The Macro Environment For Financial Markets

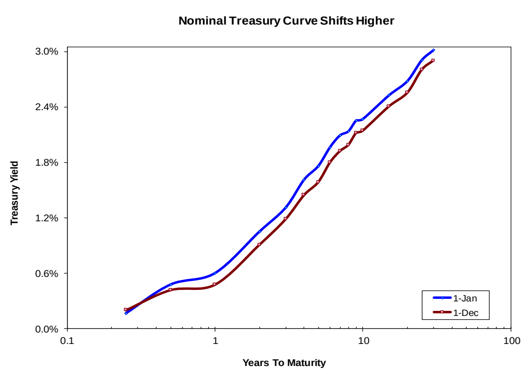
The impulse to treat the calendar as a defining variable for markets is one to be resisted, but it is irresistible nevertheless. Whenever equity markets remain sideways in the face of negative fixed-income and sociopolitical environments, such as seen in 1994 and again in 2011, they tend to resolve themselves to the upside. The logic is compelling: You were given many reasons to sell and decided not selling was preferable. However, neither of those markets involved the combination of stagnant global growth, declining corporate profits, stranded capital investment in the energy & materials sectors, rising U.S. short-term rates and the increasing importance of Chinese monetary policy. Until these issues are clarified somewhat, let's remember markets do not owe us trends and whenever the boundaries of trading ranges are approached, they look like they will break out in that direction.

The causal chain remains:

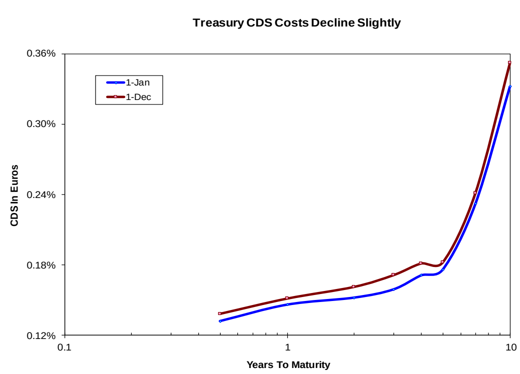
1. Higher short-term interest rates have arrived at last, but there is no rush to push them higher anytime soon;
2. Disinflationary pressures will rise once again with rising risk-aversion;
3. Inflation expectations as measured by the TIPS market have seen their lows for the immediate duration, but are biased lower once again;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are terming-out their borrowing to reduce rollover risk;
6. Swap spreads will remain low even as declining UST rates lead to a small increase; and
7. Credit spreads will retain and most likely expand their upward bias.

Key Market Indications

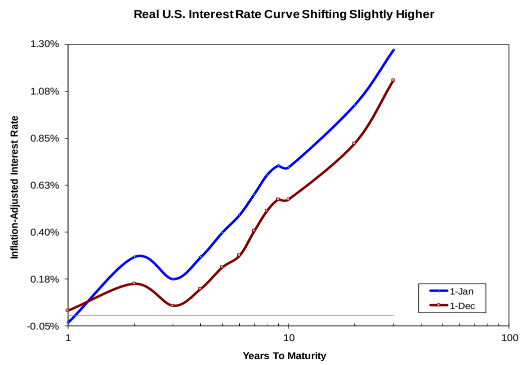
The yield curve shifted slightly higher at the end of the year, but as noted last week this is a market trapped between the artificial demand of capital charges and illiquid corporate bonds and rising short-term rates. While the secular bull market remains intact, the gains for participating in it are quite small indeed.



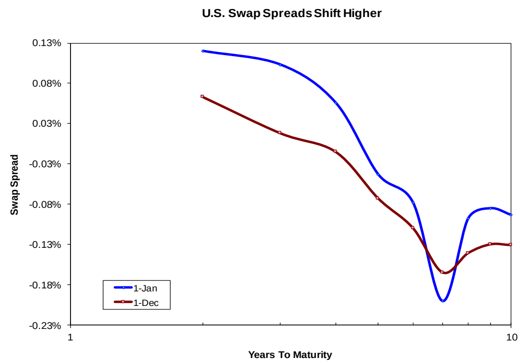
The CDS market for Treasuries declined slightly over the past month, as well it should have given the lack of news emanating from Washington, D.C., over fiscal matters.



