The Macro Environment For Financial Markets

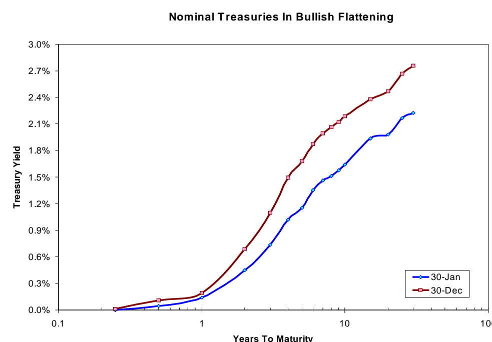
Wall Street may climb a wall of worry, but this assumes the wall in question does not separate us from St. Mary's of Bethlehem, popularly contracted as "bedlam." A roll-call of the asylum's inmates includes the new government of Greece continuing to make a mockery of the mockery that is the Eurozone, a Federal Reserve willing to raise short-term interest rates in the face of a strong dollar and declining inflation rate simply because its previous policies failed predictably and a range of central banks from Singapore to Denmark playing the "how low can you go?" game. The Saudi-led assault on crude oil prices has knee-capped both the energy industry and a wide range of service providers thereto, and on Friday at least we were treated to the spectacle of some oil-trading goofs who thought a decline in the rig count would affect March 2015 supplies. Did I mention the federal government thinks it might be a good idea to expand the rate of homeownership? Sure; that worked so well the last time. The rising polarization between left and right globally will maintain these policy confusions and raise the rate of self-inflicted wounds. I suppose we can muddle through, but why make things so unnecessarily difficult?

The causal chain remains intact:

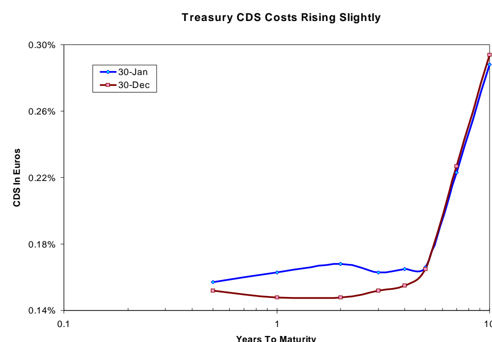
1. Short-term interest rates will remain artificially low globally;
2. Disinflationary pressures will remain so long as the global banking system remains unable to expand credit;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally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

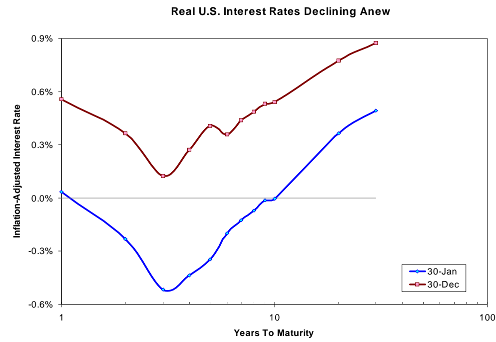
The bullish flattening of the Treasury yield curve continues with the 30-year making a new post-1981 low and the ten-year on pace to test its July 2012 low near 1.38%. The U.S. remains high-yield relative to the Eurozone and Japan, but the USD remains expensive for investors in those countries.



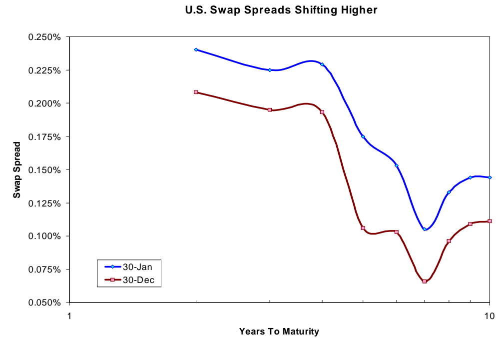
Short-dated CDS priced in EUR are advancing as the never-ending Obama era budget battles are resuming. The President's willingness to break a previous budgetary ceiling by 7% when the Congress is controlled by the opposition is not so much a profile in courage as a signal to the rest of the world the U.S. is not ready to engage in fiscal reform at a time when monetary policies allegedly are set to change.



