The Macro Environment For Financial Markets

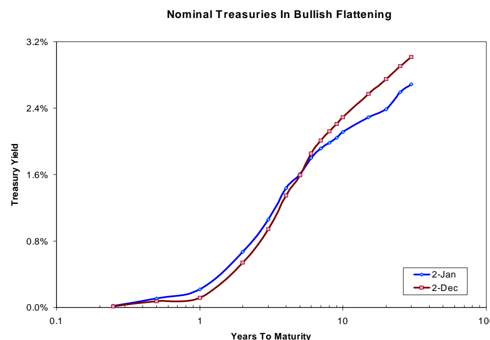
Now that the season of fearless forecasts and "top ten surprises for 2015" is behind us, let's remember the imperative of what is called an autoregressive process: The highest probability for tomorrow is today, plus-or-minus a drift term. If that drift term is biased directionally, the trend will remain your friend as it most certainly is mine. Those drift terms have been discounted into prices already by efficient markets; ergo, the only things of significance that will happen are the ones produced by events. Yes, everything you need to know in life could be deduced from one of *The Three Stooges'* cream-pie fights. Until we find ourselves reaching for the napkins, let's chalk up a slow-growth, low-rate, strong-dollar, weak-commodity disinflationary environment aided and abetted by central banks and then deal with this base case's inevitable failure with a high ratio of equanimity to ululation. It will work.

The causal chain is now:

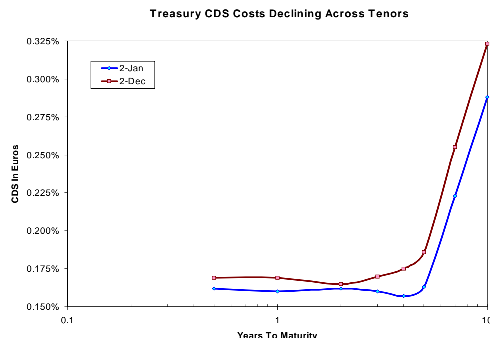
1. Short-term interest rates will remain artificially low globally;
2. Rising implied real rates will exacerbate disinflationary pressures;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally and continue to pressure U.S. long-term 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 and decline to lower levels, as the market continues to accept long-term duration risk; and
8. Credit spreads will find further declines difficult to achieve barring a new and unexpected round of monetary stimulus.

Key Market Indications

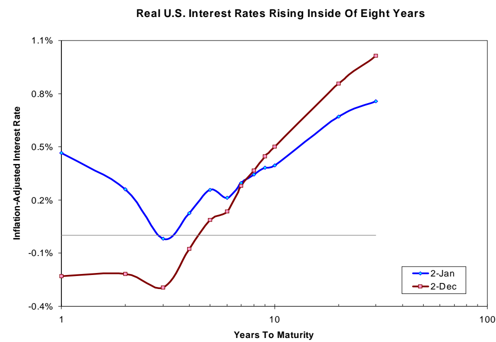
The Treasury yield curve remains at its flattest level since August 2009. The trend toward bullish flattening will continue to be driven by expectations of higher short-term rates in the U.S. and breathtakingly low rates elsewhere that make the U.S. look like a high-yield borrower. Five-year Bund rates are negative and you can lend to Japan or Switzerland for 33 and 37 basis points, respectively, if you think that is a smart thing to do.



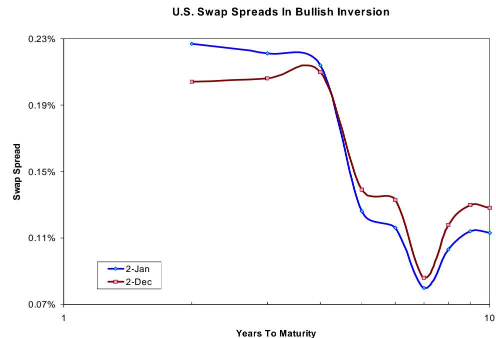
Euro-denominated CDS costs remain low as the prospects for budget battles and government shutdowns recede. This market should remain somnolent well into 2015.