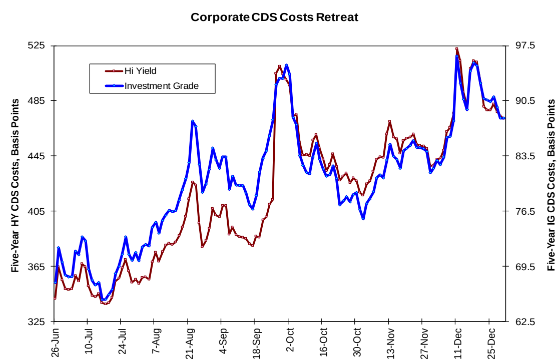
The pseudo-real rate curve rose slightly beyond one year. As movement in the TIPS market reflected a lack of trading activity and the nominal UST market was largely flat, this small shift higher can be ignored for fundamental purposes.



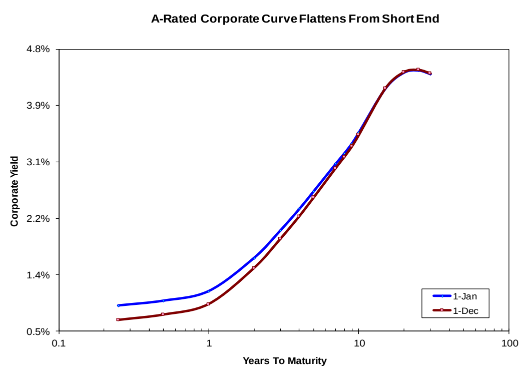
Swap spreads, which rise when floating-rate borrowers want to fix their payments, once again shifted higher in response to flattening of the yield curve from the short end. They remain negative for tenors of five years and longer.



CDS costs for both the investment-grade and high-yield indices retreated slightly, but neither measure has reversed the primary uptrend extant over the last half of 2015.



The A-rated yield curve flattened via higher short-term rates. The inability of longer-term rates to rise removes one negative from risky assets.



Market Structure

Volatile transitional structures and bear market consolidations characterized by sideways structures continue to dominate. The Softs subindex remains in a structural uptrend, and the Grains subindex moved into a structural downtrend. Both the EAFE and S&P 500 ended the year in structural downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan 4 - 8
BBerg	9	Sideways	0.051	8.8%	
BBerg Grain	23	Trending	-0.173	14.8%	-2.64%
BBerg Ind. Metl	17	Transitional	0.099	15.1%	
BBerg Pre. Metl	19	Transitional	-0.104	11.4%	
BBerg Softs	25	Trending	0.113	16.7%	0.31%
BBerg Nat. Gas	29	Trending	0.164	28.1%	
BBerg Petroleum	6	Sideways	0.002	26.9%	
BBerg Livestock	22	Trending	0.229	16.3%	0.84%
Dollar Index	11	Transitional	0.050	6.0%	
S&P 500 Index	24	Trending	-0.055	11.4%	-0.08%
EAFE Index	29	Trending	-0.017	10.7%	-0.05%
EM Index	11	Transitional	-0.031	8.2%	
Ten-year UST (price)	17	Transitional	-0.053	5.0%	

