The Macro Environment For Financial Markets

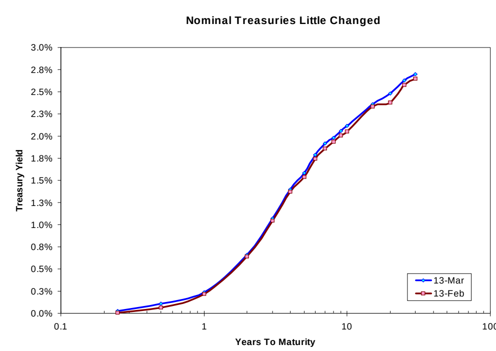
In words I never thought I would write, I kind of feel sorry for Japan and its inability to destroy the purchasing power of the yen despite three attempts in two and one-half years and allegedly another one on the way. The European Central Bank seems to have achieved this dubious goal on its first foray into QE. So far, it is hard to know what has been purchased for this policy other than a slew of negative interest rates, some local-currency rallies in European stocks and a strong signal to all and sundry not to make capital investments in the face of future higher interest rates. Of course, they can come back at the Federal Reserve and wonder why the U.S. would be raising short-term interest rates in the face of a strongly rising dollar and spot shortages of highly skilled labor. Just as low interest rates did nothing to end underemployment here after the Great Recession, a federal funds rate of 25 or 50 basis points will not affect the demand for engineers, programmers and other sorts of people the U.S. educational system does such a good job of not training. Did I just digress into social commentary? I did.

The causal chain now is:

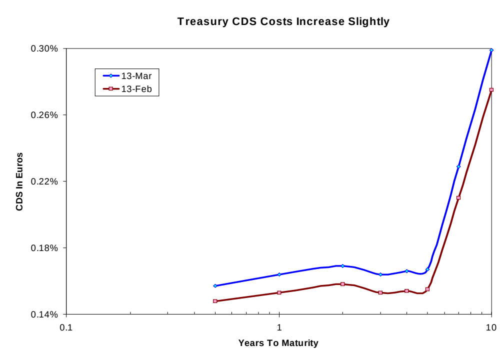
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S.;
2. Disinflationary pressures will remain so long as the global banking system remains unable to expand credit;
3. Inflation expectations as measured by the TIPS market will rise more slowly than nominal rates will;
4. Sovereign debt yields have not entered a secular bear market;
5. The U.S. yield will retain a bias toward flattening, but via higher short-term rates;
6. Short-term borrowers will start to lock in low rates and gradually end their acceptance of 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. This has yet to proceed to the long end of the yield curve; and
8. Credit spreads will remain well-confined at historically low levels.

Key Market Indications

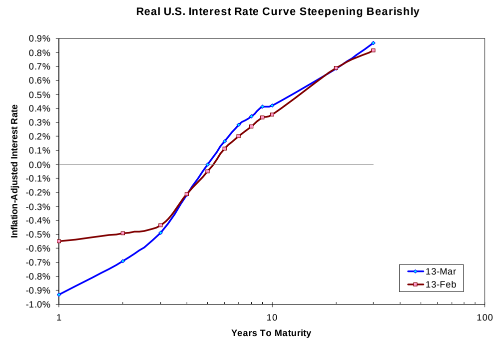
Every now and then a market stays in a range not out of inertia but rather out of fear of making a decision. It does not seem appealing to buy UST with implied real rates either negative or low, but how can you go short aggressively with rising levels of global risk aversion? The path of least resistance has been a bullish flattening of the yield curve, and once the market collects its wits about a small rate hike at some point in 2015, that secular trend may return.



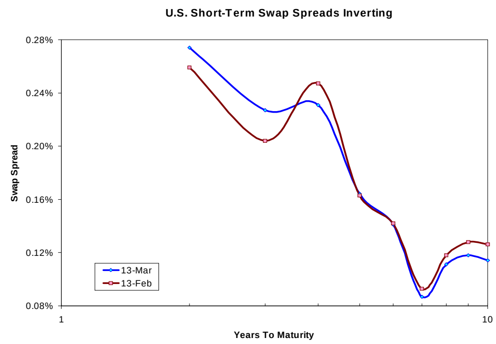
This market continues to remain uninteresting. We cannot rely on the usual collection of worthies to drum up a decent debt ceiling "crisis" anymore.



