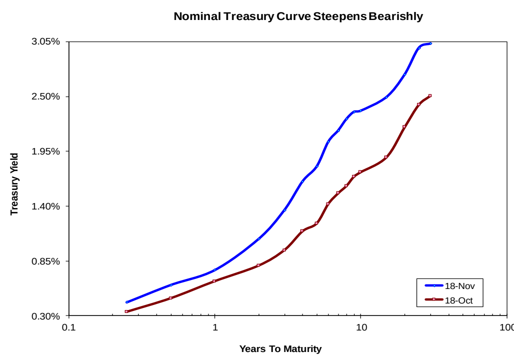
The Macro Environment For Financial Markets

Any move toward greater financial deregulation will lower the demand by commercial banks for sovereign debt and increase the kind of commercial credit creation that will stimulate both growth and inflationary pressures. This, and not some ill-conceived road-building program, will drive the capital market line and define the hierarchy of returns for risky assets. While such a normalization might be welcome, a transition to it will penalize long-duration and high-yield assets. Financial mathematics is a jealous if otherwise unrewarding mistress. The causal chain now is:

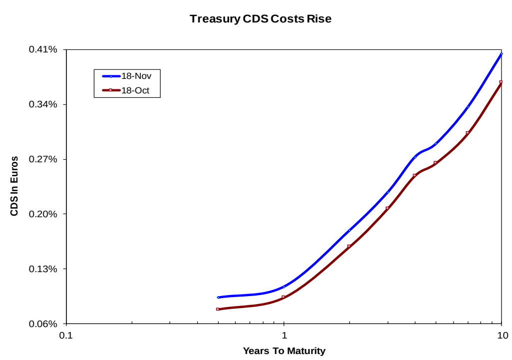
1. The market has priced in a December increase in U.S. short-term rates;
2. Inflationary expectations are rising globally, albeit excessively;
3. The U.S. yield curve has exited its long-running bullish flattening;
4. Short-term borrowers have stopped terming out short-term debt into the bond market;
5. Swap spreads are resuming their complacency over future rate increases; and
6. CDS costs have stabilized in response to a stronger equity market.

Key Market Indications

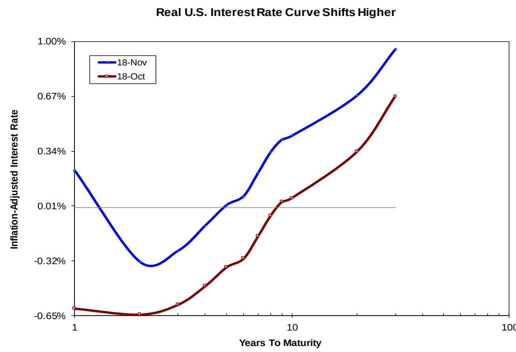
We are within five basis points of the retracement level on ten-year UST that will define whether we are still in a long-term bull market or not. The swap market is acting as if this level will hold, and we do have to respect the effects of the federal government's leverage in how the costs of higher interest rates will be absorbed. But let's not forget how much money was sucked into a bull trap in what must be regarded as the ultimate greater-fool trade of all time.



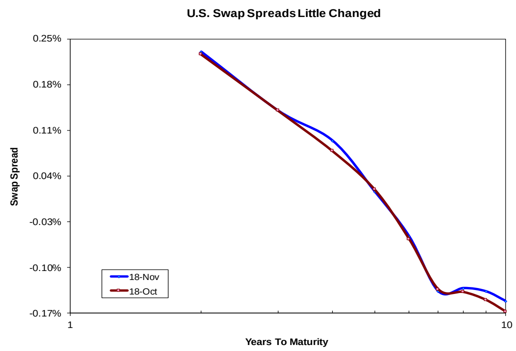
CDS costs on UST shifted higher over the past month. It is doubtful the incoming administration will jeopardize the U.S.' credit rating, but the incoming administration may be given a very short leash by foreign creditors.



