The Macro Environment For Financial Markets

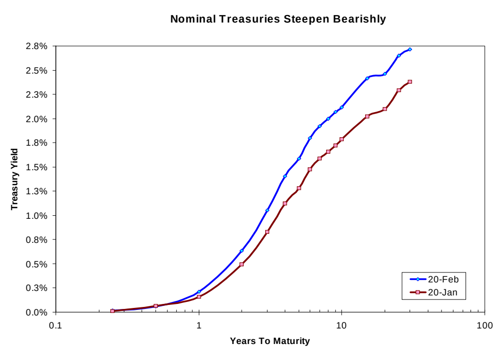
I keep returning to Churchill's characterization of Admiral Jellicoe as "the only man on either side who could lose the war in an afternoon" when discussing Federal Reserve chairs, first Bernanke and now Yellen. This was on display last week: An increase, even a small one, in short-term interest rates, could trigger a USD rally capable of forcing global balance sheet reductions in the banking system. Worse, once selling spread from sovereign debt to corporate debt, the order "Sell!" would be followed by a lonely, "To whom?" Of course, this would give the Financial Stability Oversight Council and other august bodies something to do; they would find a crisis triggered by a monetary policy action and amplified by Dodd-Frank restrictions on proprietary trading and Basel III capital valuation adjustments really was the fault of bankers too greedy or too obtuse – you pick the order – to anticipate officials' actions and compensate accordingly.

The causal chain now is:

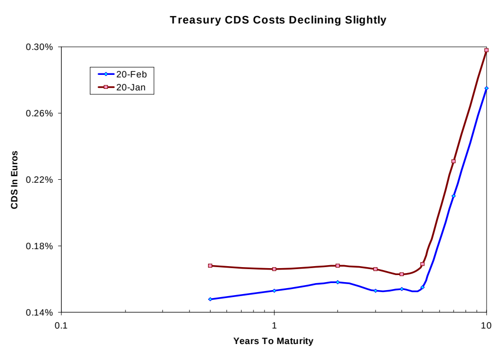
1. Short-term interest rates will remain artificially low globally;
2. Disinflationary pressures will remain so long as the global banking system remains unable to expand credit;
3. Inflation expectations as measured by the TIPS market will rise more slowly than nominal rates will;
4. Sovereign debt yields will continue their newfound secondary uptrend but remain within a long-term secular bull market;
5. The U.S. yield will retain a bias toward flattening, but via higher short-term rates;
6. Short-term borrowers will continue to accept rollover risk;
7. Swap spreads will continue their move higher as floating-rate payors move to fix their payments; and
8. Credit spreads will remain range-bound barring an external shock.

Key Market Indications

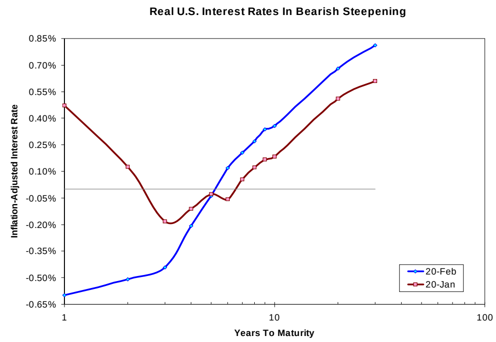
Ten-year UST broke their 2014:Q4 support level and now appear likely to move back toward 2.37% before their secondary downtrend is through. Even though the market interpreted the Federal Reserve as going slow on a rate increase, the bias for two-year rates remains higher, and this will flatten the yield curve.



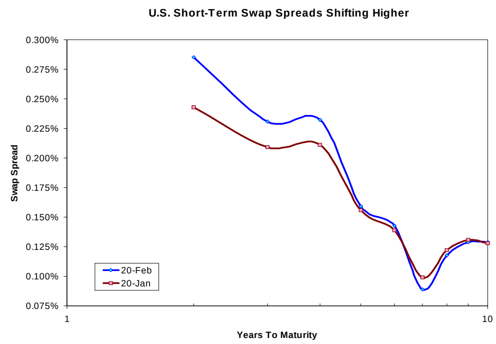
No amount of posturing in Washington has altered the perception the government will remain open and ready, willing and able to spend prodigious quantities of other peoples' money for unclear purposes. Those betting on a default and who will get paid in euros on such an event are making a bad bet, pure and simple.