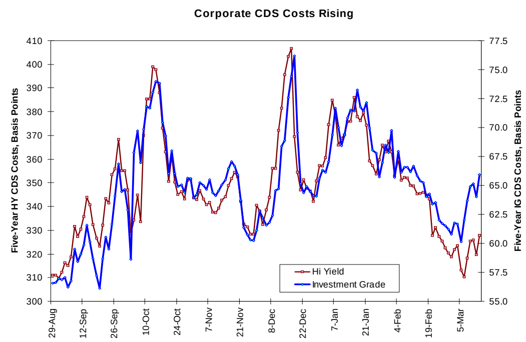
Almost nothing changed in this important market over the past week: Implied real rates continue in their bearish steepening as short-term breakevens remain elevated. Incredibly, these rates have cushioned what should have been an even stronger selloff in precious metals. The rise in long-term implied real rates should not pose an immediate threat to stocks or to corporate bonds.



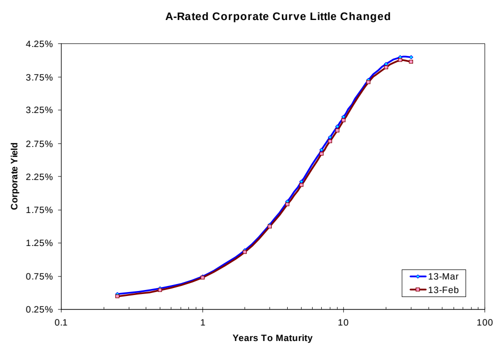
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates. These declining long-term swap spreads are by themselves positive for corporate bonds and by extension for equities. However, the same forces pushing the USD and short-term swap spreads higher are negative for equities.



The increase in HY credit risk is linked to deteriorating credit quality in energy-sector bonds. Investment-grade energy sector bonds remain unaffected so far. Both IG and HY CDS indices failed in this approach to their 2014 lows, but nothing over the past week suggests a structural reversal is at hand.



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 stable credit spreads; this will be supportive for equities.



Market Structure

All of the physical commodity indices save for Natural Gas are in structural downtrends. The EM index is in a downtrend now, while the dollar index is overbought within its uptrend. None of the other financial indices are in trending structures.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Mar. 16 - 20
BBerg	28	Trending	-0.347	12.6%	-0.44%
BBerg Grain	23	Trending	-0.142	15.5%	-0.86%
BBerg Ind. Metl	28	Trending	-0.048	15.3%	-0.36%
BBerg Pre. Metl	29	Trending	-0.325	16.0%	-0.33%
BBerg Softs	29	Trending	-0.631	16.9%	-0.21%
BBerg Nat. Gas	19	Transitional	-0.028	79.1%	
BBerg Petroleum	29	Trending	-0.219	34.8%	-1.11%
BBerg Livestock	20	Trending	-0.180	15.3%	-0.42%
Dollar Index	28	Trending	0.548	8.7%	0.33%
S&P 500 Index	29	Trending	-0.161	8.3%	
EAFE Index	29	Trending	-0.147	9.2%	
EM Index	26	Trending	-0.411	9.0%	-0.38%
Ten-year UST (price)	14	Transitional	-0.025	6.6%	

