The Macro Environment For Financial Markets

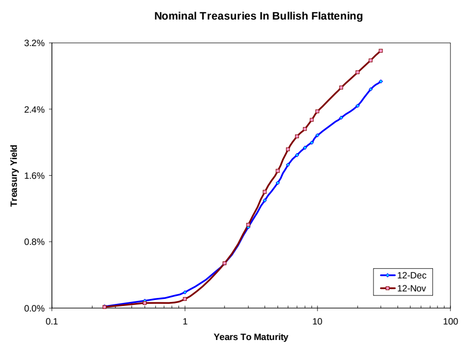
Past performance does not predict future results (OK; I do not believe that, either) but past investment patterns predict future production in cyclical industries such as mining, chemical and fertilizer production and most vividly these days in energy. The wealth destruction from the last two investment bubbles, technology and housing, did not reverse within weeks or months, and the wealth destruction in the oil service sector in the early 1980s and in the commodity industry in general in the late 1990s took reverse to recover as well. Energy investments now have to be made with the knowledge of a possible supply overhang. At least the high-yield debt issued to the energy industry did not get securitized, stamped "AAA" and get spewed out around the world. The damage here will be more confined than the housing bust, but as the U.S. energy sector was the bright spot in national growth since 2008, its problems will have a noticeable effect on GDP growth, tax receipts and monetary policy. If the oil crash leads to a postponement of rate hikes, it will slow the USD's ascent and slow reverse carry trades into the U.S.

The causal chain is now:

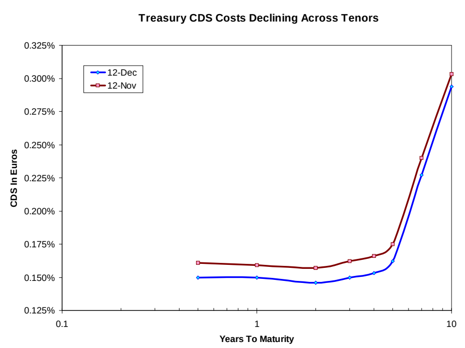
1. Short-term interest rates will remain artificially low globally;
2. Rising implied real rates will exacerbate disinflationary pressures and may argue for a new QE in 2015;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally and continue to pressure U.S. long-term yields lower;
5. The U.S. yield will retain a bias toward a bullish flattening;
6. Short-term borrowers will continue to accept rollover risk;
7. Swap spreads continue their inversion and decline to lower levels, as the market continues to accept long-term duration risk; 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

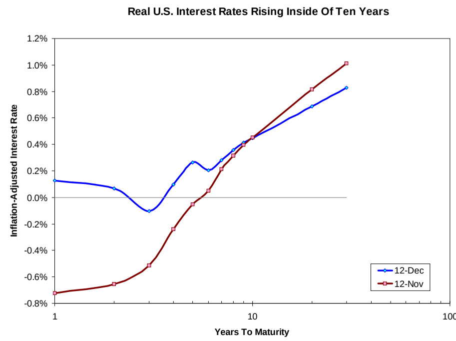
The sharp decline in equities produced the expected flight into the long end of the yield curve. Last week's increase in short-term interest rates was negated fairly quickly during the equity selloff, but movements at the short end of the yield curve are increasingly unimportant to a global sovereign debt market willing to take what once would have been unthinkable duration risk.



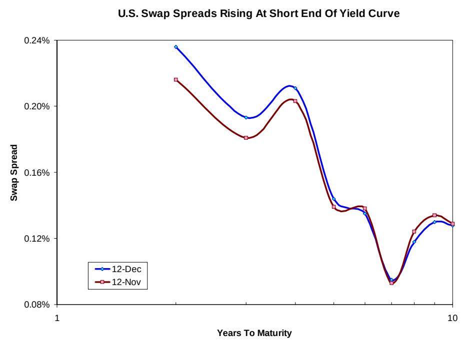
Euro-denominated CDS costs on Treasuries scarcely moved during this past week's spending bills despite obstreperous behavior from both the Democratic left and the Republican right. Although resolution remains uncertain as of the time of this writing, this is a hopeful sign the market regards these political kabuki productions as increasingly insignificant.



