The Macro Environment For Financial Markets

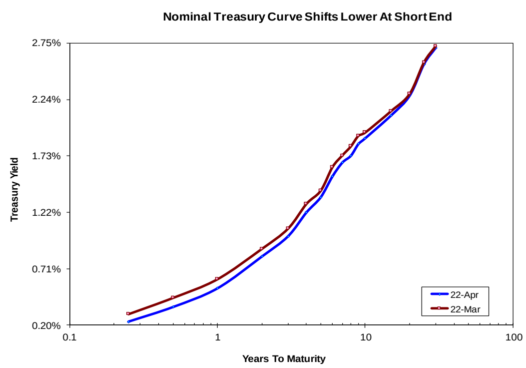
The last time people spoke of a Great Moderation financial indices were hitting new highs and real estate prices were capitalizing cheap credit into prices. We know how that ended. Now that we are living in an over-regulated environment filled with buzzwords such as "macroprudential" we will have to see how self-proclaimed bureaucratic visionaries handle overinvestment in real estate and new buyers getting priced out therefrom. They either can choke off credit – unlikely, as homebuilding remains a high-multiplier industry and a large employer of males; we still build houses by hand – or they can impose price controls and vilify sellers as being greedy. Maybe there is no word in German for *zeitgeist*, but anyone paying attention to political trends should be able to see the spirit of our times.

The causal chain now is:

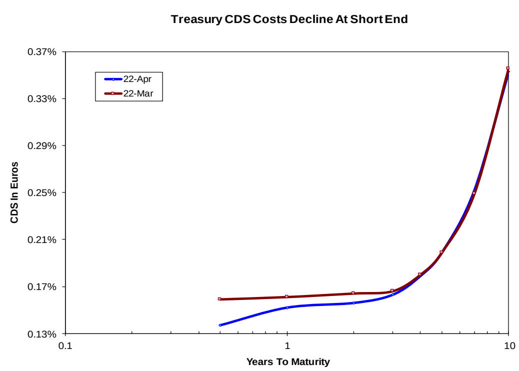
1. The market is reversing course again on the prospects for higher short-term rates in the U.S. ;
2. Disinflationary pressures will persist globally while inflationary pressures are rising in the U.S.;
3. Inflation expectations as measured by TIPS and inflation swaps have established a strong tradable bottom;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are terming out their short-term debt obligations to reduce rollover risk;
6. Swap spreads are moving higher at last; and
7. CDS costs have broken through resistance levels.

Key Market Indications

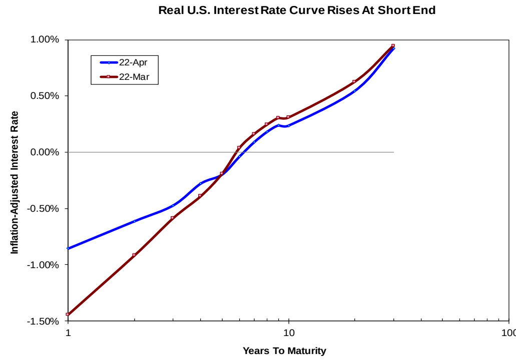
Ask yourself in a world where Argentina can return to the debt markets and where various European and Japanese sovereign markets are being smothered by central bank actions whether long-term Treasury yields are going to rise. The U.S. may signal a rise in short-term interest rates, but this threat and the concomitant flattening of the yield curve will not proceed too far regardless of any inflation scare for fear of a rising USD.



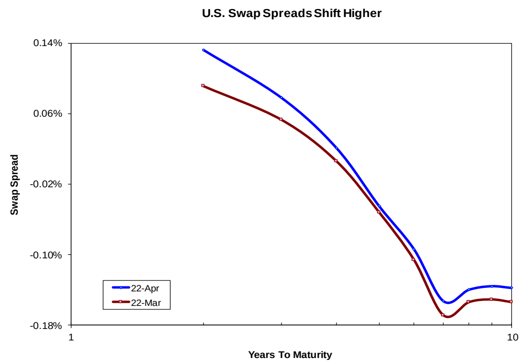
CDS costs for short-term UST continue to drift lower. We should ask ourselves why, in a world awash with negative interest rates where the U.S. is somewhat high-yielding and issues the prime reserve currency, these costs are even this high.



