The Macro Environment For Financial Markets

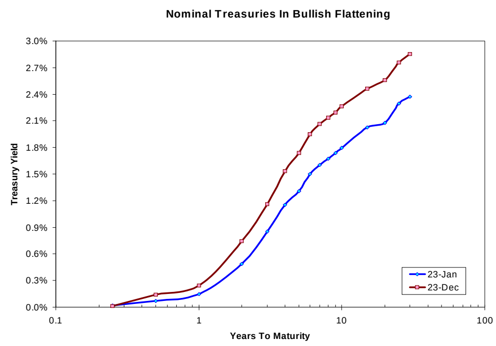
If politics is the art of the possible, then what is central banking? How are insurance firms and pension plans supposed to meet their long-term liabilities in a world of negative nominal interest rates; the present value of those liabilities increases? How is banking supposed to operate in a world where deposits create actual liabilities? How can we explain negative interbank rates other than to note it is cheaper to pay another commercial bank than to leave reserves on deposit at the central bank? What is the value of a call option with a negative "risk-free" rate? And how is everyone's currency supposed to go to zero simultaneously? Finally, why on earth would anyone consider a world where any asset yielding over 0% is overpriced and bad businesses are allowed to fester and contribute to economic slack to be "stimulated" by global QE Forever? The only answer at this point is the moment all of this stops we are all going to be exposed to the same sort of quantum rip seen in the Swiss franc market, so the path of least resistance is to keep the punchbowl full and *laissez les bon temps rouler*.

The causal chain is now:

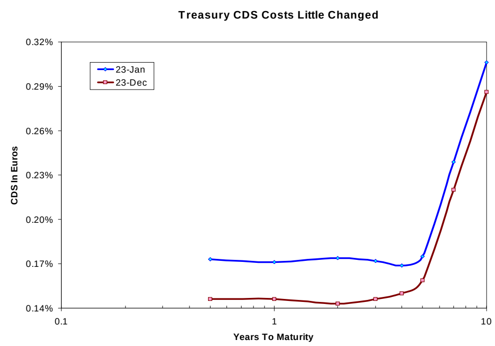
1. Short-term interest rates will remain artificially low globally;
2. Disinflationary pressures will remain so long as the global banking system remains unable to expand credit;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally 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

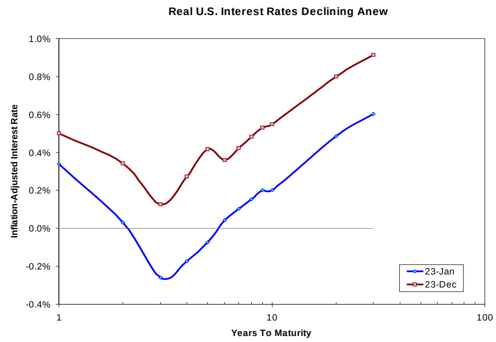
The U.S. Treasury market is getting to be high-yield in the G-20 sovereign debt world, and this reflects not only its high level of interest rate risk but the currency risk premium non-USD investors must pay to lend here. Still, the long-term trend toward a bullish flattening remains intact and the ten-year UST could rally to 1.55% easily from here.



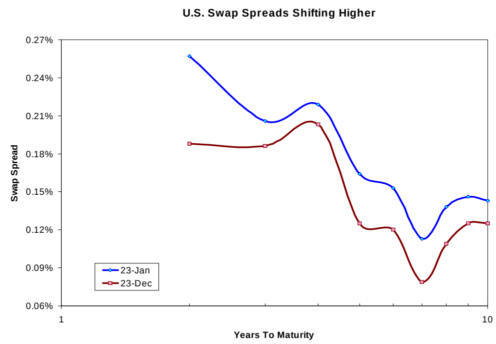
One of the odder aspects of this market is it is priced in euros on the charming theory that if the U.S. defaults the USD will be in trouble. Can anyone say without laughing the euro will be worth anything on the day the U.S. defaults on its debt?