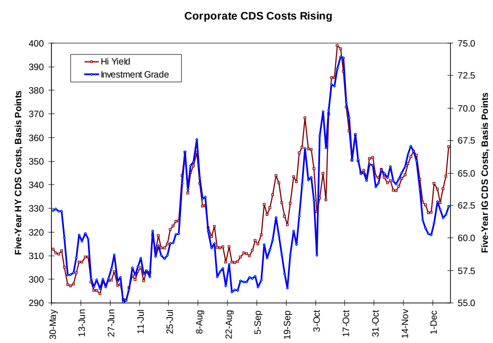
The increase in shorter-dated implied real rates is an artifact of the collapse in breakevens; when risk-averse funds seek safety, they do it in nominal Treasuries and not in TIPS. If short-term rates continue to decline, though, the rise in implied real rates very well might provide cover for a postponement of interest rate increases or for – yes – QE4. The fear of inflation will outweigh fear of financial bubbles.



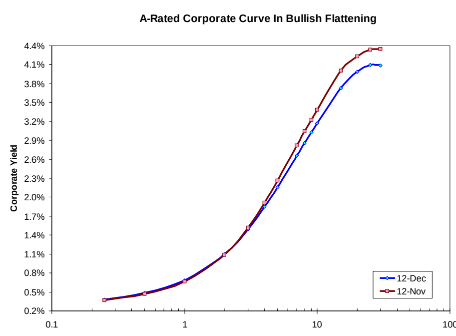
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain inverted, but with small increases at the shorter-dated tenors. This is consistent with the longer-term expectations for a bullish flattening of the yield curve regardless of whether short-term rates are tweaked higher sometime in 2015.



Both the IG and HY CDS indices are increasing under the weight of deteriorating energy sector credit. This rising risk has led HY bonds to underperform IG bonds that have underperformed Treasuries in turn. Rising risk aversion is not a formula for rising financial returns. These increases in credit risk are being amplified by the growing illiquidity of the corporate bond market and the inability of dealers to hold greater inventories in the Dodd-Frank/Basel III era.



The A-rated yield flattened bullishly but continues to steepen relative to the UST yield curve. This is an increasing headwind for risky financial assets.



Market Structure

Precious Metals moved into a structural uptrend and Grains continue their upward bias. All other physical commodities are in strong downtrends, as are the equity indices. The downtrends in emerging market equities and currencies remain self-reinforcing. Treasuries continue their uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 15 - 19
BBerg	29	Trending	-0.291	11.3%	-0.15%
BBerg Grain	19	Transitional	0.177	19.2%	
BBerg Ind. Metl	29	Trending	-0.110	14.3%	-0.14%
BBerg Pre. Metl	20	Trending	0.085	23.6%	0.57%
BBerg Softs	20	Trending	-0.297	15.2%	-0.33%
BBerg Nat. Gas	29	Trending	-0.118	28.3%	-0.58%
BBerg Petroleum	29	Trending	-0.754	26.8%	-0.49%
BBerg Livestock	29	Trending	-0.477	9.6%	-0.29%
Dollar Index	16	Transitional	-0.007	7.7%	
S&P 500 Index	29	Trending	-0.303	7.4%	-0.15%
EAFE Index	29	Trending	-0.316	8.9%	-0.63%
EM Index	29	Trending	-0.670	8.0%	-0.06%
Ten-year UST (price)	29	Trending	0.324	5.0%	0.02%

