The Macro Environment For Financial Markets

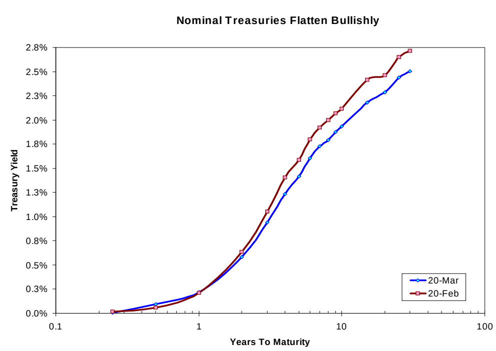
Cynicism simply is a device for getting to the right answer faster. I always questioned why the Federal Reserve would be willing to risk the one ringing success of their post-crisis policies, higher asset valuations, simply because a few more people are employed. If we add to that why they would be willing to fuel a dollar rally when it was threatening both U.S. exporters and all banks with USD liabilities, we get a recipe for blinking. We know we can keep rates low and not trigger rising inflation until and unless bank credit expands, but we do not know if raising rates by a trivial amount will slow employment growth and we are completely certain torpedoing employment growth and financial markets simultaneously via some monetary Excellent Adventure would get Janet and Her Merry Crew into the history books for all of the wrong reasons. On the other hand, if you maintain a bull market, everyone loves you and may even call you Maestro one day as they did with Alan Greenspan. What would you do?

The causal chain now is:

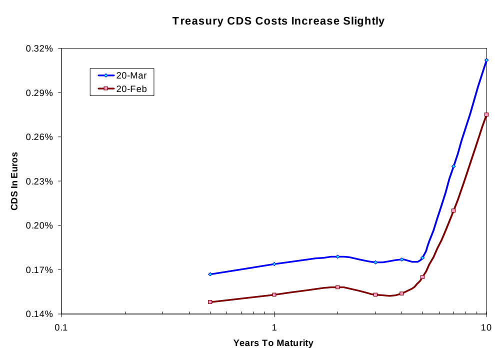
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point;
2. Disinflationary pressures will remain so long as the global banking system remains unable to expand credit;
3. Inflation expectations as measured by the TIPS market will remain confined as the demand for inflation protection will recede in a more risk-seeking environment;
4. Sovereign debt yields will remain in their secular bull market;
5. The U.S. yield will retain a bias toward flattening;
6. Short-term borrowers will continue to accept rollover risk;
7. Swap spreads will remain tame until monetary policy indications turn more hawkish; and
8. Credit spreads will remain well-confined at historically low levels.

Key Market Indications

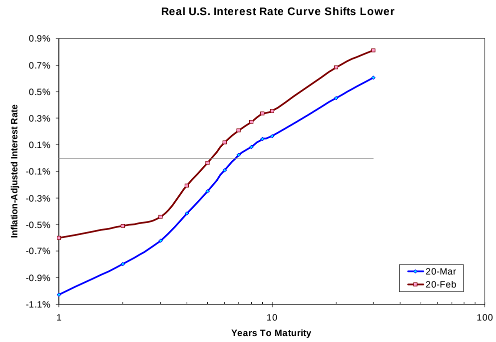
As I noted last week, the path of least resistance has been a bullish flattening of the yield curve. Every time you think otherwise, you are reminded that in a world of rising risk-aversion, low inflation, regulatory constraints and monetary ease you should be long, bull-spread or out of bonds, but never short. There are many things to dislike about the Millennial generation; the fact they have yet to experience a bear market in bonds during their lifetime is but one of them.



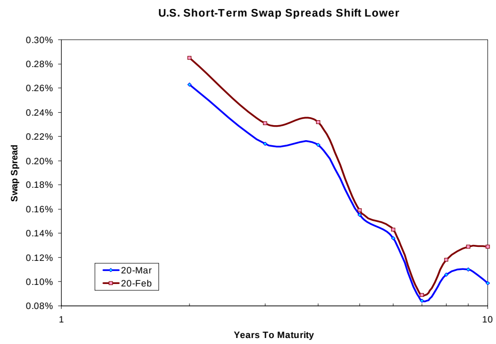
This market continues to remain uninteresting. Even some rumblings about the debt ceiling barely generated a twitch higher.



