The Macro Environment For Financial Markets

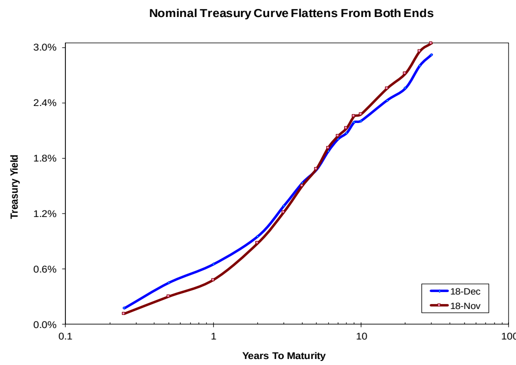
The value in equities lies in their embedded call options. Otherwise, all you have is a risky floating-rate bond. This means you have to sell a dream, and Wall Street long has excelled in doing so. However, the dream machine closes for maintenance every now and then, and this is one of those times. It is hard to point out firms and even sectors with strong upside potential right now, and we are losing the liquidity story. As years of negative real interest rates forced anything and everything yielding more than zero into overpriced territory, returns are going to be hard to come by in 2016. While this has a 2007-entering-2008 feel to it, we really do not have the catalyst for another financial calamity at the moment. That is about the best can look forward to at the moment.

The causal chain now is:

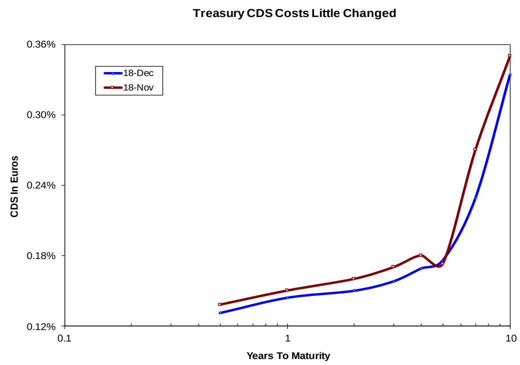
1. Higher short-term interest rates have arrived at last, but there is no rush to push them higher anytime soon;
2. Disinflationary pressures will rise once again with rising risk-aversion;
3. Inflation expectations as measured by the TIPS market have seen their lows for the immediate duration, but are 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

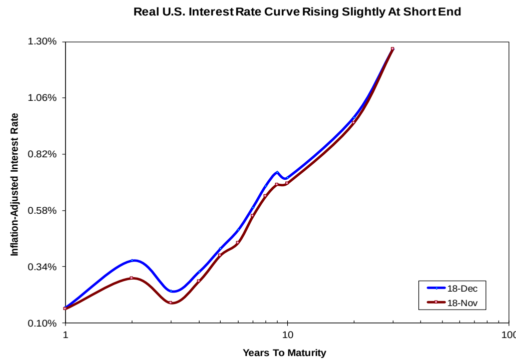
The yield curve continues to flatten via higher short-term rates and now by a drive lower in long-term rates as a function of rising risk-aversion. The yield curve flattening trade has been going on since November 2013, and yet it began from such a steep level that it remains very steep by historic standards.



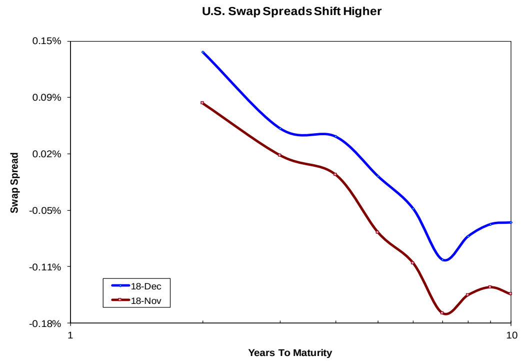
The CDS market for Treasuries has shifted back to its pre-default scare state. Anyone who seek protection in this market during an election cycle must be willing to lose money, and anyone who write protection giving Congressional predilections is not getting paid enough to assume the risk.



