The Macro Environment For Financial Markets

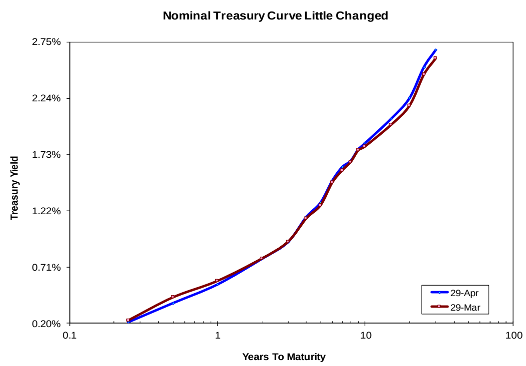
Go to a library and locate any business magazine from about 1975 to about 1989. Any one will do, because each and every one of them had a story about how Japan was a) going to eat the U.S.' lunch and b) possibly engage in some antisocial actions with the chopsticks thereafter. Now the Bank of Japan manages to drive the yen higher and Japanese price levels regardless of whatever course of action they take. Both Japan and the U.S. have seen declining rates of consumer inflation for three decades now, regardless of policy actions. Why this should be surprising in a world of increasing technological efficiency, rising debt levels and aging populations remains a mystery, but central banks seem to regard it as an affront to their omnipotence. One consequence of that rising efficiency is downward pressure on operating margins. Really; did anyone think Apple was going to be able to reap those margins forever on what will be a commodity product eventually?

The causal chain now is:

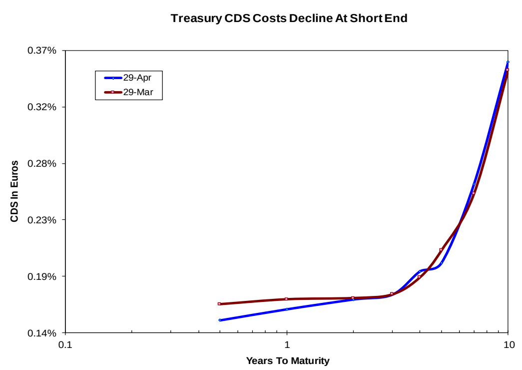
1. The market is pricing in higher short-term rates in the U.S. after June;
2. Disinflationary pressures will persist globally while inflationary pressures are rising in the U.S.;
3. Inflation expectations as measured by TIPS and inflation swaps have established a strong tradable bottom;
4. The U.S. 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 stalled at previous resistance levels.

Key Market Indications

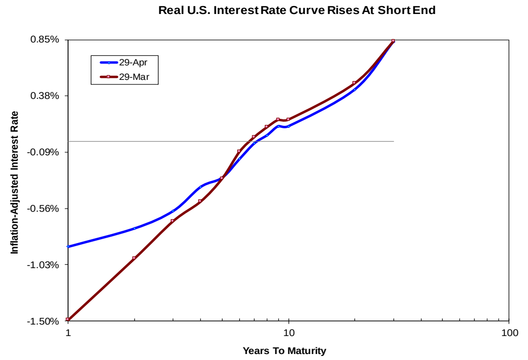
We have raised a generation of traders completely unaware of how the UST market used to be afraid of its own shadow. Rising inflationary indicators in the U.S., a declining USD and a Federal Reserve willing to risk higher inflation to keep the USD moving lower have been unable to dent the UST market. Maybe policymakers should just accept this and stop heaping abuse on the market.



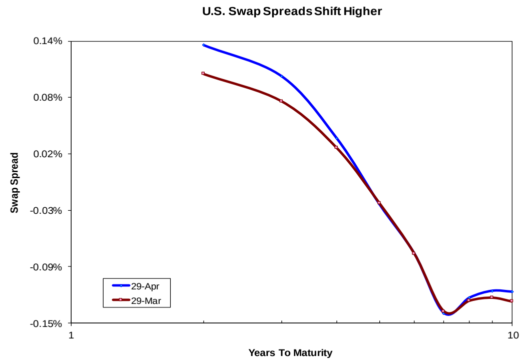
CDS costs for short-term UST continue to drift lower. We should ask ourselves why, in a world awash with negative interest rates where the U.S. is somewhat high-yielding and issues the prime reserve currency, these costs are even this high.



