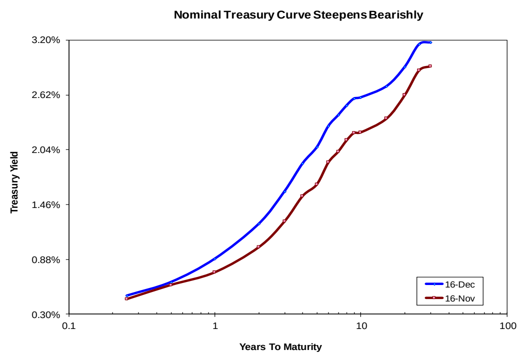
The Macro Environment For Financial Markets

Let's stipulate the FOMC is behind the curve, that higher short-term interest rates will lower the demand for cash balances and therefore will increase the supply of bank credit and that import costs will not decline dramatically. Once short-term interest rates begin their climb higher, they tend to rise further and for longer than is believed commonly. The causal chain now is:

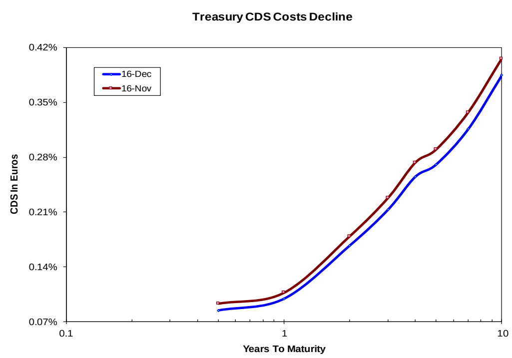
1. The market is pricing in higher short-term rates in 2017;
2. Inflationary expectations are rising globally, albeit excessively;
3. The U.S. yield curve is in a short-term bearish steepening;
4. Short-term borrowers have stopped terming out short-term debt into the bond market;
5. Swap spreads are pricing in higher future rates; and
6. CDS costs have stalled at resistance.

Key Market Indications

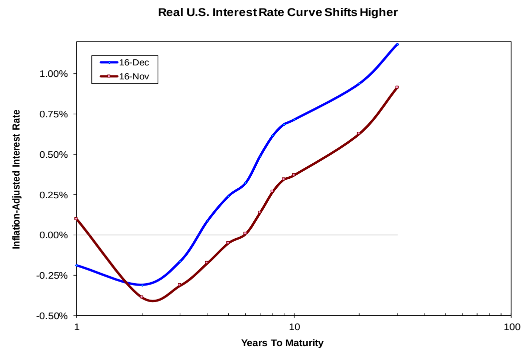
To repeat from last week, we have moved through key support at the long end of the yield curve and have to recognize this as a bear market, duration to be determined. The market is convinced the combination of lower monetary accommodation and greater fiscal stimulus will propel yields higher. As neither effect is likely to be as large as feared, the betting here is this bear market will be a short-lived affair.



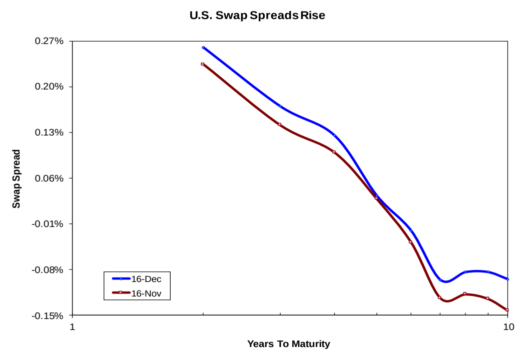
CDS costs on UST declined slightly, which is just as well considering how an impending one-party government is unlikely to default on U.S. debt.



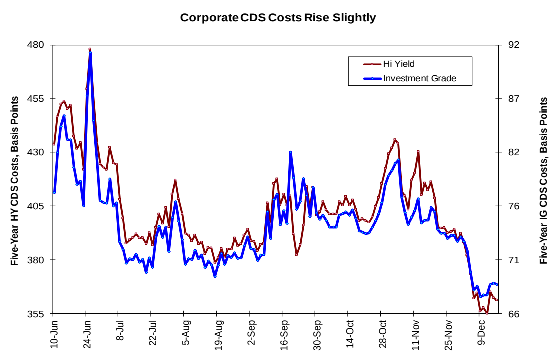
The pseudo-real yield curve declined slightly at the short end of the yield curve over the past month. Increases in these implied real rates in the Eurozone put further downward pressure on gold. The rise in long-term implied real rates is a negative for risky financial assets even though this effect has yet to manifest itself in U.S. equities.



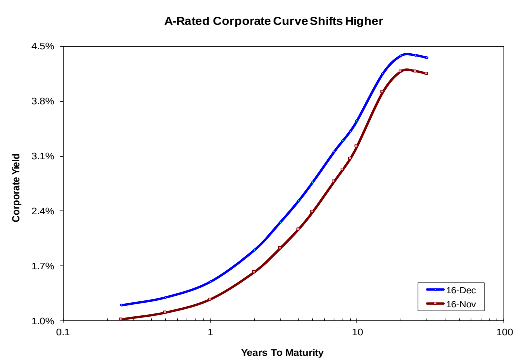
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose across tenors as the swap market finally is pricing in higher sovereign rates.



CDS costs moved slightly higher, but this is judged best as a failure at resistance and not as a reversal higher. As noted previously, market was at risk to being overpriced.



