The Macro Environment For Financial Markets

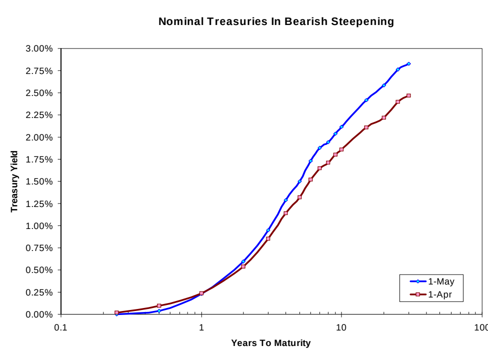
In homage to Keynes' famous riposte, "When the facts change, I change my mind. What do you do, sir?" we have to contemplate a world where the bound for negative interest rates has been established. You knew it was out there, but you did not know at what point investors would stop paying a penalty to hold sovereign debt. This appears to have been established this past week in the Eurozone, and that affects the relative attractiveness of U.S. debt and certainly of Eurozone equities. If we add to that the likely postponement of the first U.S. rate hike to either the December FOMC meeting or to a date marked on my calendar as "Hell freezes over," whichever comes first, you have a sudden repricing of the USD against the major currencies and the massive frictional costs associated by such a rapid reversal. Garden-variety monetary accommodation by the Federal Reserve cannot offset all of these headwinds. How these things to arrive in time for the "sell in May" ditty is beyond my self-understanding of who plays what role in the cosmos, but they do.

The causal chain is now:

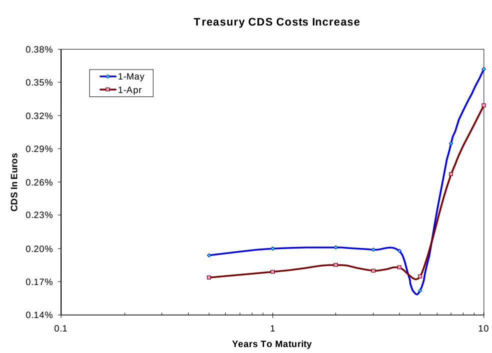
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point;
2. Disinflationary pressures are starting to abate, but this will not be a uniform process either across economies or between economic sectors;
3. Inflation expectations as measured by the TIPS market have reached their bear market retracement level near 1.95% for ten-year breakevens and may rise up to 2.10%;
4. Sovereign debt yields have established a lower bound, especially in the Eurozone;
5. The U.S. yield curve will retain its long-term bias toward flattening even as it is in a short-term bearish steepening;
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

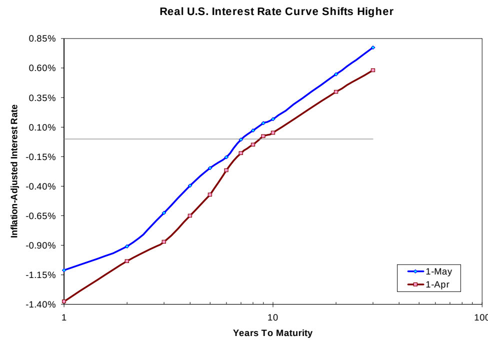
Markets that do not react bullishly to bullish news are not – wait for it - bullish. Treasuries reacted to the combination of a weak GDP report, a dovish FOMC and a weaker USD that makes them cheaper for foreign buyers by selling off alongside of Bunds and other European bonds. However, this bearish steepening of the yield curve is likely to be a temporary phenomenon unless previously risk-averse investors suddenly find themselves to be risk-seeking with equities at or near record highs.



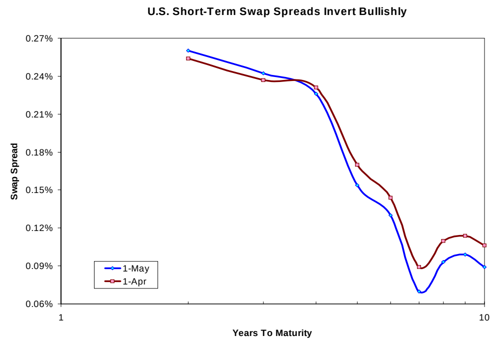
CDS costs shifted higher, but these changes are so minor as to be unimportant. We will need an irruption of dysfunction out of Washington to push these costs higher, and that does not appear likely in 2015.