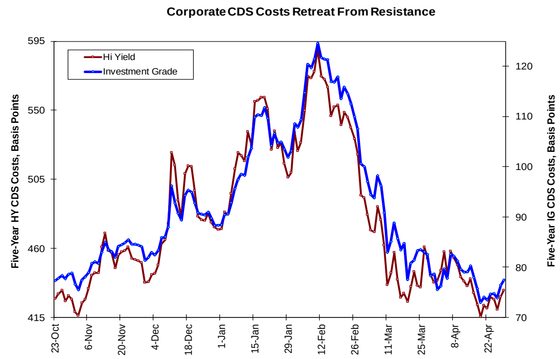
The pseudo-real rate curve continued its recent rise at the short end of the yield curve. These rates remain negative out to seven years. As noted last week, their rise is inimical to precious metals, but it is doubtful events in the U.S. can offset deeply negative short-term rates elsewhere. Rising 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.



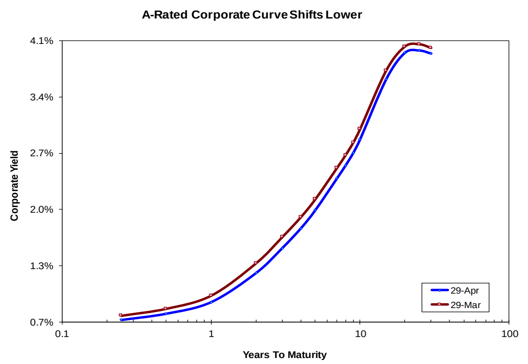
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have shifted higher over the past month and remain inverted. The inversion of this curve is confirmed in the swaption market as well. The belief seems to be that long-term rates will remain constrained even if short-term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



Both high-yield and investment-grade CDS indices retreated from resistance levels. Tellingly, however, these indices did not react to downturns in equity markets now as much as they have in the past. Poor earnings and rising default risk are two very different things.



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

None of the physical commodity indices are in structural downtrends, which is starting to look unsustainable given poor demand growth and no supply shocks. Both the EAFE and EM indices are in structural uptrends amongst the financials.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 2 - 6
BBerg	27	Trending	0.405	13.3%	0.50%
BBerg Grain	6	Sideways	0.045	24.7%	
BBerg Ind. Metl	29	Trending	0.288	17.1%	0.91%
BBerg Pre. Metl	29	Trending	0.375	14.8%	0.29%
BBerg Softs	22	Trending	0.172	20.0%	0.14%
BBerg Nat. Gas	5	Sideways	0.038	37.3%	
BBerg Petroleum	25	Trending	0.275	30.6%	0.30%
BBerg Livestock	5	Sideways	-0.016	11.0%	
Dollar Index	13	Transitional	-0.219	6.6%	
S&P 500 Index	19	Transitional	-0.060	8.8%	
EAFE Index	26	Trending	0.153	12.4%	0.46%
EM Index	20	Trending	0.050	10.1%	0.13%
Ten-year UST (price)	29	Trending	-0.031	4.7%	

Performance Measures

Ah, the myth of "commodities!" We saw between 2003 and 2008 how a wall of money could push covariance higher without any fundamental justification whatsoever. Let's put aside that "weak dollar" factor, too, as the long-term correlations between individual commodities and individual currencies are not statistically robust at all, and the current trend would imply some fantastic gearing ratios for individual commodities against individual currencies. Keynes said it best, "The market can remain irrational longer than you can remain solvent."

