The Macro Environment For Financial Markets

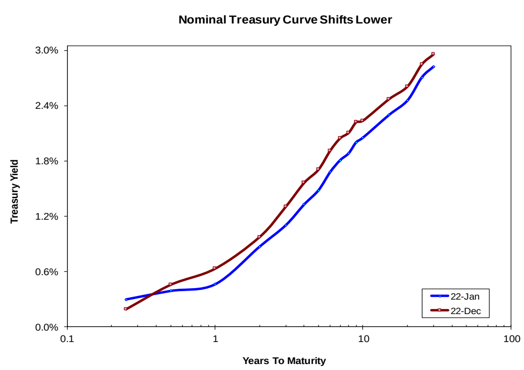
H.L. Mencken's observation, "There is always a well-known solution to every human problem – neat, plausible and wrong," has been violated so far in 2016. Incredibly, the linkage between crude oil prices and credit, equity and currency markets has been near-perfect over the short-run and has reduced markets to a single-factor exercise. To paraphrase George H.W. Bush, this will not stand. The world has emerged from previous crude oil price collapses before, and the pattern has been the same each time: A period of gradual rise followed by a sharper increase. The frictional costs of these misallocations of investment capital are large, but are not as large as the misallocations caused by years of near-zero interest rates and currency manipulations. Did I mention the European Central Bank wants to build on its self-proclaimed successes? Three-month Euribor and Euribor forward rates are now at record lows; this would not be the case if monetary stimulus was effective macroeconomically.

The causal chain now is:

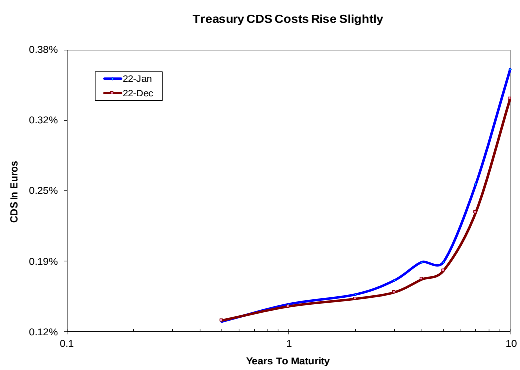
1. Higher short-term interest rates have arrived at last, but this appears to be a single move for the foreseeable future;
2. Disinflationary pressures will rise once again with rising risk-aversion;
3. Inflation expectations as measured by the TIPS market broke their recent lows; Eurozone inflation swaps are headed back to their January 2015 lows;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are terming-out their borrowing to reduce rollover risk;
6. Swap spreads will remain low; and
7. Credit spreads will continue to rise.

Key Market Indications

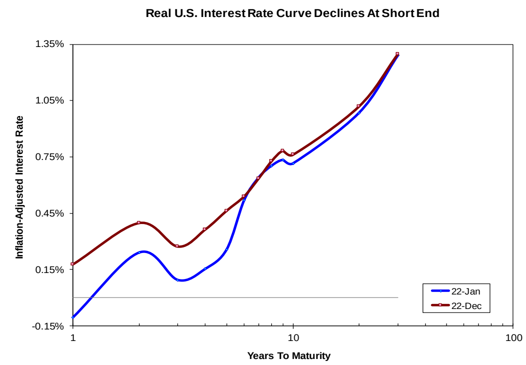
While the yield curve continues to flatten bullishly, the real surprise remains how cautious investors have been at longer maturities. If yield could not plummet over the past month, when will they? The long-term bull market in bonds remains intact, but anyone should be concerned the market is not reacting better to bullish news.



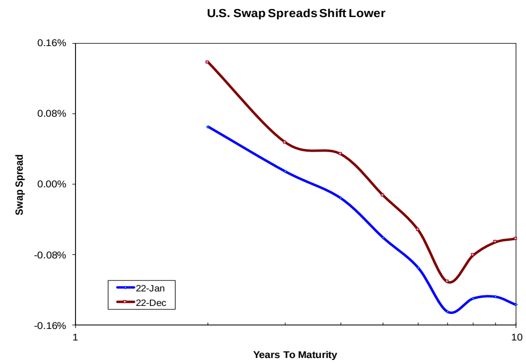
The CDS market for Treasuries has shifted higher, but not significantly so, as nothing yet is signaling a worsening of the federal fiscal outlook.



