The Macro Environment For Financial Markets

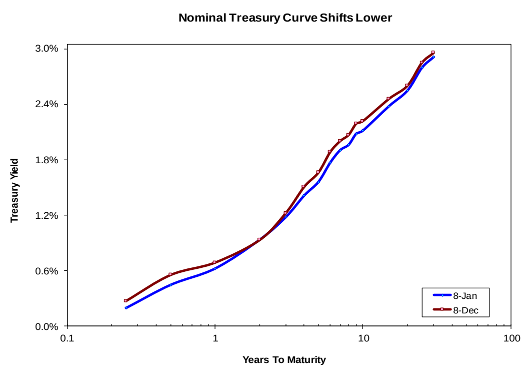
While it is hard to annihilate an army on the battlefield, it is relatively easy to do so on retreat. Unless a withdrawal or a policy unwinding is accomplished in an orderly fashion, it soon can turn into a rout. China's mishandling of a necessary yuan devaluation and of its equity markets' trading integrity illustrate this well. They want a weaker yuan but also want both foreign investors and their own connected elites to hang around and suffer the associated losses. That will not happen. As the ruling Communist Party fears disorder more than it fears yuan overvaluation, it probably will opt for a slow long-term decline of the yuan rather than a single shock. The consequences will be slower Chinese growth, uncertainty over future policies and lower global exports to China. All of this points the needle toward the disinflationary recession corner of the map, which leads to the great question of why our Federal Reserve is contemplating higher short-term interest rates and the associated stronger dollar.

The causal chain remains:

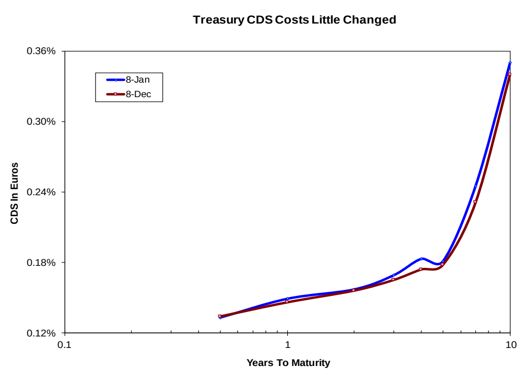
1. Higher short-term interest rates have arrived at last, but there is no rush to push them higher anytime soon;
2. Disinflationary pressures will rise once again with rising risk-aversion;
3. Inflation expectations as measured by the TIPS market have seen their lows for the immediate duration, but are 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; and
7. Credit spreads will retain and most likely expand their upward bias.

Key Market Indications

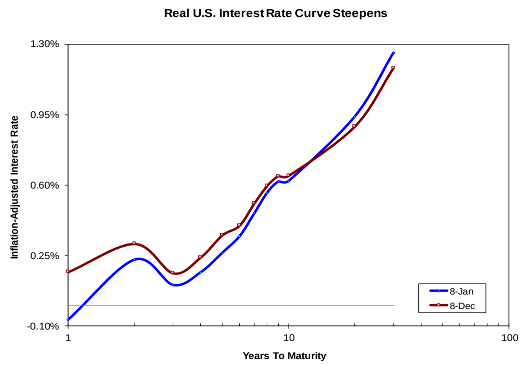
The surprise in the UST market was how little yields declined given the liquidation of equities and the rising expectations for a global growth recession if not outright contraction. As a result, the yield curve steepened slightly and TIPS breakevens did not narrow as much as we might have expected. A market that refuses to rally in the face of bullish news is suspect.



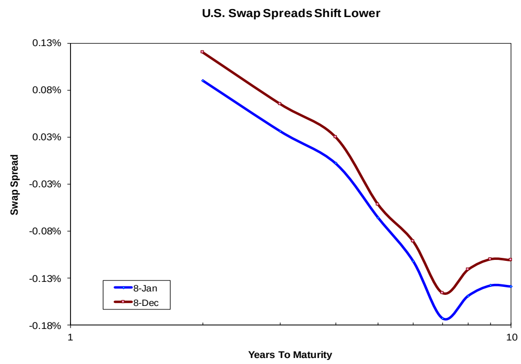
The CDS market for Treasuries has shifted very little in recent weeks as the market does not believe Congress will push budget issues to the brink in an election year.