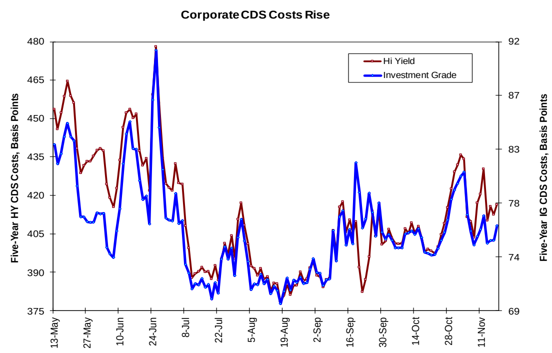
The pseudo-real yield curve rose at the short end of the yield curve over the past month. The increase in these measures in both the U.S. and elsewhere put pressure on the precious metals. The rise in long-term implied real rates is a negative for risky financial assets.



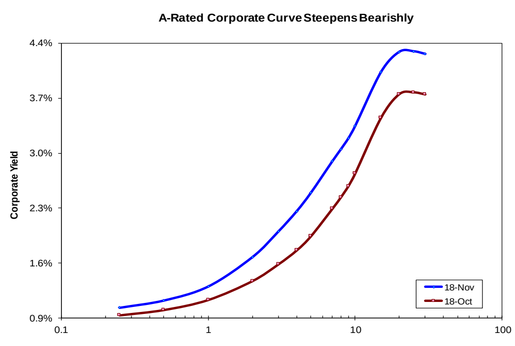
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have stopped their general shift higher. This market is acting as if the shift higher in interest rates is a singular adjustment to their rapid declines into July 2016. While this assessment is justifiable, let’s remember industry participants tend to underestimate the power of any long-term secular move.



CDS costs stabilized even as synthetic corporate bond positions continued to be liquidated. This suggests the rising equity market has slowed the correlation trade.



The A-rated corporate yield curve continues to shift higher at the long end of the yield curve. This reflects movements in the Treasury market far more than it does credit spreads.



Market Structure

Only Livestock is in a structural uptrend amongst physical commodities, while Grains, Precious Metals, Petroleum and Softs are in downtrends. The S&P 500 remains in a structural uptrend within the financials, while the EM index and ten-year UST are oversold within downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Nov. 21 - 25
BBerg	4	Sideways	0.004	9.7%	
BBerg Grain	28	Trending	-0.035	16.4%	-0.22%
BBerg Ind. Metl	5	Sideways	-0.048	25.4%	
BBerg Pre. Metl	24	Trending	-0.301	17.1%	-0.20%
BBerg Softs	28	Trending	-0.282	16.8%	-0.17%
BBerg Nat. Gas	7	Sideways	0.080	28.2%	
BBerg Petroleum	29	Trending	-0.170	22.7%	-1.75%
BBerg Livestock	28	Trending	0.287	13.0%	0.15%
Dollar Index	16	Transitional	0.226	10.5%	
S&P 500 Index	29	Trending	0.197	9.5%	0.08%
EAFE Index	7	Sideways	-0.070	14.6%	
EM Index	29	Trending	-0.417	12.6%	-0.41%
Ten-year UST (price)	29	Trending	-0.469	7.8%	-0.77%

