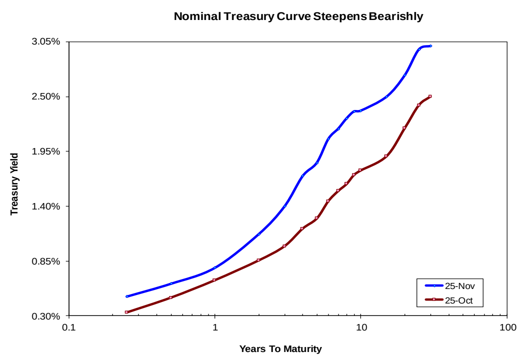
The Macro Environment For Financial Markets

It would have been nice for the recently concluded election to have been based on declared issues as opposed to inferences, but we have to take what we can get. One of these inferences, that the U.S. will embark on a course of regulatory relief, appears to be driving strong gains in sectors such as financials, but bitter experience shows this to a misplaced hope. The best advice to those watching to see whether the swamp is drained is to bet on the swamp. The bond market will enforce the rest. The causal chain now is:

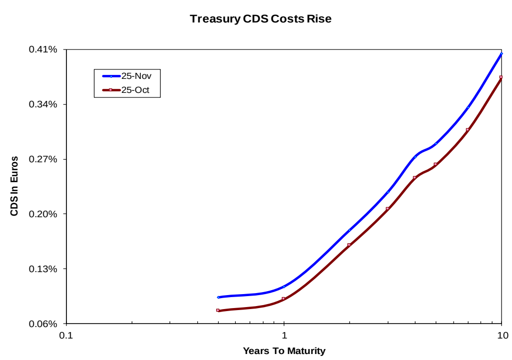
1. The market has priced in a December increase in U.S. short-term rates;
2. Inflationary expectations are rising globally, albeit excessively;
3. The U.S. yield curve has exited its long-running bullish flattening;
4. Short-term borrowers have stopped terming out short-term debt into the bond market;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

Key Market Indications

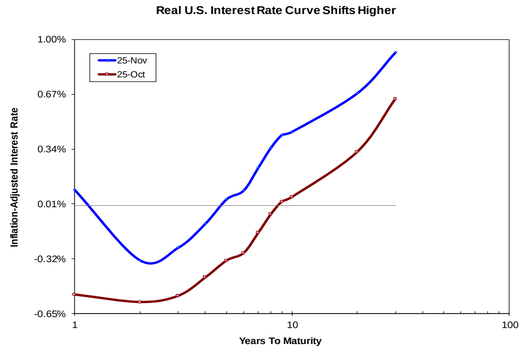
We are right at the point where the advance in long-term UST rates will have to stop to avoid spilling into a defined bear market. The swap market is acting as if this level will hold, and the market has capitalized to the extreme a far greater degree of fiscal stimulus than we are likely to see. The rising USD is discouraging foreign buyers from swapping their bonds for USTs; this is an often-ignored downside of a stronger USD.



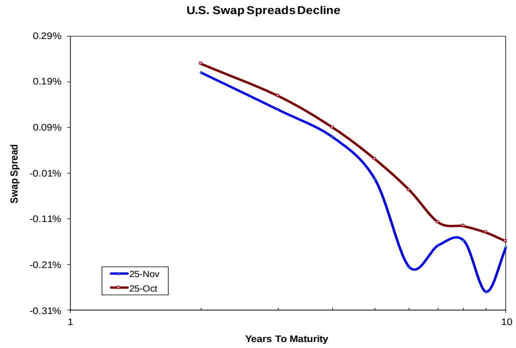
CDS costs on UST shifted higher over the past month. It is doubtful the incoming administration will jeopardize the U.S.' credit rating, but it may be given a very short leash by foreign creditors.



