The Macro Environment For Financial Markets

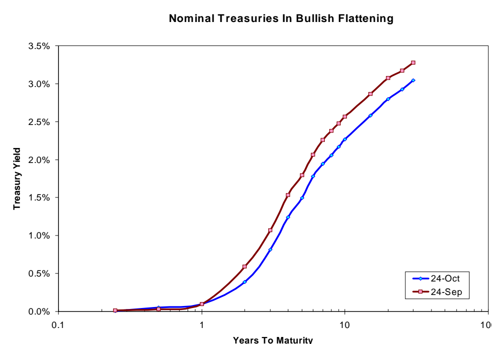
Collective hysteria is not a pretty sight to behold, is it? If we did a checklist of conditions dominating during the low-volatility environment prevailing just two months ago and asked, "What changed?" between early September and now, the answers would have to be, "Nothing of substance, and a few things of perception all of which were retracted quickly by officials who found themselves in the kitchen and unable to stand the heat, apologies to Harry Truman." To review, we were in an environment where monetary policy must remain overly loose, where the real returns on safety are negative, where the only source of positive returns involves risky financial assets and where policymakers are beholden to the owners of those risky assets. Otherwise, the whole fiction collapses. The need for financial speculation to support public-purpose activities is so great we will undertake, willingly and with eyes wide open, a reprise of the housing-finance bubble whose bursting led us into our actual new world order. This does not even include the need for the European Central Bank to up the ante and start financial corporate borrowers directly as negative nominal sovereign bond yields have not been stimulative. The meek may or may not inherit the earth, but they most certainly will be left on sidelines as this party unfolds.

The causal chain is now:

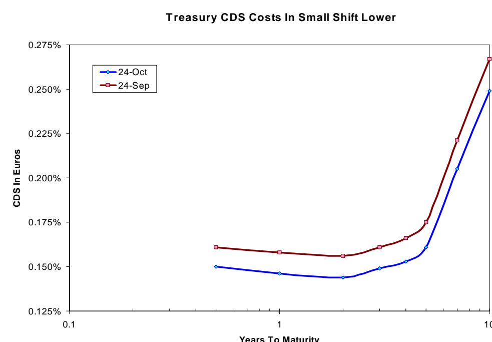
1. Short-term interest rates will remain artificially low and expectations for higher future short-term rates remain on hold;
2. Real rates will remain elevated at the short end of the yield curve and will struggle to move lower at the long end of the yield curve until LT nominal rates resume their decline;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will retrace some of their decline but remain in a secular bull market;
5. The U.S. yield curve should oscillate near its current historically steep levels;
6. Short-term borrowers will continue to accept rollover risk;
7. Swap spreads are in a stable and inverting configuration and do not yet present an impediment to corporate bonds; and
8. Credit spreads swings will remain exaggerated as CDS have moved away from their original function to being the tool for corporate bond synthesis.

Key Market Indications

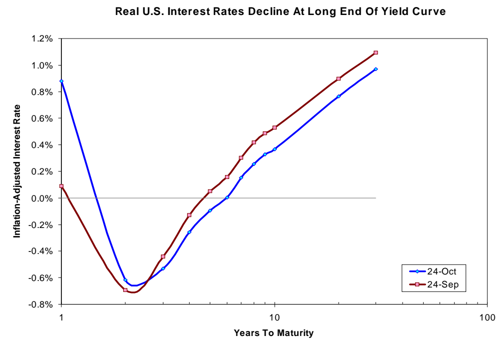
The ten-year UST remains on-track to sell off to the 2.39% level, but the bull market in Treasuries remains intact. With slower growth, a declining U.S. deficit, a possible carry trade into the USD, deflationary pressures and near-zero ST rates, how could it be otherwise? As expectations for higher ST rates have been put on hold for either the foreseeable or until the next FOMC member speaks off-script, whichever comes first, the yield curve will shift about as a direct function of longer-term rates and little else.



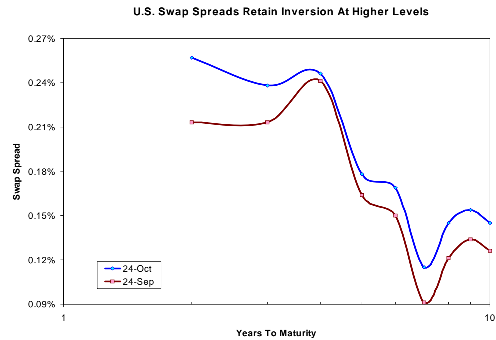
Euro-denominated CDS costs on Treasuries are shifting about within a small range. The U.S. fiscal situation is one of the lowest areas of concern for global markets at present.