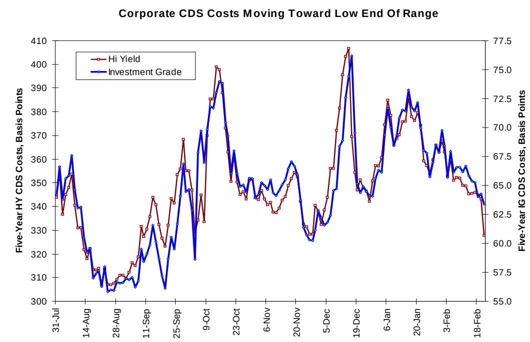
Implied real rates are in a bearish steepening as inflation breakevens have not moved higher as rapidly as nominal rates have. However, it is important to remember implied real rates remain negative out to five years and the implied 30-year real rate of 81 basis points will not constitute an impediment to risky assets.



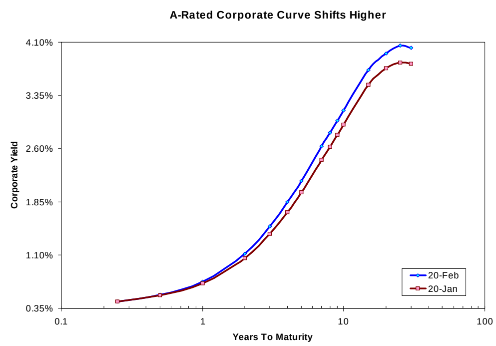
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue their small move higher, but the term structure remains strongly inverted. The stability of longer-tenor swap spreads removes a headwind for corporate bonds and by extension for equities.



Both the IG and HY CDS indices moved toward the lower end of their range, with the HY index declining more rapidly now that energy-linked bonds have stabilized. The decline in HY credit risk is unabashedly supportive for equities.



The A-rated yield curve continues to mimic the UST yield curve. If the UST yield curve steepens bearishly – a statement and not a forecast – the A-rated yield curve is unlikely to steepen as rapidly as it was not suppressed as much.



Market Structure

Natural Gas moved into an uptrend while Precious Metals and Softs remain in downtrend structures. The EAFE and S&P 500 indices are in uptrends amongst the financials while ten-year Treasuries moved into a structural downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Feb. 23 - 27
BBerg	15	Transitional	-0.005	14.5%	
BBerg Grain	13	Transitional	-0.028	17.8%	
BBerg Ind. Metl	15	Transitional	-0.118	15.4%	
BBerg Pre. Metl	29	Trending	-0.242	18.0%	-0.33%
BBerg Softs	29	Trending	-0.233	17.0%	-0.21%
BBerg Nat. Gas	20	Trending	0.148	39.5%	0.59%
BBerg Petroleum	8	Sideways	-0.022	30.6%	
BBerg Livestock	10	Sideways	0.003	16.0%	
Dollar Index	12	Transitional	-0.007	7.8%	
S&P 500 Index	29	Trending	0.232	12.7%	0.13%
EAFE Index	25	Trending	0.249	13.3%	0.20%
EM Index	16	Transitional	0.086	10.1%	
Ten-year UST (price)	29	Trending	-0.217	8.4%	-0.10%

