufacturing Survey were well above expectations, these are second tier metrics that rarely cause important moves such as this. Similarly the bullish comments made by a number of FOMC members will have helped, but nothing truly surprising was said during the multiple speeches that were made on Wednesday (the quite hawkish Powell comments came after the market had closed). This actually makes the move a little more impressive, with the 12 bp increase in the 30 year yield being the largest intraday move since the November 2016 election, a "news driven" move by any definition.

The current move higher looks to be an adjustment to several months of data that suggested that the US economy has accelerated over the course of 2018. In particular the labor market looks to have tightened considerably, and recent commentary by the FOMC suggests that this has not gone unnoticed. Furthermore although concern about the global economy have ratcheted higher, there is no evidence that US exports have suffered any deterioration. The breakout of yields suggests that the reflationary forces that were in evidence between 2016 and early 2018 have been suppressed in recent months rather than extinguished by the ongoing trade dispute. Indeed the overall commodity complex was able to absorb the coincident surge by the USD with crude oil breaking out to its own 4 year high

It is also worth noting that the move higher in yields has been global. This point may be obscured by the fact that yields remain much lower outside the US, but they have still been rising across the developed world in recent weeks. Japan's 10 year yield remains paltry at 15 bp but this is still its highest level since early 2016 and has been accompanied by a breakout by the local equity market to a 27 high. This again cuts against the narrative of a worsening global economy although it would certainly be fair to call it a more complicated one.

We would therefore be open minded as to whether the breakout by US yields means that the USD is bound to follow suit. The USD certainty was in strong demand on Wednesday, but if other countries yields continue to move higher this may not prove to be a simple relationship. Of course this will determine if it is only US economically sensitive sectors which are swept higher, or a broader global improvement of the type that we would expect to take hold. As we note above the commodity complex was able to hold into its recent gains, and even precious metals were hardly troubled. Emerging markets instruments traded in the US were generally liquidated, but it remains to be seen how local markets respond in the coming sessions, particularly once China re-opens next week.

The clearest losers in this adjustment look to be bonds (even the AGG ETF now stands in negative territory on a YTD basis), with duration generally performing worse than credit. However, with high yield spreads now back to record lows the risk adjusted return for US credit look to be quite unappealing. Ironically following the summer sell-off local currency emerging market credit now has much less duration risk compared (but plenty of credit and FX) risk, although this will probably go unnoticed for the time-being.



Bond proxies such as Utilities and REITs once again look vulnerable. Both sectors enjoyed strong summers as defensive allocations. Utilities have held on to most of their gains but REITs are starting to roll over once more and have already reversed about 40% of the February to August rally. As regular readers will be aware we harbor significant concerns about the prospects for US commercial real estate and if US interest rates are indeed about to experience a hike across the curve then this industry looks poorly positioned to deal with this. Utilities by contrast merely look overvalued, although a surge in energy input costs would presumably pressure margins, particularly in regulated entities.

S&P 500

The grind higher in the SPX continues and yesterday the large cap index challenged the September 19th intra-day high at 2,940.91, falling short of it by a point and by the close the index fell back to be up only +2.08 points at 2,925.51. That said, the series of higher lows remains in place and the 50-day ma hasn't really been tested since late June. MACD continues to track sideways in positive territory. We now mark first support at 2,900 and second at the rising 50-day ma at 2,875.06.

NASDAQ 100

During the first trading session of the month the NDX eked out a new all time intra-day high at 7,700.56 before pulling back at the end of the day and the high tech index has been quietly tracking sideways since. As has been the case since early May it has all been about support at the 50-day ma and that continues, leaving us to mark it as first support (7,479.90 at yesterday's close). MACD has retaken the ground above its signal line and is gently tracking higher in positive territory. We continue to mark second support at the 200-day ma at 7,012.48.

Russell 2000

Even with yesterday's +15.25 point or +0.92% gain the RTY continues to underperform its larger cap brethren. The small cap index is down 1.20% versus a +0.98% gain in the NDX and +0.67% return in the SPX over the past five trading days. The RTY fell through its 50-day ma last Wednesday and has been unable to re-take the ground above it since. MACD is tracking lower in negative territory for the first time since mid-April. We continue to mark first support at 1,650 and second key support at the 200-day ma at 1,618.03 which has held (on a closing basis) during deeper price retracements in the index since August of last year. We now mark first resistance at 1,700 and second at 1,740.

