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## The Macro Environment For Financial Markets

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We are at an interesting junction where the policies designed to support economic growth are proving wildly successful at stimulating risky financial assets and are laying the foundation for significant downside macro risk if and when financial markets wobble. Take the Chinese market, where the MSCI China Free index has returned 22.34% in USD terms year-to-date. There will be more of this bubbly behavior to come, and all of us will fancy ourselves brilliant investors because of it, but the perpetuation of unreality will depend on the ability to maintain negative real interest rates in key funding currencies. Those are inconsistent with stable growth and are absolutely inimical to savings, investment and sober fiscal policies. Asking an elected government to stop spending wantonly when they are paid to borrow is like asking foxes to vote themselves out of the henhouse: Foxes do not do that.

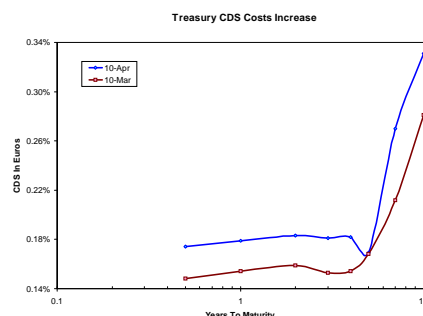
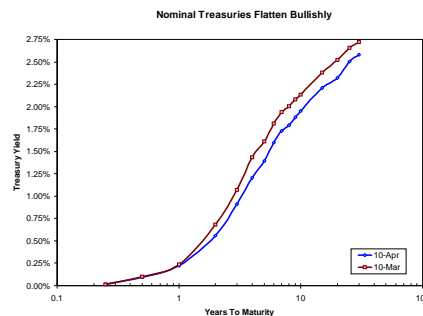
The causal chain continues unchanged:

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 curve 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.

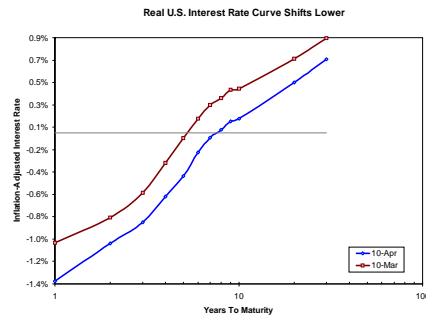
### Key Market Indications

It is strange to consider how half a year after QE's end and almost six years after the Great Recession ended, at least by official measures, ten-year UST could sell off to 1.95%. That used to be considered low for the overnight rate. Of course, the U.S. is high-yield compared to Spain, Italy, etc. This yield gap and the huge regulatory distortions produced by Basel III and Dodd-Frank will keep spare cash worldwide flowing into high-quality sovereign debt.

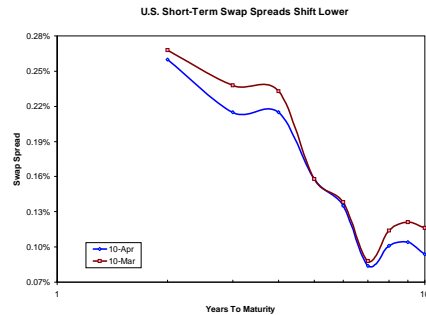
The small blip higher in CDS costs on U.S. debt was not connected to any particular event or development, which makes it puzzling. If this persists, the signal will be powerful as moves without a proximate cause tend to be significant.



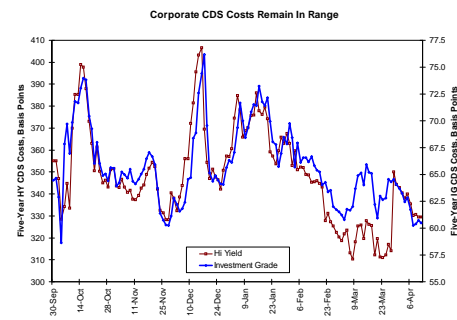
Pseudo-real rates are negative out to seven years. This shift is attributable to rising inflation breakevens being subtracted from stable nominal rates. Their continued decline will support both precious metals and risky financial assets simultaneously.



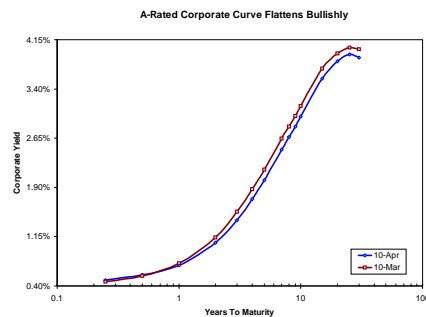
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates.



Both investment-grade and high-yield CDS costs remain in their downward-sloping trading range. The postponement of a rate hike should maintain this downward drift barring a more serious macro shock.



