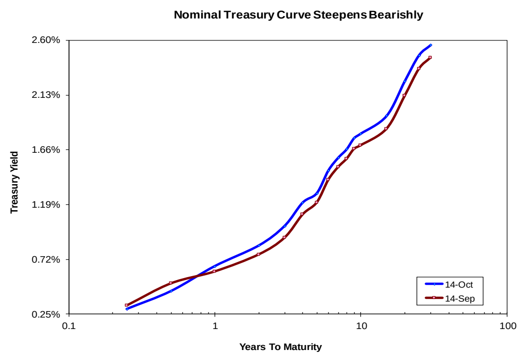
The Macro Environment For Financial Markets

Despite the monetary policy's lack of deterministic outcomes, Janet Yellen continues to believe low short-term rates will succeed in solving the mismatches between available labor and specialized demands therefor. This is giving arrogance a bad name. The term du jour of "running hot" ignores a weaker China, a downturn in the U.K. and the pressures on emerging markets a rising USD presents. The cavalier willingness in both the U.S. and the U.K. about rising inflation risks presumes central banks can solve those. Yes; just as well as they did in the 1970s or disinflationary pressures since the financial crisis. The causal now is:

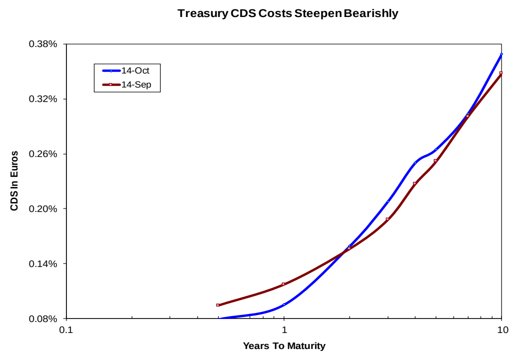
1. The market is pricing in a December increase in U.S. short-term rates;
2. Disinflationary pressures will persist globally but are rising in the U.S.;
3. Inflation expectations as measured by TIPS and inflation swaps are in a defined uptrend;
4. The U.S. yield curve retains its long-term bias toward flattening despite a short-term bearish steepening;
5. Short-term borrowers are terming out short-term debt into the bond market;
6. Swap spreads have stopped rising; and
7. CDS costs remain compressed.

Key Market Indications

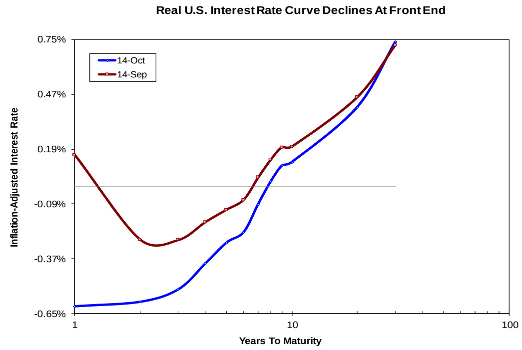
Rising inflation expectations and the increased talk of higher short-term interest rates have led to a bearish steepening of the yield curve over the past month. A stronger USD will not attract capital inflows perforce as USD-denominated assets will become more expensive for foreign investors. This has been a truism for decades and has been ignored for at least as long.



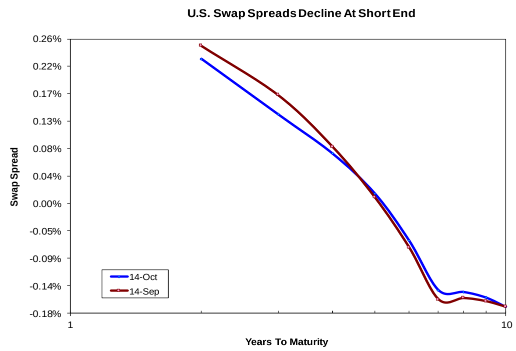
CDS costs on UST continued to decline at the short end of the yield curve even as they rose past two years. This suggests markets are looking at two years or more of a Republican-controlled Congress thwarting the next President, whomever or whatever that may be.



