The Macro Environment For Financial Markets

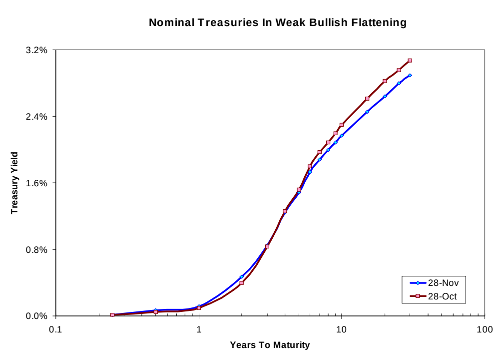
Will revenue-hungry governments attempt to capture the rent of declining crude oil prices by imposing taxes in the name of some climate-change scheme? Right now, the benefit of those lower prices is going to consumers, and the impetus to protect the Great Unwashed from their carbon addiction will be extreme. The frictional costs of lower petroleum prices will not be limited to the upstream side of the sector where share prices and fixed-income CDS spreads have taken a beating; they will spread to all of the uneconomic alternative energy production schemes undertaken in recent years. Various petroleum exporters will be affected very negatively as well. It is important to remember that just as no battle plan survives contact with the enemy, no crude oil price forecast survives contact with market forces. It the post-OPEC era lasts as long as their post-1970 control of marginal crude oil prices started by the late Muammar Qaddafi, I will be both quite surprised and more than 100 years old simultaneously.

The causal chain is now:

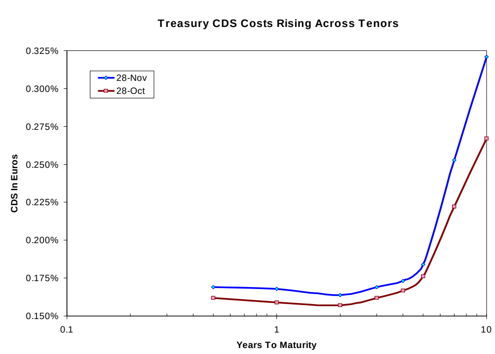
1. Short-term interest rates will remain artificially low globally and will be transmitted into the U.S. via USD appreciation unless the Federal Reserve finds yet one more reason to signal lower rates into 2015;
2. Real rates will decline slowly as global economic growth remains slow and debt levels remain high;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally and continue to cap U.S. long-term yields;
5. The U.S. yield curve should oscillate near its current historically steep levels and will retain a bias toward a bullish flattening;
6. Short-term borrowers will continue to accept rollover risk;
7. Swap spreads are in a stable and inverting configuration, are declining at the short end and do not yet present an impediment to corporate bonds; and
8. Credit spreads will find further declines difficult to achieve barring a new and unexpected round of monetary stimulus. Credit spreads in the energy sector, both high-yield and investment-grade, will rise.

Key Market Indications

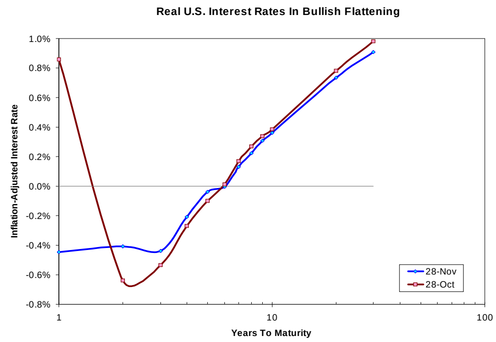
The comment made for the preceding two weeks the longer-term bullish flattening trend remains intact was realized this week. The Treasury market remains oddly rich in comparison to other OECD sovereign debt. The impediment to carry trade inflows into the Treasury market remains foreign investors are facing a short put option on the USD when they make such purchases; this is not a trivial concern.



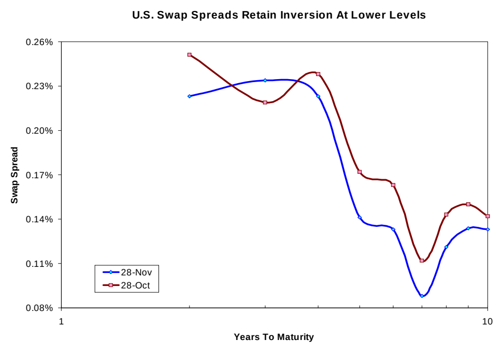
Euro-denominated CDS costs on Treasuries are shifting about within a small range. This may change slightly if the administration provokes Congress into some avoidable budget battle, but that will be a January 2015 story at the earliest.



