The Macro Environment For Financial Markets

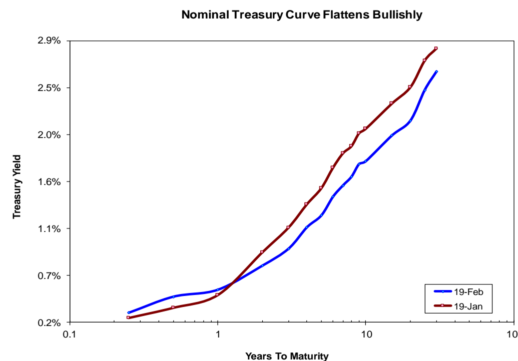
The collective intellectual bankruptcy of policymakers is large enough to induce calls for greater deficit spending, a la the oh-so-successful 2009 American Reinvestment & Recovery Act. With the arguable exception for Build America Bonds, we could have received a greater economic return by dumping $700 billion into the mouth of an active volcano in an attempt to appease Pele. Who knows; if we outlaw cash, someone might propose this as a disposal method. The best thing to come out of the current situation globally will be the discrediting of central bankers, all of whom have been too willing to accept their deification by politicians eager to offload responsibility. The spectacle of Haruhiko Kuroda being called on the carpet in all-too-collegial Japan tells us the game is up, and not a moment too soon.

The causal chain now is:

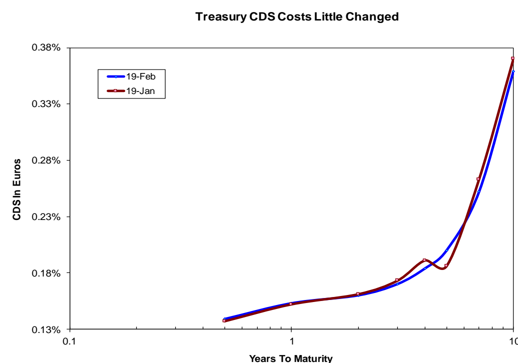
1. The market has priced out higher short-term rates in the U.S. in March, but remains confused for the rest of 2016;
2. Disinflationary pressures will persist;
3. Inflation expectations as measured by TIPS and inflation swaps will remain contained, even though their decline is exaggerated by the declines in nominal rates more than an actual assessment of inflation;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are continuing to accept rollover risk;
6. Swap spreads will remain low; and
7. Credit spreads will remain biased toward increasing.

Key Market Indications

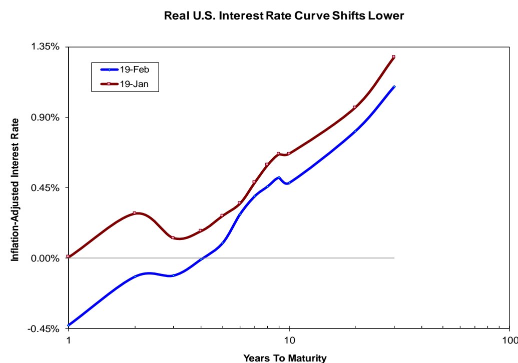
One day investors will have to wrap their minds around the concept bonds can be in a bear market. But to paraphrase St. Augustine, not yet. China is liquidating Treasuries to support the yuan and yields are falling. Moreover, inflation expectations are falling and the U.S. remain relatively high-yield amongst major sovereign debt markets. The simple and unpleasant reality of the whole matter is highly debt-laden economies cannot function in a rising yield environment.



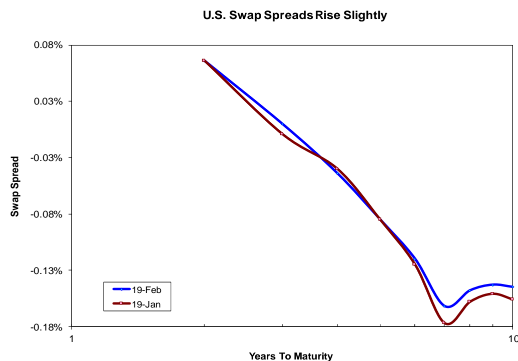
The CDS market for Treasuries has shifted higher, but not significantly so, as nothing yet is signaling a worsening of the federal fiscal outlook.



