The Macro Environment For Financial Markets

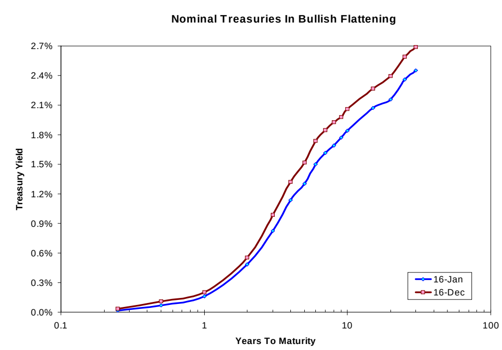
Central banks are to currencies as asteroids were to dinosaurs with the major difference the asteroids gave some visible warning. The Swiss National Bank managed to create a Möbius strip market where everyone on all sides appeared to be wrong simultaneously. As the best predictor of something happening is whether it happened before, all financial markets will have to build in greater insurance costs in terms of higher volatility. This will compound the liquidity and capital-charge problems created by post-crisis law and regulation. The result will be less-efficient capital markets and greater misallocation of resources. On the other side, the Federal Reserve's transparency campaign has created a series of instant capitalization to the extreme of its every utterance and a series of self-defeating prophecies, and let's not even start with the European Central Bank's two-year fan-dance about if and when it is going to succumb to the inevitable and buy bonds because we all know how onerous those 0.454% and 0.633% German and French ten-year yields have been. Buy bonds where you work; they do.

The causal chain is now:

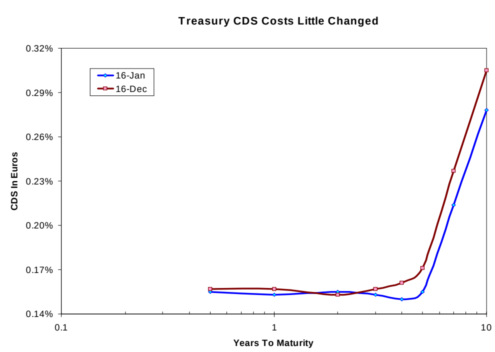
1. Short-term interest rates will remain artificially low globally;
2. Disinflationary pressures will remain so long as the global banking system remains unable to expand credit;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally and continue to pressure U.S. long-term yields lower;
5. The U.S. yield will retain a bias toward a bullish flattening;
6. Short-term borrowers will continue to accept rollover risk;
7. Swap spreads continue their inversion as the market continues to accept long-term duration risk; and
8. Credit spreads will find declines difficult to achieve barring a new and unexpected round of monetary stimulus.

Key Market Indications

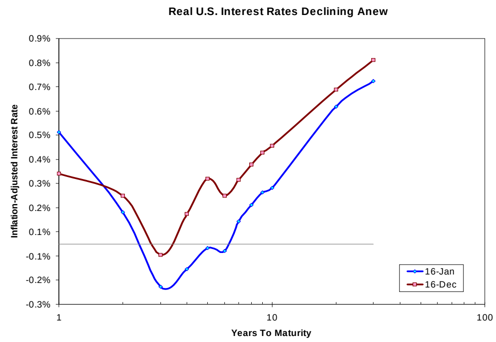
I asked two weeks ago why the USD was not stronger, and the implicit answer was potential changes in U.S. monetary policy created an embedded short call option on it. That same option explains why U.S. yields remain much higher than those for Eurozone or Japanese bonds: What good does it do to swap your EUR for USD to pick up yield only to have the Federal Reserve kneecap you with a weaker USD? Yes, I know the Treasury is responsible for the dollar, the Federal Reserve is independent and the check is in the mail.



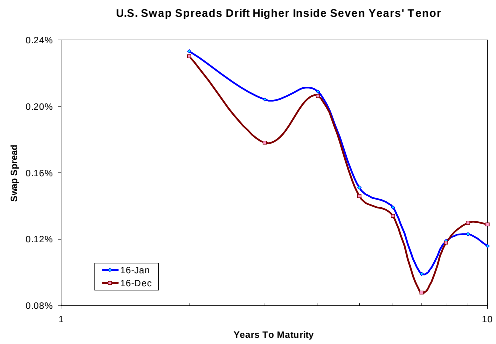
Euro-denominated CDS costs remain low as the prospects for budget battles and government shutdowns recede. This market should remain somnolent well into 2015.