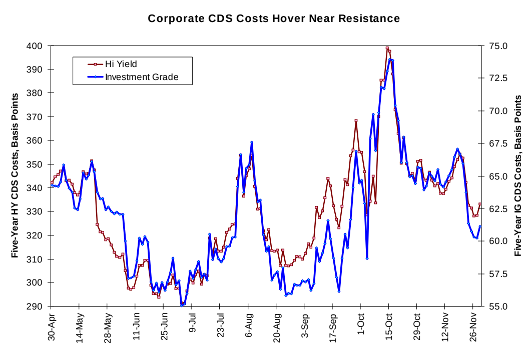
The yield curve for implied real rates is in a small bullish flattening. This results from declines in the nominal yield curve intersecting with resistance to accepting lower implied real rates. The net effect remains supportive for risky financial assets.



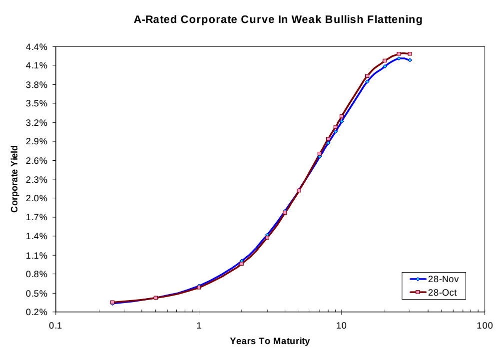
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain inverted and at lower levels. The fixed-income market's complacency has returned and will encourage moves into risky financial assets.



Both the IG and HY CDS indices remain at their resistance levels established a month ago. The small increase in the overall indices on Friday masks deterioration in the energy sector that could get worse given the break in crude oil prices. That risk remains confined for now, but we should remember "confined" was used to describe the housing industry's problems in 2007-2008 before they became unconfined.



The A-rated yield curve continues to mimic the UST curve and has returned to a weak bullish flattening. As swap spreads and CDS levels remain benign, and as the UST yield curve remains biased toward a bullish flattening still, this trend should continue.



Market Structure

With the exception of Grains and Livestock, the physical commodity indices are either in structural downtrends or are hovering near downtrends. Both ten-year Treasuries and the EAFE joined the S&P 500 in an uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 1 - 5
BBerg	24	Trending	-0.322	10.2%	-0.15%
BBerg Grain	11	Transitional	0.044	17.1%	
BBerg Ind. Metl	24	Trending	-0.180	14.5%	-0.14%
BBerg Pre. Metl	29	Trending	-0.142	17.5%	-0.15%
BBerg Softs	13	Transitional	-0.124	15.9%	
BBerg Nat. Gas	9	Sideways	-0.108	24.1%	
BBerg Petroleum	22	Trending	-0.577	24.0%	-0.49%
BBerg Livestock	29	Trending	0.107	9.6%	0.09%
Dollar Index	11	Transitional	0.086	6.7%	
S&P 500 Index	29	Trending	0.312	7.9%	0.03%
EAFE Index	25	Trending	0.151	9.8%	0.16%
EM Index	17	Transitional	0.102	7.8%	
Ten-year UST (price)	26	Trending	0.244	4.8%	0.02%