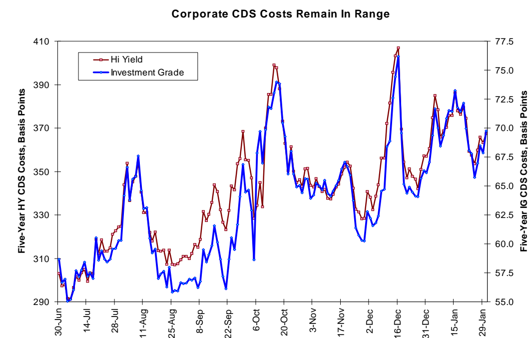
Implied real rates have shifted sharply lower over the past month and with the bare exception of the one-year are negative out to nine years. This shift reflects the decline in nominal rates more than anything else. It should support risky financial assets and if short-term inflation expectations rise, the precious metals.



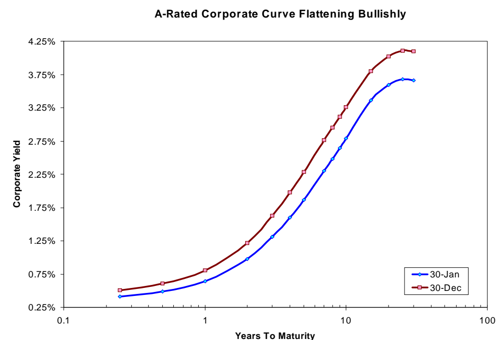
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue their small move higher, but the term structure remains strongly inverted. These long-term swap spreads do not constitute an impediment to either corporate bonds or, by extension, to equities. However, these rising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



Both the IG and HY CDS indices are settling into a new range. Critically, this range is biased higher and it does not appear as if the 2014:Q3 lows will be challenged anytime soon. Any further evidence of an economic slowdown will raise these costs and by extension corporate bond yields. Such a move would be negative for equities.



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

Only the Grains index has any manner of directional certainty at present. Such situations seldom are resolved without assets being transferred from weaker, short-term hands to stronger, long-term hands. That process typically involves lower valuations.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Feb. 2 - 6
BBerg	11	Transitional	-0.027	12.7%	
BBerg Grain	29	Trending	-0.423	17.1%	-0.62%
BBerg Ind. Metl	10	Sideways	-0.012	24.1%	
BBerg Pre. Metl	29	Trending	0.168	17.8%	0.06%
BBerg Softs	19	Transitional	-0.131	19.1%	
BBerg Nat. Gas	13	Transitional	-0.150	46.3%	
BBerg Petroleum	10	Sideways	0.159	32.1%	
BBerg Livestock	4	Sideways	0.020	20.6%	
Dollar Index	4	Sideways	0.033	9.1%	
S&P 500 Index	11	Transitional	-0.118	14.2%	
EAFE Index	17	Transitional	0.066	14.7%	
EM Index	29	Trending	0.009	9.1%	0.26%
Ten-year UST (price)	10	Sideways	0.160	7.5%	

