The Macro Environment For Financial Markets

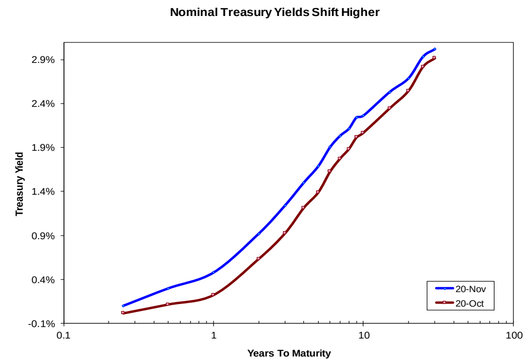
One of the greatest myths is wars are good for the economy. No; selling to other combatants can be good business, but incurring the costs of fighting yourself is a deadweight loss. Ask yourself whether the U.S. benefited from the costs of fighting in Iraq and Afghanistan and then project that effort to the undertakings now underway in Europe with much weaker economic bases. However, any cursory delving into long-term economic history reveals prolonged periods of deflationary slow growth often are followed by the destruction of production capacity. This is a grim outlook for a world where increasing segments of the population are becoming net negative contributors. The idea we can raise the price of labor in such an environment is wrong, and willfully so.

The causal chain now is:

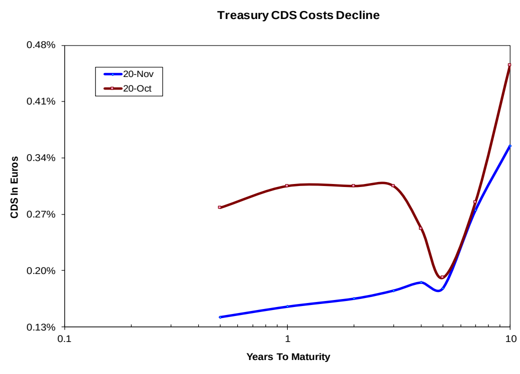
1. Higher short-term interest rates are being priced in still starting in December 2015;
2. Disinflationary pressures are dominating inflationary pressures;
3. Inflation expectations as measured by the TIPS market have seen their lows for the immediate duration;
4. The U.S. yield curve retains its bias toward flattening;
5. Short-term borrowers are terming-out their borrowing to reduce rollover risk;
6. Swap spreads will remain tame; and
7. Credit spreads will retain their upward bias.

Key Market Indications

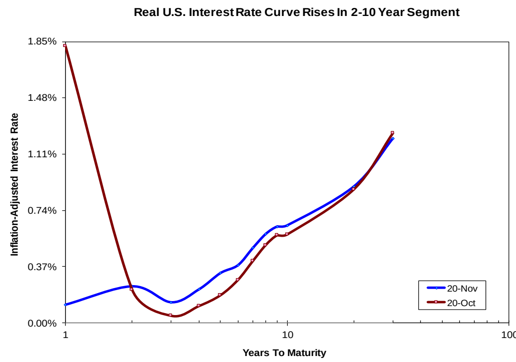
The yield curve continues to flatten to levels not seen since the start of the ZIRP era seven years ago by virtue of rising two-year rates. At the same time, long-term rates remain stable in the face of rising inflation expectations as measured in the TIPS market. While this may suggest long-term UST are overvalued, they are quite attractive on a risk-adjusted basis to similar sovereign bonds elsewhere, the Eurozone in particular.



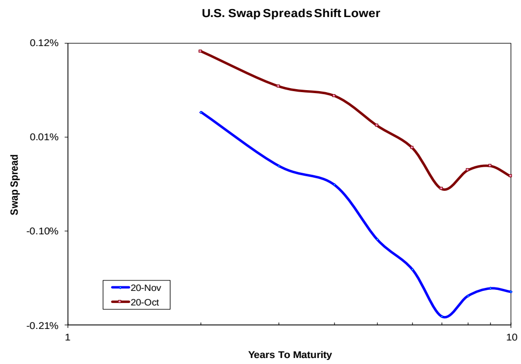
The CDS market for Treasuries has shifted back to its pre-default scare state. Anyone who seek protection in this market during an election cycle must be willing to lose money, and anyone who write protection giving Congressional predilections is not getting paid enough to assume the risk.