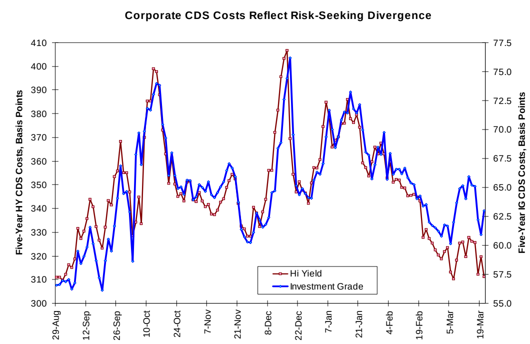
The combination of lower nominal rates and higher breakevens push implied real rates lower. This was supportive of both risky financial assets and precious metals simultaneously.



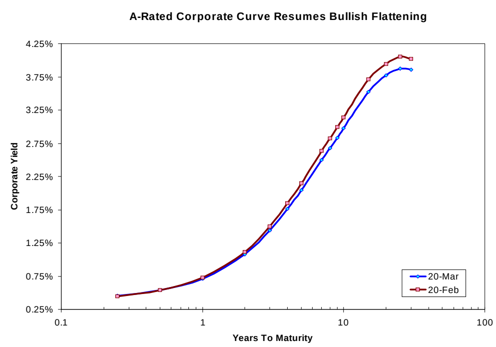
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates. If we add lower short-term rates to the mix, we see a downward shift in swap spreads, including those at the short end of the yield curve. This is bullish for both corporate bonds and for equities.



One of the better Wall Street clichés is “the dash for trash.” High-yield CDS levels declined more rapidly than investment-grade CDS levels as lower short-term interest rates and declining swap spreads encouraged risk-takers to take risk. That is what they do, after all. We are at the point where taking credit risk is preferable to accepting negative yields.



The A-rated yield curve has been far more stable than has the UST yield curve over the past month. The bullish flattening here was smaller than that for Treasuries, but the end effect is the same; it will encourage further risk-seeking behavior..



Market Structure

While the main Bloomberg index remains in a structural downtrend, only Petroleum and Livestock do after a week of short-covering. Treasuries, the S&P 500 and the EAFE index all re-entered structural uptrends. The dollar index fell out of one.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Mar. 23 - 27
BBerg	29	Trending	-0.124	12.0%	-0.44%
BBerg Grain	25	Trending	0.019	16.0%	
BBerg Ind. Metl	29	Trending	0.137	15.4%	0.17%
BBerg Pre. Metl	29	Trending	0.044	14.2%	
BBerg Softs	5	Sideways	0.033	17.5%	
BBerg Nat. Gas	19	Transitional	0.004	78.4%	
BBerg Petroleum	29	Trending	-0.195	29.9%	-1.11%
BBerg Livestock	22	Trending	-0.056	14.4%	-0.42%
Dollar Index	4	Sideways	-0.040	23.3%	
S&P 500 Index	29	Trending	0.112	8.3%	0.06%
EAFE Index	29	Trending	0.204	10.4%	0.11%
EM Index	29	Trending	-0.014	9.9%	-0.38%
Ten-year UST (price)	29	Trending	0.147	7.0%	0.13%

