The Macro Environment For Financial Markets

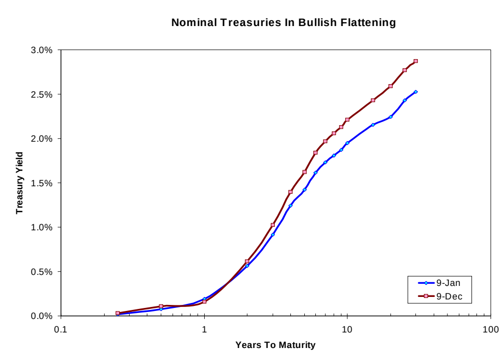
Listening to the FOMC talk about the timing of interest rate hikes is like listening to the Obama administration's objections to the Keystone XL pipeline: Both sound better after pressing the mute button. The Great Unmentionable is QE never did nor never could achieve macroeconomic goals such as increasing output and employment and ZIRP simply created investment-destroying rational expectations for higher future interest rates. However, raising rates just because lowering them serves no positive purpose is inviting a catastrophic deleveraging of asset markets and a surge in the USD that would kneecap global borrowers of the greenback. So let's back off here and encourage other central banks, including a certain one in Frankfurt whose mandate says thou shall not monetize sovereign debt, to do what has yet to work in the U.S., Japan, Switzerland or the U.K. Did I mention the Federal Reserve's war on deflation has worked as well as its 1970s-era war on inflation did? No? Well, it has, and this is why we continued deification of the institution, its brethren and all members of their priestly classes makes so little sense. Surely there are some underemployed Druids out there who could do just as well more cheaply and be more entertaining to boot.

The causal chain is now:

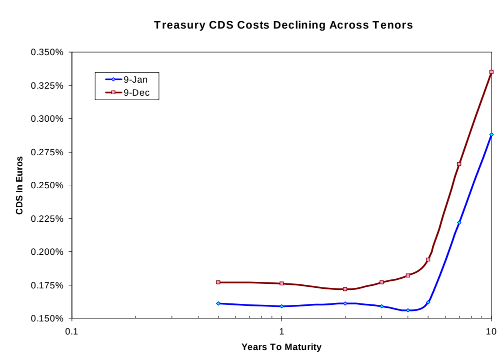
1. Short-term interest rates will remain artificially low globally;
2. Rising implied real rates will exacerbate disinflationary pressures;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally and continue to pressure U.S. long-term 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

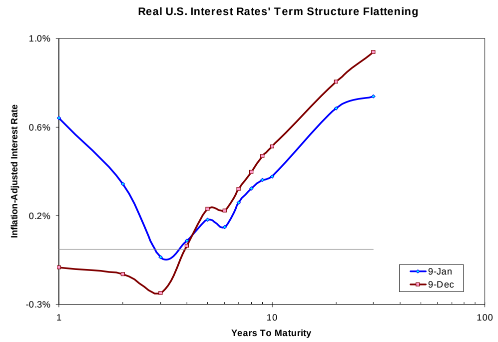
The Treasury yield curve steepened bullishly as two-year yields fell more than ten-year yields did. The operative word remains "bullish," though. Twenty months after the end of QE was hinted, ten-year yields have returned to May 2013 levels; this is with a modestly improving economy in the U.S. The move projects to a yield of 1.45%, which seems unbelievable but then again when compared to ten-year yields of 28 and 22 basis points in Japan and Switzerland, respectively, such a move would simply be keeping with global trends.



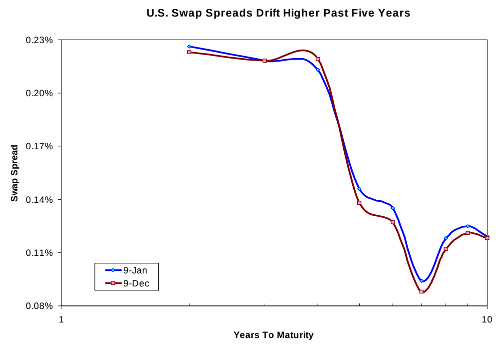
Euro-denominated CDS costs remain low as the prospects for budget battles and government shutdowns recede. This market should remain somnolent well into 2015.



