The Macro Environment For Financial Markets

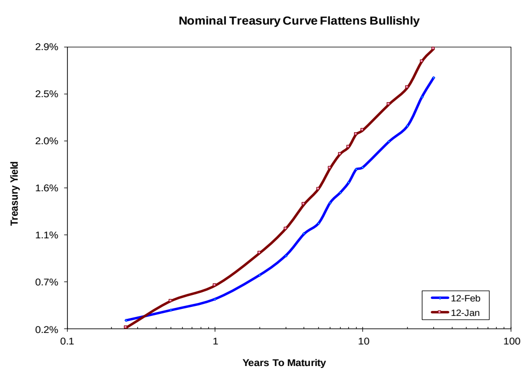
At some point in your education you were introduced to the number '*i*,' √-1. You did not know what to do with it at the time, but you swore if it ever came up again in life, you would be all over it. That time is now, as we are living in a world choking on negative interest rates, one where logarithmic scales have been rendered useless because in another paean to your math education, you cannot take the logarithm of a negative number. And they wonder why the politics of anger have spread across the land. These negative rates have made a bad banking situation worse if for no other reason commercial banks have had to labor under the regulatory fiction sovereign debt is risk-free. As a result, they have stuffed themselves with negative-yield bonds certain to be capital losses if held to maturity. Memo to file: The more money-losing bonds banks hold, the more money they are going to lose. Moreover, the more these banks are stuffed with reserves by central banks, the less potential interest rate margin they have. Toss in a few bright ideas like contingent convertible bonds and you have the latest triumph of over-educated disaster, macro-prudential regulation. Remember, we have things like the Financial Stability Oversight Council to sniff trouble out before it happens. If this fills you with confidence, see me immediately.

The causal chain remains:

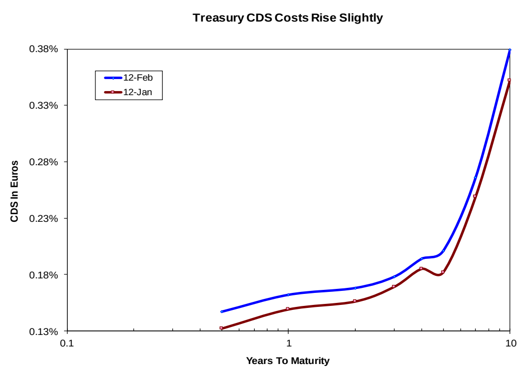
1. The market is pricing out higher short-term interest rates in the U.S. as policy rates are being driven lower globally;
2. Disinflationary pressures will persist;
3. Inflation expectations as measured by TIPS and inflation swaps will remain contained;
4. The U.S. yield curve retains its long-term 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

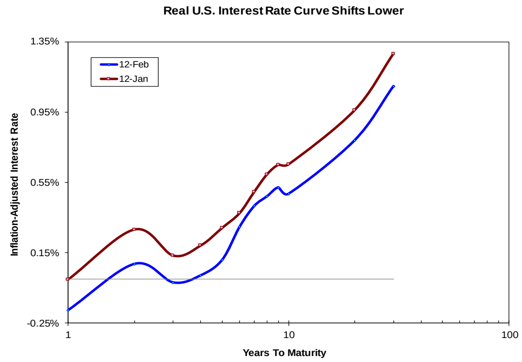
The bullish flattening of the UST yield curve continues; once again the biggest question is why long-term rates have not fallen even further and faster. If large holders of USD reserves, China in particular, are liquidating them and yields are falling, then we know intrinsic demand in what is still a bull market remains quite high.



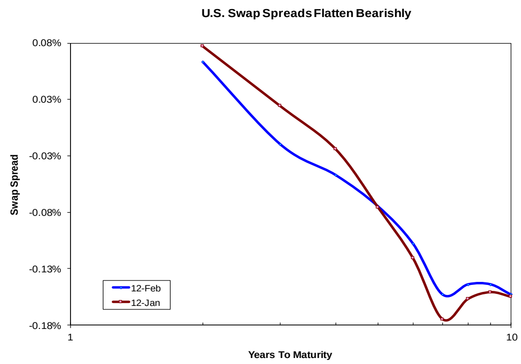
The CDS market for Treasuries has shifted higher, but not significantly so, as nothing yet is signaling a worsening of the federal fiscal outlook.