The A-rated yield curve has flattened bullishly over the past month. It should remain less volatile than the UST yield curve. Until this yield curve starts steepening bearishly, it will not present a threat to equity gains.



## Market Structure

The main Bloomberg index remains in a structural downtrend, which is interesting considering how only Natural Gas and Grains are in downtrends amongst physical markets. All of the major equity indices are in structural uptrends.

|                      | N-Day Speed | Market Structure | Trend Oscillator | HLC Volatility | Daily Trend Rate<br>Apr. 13 - 17 |
|----------------------|-------------|------------------|------------------|----------------|----------------------------------|
| BBerg                | 29          | Trending         | -0.021           | 11.5%          | -0.44%                           |
| BBerg Grain          | 29          | Trending         | -0.073           | 15.4%          | -0.70%                           |
| BBerg Ind. Metl      | 29          | Trending         | 0.030            | 14.9%          | 0.17%                            |
| BBerg Pre. Metl      | 6           | Sideways         | -0.030           | 13.1%          |                                  |
| BBerg Sots           | 12          | Transitional     | 0.020            | 15.9%          |                                  |
| BBerg Nat. Gas       | 27          | Trending         | -0.115           | 66.2%          | -1.02%                           |
| BBerg Petroleum      | 29          | Trending         | 0.050            | 29.7%          | 0.36%                            |
| BBerg Livestock      | 26          | Trending         | 0.036            | 12.1%          |                                  |
| Dollar Index         | 15          | Transitional     | 0.146            | 10.7%          |                                  |
| S&P 500 Index        | 24          | Trending         | 0.130            | 9.6%           | 0.28%                            |
| EAFE Index           | 25          | Trending         | 0.176            | 11.7%          | 0.16%                            |
| EM Index             | 29          | Trending         | 0.531            | 10.8%          | 0.20%                            |
| Ten-year UST (price) | 10          | Sideways         | -0.041           | 5.5%           |                                  |

## Performance Measures

Petroleum markets are proving, once again, markets can overlook current conditions and convince themselves of future conditions. This is not the case in the other physical markets, Grains and Natural Gas especially, where no one has a convincing story about how future supply excesses will be curbed.

|                                    | Commodity Total Returns |           |            |          |
|------------------------------------|-------------------------|-----------|------------|----------|
|                                    | Five-Days               | One Month | Six Months | One Year |
| <b>Bloomberg Index</b>             | -0.22%                  | 1.94%     | -16.43%    | -27.06%  |
| <b>Grains Sub-Index</b>            | -2.80%                  | -0.07%    | 1.06%      | -27.17%  |
| Corn                               | -2.47%                  | -0.93%    | 3.20%      | -30.86%  |
| Soybeans                           | -3.51%                  | -2.32%    | -1.27%     | -23.63%  |
| Wheat                              | -1.86%                  | 4.83%     | 2.82%      | -25.98%  |
| <b>Energy Sub-Index</b>            | 1.53%                   | 2.15%     | -36.62%    | -46.45%  |
| <b>Petroleum Sub-Index</b>         | 4.60%                   | 6.05%     | -37.07%    | -46.24%  |
| WTI                                | 5.41%                   | 10.07%    | -41.51%    | -49.15%  |
| Brent                              | 4.92%                   | 5.21%     | -39.52%    | -49.35%  |
| ULSD                               | 4.80%                   | 3.94%     | -28.40%    | -38.10%  |
| Gasoline                           | 2.56%                   | 2.73%     | -31.77%    | -42.83%  |
| Natural Gas                        | -7.40%                  | -8.85%    | -39.65%    | -50.46%  |
| <b>Precious Metals Sub-Index</b>   | -0.28%                  | 4.79%     | -3.21%     | -11.51%  |
| Gold                               | 0.31%                   | 4.45%     | -2.28%     | -8.98%   |
| Silver                             | -1.91%                  | 5.73%     | -6.09%     | -18.90%  |
| <b>Industrial Metals Sub-Index</b> | -0.16%                  | 1.08%     | -11.23%    | -10.32%  |
| Copper                             | -0.01%                  | 2.64%     | -9.91%     | -9.99%   |
| Aluminum                           | -1.32%                  | -0.80%    | -10.88%    | -10.46%  |
| Nickel                             | -3.13%                  | -10.82%   | -23.96%    | -28.72%  |
| Zinc                               | 3.77%                   | 9.94%     | -6.25%     | 6.75%    |
| <b>Softs Sub-Index</b>             | -0.12%                  | 0.90%     | -25.26%    | -34.95%  |
| Coffee                             | -4.14%                  | 4.06%     | -40.51%    | -38.64%  |
| Sugar                              | 0.75%                   | 1.07%     | -22.78%    | -39.21%  |
| Cotton                             | 2.48%                   | 7.88%     | 2.20%      | -19.07%  |
| <b>Livestock Sub-Index</b>         | -0.65%                  | 2.89%     | -15.94%    | -11.23%  |
| Cattle                             | -2.98%                  | 2.43%     | -5.64%     | 11.91%   |
| Hogs                               | 3.24%                   | 3.62%     | -32.39%    | -39.86%  |

