The Macro Environment For Financial Markets

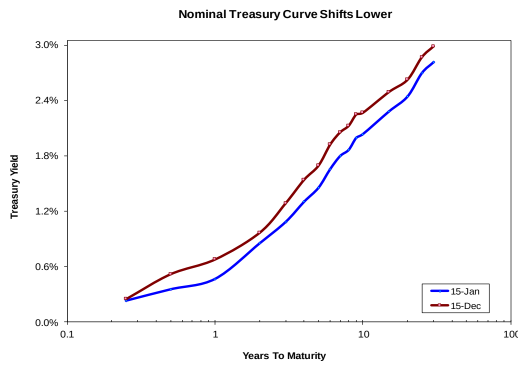
When Franklin Roosevelt proclaimed we had nothing to fear but fear itself, he was on to something profound: A massive loss of confidence and risk-taking is a powerful macro factor in itself. No one yet has built a more exquisite measuring device for human behavior than a cash register, and those weak retail sales numbers are telling us something. If consumers are saving the money saved from lower energy and import prices and are willing to accept near-zero yields for doing so, then the destruction of those industries and their service providers simply is a deadweight loss to the economy. All of this leans in the deflationary direction at a time when the Federal Reserve is yammering about higher short-term rates. At least they are not talking about shrinking their balance sheet yet.

The causal chain now is:

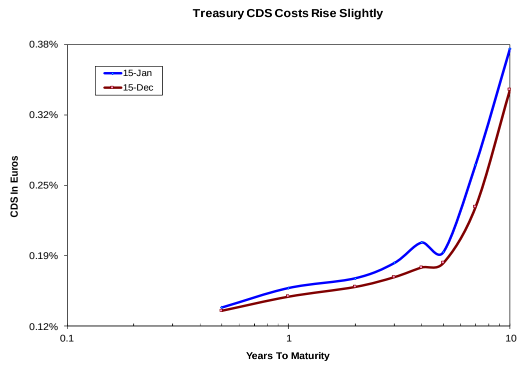
1. Higher short-term interest rates have arrived at last, but this appears to be a single move for the foreseeable future;
2. Disinflationary pressures will rise once again with rising risk-aversion;
3. Inflation expectations as measured by the TIPS market are approaching and may break their recent lows;
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; and
7. Credit spreads will continue to rise.

Key Market Indications

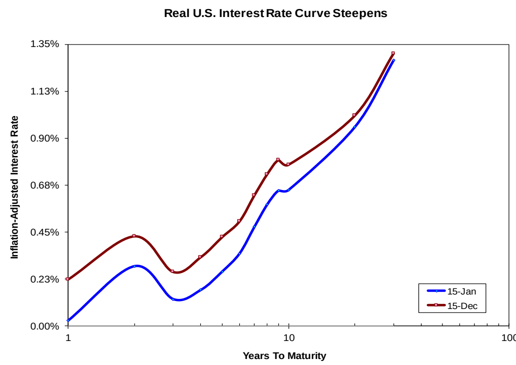
To repeat from last week, the one surprise for the UST market is how yields did not decline further given rising risk-aversion and what is looking like a reversal in expectations for higher short-term rates. Improbable as it may sound, ten-year UST are yielding more than ten-year Spanish and Italian bonds.



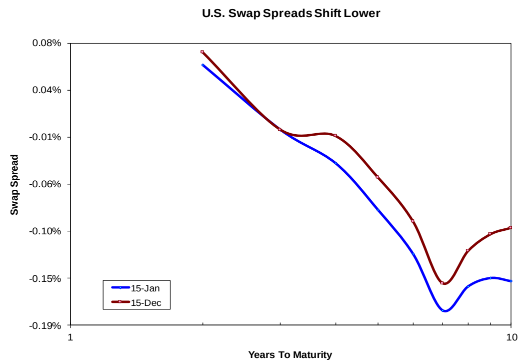
The CDS market for Treasuries has shifted higher, but not significantly so, as nothing yet is signaling a worsening of the federal fiscal outlook.