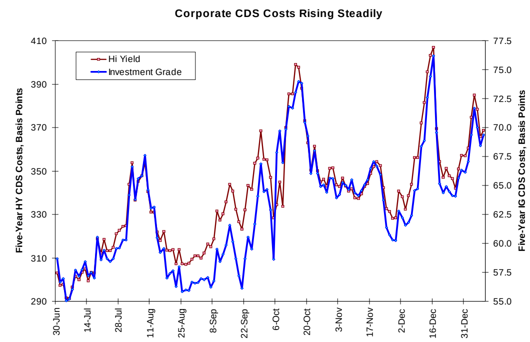
Implied real rates at the short end of the yield curve remain high in the face declining inflation expectations, but those at the long end of the yield curve are falling. This latter move is supportive for risky financial assets.



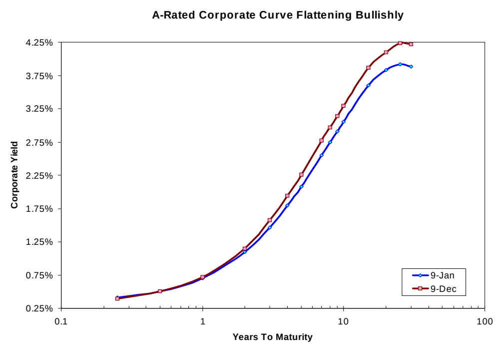
Swap spreads, which rise when floating-rate borrowers want to fix their payments, are inching higher past five years, but the term structure remains strongly inverted. These long-term swap spreads do not constitute an impediment to either corporate bonds or, by extension, to equities.



Both the IG and HY CDS indices are continuing their small drift higher since the end of June. This is consistent with the rising recognition of credit risk as a percentage of yields in the corporate bond market even as higher interest rate risk is being accepted.



The A-rated yield flattened bullishly and finally stopped steepening relative to the UST yield curve. While nominally supportive for risky financial assets, we have to recognize this relative flattening as an artifact of lower two-year Treasury yields and nothing more.



Market Structure

Precious Metals reversed into an uptrend while the other physical commodity indices outside of Industrial Metals exited structural downtrends. The EAFE index remains in a downtrend while both ten-year UST and the dollar index are in uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Jan. 12- 16
BBerg	4	Sideways	-0.002	8.3%	
BBerg Grain	29	Trending	-0.085	18.3%	
BBerg Ind. Metl	29	Trending	-0.280	13.8%	-0.14%
BBerg Pre. Metl	29	Trending	0.056	21.1%	0.06%
BBerg Softs	29	Trending	0.049	16.5%	
BBerg Nat. Gas	4	Sideways	0.043	40.1%	
BBerg Petroleum	13	Transitional	-0.212	33.0%	
BBerg Livestock	13	Transitional	-0.180	11.7%	
Dollar Index	28	Trending	0.327	7.4%	0.14%
S&P 500 Index	15	Transitional	-0.075	10.3%	
EAFE Index	29	Trending	-0.273	10.7%	-0.63%
EM Index	14	Transitional	0.123	8.5%	
Ten-year UST (price)	29	Trending	0.272	6.2%	0.28%

