The Macro Environment For Financial Markets

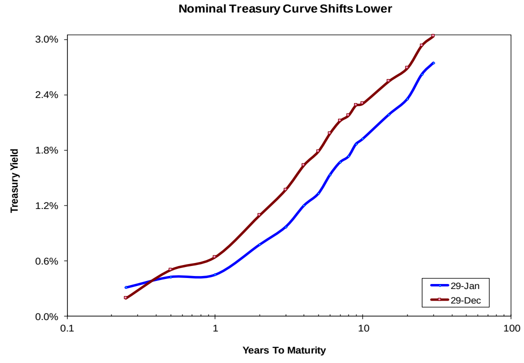
To borrow a page from various self-help programs, the first step toward the development of constructive policies is to define the objective. You might think that 30-35 years of slowing inflation, declining interest rates, a world tilting toward an aged demographic skew and much faster growth of productivity in non-labor factors of such as capital and technology would lead policymakers to conclude this is the natural state of affairs. You would be wrong, not about the environment but rather the policy response. Keeping interest rates slow maintains slack capacity and places downward pressure not only on price levels but on new investment. It also encourages negative interest rates, removes any governor on fiscal profligacy and enables rather grotesque accumulations of public debt. But when you are a hammer, all problems look like nails, and when you are a central bank all answers are more of the same that has yet to work.

The causal chain now is:

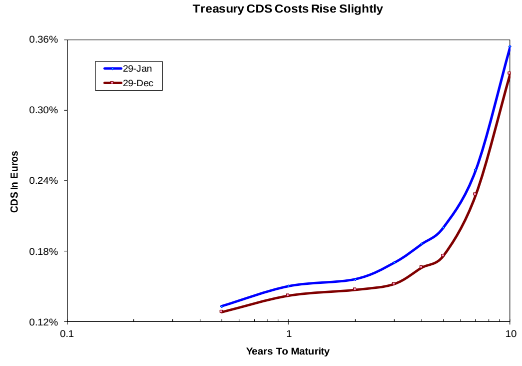
1. The market is pricing out higher short-term interest rates in the U.S. as policy rates are being driven lower globally;
2. Disinflationary pressures will persist;
3. Inflation expectations as measured by TIPS and inflation swaps will remain contained;
4. The U.S. yield curve retains its long-term bias toward flattening even though short-term rates are declining anew;
5. Short-term borrowers will stop terming-out their borrowing to reduce rollover risk;
6. Swap spreads will remain low; and
7. Credit spreads will remain biased toward increasing.

Key Market Indications

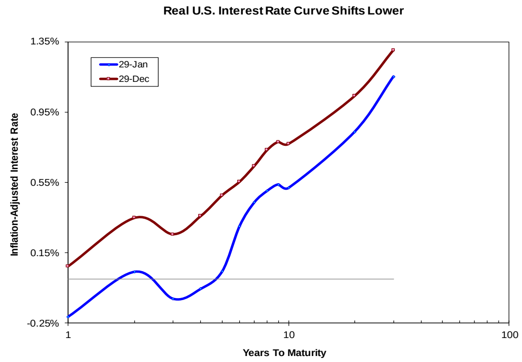
The Treasury market yields far more than is available in other major sovereign debt markets despite high levels of financial stress, low inflation, tepid economic growth and a growing but sure-to-be-changed consensus the Federal Reserve is on hold once again. It is as if UST buyers have a primal fear of buying the high, the near 35-year uptrend notwithstanding.



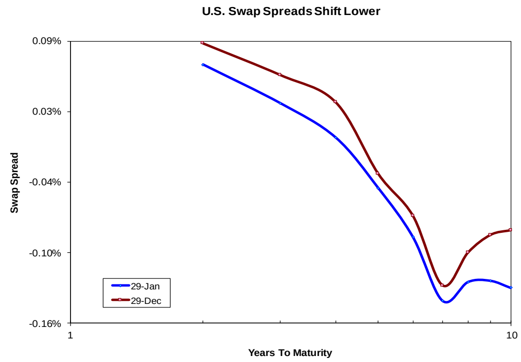
The CDS market for Treasuries has shifted higher, but not significantly so, as nothing yet is signaling a worsening of the federal fiscal outlook.



