The Macro Environment For Financial Markets

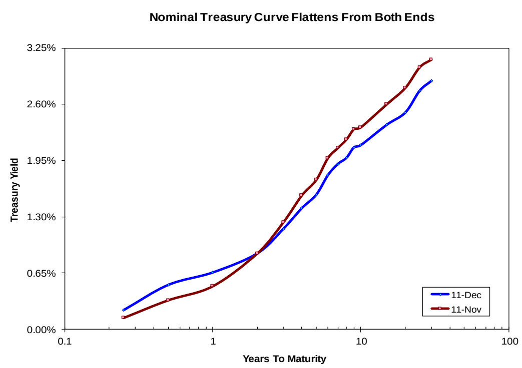
The problem of disappearing liquidity in the corporate bond market has been known since the adoption of the Basel III standards. Per usual, everyone thought they could be the first one to sell and per usual everyone was completely wrong. As happens in these situations, you sell what you can and not what you should, and that means those trapped in high-yield bonds will try to hedge their positions via correlation trades in equities. When you trade a sympathetic market, all you get is sympathy. If we combine this with last week's ECB disappointment and the likely increase in U.S. short-term interest rates along with the engineered decline in the Chinese yuan, we have the makings of a very poor end of the year in financial markets along with the rising risk of an outright recession in 2016. We must remember higher short-term rates in the U.S. will involve draining liquidity from the banking system while risk-averse investors are liquefying assets. This is deflationary; worse, it is an unnecessary policy risk.

The causal chain now is:

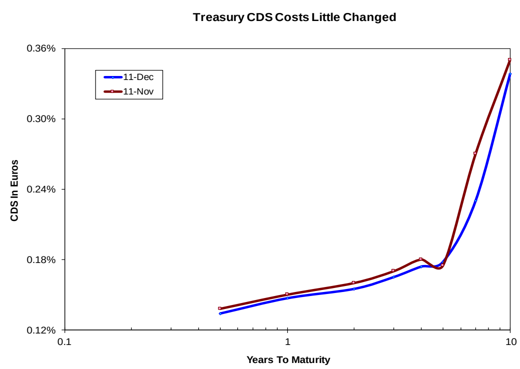
1. Higher short-term interest rates are being priced in still starting in December 2015;
2. Disinflationary pressures will rise once again with rising risk-aversion;
3. Inflation expectations as measured by the TIPS market have seen their lows for the immediate duration, but are biased lower once again;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are terming-out their borrowing to reduce rollover risk;
6. Swap spreads will remain low even as declining UST rates lead to a small increase; and
7. Credit spreads will retain and most likely expand their upward bias.

Key Market Indications

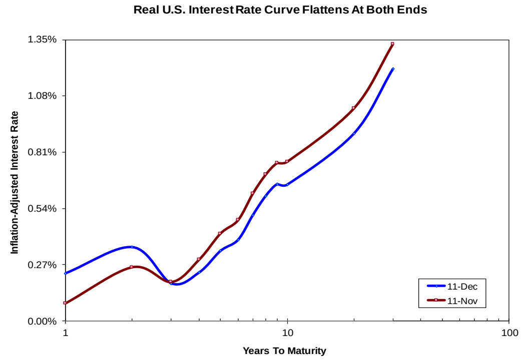
The yield curve continues to flatten via higher short-term rates and now by a drive lower in long-term rates as a function of rising risk-aversion. While some of the flatteners may be closed after the FOMC meeting, the secular trend toward a bullish flattening of the yield curve remains intact.



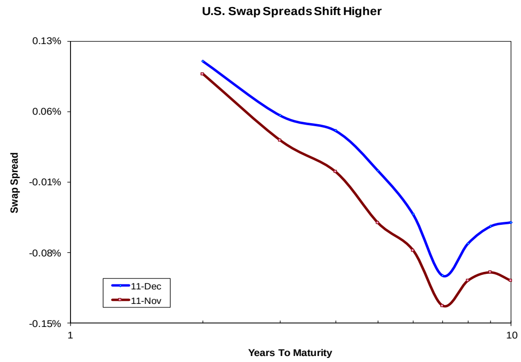
The CDS market for Treasuries has shifted back to its pre-default scare state. Anyone who seek protection in this market during an election cycle must be willing to lose money, and anyone who write protection giving Congressional predilections is not getting paid enough to assume the risk.