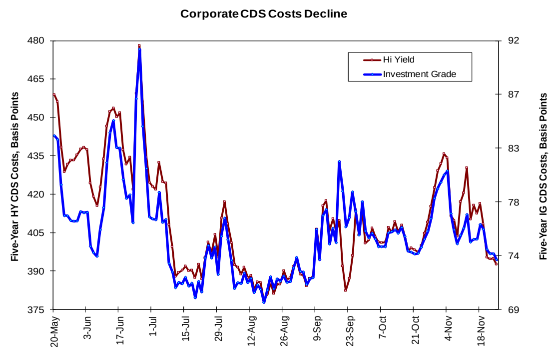
The pseudo-real yield curve rose at the short end of the yield curve over the past month. The increase in these measures in both the U.S. and elsewhere put pressure on the precious metals. The rise in long-term implied real rates is a negative for risky financial assets even though this effect has yet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



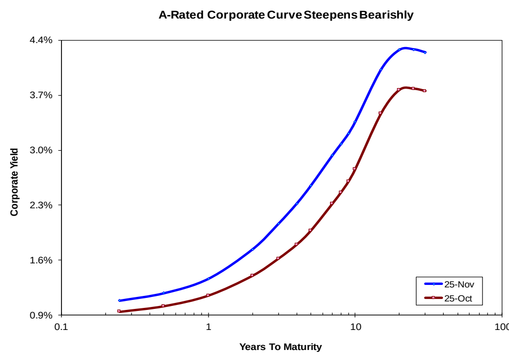
Swap spreads, which rise when floating-rate borrowers want to fix their payments, fell at the long end of the yield curve, which is interesting given the strong bearish steepening in fixed-income markets. To repeat verbatim from last week, this market is acting as if the shift higher in interest rates 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 resumed declining, which is completely consistent with expectations for stronger economic growth and with rising equities ending 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 Precious Metals, Petroleum and Softs are in downtrends. The S&P 500 remains in a structural uptrend within the financials, while the EAFE joined the EM index in a downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Nov. 28 - Dec. 2
BBerg	29	Trending	0.054	11.2%	
BBerg Grain	26	Trending	0.090	15.1%	
BBerg Ind. Metl	10	Sideways	0.144	30.8%	
BBerg Pre. Metl	27	Trending	-0.370	17.5%	-0.20%
BBerg Softs	29	Trending	-0.388	16.6%	-0.17%
BBerg Nat. Gas	29	Trending	0.065	30.6%	
BBerg Petroleum	29	Trending	-0.091	23.5%	-1.75%
BBerg Livestock	29	Trending	0.417	12.2%	0.15%
Dollar Index	19	Transitional	0.205	10.2%	
S&P 500 Index	29	Trending	0.323	8.7%	0.08%
EAFE Index	28	Trending	-0.078	11.8%	-0.12%
EM Index	29	Trending	-0.252	12.5%	-0.41%
Ten-year UST (price)	4	Sideways	-0.028	6.8%	