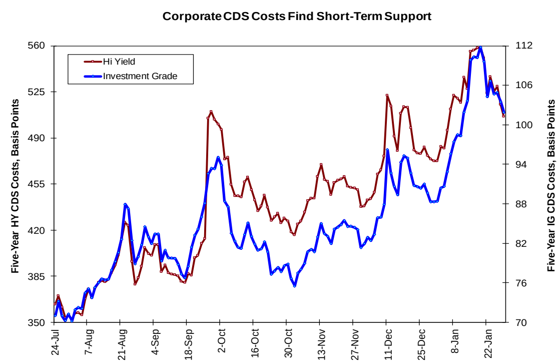
The pseudo-real rate curve shifted lower over the past month and is not significantly over zero until six years. The ongoing decline in implied real yields at the short end is supportive for gold, but only until such time as massive risk-aversion dissipates.



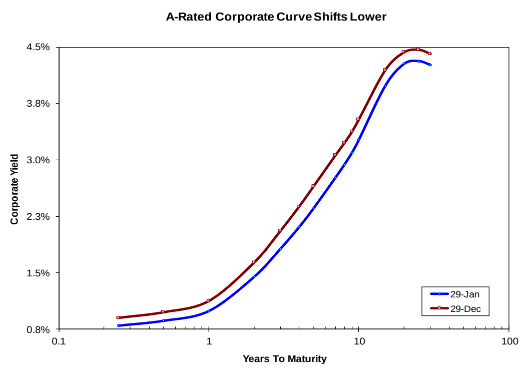
Swap spreads, which rise when floating-rate borrowers want to fix their payments, fell once again as markets seem to have no immediate fear of higher interest rates at any tenor. Swap spreads are remain negative for tenors of five years and longer.



CDS costs for both the investment-grade and high-yield continued their decline from the middle of the past week. 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 remains one of the few pieces of good news for risky financial assets so far in 2016.



Market Structure

Only the Softs remain in a structural downtrend amongst the physical markets; Grains and both Precious and Industrial Metals have moved into structural uptrends. Within the financials, the dollar index and ten-year UST remain in uptrends while equities have exited their downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Feb. 1 - 5
BBerg	25	Trending	0.106	13.3%	
BBerg Grain	29	Trending	0.089	14.4%	0.12%
BBerg Ind. Metl	29	Trending	0.088	16.4%	0.39%
BBerg Pre. Metl	29	Trending	0.183	12.2%	0.49%
BBerg Softs	29	Trending	-0.281	16.0%	-0.12%
BBerg Nat. Gas	24	Trending	-0.017	30.6%	
BBerg Petroleum	7	Sideways	0.108	62.6%	
BBerg Livestock	16	Transitional	0.108	11.3%	
Dollar Index	29	Trending	0.115	7.1%	0.03%
S&P 500 Index	8	Sideways	0.117	21.5%	
EAFE Index	6	Sideways	0.057	16.7%	
EM Index	8	Sideways	0.221	18.4%	
Ten-year UST (price)	29	Trending	0.274	6.1%	0.16%