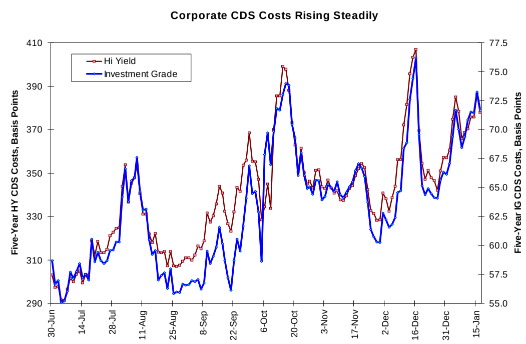
One-year implied real rates in the U.S. remain high, but the rest of the curve is falling and 3-7 year implied real rates are negative once again. These declining longer-term implied real rates are supportive for risky financial assets.



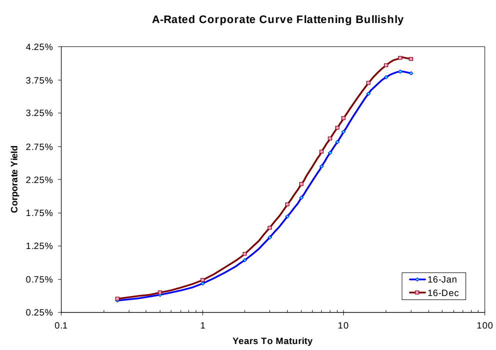
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue their small move higher, but the term structure remains strongly inverted. These long-term swap spreads do not constitute an impediment to either corporate bonds or, by extension, to equities.



Both the IG and HY CDS indices are continuing their small drift higher since the end of June. This is consistent with the rising recognition of credit risk as a percentage of yields in the corporate bond market even as higher interest rate risk is being accepted.



The A-rated yield flattened bullishly and finally stopped steepening relative to the UST yield curve. While nominally supportive for risky financial assets, we have to recognize this relative flattening as an artifact of lower two-year Treasury yields and nothing more.



Market Structure

Grains and Industrial Metals are in downtrends while Precious Metals remain in their uptrend. Within financial markets, ten-year UST remain in an uptrend while the EAFE is in a downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 19- 23
BBerg	29	Trending	-0.251	11.7%	-0.29%
BBerg Grain	29	Trending	-0.312	19.0%	-0.44%
BBerg Ind. Metl	29	Trending	-0.296	15.4%	-0.14%
BBerg Pre. Metl	29	Trending	0.345	17.2%	0.06%
BBerg Softs	4	Sideways	-0.012	18.3%	
BBerg Nat. Gas	8	Sideways	0.045	43.1%	
BBerg Petroleum	4	Sideways	0.036	50.7%	
BBerg Livestock	16	Transitional	-0.303	13.0%	
Dollar Index	5	Sideways	0.024	11.3%	
S&P 500 Index	21	Trending	-0.109	12.7%	
EAFE Index	29	Trending	-0.093	13.4%	-0.63%
EM Index	4	Sideways	-0.009	9.4%	
Ten-year UST (price)	29	Trending	0.278	7.1%	0.28%