Performance Measures

Natural gas and zinc both rose more than 11%; once again the lower liquidity in commodity markets had made them subject to much greater price volatility. The rise in the Industrial Metals index flies in the face of both a weaker CNY and a stronger USD. The strong drop in the Petroleum subindex at week's end reflects one more round of skepticism about coordinated production cutbacks; the real question is why anyone ever placed credence in those rumors at all.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.80%	-0.99%	-0.35%	5.17%
Grains Sub-Index	3.12%	0.34%	-13.75%	-4.52%
Corn	2.44%	-1.55%	-18.58%	-10.30%
Soybeans	5.72%	3.39%	-2.64%	19.25%
Wheat	-0.11%	-1.56%	-22.07%	-23.40%
Energy Sub-Index	3.85%	-5.22%	-4.83%	-10.74%
Petroleum Sub-Index	1.15%	-6.47%	-10.92%	-14.25%
WTI	0.19%	-6.60%	-13.45%	-20.54%
Brent	1.19%	-7.16%	-10.36%	-11.60%
ULSD	1.93%	-5.70%	-7.23%	-7.53%
Gasoline	2.33%	-5.50%	-10.30%	-16.39%
Natural Gas	11.39%	-1.84%	19.25%	-3.84%
Precious Metals Sub-Index	-2.79%	-7.68%	-2.47%	12.38%
Gold	-3.15%	-7.73%	-3.58%	10.88%
Silver	-1.89%	-7.54%	0.37%	15.95%
Industrial Metals Sub-Index	6.59%	14.10%	26.97%	33.40%
Copper	7.19%	21.76%	25.56%	28.50%
Aluminum	4.06%	2.05%	11.80%	17.25%
Nickel	2.76%	10.70%	36.23%	29.69%
Zinc	11.33%	17.39%	47.30%	78.87%
Softs Sub-Index	-2.71%	-9.09%	14.45%	20.34%
Coffee	-4.62%	-8.11%	20.64%	14.64%
Sugar	-1.87%	-10.44%	9.64%	27.14%
Cotton	-1.77%	-0.24%	9.68%	10.32%
Livestock Sub-Index	3.74%	5.83%	-12.35%	-10.80%
Cattle	3.14%	6.42%	-5.11%	-8.55%
Hogs	4.67%	5.07%	-22.06%	-13.68%

The USD's advance is not continuing across the board, but rather differentiating into weak minor currencies and stabilizing majors, the JPY and CHF excepted. While focus remains on the USD, the greater global issue is the weakening of the CNY and China's difficulty in managing the descent. The last two times the CNY dropped strongly, in August and in December 2015, emerging markets reacted very badly.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.01%	-2.76%	-5.07%	-0.33%
Chinese yuan	-0.47%	-2.00%	-5.21%	-7.65%
Japanese yen	-2.04%	-7.95%	-2.68%	8.41%
British pound	1.09%	2.37%	-15.11%	-17.53%
Swiss franc	-0.39%	-1.95%	-2.25%	0.76%
Canadian dollar	-0.10%	-1.24%	-3.69%	-1.69%
Australian dollar	1.43%	-2.66%	3.40%	2.63%
Swedish krona	0.53%	-3.50%	-10.32%	-5.63%
Norwegian krone	0.20%	-3.47%	-2.52%	0.71%
New Zealand dollar	0.47%	-1.68%	4.53%	7.07%
Indian rupee	-0.49%	-2.41%	-1.66%	-3.14%
Brazilian real	-0.95%	-8.83%	4.96%	9.71%
Mexican peso	-0.05%	-10.33%	-10.50%	-20.10%
Chilean peso	-0.15%	-3.90%	1.73%	5.12%
Colombian peso	0.29%	-7.46%	-3.53%	-2.74%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.16%	-2.33%	-2.66%	-3.96%

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	1.40%	1.97%	3.81%	3.91%
North America	1.47%	3.34%	7.11%	8.35%
Latin America	1.33%	-12.10%	12.20%	17.45%
Emerging Market Free	1.34%	-6.74%	8.86%	5.15%
EAFE	1.29%	-1.98%	-0.42%	-2.83%
Pacific	1.26%	-0.59%	7.24%	4.53%
Eurozone	1.11%	-4.12%	-4.14%	-7.52%

Both CTAs and hedge funds seem to have jumped on the "Trump trade" of expecting higher interest rates, inflation, growth and U.S. relative performance, replete with a stronger dollar. This will unwind unceremoniously at some point.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.93%	-3.81%	-3.55%	-7.41%
Newedge Trend	0.42%	-3.38%	-2.85%	-3.53%
Newedge Short-Term	0.84%	-0.87%	-4.21%	-3.35%
HFR Global Hedge Fund	0.43%	0.12%	3.34%	0.13%
HFR Macro/CTA	0.45%	-2.05%	-1.85%	-5.12%
HFR Macro: Sytematic Diversified CTA	0.63%	-1.96%	-0.74%	-3.08%