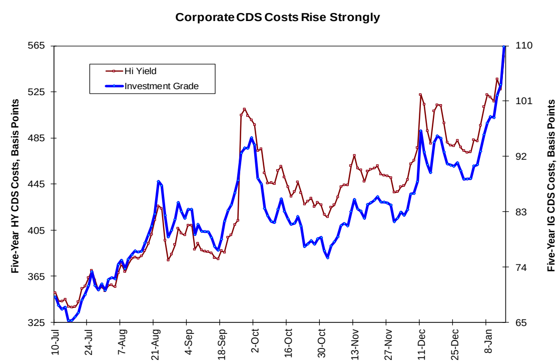
The pseudo-real rate curve shifted lower inside of ten years over the past month. These moves have been constrained by UST buyers' hesitance to push nominal yields lower. The decline in implied real yields at the short end is supportive for gold.



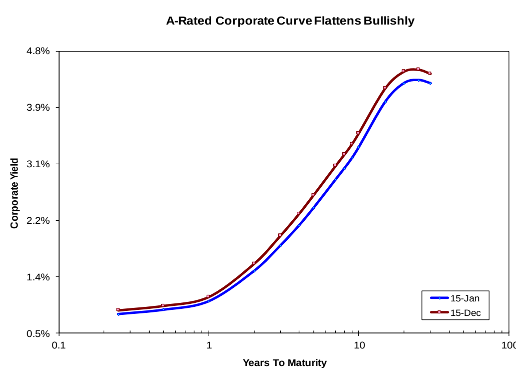
Swap spreads, which rise when floating-rate borrowers want to fix their payments, fell as the risk-off shocks in financial markets once again led to expectations for tame moves in interest rates.



CDS costs for both the investment-grade and high-yield indices continue to break higher. While the CDS market, especially for single names, is nowhere near as active as it once was, protection writers often sell stock in a correlation trade as a hedge against their positions.



The A-rated yield curve flattened bullishly. The inability of longer-term investment-grade rates to rise is one of the few pieces of good news for risky financial assets so far in 2016.



Market Structure

Precious Metals remained in a structural uptrend while all other physical commodities were either in a downtrend or in a volatile transitional structure. Within financials, all of the equity indices are oversold within structural downtrends while ten-year UST and the dollar index remain in uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 18 - 22
BBerg	19	Transitional	-0.404	11.2%	
BBerg Grain	29	Trending	-0.050	15.2%	-2.64%
BBerg Ind. Metl	26	Trending	-0.256	16.1%	-0.84%
BBerg Pre. Metl	22	Trending	0.054	12.7%	0.49%
BBerg Softs	29	Trending	-0.122	16.4%	-0.12%
BBerg Nat. Gas	19	Transitional	-0.100	31.4%	
BBerg Petroleum	16	Transitional	-0.431	37.7%	
BBerg Livestock	25	Trending	-0.057	14.0%	
Dollar Index	29	Trending	0.069	7.5%	0.03%
S&P 500 Index	29	Trending	-0.432	16.4%	-0.08%
EAFE Index	29	Trending	-0.495	14.2%	-0.05%
EM Index	21	Trending	-0.675	12.4%	-1.01%
Ten-year UST (price)	29	Trending	0.218	6.1%	0.16%