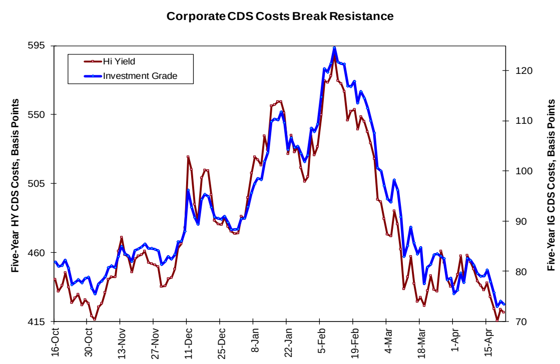
The pseudo-real rate curve finally rose over the past month as short-term breakevens fell. These rates continue to remain negative out to six years. Their rise is inimical to precious metals, but it is doubtful events in the U.S. can offset deeply negative short-term rates elsewhere. Rising pseudo-real rates will not pose a threat to risky financial assets until and unless they start to rise at the long end of the yield curve.



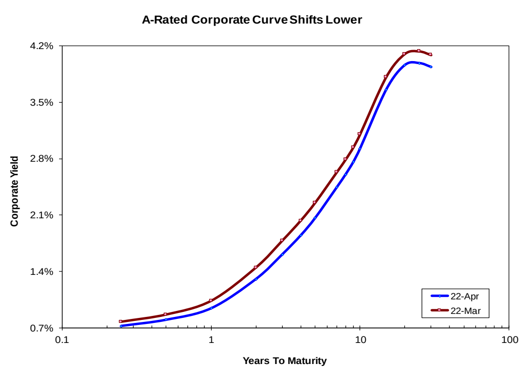
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have shifted higher over the past month and remain inverted. The inversion of this curve is confirmed in the swaption market as well. The belief seems to be that long-term rates will remain constrained even if short-term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



Both high-yield and investment-grade CDS indices broke through resistance levels. The combination of expected easier monetary policy in a non-recessionary environment is going to keep these costs suppressed until further notice.



The A-rated corporate yield curve is shifting lower as the search for yield is pushing investors out of UST and into corporate bonds. This advance will continue to support risky assets.



Market Structure

Only Livestock is in a structural downtrend amongst the physical markets; with the exception of the Softs index, everything else has moved into structural uptrends. The dollar index exited its downtrend and ten-year UST exited their uptrend, while the EAFE index reentered a structural uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate April 25 - 29
BBerg	22	Trending	0.263	13.4%	0.50%
BBerg Grain	29	Trending	0.094	14.3%	0.12%
BBerg Ind. Metl	29	Trending	0.241	17.2%	0.91%
BBerg Pre. Metl	27	Trending	0.096	14.6%	0.29%
BBerg Softs	19	Transitional	0.084	20.1%	
BBerg Nat. Gas	29	Trending	0.291	30.0%	2.27%
BBerg Petroleum	22	Trending	0.195	31.5%	0.30%
BBerg Livestock	29	Trending	-0.389	10.8%	-0.28%
Dollar Index	6	Sideways	0.090	6.5%	
S&P 500 Index	14	Transitional	0.100	8.5%	
EAFE Index	22	Trending	0.246	12.3%	0.46%
EM Index	16	Transitional	0.124	11.1%	
Ten-year UST (price)	29	Trending	-0.107	4.8%	