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.97%	9.74%	-1.43%	-17.17%
Grains Sub-Index	3.57%	7.84%	2.69%	0.19%
Corn	4.33%	9.81%	-0.33%	-1.52%
Soybeans	3.37%	11.15%	15.31%	7.54%
Wheat	3.06%	1.22%	-6.57%	-2.04%
Energy Sub-Index	3.02%	17.11%	-16.84%	-39.84%
Petroleum Sub-Index	4.73%	19.59%	-16.58%	-39.02%
WTI	4.83%	20.45%	-22.96%	-44.35%
Brent	5.11%	21.20%	-14.69%	-41.03%
ULSD	4.85%	20.61%	-16.83%	-39.94%
Gasoline	3.64%	14.01%	-10.68%	-26.66%
Natural Gas	-2.56%	8.85%	-22.00%	-44.27%
Precious Metals Sub-Index	4.98%	8.82%	14.08%	9.58%
Gold	4.92%	5.50%	13.53%	9.51%
Silver	5.13%	18.17%	14.99%	9.17%
Industrial Metals Sub-Index	1.49%	7.06%	3.35%	-21.67%
Copper	0.67%	5.18%	-2.36%	-23.06%
Aluminum	1.65%	9.45%	11.27%	-16.78%
Nickel	3.88%	13.46%	-7.42%	-32.27%
Zinc	1.52%	3.43%	13.97%	-19.61%
Softs Sub-Index	2.32%	0.87%	4.70%	-1.80%
Coffee	-1.50%	-6.00%	-3.82%	-18.22%
Sugar	5.50%	5.81%	7.01%	12.51%
Cotton	0.13%	8.59%	0.53%	-5.54%
Livestock Sub-Index	1.85%	-2.47%	-5.90%	-13.39%
Cattle	0.24%	-6.98%	-14.01%	-20.32%
Hogs	3.65%	2.95%	7.29%	-1.89%

The obvious dovish signal from the FOMC and the Bank of Japan's decision not to compound previous errors led to a very strong week for the JPY. Key Latin currencies posted a very strong week on a self-reinforcing trend involving commodity and equity gains; the woebegone region is one of the few "cheap" places on the globe.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	2.04%	1.42%	4.32%	2.90%
Chinese yuan	0.33%	0.46%	-1.87%	-4.30%
Japanese yen	4.97%	5.82%	13.74%	11.76%
British pound	1.45%	1.59%	-4.56%	-5.35%
Swiss franc	1.95%	0.72%	3.08%	-2.15%
Canadian dollar	0.92%	4.13%	4.91%	-4.27%
Australian dollar	-1.36%	-0.31%	7.48%	-5.06%
Swedish krona	1.61%	2.06%	6.26%	3.71%
Norwegian krone	2.43%	4.26%	6.39%	-6.53%
New Zealand dollar	1.82%	1.85%	4.24%	-9.15%
Indian rupee	0.23%	0.31%	-1.55%	-4.56%
Brazilian real	3.80%	5.91%	12.02%	-13.81%
Mexican peso	1.73%	0.98%	-3.18%	-11.34%
Chilean peso	1.23%	3.22%	4.30%	-7.89%
Colombian peso	3.41%	7.32%	2.30%	-16.52%
Bloomberg-JP Morgan Asian dollar index (spot)	0.47%	0.49%	0.12%	-4.26%

One of the characteristics of the bull market has been an unwillingness to push valuations beyond reason; everyone has seen the movie. We get the sort of pullbacks seen this past week and they will last until investors remember they have no choice but to take risk to make any sort of positive return.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.83%	2.42%	-0.79%	-4.52%
North America	-1.09%	1.23%	0.05%	-1.23%
Latin America	4.01%	7.79%	17.05%	-13.43%
Emerging Market Free	-0.56%	3.29%	0.20%	-18.47%
EAFE	-0.40%	4.43%	-2.14%	-9.57%
Pacific	-1.12%	3.82%	0.55%	-9.92%
Eurozone	-0.93%	3.80%	-4.76%	-9.49%

CTAs completed a poor month, which is surprising given the prevalence of fairly regular uptrends in the physical markets and a downtrend in the USD. Hedge funds managed a small gain over the month.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.65%	-2.32%	-0.91%	-7.05%
Newedge Trend	-0.43%	-1.33%	1.96%	-3.11%
Newedge Short-Term	-0.48%	0.27%	3.88%	-1.84%
HFR Global Hedge Fund	0.02%	0.99%	-3.21%	-7.38%
HFR Macro/CTA	0.06%	0.48%	0.90%	-3.46%
HFR Macro: Sytematic Diversified CTA	-0.40%	-0.27%	2.64%	-1.60%