Performance Measures

An absolute truth about physical commodities is they will not go to zero; a corollary is bear market profits become exponentially more difficult to achieve. Thus both the economically important Petroleum and Industrial Metals indices put in short-term bottoming attempts. The longer-term oversupply conditions seen in the metals will remain, but the petroleum one will start to get tricky if evidence builds for a slowdown in shale drilling. Long-term, the resource will remain as an inventory overhang and will discourage investment even if prices rise.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.29%	-2.91%	-20.64%	-20.02%
Grains Sub-Index	-3.48%	-7.81%	-7.20%	-16.36%
Corn	-4.33%	-6.50%	-1.64%	-21.43%
Soybeans	-1.21%	-4.61%	-10.52%	-10.57%
Wheat	-5.14%	-13.50%	-9.81%	-15.93%
Energy Sub-Index	1.97%	-6.86%	-43.08%	-45.29%
Petroleum Sub-Index	6.56%	-6.41%	-47.62%	-46.20%
WTI	5.81%	-9.17%	-49.69%	-47.05%
ULSD	4.92%	-4.61%	-39.86%	-41.61%
Gasoline	7.75%	0.71%	-43.15%	-41.37%
Natural Gas	-9.03%	-10.27%	-33.46%	-45.39%
Precious Metals Sub-Index	-2.43%	8.04%	-5.21%	-0.73%
Gold	-1.11%	7.76%	-1.34%	2.91%
Silver	-5.97%	9.13%	-16.07%	-11.07%
Industrial Metals Sub-Index	1.31%	-4.82%	-16.15%	-7.31%
Copper	-0.28%	-11.46%	-22.63%	-21.73%
Aluminum	1.71%	1.63%	-7.73%	3.72%
Nickel	5.65%	2.17%	-18.33%	6.79%
Zinc	1.52%	-3.69%	-10.11%	5.60%
Softs Sub-Index	-0.77%	0.40%	-16.58%	-7.75%
Coffee	-0.34%	0.53%	-19.59%	18.39%
Sugar	-2.50%	4.38%	-21.89%	-25.72%
Cotton	3.60%	-0.37%	-4.07%	-23.44%
Livestock Sub-Index	2.31%	-9.36%	-11.67%	-2.17%
Cattle	2.34%	-7.29%	-3.91%	10.16%
Hogs	2.26%	-12.76%	-24.95%	-20.20%

Keeping track of competitive devaluations is getting to be an exercise in chasing butterflies around the room. Moves in this direction in commodity-linked currencies such as the CAD, AUD and BRL led to significant breaks. The CHF seems to have put it a panic high following the removal of the franc ceiling, but bold actions here will not be rewarded.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.78%	-7.12%	-15.72%	-16.70%
Chinese yuan	-0.35%	-0.76%	-1.26%	-3.04%
Japanese yen	0.24%	1.69%	-12.51%	-12.57%
British pound	0.47%	-3.23%	-10.96%	-8.64%
Swiss franc	-4.36%	7.47%	-1.24%	-1.89%
Canadian dollar	-2.45%	-8.80%	-14.37%	-12.37%
Australian dollar	-1.90%	-5.14%	-16.81%	-11.74%
Swedish krona	0.60%	-6.57%	-16.93%	-21.35%
Norwegian krone	0.47%	-3.87%	-19.03%	-19.12%
New Zealand dollar	-2.54%	-7.26%	-14.49%	-11.08%
Indian rupee	-0.70%	2.44%	-2.93%	1.14%
Brazilian real	-3.83%	-0.94%	-16.30%	-10.19%
Mexican peso	-2.14%	-1.61%	-12.17%	-10.76%
Chilean peso	-1.44%	-4.52%	-9.84%	-13.77%
Colombian peso	-2.08%	-2.53%	-22.92%	-17.60%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.87%	-0.64%	-3.69%	-2.78%

We have seen a bifurcation of risk preferences for several years wherein the risk-averse accepted the insurance cost implied in debt and the risk-seeking have outperformed in equities on the basis even stable earnings justified it. Thus the short-term underperformance of equities is worrisome as it implies an earnings contraction.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.75%	-2.44%	-2.64%	6.98%
North America	-2.66%	-4.09%	0.79%	12.22%
Latin America	-6.09%	-5.96%	-25.62%	-8.64%
Emerging Market Free	-2.94%	0.79%	-10.01%	5.63%
EAFE	-0.25%	0.32%	-7.67%	-0.51%
Pacific	0.47%	1.13%	-5.87%	3.76%
Eurozone	-0.28%	-0.19%	-8.98%	-4.05%

CTAs seem to be enjoying the one-way markets in sovereign debt and the stronger dollar. Hedge funds did not suffer during equity markets' declines, a long-overdue step in the right direction. After all, alpha is supposed to be independent of market trend unless, of course, alpha is simply a marketing term, heaven forfend.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.58%	5.24%	24.49%	31.18%
Newedge Trend	0.99%	4.52%	18.37%	23.51%
Newedge Short-Term	0.72%	2.26%	10.59%	10.14%
HFR Global Hedge Fund	0.02%	-0.19%	-2.17%	-0.50%
HFR Macro/CTA	0.66%	1.89%	6.65%	7.37%
HFR Macro: Sytematic Diversified CTA	1.29%	2.98%	7.98%	5.91%