Performance Measures

The collapse of crude oil was notable, but so was the collapse in economically important Industrial Metals. The saving grace of the physical commodity downturns to-date has been they have been driven by supply overhangs; the recent decision in China to re-enter the stimulus game suggests slowing demand growth may be coming into the equation as well. If so, the macro implications for the Pacific Rim and for commodity-linked equities will be negative and will spill over into the credit quality of those firms. The financial consequence of these downturns will be continued monetary ease.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-4.22%	-4.07%	-15.60%	-9.04%
Grains Sub-Index	1.51%	0.89%	-18.73%	-13.93%
Corn	0.65%	-0.21%	-21.15%	-15.59%
Soybeans	-0.44%	-3.17%	-20.10%	-7.66%
Wheat	4.71%	7.21%	-13.34%	-19.60%
Energy Sub-Index	-11.47%	-10.47%	-26.99%	-18.43%
Petroleum Sub-Index	-11.12%	-16.94%	-32.52%	-28.27%
WTI	-12.79%	-17.74%	-32.73%	-23.35%
ULSD	-8.54%	-13.81%	-26.06%	-28.09%
Gasoline	-9.30%	-14.82%	-32.08%	-27.81%
Natural Gas	-12.07%	3.26%	-15.38%	4.12%
Precious Metals Sub-Index	-1.95%	-0.68%	-8.74%	-10.73%
Gold	-1.34%	0.26%	-5.82%	-6.21%
Silver	-3.93%	-3.73%	-17.44%	-23.27%
Industrial Metals Sub-Index	-2.93%	-3.37%	-3.57%	2.12%
Copper	-5.50%	-6.43%	-9.06%	-10.92%
Aluminum	-1.42%	-1.93%	6.93%	7.77%
Nickel	-0.52%	3.03%	-16.25%	18.68%
Zinc	-1.70%	-4.29%	6.58%	15.24%
Softs Sub-Index	-1.48%	-4.13%	-14.79%	#VALUE!
Coffee	-0.74%	-2.57%	-0.67%	54.83%
Sugar	-3.17%	-2.80%	-26.04%	-29.00%
Cotton	2.07%	-4.70%	-21.57%	-16.18%
Livestock Sub-Index	-1.98%	0.83%	4.47%	14.94%
Cattle	-1.51%	1.03%	17.07%	26.65%
Hogs	-2.94%	0.41%	-13.43%	-2.01%

The EUR, CHF and SEK all gained on the USD as the market waits on whether the ECB will engage in sovereign debt buying. The USD gained, and strongly, almost everywhere else as the U.S. is out of the over monetary accommodation business for the time being. The stronger USD eventually will cause some pressure to ease, but we may be years – yes, years – from that point.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.49%	-2.21%	-8.38%	-8.48%
Chinese yuan	-0.33%	-0.50%	1.80%	-0.85%
Japanese yen	-0.71%	-8.83%	-14.14%	-13.74%
British pound	-0.07%	-3.01%	-6.38%	-4.27%
Swiss franc	0.46%	-1.88%	-6.93%	-6.18%
Canadian dollar	-1.60%	-2.19%	-4.74%	-7.31%
Australian dollar	-1.89%	-3.95%	-7.90%	-6.54%
Swedish krona	0.20%	-1.55%	-10.85%	-12.17%
Norwegian krone	-3.17%	-5.95%	-15.01%	-13.40%
New Zealand dollar	-0.55%	-0.99%	-7.69%	-3.41%
Indian rupee	-0.42%	-1.13%	-5.01%	0.61%
Brazilian real	-1.93%	-4.07%	-13.00%	-9.66%
Mexican peso	-2.24%	-3.50%	-7.57%	-6.13%
Chilean peso	-2.26%	-4.82%	-9.38%	-13.14%
Colombian peso	-3.18%	-7.29%	-13.88%	-13.19%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.37%	-1.71%	-1.75%	-1.97%

The Latin American index returned to its losing ways as the region's currencies lost heavily and the downtrend on physical commodities weighed on prospective earnings. The opposite applied to the Eurozone.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.16%	3.49%	3.03%	9.47%
North America	-0.04%	4.01%	8.44%	15.93%
Latin America	-3.97%	-1.11%	-7.95%	-4.83%
Emerging Market Free	0.06%	1.31%	-1.61%	2.03%
EAFE	0.48%	2.67%	-4.65%	0.44%
Pacific	-0.41%	0.95%	-0.31%	-0.75%
Eurozone	2.27%	4.92%	-7.12%	-0.26%

I would appear CTAs finally embraced their inner bear and sold crude oil and precious metals along with buying the USD. It was a weaker week for the more equity-oriented hedge funds as those markets had uneven and not very strong advances.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	2.15%	6.36%	17.51%	15.20%
Newedge Trend	2.04%	5.59%	11.86%	12.59%
Newedge Short-Term	1.75%	2.76%	7.74%	10.90%
HFR Global Hedge Fund	0.66%	0.91%	-0.15%	1.04%
HFR Macro/CTA	0.11%	2.53%	5.97%	4.49%
HFR Macro: Sytematic Diversified CTA	0.62%	3.05%	5.37%	2.51%