Performance Measures

I noted last week the key question for the Petroleum subindex would be if it could rally after the Doha failure. It did, and nothing can define a bullish trend better. The economically important Industrial Metals index is advancing in a similar manner. The danger, as always, is excess funds will chase physical commodities on the always-wrong assumption these are investment vehicles as opposed to factors of production. The last time this happened, markets rose to levels where demand growth was choked off and excess production capacity was created. To ask whether such folly is repeatable is to ignore millennia of commercial history.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	3.31%	4.82%	-4.91%	-18.13%
Grains Sub-Index	0.72%	3.13%	-1.09%	-4.81%
Corn	-1.70%	0.70%	-5.29%	-7.33%
Soybeans	3.32%	8.45%	9.41%	3.40%
Wheat	1.39%	0.92%	-6.11%	-7.77%
Energy Sub-Index	6.71%	9.00%	-19.12%	-39.60%
Petroleum Sub-Index	4.87%	7.06%	-17.99%	-40.50%
WTI	4.71%	7.13%	-23.97%	-45.60%
Brent	4.67%	8.78%	-17.27%	-42.82%
ULSD	5.75%	7.60%	-19.23%	-41.30%
Gasoline	4.76%	3.17%	-9.51%	-27.91%
Natural Gas	13.21%	16.11%	-25.55%	-38.35%
Precious Metals Sub-Index	0.75%	3.39%	6.06%	5.13%
Gold	-0.37%	0.55%	5.70%	4.32%
Silver	3.66%	11.27%	6.48%	6.85%
Industrial Metals Sub-Index	4.42%	5.37%	0.10%	-18.61%
Copper	4.93%	1.40%	-4.29%	-18.67%
Aluminum	6.39%	12.02%	9.20%	-14.11%
Nickel	1.94%	4.98%	-14.22%	-32.10%
Zinc	1.99%	6.30%	7.45%	-17.20%
Softs Sub-Index	1.67%	-5.56%	2.18%	-1.24%
Coffee	-1.20%	-4.79%	-2.07%	-21.62%
Sugar	1.78%	-4.06%	7.32%	4.38%
Cotton	6.12%	11.24%	1.24%	-5.28%
Livestock Sub-Index	-2.67%	-5.78%	-11.07%	-14.91%
Cattle	-6.16%	-8.54%	-15.25%	-21.58%
Hogs	1.55%	-2.48%	-5.24%	-3.21%

The only divergence trade working in the currency markets right now is the divergence from reality. The BOJ is producing a deflationary outcome with policies intended to be inflationary, the Federal Reserve is arguing with itself in public once again and the ECB is finding its foray into corporate bonds difficult to execute. The downturn in the BRL is noteworthy given the months-long propensity to rally in the face of increasing corruption scandals.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.55%	0.04%	1.02%	4.63%
Chinese yuan	-0.37%	-0.14%	-2.18%	-4.69%
Japanese yen	-2.71%	0.52%	7.96%	7.26%
British pound	1.42%	1.37%	-6.44%	-4.22%
Swiss franc	-1.09%	-0.60%	-0.55%	-0.73%
Canadian dollar	1.18%	2.98%	3.28%	-3.42%
Australian dollar	-0.22%	1.13%	6.94%	-0.61%
Swedish krona	-0.37%	0.82%	3.52%	6.96%
Norwegian krone	0.06%	1.91%	1.06%	-4.16%
New Zealand dollar	-0.97%	1.47%	0.87%	-10.61%
Indian rupee	0.24%	0.35%	-2.04%	-5.49%
Brazilian real	-0.96%	0.39%	9.54%	-15.58%
Mexican peso	0.45%	-0.81%	-5.71%	-11.62%
Chilean peso	-0.27%	0.73%	3.12%	-7.39%
Colombian peso	1.70%	2.82%	-1.46%	-15.51%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.28%	-0.01%	-0.71%	-4.36%

Can a bull market continue when many leading and large-capitalization firms continue to struggle in their core businesses? The answer should be obvious: Of course. Investing is a relative game, and to where else will the money go?

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.97%	2.91%	1.09%	-3.17%
North America	0.76%	2.54%	2.86%	-0.06%
Latin America	-0.66%	2.29%	10.26%	-14.13%
Emerging Market Free	-0.14%	1.98%	-0.64%	-17.03%
EAFE	1.31%	3.53%	-1.74%	-7.99%
Pacific	1.28%	3.94%	2.22%	-7.25%
Eurozone	2.00%	3.00%	-3.78%	-7.68%

CTAs had another poor week, unsurprising given the reversals in crude oil and the JPY. While macro-oriented CTAs struggled, the general rise in equities helped hedge fund performance in general.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.33%	-1.80%	1.54%	-7.05%
Newedge Trend	-1.01%	-0.87%	3.88%	-2.99%
Newedge Short-Term	0.08%	0.31%	5.93%	-1.86%
HFR Global Hedge Fund	0.42%	0.91%	-2.38%	-7.56%
HFR Macro/CTA	-0.08%	0.18%	1.85%	-4.44%
HFR Macro: Sytematic Diversified CTA	-0.60%	-0.54%	4.19%	-2.49%