The Macro Environment For Financial Markets

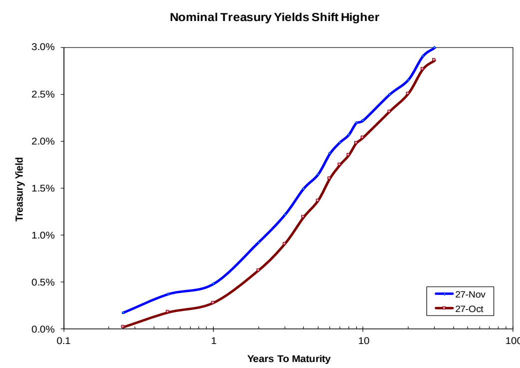
The most-likely apocryphal story of Nero fiddling while Rome burned has many potential analogs today; at least he did not have to deal with the conflagration's carbon footprint. The industrial world was warned forty-five years ago that internalizing the costs of pollution, a worthy goal, would raise the cost of production and create pollution havens in the developing world. Check and check. Now as the world faces a rising tide of recession, deflation, conflict and the marginalization of labor – a modern Four Horsemen – worthies shall fly in their private jets and ride in their armored limousines to assemble in Paris and demand you pay for yet another internalization of production costs. Nero would understand.

The causal chain remains:

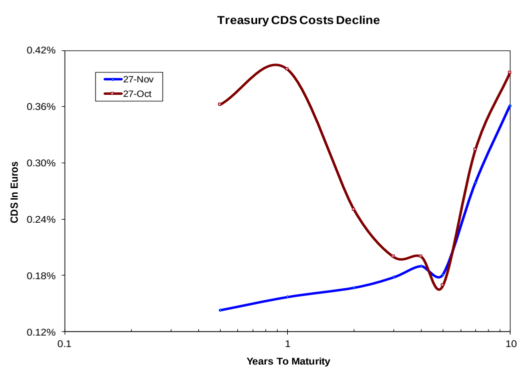
1. Higher short-term interest rates are being priced in still starting in December 2015;
2. Disinflationary pressures are dominating inflationary pressures;
3. Inflation expectations as measured by the TIPS market have seen their lows for the immediate duration;
4. The U.S. yield curve retains its bias 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

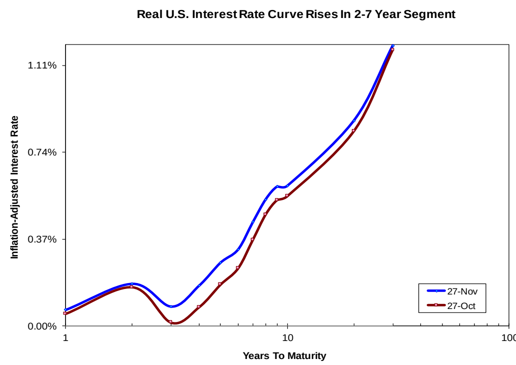
The yield curve continues to flatten to levels not seen since the start of the ZIRP era seven years ago by virtue of rising two-year rates. At the same time, long-term rates remain stable in the face of rising inflation expectations as measured in the TIPS market. While this may suggest long-term UST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



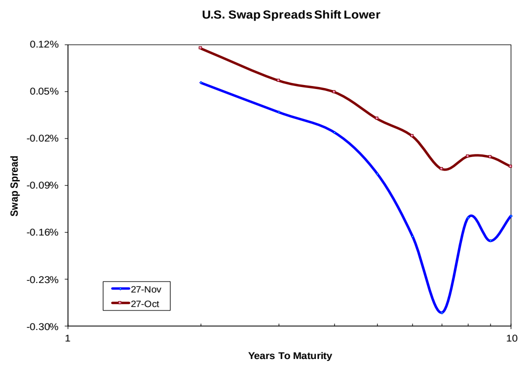
The CDS market for Treasuries has shifted back to its pre-default scare state. Anyone who seek protection in this market during an election cycle must be willing to lose money, and anyone who write protection giving Congressional predilections is not getting paid enough to assume the risk.