Performance Measures

I noted last week we would have to "endure the inevitable short-covering outbursts that dot every commodity bear market. " Coffee returned 10.44% this week because the FOMC tap-danced? Really? As the Great Depression ditty went, "Let's have another cup of coffee; let's have another piece of pie." Let's also remind ourselves we have been in a commodity bear market for four years while global monetary policies have broken records for ease. Good traders sell physical commodities in bear markets; great traders sell them at higher prices.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.02%	-3.10%	-16.68%	-25.28%
Grains Sub-Index	1.86%	-0.66%	6.10%	-25.33%
Corn	1.18%	-2.03%	10.01%	-26.42%
Soybeans	-0.03%	-2.84%	-0.22%	-20.16%
Wheat	5.58%	4.54%	10.26%	-30.04%
Energy Sub-Index	0.86%	-7.72%	-40.96%	-45.08%
Petroleum Sub-Index	0.56%	-8.09%	-45.09%	-47.55%
WTI	-1.04%	-10.60%	-50.83%	-52.20%
Brent	0.90%	-8.48%	-47.56%	-50.81%
ULSD	1.14%	-8.52%	-34.71%	-39.39%
Gasoline	2.06%	-2.89%	-39.30%	-40.95%
Natural Gas	1.71%	-6.66%	-32.65%	-41.27%
Precious Metals Sub-Index	4.40%	-0.35%	-3.43%	-12.94%
Gold	2.78%	-1.71%	-2.78%	-11.22%
Silver	8.97%	3.45%	-5.93%	-18.41%
Industrial Metals Sub-Index	2.54%	3.24%	-11.73%	-3.13%
Copper	3.66%	6.56%	-10.52%	-5.51%
Aluminum	1.42%	-0.07%	-10.56%	0.54%
Nickel	0.79%	1.97%	-20.53%	-11.66%
Zinc	2.72%	0.73%	-10.15%	3.29%
Softs Sub-Index	3.40%	-8.22%	-16.41%	-30.85%
Coffee	10.44%	-6.24%	-22.64%	-24.74%
Sugar	-0.16%	-11.45%	-19.52%	-40.63%
Cotton	3.84%	-2.84%	-0.67%	-24.38%
Livestock Sub-Index	1.38%	0.97%	-14.54%	-15.67%
Cattle	3.58%	7.10%	0.24%	12.81%
Hogs	-2.09%	-8.81%	-36.26%	-47.33%

Maybe the FOMC was not motivated by the USD's strength. That is irrelevant; what we can see is how a pause in the path toward higher short-term rates could intersect with imbalanced risk positions and drive even well-avoided currencies such as the BRL and abused negative-rate currencies such as the SEK higher. This is likely to reverse once the inevitable drumbeat about higher short-term rates in the U.S. begins anew.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	3.10%	-4.92%	-15.78%	-21.47%
Chinese yuan	0.88%	0.83%	-1.03%	0.39%
Japanese yen	1.13%	-0.84%	-9.33%	-14.70%
British pound	1.39%	-2.92%	-8.63%	-9.42%
Swiss franc	3.12%	-3.79%	-3.62%	-9.37%
Canadian dollar	1.84%	-0.17%	-12.01%	-10.42%
Australian dollar	1.81%	-0.85%	-12.37%	-13.98%
Swedish krona	1.05%	-2.76%	-17.06%	-25.61%
Norwegian krone	2.39%	-6.14%	-20.86%	-24.33%
New Zealand dollar	3.16%	0.53%	-6.83%	-11.32%
Indian rupee	0.80%	-0.40%	-2.64%	-1.82%
Brazilian real	0.55%	-11.18%	-25.78%	-27.95%
Mexican peso	2.87%	-0.17%	-11.81%	-11.93%
Chilean peso	0.98%	-2.68%	-5.05%	-10.56%
Colombian peso	3.77%	-4.45%	-22.42%	-22.53%
Bloomberg-JP Morgan Asian dollar index (spot)	1.13%	0.32%	-3.21%	-1.99%

Follow the money; what, did you think it was going to follow you? In this case, excess EAFE-based currencies were flowing not into EM or North American markets but were remaining in EAFE markets. The key to the global equity rally was the removal of the dollar-squeeze threat to non-U.S. banks.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	3.22%	0.59%	3.04%	9.97%
North America	2.72%	0.06%	4.82%	13.75%
Latin America	5.46%	-6.01%	-26.57%	-14.11%
Emerging Market Free	3.21%	-1.41%	-7.30%	6.01%
EAFE	4.02%	1.45%	0.33%	4.40%
Pacific	2.69%	2.78%	4.87%	14.34%
Eurozone	4.26%	1.36%	-1.93%	-1.14%

The ability of both CTAs and hedge funds to record gains in a week with high volatility and multiple reversals is impressive. Trades had become quite crowded and with liquidity suspect in many markets, this was just the sort of set-up that precedes headline disasters and *Wall Street Journal* post-mortems.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.52%	5.73%	22.74%	39.16%
Newedge Trend	1.26%	3.88%	17.92%	26.07%
Newedge Short-Term	0.47%	2.44%	9.77%	13.18%
HFR Global Hedge Fund	0.34%	1.03%	-0.46%	0.51%
HFR Macro/CTA	1.03%	2.62%	7.37%	11.76%
HFR Macro: Sytematic Diversified CTA	1.83%	3.61%	10.67%	12.40%