Performance Measures

One of life's great mysteries has been how the downturn in crude oil endured for as long as it did without all of the rumors of OPEC-induced production cuts. Precious Metals have ended their long-running downtrend as well on the back of negative holding costs; this could be a fairly persistent move. The advance in Industrial Metals is a little more suspect given the uncertainties over actual Chinese demand growth.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.65%	-2.28%	-16.95%	-21.75%
Grains Sub-Index	0.58%	1.82%	-5.68%	-9.97%
Corn	0.48%	2.64%	-3.91%	-10.47%
Soybeans	0.66%	1.93%	-7.21%	-7.86%
Wheat	0.79%	0.76%	-4.91%	-7.85%
Energy Sub-Index	6.61%	-8.80%	-36.70%	-36.25%
Petroleum Sub-Index	6.33%	-11.05%	-37.41%	-36.18%
WTI	4.45%	-13.47%	-39.91%	-40.88%
Brent	9.72%	-8.84%	-40.30%	-40.05%
ULSD	7.06%	-8.76%	-38.99%	-39.22%
Gasoline	2.19%	-13.62%	-27.16%	-17.62%
Natural Gas	7.34%	-4.11%	-36.02%	-37.78%
Precious Metals Sub-Index	1.70%	3.95%	0.49%	-12.72%
Gold	1.84%	4.52%	2.07%	-11.46%
Silver	1.33%	2.28%	-3.94%	-16.23%
Industrial Metals Sub-Index	3.01%	-1.85%	-15.15%	-22.30%
Copper	3.23%	-3.23%	-14.72%	-16.44%
Aluminum	2.30%	-1.28%	-10.93%	-20.93%
Nickel	-1.02%	-1.57%	-23.90%	-42.99%
Zinc	7.57%	1.21%	-18.71%	-24.24%
Softs Sub-Index	-4.72%	-7.40%	0.39%	-19.02%
Coffee	0.31%	-4.18%	-9.61%	-34.53%
Sugar	-8.87%	-11.08%	6.20%	-19.65%
Cotton	-2.11%	-4.27%	-4.51%	0.65%
Livestock Sub-Index	1.41%	2.37%	-6.78%	-9.85%
Cattle	0.70%	-1.79%	-11.69%	-10.19%
Hogs	2.47%	9.65%	1.90%	-9.42%

Commodity-linked currencies such as the CAD, AUD, CLP and NOK continued their rise from last week. The Latin American currencies joined the rebound on rising interest rate carries from the EUR and JPY. Japan's move to negative interest rates means they are willing to see the JPY weaken, as if that will do any good for their economic outlook.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.32%	-0.82%	-1.39%	-4.32%
Chinese yuan	0.04%	-1.37%	-5.58%	-5.01%
Japanese yen	-1.95%	-0.56%	2.31%	-2.35%
British pound	-0.15%	-3.87%	-8.70%	-5.46%
Swiss franc	-0.68%	-2.92%	-5.39%	-9.71%
Canadian dollar	1.02%	-0.94%	-7.38%	-9.73%
Australian dollar	1.17%	-2.91%	-2.89%	-8.73%
Swedish krona	0.07%	-2.30%	0.70%	-3.52%
Norwegian krone	0.69%	0.51%	-6.06%	-9.79%
New Zealand dollar	-0.14%	-5.60%	-2.73%	-10.76%
Indian rupee	-0.24%	-2.06%	-5.73%	-8.73%
Brazilian real	2.37%	-3.38%	-16.71%	-34.88%
Mexican peso	1.85%	-4.71%	-10.03%	-18.29%
Chilean peso	0.57%	-0.37%	-6.43%	-11.80%
Colombian peso	0.72%	-3.52%	-13.26%	-26.58%
Bloomberg-JP Morgan Asian dollar index (spot)	0.18%	-1.20%	-4.45%	-5.94%

Are we returning to the TINA argument? No matter how poor earnings or overall economic growth are, equities can and will benefit from negative sovereign debt yields. The key is avoiding event-driven flushes that make the embedded short put options dangerous.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	1.68%	-7.22%	-10.32%	-5.47%
North America	1.79%	-6.72%	-8.19%	-3.54%
Latin America	7.63%	-6.53%	-22.95%	-32.20%
Emerging Market Free	4.48%	-7.13%	-16.67%	-21.56%
EAFE	1.51%	-8.04%	-13.67%	-8.52%
Pacific	2.10%	-8.14%	-11.98%	-6.53%
Eurozone	1.07%	-8.18%	-14.60%	-9.57%

Neither CTAs nor macro-oriented hedge funds managed to catch the rebound in crude oil and equities or the decline in the USD against major currencies ongoing until the JPY's decline at the end of the week. Three weeks of gains was too much of a good thing.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-2.35%	3.29%	3.36%	-1.15%
Newedge Trend	-2.61%	4.44%	4.34%	0.38%
Newedge Short-Term	-1.58%	3.75%	2.33%	-3.83%
HFR Global Hedge Fund	-0.07%	-3.16%	-7.56%	-6.56%
HFR Macro/CTA	-0.68%	0.02%	-2.25%	-3.25%
HFR Macro: Sytematic Diversified CTA	-1.71%	1.50%	0.69%	-1.43%