Performance Measures

Precious Metals continued their rebound as risky assets were sold; this knee-jerk response has failed continuously for three years. Grains continue to advance during the Southern Hemisphere growing season, while both Livestock and Softs have turned lower. All of this pales, of course, next to the collapse of the Petroleum markets; their outsized weight in physical commodity indices continues to pull the main Bloomberg index lower.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.27%	-5.22%	-17.80%	-12.14%
Grains Sub-Index	2.04%	4.05%	-11.97%	-8.87%
Corn	3.17%	3.36%	-13.80%	-11.73%
Soybeans	1.11%	2.44%	-14.96%	-4.25%
Wheat	2.10%	7.78%	-2.55%	-10.35%
Energy Sub-Index	-6.65%	-16.98%	-36.74%	-29.61%
Petroleum Sub-Index	-10.15%	-21.58%	-42.34%	-37.17%
WTI	-11.84%	-23.44%	-43.26%	-35.50%
ULSD	-6.13%	-17.04%	-34.58%	-32.92%
Gasoline	-9.89%	-20.95%	-42.32%	-36.10%
Natural Gas	-0.26%	-8.15%	-25.07%	-12.29%
Precious Metals Sub-Index	3.22%	3.33%	-6.71%	-4.61%
Gold	2.70%	3.05%	-4.21%	-1.21%
Silver	4.91%	4.24%	-13.97%	-14.02%
Industrial Metals Sub-Index	-0.82%	-2.50%	-1.49%	-1.22%
Copper	1.09%	-3.44%	-3.38%	-11.14%
Aluminum	-2.52%	-5.03%	2.49%	1.11%
Nickel	-0.79%	6.80%	-8.54%	16.44%
Zinc	-2.21%	-3.26%	3.84%	8.32%
Softs Sub-Index	-1.70%	-7.09%	-17.33%	-6.47%
Coffee	-3.39%	-11.38%	-5.80%	38.23%
Sugar	-1.06%	-5.78%	-27.53%	-28.09%
Cotton	1.51%	1.53%	-20.39%	-19.46%
Livestock Sub-Index	-2.00%	-6.94%	-5.56%	11.91%
Cattle	-1.64%	-5.31%	6.05%	22.65%
Hogs	-2.77%	-10.24%	-22.30%	-3.93%

While the USD continued strong gains against emerging market currencies and the CNY, it retreated against the majors save the NOK as the schedule of a tightening of U.S. credit conditions came into doubt. This skepticism is no doubt well-placed given the Federal Reserve's continuous blinking in the face of financial stress since 2009.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.46%	0.19%	-8.04%	-9.39%
Chinese yuan	-0.58%	-1.00%	0.50%	-1.89%
Japanese yen	2.28%	-2.75%	-14.36%	-12.94%
British pound	0.87%	-0.40%	-7.17%	-3.88%
Swiss franc	1.56%	0.28%	-6.78%	-7.74%
Canadian dollar	-1.26%	-2.26%	-6.26%	-8.13%
Australian dollar	-0.83%	-5.41%	-12.51%	-7.72%
Swedish krona	0.16%	-1.61%	-11.35%	-12.56%
Norwegian krone	-2.64%	-7.46%	-18.48%	-15.69%
New Zealand dollar	0.86%	-1.29%	-10.48%	-5.73%
Indian rupee	-0.82%	-1.26%	-4.88%	-0.75%
Brazilian real	-2.47%	-3.24%	-15.93%	-12.07%
Mexican peso	-2.73%	-8.16%	-12.09%	-12.17%
Chilean peso	-1.12%	-4.03%	-10.40%	-13.99%
Colombian peso	-3.65%	-11.76%	-22.09%	-19.62%
Bloomberg-JP Morgan Asian dollar index (spot)	0.18%	-1.07%	-2.44%	-2.44%

Only the North American index has maintained positive returns since crude oil started its breakdown at the end of June. This seems likely to come undone going into the first quarter as the frictional costs of the downturn are going to produce concentrated damage in excess of the diffuse benefits.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-3.61%	-2.17%	-1.95%	8.07%
North America	-3.66%	-2.15%	3.38%	13.77%
Latin America	-8.64%	-13.09%	-22.66%	-14.45%
Emerging Market Free	-4.78%	-5.72%	-9.69%	-2.73%
EAFE	-3.54%	-2.20%	-9.51%	-0.05%
Pacific	-1.45%	-3.46%	-4.35%	0.76%
Eurozone	-4.90%	0.84%	-12.97%	-1.62%

Hedge funds continue to struggle when equity markets turn lower and have found the strong directional trends in emerging market currencies, sovereign debt and corporate debt difficult to embrace for liquidity conditions if nothing else. CTA performance should have been stronger this week than it was given market conditions; at least they were not strongly on the wrong side of these markets.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.13%	5.19%	18.83%	20.79%
Newedge Trend	0.08%	4.56%	12.85%	16.26%
Newedge Short-Term	0.16%	2.33%	7.74%	10.33%
HFR Global Hedge Fund	-1.17%	-1.24%	-3.01%	-0.48%
HFR Macro/CTA	-0.92%	-0.03%	4.07%	4.59%
HFR Macro: Sytematic Diversified CTA	-0.69%	0.96%	4.31%	2.70%