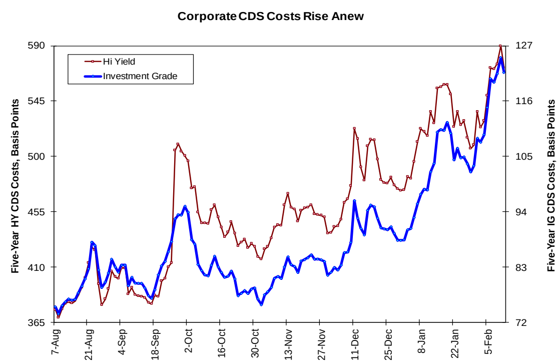
The pseudo-real rate curve shifted lower over the past month and is not significantly over zero until five years. The ongoing decline in implied real yields at the short end is supportive for gold, but only until such time as massive risk-aversion dissipates.



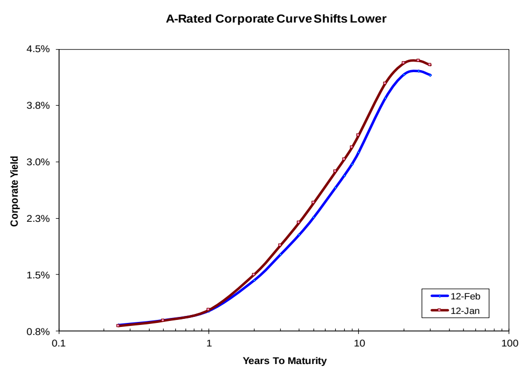
Swap spreads, which rise when floating-rate borrowers want to fix their payments, flattened bearishly over the past month as spreads for four years' tenor and less fell and longer-tenor spreads rose. Before we alarm ourselves, let's remember those spreads for four years' tenor and longer remain negative. This is not a market worried about a surge higher in financing costs.



CDS costs resumed their move higher for both the investment-grade and high-yield indices. The continued difficulties of the energy and mining sectors have spilled over into higher risk for banks.



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

Softs and Livestock joined Natural Gas and Grains in structural downtrends, while both Precious and Industrial Metals are in uptrends. The dollar index and ten-year UST remain in down- and uptrends, respectively.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Feb. 15 - 19
BBerg	16	Transitional	0.018	14.2%	
BBerg Grain	23	Trending	-0.142	12.0%	-0.08%
BBerg Ind. Metl	29	Trending	0.008	18.1%	0.39%
BBerg Pre. Metl	29	Trending	0.591	15.3%	0.49%
BBerg Softs	29	Trending	-0.195	16.9%	-0.28%
BBerg Nat. Gas	29	Trending	-0.257	30.3%	-0.41%
BBerg Petroleum	14	Transitional	0.009	50.6%	
BBerg Livestock	21	Trending	-0.129	11.0%	-0.48%
Dollar Index	29	Trending	-0.277	8.8%	-0.03%
S&P 500 Index	14	Transitional	-0.063	19.2%	
EAFE Index	14	Transitional	-0.241	17.7%	
EM Index	14	Transitional	-0.156	14.3%	
Ten-year UST (price)	29	Trending	0.239	7.5%	0.16%