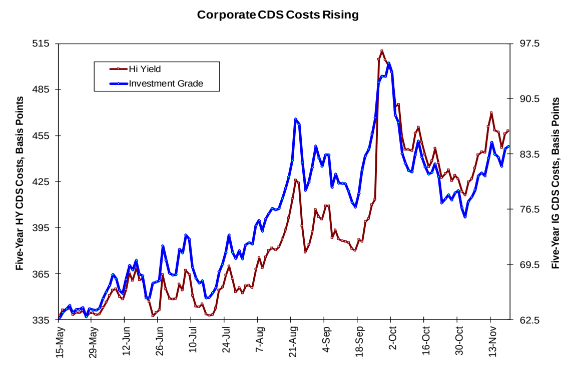
Pseudo-real rates remain lower at the short end of the yield curve over the past month. However, higher nominal yields at longer maturities have pulled implied real rates in the 2-10 year segment higher. These are not presenting a threat to risky asset returns yet.



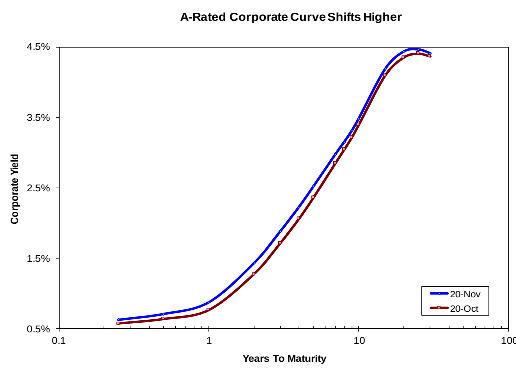
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue to decline for tenors longer than one year. Spreads of three years' tenor and longer are negative, a decisively complacent stance on interest rates.



CDS costs for both the investment-grade and high-yield indices turned higher as renewed stresses in sectors such as energy and basic materials combined with increasingly negative macro news outside of the U.S. increased risk aversion. Higher short-term rates will only exacerbate this deteriorating credit-quality situation, and that is anything but supportive for risky financial assets.



The A-rated yield curve has shifted higher. If this curve starts steepening bearishly, it will be a negative for risky financial assets.



Market Structure

Softs are on the verge of moving into a structural uptrend, but the physical commodities remain mired in their long-term structural downtrend. The S&P 500 has moved into a structural uptrend while the EM index remains in a downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Nov. 23 - 27
BBerg	29	Trending	-0.478	10.3%	-0.30%
BBerg Grain	5	Sideways	0.003	11.5%	
BBerg Ind. Metl	29	Trending	-0.517	16.8%	-0.30%
BBerg Pre. Metl	5	Sideways	-0.003	13.6%	
BBerg Softs	13	Transitional	0.133	21.6%	
BBerg Nat. Gas	12	Transitional	-0.212	26.2%	
BBerg Petroleum	29	Trending	-0.228	24.4%	-0.15%
BBerg Livestock	29	Trending	-0.254	17.3%	-0.47%
Dollar Index	6	Sideways	0.031	6.0%	
S&P 500 Index	29	Trending	0.141	8.7%	0.07%
EAFE Index	29	Trending	0.023	10.3%	
EM Index	29	Trending	-0.075	9.7%	-0.23%
Ten-year UST (price)	29	Trending	-0.177	4.3%	-0.04%