VXO

Despite the surge higher in long term yields the VXO index remains becalmed at 11.55, a reflection of the fact that winners and losers from the move in yields have largely cancelled each other out at the level of the overall SPX index. The VXN index was also little changed in recent sessions, closing Wednesday at 17.50 and in the middle of its 15-20 trading range.

The only major index to see a significant increase in hedging costs is the small cap RTY index, with the RVX index moving up to 17.24 on Tuesday, its highest level since mid-June and indicating that the significant under-performance of small cap equities in recent weeks was starting to make investors chase protection. However, Wednesday saw a fairly sharp reversal, with the RVX dropping back to 15.86 and back within its recent range.

Morgan Stanley Emerging Markets

Since falling through the 50-day ma in March six rally attempts have been capped by the shorter term moving average and last week (the sixth) was not an exception (the smoothing indicator remains first resistance). At this point the bull's best hope is that a bid in EM Markets resurfaces and the MXEF establishes a higher low but with the Chinese equity markets closed for all of this week a crucial sentiment indicator will be absent in the market. MACD made a valiant attempt to cross into positive territory but is beginning to roll over at neutral again. We continue to mark key support at 1,000 and as we said last week only a sustained move above the 1,100 level would give investors the confidence that emerging markets would be investable again.

10 Year Treasury Note

We have spent the last few months explaining that the 30 year bond yield was the key to the entire yield curve and so Wednesday's explosive session should not have come as a surprise to our readers. Resistance at 3.25% finally gave way, with the follow through ripping the yield up to 3.33% by the close. The 10 year yield followed suit, surpassing its May high by 6 bp to close at 3.18%.

We would not be surprised to see the 30 year yield move up to 3.50% during the current move and the 10 year to follow up to 3.30% or so. As high as this might seem, it would still keep the 10 year well below its 2011 high at 3.77% and would only generate a "real" yield of about 50 bp based on current CPI.

US Dollar

The DXY held support around the 94 level early last week and after a sharp rally on Thursday and 5 days of higher closes the DXY settled at 95.89 yesterday, just below our first resistance level. Yesterday's explosive move higher in US yields was too much for the DXY to ignore as it had done since the middle of August. In the coming days it will all be about what global yields do in response to the run up in US yields. If the DXY is able to surpass and leave the 96 level behind with the conviction we have witnessed over the past five trading days it will put second resistance at the August 15th highs at 97 in the bull's crosshairs. First support remains at 94 and second at 93.

Gold

Gold experienced a strange week, declining sharply on Thursday in what we assume was quarter end allocation and then bouncing sharply on Tuesday. By contrast Wednesday's sharp break higher by both interest rates and the USD left the metal only $6 lower (50 bp) when a more significant decline may have been expected. This muted reaction is probably explained by the extreme negative positioning in the metal, reducing any reaction from the break-out in yields. To some extend this is encouraging, but it would be more so if the metal could force its way above the $1215 level which has capped prices since the august plunge.

It is worth noting platinum and silver enjoyed stronger weeks than gold. Both metals were trounced over the summer months but are now showing signs of recovery. Platinum has already retaken its 50 day ma and survived a test of support this week, while silver has only achieved an intraday breach of its 50 day ma, which was then repulsed at the $15 level which now marks key resistance.

Crude Oil

When oil prices overtook our previous price resistance at $72 we suggested that the key resistance at the recovery highs at $75 would be the next target in the eyes of the bulls. On Monday oil rose through that level and after a brief rest on Tuesday prices measured by the front month WTI futures contract pushed higher to close yesterday's session at $76.20. MACD reflects the strong move higher in price from the August lows but also reflects a growing overbought condition but with the wind at its back oil could easily tag $80 before a short term backing and filling unfolds. We now mark first support at $72 and second at $70.

Copper

Copper continues to consolidate its recent gains and has established a range between $6150 and $6400 in recent sessions. We are hopeful that this will be resolved to the upside given the fact that reflationary forces appear to be building once more. MACD shows that momentum is now back in positive territory, but the metal still needs to show that it has the ability to force its way above key resistance at the $6400 level, opening up the way for a re-entry into its $6600-$7200 trading range.

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