Performance Measures

The most important fundamental in physical commodity markets is whether production is state-owned or not. Where it is in private hands, as is the case in grain or industrial metals markets, production can be reduced in an attempt to support prices. If it is state-owned, as in the case of crude oil, production can be maintained in an attempt to cover fixed costs and to provide social welfare. In addition, those producers can hope, unsuccessfully so far, to drive private producers out of business. They will win this bet eventually, but between now and eventually lies more pain.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.59%	-3.89%	-22.64%	-24.66%
Grains Sub-Index	-1.40%	-2.84%	-19.37%	-19.42%
Corn	-1.84%	-3.99%	-19.36%	-19.22%
Soybeans	-1.87%	-3.13%	-16.74%	-14.63%
Wheat	0.11%	-0.30%	-21.37%	-22.21%
Energy Sub-Index	3.03%	-11.14%	-38.34%	-38.87%
Petroleum Sub-Index	-0.44%	-15.25%	-40.14%	-39.42%
WTI	-0.65%	-15.34%	-41.99%	-44.35%
Brent	-0.57%	-17.41%	-44.34%	-45.57%
ULSD	-2.44%	-19.59%	-43.74%	-42.84%
Gasoline	1.67%	-7.93%	-25.23%	-12.65%
Natural Gas	12.47%	0.63%	-32.70%	-39.95%
Precious Metals Sub-Index	-1.44%	-0.72%	-10.15%	-11.45%
Gold	-0.75%	-0.29%	-9.53%	-10.88%
Silver	-3.38%	-1.97%	-11.91%	-12.72%
Industrial Metals Sub-Index	0.28%	2.17%	-19.45%	-26.88%
Copper	0.50%	3.09%	-19.40%	-25.13%
Aluminum	-1.90%	2.24%	-15.14%	-22.94%
Nickel	1.70%	-1.91%	-27.18%	-42.64%
Zinc	3.50%	1.93%	-22.59%	-27.98%
Softs Sub-Index	1.53%	2.68%	2.80%	-9.85%
Coffee	4.76%	5.69%	-5.34%	-31.54%
Sugar	0.60%	-1.27%	13.45%	-4.70%
Cotton	0.82%	-0.39%	-6.51%	2.97%
Livestock Sub-Index	2.25%	1.08%	-9.99%	-18.83%
Cattle	1.58%	1.64%	-13.84%	-14.30%
Hogs	3.51%	0.06%	-2.76%	-26.09%

The currency world's focus in 2016 should be on the Pacific region and the pace at which the CNY is allowed to decline and the degree to which regional currencies match that decline. The bias remains for the USD to continue firming against the EUR and other major European currencies, but changes in these markets should be more incremental. The divergence trade has been known for more than one year already.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.95%	2.10%	-1.78%	-10.31%
Chinese yuan	-0.27%	-1.47%	-4.51%	-4.44%
Japanese yen	-0.18%	1.92%	2.17%	-0.67%
British pound	-1.12%	-2.23%	-5.58%	-5.39%
Swiss franc	-1.32%	2.45%	-5.29%	-0.75%
Canadian dollar	-0.22%	-3.59%	-9.13%	-16.20%
Australian dollar	0.32%	-0.27%	-4.47%	-10.75%
Swedish krona	-0.81%	2.61%	-0.91%	-7.76%
Norwegian krone	-2.12%	-2.76%	-10.50%	-15.95%
New Zealand dollar	0.61%	3.09%	2.21%	-11.75%
Indian rupee	0.11%	0.54%	-3.83%	-4.21%
Brazilian real	-0.42%	-2.36%	-21.66%	-32.90%
Mexican peso	-0.13%	-4.29%	-8.60%	-14.57%
Chilean peso	-1.12%	0.36%	-9.81%	-14.42%
Colombian peso	0.37%	-0.89%	-17.91%	-25.14%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.35%	-0.91%	-4.43%	-5.49%

Equity markets increasingly are becoming a contrary bet, one based on the assumptions 1) the bad news is known, and 2) the alternatives remain unappealing. This argues for a binary outcome in 2016, either an event creating a bear market or unexpectedly strong returns.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.63%	-1.72%	-3.18%	-0.32%
North America	-0.86%	-1.96%	-1.43%	-0.27%
Latin America	-1.64%	-4.23%	-26.23%	-30.82%
Emerging Market Free	-1.02%	-2.17%	-17.18%	-14.60%
EAFE	-0.26%	-1.33%	-5.92%	-0.39%
Pacific	1.29%	0.95%	-5.28%	3.21%
Eurozone	-1.28%	-3.45%	-5.73%	-2.13%

With the exception of a minor gain for global hedge funds, all of the professional trader indices lost in the final week of an already poor trading year. The real question should be what will end this, better performance or investors pulling the plug?

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.09%	-1.13%	0.97%	1.31%
Newedge Trend	-0.76%	-0.56%	1.01%	0.86%
Newedge Short-Term	-0.13%	-2.53%	-0.86%	-4.99%
HFR Global Hedge Fund	0.06%	-1.17%	-4.70%	-3.47%
HFR Macro/CTA	-0.06%	-0.86%	-0.07%	-1.28%
HFR Macro: Sytematic Diversified CTA	-0.23%	-0.60%	2.66%	-0.22%