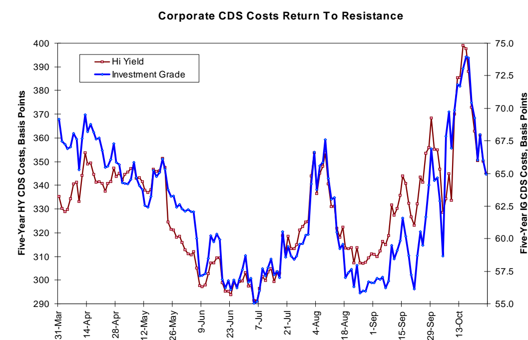
Real rates remain higher at the short end of the yield curve and lower at the long end. The decline at the long end of the yield curve will have to proceed further to maintain the attractiveness of risky financial assets; that will necessitate either a decline in nominal LT rates or an increase in LT inflation expectations or both. The increase in ST implied real rates will remain intact with lower ST inflation expectations and will continue to pressure precious metals.



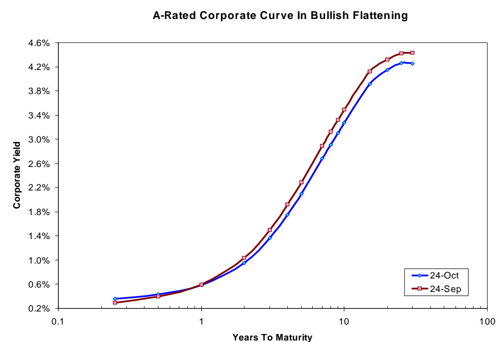
Swap spreads, which rise when floating-rate borrowers want to fix their payments, are increasingly inverted as floating-rate borrowers are trying to fix short-dated and mid-curve payments but are willing to remain floating at the long end of the yield curve. This inversion at historically low levels will maintain both the carry trade inflow into U.S. assets and lower LT corporate bond yields.



The good news is both IG and HY CDS levels pulled back to their first resistance levels and remain very low by historic standards. The bad news is their recent behavior underscored how de-linked these instruments have become from actual default risk and how their rise forced writers to sell stock in correlation trades. The end result of poorly conceived financial over-regulation has been an illiquid and derivative corporate bond market where the CDS tail wags both the corporate bond and increasingly the stock dog. None of this is physically possible, mind you.



The A-rated yield curve flattened bullishly along with the Treasury curve. This flattening continues to lag that of the UST curve as much of the Treasury rally even as swap spreads remain tame and credit spreads have started to decline once again. However, less-bullish is bullish nevertheless and the longer-term trend of declining corporate debt costs will continue to support risky assets.



Market Structure

Large intraday ranges and swift reversals have collapsed most markets into sideways structures. Only Natural Gas is in a structural downtrend amongst physical markets and none of the financial indices are in a defined trending structure.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For Oct. 27 - 31
BBerg	4	Sideways	-0.044	7.4%	
BBerg Grain	17	Transitional	0.116	19.6%	
BBerg Ind. Metl	12	Transitional	-0.032	14.9%	
BBerg Pre. Metl	14	Transitional	-0.017	13.1%	
BBerg Softs	28	Trending	-0.093	21.0%	
BBerg Nat. Gas	29	Trending	-0.319	21.6%	-0.27%
BBerg Petroleum	5	Sideways	0.008	19.9%	
BBerg Livestock	21	Trending	-0.022	13.4%	
Dollar Index	13	Transitional	0.037	8.8%	
S&P 500 Index	29	Trending	0.059	13.7%	
EAFE Index	7	Sideways	0.085	14.9%	
EM Index	5	Sideways	0.013	8.5%	
Ten-year UST (price)	7	Sideways	-0.043	9.5%	