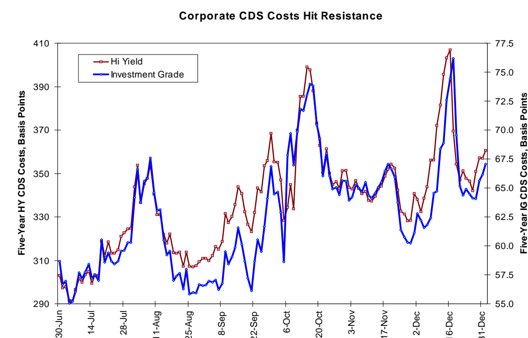
As short-dated inflation expectations remain low or even negative in the case of the one-year, implied real rates at the short end of the yield curve remain high and an impediment to the precious metals markets. Their constrained behavior at the long end of the yield curve is not yet a headwind to risky financial assets.



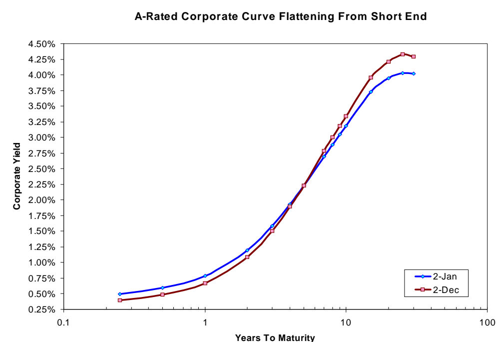
Swap spreads, which rise when floating-rate borrowers want to fix their payments, are inverting bullishly with greater demand to fix payments at the short end and a willingness to remain floating at the long end. The lower long-term swap spreads do not constitute an impediment to either corporate bonds or, by extension, to equities.



Both the IG and HY CDS indices advanced slightly, but nothing of significance was involved over holiday trading. Once we ignore the noise, the primary signal remains the small drift higher since the end of June.



The A-rated yield flattened bullishly but once again continues to steepen relative to the UST yield curve. This relative steepening actually is a headwind for risky financial assets but it is easy to overlook.



Market Structure

Only the EAFE index is in a structural downtrend amongst the financial markets, and both the main Bloomberg index and most of its major subindices are in structural downtrends as well. For all of the talk about rising volatility and thin trading, the physical markets seem rather convinced their primary direction is lower.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 5 - 9
BBerg	29	Trending	-0.483	11.6%	-0.15%
BBerg Grain	29	Trending	-0.102	18.3%	
BBerg Ind. Metl	29	Trending	-0.299	13.9%	-0.14%
BBerg Pre. Metl	29	Trending	-0.071	21.3%	-0.24%
BBerg Softs	29	Trending	-0.504	14.7%	-0.37%
BBerg Nat. Gas	29	Trending	-0.530	27.1%	-0.58%
BBerg Petroleum	9	Sideways	-0.113	30.9%	
BBerg Livestock	29	Trending	-0.018	12.7%	-0.18%
Dollar Index	17	Transitional	0.250	7.4%	
S&P 500 Index	20	Trending	0.022	11.5%	
EAFE Index	29	Trending	-0.215	9.9%	-0.63%
EM Index	4	Sideways	-0.032	7.0%	
Ten-year UST (price)	29	Trending	0.143	5.6%	