Performance Measures

Gold has been falling for four and one-half years during a period of global monetary ease but rose when the combination of high risk-aversion and negative short-term real rates made it attractive. This would have been a tough explanation forty years ago. Another tough explanation for people in that era would be how equity investors are pulling for the successful re-cartelization of the crude oil market.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.20%	1.38%	-16.88%	-26.70%
Grains Sub-Index	-1.13%	-1.27%	-6.05%	-14.73%
Corn	-1.94%	0.56%	-4.71%	-16.25%
Soybeans	0.56%	-0.22%	-4.90%	-10.15%
Wheat	-1.82%	-4.76%	-8.38%	-13.94%
Energy Sub-Index	-2.08%	-4.11%	-40.45%	-48.43%
Petroleum Sub-Index	-1.37%	-0.77%	-38.65%	-49.57%
WTI	-3.53%	-5.44%	-40.18%	-54.58%
Brent	-2.21%	3.93%	-40.77%	-52.93%
ULSD	0.35%	5.36%	-39.09%	-49.37%
Gasoline	2.87%	-7.96%	-33.78%	-34.73%
Natural Gas	-4.21%	-12.59%	-46.08%	-46.27%
Precious Metals Sub-Index	7.00%	14.37%	7.92%	-1.11%
Gold	7.06%	14.22%	10.27%	1.14%
Silver	6.84%	14.85%	1.45%	-7.24%
Industrial Metals Sub-Index	-1.85%	3.97%	-13.08%	-26.02%
Copper	-3.53%	3.58%	-14.20%	-22.67%
Aluminum	-0.01%	2.83%	-8.25%	-23.18%
Nickel	-4.23%	-5.29%	-26.77%	-47.62%
Zinc	1.68%	16.18%	-8.17%	-22.53%
Softs Sub-Index	-2.24%	-3.74%	0.98%	-21.56%
Coffee	-4.13%	0.96%	-17.04%	-36.85%
Sugar	-0.57%	-6.07%	15.95%	-19.85%
Cotton	-3.07%	-5.61%	-10.32%	-8.84%
Livestock Sub-Index	-2.29%	0.22%	-7.67%	-8.13%
Cattle	-3.92%	-2.62%	-14.97%	-13.80%
Hogs	0.11%	4.56%	5.77%	2.33%

The fundamental currency equation compares nominal rates between two currencies. As real rates have to be the same at any maturity, the difference devolves into relative expected inflation. On that basis, the non-USD majors save for the NOK and NZD are poised to enter deflation with the emerging market currencies all have higher expected rates of inflation than the U.S.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.88%	3.67%	0.87%	-1.29%
Chinese yuan	0.03%	-0.89%	-5.55%	-4.89%
Japanese yen	3.20%	3.89%	9.68%	5.17%
British pound	0.00%	0.38%	-7.11%	-5.73%
Swiss franc	1.42%	2.57%	-0.17%	-4.73%
Canadian dollar	0.48%	2.97%	-6.30%	-9.68%
Australian dollar	0.64%	1.80%	-3.62%	-8.05%
Swedish krona	0.62%	1.52%	2.29%	0.49%
Norwegian krone	-0.47%	3.27%	-5.18%	-11.18%
New Zealand dollar	-0.03%	1.36%	0.11%	-10.75%
Indian rupee	-0.85%	-2.00%	-5.01%	-8.69%
Brazilian real	-2.48%	0.62%	-13.05%	-29.46%
Mexican peso	-2.48%	-5.36%	-13.91%	-21.11%
Chilean peso	-0.16%	3.59%	-3.13%	-11.78%
Colombian peso	-1.46%	-3.18%	-13.11%	-29.40%
Bloomberg-JP Morgan Asian dollar index (spot)	0.23%	0.98%	-1.93%	-5.43%

Let's reflect for moment China was closed for the Tet holiday this past week and still the Pacific region got clobbered. Attempts to weaken the yen led to a stronger yen. The Eurozone is struggling with its ongoing commercial bank struggles. As bad as the U.S. seemed, it remained the relatively strong performer.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-2.39%	-4.65%	-13.76%	-12.50%
North America	-0.96%	-3.68%	-10.92%	-10.52%
Latin America	-3.61%	1.77%	-21.39%	-33.09%
Emerging Market Free	-3.82%	-1.59%	-16.67%	-24.73%
EAFE	-4.71%	-6.23%	-18.20%	-15.66%
Pacific	-7.48%	-8.36%	-19.08%	-15.56%
Eurozone	-3.63%	-6.20%	-18.77%	-16.47%

The CTA world has enjoyed 2016 so far, suggesting they have embraced the risk-off trade with enthusiasm. We can say the same for macro-oriented hedge funds but not for the global hedge funds that tend to have a long-equity bias.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	4.09%	5.32%	5.99%	5.35%
Newedge Trend	3.21%	4.61%	6.74%	5.30%
Newedge Short-Term	2.59%	4.69%	6.06%	0.23%
HFR Global Hedge Fund	-1.61%	-3.15%	-9.00%	-8.71%
HFR Macro/CTA	0.58%	0.27%	-1.91%	-2.78%
HFR Macro: Sytematic Diversified CTA	3.44%	3.94%	4.62%	3.56%