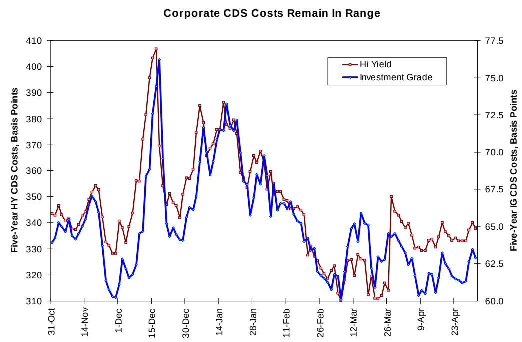
Pseudo-real rates have shifted higher and are negative out to "only" six years at this point. This shift is attributable to the bearish steepening of the nominal UST yield curve. These higher implied real rates were negative for precious metals but have yet to shift to the point where they are negative for risky financial assets.



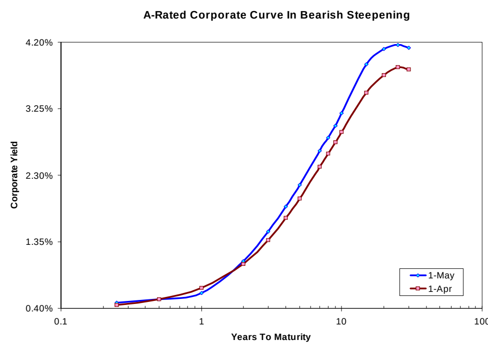
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates. The small shift higher over the past month at the short end of the yield curve is too minor to constitute a major fundamental shift in this market's assessment of interest rate risks.



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



The A-rated yield curve has steepened bearishly over the past month, but this shift has been quite small. Unless CDS costs and swap spreads increase, this should not present any sort of headwind for equities.



Market Structure

The main Bloomberg index remains in a structural uptrend, mostly thanks to the uptrend in the Petroleum index. The dollar index has moved into a downtrend where it is joined by ten-year UST. The S&P 500 and EAFE indices remain in uptrends, but both appear wobbly at the moment.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 4 - 8
BBerg	29	Trending	0.211	10.5%	0.51%
BBerg Grain	29	Trending	-0.339	14.1%	-0.70%
BBerg Ind. Metl	27	Trending	0.384	14.6%	0.17%
BBerg Pre. Metl	29	Trending	-0.150	13.5%	-0.15%
BBerg Softs	21	Trending	-0.054	17.6%	
BBerg Nat. Gas	29	Trending	0.132	27.1%	
BBerg Petroleum	29	Trending	0.259	28.0%	0.36%
BBerg Livestock	27	Trending	0.064	11.0%	0.01%
Dollar Index	25	Trending	-0.230	10.1%	-0.27%
S&P 500 Index	29	Trending	0.094	8.9%	0.28%
EAFE Index	26	Trending	0.063	10.6%	0.16%
EM Index	10	Sideways	-0.073	8.4%	
Ten-year UST (price)	29	Trending	-0.251	5.7%	-1.50%

