The Macro Environment For Financial Markets

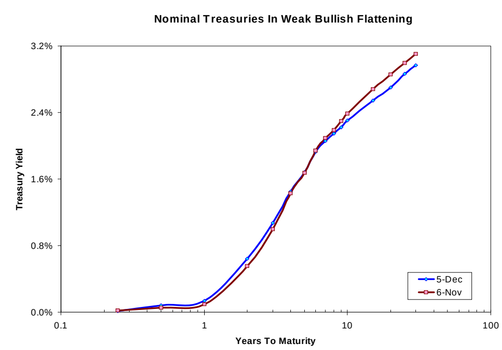
Just as highway accidents are caused more by vehicles traveling at widely different as opposed to excessive speeds, economic disruptions are caused more by divergences than by the convergent everyone-muddles-along torpor of the post-crisis era. Thus the challenges of rising short-term U.S. interest rates, something underway quietly since the mid-October panic ended, the rising USD and wealth transfer from energy producers to consumers will define the background for the next round of turmoil. Rising risk-aversion in fixed-income markets has yet to derail the equity rally, but it will invariably.

The causal chain is now:

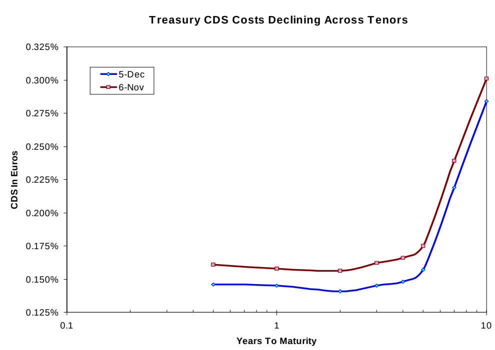
1. Short-term interest rates will remain artificially low globally and will be transmitted into the U.S. via USD appreciation;
2. Real rates will rise at the short end of the yield curve but will be slow to rise at the long end of the yield curve as global economic growth remains slow and debt levels remain high;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally and continue to cap U.S. long-term yields;
5. The U.S. yield will retain a bias toward a bullish flattening with most of the flattening driven by rising short-term rates;
6. Short-term borrowers will continue to accept rollover risk;
7. Swap spreads continue their inversion and decline to lower levels, but this is becoming increasingly unstable; 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

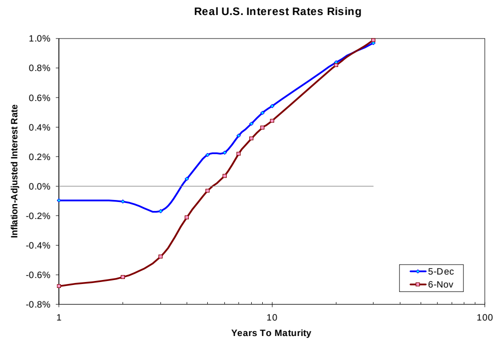
While it felt as if the ten-year broke this week, it simply sold off to first support at 2.317%. Of greater significance was the flattening of the yield curve via rising two-year yields. This will maintain the USD rally without impeding the flow of funds into risky assets.



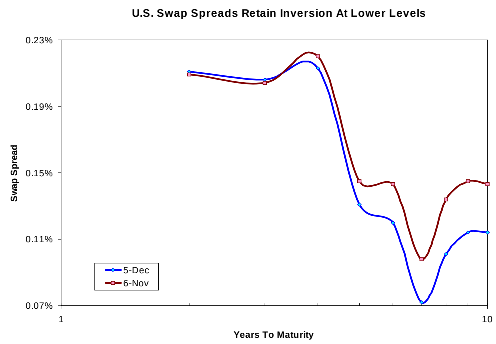
Euro-denominated CDS costs on Treasuries are shifting about within a small range. This may change slightly if the administration provokes Congress into some avoidable budget battle, but that will be a January 2015 story at the earliest.