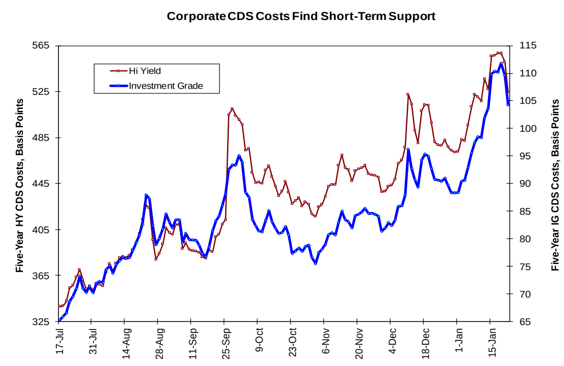
The pseudo-real rate curve shifted lower inside of ten years over the past month, with short-term implied real rates declining faster than their long-term counterparts. This decline in implied real yields at the short end is supportive for gold, but only until such time as massive risk-aversion dissipates.



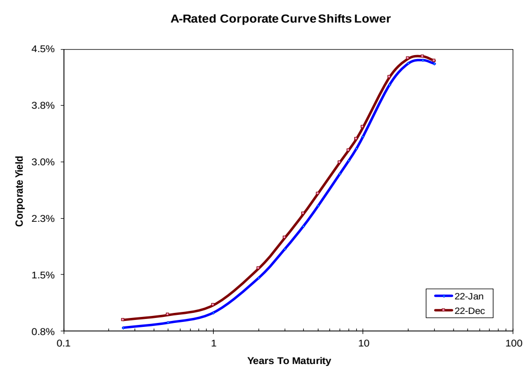
Swap spreads, which rise when floating-rate borrowers want to fix their payments, fell once again as the risk-off shocks in financial markets once again led to expectations for tame moves in interest rates. Swap spreads are now negative for tenors of four years and longer.



CDS costs for both the investment-grade and high-yield indices finally hit a support point on Wednesday. The overall trend remains higher; even if crude oil prices stabilize and rebound slightly, credit stresses in the energy and basic materials sectors have increased to the point where multiple bankruptcies are inevitable.



The A-rated yield curve continues to shift lower. The inability of longer-term investment-grade rates to rise is one of the few pieces of good news for risky financial assets so far in 2016.



Market Structure

Precious Metals remained in a structural uptrend while all other physical commodities were either in a downtrend or in a volatile transitional structure. Within financials, the global equity indices remain in structural downtrends while ten-year UST and the dollar index remain in uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 25 - 20
BBerg	23	Trending	-0.116	12.1%	-0.25%
BBerg Grain	29	Trending	0.019	14.9%	
BBerg Ind. Metl	28	Trending	-0.092	16.7%	-0.84%
BBerg Pre. Metl	22	Trending	0.074	11.9%	0.49%
BBerg Softs	29	Trending	-0.087	16.9%	-0.12%
BBerg Nat. Gas	22	Trending	-0.055	31.2%	
BBerg Petroleum	19	Transitional	-0.120	41.2%	
BBerg Livestock	28	Trending	0.089	13.5%	0.09%
Dollar Index	29	Trending	0.136	7.4%	0.03%
S&P 500 Index	6	Sideways	0.038	28.2%	
EAFE Index	29	Trending	-0.332	15.8%	-0.05%
EM Index	25	Trending	-0.457	14.5%	-1.01%
Ten-year UST (price)	29	Trending	0.159	6.2%	0.16%