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

The main Bloomberg index, Grains, Livestock and Petroleum are in structural uptrends within physical markets. The EAFE and the S&P 500 are in structural uptrends within the financials.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 19 - 23
BBerg	29	Trending	0.142	12.0%	0.30%
BBerg Grain	27	Trending	0.035	14.7%	0.11%
BBerg Ind. Metl	7	Sideways	-0.063	19.5%	
BBerg Pre. Metl	11	Transitional	-0.184	15.0%	
BBerg Softs	7	Sideways	-0.058	18.8%	
BBerg Nat. Gas	4	Sideways	-0.014	29.5%	
BBerg Petroleum	29	Trending	0.256	27.6%	0.74%
BBerg Livestock	29	Trending	0.400	12.6%	0.15%
Dollar Index	14	Transitional	0.148	11.1%	
S&P 500 Index	29	Trending	0.284	8.4%	0.08%
EAFE Index	26	Trending	0.110	12.4%	0.15%
EM Index	19	Transitional	-0.083	8.7%	
Ten-year UST (price)	15	Transitional	-0.188	6.7%	

Performance Measures

Higher short-term interest rates continue driving the precious metals lower, as did a forecast for warmer weather for the U.S. did for natural gas. Concern about Chinese demand growth pressured the base metals, while the petroleum markets remain bid.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.14%	4.99%	-1.62%	12.86%
Grains Sub-Index	-0.68%	1.03%	-19.14%	-7.47%
Corn	-0.89%	0.82%	-23.79%	-12.52%
Soybeans	-0.18%	4.26%	-10.34%	15.89%
Wheat	-1.67%	-3.73%	-24.36%	-26.45%
Energy Sub-Index	-0.82%	14.65%	4.83%	18.88%
Petroleum Sub-Index	1.79%	13.84%	3.66%	15.79%
WTI	1.12%	12.07%	0.28%	8.24%
Brent	1.39%	14.38%	3.29%	24.14%
ULSD	2.49%	14.18%	5.82%	28.56%
Gasoline	3.50%	16.21%	9.94%	1.83%
Natural Gas	-7.24%	16.69%	9.07%	23.29%
Precious Metals Sub-Index	-2.79%	-5.20%	-11.43%	8.01%
Gold	-2.10%	-6.09%	-12.73%	5.92%
Silver	-4.42%	-2.99%	-8.11%	13.21%
Industrial Metals Sub-Index	-2.00%	3.62%	20.78%	26.51%
Copper	-3.13%	3.53%	23.72%	19.71%
Aluminum	-1.85%	1.27%	5.38%	11.41%
Nickel	-2.61%	2.88%	22.32%	25.49%
Zinc	0.69%	7.31%	36.73%	77.22%
Softs Sub-Index	-2.07%	-9.71%	-5.26%	14.81%
Coffee	2.23%	-12.09%	-4.74%	9.17%
Sugar	-5.29%	-9.54%	-11.02%	15.77%
Cotton	0.35%	-1.73%	7.01%	10.43%
Livestock Sub-Index	4.69%	11.29%	-8.38%	0.40%
Cattle	4.38%	6.01%	0.93%	0.27%
Hogs	5.13%	19.47%	-18.58%	0.25%

The USD gained across the board as the market had to accommodate to the FOMC's hint it may raise short-term interest rates faster than thought previously. Countering this is the reality the FOMC has been a poor predictor of FOMC actions and the costs of a rising USD will affect their actions considerably.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.04%	-2.24%	-6.90%	-4.22%
Chinese yuan	-0.77%	-1.17%	-5.31%	-7.02%
Japanese yen	-2.21%	-7.50%	-11.59%	3.63%
British pound	-0.60%	0.43%	-12.02%	-16.72%
Swiss franc	-0.88%	-2.36%	-5.95%	-3.51%
Canadian dollar	-1.18%	0.82%	-2.77%	3.33%
Australian dollar	-1.95%	-2.35%	-0.80%	0.98%
Swedish krona	-1.61%	-1.50%	-10.71%	-8.98%
Norwegian krone	-1.95%	-2.25%	-3.26%	0.96%
New Zealand dollar	-2.42%	-1.51%	-1.16%	2.43%
Indian rupee	-0.52%	0.26%	-0.73%	-1.54%
Brazilian real	-0.23%	1.13%	2.31%	14.65%
Mexican peso	-0.25%	-1.13%	-7.31%	-16.91%
Chilean peso	-3.27%	0.22%	2.30%	5.14%
Colombian peso	-0.06%	4.14%	0.27%	10.89%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.82%	-1.08%	-3.49%	-3.47%

While the EAFE markets reacted well to weaker currencies, the opposite was true for the EM markets. Here weaker currencies tend to be met with higher ST rates, something rarely bullish for equities.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.28%	3.51%	8.42%	10.28%
North America	-0.13%	3.83%	9.75%	11.68%
Latin America	-4.36%	-1.84%	9.40%	22.73%
Emerging Market Free	-2.43%	1.16%	8.66%	11.32%
EAFE	-0.55%	2.79%	7.51%	1.93%
Pacific	-1.72%	1.38%	9.61%	7.18%
Eurozone	0.60%	5.93%	6.78%	0.93%

Both hedge funds and CTAs had a strong week, suggesting they have latched on to the higher interest rate trend. The next two weeks normally would have been used to protect gains, but no such gains existed.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.86%	3.10%	-4.09%	-5.16%
Newedge Trend	1.08%	1.67%	-4.09%	-2.21%
Newedge Short-Term	1.46%	2.97%	-6.35%	-1.08%
HFR Global Hedge Fund	0.07%	1.38%	3.45%	2.77%
HFR Macro/CTA	1.00%	1.39%	-1.51%	-3.05%
HFR Macro: Sytematic Diversified CTA	1.64%	2.40%	-0.91%	-0.43%