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Polar Futures Guarded Opportunity

January 2018

Monthly Performance = 4.5%
YTD = 4.5%
**net of fees*

We got off to a strong start in 2018, even as key themes that I thought were overdone through the holiday season persisted into the New Year. The gains in the month were largely in part to staying with the existing short position in the US 10yr note.

I believe the direction of the USD going through start of the year will be critical in all trade selection. Given that, the thesis for USD strength seems to be perched perilously on a rather wobbly fence at the moment. This month saw a new 3 year low in the USD. The turn lower in the USD going back to the start of 2017 has maintained its downward trajectory; however I'm starting to wonder if we are seeing too much USD bearishness, especially against the EUR. Speculators have built their largest long EUR position ever! This overly bearish sentiment may provide some great opportunities in the short to medium term.

The short US 10yr Treasury note position was held throughout the month again. However unlike last month's flat price action, this position had great gains in the month. Our current position was established at the end of November with the aim of holding it through the start of 2018 on the view that US 10yr yields could move higher, and faster than most were expecting. I continue to think that a run to 3% is possible and at that point gains will likely be taken as some consolidation may be necessary. The tide of rates moving higher globally will likely give this position more staying power than past interest rate moves and will likely be a trend to be traded over the coming years. The US sovereign rate market faces further headwinds as central banks reduce bond bids at a time while fiscal policy is increasing the supply. While every market has quirks, price is always settled by supply and demand. Echoing this soft sentiment was the last couple of trading days of the month that saw stocks sell off with 10yr notes down at the same time.

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Near the start of the month we entered into a short gold trade. Gold had rallied more than $85 through the holidays and into the New Year while real interest rates also moved higher. Given that real rates tend to move in the opposite direction of gold, the multi-week run up seemed to be overdone. The other key to initiating the position was the view that the excessive weakness in the USD through December would likely find support around the August 2017 lows. Any strength or even stability in the USD would leave the gold price vulnerable to a large "catch up" lower to get back in alignment with real yields. This trade held water for the first week, however the sharp mid-month move to new lows in the USD accelerated the gold price to new one and half year highs. The sudden swing higher is testing the thesis of the trade, most notably the likelihood of the USD regaining strength; however it may have just been early, and may still have time to come around if the drop in price proves as sharp as I think it could be.

Near the end of the month we added a short Canadian dollar position. The catalyst to enter the trade was after the US Treasury Secretary made his “weak USD” comments that saw a sharp selloff in USD. We used this spike higher in CAD to establish a limited risk position against CAD. Although the USD strength/weakness will be critical to the success of this trade, it is far from the only factor, with 5 other areas I’m watching closely.

1) <u>Relative Performance</u> - CAD had been a “laggard” compared to other currencies in a weak USD environment, signaling weakness.

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2) <u>NAFTA</u>- ongoing negotiations continue cause uncertainties throughout the economy and Bank of Canada decision making.
3) <u>Household Debt/Real estate</u> – the high debt levels of Canadian households and high priced real estate markets. I believe this are raises the bar for the Bank of Canada raising rates.
4) <u>Oil</u> – western Canada select crude trading at a huge discount, is now worth only half the price WTI.
5<u>) Interest Rates</u> – the differential between Canadian and US interest rates continues to widen, enticing funds to flow out of CAD. I think we will continue to see the interest rate differentials widen as the Bank of Canada is more likely to remain on hold.

I’m looking for CAD to work back toward 77.50 cent level that was supportive at the end of last year, at which point the market condition will dictate looking for a move even lower or getting out of the trade.

I’m grateful to start the year off in the right direction and believe that we will see larger volatility this year which should provide some great opportunities across different markets. However, I continue to be wary / cautious around the USD after such a weak start to the year continuing last year’s losses. The USD is so important across asset classes that having a correct trade idea or thesis can be thrown out the window if we get the USD moves wrong. As such, it will be very important to stay clear and unbiased on the future direction of the USD. The only thing worse than being wrong about the USD, would be to stay wrong!

Until next month, Drew Zimmerman

DZIMMERMAN@PIFINANCIAL.COM 604-664-2842 POLARFUTURESGROUP.COM