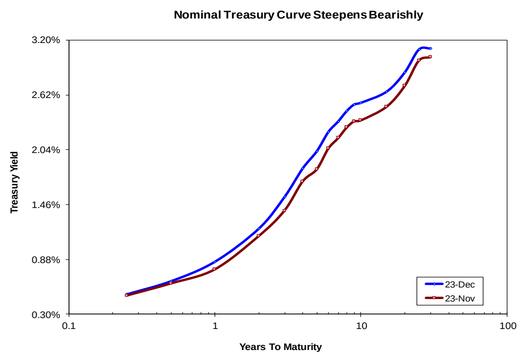
The Macro Environment For Financial Markets

One year ago, Chinese markets were coming unglued, crude oil prices were collapsing, emerging markets were sell off hard and credit risk was rising. Mid-way through February, anyone who predicted double-digit returns for U.S. equities would have been laughed out of the room. The year 2016 rewarded flexibility and a willingness to accept the improbable. It is a fair bet to say 2017 will bring more of the same. The causal chain now is:

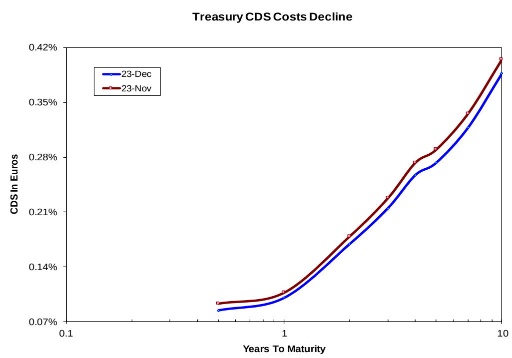
1. The market is pricing in higher short-term rates in 2017;
2. Inflationary expectations have stopped rising for the short-term;
3. The U.S. yield curve is in a short-term bearish steepening;
4. Short-term borrowers have stopped terming out short-term debt into the bond market;
5. Swap spreads are pricing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

Key Market Indications

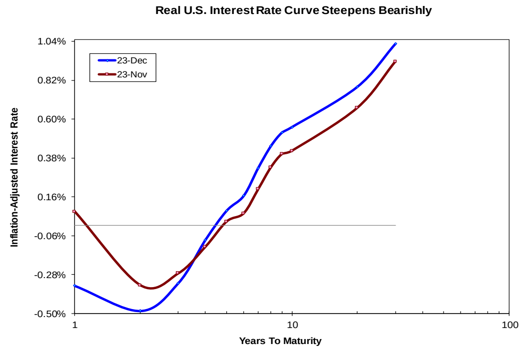
While the overall tenor of the market has to be considered bearish, it will be difficult for the U.S. to sell off significantly when there is such a rate gap with other OECD bond markets. We should enter a consolidation period between now and the inauguration.



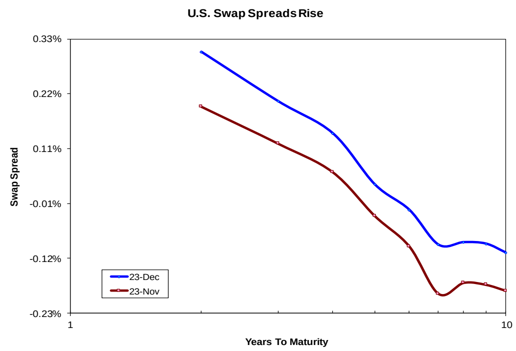
CDS costs on UST declined slightly, which is just as well considering how an impending one-party government is unlikely to default on U.S. debt.



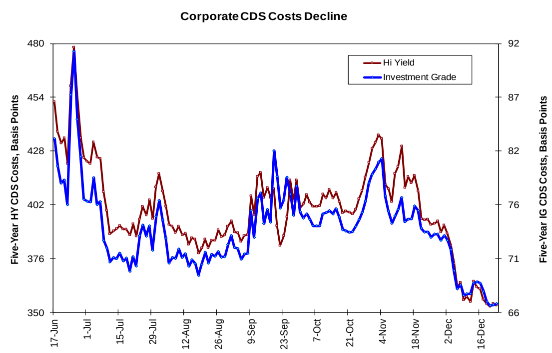
The pseudo-real yield curve declined slightly at the short end of the yield curve over the past month. Increases in these implied real rates in the Eurozone put further downward pressure on gold. The rise in long-term implied real rates is a negative for risky financial assets even though this effect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



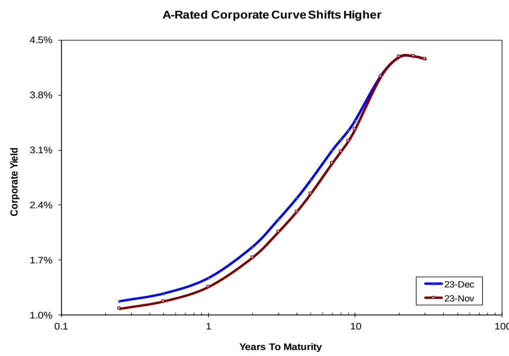
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose across tenors as the swap market finally is pricing in higher sovereign rates.



CDS costs declined, but not significantly. Well, the economy is not weakening, short-term rate hikes are somewhere in the future and corporate balance sheets are awash with cash. Why should these costs rise?



The A-rated corporate yield curve continues shifted higher at the short end of the yield curve. The ability of the long end of the corporate curve to hold in the face of higher UST yields signals short-term exhaustion in the face of the post-election selloff.