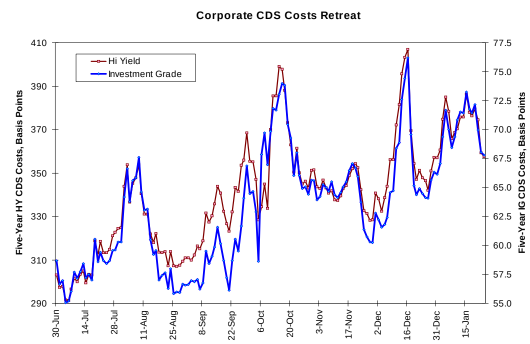
A small upturn in inflation expectations intersected with a decline in nominal UST yields to produce lower implied real rates once again. These declining longer-term implied real rates are supportive for risky financial assets.



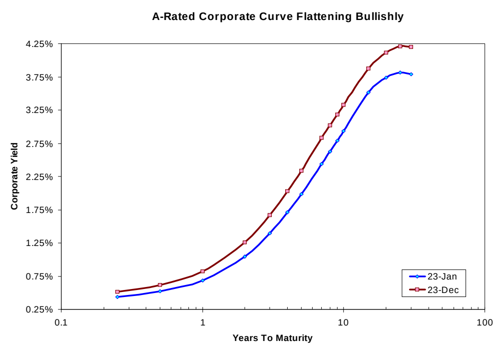
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue their small move higher, but the term structure remains strongly inverted. These long-term swap spreads do not constitute an impediment to either corporate bonds or, by extension, to equities. However, these rising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



Both the IG and HY CDS indices declined as the wave of interest rate cuts around the world raised the probability even poor business models could get refinanced if and when trouble is encountered. If these debt assumptions are part of a new wave of mergers, equities will rise as a result. It will be interesting to see how many non-energy firms decide to acquire struggling energy firms to produce America's next wave of ill-considered mergers and acquisitions.



The A-rated yield flattened bullishly but not as much as did the UST yield curve. An unenthusiastic rally is a rally nevertheless.



Market Structure

While the general bear markets in physical commodities, Precious Metals excepted, continues, they have moved into consolidation structures. The EAFE and EM indices have reversed into uptrends within the financials, but the S&P 500 has not.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 26- 30
BBerg	6	Sideways	-0.070	12.4%	
BBerg Grain	5	Sideways	-0.022	16.2%	
BBerg Ind. Metl	6	Sideways	-0.096	22.8%	
BBerg Pre. Metl	29	Trending	0.354	18.1%	0.06%
BBerg Softs	14	Transitional	-0.089	20.1%	
BBerg Nat. Gas	11	Transitional	0.002	42.9%	
BBerg Petroleum	6	Sideways	-0.038	31.1%	
BBerg Livestock	20	Trending	-0.522	14.2%	-0.74%
Dollar Index	8	Sideways	0.138	13.1%	
S&P 500 Index	21	Trending	0.036	13.6%	
EAFE Index	29	Trending	0.124	13.7%	0.35%
EM Index	20	Trending	0.355	9.3%	0.26%
Ten-year UST (price)	6	Sideways	0.037	7.6%	