Performance Measures

I noted last week the important takeaway from the physical commodity markets was they were moving back into bear markets without a strong downturn in the Petroleum complex. No more; these markets look as if the January lows will be taken out soon. To repeat, while the relationship between individual currencies, short-term interest rates and individual commodity prices is not the simple one portrayed commonly, this is a business of shooting first and asking questions later. Right now, the initial reaction is to err on the side of bearishness and endure the inevitable short-covering outbursts that dot every commodity bear market.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-3.17%	-6.60%	-19.55%	-27.48%
Grains Sub-Index	-0.10%	-3.50%	0.74%	-25.53%
Corn	-1.42%	-3.73%	6.47%	-28.25%
Soybeans	-1.12%	-2.08%	-3.06%	-18.00%
Wheat	4.04%	-5.15%	-1.38%	-30.78%
Energy Sub-Index	-7.02%	-9.46%	-41.34%	-45.53%
Petroleum Sub-Index	-8.03%	-11.43%	-45.20%	-47.78%
WTI	-8.57%	-14.37%	-50.16%	-51.22%
Brent	-8.40%	-11.56%	-47.93%	-51.46%
ULSD	-8.11%	-11.27%	-36.04%	-39.89%
Gasoline	-6.47%	-6.20%	-39.24%	-42.84%
Natural Gas	-4.04%	-3.40%	-33.90%	-42.34%
Precious Metals Sub-Index	-1.28%	-7.32%	-9.29%	-19.28%
Gold	-1.03%	-6.10%	-6.56%	-16.26%
Silver	-1.98%	-10.63%	-17.20%	-27.83%
Industrial Metals Sub-Index	0.48%	-1.59%	-15.27%	-6.09%
Copper	2.09%	2.19%	-14.10%	-8.67%
Aluminum	-0.65%	-3.78%	-14.20%	-2.69%
Nickel	-1.68%	-3.62%	-23.86%	-11.96%
Zinc	-0.45%	-6.71%	-12.60%	-0.82%
Softs Sub-Index	-5.58%	-14.45%	-22.10%	-38.45%
Coffee	-7.22%	-22.04%	-32.44%	-42.37%
Sugar	-5.51%	-14.42%	-21.96%	-43.10%
Cotton	-3.92%	-4.45%	-9.42%	-26.78%
Livestock Sub-Index	-2.34%	-1.69%	-16.34%	-16.07%
Cattle	-0.70%	0.22%	-3.56%	8.38%
Hogs	-5.07%	-4.93%	-35.89%	-44.85%

Let's start with the exceptions: Neither the CNY nor the MXN turned lower this week. The USD gained everywhere else, with the gains against the EUR being notable for a currency of its importance. The downturns in the other Latin American currencies reflect not only USD strength but a wholesale vote against economic mismanagement and political corruption. Please note neither Argentina nor Venezuela are included in this table.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-3.21%	-7.88%	-18.89%	-24.32%
Chinese yuan	0.07%	-0.29%	-1.88%	-1.94%
Japanese yen	-0.47%	-2.18%	-11.71%	-16.11%
British pound	-1.95%	-4.23%	-9.17%	-11.31%
Swiss franc	-1.95%	-7.30%	-7.00%	-13.02%
Canadian dollar	-1.24%	-2.62%	-13.52%	-13.35%
Australian dollar	-1.02%	-1.61%	-15.41%	-15.44%
Swedish krona	-2.87%	-3.33%	-18.34%	-26.78%
Norwegian krone	-3.70%	-7.57%	-22.14%	-27.29%
New Zealand dollar	-0.38%	-1.65%	-10.30%	-14.15%
Indian rupee	-1.26%	-1.22%	-2.89%	-2.84%
Brazilian real	-5.69%	-12.74%	-27.88%	-27.23%
Mexican peso	0.07%	-3.89%	-14.54%	-14.18%
Chilean peso	-1.82%	-3.23%	-6.73%	-10.46%
Colombian peso	-3.18%	-10.68%	-25.53%	-23.30%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.54%	-1.36%	-4.50%	-3.94%

The euro carry trade may be operating for EM bonds, but it most certainly is not operating for EM equities. The renewed downturn in crude oil is combining with the strong USD and prospects for higher short-term interest rates to stall the U.S. market.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.22%	-1.61%	0.47%	6.73%
North America	-0.90%	-2.01%	3.11%	12.08%
Latin America	-5.00%	-11.53%	-30.30%	-15.19%
Emerging Market Free	-3.24%	-4.67%	-10.77%	2.47%
EAFE	-1.72%	-0.96%	-3.52%	-0.95%
Pacific	-0.22%	2.55%	1.17%	6.90%
Eurozone	-1.90%	-1.81%	-5.57%	-4.14%

CTAs and macro-oriented hedge funds turned in a strong performance this week, most likely impelled by the strong USD rally. The trade is getting crowded, but sometimes trades get crowded for good reasons.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.27%	3.03%	21.15%	32.98%
Newedge Trend	0.73%	1.98%	15.29%	23.56%
Newedge Short-Term	0.06%	1.66%	9.66%	10.99%
HFR Global Hedge Fund	0.04%	1.16%	-0.69%	0.12%
HFR Macro/CTA	0.86%	1.81%	7.21%	10.67%
HFR Macro: Sytematic Diversified CTA	1.19%	1.97%	9.98%	10.04%