Performance Measures

About the only encouraging thing that can be said for the energy markets is many long-term trends end with the sort of hyperbolic moves we have seen over the past month. However, this is not actionable information any more than is the knowledge you will die someday. The markets with more atomistic producers, such as Grains, Softs and Livestock are showing some signs of two-way trade, which is unsurprising given how lower prices induce supply destruction when said suppliers are not engaged in a price war.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-4.22%	-5.25%	-25.34%	-27.71%
Grains Sub-Index	1.07%	-2.28%	-17.73%	-13.74%
Corn	1.76%	-3.69%	-19.67%	-14.54%
Soybeans	1.59%	1.32%	-14.18%	-10.32%
Wheat	-0.99%	-4.13%	-17.70%	-13.19%
Energy Sub-Index	-12.82%	-15.23%	-46.04%	-45.76%
Petroleum Sub-Index	-12.34%	-23.36%	-47.97%	-44.43%
WTI	-11.45%	-23.16%	-48.83%	-49.08%
Brent	-15.12%	-26.76%	-53.38%	-50.02%
ULSD	-11.65%	-22.38%	-48.90%	-46.19%
Gasoline	-9.63%	-18.58%	-34.81%	-20.65%
Natural Gas	-13.92%	9.10%	-41.71%	-49.83%
Precious Metals Sub-Index	-0.55%	2.28%	-5.95%	-15.68%
Gold	-0.67%	2.74%	-5.16%	-14.17%
Silver	-0.15%	0.94%	-8.19%	-19.85%
Industrial Metals Sub-Index	-2.64%	-2.92%	-22.79%	-26.95%
Copper	-3.88%	-5.47%	-23.45%	-24.71%
Aluminum	-1.25%	0.16%	-16.34%	-22.11%
Nickel	-1.98%	-1.88%	-27.33%	-42.83%
Zinc	-2.22%	-2.01%	-30.20%	-30.30%
Softs Sub-Index	0.76%	-0.57%	0.22%	-17.84%
Coffee	-3.44%	-4.15%	-15.97%	-41.44%
Sugar	3.19%	2.28%	10.90%	-11.74%
Cotton	0.02%	-2.98%	-5.53%	1.24%
Livestock Sub-Index	-1.21%	3.05%	-11.74%	-16.70%
Cattle	-3.98%	1.66%	-17.44%	-15.16%
Hogs	3.37%	5.01%	-1.14%	-19.27%

The USD continues to gain against commodity-linked and emerging market currencies far more than against the EUR and JPY. This past week's gains by the CNY were the product of interventions and expenditures of reserves by the Peoples' Bank and will be short-lived.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.05%	-0.14%	-0.31%	-6.16%
Chinese yuan	0.15%	-1.86%	-5.71%	-6.02%
Japanese yen	0.24%	4.02%	5.80%	-0.69%
British pound	-1.78%	-5.19%	-8.83%	-6.09%
Swiss franc	-0.64%	-0.98%	-4.92%	-16.18%
Canadian dollar	-2.54%	-5.56%	-11.20%	-17.74%
Australian dollar	-1.28%	-4.56%	-6.98%	-16.47%
Swedish krona	-0.94%	-0.86%	-0.88%	-5.59%
Norwegian krone	0.51%	-1.64%	-7.70%	-14.22%
New Zealand dollar	-1.25%	-4.49%	-1.93%	-17.41%
Indian rupee	-1.43%	-0.99%	-6.19%	-8.19%
Brazilian real	-0.60%	-4.39%	-22.45%	-34.75%
Mexican peso	-1.80%	-6.31%	-13.59%	-19.70%
Chilean peso	-0.47%	-2.76%	-12.09%	-14.41%
Colombian peso	-1.05%	0.41%	-17.74%	-26.96%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.18%	-1.79%	-5.52%	-7.37%

There are bear markets and there are systemic financial crises. We should proceed on the bear market model for now, but the possibility of a greater collapse involving sovereign credit crises cannot be discounted. In addition, let's remind ourselves we will not be able to repeat recent policy measures to rescue financial markets.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-2.58%	-7.51%	-13.06%	-6.23%
North America	-2.43%	-8.15%	-11.28%	-5.37%
Latin America	-2.91%	-12.72%	-33.72%	-36.33%
Emerging Market Free	-4.17%	-8.75%	-23.54%	-24.03%
EAFE	-2.82%	-6.44%	-15.86%	-7.61%
Pacific	-2.77%	-3.60%	-12.80%	-5.53%
Eurozone	-2.40%	-8.19%	-17.25%	-7.65%

CTAs managed a second week of gains as commodities and equities collapsed and as fixed-income returns benefited from rising risk aversion. Macro hedge funds did well, but more long-biased hedge funds lost on the week once again.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	2.58%	2.87%	5.79%	0.72%
Newedge Trend	2.27%	3.75%	5.84%	1.40%
Newedge Short-Term	1.50%	2.13%	2.17%	-1.87%
HFR Global Hedge Fund	-0.87%	-1.55%	-7.36%	-5.31%
HFR Macro/CTA	0.24%	0.35%	-1.35%	-2.05%
HFR Macro: Sytematic Diversified CTA	0.23%	1.26%	2.22%	-0.02%