Performance Measures

The bear markets in the physical commodity indices remain intact; only the economically unimportant Livestock index had a strong week and Precious Metals had a small gain in thin trading. Commodity producers faced with excess capacity, revenue needs and slow demand growth have every incentive to maintain production to cover fixed costs. This downward pressure will not end soon barring some supply shocks or other events.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.17%	-7.43%	-22.61%	-16.82%
Grains Sub-Index	-3.38%	-1.61%	-9.42%	-9.85%
Corn	-2.94%	0.19%	-9.43%	-13.87%
Soybeans	-2.68%	-3.33%	-12.40%	-5.40%
Wheat	-4.95%	-2.14%	-3.87%	-10.82%
Energy Sub-Index	-4.51%	-19.12%	-43.54%	-38.11%
Petroleum Sub-Index	-5.54%	-18.21%	-46.93%	-41.73%
WTI	-5.53%	-19.84%	-47.63%	-39.63%
ULSD	-4.42%	-13.62%	-38.61%	-37.29%
Gasoline	-5.77%	-18.84%	-48.07%	-42.47%
Natural Gas	-2.50%	-20.80%	-35.91%	-29.74%
Precious Metals Sub-Index	0.92%	-0.97%	-14.42%	-9.38%
Gold	1.08%	-0.35%	-10.33%	-4.46%
Silver	0.37%	-3.01%	-25.88%	-22.91%
Industrial Metals Sub-Index	-1.15%	-5.68%	-12.76%	-6.22%
Copper	-1.26%	-2.93%	-14.34%	-15.76%
Aluminum	-1.64%	-7.98%	-7.69%	-2.56%
Nickel	-3.37%	-11.87%	-26.09%	5.44%
Zinc	2.23%	-1.67%	-2.60%	6.14%
Softs Sub-Index	-4.49%	-8.27%	-21.74%	-12.11%
Coffee	-5.35%	-10.57%	-10.45%	26.73%
Sugar	-4.00%	-6.40%	-31.30%	-31.18%
Cotton	-3.56%	-0.10%	-15.46%	-20.48%
Livestock Sub-Index	2.17%	-1.29%	-7.87%	11.13%
Cattle	3.18%	0.49%	2.49%	22.12%
Hogs	0.00%	-5.05%	-24.31%	-5.64%

To repeat from last week, the longer-term bull market for the USD remains very much intact. A reasonable question has to be why it has not been even stronger given rising incentives for reverse carry trades. The most likely answer is the market fears a dollar-weakening measure past a point and effectively has embedded a short call option into long USD positions.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.49%	-3.08%	-12.14%	-12.21%
Chinese yuan	0.09%	-0.93%	0.04%	-2.53%
Japanese yen	-0.16%	-1.07%	-15.54%	-13.02%
British pound	-1.48%	-1.98%	-10.71%	-6.84%
Swiss franc	-1.42%	-2.96%	-11.27%	-10.25%
Canadian dollar	-1.34%	-3.21%	-9.51%	-9.46%
Australian dollar	-0.39%	-4.22%	-14.34%	-9.22%
Swedish krona	-0.98%	-5.15%	-15.47%	-17.85%
Norwegian krone	-1.63%	-7.39%	-18.66%	-18.77%
New Zealand dollar	-0.77%	-1.36%	-12.23%	-5.93%
Indian rupee	0.43%	-2.23%	-5.69%	-1.62%
Brazilian real	-0.93%	-4.64%	-17.47%	-11.37%
Mexican peso	-0.83%	-4.95%	-12.41%	-11.36%
Chilean peso	-0.89%	0.10%	-10.03%	-13.68%
Colombian peso	-0.28%	-3.26%	-21.77%	-18.25%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.10%	-1.01%	-3.33%	-3.06%

I asked last week whether equities should go down in the face of a firming U.S. economy, accommodative global monetary policies and poor alternatives and concluded they should not. That was damning with faint praise; the reality is upside prospects in the U.S. are constrained by valuation and elsewhere by the effects of the reverse carry trade into the U.S. But "not wildly bullish" is not bearish.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.39%	-1.66%	-2.01%	6.21%
North America	-1.31%	-0.30%	3.98%	13.50%
Latin America	-2.69%	-7.99%	-20.79%	-13.17%
Emerging Market Free	0.31%	-2.86%	-8.84%	-0.90%
EAFE	-1.52%	-3.84%	-10.62%	-4.11%
Pacific	-0.58%	-2.05%	-6.78%	-2.75%
Eurozone	-2.45%	-5.55%	-13.69%	-6.24%

A second short week with no reversals of significance produced gains for both CTAs and hedge funds. Of greater significance for the hedge fund world was its ability to avoid losing money during a down week for equities.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.65%	1.76%	19.99%	19.11%
Newedge Trend	0.59%	1.22%	13.94%	15.21%
Newedge Short-Term	0.09%	0.48%	7.99%	10.00%
HFR Global Hedge Fund	0.30%	-0.77%	-2.32%	-0.44%
HFR Macro/CTA	0.08%	0.20%	5.87%	5.12%
HFR Macro: Sytematic Diversified CTA	0.46%	0.85%	5.83%	2.72%