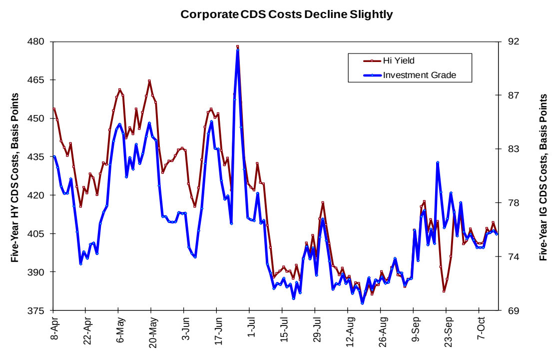
The pseudo-real yield curve declined at the short end of the yield curve. However, the threat of higher short-term real rates in the Eurozone affected gold's "best-of" option negatively and induced a selloff. Long-term implied real rates have yet to increase to the point where they pose a direct threat to risky financial assets.



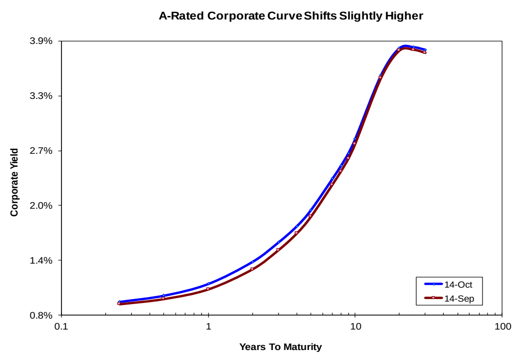
Swap spreads, which rise when floating-rate borrowers want to fix their payments, shifted lower at the short end of the yield curve and remain bullishly inverted. This has been a very persistent pattern for the past five years. Floating-rate payors are not in any demonstrable hurry to fix their payments.



CDS costs moved very little in the face of rising UST yields and firmer expectations of a rise in short-term rates in the U.S. FOMC minutes showed the members were concerned about the rising debt levels of corporate borrowers. That this was one of the goals of their monetary policies was left unmentioned.



The A-rated corporate yield curve continues to mirror the UST curve as credit spreads remain in a narrow range. So long as both the European Central Bank and the Bank of England are in the market buying corporate bonds, it will be hard for U.S. investment-grade bonds to sell off very much.



Market Structure

Only Natural Gas remains in a structural uptrend amongst the physical commodity subindices. The dollar index remained in an uptrend while both the EAFE and EM indices entered structural downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Oct. 17 - 21
BBerg	29	Trending	0.193	9.6%	0.16%
BBerg Grain	18	Transitional	0.147	16.9%	
BBerg Ind. Metl	29	Trending	-0.022	11.8%	
BBerg Pre. Metl	4	Sideways	-0.006	8.4%	
BBerg Softs	11	Transitional	0.046	18.2%	
BBerg Nat. Gas	29	Trending	0.325	21.6%	0.12%
BBerg Petroleum	4	Sideways	-0.005	19.3%	
BBerg Livestock	7	Sideways	-0.026	17.9%	
Dollar Index	29	Trending	0.351	6.0%	0.22%
S&P 500 Index	18	Transitional	-0.119	8.7%	
EAFE Index	20	Trending	-0.152	11.2%	-0.32%
EM Index	26	Trending	-0.077	11.0%	-0.31%
Ten-year UST (price)	19	Transitional	-0.242	4.3%	