Performance Measures

The general bear market in the physical commodity indices remains intact; we can ignore the jumps in the Softs. The rise in Precious Metals is a reaction to negative real interest rates in the European markets; perversely holding gold can be a defense against deflationary forces. The slide in crude oil has yet to show signs of bottoming and given the popularity of bottom-picking here and in Industrial Metals markets such as copper, this may be a long time coming.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.23%	-7.47%	-21.22%	-15.26%
Grains Sub-Index	0.95%	-0.58%	-4.74%	-7.48%
Corn	1.14%	1.27%	-4.13%	-10.46%
Soybeans	4.44%	-0.32%	-6.05%	-1.39%
Wheat	-3.01%	-3.75%	-1.99%	-10.33%
Energy Sub-Index	-5.95%	-21.45%	-45.29%	-39.70%
Petroleum Sub-Index	-8.13%	-22.71%	-50.25%	-45.76%
WTI	-7.76%	-23.74%	-50.85%	-42.95%
ULSD	-6.41%	-17.99%	-41.39%	-40.90%
Gasoline	-7.18%	-22.52%	-50.59%	-46.45%
Natural Gas	-1.74%	-19.06%	-33.57%	-25.76%
Precious Metals Sub-Index	2.89%	-1.97%	-12.06%	-5.63%
Gold	2.52%	-1.29%	-8.33%	-1.31%
Silver	4.13%	-4.17%	-22.57%	-17.57%
Industrial Metals Sub-Index	-1.19%	-6.59%	-13.45%	-5.72%
Copper	-2.24%	-5.91%	-15.45%	-16.25%
Aluminum	-1.30%	-8.63%	-8.97%	-2.38%
Nickel	3.16%	-7.63%	-22.37%	12.85%
Zinc	-2.30%	-3.12%	-6.58%	4.64%
Softs Sub-Index	7.42%	-1.41%	-14.34%	-4.69%
Coffee	11.80%	-0.22%	-0.52%	38.12%
Sugar	5.22%	-3.30%	-26.09%	-24.77%
Cotton	1.98%	1.47%	-10.83%	-18.77%
Livestock Sub-Index	-3.01%	-3.16%	-8.62%	8.32%
Cattle	-3.06%	-1.50%	2.06%	18.18%
Hogs	-2.97%	-6.76%	-25.35%	-6.91%

While the EUR, GBP, CHF and SEK continued lower, the JPY, AUD and an interesting assortment of minor currencies such as the BRL, MXN and INR moved higher. The JPY turned out to be a risk-haven currency despite the best official efforts to ruin it forever and the EM currencies are starting to price out higher short-term interest rates in the U.S. The real story increasingly is what will the ECB do?

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.33%	-4.30%	-13.19%	-12.98%
Chinese yuan	-0.02%	-0.34%	-0.16%	-2.47%
Japanese yen	1.69%	1.00%	-14.23%	-11.54%
British pound	-1.10%	-3.24%	-11.64%	-8.02%
Swiss franc	-1.24%	-4.23%	-12.16%	-10.58%
Canadian dollar	-0.69%	-3.55%	-10.25%	-8.64%
Australian dollar	1.42%	-1.07%	-12.85%	-7.82%
Swedish krona	-1.56%	-6.53%	-15.73%	-18.64%
Norwegian krone	-0.82%	-6.90%	-19.61%	-19.30%
New Zealand dollar	1.77%	2.00%	-11.19%	-5.06%
Indian rupee	1.56%	-0.70%	-4.12%	-0.40%
Brazilian real	2.33%	-1.40%	-15.96%	-9.20%
Mexican peso	1.61%	-1.24%	-11.20%	-10.35%
Chilean peso	-0.22%	-0.15%	-9.99%	-13.16%
Colombian peso	-1.78%	-2.87%	-23.11%	-20.04%
Bloomberg-JP Morgan Asian dollar index (spot)	0.53%	-0.25%	-3.21%	-2.45%

If the consensus U.S. interest rate increases are going to get postponed grows, emerging market currencies will rebound and take their associated equities along for the ride. Given the amount of free money looking for a home and the valuation-constrained upside in the U.S., any EM rally could be sharp and quite likely short-lived.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.20%	-2.08%	-2.61%	4.84%
North America	-0.81%	-0.62%	3.21%	12.33%
Latin America	1.64%	-3.33%	-20.31%	-8.82%
Emerging Market Free	0.81%	-0.15%	-8.27%	2.77%
EAFE	-1.86%	-4.44%	-11.09%	-5.80%
Pacific	-0.39%	-2.46%	-6.48%	-2.41%
Eurozone	-4.01%	-7.53%	-15.69%	-10.42%

The one thing that stands out in performance was neither CTAs nor hedge funds were short bonds or long the euro and crude oil. This also means most trades are crowded, a condition usually good for a few laughs at some point in the near future.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	2.32%	4.75%	23.54%	24.97%
Newedge Trend	2.05%	3.56%	16.67%	19.21%
Newedge Short-Term	0.36%	0.89%	8.54%	10.48%
HFR Global Hedge Fund	0.01%	0.19%	-2.11%	-0.74%
HFR Macro/CTA	1.57%	2.17%	7.41%	7.23%
HFR Macro: Sytematic Diversified CTA	2.06%	3.80%	7.84%	6.08%