Performance Measures

It should be a simple point, but it is not: The long-term real price of physical commodities is lower; to believe otherwise would be to accept buyers will not find substitutes or get more efficient in consumption. Energy commodities that are extracted without replacement and cannot be recycled can defy this cyclically as can extremely rare and price-inelastic commodities such as platinum. Moreover, prices can and do collapse below the marginal cost of production if suppliers need to cover their fixed costs. This bear market will end, but not tomorrow and maybe not in 2016 barring some serious events.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.22%	-6.88%	-20.55%	-31.04%
Grains Sub-Index	0.19%	-3.88%	-6.30%	-15.99%
Corn	1.17%	-4.83%	-4.36%	-14.22%
Soybeans	0.27%	-4.29%	-5.00%	-16.78%
Wheat	-1.55%	-0.72%	-7.54%	-13.61%
Energy Sub-Index	-2.35%	-8.65%	-33.81%	-51.87%
Petroleum Sub-Index	0.40%	-7.00%	-33.04%	-48.86%
WTI	-0.24%	-7.84%	-34.96%	-54.09%
Brent	0.24%	-8.14%	-35.94%	-52.41%
ULSD	-0.56%	-7.24%	-33.18%	-43.49%
Gasoline	2.92%	-2.86%	-24.40%	-36.39%
Natural Gas	-9.30%	-12.94%	-35.15%	-59.65%
Precious Metals Sub-Index	-0.54%	-8.43%	-12.79%	-11.87%
Gold	-0.48%	-7.50%	-10.89%	-10.62%
Silver	-0.73%	-11.01%	-17.88%	-15.37%
Industrial Metals Sub-Index	-4.61%	-10.25%	-26.27%	-34.95%
Copper	-5.35%	-12.75%	-27.38%	-32.65%
Aluminum	-3.07%	-3.13%	-20.82%	-33.69%
Nickel	-7.41%	-17.12%	-31.79%	-48.32%
Zinc	-3.44%	-11.02%	-29.16%	-33.54%
Softs Sub-Index	2.83%	3.70%	0.45%	-18.37%
Coffee	7.43%	2.03%	-8.57%	-41.29%
Sugar	1.73%	7.15%	11.66%	-13.68%
Cotton	1.36%	-0.14%	-2.09%	3.50%
Livestock Sub-Index	0.46%	-10.17%	-16.24%	-26.65%
Cattle	-0.47%	-9.36%	-16.66%	-21.44%
Hogs	2.24%	-11.75%	-14.70%	-35.30%

Is the USD getting stronger or is the EUR getting weaker as the ECB pledges to destroy its purchasing power in a vainglorious attempt to fight deflation? A small stabilization in Asian and Latin American currencies suggests the latter, but the ability of those currencies to move higher in the face of slow Chinese demand growth and spectacular economic mismanagement is limited.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.18%	-6.17%	-4.04%	-15.10%
Chinese yuan	-0.17%	-0.57%	-2.83%	-4.05%
Japanese yen	-0.16%	-2.42%	-1.19%	-3.75%
British pound	-0.30%	-1.64%	-2.22%	-3.19%
Swiss franc	-1.19%	-6.09%	-7.96%	-5.87%
Canadian dollar	-0.17%	-2.74%	-8.53%	-15.29%
Australian dollar	1.57%	-0.29%	-8.08%	-16.02%
Swedish krona	-0.56%	-4.75%	-4.26%	-15.19%
Norwegian krone	0.39%	-5.99%	-12.38%	-21.70%
New Zealand dollar	0.37%	-2.80%	-10.17%	-16.58%
Indian rupee	-0.15%	-1.72%	-3.58%	-6.41%
Brazilian real	3.88%	5.38%	-18.98%	-30.57%
Mexican peso	0.88%	0.14%	-8.14%	-17.46%
Chilean peso	-0.88%	-3.20%	-14.89%	-15.68%
Colombian peso	0.40%	-4.16%	-18.49%	-29.61%
Bloomberg-JP Morgan Asian dollar index (spot)	0.40%	-0.86%	-4.17%	-5.49%

Anyone who maintained a bearish bias in 2015 must be ready for a long walk in the woods by now as they have been defeated time and again by the TINA argument. The latest iteration is emerging markets are attractive because they have been so bad since late 2010 and therefore are "cheap."

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	2.99%	1.74%	-4.54%	1.14%
North America	3.28%	2.57%	-2.03%	2.12%
Latin America	4.82%	2.30%	-20.78%	-28.97%
Emerging Market Free	2.73%	-2.37%	-17.10%	-12.42%
EAFE	2.52%	0.42%	-8.42%	-0.43%
Pacific	1.93%	2.93%	-6.92%	2.66%
Eurozone	2.28%	-0.04%	-8.79%	-0.82%

CTAs managed gains for a second consecutive week as the bearish trends abated without reversing. Global hedge funds gains during a strong week for equities were unusually small for a bull market. The biggest news for macro funds is the continuing stream of closures.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.71%	2.28%	-0.41%	8.40%
Newedge Trend	1.21%	1.84%	-1.45%	6.05%
Newedge Short-Term	0.97%	1.90%	-3.43%	-0.90%
HFR Global Hedge Fund	0.05%	-0.26%	-4.81%	-2.50%
HFR Macro/CTA	0.60%	2.67%	-1.02%	0.25%
HFR Macro: Sytematic Diversified CTA	1.20%	2.27%	0.39%	2.22%