Performance Measures

Will those who have persisted in the error of trying to explain physical commodity markets in terms of monetary policies and currencies finally admit they know not of where they speak? I doubt it. If excess cash and low rates drove prices higher, we certainly would not see the -21.69% decline in the main Bloomberg index over the past three months that is on the scoreboard, and if gold was a defense against dollar debasement and inflation we would not see its 9.74% rise over the past month.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.58%	-6.01%	-21.69%	-19.69%
Grains Sub-Index	-0.05%	-9.54%	-5.21%	-13.34%
Corn	1.78%	-6.58%	-0.02%	-16.91%
Soybeans	-1.84%	-6.98%	-10.95%	-9.07%
Wheat	-0.52%	-16.60%	-4.30%	-13.59%
Energy Sub-Index	-1.52%	-15.35%	-45.45%	-45.19%
Petroleum Sub-Index	0.11%	-19.14%	-52.47%	-49.73%
WTI	-2.44%	-20.68%	-54.87%	-49.87%
ULSD	1.73%	-15.73%	-43.07%	-44.23%
Gasoline	2.89%	-14.72%	-49.00%	-46.36%
Natural Gas	-5.22%	-7.45%	-26.43%	-35.20%
Precious Metals Sub-Index	3.46%	11.32%	-4.25%	-0.79%
Gold	2.20%	9.74%	-1.12%	2.19%
Silver	7.01%	16.07%	-13.40%	-9.63%
Industrial Metals Sub-Index	-0.22%	-7.58%	-18.29%	-11.58%
Copper	-2.21%	-12.72%	-22.23%	-23.63%
Aluminum	2.21%	-2.19%	-11.24%	-1.56%
Nickel	-0.88%	-7.26%	-25.37%	-3.74%
Zinc	1.53%	-3.35%	-12.52%	-0.03%
Softs Sub-Index	-3.59%	-0.97%	-16.32%	-6.33%
Coffee	-8.04%	-5.00%	-12.12%	29.11%
Sugar	-1.17%	2.30%	-22.76%	-21.22%
Cotton	-3.68%	-7.31%	-13.95%	-27.36%
Livestock Sub-Index	-5.36%	-9.62%	-16.65%	-3.74%
Cattle	-2.60%	-6.54%	-7.29%	7.51%
Hogs	-9.83%	-15.05%	-31.68%	-20.41%

Let's congratulate the INR, BRL and CLP for not declining against the USD. These are other minor currencies will be the beneficiaries of euro carry trade inflows. As dollar carry trades unwind, the USD will continue its advance regardless of whatever U.S. monetary policy will be in 2015.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-3.14%	-7.95%	-16.79%	-18.20%
Chinese yuan	-0.34%	-0.05%	-0.48%	-2.83%
Japanese yen	-0.22%	2.48%	-13.83%	-12.32%
British pound	-1.06%	-3.43%	-12.06%	-9.91%
Swiss franc	-2.43%	12.24%	2.51%	1.95%
Canadian dollar	-3.51%	-6.47%	-13.62%	-10.61%
Australian dollar	-3.78%	-2.38%	-16.33%	-9.76%
Swedish krona	-2.94%	-6.40%	-17.95%	-23.15%
Norwegian krone	-2.74%	-4.23%	-20.20%	-21.60%
New Zealand dollar	-4.36%	-3.36%	-14.38%	-10.26%
Indian rupee	0.71%	3.02%	-2.16%	0.81%
Brazilian real	1.63%	4.44%	-13.98%	-7.00%
Mexican peso	-0.68%	0.70%	-11.76%	-8.57%
Chilean peso	0.40%	-2.64%	-9.92%	-12.21%
Colombian peso	-0.90%	-1.89%	-22.71%	-16.42%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.24%	0.48%	-3.05%	-2.05%

If equities cannot compete successfully against negative-yielding bonds, the end is nigh. The emergence of the euro carry trade will replace the dollar and yen carry trades and will redound to the benefit of all but the rattiest emerging and frontier markets.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	1.96%	-0.84%	-1.68%	6.07%
North America	1.55%	-1.49%	2.75%	13.15%
Latin America	2.21%	-0.12%	-22.18%	-5.75%
Emerging Market Free	3.50%	4.32%	-7.16%	5.81%
EAFE	2.64%	0.24%	-8.17%	-3.83%
Pacific	2.16%	1.69%	-6.00%	-0.31%
Eurozone	3.25%	-1.57%	-9.88%	-7.33%

The one-way markets in currencies and Eurozone sovereign debt helped CTAs again, but the hedge fund industry is finding it increasingly difficult to gain in anything other than an equity bull market. In other words, they are acting like high-cost mutual funds.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.70%	4.20%	21.62%	24.80%
Newedge Trend	0.74%	3.97%	16.68%	19.83%
Newedge Short-Term	1.14%	1.61%	9.85%	12.25%
HFR Global Hedge Fund	0.41%	0.24%	-2.32%	-1.31%
HFR Macro/CTA	0.45%	1.38%	6.72%	6.68%
HFR Macro: Sytematic Diversified CTA	0.40%	2.06%	7.22%	4.93%