Performance Measures

The main Bloomberg index remains in its primary uptrend despite a momentary respite in the Petroleum index and a decline in Industrial Metals. We should note the gain in the main Bloomberg index came in the face of both a stronger USD and weak Chinese export data.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.82%	4.46%	7.22%	-3.96%
Grains Sub-Index	3.29%	4.29%	-7.30%	-11.02%
Corn	4.27%	6.81%	-9.87%	-13.90%
Soybeans	0.63%	2.15%	2.60%	5.58%
Wheat	6.66%	4.49%	-15.83%	-24.90%
Energy Sub-Index	1.25%	12.47%	16.60%	-14.28%
Petroleum Sub-Index	0.38%	12.85%	11.08%	-14.69%
WTI	0.85%	13.81%	9.34%	-23.12%
Brent	0.20%	12.51%	12.98%	-12.30%
ULSD	-0.29%	12.48%	18.11%	-10.82%
Gasoline	0.53%	11.96%	4.34%	-9.38%
Natural Gas	3.51%	11.34%	35.33%	-16.18%
Precious Metals Sub-Index	0.31%	-6.24%	3.15%	6.16%
Gold	0.29%	-5.30%	1.75%	5.70%
Silver	0.36%	-8.50%	6.79%	6.80%
Industrial Metals Sub-Index	-1.20%	1.32%	5.44%	-2.00%
Copper	-2.44%	-2.04%	-3.75%	-13.90%
Aluminum	-0.13%	5.64%	6.08%	2.49%
Nickel	2.79%	6.42%	15.59%	-1.53%
Zinc	-3.00%	-0.99%	20.13%	21.71%
Softs Sub-Index	0.97%	7.73%	35.70%	31.59%
Coffee	5.01%	4.39%	19.55%	4.45%
Sugar	-2.17%	10.54%	54.33%	55.93%
Cotton	5.37%	4.53%	15.75%	10.20%
Livestock Sub-Index	-3.84%	-10.47%	-22.83%	-29.17%
Cattle	-5.43%	-8.37%	-18.06%	-23.05%
Hogs	-0.87%	-13.98%	-30.24%	-38.44%

Renewed speculation of higher short-term rates in the U.S. pushed the USD higher against the European currencies but not against the CAD or AUD. Oddly, major EM currencies such as the BRL and MXN gained even though they would be hurt by a pullback in EM equities. The downturn in the CNY did not push the USD higher across the board as it has twice since August 2015.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-2.04%	-2.47%	-2.63%	-4.38%
Chinese yuan	-0.84%	-0.80%	-3.65%	-5.65%
Japanese yen	-1.15%	-1.68%	5.01%	14.06%
British pound	-1.95%	-7.89%	-13.88%	-21.23%
Swiss franc	-1.29%	-1.71%	-2.36%	-4.10%
Canadian dollar	1.19%	0.43%	-2.25%	-1.55%
Australian dollar	0.47%	1.99%	-1.00%	4.36%
Swedish krona	-2.44%	-4.02%	-8.01%	-8.27%
Norwegian krone	-1.63%	0.22%	0.15%	-1.69%
New Zealand dollar	-0.96%	-2.69%	3.51%	4.39%
Indian rupee	-0.05%	0.27%	-0.10%	-2.51%
Brazilian real	0.47%	4.32%	8.63%	18.91%
Mexican peso	1.54%	1.40%	-8.22%	-13.33%
Chilean peso	-0.11%	0.62%	-0.95%	1.66%
Colombian peso	0.17%	0.95%	2.48%	0.13%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.76%	-0.76%	-1.73%	-2.61%

The tilt back toward expectations of higher short-term rates in the U.S. and the effects of a stronger USD pushed equities lower again this week. If a compelling alternative to equities was available, investors would be availing themselves thereof.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.08%	0.28%	2.72%	5.22%
North America	-0.90%	0.55%	3.85%	8.88%
Latin America	1.70%	8.65%	13.93%	27.23%
Emerging Market Free	-1.93%	1.46%	8.08%	8.51%
EAFE	-1.39%	-0.19%	0.84%	-0.55%
Pacific	-1.31%	2.02%	4.57%	7.72%
Eurozone	-0.68%	0.05%	0.44%	-3.33%

Both CTAs and hedge funds had losing weeks. Hedge funds have lost 0.29% over the past year while the MSCI World index has gained 5.22% with none of the fee structures or complexities. Discuss.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.30%	-0.33%	-6.49%	-2.63%
Newedge Trend	-0.89%	-0.64%	-4.80%	0.82%
Newedge Short-Term	-0.25%	-2.24%	-5.18%	0.71%
HFR Global Hedge Fund	-0.42%	0.39%	2.69%	-0.29%
HFR Macro/CTA	-0.52%	-0.16%	-2.52%	-0.41%
HFR Macro: Sytematic Diversified CTA	-1.43%	-0.71%	-3.74%	1.40%