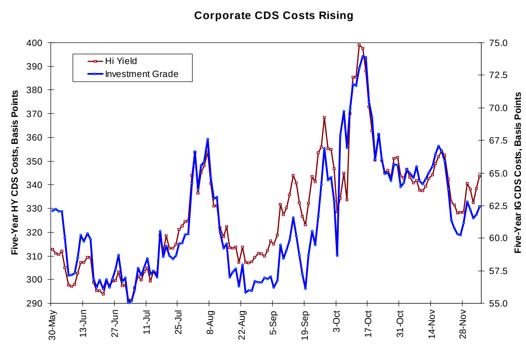
The yield curve for implied real rates shows a bearish increase at shorter maturities. This will maintain upward pressure on the USD and downward pressure on precious metals. Only an increase at longer maturities will be bearish for risky financial assets.



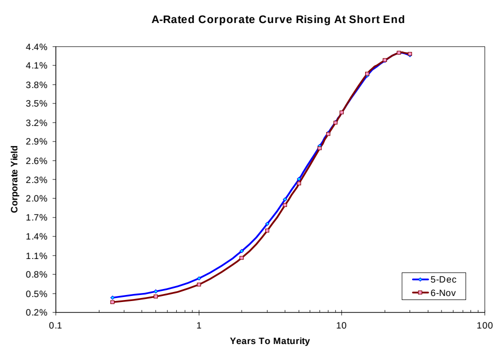
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain inverted and at lower levels. This complacency remains supportive for risky financial assets now, but it can reverse swiftly once expectations change.



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, and what is a rumble now will turn into something more serious if and when a high-profile failure occurs in the energy sector.



The A-rated yield curve is shifting higher at the short end as is steepening relative to the UST yield curve. This is an increasing headwind for risky financial assets.



Market Structure

None of the physical commodities are in uptrends at present. Of greater significance is emerging market equities are now in a structural downtrend that will be mutually reinforcing with the weakness in their currencies.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 8 - 12
BBerg	28	Trending	-0.252	11.4%	-0.15%
BBerg Grain	14	Transitional	0.118	18.7%	
BBerg Ind. Metl	28	Trending	-0.087	14.9%	-0.14%
BBerg Pre. Metl	5	Sideways	-0.036	34.0%	
BBerg Softs	18	Transitional	-0.267	15.3%	
BBerg Nat. Gas	28	Trending	-0.121	29.1%	-0.58%
BBerg Petroleum	28	Trending	-0.498	25.9%	-0.49%
BBerg Livestock	29	Trending	-0.293	9.6%	-0.29%
Dollar Index	13	Transitional	0.190	6.6%	
S&P 500 Index	6	Sideways	0.058	5.9%	
EAFE Index	29	Trending	0.084	9.6%	0.16%
EM Index	26	Trending	-0.140	8.0%	-0.06%
Ten-year UST (price)	28	Trending	0.006	4.7%	0.02%

Performance Measures

Both Precious and Industrial Metals had rebound weeks, but these still have the feeling of short-covering within longer-term bear markets. Energy and the less-important Livestock and Softs indices declined. The Grains continue to move ahead as farmers have elected to pay storage costs (and receive subsidies therefor) rather than sell at prices deemed by them to be "too low." These carryover stocks will weigh on prices in 2015 barring a failure in the Northern Hemisphere growing season.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.66%	-4.65%	-16.08%	-10.48%
Grains Sub-Index	1.80%	5.20%	-15.96%	-12.09%
Corn	1.61%	3.95%	-18.70%	-16.16%
Soybeans	1.97%	-0.07%	-16.50%	-5.06%
Wheat	2.68%	13.94%	-9.72%	-15.20%
Energy Sub-Index	-3.50%	-16.20%	-30.08%	-23.96%
Petroleum Sub-Index	-1.46%	-16.51%	-33.17%	-31.52%
WTI	-0.47%	-16.23%	-33.01%	-27.56%
ULSD	-2.47%	-15.32%	-27.46%	-30.46%
Gasoline	-2.97%	-16.36%	-33.36%	-31.60%
Natural Gas	-6.99%	-15.64%	-24.10%	-6.93%
Precious Metals Sub-Index	2.01%	2.02%	-7.65%	-7.17%
Gold	1.27%	1.69%	-5.12%	-3.37%
Silver	4.51%	3.13%	-15.12%	-17.71%
Industrial Metals Sub-Index	0.83%	-1.90%	-2.51%	1.65%
Copper	1.99%	-4.31%	-5.05%	-10.37%
Aluminum	-1.66%	-4.11%	2.58%	4.75%
Nickel	3.13%	8.71%	-11.81%	20.23%
Zinc	0.94%	-0.49%	5.06%	15.20%
Softs Sub-Index	-3.05%	-3.77%	-15.61%	-3.43%
Coffee	-3.92%	-3.52%	-1.57%	54.98%
Sugar	-2.89%	-3.50%	-26.22%	-28.72%
Cotton	-0.73%	-4.67%	-20.78%	-17.89%
Livestock Sub-Index	-2.69%	-2.45%	-1.05%	13.32%
Cattle	-2.57%	-2.01%	11.88%	24.69%
Hogs	-2.95%	-3.37%	-19.01%	-3.22%