Performance Measures

Did this past week's action signal the end of a hyperbolic decline in crude oil? Well, let's note the Bloomberg three-month forward petroleum index noted here rose 11.22% in two days, and if that sort of rebound does not signal price below value, what does? Of perhaps equal importance was the stabilization in Industrial Metals. We may be in a slow-growth period with slack production capacity in many markets, but once physical commodity prices retreat to levels where non-state producers start exiting the business, supply overhangs shrink, inventories come out of storage and markets renormalize.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.91%	-2.49%	-21.02%	-25.89%
Grains Sub-Index	1.53%	0.25%	-12.26%	-12.99%
Corn	3.43%	1.11%	-12.68%	-13.74%
Soybeans	-0.65%	-1.00%	-12.66%	-9.26%
Wheat	1.45%	0.82%	-9.40%	-13.03%
Energy Sub-Index	0.58%	-7.14%	-42.16%	-41.14%
Petroleum Sub-Index	1.49%	-12.08%	-42.89%	-40.39%
WTI	0.25%	-13.12%	-42.93%	-45.57%
Brent	3.14%	-13.16%	-47.75%	-44.90%
ULSD	0.99%	-12.27%	-45.50%	-43.43%
Gasoline	1.07%	-8.60%	-31.38%	-17.34%
Natural Gas	-1.78%	5.28%	-41.30%	-44.25%
Precious Metals Sub-Index	2.15%	1.07%	-1.12%	-18.39%
Gold	2.11%	2.06%	0.30%	-16.12%
Silver	2.25%	-1.78%	-5.12%	-24.47%
Industrial Metals Sub-Index	0.76%	-2.75%	-18.25%	-27.05%
Copper	1.35%	-5.03%	-18.09%	-23.04%
Aluminum	-0.08%	-1.72%	-12.61%	-24.87%
Nickel	1.45%	0.65%	-24.63%	-42.23%
Zinc	-0.03%	-0.56%	-25.73%	-31.37%
Softs Sub-Index	-1.34%	-3.13%	4.83%	-17.64%
Coffee	0.09%	-2.62%	-11.97%	-34.70%
Sugar	-3.09%	-4.10%	17.36%	-17.70%
Cotton	0.89%	-1.10%	-3.43%	6.04%
Livestock Sub-Index	1.45%	4.21%	-7.74%	-11.44%
Cattle	1.20%	0.27%	-12.29%	-11.58%
Hogs	1.81%	11.35%	0.48%	-11.21%

The ability of commodity-linked currencies such as the CAD, AUD, CLP and NOK to rise reflects the sense markets overshot to the downside. The USD's gains were against other majors, such as the EUR and JPY, where central banks are signaling a new round of easier credit. The Federal Reserve is likely to signal a pause in its rate-hike campaign to avoid an expanding policy divergence.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.10%	-1.47%	-1.22%	-5.02%
Chinese yuan	0.09%	-1.52%	-5.62%	-5.62%
Japanese yen	-1.52%	1.93%	4.37%	-0.24%
British pound	0.05%	-3.80%	-8.63%	-4.96%
Swiss franc	-1.47%	-2.85%	-5.52%	-14.25%
Canadian dollar	2.99%	-1.41%	-7.69%	-12.32%
Australian dollar	2.01%	-3.23%	-5.08%	-12.76%
Swedish krona	-0.03%	-1.87%	0.14%	-4.14%
Norwegian krone	1.11%	-0.38%	-6.85%	-12.39%
New Zealand dollar	0.46%	-4.60%	-1.20%	-13.46%
Indian rupee	-0.04%	-1.92%	-5.99%	-8.76%
Brazilian real	-1.09%	-2.56%	-21.27%	-37.11%
Mexican peso	-0.96%	-6.78%	-12.69%	-20.66%
Chilean peso	2.16%	-2.59%	-8.62%	-12.77%
Colombian peso	-0.21%	0.15%	-15.66%	-28.34%
Bloomberg-JP Morgan Asian dollar index (spot)	0.52%	-1.38%	-4.83%	-6.73%

Until and unless global growth rates rise and disinflationary pressures abate, the best equities can do is rise on a relative basis to a cap imposed by corporate bond yields. Otherwise, their embedded call options are not worth very much and their embedded put options are downright dangerous.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	1.06%	-6.76%	-12.08%	-7.91%
North America	1.58%	-6.56%	-9.96%	-7.08%
Latin America	-0.31%	-11.16%	-30.95%	-39.64%
Emerging Market Free	0.21%	-10.34%	-22.85%	-25.70%
EAFE	0.21%	-7.09%	-15.41%	-9.25%
Pacific	-2.12%	-8.60%	-14.81%	-7.65%
Eurozone	1.39%	-6.80%	-16.00%	-9.56%

CTAs managed their third consecutive week of gains, as did macro-oriented hedge funds. This performance differs markedly from that seen in August 2015, when both classes of trader failed at the time when they were supposed to shine.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	2.52%	5.42%	6.37%	4.03%
Newedge Trend	2.07%	5.68%	6.48%	3.80%
Newedge Short-Term	1.00%	4.32%	2.64%	-1.48%
HFR Global Hedge Fund	-0.98%	-2.67%	-8.40%	-6.15%
HFR Macro/CTA	0.45%	0.90%	-1.92%	-1.48%
HFR Macro: Sytematic Diversified CTA	1.80%	3.19%	2.78%	2.18%