Market Structure

While the main Bloomberg index remains in a structural uptrend, Grains have moved into a downtrend and all other physical markets are without structure. The EM index has moved back into a downtrend while the S&P 500 remains in an uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 26 - 30
BBerg	29	Trending	0.005	10.2%	0.30%
BBerg Grain	27	Trending	-0.239	13.1%	-0.82%
BBerg Ind. Metl	18	Transitional	-0.196	20.7%	
BBerg Pre. Metl	15	Transitional	-0.199	13.4%	
BBerg Softs	7	Sideways	-0.087	17.9%	
BBerg Nat. Gas	10	Sideways	0.082	30.7%	
BBerg Petroleum	8	Sideways	0.048	20.0%	
BBerg Livestock	4	Sideways	-0.041	14.1%	
Dollar Index	4	Sideways	-0.009	6.1%	
S&P 500 Index	6	Sideways	0.021	5.0%	
EAFE Index	28	Trending	0.133	10.3%	0.15%
EM Index	23	Trending	-0.266	8.3%	-0.24%
Ten-year UST (price)	5	Sideways	0.024	4.3%	

Performance Measures

Concern about Chinese demand growth continues to pressure Industrial Metals, while Grains are reflecting the prospects for ample supplies. Natural Gas has resumed its uptrend on the back of short-term weather forecasts.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.96%	1.14%	-2.15%	10.84%
Grains Sub-Index	-3.69%	-4.73%	-15.69%	-8.79%
Corn	-2.94%	-3.72%	-16.57%	-13.00%
Soybeans	-4.70%	-4.53%	-10.93%	11.95%
Wheat	-3.84%	-7.10%	-22.74%	-26.68%
Energy Sub-Index	1.92%	11.73%	3.33%	17.83%
Petroleum Sub-Index	0.53%	9.82%	0.40%	14.66%
WTI	0.10%	8.43%	-2.93%	4.94%
Brent	0.15%	10.11%	-0.28%	22.62%
ULSD	-0.44%	8.88%	2.20%	26.82%
Gasoline	3.54%	13.34%	7.88%	6.31%
Natural Gas	5.72%	16.82%	12.86%	22.33%
Precious Metals Sub-Index	-1.05%	-4.74%	-10.72%	6.26%
Gold	-0.32%	-4.89%	-10.83%	5.24%
Silver	-2.80%	-4.36%	-10.43%	8.56%
Industrial Metals Sub-Index	-3.41%	-5.16%	12.78%	20.82%
Copper	-3.32%	-5.25%	13.58%	15.08%
Aluminum	0.18%	-3.25%	3.76%	9.38%
Nickel	-6.83%	-10.37%	11.99%	18.22%
Zinc	-5.55%	-3.60%	25.36%	63.23%
Softs Sub-Index	-1.83%	-8.39%	-5.94%	10.17%
Coffee	-4.41%	-13.63%	-8.98%	2.66%
Sugar	-0.37%	-7.26%	-8.07%	14.95%
Cotton	-1.64%	-2.43%	6.06%	10.21%
Livestock Sub-Index	-0.49%	8.48%	-7.40%	-5.23%
Cattle	0.83%	5.01%	0.60%	-5.77%
Hogs	-2.31%	13.82%	-17.00%	-4.02%

While year-end currency markets should not be overanalyzed, it is interesting to note the commodity-linked CAD and AUD weakened while most other majors consolidated their losses against the USD. The EM currencies remain soundly within their downtrends.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.05%	-0.92%	-8.16%	-4.18%
Chinese yuan	0.22%	-0.39%	-5.26%	-6.75%
Japanese yen	0.51%	-4.10%	-9.52%	3.06%
British pound	-1.71%	-1.29%	-17.44%	-17.41%
Swiss franc	-0.04%	-0.95%	-6.67%	-3.49%
Canadian dollar	-1.46%	-0.33%	-5.76%	2.34%
Australian dollar	-1.75%	-2.83%	-5.74%	-0.80%
Swedish krona	1.47%	0.81%	-11.32%	-8.28%
Norwegian krone	-0.33%	-1.01%	-6.38%	0.22%
New Zealand dollar	-1.28%	-1.90%	-5.19%	1.18%
Indian rupee	-0.08%	1.09%	-0.85%	-2.38%
Brazilian real	3.60%	3.67%	2.06%	20.51%
Mexican peso	-0.82%	0.17%	-11.56%	-16.43%
Chilean peso	-0.08%	0.90%	-0.76%	3.79%
Colombian peso	0.25%	5.78%	-3.44%	7.11%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.14%	-0.49%	-4.45%	-3.63%

To repeat from last week, 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	0.29%	3.04%	5.11%	8.08%
North America	0.24%	2.67%	8.00%	12.28%
Latin America	1.32%	-1.14%	3.56%	25.17%
Emerging Market Free	-1.67%	-1.56%	2.11%	7.66%
EAFE	0.38%	3.72%	0.31%	1.26%
Pacific	0.19%	1.43%	6.51%	6.76%
Eurozone	1.00%	7.07%	0.46%	0.63%

CTAs and macro-oriented hedge funds continue to perform poorly. The most interesting news out of this space has to be Ray Dalio's attempt to clone himself with an AI program. Had Napoleon done this, we would all be speaking French today.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.70%	2.50%	-1.99%	-5.79%
Newedge Trend	-0.42%	1.62%	-2.37%	-2.47%
Newedge Short-Term	0.08%	2.63%	-3.65%	0.77%
HFR Global Hedge Fund	0.18%	1.24%	3.61%	2.89%
HFR Macro/CTA	-0.13%	1.39%	-0.99%	-3.23%
HFR Macro: Sytematic Diversified CTA	-0.62%	2.03%	-0.39%	-1.40%