The Macro Environment For Financial Markets

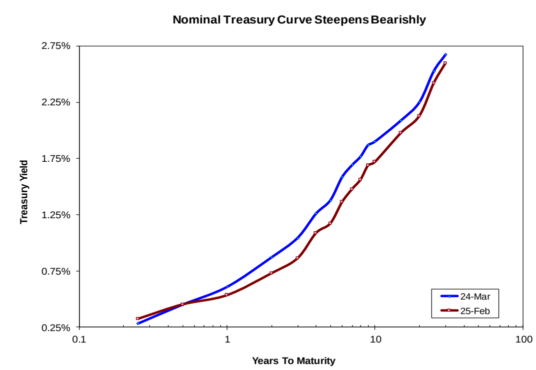
Perhaps the only thing more tedious than a Fed-watcher is a Fed-watcher with a seat on the FOMC. That group no more than excused itself from raising rates before it started acting as if no one in the room was responsible. This is where the old Soviet principle of democratic centralism, “Freedom in discussion, unity in action,” would be useful. In the meantime, things just keep muddling through in the same low-growth, low-profit, and low-investment state of affairs prevailing since the financial crisis. Who in the present political environment prevailing in the industrialized world can advocate raising interest rates to discourage consumption and raise the cost of public-sector transfer payments to restore the incentives for savings and investment? Hint: The answer is no one.

The causal chain now is:

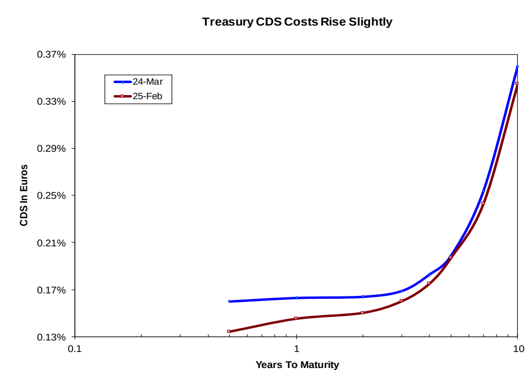
1. The market once again has to entertain the prospect of higher short-term rates in the U.S. ;
2. Disinflationary pressures will persist globally but are starting to dissipate in the U.S.;
3. Inflation expectations as measured by TIPS and inflation swaps have established a strong tradable bottom;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are reducing rollover risk;
6. Swap spreads will remain low; and
7. Credit spreads have failed to break resistance levels.

Key Market Indications

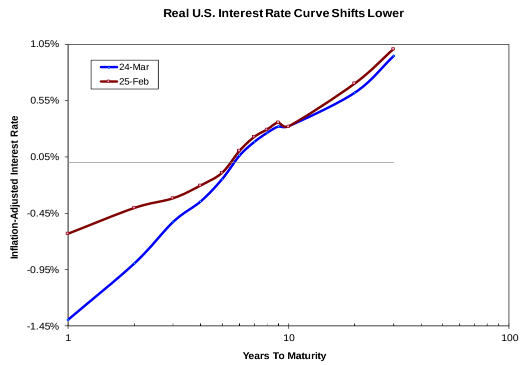
If we run the thought-experiment on where UST yields would be in the absence of negative sovereign rates elsewhere, the answer probably would be higher, but only if inflationary expectations do not get out of hand. The threat of the latter explains why the Federal Reserve keeps talking about raising short-term rates even though there is no evidence such a move would lower either expected or reported inflation. Its most likely effect would be a flattening of the yield curve, most likely a bullish one.



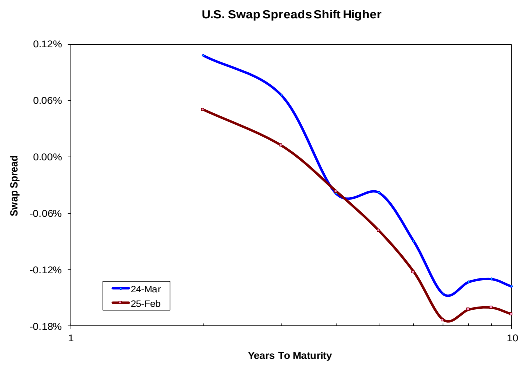
The CDS market for Treasuries has been completely dormant, as it should be. The small shift higher at shorter tenors is insignificant.