Performance Measures

I noted last week buyers' fixing of prices in Grains would support those markets until the Southern Hemisphere growing season began. The one-day feint in crude oil arrested the Petroleum index' decline, but Natural Gas is facing decimation unless rescued by a reprise of last winter. The downturn in nickel put the economically important Industrial Materials index lower, but this is not confirmed by the larger markets for copper and aluminum.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.74%	-2.18%	-15.54%	-8.54%
Grains Sub-Index	1.30%	8.27%	-28.58%	-21.04%
Corn	1.44%	9.29%	-32.75%	-25.51%
Soybeans	2.45%	7.08%	-22.73%	-7.66%
Wheat	0.34%	9.17%	-30.40%	-30.57%
Energy Sub-Index	-1.77%	-11.25%	-20.09%	-9.89%
Petroleum Sub-Index	-0.66%	-11.72%	-18.38%	-14.09%
WTI	-1.00%	-12.43%	-15.63%	-11.37%
ULSD	-0.78%	-8.85%	-17.97%	-14.51%
Gasoline	-0.63%	-12.54%	-20.77%	-12.28%
Natural Gas	-4.15%	-10.07%	-24.03%	-1.86%
Precious Metals Sub-Index	-0.65%	0.53%	-7.42%	-13.38%
Gold	-0.58%	1.35%	-5.42%	-9.14%
Silver	-0.86%	-2.02%	-13.32%	-24.96%
Industrial Metals Sub-Index	-0.10%	-1.49%	-1.82%	-1.70%
Copper	1.25%	0.18%	-2.04%	-7.10%
Aluminum	-0.10%	0.95%	3.63%	-2.44%
Nickel	-4.38%	-11.72%	-19.37%	1.37%
Zinc	0.39%	-0.52%	8.35%	12.73%
Softs Sub-Index	-4.48%	2.36%	-20.06%	-4.32%
Coffee	-9.09%	2.93%	-10.95%	59.89%
Sugar	-1.44%	-1.09%	-24.34%	-32.77%
Cotton	1.29%	3.10%	-24.62%	-13.97%
Livestock Sub-Index	0.63%	0.38%	2.35%	13.21%
Cattle	1.12%	2.96%	17.86%	25.62%
Hogs	-0.36%	-4.47%	-17.41%	-4.26%

I noted last week the USD would advance against an array of emerging market currencies until the current risk-off period ended and a more stable hierarchy of short-term interest rates expectations was reestablished. This process is unfolding. Of note is how higher-yielding commodity-linked currencies such as the CAD and AUD have advanced in the face of declining physical commodity prices and allegedly slower industrial materials demand. The BRL is an election-linked exception here.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.71%	-0.85%	-8.39%	-8.19%
Chinese yuan	0.14%	0.29%	2.19%	-0.57%
Japanese yen	-1.18%	0.81%	-5.40%	-10.06%
British pound	-0.02%	-1.53%	-4.24%	-0.69%
Swiss franc	-0.59%	-0.67%	-7.39%	-6.26%
Canadian dollar	0.41%	-1.54%	-1.87%	-7.20%
Australian dollar	0.56%	-1.04%	-5.08%	-8.63%
Swedish krona	-1.01%	-0.99%	-9.35%	-12.40%
Norwegian krone	-0.80%	-3.13%	-9.05%	-10.69%
New Zealand dollar	-0.86%	-2.76%	-8.32%	-6.00%
Indian rupee	0.23%	-0.75%	-0.84%	0.60%
Brazilian real	-1.56%	-3.66%	-10.51%	-10.94%
Mexican peso	-0.26%	-2.09%	-3.41%	-4.37%
Chilean peso	0.38%	2.40%	-4.22%	-13.81%
Colombian peso	-0.08%	-2.75%	-6.18%	-8.93%
Bloomberg-JP Morgan Asian dollar index (spot)	0.15%	-0.34%	0.32%	-1.30%

The TINA argument – There Is No Alternative – remains a powerful one. The implied free put option supplied by central banks led to an unwinding of market hedges and forced those who had sold ever-greater quantities of stock at ever-lower prices to repurchase those shares and restore the value of the embedded long call option. The past month was much more of a market mechanics event than a macro event.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	3.39%	-3.07%	0.51%	6.35%
North America	4.03%	-1.78%	5.19%	13.44%
Latin America	-3.57%	-7.83%	-5.43%	-8.10%
Emerging Market Free	0.79%	-4.80%	-0.15%	-1.83%
EAFE	2.39%	-5.06%	-6.14%	-3.29%
Pacific	3.45%	-3.24%	0.12%	-3.53%
Eurozone	1.63%	-6.95%	-10.83%	-5.16%

CTA performance split along position-length lines with the trend-followers gaining and short-term traders losing over the week. Hedge funds demonstrated their dependence on equity markets once again with strong gains following this week's rebound.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.01%	1.53%	13.56%	10.80%
Newedge Trend	0.38%	1.01%	8.26%	8.47%
Newedge Short-Term	-0.83%	1.35%	4.84%	8.64%
HFR Global Hedge Fund	1.42%	-2.18%	-1.34%	0.48%
HFR Macro/CTA	0.84%	-0.26%	3.75%	2.03%
HFR Macro: Sytematic Diversified CTA	0.54%	0.19%	2.55%	0.53%