The Macro Environment For Financial Markets

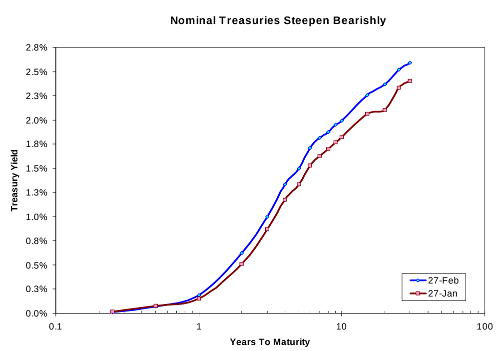
Now that the baseball season is approaching through the snow and ice, let's turn to White Sox broadcaster Ken Harrelson's parable of the Heinie Bird, a mythical creature that flies in perfectly executed concentric circles until it eventually flies up its own backside and disappears. Now that I have explained the European Central Bank's plan to buy increasing amounts of ever-scarcer Bunds and other high-quality (snicker) Eurozone sovereign debt at negative yields, make cash a hot potato (*Patate chaude*? *Heisse kartoffel*?) and assure the complete misallocation of capital as all investments today in real plant and equipment have to be made with the rational expectation long-term interest rates will be higher when they become operational. Did I mention the part about demanding fiscal reforms when governments are being paid to go into debt? All of this loose cash (*Dinero suelto*?) will support financial assets and, I assure you, will be a complete Heinie Bird for real output and employment. How would you like to have been Janet Yellen facing questions of whether the Federal Reserve is serving a "liberal" agenda?

The causal chain now is:

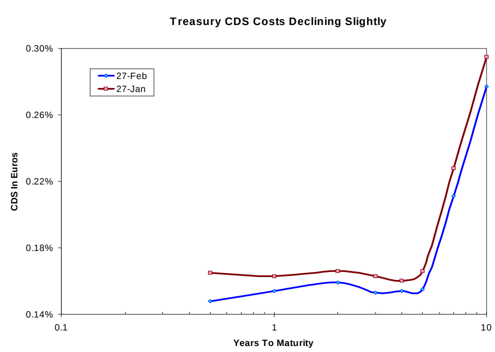
1. Short-term interest rates will remain artificially low globally;
2. Disinflationary pressures will remain so long as the global banking system remains unable to expand credit;
3. Inflation expectations as measured by the TIPS market will rise more slowly than nominal rates will;
4. Sovereign debt yields will 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 at the short end of the yield curve as floating-rate payors move to fix their payments but will reflect a rising complacency about long-term rates; and
8. Credit spreads will move toward their 2014 lows

Key Market Indications

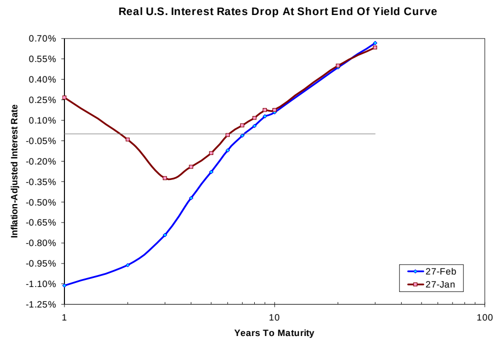
Ten-year UST were unable to mount a decent challenge of support even when the market is imbalanced with complacent longs. The U.S. is a relatively high-yielding bond market and feints toward higher short-term interest rates are greeted with a flattening of the yield curve as higher rates are seen as disinflationary. The answer to the question, "How long can this persist?" is "Longer than you think."



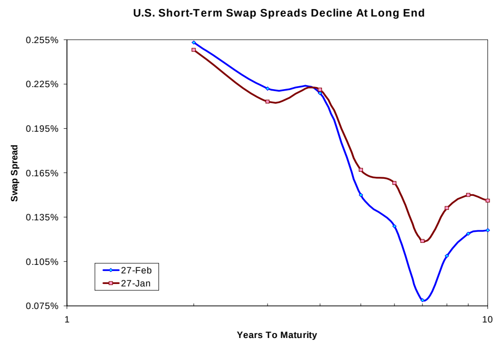
Future Washington veterans will recall the days when we really knew how to manufacture crises. Two people on the planet got worked up about closing down Homeland Security, and both of them probably worked at CNN. Euro-denominated CDS on U.S. debt have declined, which is just as well because right after getting paid in euros, you will get the proverbial two weeks in Philadelphia as a bonus.