Performance Measures

The bear market in the physical commodity indices remains intact. Precious Metals markets are benefiting from extremely negative real short-term rates and are in an upside breakout for EUR-domiciled investors. The IEA cut its global oil production forecast, but it remains to be seen whether state firms cut production and risk loss of market share. Shale oil not produced today can be produced quickly in the near future and act like an inventory overhang.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.30%	-4.92%	-20.09%	-17.44%
Grains Sub-Index	-4.53%	-8.13%	-5.71%	-12.76%
Corn	-3.31%	-5.72%	-2.31%	-15.88%
Soybeans	-5.75%	-4.50%	-9.94%	-10.08%
Wheat	-5.50%	-15.74%	-4.07%	-12.14%
Energy Sub-Index	1.12%	-13.98%	-43.55%	-40.92%
Petroleum Sub-Index	-0.54%	-15.45%	-50.13%	-46.75%
WTI	0.29%	-14.52%	-50.81%	-44.42%
ULSD	-1.94%	-13.96%	-41.96%	-43.00%
Gasoline	2.03%	-12.91%	-48.26%	-44.86%
Natural Gas	4.75%	-10.73%	-26.70%	-27.29%
Precious Metals Sub-Index	5.79%	7.75%	-5.99%	-2.27%
Gold	5.01%	6.77%	-2.65%	1.78%
Silver	8.11%	10.73%	-15.56%	-13.62%
Industrial Metals Sub-Index	-2.37%	-6.21%	-14.80%	-11.06%
Copper	-4.99%	-9.27%	-18.07%	-21.51%
Aluminum	2.15%	-3.35%	-8.96%	-4.12%
Nickel	-3.42%	-5.38%	-21.51%	-1.02%
Zinc	-2.60%	-3.89%	-9.54%	-1.50%
Softs Sub-Index	-0.51%	0.83%	-11.55%	-5.62%
Coffee	-5.03%	-2.12%	-5.25%	33.64%
Sugar	2.82%	2.34%	-21.99%	-21.33%
Cotton	-2.52%	-2.72%	-10.60%	-24.46%
Livestock Sub-Index	-3.72%	-4.61%	-11.85%	2.50%
Cattle	-3.93%	-3.63%	-2.44%	11.54%
Hogs	-3.33%	-6.89%	-26.94%	-11.50%

It will be important to remember the EUR does not have a free and clear path lower if and when the ECB engages in QE; it could invite asset inflows once the move is known for sure. Moreover, the JPY has shown repeatedly it can rise following aggressive BOJ actions. Finally, what appeared to be a certainty of higher short-term interest rates in the U.S. seems to be worse than yesterday's news. The various EM currencies might be the gainers from this rearranging of expectations.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-2.32%	-7.55%	-14.48%	-15.07%
Chinese yuan	0.01%	-0.28%	-0.05%	-2.45%
Japanese yen	0.84%	-0.94%	-13.48%	-11.20%
British pound	-0.07%	-3.81%	-11.59%	-7.36%
Swiss franc	18.12%	11.79%	4.62%	5.37%
Canadian dollar	-0.98%	-2.98%	-10.37%	-8.80%
Australian dollar	0.23%	0.06%	-12.22%	-6.78%
Swedish krona	-0.40%	-5.72%	-15.61%	-20.18%
Norwegian krone	1.34%	-1.69%	-17.95%	-18.18%
New Zealand dollar	-0.59%	-0.09%	-10.58%	-6.76%
Indian rupee	0.73%	2.69%	-2.81%	-0.53%
Brazilian real	0.40%	4.44%	-15.21%	-9.95%
Mexican peso	0.31%	1.33%	-11.27%	-8.81%
Chilean peso	-2.13%	-1.24%	-10.86%	-15.13%
Colombian peso	2.07%	2.45%	-21.14%	-17.67%
Bloomberg-JP Morgan Asian dollar index (spot)	0.27%	0.11%	-2.49%	-2.24%

At the end of all bull (bear) markets investors have been trained not to sell (buy). If we were living in a free-market environment, it would be hard to argue for higher stock valuations, but we are not so the "there is no alternative" argument remains. However, negative ten-year Swiss rates tells us maybe there are alternatives.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.50%	1.31%	-3.41%	3.49%
North America	-1.23%	2.46%	1.59%	10.43%
Latin America	-0.63%	6.93%	-22.49%	-10.36%
Emerging Market Free	-0.40%	5.49%	-9.35%	1.13%
EAFE	0.73%	-0.54%	-10.70%	-6.29%
Pacific	-0.54%	1.26%	-7.45%	-2.84%
Eurozone	2.06%	-2.95%	-13.54%	-10.63%

Given the well-publicized losses in the FX space, the surprise in CTA performance was it was positive for the most part. This suggests a greater focus on the bear markets in physical commodities and the bull market in sovereign debt. Hedge fund performance deteriorated along with long equity positions. These two have been one and the same for months now.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.14%	6.40%	24.25%	27.15%
Newedge Trend	0.72%	4.81%	17.17%	20.12%
Newedge Short-Term	-0.09%	1.78%	8.87%	10.81%
HFR Global Hedge Fund	-0.63%	1.20%	-2.51%	-1.64%
HFR Macro/CTA	-0.73%	2.31%	6.89%	6.25%
HFR Macro: Sytematic Diversified CTA	-0.78%	3.20%	7.49%	5.12%