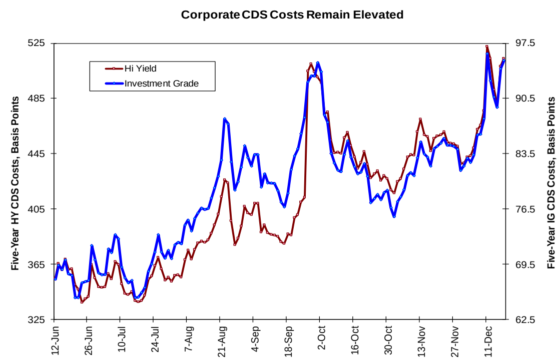
The pseudo-real rate curve rose slightly at the short end of the yield curve as the nominal UST curve continues to flatten. This will continue to pressure precious metals.



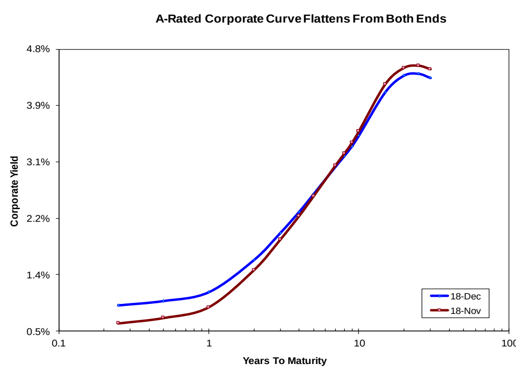
Swap spreads, which rise when floating-rate borrowers want to fix their payments, shifted higher in response to the decline in the UST yield curve. They remain negative for tenors of six years and longer.



CDS costs for both the investment-grade and high-yield indices remain elevated 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 major equity indices all are in downtrends at the moment, which is unusual for December.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 21 - 25
BBerg	17	Transitional	-0.174	11.7%	
BBerg Grain	10	Sideways	0.026	17.4%	
BBerg Ind. Metl	12	Transitional	0.065	17.4%	
BBerg Pre. Metl	11	Transitional	-0.022	13.9%	
BBerg Softs	28	Trending	0.013	19.5%	-0.52%
BBerg Nat. Gas	28	Trending	-0.342	25.5%	-0.55%
BBerg Petroleum	29	Trending	-0.419	28.9%	-0.59%
BBerg Livestock	6	Sideways	0.023	16.7%	
Dollar Index	15	Transitional	0.022	9.3%	
S&P 500 Index	20	Trending	-0.239	12.3%	-0.09%
EAFE Index	29	Trending	-0.192	11.3%	-0.22%
EM Index	29	Trending	-0.310	10.3%	-0.49%
Ten-year UST (price)	8	Sideways	0.026	5.7%	

Performance Measures

Negative-sum games can be appalling to watch. Right now we are seeing the intersection of an OPEC price war with non-OPEC producers whose only hope of staying in business is to sell whatever they can for whatever they can. At least the major mining firms do not have to contend with state-owned producers. Weaker demand from China, a stronger USD, rising short-term interest rates, disillusionment with the always-contrived concept something called "commodities" was an asset class…you would think all of the bad news would be out by now. Not yet.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.23%	-5.03%	-22.98%	-28.60%
Grains Sub-Index	0.44%	2.10%	-4.14%	-20.39%
Corn	-0.19%	1.71%	-2.16%	-18.55%
Soybeans	2.18%	3.73%	-6.04%	-13.49%
Wheat	-0.76%	0.38%	-2.86%	-27.50%
Energy Sub-Index	-4.28%	-17.99%	-43.90%	-47.60%
Petroleum Sub-Index	-3.52%	-15.28%	-43.47%	-41.52%
WTI	-3.52%	-17.67%	-46.97%	-46.75%
Brent	-4.22%	-18.21%	-46.93%	-47.51%
ULSD	-3.72%	-20.21%	-45.18%	-43.20%
Gasoline	-2.29%	-0.50%	-28.12%	-16.45%
Natural Gas	-6.41%	-24.91%	-44.10%	-59.99%
Precious Metals Sub-Index	-0.35%	-0.29%	-12.09%	-11.73%
Gold	-0.99%	-0.35%	-11.60%	-11.28%
Silver	1.53%	-0.12%	-13.46%	-12.75%
Industrial Metals Sub-Index	0.15%	0.94%	-20.67%	-29.00%
Copper	-0.18%	1.43%	-19.68%	-26.65%
Aluminum	1.59%	1.89%	-14.20%	-25.53%
Nickel	0.80%	-2.49%	-31.59%	-44.83%
Zinc	-2.33%	-0.36%	-27.90%	-30.53%
Softs Sub-Index	1.59%	3.33%	5.68%	-14.39%
Coffee	-1.81%	2.83%	-14.44%	-38.56%
Sugar	3.57%	4.37%	19.61%	-8.54%
Cotton	-0.03%	1.21%	-1.81%	2.69%
Livestock Sub-Index	-2.75%	-3.54%	-16.39%	-23.28%
Cattle	-0.57%	-5.69%	-20.04%	-18.87%
Hogs	-6.48%	0.64%	-9.33%	-30.60%