Performance Measures

Which will define the end of time first, the sun exploding or petroleum traders reacting bullishly to rumors of OPEC production cuts? Both Industrial and Precious Metals pulled back, the former in reaction to the previous week's outsized gains and the latter in response to higher implied short-term real rates in the Eurozone. In all cases, the strength in the USD over the past two weeks was a non-factor. Of greater significance, however, is the lingering supply overhang in key markets in the face of a non-contractionary demand environment. This has ended what appeared to be the start of a longer-term rise in the main Bloomberg index.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.79%	-3.55%	-2.02%	2.27%
Grains Sub-Index	1.02%	-1.21%	-13.12%	-6.80%
Corn	1.30%	-2.17%	-15.94%	-12.09%
Soybeans	0.80%	0.18%	-6.45%	15.33%
Wheat	0.90%	-1.65%	-18.68%	-24.10%
Energy Sub-Index	4.38%	-11.59%	-6.51%	-13.23%
Petroleum Sub-Index	4.31%	-10.27%	-10.34%	-14.17%
WTI	5.02%	-9.83%	-11.23%	-20.39%
Brent	4.66%	-11.07%	-9.55%	-11.97%
ULSD	3.61%	-8.90%	-7.76%	-9.87%
Gasoline	2.71%	-11.00%	-12.64%	-13.93%
Natural Gas	4.58%	-14.93%	9.07%	-13.60%
Precious Metals Sub-Index	-2.14%	-4.76%	-3.09%	13.01%
Gold	-1.24%	-4.66%	-4.18%	11.62%
Silver	-4.32%	-4.99%	-0.23%	16.46%
Industrial Metals Sub-Index	-1.36%	11.98%	20.01%	24.29%
Copper	-1.66%	18.18%	19.33%	18.63%
Aluminum	-2.79%	4.25%	8.40%	14.02%
Nickel	-3.26%	8.78%	26.61%	22.34%
Zinc	2.70%	12.15%	35.06%	59.22%
Softs Sub-Index	-3.21%	-6.71%	16.36%	27.67%
Coffee	-0.60%	1.62%	22.41%	18.81%
Sugar	-7.13%	-11.25%	14.28%	26.33%
Cotton	4.78%	3.82%	16.03%	13.93%
Livestock Sub-Index	1.32%	7.83%	-15.49%	-13.58%
Cattle	2.41%	5.75%	-8.75%	-10.06%
Hogs	-0.31%	12.16%	-24.83%	-18.52%

The combination of fiscal stimulus and monetary contraction leads to a stronger currency. The markets are acting as if both are *fait accompli*; neither is the case, but then again 2016 has not been a good year for experts, has it? The last time the USD rose under such a combination, during the first Reagan administration, free trade was the prevailing ethos. We have yet to see how protectionism can be reconciled with a stronger USD.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-2.46%	-3.58%	-5.60%	-0.68%
Chinese yuan	-1.08%	-2.11%	-5.05%	-7.29%
Japanese yen	-3.84%	-6.35%	-0.65%	11.48%
British pound	-2.02%	0.36%	-15.46%	-19.00%
Swiss franc	-2.19%	-2.00%	-2.22%	0.96%
Canadian dollar	0.27%	-2.93%	-3.49%	-1.50%
Australian dollar	-2.76%	-4.28%	1.51%	3.19%
Swedish krona	-2.18%	-5.07%	-10.17%	-6.17%
Norwegian krone	-2.37%	-5.18%	-3.28%	0.85%
New Zealand dollar	-1.68%	-2.50%	4.01%	8.31%
Indian rupee	-1.31%	-2.07%	-1.69%	-2.70%
Brazilian real	0.61%	-5.74%	5.43%	11.33%
Mexican peso	1.00%	-9.82%	-10.63%	-18.93%
Chilean peso	-1.37%	-1.52%	1.73%	5.34%
Colombian peso	-4.33%	-8.67%	-4.89%	-2.47%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.84%	-2.41%	-2.46%	-3.23%

The weakness of Eurozone equities in the face of a weaker EUR runs counter to the prevailing pattern. However, Eurozone short-term rates are moving back toward zero from deeply negative rates, and this necessitates a repricing of equities.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.10%	-0.02%	4.71%	2.35%
North America	1.02%	1.99%	7.74%	7.13%
Latin America	2.82%	-11.65%	8.52%	15.54%
Emerging Market Free	-0.52%	-6.98%	8.20%	5.45%
EAFE	-1.52%	-3.37%	-0.43%	-3.54%
Pacific	-0.64%	-2.23%	7.06%	2.15%
Eurozone	-2.70%	-4.61%	-2.06%	-8.24%

Performance has been mixed, with trend-following CTAs and macro-oriented hedge funds losing money while short-term CTAs and global hedge funds made money. The real issue with professional traders is not performance, but institutional investors' exit.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.51%	-3.09%	-5.96%	-8.45%
Newedge Trend	-0.43%	-2.52%	-4.47%	-4.21%
Newedge Short-Term	1.14%	-1.53%	-6.02%	-3.72%
HFR Global Hedge Fund	0.14%	0.35%	2.94%	-0.11%
HFR Macro/CTA	-0.62%	-1.63%	-3.05%	-5.05%
HFR Macro: Sytematic Diversified CTA	-0.63%	-1.76%	-3.19%	-3.35%