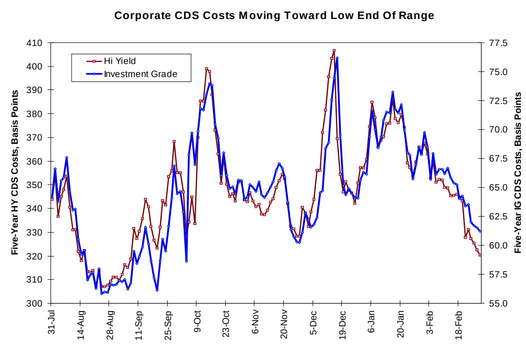
Implied real rates are in a bearish steepening as short-term breakevens rose. These lower short-term implied real rates, both in the U.S. and in the Eurozone, put a floor under gold. Stable long-term implied real rates pose no threat to stocks or corporate bonds.



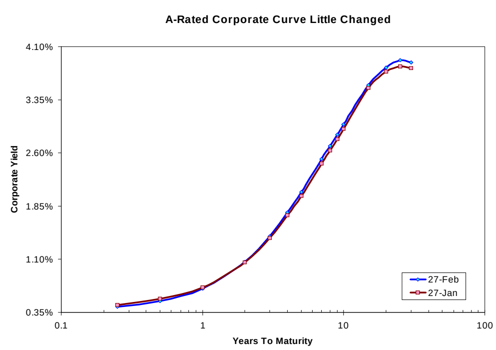
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have been even more strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates. These declining long-term swap spreads are positive for corporate bonds and by extension for equities.



Both the IG and HY CDS indices moved further 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. A challenge of 2014's lows in credit spreads looks increasingly possible, something that seemed out of the question only two months ago.



The A-rated yield curve has been far more stable than has the UST yield curve over the past month. The small shift higher in long-term yields will dissipate under declining swap spreads and credit spreads; this will be bullish for equities.



Market Structure

Life can be full of mysteries: While none of the physical commodity subindices are in structural uptrends, the main Bloomberg index moved into one. Both the EAFE and EM indices joined the S&P 500 in uptrends in the financials while ten-year UST remained in a downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Mar. 2 - 6
BBerg	20	Trending	0.052	14.0%	0.06%
BBerg Grain	17	Transitional	0.052	16.6%	
BBerg Ind. Metl	18	Transitional	0.025	16.0%	
BBerg Pre. Metl	29	Trending	-0.167	17.7%	-0.33%
BBerg Softs	29	Trending	-0.418	16.0%	-0.21%
BBerg Nat. Gas	19	Transitional	-0.030	38.7%	
BBerg Petroleum	8	Sideways	0.082	30.7%	
BBerg Livestock	13	Transitional	0.070	15.0%	
Dollar Index	18	Transitional	0.115	8.2%	
S&P 500 Index	29	Trending	0.184	10.5%	0.13%
EAFE Index	29	Trending	0.359	9.7%	0.20%
EM Index	21	Trending	0.119	9.5%	0.15%
Ten-year UST (price)	27	Trending	-0.075	8.1%	-0.10%