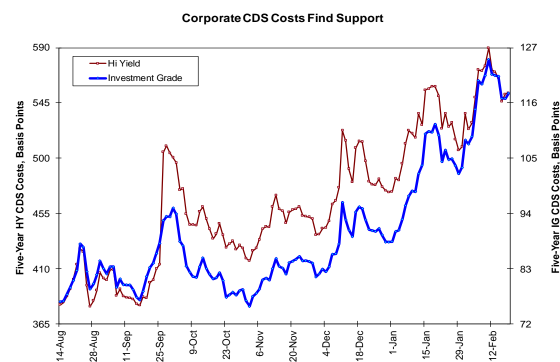
The pseudo-real rate curve shifted lower over the past month and is negative through four years. As I noted last week, the ongoing decline in implied real yields at the short end is supportive for gold, but only until such time as massive risk-aversion dissipates. That gold retreated with this decline in implied real rates should be considered as a market failing to move higher on bullish news. Such developments tend to mark short-term tops.



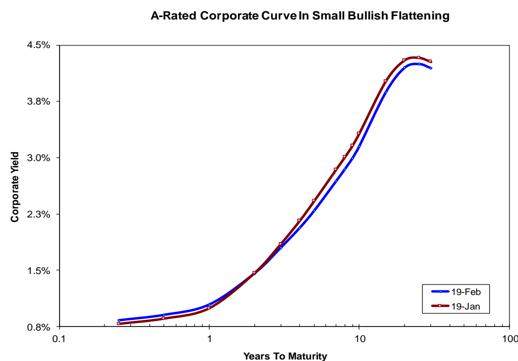
Swap spreads, which rise when floating-rate borrowers want to fix their payments, started to rise for tenors greater than five years. However, they remain negative for tenors greater than three years, so we should not interpret the small rise as a rush to fix floating-rate payments just yet. It would take a consensus that higher short-term rates will arrive and not lead to a further bullish flattening of the yield curve for that to happen.



CDS costs for both the investment-grade and high-yield indices finally found a measure of support, but even a casual glance at the adjacent chart tells us we are in a period of higher highs for these measures of credit risk. Previous periods of monetary ease led to lower CDS costs; the current period of ease is leading to greater banking system stress.



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 remain in structural downtrends, while Industrial Metals remain in an uptrend. Ten-year UST exited into a bullish consolidation while the dollar index remains in a downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Feb. 22 - 26
BBerg	18	Transitional	-0.022	14.4%	
BBerg Grain	25	Trending	-0.049	10.1%	-0.08%
BBerg Ind. Metl	29	Trending	0.199	16.9%	0.39%
BBerg Pre. Metl	4	Sideways	0.033	21.1%	
BBerg Softs	29	Trending	-0.223	15.9%	-0.28%
BBerg Nat. Gas	29	Trending	-0.444	28.2%	-0.41%
BBerg Petroleum	15	Transitional	-0.028	45.5%	
BBerg Livestock	21	Trending	-0.063	10.5%	-0.48%
Dollar Index	29	Trending	-0.171	8.4%	-0.03%
S&P 500 Index	16	Transitional	0.073	17.5%	
EAFE Index	16	Transitional	0.013	18.7%	
EM Index	15	Transitional	0.079	14.5%	
Ten-year UST (price)	5	Sideways	0.023	6.7%	