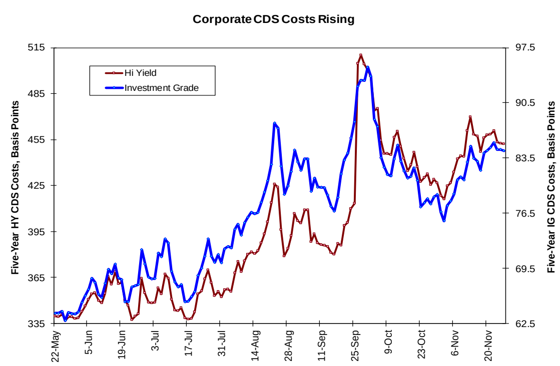
Pseudo-real rates have increased over the 2-7 segment in the past month. These are not presenting a threat to risky asset returns yet. The absence of negative implied short-term real rates has contributed to the significant decline in gold prices.



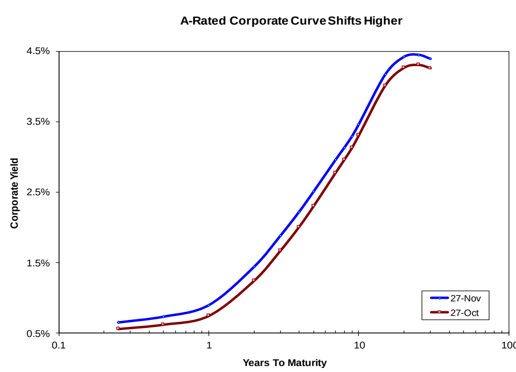
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue to decline. Spreads of four years' tenor and longer are negative, a decisively complacent stance on interest rates.



CDS costs for both the investment-grade and high-yield indices remain elevated as renewed stresses in sectors such as energy and basic materials combined with increasingly negative macro news outside of the U.S. have 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

While only the Petroleum and Industrial Metals indices remain in structural downtrends, this is deceptive; the other physical markets simply have moved into bearish consolidations. The opposite applies to the financial indices; while the EM index is in a downtrend, the others are in bullish consolidations.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Nov. 30 - Dec. 4
BBerg	6	Sideways	-0.048	12.0%	
BBerg Grain	7	Sideways	-0.033	11.8%	
BBerg Ind. Metl	29	Trending	-0.353	18.5%	-0.30%
BBerg Pre. Metl	6	Sideways	-0.087	13.2%	
BBerg Softs	17	Transitional	0.058	21.4%	
BBerg Nat. Gas	16	Transitional	-0.191	28.5%	
BBerg Petroleum	29	Trending	-0.154	25.5%	-0.15%
BBerg Livestock	7	Sideways	-0.008	16.5%	
Dollar Index	6	Sideways	0.064	6.3%	
S&P 500 Index	4	Sideways	0.008	8.1%	
EAFE Index	19	Transitional	0.027	10.3%	
EM Index	29	Trending	-0.257	9.4%	-0.23%
Ten-year UST (price)	5	Sideways	0.041	3.5%	