The USD reversed much of the previous week's action by gaining against the majors and against the woebegone BRL, but it retreated against the INR and against the other Latin American currencies listed. That does not include the Argentine peso or Venezuelan bolivar: Only two countries but every embarrassing left-wing legacy.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.07%	1.95%	-4.32%	-11.54%
Chinese yuan	-0.40%	-1.49%	-4.21%	-4.10%
Japanese yen	-0.12%	2.05%	1.49%	-1.91%
British pound	-2.09%	-2.24%	-6.20%	-4.95%
Swiss franc	-0.97%	2.78%	-7.11%	-1.24%
Canadian dollar	-1.44%	-4.69%	-12.43%	-17.06%
Australian dollar	-0.18%	0.91%	-8.00%	-12.11%
Swedish krona	-0.64%	1.96%	-4.97%	-10.03%
Norwegian krone	-0.67%	-0.86%	-10.85%	-15.50%
New Zealand dollar	0.16%	3.96%	-2.87%	-13.33%
Indian rupee	0.74%	-0.16%	-4.02%	-4.96%
Brazilian real	-2.77%	-5.48%	-23.17%	-33.15%
Mexican peso	1.48%	-2.35%	-10.48%	-14.94%
Chilean peso	1.45%	2.31%	-10.10%	-12.03%
Colombian peso	0.05%	-6.78%	-23.65%	-30.21%
Bloomberg-JP Morgan Asian dollar index (spot)	0.16%	-0.72%	-4.93%	-5.59%

The strong post-FOMC selloff made it feel as if equity returns should have been lower. They will be in coming weeks as bad positions in relatively illiquid corporate bonds are going to get hedged with short equity positions.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.23%	-3.28%	-7.28%	-1.88%
North America	-0.26%	-3.77%	-5.93%	-2.00%
Latin America	0.46%	-7.31%	-27.25%	-28.06%
Emerging Market Free	2.13%	-3.94%	-17.92%	-13.16%
EAFE	-0.17%	-2.47%	-9.43%	-1.68%
Pacific	-0.65%	-1.17%	-7.35%	3.13%
Eurozone	0.44%	-2.83%	-9.17%	-4.10%

Trend-following CTAs managed gains this week, which is encouraging considering there were strong trends. Of greater note were the gains posted by macro-oriented hedge funds in a week with strong equity reversals.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.46%	0.88%	2.49%	4.82%
Newedge Trend	1.19%	0.56%	2.13%	3.48%
Newedge Short-Term	-0.16%	-0.92%	-1.99%	-3.07%
HFR Global Hedge Fund	-0.38%	-1.34%	-5.73%	-1.98%
HFR Macro/CTA	0.73%	-0.45%	-1.04%	0.29%
HFR Macro: Sytematic Diversified CTA	1.09%	0.43%	1.69%	2.44%