Performance Measures

Did nickel really rise almost 13% in one week? It did, and that may tell us all we need to know about the power of bear-market rallies. It should be increasingly clear, though, the secular bear market in physical commodities is much closer to a bottom than anything else as producers are starting to enter bankruptcy and this will perforce restrict supply growth. Those who are salivating over the prospect of a new bull market in precious metals should consider much of their recent gains were propelled by the prospect of runaway negative interest rates and the fear of a new financial crisis. While those have not disappeared entirely, the recent peaks should tell us something about their upside bounds.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	1.56%	2.06%	-15.09%	-27.17%
Grains Sub-Index	0.92%	-1.33%	-5.62%	-14.93%
Corn	1.17%	-0.91%	-5.85%	-16.37%
Soybeans	0.35%	-0.76%	-2.67%	-11.90%
Wheat	0.71%	-2.52%	-8.02%	-13.10%
Energy Sub-Index	2.95%	-0.49%	-38.50%	-50.77%
Petroleum Sub-Index	7.40%	4.40%	-35.98%	-50.62%
WTI	8.56%	-0.57%	-36.92%	-54.77%
Brent	9.23%	11.28%	-37.72%	-53.90%
ULSD	5.61%	12.05%	-38.24%	-50.83%
Gasoline	3.75%	-7.12%	-31.39%	-37.55%
Natural Gas	-8.64%	-12.96%	-46.09%	-52.50%
Precious Metals Sub-Index	-1.68%	11.92%	6.88%	-0.87%
Gold	-1.36%	13.04%	9.10%	1.53%
Silver	-2.58%	8.95%	0.82%	-7.38%
Industrial Metals Sub-Index	4.79%	5.66%	-7.43%	-22.39%
Copper	3.54%	5.09%	-9.11%	-21.27%
Aluminum	4.63%	4.21%	-2.81%	-19.40%
Nickel	12.97%	-0.32%	-18.24%	-39.55%
Zinc	2.24%	15.75%	-3.78%	-18.05%
Softs Sub-Index	-0.55%	-8.18%	-1.46%	-20.60%
Coffee	1.35%	-0.98%	-17.43%	-31.29%
Sugar	-2.68%	-13.60%	11.45%	-21.17%
Cotton	1.42%	-5.50%	-11.46%	-10.12%
Livestock Sub-Index	1.70%	2.47%	-7.18%	-8.30%
Cattle	3.42%	2.95%	-10.91%	-10.80%
Hogs	-0.79%	1.76%	-0.56%	-3.62%

Interventions are the order of the day in currency markets, with both Mexico and China pushing their currencies higher. The rest of the currency world is getting very messy as competitive devaluations and negative interest rates are removing the single most important price in any economy away from market direction. This will result in a massive misallocation of resources just as artificially low short-term rates have.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.12%	2.04%	0.09%	-2.09%
Chinese yuan	0.80%	0.86%	-1.94%	-4.10%
Japanese yen	0.55%	4.45%	9.92%	5.61%
British pound	-0.67%	1.75%	-8.13%	-6.54%
Swiss franc	-1.34%	1.32%	-2.50%	-4.13%
Canadian dollar	0.61%	5.91%	-4.63%	-9.23%
Australian dollar	0.51%	3.46%	-2.72%	-8.26%
Swedish krona	-0.56%	1.09%	0.88%	-0.30%
Norwegian krone	0.50%	2.95%	-3.18%	-11.35%
New Zealand dollar	0.08%	3.45%	0.47%	-11.80%
Indian rupee	-0.24%	-1.14%	-4.60%	-8.95%
Brazilian real	-0.47%	1.05%	-13.17%	-28.72%
Mexican peso	3.77%	0.31%	-8.78%	-17.67%
Chilean peso	0.84%	3.67%	-0.37%	-11.75%
Colombian peso	0.80%	-1.39%	-9.93%	-27.15%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.55%	0.40%	-1.94%	-5.64%

It was not that long ago higher crude oil prices were seen as anathema for risky financial assets; they now are seen as a necessary stabilizer. If this and a Chinese intervention to keep the CNY overvalued are greeted as supportive news, then equities globally are resting on a thin reed.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	3.56%	1.41%	-9.92%	-10.43%
North America	3.04%	2.47%	-7.84%	-8.24%
Latin America	3.98%	8.64%	-15.35%	-31.62%
Emerging Market Free	4.22%	3.83%	-11.01%	-22.68%
EAFE	4.45%	-0.30%	-13.21%	-13.90%
Pacific	6.95%	-1.13%	-12.26%	-12.36%
Eurozone	3.19%	-0.99%	-14.02%	-15.60%

I noted last week how CTAs appeared to have accepted the risk-off trade with a great deal of enthusiasm; this goes a long way to explaining their huge downturn this week. The more long equity-biased hedge funds benefited from the shift back into equities.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-3.43%	-0.61%	3.22%	2.59%
Newedge Trend	-2.66%	0.05%	5.36%	3.51%
Newedge Short-Term	-1.68%	1.77%	5.40%	-1.37%
HFR Global Hedge Fund	1.12%	-1.24%	-7.71%	-8.20%
HFR Macro/CTA	0.08%	-0.30%	-1.74%	-2.80%
HFR Macro: Sytematic Diversified CTA	-1.43%	1.00%	3.38%	1.83%