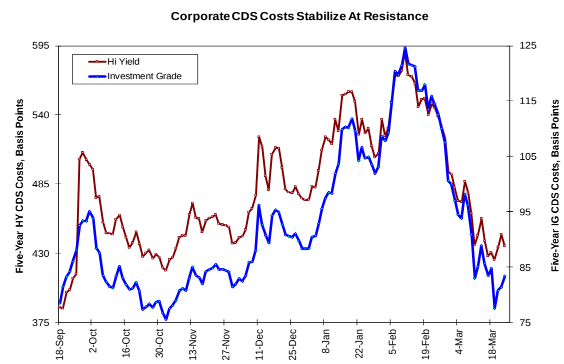
The pseudo-real rate curve shifted lower over the past month and is negative through five years. The strong move lower at the short end of the yield curve is attributable to a large increase in breakevens intersecting with smaller changes in nominal rates. The decline in pseudo-real rates remains positive for precious metals even after this past week's decline in those markets.



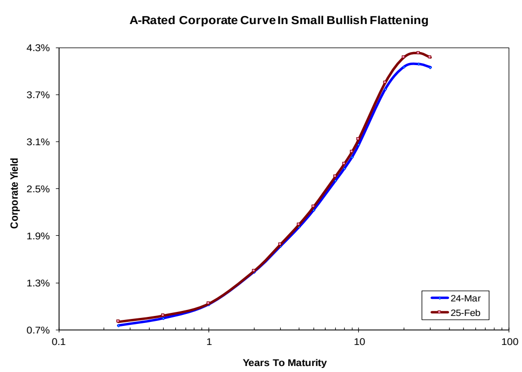
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have shifted higher over the past month and remain inverted. The inversion of this curve is confirmed in the swaption market as well. The belief seems to be that long-term rates will remain constrained even if short-term rates are pushed higher.



CDS costs for both the investment-grade and high-yield indices have stabilized just over their late-2014 resistance levels. They are likely to remain here as credit conditions are not worsening in sectors such as finance, energy and basic materials nor are they improving significantly in response to the continuation of low and negative short-term rates globally.



Last week's comment can be repeated verbatim: The A-rated yield curve had a small bullish flattening over the past month, a divergence from the UST curve's bearish steepening, but this decline in credit spreads is relatively minor. Please remember the A-rated yield curve never worsened significantly during the January-February selloff; this market has been a buffer in general and a haven for longer-term investors.



Market Structure

None of the physical commodities are in structural downtrends. Upward momentum, however, has dissipated. Both ten-year UST and the dollar index remain in structural downtrends while the stock indices remain in uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Mar. 28 - Apr. 1
BBerg	29	Trending	0.170	11.6%	0.36%
BBerg Grain	6	Sideways	0.028	10.5%	
BBerg Ind. Metl	11	Transitional	-0.096	15.1%	
BBerg Pre. Metl	18	Transitional	-0.131	15.3%	
BBerg Softs	29	Trending	0.325	16.8%	0.41%
BBerg Nat. Gas	15	Transitional	0.025	31.2%	
BBerg Petroleum	29	Trending	0.140	36.8%	0.71%
BBerg Livestock	29	Trending	-0.076	9.2%	
Dollar Index	24	Trending	-0.074	9.3%	-0.19%
S&P 500 Index	29	Trending	0.254	10.8%	0.42%
EAFE Index	28	Trending	0.068	14.6%	0.58%
EM Index	29	Trending	0.360	13.0%	0.28%
Ten-year UST (price)	25	Trending	-0.064	6.0%	-0.08%