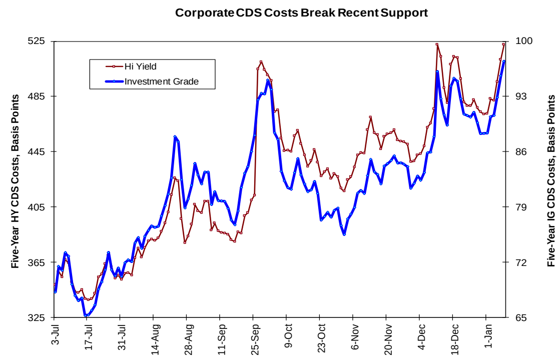
The pseudo-real rate curve shifted lower inside of ten years and turned negative for one-year maturities. These moves have been constrained by UST buyers' hesitance to push nominal yields lower. The implied negative real yield at the short end is supportive for gold.



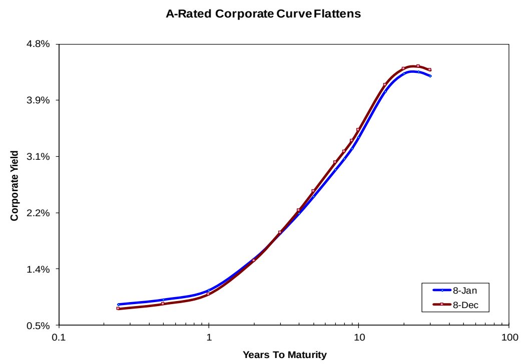
Swap spreads, which rise when floating-rate borrowers want to fix their payments, fell as the risk-off shocks in financial markets once again led to expectations for tame moves in interest rates.



CDS costs for both the investment-grade and high-yield indices broke through their recent support levels. 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 via higher short-term rates. The inability of longer-term rates to rise removes one negative from risky assets.



Market Structure

Both Precious Metals and Natural Gas moved into structural uptrends while Grains, Softs and Industrial Metals are in structural downtrends. Within financials, the S&P 500 and EAFE are oversold within structural downtrends while ten-year UST and the dollar index moved into uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 11 - 15
BBerg	11	Transitional	-0.120	10.8%	
BBerg Grain	28	Trending	-0.126	14.6%	-2.64%
BBerg Ind. Metl	20	Trending	-0.133	17.0%	-0.84%
BBerg Pre. Metl	22	Trending	0.125	11.6%	0.49%
BBerg Softs	25	Trending	-0.159	16.6%	-0.12%
BBerg Nat. Gas	29	Trending	0.302	28.9%	0.61%
BBerg Petroleum	11	Transitional	-0.180	36.2%	
BBerg Livestock	22	Trending	0.063	15.2%	0.84%
Dollar Index	25	Trending	0.027	8.6%	0.03%
S&P 500 Index	29	Trending	-0.479	13.1%	-0.08%
EAFE Index	29	Trending	-0.442	12.8%	-0.05%
EM Index	16	Transitional	-0.547	10.7%	
Ten-year UST (price)	25	Trending	0.152	5.9%	0.16%