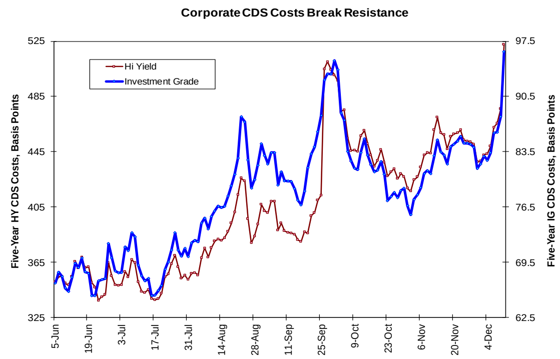
The pseudo-real rate curve declined from both ends as the nominal UST curve flattened. This move represents the combination of a flight to safety at the long end combined with the shift higher at the short end.



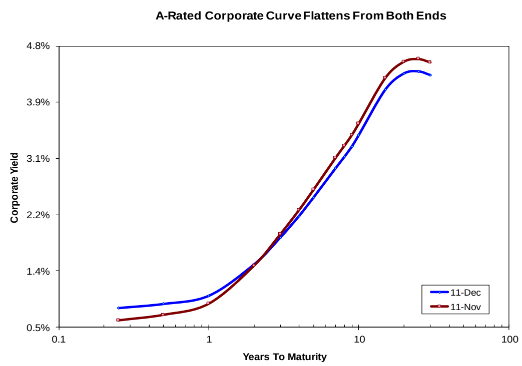
Swap spreads, which rise when floating-rate borrowers want to fix their payments, shifted higher in response to the decline in the UST yield curve. They remain negative for tenors of six years and longer.



CDS costs for both the investment-grade and high-yield indices broke through resistance as the energy and basic materials sectors are facing rising default risk.



The A-rated yield curve mirrored the UST curve over the past month as it flattened from both ends via a combination of higher short-term rates and lower long-term rates.



Market Structure

Volatile transitional structures and bear market consolidations characterized by sideways structures continue to dominate. Nothing in either the physical or financial markets is in a structural uptrend. The trend oscillator for the EM index is at an astonishing -0.691.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 14 - 18
BBerg	13	Transitional	-0.189	11.4%	
BBerg Grain	5	Sideways	-0.008	15.2%	
BBerg Ind. Metl	10	Sideways	0.061	17.4%	
BBerg Pre. Metl	10	Sideways	-0.007	13.6%	
BBerg Softs	25	Trending	-0.063	20.0%	-0.52%
BBerg Nat. Gas	23	Trending	-0.293	24.6%	-0.55%
BBerg Petroleum	29	Trending	-0.423	28.2%	-0.59%
BBerg Livestock	15	Transitional	-0.055	17.7%	
Dollar Index	14	Transitional	-0.160	8.8%	
S&P 500 Index	19	Transitional	-0.255	11.6%	
EAFE Index	18	Transitional	-0.255	10.1%	
EM Index	29	Trending	-0.691	10.1%	-0.49%
Ten-year UST (price)	18	Transitional	0.144	5.6%	