Performance Measures

The economically unimportant Softs continue their downtrends, but the Petroleum and Industrial Metals indices gained this week, with both ULSD and gasoline leading the way. Natural Gas managed to turn lower as winter's concluding blasts will not be sufficient to create a supply shortfall.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.69%	2.09%	-17.44%	-22.77%
Grains Sub-Index	1.21%	4.85%	-2.43%	-19.43%
Corn	0.06%	4.16%	2.40%	-22.41%
Soybeans	2.94%	7.00%	-1.96%	-14.23%
Wheat	1.18%	4.13%	-8.75%	-20.86%
Energy Sub-Index	0.24%	5.95%	-36.63%	-42.18%
Petroleum Sub-Index	3.07%	7.67%	-39.25%	-42.66%
WTI	0.10%	1.02%	-45.22%	-48.05%
ULSD	3.10%	11.94%	-28.56%	-33.41%
Gasoline	6.61%	9.50%	-32.91%	-36.89%
Natural Gas	-7.73%	0.92%	-34.01%	-44.51%
Precious Metals Sub-Index	0.89%	-4.80%	-6.71%	-12.32%
Gold	0.68%	-5.00%	-4.23%	-8.45%
Silver	1.46%	-4.27%	-14.04%	-23.03%
Industrial Metals Sub-Index	2.30%	0.95%	-16.17%	-8.07%
Copper	3.88%	8.10%	-14.53%	-15.37%
Aluminum	1.17%	-3.12%	-15.45%	-1.21%
Nickel	0.97%	-8.18%	-24.68%	-5.90%
Zinc	0.78%	-3.22%	-14.11%	-3.07%
Softs Sub-Index	-4.02%	-7.81%	-21.68%	-29.73%
Coffee	-8.11%	-14.98%	-35.56%	-28.75%
Sugar	-3.84%	-2.90%	-24.64%	-37.75%
Cotton	0.42%	7.96%	1.22%	-17.32%
Livestock Sub-Index	1.42%	-0.89%	-11.81%	-10.88%
Cattle	2.14%	1.40%	-2.03%	6.30%
Hogs	0.11%	-4.86%	-27.84%	-33.88%

It should be apparent by now there is no monolithic USD rally. The markets understand the USD will not be permitted to advance too strongly for fear of creating a banking crisis amongst all those institutions with USD liabilities. The outsized weight of the EUR in most currency indices makes them look weaker than they are, and this is likely to continue given the continued drive lower in Eurozone interest rates.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.63%	-1.63%	-15.14%	-18.34%
Chinese yuan	-0.21%	-0.42%	-2.01%	-2.25%
Japanese yen	-0.50%	-1.47%	-13.17%	-14.63%
British pound	0.25%	1.59%	-6.87%	-7.49%
Swiss franc	-1.69%	-5.39%	-4.14%	-6.92%
Canadian dollar	0.13%	-0.93%	-13.18%	-11.14%
Australian dollar	-0.43%	-1.63%	-16.38%	-12.91%
Swedish krona	0.57%	-1.86%	-16.65%	-21.83%
Norwegian krone	-1.81%	0.87%	-19.38%	-21.21%
New Zealand dollar	0.50%	1.50%	-9.67%	-9.62%
Indian rupee	0.62%	-0.70%	-2.24%	0.24%
Brazilian real	1.00%	-9.42%	-20.91%	-18.37%
Mexican peso	0.54%	-2.22%	-12.48%	-11.30%
Chilean peso	-0.27%	0.89%	-4.45%	-9.02%
Colombian peso	-1.65%	-4.99%	-22.82%	-17.86%
Bloomberg-JP Morgan Asian dollar index (spot)	0.25%	-0.85%	-4.13%	-2.91%

Let's be blunt: If equities cannot advance in the face of negative-yielding bonds across most of Europe, they never should. Take all of the claptrap about earnings fundamentals and the distraction of the news flow and put it aside for now. You either go long equities or long real estate because both bonds and cash are unappealing and bonds quite possibly are riskier.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.31%	4.19%	2.27%	8.91%
North America	-0.17%	3.96%	4.94%	14.45%
Latin America	1.02%	-2.44%	-25.81%	-6.78%
Emerging Market Free	0.61%	0.18%	-8.67%	5.74%
EAFE	1.09%	4.56%	-1.73%	1.05%
Pacific	0.85%	4.42%	0.03%	6.84%
Eurozone	1.57%	5.23%	-2.28%	-1.95%

Even though CTAs had a flat-to-down month, they had a good last week of February, suggesting they were long the equity indices and took selective winning positions within currencies. The decent performance of hedge funds is, once again, associated with rising equity markets.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	2.07%	-0.02%	22.35%	31.69%
Newedge Trend	1.64%	-0.90%	17.20%	22.82%
Newedge Short-Term	1.53%	0.59%	10.73%	10.72%
HFR Global Hedge Fund	0.48%	1.46%	-0.79%	-0.03%
HFR Macro/CTA	0.77%	0.73%	7.35%	8.99%
HFR Macro: Sytematic Diversified CTA	1.13%	0.87%	9.16%	8.36%