Performance Measures

The modest increase in gold can be attributed to expectations of lower real short-term interest rates and to a general risk-off environment, and the rise in natural gas can be attributed to the surprising news it can get cold in January. Beyond that, it was more of the same conditions driving the physical commodity bear market of the last four-plus years: The need to maintain production to cover fixed costs, revenue maximization and the decline in Chinese import demand. If the Saudis devalue the riyal that will induce other petroleum producers to do the same and further lower production costs. This will end at some point, as it always does, but not before even more pain is incurred.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.33%	-2.14%	-22.72%	-25.91%
Grains Sub-Index	0.21%	-3.03%	-19.54%	-19.21%
Corn	-0.48%	-4.84%	-22.01%	-20.26%
Soybeans	0.12%	-0.95%	-16.05%	-16.86%
Wheat	1.81%	-2.43%	-18.21%	-17.15%
Energy Sub-Index	-5.48%	-4.15%	-39.16%	-38.65%
Petroleum Sub-Index	-9.66%	-11.90%	-42.89%	-39.46%
WTI	-10.08%	-11.00%	-43.77%	-45.15%
Brent	-9.92%	-13.03%	-46.91%	-44.45%
ULSD	-6.55%	-11.41%	-44.45%	-41.84%
Gasoline	-10.85%	-12.16%	-32.30%	-14.06%
Natural Gas	4.58%	17.30%	-29.14%	-38.28%
Precious Metals Sub-Index	2.87%	1.62%	-6.75%	-11.81%
Gold	3.56%	2.08%	-5.39%	-10.13%
Silver	0.84%	0.27%	-10.62%	-16.39%
Industrial Metals Sub-Index	-3.93%	-2.42%	-20.11%	-28.50%
Copper	-5.29%	-4.45%	-20.86%	-27.26%
Aluminum	-1.06%	0.63%	-14.31%	-21.87%
Nickel	-2.91%	-1.57%	-24.45%	-44.84%
Zinc	-6.37%	-2.94%	-26.23%	-31.82%
Softs Sub-Index	-4.86%	-4.12%	0.84%	-17.31%
Coffee	-6.07%	-1.80%	-10.56%	-40.50%
Sugar	-5.11%	-0.80%	7.91%	-11.94%
Cotton	-2.97%	-3.61%	-6.48%	-0.89%
Livestock Sub-Index	-1.84%	2.91%	-9.60%	-18.61%
Cattle	-2.86%	5.27%	-14.18%	-15.22%
Hogs	0.09%	-1.14%	-0.76%	-23.85%

The divergence of currency moves was notable in how the USD weakened against the EUR, JPY and CHF while it strengthened massively against commodity-linked and emerging market currencies. We should interpret this as the currency market betting the Federal Reserve will have to back down on its fantasy program of rate hikes.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.61%	0.28%	-1.40%	-7.39%
Chinese yuan	-1.53%	-2.68%	-5.85%	-5.77%
Japanese yen	2.81%	4.84%	2.94%	2.05%
British pound	-1.55%	-3.27%	-5.49%	-3.80%
Swiss franc	0.66%	-0.24%	-4.98%	2.37%
Canadian dollar	-2.24%	-4.14%	-10.06%	-16.52%
Australian dollar	-4.79%	-3.63%	-6.41%	-14.40%
Swedish krona	-0.49%	0.14%	-0.45%	-5.54%
Norwegian krone	-0.15%	-1.01%	-7.38%	-14.12%
New Zealand dollar	-4.91%	-1.53%	-2.73%	-16.36%
Indian rupee	-0.74%	0.31%	-4.56%	-5.95%
Brazilian real	-1.59%	-5.67%	-19.62%	-33.85%
Mexican peso	-3.75%	-5.09%	-11.64%	-18.22%
Chilean peso	-2.63%	-2.77%	-10.39%	-15.80%
Colombian peso	-2.83%	1.27%	-17.86%	-26.63%
Bloomberg-JP Morgan Asian dollar index (spot)	-1.43%	-1.81%	-5.68%	-6.64%

I commented last week much of the bad news was known and therefore should have been discounted. Um, no. A repeat of last August's China-induced volatility raises the specter of a deflationary recession at a time when policy tools are exhausted.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-6.06%	-6.39%	-7.55%	-5.54%
North America	-6.00%	-6.81%	-6.51%	-6.26%
Latin America	-8.41%	-10.76%	-29.21%	-35.80%
Emerging Market Free	-6.80%	-6.67%	-17.11%	-20.63%
EAFE	-6.14%	-5.71%	-9.22%	-4.30%
Pacific	-5.74%	-4.32%	-8.24%	-0.95%
Eurozone	-6.63%	-7.21%	-8.99%	-6.03%

To give credit where it is due, CTAs navigated the first week of the year well, indicating they returned to long USD and short equity positions and quite probably to short crude oil positions as well. Macro hedge funds did well, but more long-biased hedge funds lost on the week.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.28%	0.22%	1.90%	-0.65%
Newedge Trend	1.04%	2.37%	2.98%	-0.07%
Newedge Short-Term	1.70%	0.61%	-0.07%	-4.02%
HFR Global Hedge Fund	-1.36%	-2.05%	-5.83%	-4.39%
HFR Macro/CTA	0.50%	-0.35%	-0.79%	-2.33%
HFR Macro: Sytematic Diversified CTA	1.92%	1.26%	2.83%	-0.42%