I commented last week, "The stronger USD eventually will cause some pressure to ease, but we may be years – yes, years – from that point." Only the INR gained on the USD this week. With short-term rates in the U.S. already on the rise and expected to rise relative to those of other major currencies, the USD is poised to make its strongest long-term gains since the early 1980s.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.36%	-1.63%	-10.08%	-10.13%
Chinese yuan	-0.12%	-0.61%	1.66%	-0.99%
Japanese yen	-2.33%	-5.62%	-15.68%	-16.19%
British pound	-0.42%	-2.48%	-7.37%	-4.61%
Swiss franc	-1.38%	-1.51%	-8.93%	-8.39%
Canadian dollar	-0.17%	-0.43%	-4.46%	-6.83%
Australian dollar	-2.23%	-3.23%	-10.96%	-8.24%
Swedish krona	-1.41%	-2.50%	-11.84%	-14.13%
Norwegian krone	-1.76%	-4.60%	-16.37%	-14.02%
New Zealand dollar	-1.66%	-0.23%	-9.27%	-6.19%
Indian rupee	0.40%	-0.60%	-3.97%	-0.03%
Brazilian real	-0.89%	-3.12%	-12.61%	-8.96%
Mexican peso	-2.99%	-5.46%	-10.39%	-8.84%
Chilean peso	-0.59%	-3.66%	-9.84%	-13.41%
Colombian peso	-4.34%	-10.48%	-18.39%	-16.31%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.50%	-1.34%	-2.33%	-2.61%

The Latin American index continues to struggle under the weight of falling physical commodity prices and rising internal corruption. The latter point is more devastating than realized commonly. Only the North American index, buoyed by a stronger USD, is holding on to gains.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.03%	2.10%	1.78%	11.46%
North America	0.20%	2.57%	6.97%	17.53%
Latin America	-4.96%	-6.99%	-11.05%	-7.05%
Emerging Market Free	-1.88%	-1.21%	-3.24%	1.46%
EAFE	-0.40%	1.33%	-5.65%	2.82%
Pacific	-0.52%	-1.58%	-2.09%	1.14%
Eurozone	-0.44%	4.73%	-8.32%	3.26%

Even though some high-profile CTAs have struggled of late, their broad index performance is quite strong. Hedge fund performance remains a different story, which suggests too many traders have tried trading simple markets with complex strategies. Why be too clever for your own good?

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.27%	5.47%	21.03%	19.31%
Newedge Trend	0.78%	4.67%	14.13%	15.04%
Newedge Short-Term	0.25%	2.31%	8.40%	11.19%
HFR Global Hedge Fund	-0.59%	0.21%	-1.36%	0.64%
HFR Macro/CTA	0.37%	1.57%	5.93%	5.22%
HFR Macro: Sytematic Diversified CTA	0.28%	2.37%	5.92%	2.93%