The trading range for the USD did not last very long as all of the majors save the AUD sold off sharply. The real question is whether the Federal Reserve will be willing to let the USD rise and put a second impediment, higher short-term rates being the first, into U.S. growth.

|  | Currency Returns |           |            |          |
|--|------------------|-----------|------------|----------|
|  | Five-Days        | One Month | Six Months | One Year |
| Euro   | -3.33%           | -0.88%    | -16.03%    | -23.64%  |
| Chinese yuan                                     | -0.23%           | 0.86%     | -1.25%     | 0.06%    |
| Japanese yen                                     | -1.04%           | 0.76%     | -10.45%    | -15.55%  |
| British pound                                    | -1.93%           | -2.91%    | -8.98%     | -12.83%  |
| Swiss franc                                      | -2.80%           | -2.08%    | -2.25%     | -10.48%  |
| Canadian dollar                                  | -0.65%           | 0.98%     | -10.88%    | -12.97%  |
| Australian dollar                                | 0.64%            | 0.73%     | -11.56%    | -18.39%  |
| Swedish krona                                    | -3.08%           | -3.00%    | -18.02%    | -25.95%  |
| Norwegian krone                                  | -1.93%           | -0.15%    | -19.62%    | -26.79%  |
| New Zealand dollar                               | -0.99%           | 3.59%     | -3.57%     | -13.20%  |
| Indian rupee                                     | 0.28%            | 0.74%     | -1.58%     | -3.61%   |
| Brazilian real                                   | 1.54%            | 0.84%     | -21.02%    | -28.24%  |
| Mexican peso                                     | -2.62%           | 2.61%     | -11.47%    | -14.21%  |
| Chilean peso                                     | -0.79%           | 2.43%     | -4.53%     | -12.28%  |
| Colombian peso                                   | 2.29%            | 4.77%     | -18.32%    | -23.56%  |
| Bloomberg-JP Morgan<br>Asian dollar index (spot) | -0.76%           | 1.30%     | -2.27%     | -2.85%   |

Time heals all wounds and free money eventually finds its way into risky financial assets. The gains in both the EM index and in the Chinese markets are suggesting the long-awaited equity bubble finally is arriving. If so, it will have much further to go before the inevitable crash.

|                       | Equity Total Returns |           |            |          |
|-----------------------|----------------------|-----------|------------|----------|
|                       | Five-Days            | One Month | Six Months | One Year |
| <b>MSCI WorldFree</b> | 1.72%                | -4.21%    | 10.60%     | 10.13%   |
| North America         | 1.81%                | 3.28%     | 10.97%     | 15.87%   |
| Latin America         | 2.65%                | 10.83%    | -16.70%    | -17.84%  |
| Emerging Market Free  | 4.09%                | 9.81%     | 5.39%      | -1.08%   |
| EAFE                  | 1.57%                | 5.68%     | 10.00%     | 2.08%    |
| Pacific               | 2.02%                | 5.79%     | 12.31%     | 11.32%   |
| Eurozone              | 0.48%                | 6.37%     | 10.04%     | -3.05%   |

Both CTAs and macro-oriented hedge funds put in a second week of gains, suggesting they are crowding into the long equity trade and probably moving back into long dollar positions.

|                            | CTA/Hedge Fund Returns |           |            |          |
|----------------------------|------------------------|-----------|------------|----------|
|                            | Five-Days              | One Month | Six Months | One Year |
| Newedge CTA                | 1.46%                  | 3.08%     | 21.40%     | 37.05%   |
| Newedge Trend              | 0.35%                  | 1.95%     | 15.82%     | 25.32%   |
| Newedge Short-Term         | 0.59%                  | -0.26%    | 7.74%      | 11.56%   |
| HFR Global Hedge Fund      | 0.84%                  | 1.40%     | 2.87%      | 1.57%    |
| HFR Macro/CTA              | 1.47%                  | 1.42%     | 7.37%      | 11.13%   |
| HFR Macro                  | 1.67%                  | 2.76%     | 10.34%     | 12.96%   |
| Systematic Diversified CTA |                        |           |            |          |