Performance Measures

The uniformity of downtrends over the past week was notable; only the Grains subindex managed a gain, and it was a minor one. The main Bloomberg index has failed at November 2015 levels; while various production cutbacks and threats of cutbacks propelled a significant short-covering rally since mid-February, this is still very much a secular bear market in physical commodities. It will remain so until import demand in general and Chinese import demand in particular revives.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.50%	4.66%	-10.35%	-20.90%
Grains Sub-Index	0.68%	3.41%	-5.93%	-12.96%
Corn	0.41%	2.66%	-8.19%	-15.59%
Soybeans	1.43%	5.23%	1.12%	-5.87%
Wheat	0.11%	2.01%	-10.13%	-13.69%
Energy Sub-Index	-3.77%	9.69%	-30.43%	-40.72%
Petroleum Sub-Index	-3.05%	12.32%	-26.41%	-37.70%
WTI	-5.27%	13.32%	-31.17%	-42.42%
Brent	-2.63%	12.88%	-25.95%	-40.46%
ULSD	-4.22%	9.78%	-29.61%	-39.14%
Gasoline	1.46%	11.87%	-17.49%	-23.95%
Natural Gas	-6.41%	0.82%	-43.76%	-51.12%
Precious Metals Sub-Index	-3.86%	-0.96%	4.98%	-1.95%
Gold	-3.37%	-1.30%	6.70%	1.76%
Silver	-5.20%	0.03%	0.23%	-11.66%
Industrial Metals Sub-Index	-2.94%	2.71%	-3.83%	-22.26%
Copper	-2.76%	7.55%	-2.86%	-20.96%
Aluminum	-3.63%	-5.69%	-7.87%	-21.62%
Nickel	-2.79%	3.55%	-13.70%	-37.68%
Zinc	-2.47%	3.52%	8.21%	-16.01%
Softs Sub-Index	-1.77%	10.01%	17.44%	1.59%
Coffee	-3.77%	9.84%	-0.70%	-17.96%
Sugar	-0.74%	11.79%	28.73%	15.50%
Cotton	-1.09%	-0.04%	-5.80%	-10.74%
Livestock Sub-Index	-3.82%	-1.33%	-3.99%	-7.93%
Cattle	-4.07%	-1.11%	-3.02%	-14.92%
Hogs	-3.51%	-1.62%	-6.04%	5.72%

Only the INR and COP managed to gain against the USD over the past week. While it is easy to attribute the USD's strength to the renewed prospect of higher short-term rates in the USD, let's remind ourselves the greenback has been in a trading range for about seven months through several reversals of interest rate expectations. The U.S., quite simply, cannot maintain a strong-dollar policy.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.95%	1.32%	-0.29%	1.76%
Chinese yuan	-0.68%	0.27%	-2.17%	-4.65%
Japanese yen	-1.34%	-0.06%	6.65%	5.68%
British pound	-2.39%	1.20%	-6.92%	-5.04%
Swiss franc	-0.89%	1.25%	0.13%	-1.89%
Canadian dollar	-1.98%	1.98%	0.53%	-5.63%
Australian dollar	-1.28%	3.80%	6.93%	-4.26%
Swedish krona	-0.92%	2.34%	1.28%	2.18%
Norwegian krone	-1.40%	1.65%	0.41%	-7.65%
New Zealand dollar	-1.75%	-0.57%	4.70%	-12.11%
Indian rupee	0.90%	2.93%	-0.97%	-6.54%
Brazilian real	-1.38%	7.59%	7.40%	-14.66%
Mexican peso	-0.85%	3.33%	-3.25%	-14.57%
Chilean peso	-1.64%	2.23%	2.64%	-8.64%
Colombian peso	0.05%	8.74%	1.14%	-18.25%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.58%	1.78%	0.50%	-4.38%

On one level the ability of equity indices to retain most of their gains from mid-February is bullish, but a better way of viewing it is these markets have a low ceiling defined by slow macroeconomic and earnings growth.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.22%	5.99%	3.40%	-6.12%
North America	-0.40%	5.93%	5.52%	-2.21%
Latin America	-2.70%	17.67%	14.80%	-14.12%
Emerging Market Free	-0.34%	10.68%	4.42%	-14.46%
EAFE	-2.57%	6.09%	-0.02%	-12.15%
Pacific	-1.96%	5.40%	2.64%	-10.82%
Eurozone	-2.82%	7.40%	-0.17%	-13.71%

Both CTAs and hedge funds managed to gain during a short week characterized by numerous consolidations and moves back toward what had been primary trends of weaker equities, lower physical commodities and a stronger USD.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.79%	-3.63%	0.57%	-4.79%
Newedge Trend	0.53%	-3.31%	3.52%	-2.21%
Newedge Short-Term	0.07%	-1.47%	3.49%	-3.76%
HFR Global Hedge Fund	0.32%	1.56%	-3.73%	-7.70%
HFR Macro/CTA	0.36%	-1.11%	-0.09%	-5.29%
HFR Macro: Sytematic Diversified CTA	0.91%	-2.66%	1.91%	-2.73%