Performance Measures

The primary bear markets in non-energy physical commodities reasserted themselves with a vengeance and the energy bear markets turned into a genuine rout despite that term's overuse. The financial stresses facing miners, energy producers and various emerging market producers of soft commodities and even softer currencies are such they must continue to maintain production in the face of lower prices in a vain attempt to cover fixed costs and repay creditors. This will end with multiple failures; then and only then will the prospect of a market clearing at higher prices come into view.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-4.01%	-4.85%	-22.00%	-29.17%
Grains Sub-Index	-1.71%	1.51%	-3.69%	-18.89%
Corn	-1.63%	2.68%	-0.68%	-17.69%
Soybeans	-3.89%	1.82%	-4.18%	-16.18%
Wheat	1.24%	-1.44%	-5.42%	-21.07%
Energy Sub-Index	-9.08%	-14.62%	-41.19%	-47.85%
Petroleum Sub-Index	-9.30%	-12.19%	-41.28%	-42.53%
WTI	-10.45%	-14.77%	-44.67%	-48.31%
Brent	-11.43%	-15.11%	-44.83%	-47.79%
ULSD	-13.49%	-17.33%	-42.48%	-43.46%
Gasoline	0.27%	3.46%	-26.54%	-18.21%
Natural Gas	-8.44%	-20.76%	-39.84%	-58.94%
Precious Metals Sub-Index	-1.72%	-1.01%	-10.06%	-14.33%
Gold	-0.77%	-0.52%	-8.99%	-12.42%
Silver	-4.43%	-2.42%	-13.04%	-19.73%
Industrial Metals Sub-Index	-0.20%	-3.03%	-22.85%	-31.14%
Copper	1.81%	-2.72%	-21.67%	-28.53%
Aluminum	-2.26%	-1.11%	-17.50%	-27.66%
Nickel	-3.25%	-7.88%	-34.24%	-48.65%
Zinc	0.02%	-4.69%	-28.11%	-31.00%
Softs Sub-Index	-4.60%	0.26%	2.15%	-16.48%
Coffee	-4.52%	4.68%	-14.45%	-37.30%
Sugar	-5.81%	-3.04%	11.85%	-11.64%
Cotton	-1.54%	2.79%	-1.69%	3.19%
Livestock Sub-Index	-0.59%	-1.04%	-14.85%	-22.73%
Cattle	-2.30%	-4.81%	-20.35%	-20.24%
Hogs	2.46%	6.15%	-3.96%	-27.02%

Did the USD gain or lose this past week? If you are willing to measure it against the highly unrepresentative ICE dollar index, it retreated. If you widen the scope out to include the CNY, the Nordics and all emerging market currencies of note, it gained. This is the same sort of "risk-off" action we saw several times earlier this year, especially in August.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.97%	2.26%	-2.42%	-11.48%
Chinese yuan	-0.81%	-1.37%	-3.85%	-4.13%
Japanese yen	1.74%	1.53%	1.99%	-1.95%
British pound	0.67%	0.00%	-1.96%	-3.30%
Swiss franc	1.40%	2.24%	-5.04%	-1.50%
Canadian dollar	-2.86%	-3.59%	-10.64%	-16.25%
Australian dollar	-2.04%	1.80%	-7.30%	-13.09%
Swedish krona	-0.24%	2.11%	-3.48%	-11.49%
Norwegian krone	-2.01%	-0.87%	-9.71%	-16.07%
New Zealand dollar	-0.44%	2.41%	-4.22%	-14.07%
Indian rupee	-0.31%	-0.87%	-4.37%	-6.80%
Brazilian real	-3.11%	-2.89%	-20.21%	-31.51%
Mexican peso	-4.24%	-3.81%	-11.75%	-15.04%
Chilean peso	-0.88%	-1.48%	-10.94%	-13.12%
Colombian peso	-3.88%	-11.68%	-23.99%	-27.72%
Bloomberg-JP Morgan Asian dollar index (spot)	-1.11%	-1.21%	-4.79%	-5.97%

Equities can survive bad economic news and even bad earnings news. They seldom do well when corporate bonds do poorly, and that is exactly what has been happening. The ongoing disintegration of the energy and basic materials sectors and the impending rise in U.S. short-term interest rates have not been conducive at all to risk-taking.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-3.33%	-3.02%	-6.99%	-1.21%
North America	-3.90%	-3.08%	-5.10%	-0.35%
Latin America	-4.84%	-8.28%	-25.48%	-28.81%
Emerging Market Free	-4.75%	-7.12%	-19.51%	-15.94%
EAFE	-2.39%	-2.93%	-9.94%	-2.60%
Pacific	-1.02%	-1.40%	-7.43%	2.25%
Eurozone	-2.86%	-4.27%	-10.67%	-5.55%

If trend-following CTAs lost more than 2% this past week, they really should have to explain why. The same should apply to global hedge funds and their inability to provide returns in almost any environment save an equity bull market.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.11%	0.91%	1.39%	3.73%
Newedge Trend	-2.10%	1.00%	0.58%	1.90%
Newedge Short-Term	-1.63%	0.35%	-2.80%	-3.31%
HFR Global Hedge Fund	-0.60%	-1.40%	-5.47%	-2.41%
HFR Macro/CTA	-0.30%	-0.34%	-1.71%	-0.46%
HFR Macro: Sytematic Diversified CTA	0.60%	0.87%	0.77%	1.22%