January 5, 2012

S&P CTI Sector Overview for December

Energy – The S&P CTI was long the Energy sector for the month of December. Crude Oil and its products followed a pattern which nearly matched that of the S&P 500 futures: lower during the first half of December, then a recovery in the second half but not a complete retracement. The market seems to be generally shaking off Iranian threats to close the Strait of Hormuz. In the meantime, ample supplies kept Natural Gas on a slow and steady decline, with the March contract breaking in the "2" handle at the end of the month. We believe that further ECU debt issues, domestic economic data, inventory levels, developments with Iran, stockpile levels, and the direction of the U.S. Dollar are the most important factors in the Energy markets. The sector is now flat for January.

Industrial Metals – The S&P CTI was short the Industrial Metals sector for December. Copper also followed a pattern very close to that of the equity markets, although the rally during the second half was less powerful. Questions about global demand and the state of the Chinese economy remain. We believe that Chinese demand, U.S. economic data, the direction of the U.S. Dollar and the state of the housing market remain the major factors in the Industrial Metals markets. The sector remains short for January.

Precious Metals – The S&P CTI was short the Precious Metals sector for December. With the stronger U.S. Dollar and subsiding fears of imminent collapse in Europe, Gold and Silver were both lower for the month. Late in December both Gold and Silver bounced off of their respective September lows, which have the possibility of being a sign of a change in trend. We believe that any new global economic developments, developments with Iran, equity prices, the European debt crisis, and the direction of the U.S. Dollar are the major factors influencing the Precious Metals markets. The sector remains short for January.

Grains – The S&P CTI was short the Grains sector for December. Wheat, Corn, and Soybeans all staged a rally in the second half of the month, finishing December higher but not significantly so. The stronger U.S. Dollar kept a lid on exports, and crops are developing at a moderate rate. Some cold weather lent support to prices, and after three months of trading across the page prices may be stabilizing in preparation for a more powerful move. We believe that acreage or planting news, weather concerns, economic data, and the direction of the U.S. Dollar are the major factors in the Grains markets. The sector remains short for January.

Livestock – The S&P CTI was long the Livestock sector for December. Like many other commodities, Cattle followed the down-and-up pattern of December, although both the decline and the rally were sharper than many products experienced. Concerns over the cold mid-December weather supported prices. Hogs, on the other hand, saw slowing demand and weak exports, pushing prices down to levels not seen since May. We believe that domestic and global demand, herd sizes, the direction of the U.S. Dollar, and any weather issues will be the main influences on the Livestock markets. The sector is now short for January.

Softs – Softs were mixed for December. Sugar finished the month almost unchanged, with no major moves and a lack of news (we were short for December and remain short for January). Coffee also saw little meaningful news, and followed the typical down-and-up pattern of many commodities, finishing slightly lower (we were short for December and remain short for January). After a nine-month downtrend, Cocoa may have finally found a short-term bottom on December 12th, and finished December only slightly lower (we were short for December and remain short for January). Cotton similarly followed the down-and-up pattern, and finished December near unchanged as well (we were short for December and remain short for January). In summary, we remain short Cocoa, Cotton, Sugar and Coffee for January.

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Opinion, News Interpretation and Outlook

2011 was a year that was more difficult than any year I can remember. It was a rare paradox: volatile markets which still managed to trend sideways. The forces driving those markets have shed much of their historical patterns and correlations. For example, there seems to have been a complete disconnect between GDP and corporate earnings. At the beginning of 2011, the consensus projection for U.S. GDP was +3.4%, and globally +4.7%. U.S. GDP is now predicted to be +1.8%, and global GDP is now estimated at +3.8%. Meanwhile, earnings for the S&P 500 were originally projected to be $94 a share, but those estimates have been raised closer to $97. Lower GDP but higher earnings; this is not the normal state of affairs. By way of further example, the commodity markets, of late, are highly correlated to both GDP and the equity markets. The Dow Jones UBS Commodity Index (DJUBS CI) has a correlation to the S&P 500 from June 2008 of 87% (based on rolling 12-month periods). Meanwhile, the S&P 500 has outperformed the DJUBS CI by a big margin since June 2008: the S&P 500 has lost -1.06% while the DJ UBS CI TR has declined -10.05%.