Performance Measures

While we are seeing the first rumblings of production cutbacks in base metals, these have not yet moved to the point where we can say marginal supply is shrinking as a function of price. The same applies to gold and crude oil: You will see some mines shut and some high-cost production sources taken off-line, but until total supply is reduced or until total demand rises, the marginal unit of production remains elusive. Moreover, low-cost producers may have longer-term incentives to lose money now to force high-cost producers out of business. Ask yourself whether total production has increased or decreased in the face of the price decline or whether demand growth has accelerated in the face of lower prices. Game theory can turn classic supply/demand analysis on its head.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.79%	-7.23%	-19.64%	-28.17%
Grains Sub-Index	-0.52%	-5.34%	-3.95%	-17.02%
Corn	-0.81%	-6.09%	-2.71%	-15.57%
Soybeans	1.51%	-1.43%	-4.29%	-13.36%
Wheat	-2.69%	-8.80%	-2.36%	-19.20%
Energy Sub-Index	-1.51%	-10.25%	-32.92%	-46.52%
Petroleum Sub-Index	1.05%	-9.95%	-33.05%	-41.48%
WTI	-0.02%	-12.13%	-35.88%	-47.14%
Brent	0.86%	-11.13%	-36.16%	-45.53%
ULSD	-1.25%	-10.70%	-33.82%	-38.57%
Gasoline	5.66%	-2.51%	-21.16%	-24.95%
Natural Gas	-8.29%	-11.16%	-30.82%	-57.91%
Precious Metals Sub-Index	-1.88%	-8.18%	-12.85%	-10.76%
Gold	-2.03%	-7.52%	-11.45%	-10.58%
Silver	-1.44%	-10.02%	-16.62%	-10.95%
Industrial Metals Sub-Index	-0.79%	-8.50%	-24.78%	-32.21%
Copper	-1.22%	-11.61%	-25.25%	-28.38%
Aluminum	-0.61%	-1.19%	-18.71%	-31.51%
Nickel	-1.96%	-12.91%	-30.91%	-46.92%
Zinc	1.07%	-9.59%	-30.26%	-31.80%
Softs Sub-Index	0.61%	3.17%	5.21%	#VALUE!
Coffee	1.15%	-0.72%	-8.57%	-40.65%
Sugar	0.14%	3.11%	12.26%	-12.83%
Cotton	1.29%	0.71%	-2.00%	4.33%
Livestock Sub-Index	1.47%	-6.74%	-15.89%	-24.82%
Cattle	1.37%	-7.01%	-15.83%	-18.97%
Hogs	1.68%	-6.24%	-15.38%	-34.41%

The EM currencies, led by Brazil, turned lower once again as corruption scandals and China's economic slowdown are pushing both the currencies and equities lower. If we combine this with the ECB's determination to weaken the EUR, we have an open door for the USD to continue its rise.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.50%	-4.14%	-2.85%	-15.03%
Chinese yuan	-0.15%	-0.66%	-3.02%	-4.00%
Japanese yen	0.01%	-1.91%	0.70%	-4.15%
British pound	-1.02%	-1.73%	-2.07%	-4.45%
Swiss franc	-1.16%	-4.26%	-7.84%	-6.42%
Canadian dollar	-0.19%	-0.76%	-6.87%	-15.26%
Australian dollar	-0.64%	0.00%	-6.93%	-15.82%
Swedish krona	-0.20%	-2.69%	-2.64%	-14.93%
Norwegian krone	-0.75%	-2.90%	-10.77%	-20.44%
New Zealand dollar	-0.47%	-3.43%	-10.09%	-16.95%
Indian rupee	-0.84%	-2.69%	-4.09%	-7.31%
Brazilian real	-3.66%	1.09%	-18.38%	-34.20%
Mexican peso	-0.53%	-0.49%	-8.08%	-17.21%
Chilean peso	-0.14%	-3.21%	-13.36%	-15.52%
Colombian peso	-1.38%	-5.07%	-18.38%	-30.38%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.31%	-1.01%	-4.06%	-5.88%

The renewed downturn in emerging markets in general and Latin American markets in particular serves as a reminder there are many reasons to buy something but the fact they are beaten-down generally is not one of them.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.12%	0.48%	-4.15%	-0.13%
North America	0.10%	1.28%	-1.78%	1.29%
Latin America	-3.86%	-1.34%	-20.55%	-33.54%
Emerging Market Free	-2.02%	-4.15%	-17.47%	-16.12%
EAFE	-0.47%	-0.82%	-7.84%	-2.39%
Pacific	-1.05%	-0.52%	-7.34%	1.32%
Eurozone	0.32%	-0.65%	-6.66%	-4.28%

CTAs managed gains for a third consecutive week as the bearish trends abated without reversing. Global hedge funds posted small losses as emerging markets once again disconnected to the downside.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.11%	0.98%	-1.22%	6.13%
Newedge Trend	0.19%	0.70%	-1.52%	4.05%
Newedge Short-Term	0.42%	1.35%	-3.37%	-1.80%
HFR Global Hedge Fund	-0.07%	-0.28%	-4.92%	-3.00%
HFR Macro/CTA	-0.13%	2.21%	-1.30%	0.21%
HFR Macro: Sytematic Diversified CTA	-0.26%	1.82%	0.18%	1.71%