Performance Measures

The economically important Petroleum and Industrial Metals indices remain under pressure, as do the economically unimportant Softs index and the indicative Precious Metals index. A few more weeks of high heating degree-day readings will set natural gas up for at least one run at the March/April widow-maker trade.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.27%	1.58%	-18.08%	-23.14%
Grains Sub-Index	0.09%	-0.52%	-5.09%	-19.12%
Corn	0.51%	-0.48%	0.20%	-21.70%
Soybeans	1.57%	2.52%	-5.68%	-13.39%
Wheat	-2.45%	-4.32%	-10.98%	-22.21%
Energy Sub-Index	1.66%	10.30%	-37.55%	-43.24%
Petroleum Sub-Index	-0.50%	15.00%	-41.95%	-44.53%
WTI	-2.64%	9.74%	-45.90%	-47.84%
ULSD	0.54%	17.72%	-31.60%	-35.98%
Gasoline	0.16%	15.58%	-38.15%	-41.26%
Natural Gas	8.25%	-0.90%	-28.81%	-42.58%
Precious Metals Sub-Index	-1.77%	-7.99%	-8.72%	-13.79%
Gold	-1.29%	-6.86%	-6.01%	-9.21%
Silver	-3.06%	-11.05%	-16.61%	-26.14%
Industrial Metals Sub-Index	-2.25%	0.16%	-18.25%	-10.77%
Copper	-0.35%	3.59%	-19.45%	-20.34%
Aluminum	-2.63%	-2.26%	-14.71%	-3.47%
Nickel	-5.14%	-2.89%	-26.23%	-4.45%
Zinc	-4.66%	-2.41%	-13.90%	-1.98%
Softs Sub-Index	-3.85%	-5.27%	-16.71%	-22.46%
Coffee	-8.69%	-7.48%	-21.60%	-17.52%
Sugar	-3.96%	-5.35%	-20.72%	-33.03%
Cotton	2.95%	12.37%	-0.53%	-18.79%
Livestock Sub-Index	0.41%	-1.80%	-8.61%	-8.20%
Cattle	-1.72%	-0.18%	-0.54%	6.67%
Hogs	4.50%	-4.60%	-22.49%	-28.96%

In homage to Jimmy Piersall, the theme for the USD rally should be "fear strikes out." While it advanced on the EUR, CAD, CHF and JPY amongst the majors, it retreated against the Nordics, the AUD and the NZD. Its performance against the minors has been mixed. Everyone is fearful about a runaway USD; the real story here is why it has yet to do so.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.11%	-1.46%	-14.16%	-17.04%
Chinese yuan	-0.25%	-0.68%	-1.84%	-2.74%
Japanese yen	-0.24%	-0.18%	-12.83%	-14.07%
British pound	0.03%	1.68%	-7.21%	-7.52%
Swiss franc	-0.64%	-6.66%	-2.64%	-5.19%
Canadian dollar	-0.66%	-3.34%	-12.46%	-11.43%
Australian dollar	1.03%	-4.04%	-15.56%	-12.93%
Swedish krona	0.46%	-2.51%	-17.53%	-22.08%
Norwegian krone	0.83%	1.94%	-17.70%	-19.01%
New Zealand dollar	0.93%	-1.47%	-10.13%	-9.37%
Indian rupee	-0.04%	-0.86%	-2.57%	0.01%
Brazilian real	-1.21%	-8.94%	-21.17%	-17.39%
Mexican peso	-0.97%	-2.46%	-12.62%	-11.66%
Chilean peso	0.42%	2.08%	-5.13%	-9.81%
Colombian peso	-3.00%	-3.35%	-22.01%	-16.83%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.57%	-0.95%	-4.04%	-3.25%

We get to pretend once more Greece will pay its bills. This is a distraction; the real story is all corporate earnings everywhere are going to remain discounted against artificially low rates. The one story that needs more attention is the ongoing struggle of the Latin American market.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.96%	5.13%	2.87%	9.46%
North America	0.60%	4.74%	5.90%	15.54%
Latin America	-0.74%	-0.06%	-25.13%	-7.17%
Emerging Market Free	-0.21%	2.97%	-8.46%	6.51%
EAFE	1.55%	5.78%	-1.69%	0.83%
Pacific	2.47%	6.17%	-0.78%	7.71%
Eurozone	1.00%	6.05%	-1.25%	-3.48%

CTAs managed to do well this week in the absence of strong trends, suggesting they remain short the energy complex and long equities. The decent performance of hedge funds was predictable given the upturn in both U.S. and EAFE equities.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.17%	0.88%	22.00%	30.22%
Newedge Trend	0.20%	0.41%	16.58%	21.75%
Newedge Short-Term	0.16%	1.46%	9.50%	9.21%
HFR Global Hedge Fund	0.47%	1.66%	-0.88%	-0.11%
HFR Macro/CTA	0.24%	1.24%	7.60%	8.38%
HFR Macro: Sytematic Diversified CTA	0.22%	1.40%	8.79%	7.10%