So what happened to the markets in 2011?

- The S&P 500 was unchanged for the year, while most other U.S. equity indexes were down (the Dow Jones Industrial Average being the major exception).
- The Dow Jones Global ex-U.S. Index in Dollar terms was down -16.3% for the year.
- Commodity markets were down[1] for the year.
- Ten-Year U.S. Treasury Notes ended the year with a yield of 1.88%, and Thirty-Year Treasury Bonds finished the year with a yield of 2.89%, after starting the year at yields of 3.30% and 4.45% respectively. Reflecting these falling yields and rising bond prices, the Ibbotson Long-Term Government Bond index was up an estimated 26.7%!
- Inflation in the U.S. was projected to be only +0.5 (as measured by the core CPI) and came in at +1.7.

In summary, inflation was worse than expected, equity markets were generally down, and commodity markets did poorly, while the bond markets performed the best by far. Corporate earnings did better than expected, but the equity markets still performed poorly overall. GDP was weaker, but the S&P 500 did well by breaking even. 2011 was a year where it appears nearly every market or asset class performed in its own private universe, unaffected by the rest of the financial world (or at least not affected as it historically had been).

Outlook for 2012:

2012 looks like it will experience a weak first half economically, and the second half depends on whether President Obama is re-elected or not. Another term for the current President would likely include the lapsing of the "Bush tax cuts," and such an event would in my view lead to a depression. The precedent to this is 1931, the worst year for all markets in U.S. history. The keys to the second half of 2012 are the poll results between the two candidates as the election draws closer. If the Republicans win (or the polls suggest as much), I believe the U.S. stock and commodity markets will boom while bonds should decline (or even crash). I believe the markets will decline until the April 24th and 25th FOMC meeting, after which I expect the U.S. Federal Reserve will announce “QE3.” It is unlikely such a program would do anything visible to help GDP or unemployment, but that won’t stop “Helicopter Ben” from giving it a whirl.

I do find it interesting that world commodity and FX markets are nearly all in downtrends coming into the New Year. U.S. GDP is now estimated to come out at +3.0% or better in the 4th quarter, but the downtrends may be signaling a weaker outcome than predicted, as has been the case with GDP growth and unemployment rates since the President was elected. In all, this is not new, for equity markets are still thought to be in a bear market by this writer since August 2011, which almost always portends a recession.

The gold market is currently reflecting a recession in Europe. The ECB found a way to print money by making an end-around its own rules. However, this liquidity (i.e. loans) will not solve the debt problems nor help sustain growth. All it really does is “kick

[1] Using the DJUBS CI TR as a proxy, which was minus -13.37%

the can down the road" a bit longer. It is my strong view that the Euro cannot survive given the mentality of the leaders in Europe today.

What this means has to be boiled down to the nitty-gritty:

The S&P 500 is doing comparatively well because corporate earnings are at all-time highs while the percentage of taxes those corporations pay is at an 11-year low. Profits as a share of GDP are coming in at 14.7% of GDP in 2011, but taxes are estimated to be only $181.1 billion (or 1.2% of GDP)…yet in 2000 those same corporations paid $214 billion!

The equity markets have been very adept at doing well in spite of all the economic problems. Obviously, campaign cash continues to earn the corporate world government favors and pseudo-partnerships with the world's central banks. In this regard, I believe that exposure to the equity and commodity markets will provide the greatest potential for later in 2012, assuming a change in political power in the U.S.

In my view, the major apparent risks of the coming year remain the end of the Euro or the partial break-up of the European Union, oil prices shooting towards $200 due to heightened tensions with Iran, and another recession in the US.

In the end, inflation has to occur. The only real question is when, and the answer remains when the central banks start printing in earnest. Good luck in 2012!

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