Performance Measures

The economically important Industrial Metals and Energy indices are proving once again all it takes for markets to rally is hope of an end to oversupply. You can make up a story related to China's stimulus program if that makes you feel better. The Grains continue to drive lower as Northern Hemisphere planting intentions leave little room for a pretense of lower supply in 2015; we will need a weather story for that to happen.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	1.78%	3.73%	-11.22%	-24.33%
Grains Sub-Index	-1.60%	-7.32%	-8.33%	-32.14%
Corn	-1.82%	-7.96%	-7.56%	-34.10%
Soybeans	-0.62%	-2.60%	-5.92%	-24.15%
Wheat	-2.97%	-11.31%	-11.50%	-37.56%
Energy Sub-Index	3.43%	12.55%	-26.90%	-40.38%
Petroleum Sub-Index	2.18%	16.81%	-24.15%	-39.41%
WTI	2.48%	16.36%	-29.29%	-42.44%
Brent	1.91%	18.03%	-26.53%	-43.40%
ULSD	2.46%	17.03%	-16.14%	-30.76%
Gasoline	1.87%	15.50%	-17.55%	-35.24%
Natural Gas	7.80%	0.22%	-36.94%	-46.73%
Precious Metals Sub-Index	0.72%	-2.58%	0.36%	-12.27%
Gold	-0.04%	-2.20%	0.36%	-10.16%
Silver	2.90%	-3.64%	0.29%	-18.58%
Industrial Metals Sub-Index	5.46%	7.32%	-4.53%	-3.29%
Copper	6.41%	7.07%	-2.83%	-4.81%
Aluminum	4.91%	6.92%	-9.02%	2.88%
Nickel	4.15%	5.45%	-10.78%	-26.10%
Zinc	4.56%	10.21%	3.34%	12.65%
Softs Sub-Index	-2.41%	3.68%	-18.46%	-34.72%
Coffee	-5.59%	-6.55%	-32.80%	-40.08%
Sugar	-2.12%	2.11%	-16.81%	-38.36%
Cotton	0.41%	4.38%	7.78%	-20.95%
Livestock Sub-Index	0.07%	1.05%	-12.39%	-10.88%
Cattle	-1.34%	-2.74%	-5.37%	10.34%
Hogs	2.27%	7.33%	-24.40%	-37.99%

To repeat from last week, you will not hear a peep of protest about the downshift in the USD from U.S. multinationals, labor protectionists or global banks with USD liabilities. You will, however, find EUR and related-currency investors who had come to enjoy the exaggerated gains in European equities contemplating the costs of a stronger EUR and declining support from increasingly negative interest rates.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	3.00%	4.05%	-10.28%	-19.26%
Chinese yuan	-0.09%	-0.06%	-1.45%	0.91%
Japanese yen	-0.97%	-0.32%	-5.08%	-14.83%
British pound	-0.26%	2.19%	-5.16%	-10.33%
Swiss franc	2.31%	3.71%	3.59%	-5.70%
Canadian dollar	0.12%	3.80%	-6.58%	-9.89%
Australian dollar	0.35%	3.30%	-9.56%	-15.34%
Swedish krona	2.72%	3.16%	-11.61%	-22.54%
Norwegian krone	2.24%	5.65%	-10.55%	-21.83%
New Zealand dollar	-0.89%	1.09%	-2.40%	-12.73%
Indian rupee	-0.16%	-1.46%	-3.24%	-4.87%
Brazilian real	-1.45%	6.04%	-17.80%	-25.95%
Mexican peso	-1.03%	-2.51%	-12.45%	-16.08%
Chilean peso	0.18%	0.97%	-4.77%	-7.72%
Colombian peso	2.60%	7.69%	-13.70%	-19.03%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.28%	0.20%	-1.98%	-2.37%

One of the realities of the six-year bull market has been you do not need economic growth to drive earnings and you do not need earnings to drive equity returns. You just needed ever-more money flowing into markets and increasingly poor returns from alternative markets. This is poised to change.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.64%	3.06%	5.91%	8.37%
North America	-0.48%	2.65%	5.37%	13.24%
Latin America	-1.96%	6.71%	-13.92%	-15.43%
Emerging Market Free	-1.33%	6.62%	3.87%	7.91%
EAFE	-0.89%	3.72%	6.76%	1.46%
Pacific	-2.29%	3.66%	7.78%	10.93%
Eurozone	0.56%	2.26%	6.60%	-4.04%

You would not expect either CTAs or macro hedge funds to perform well in a week with so many reversals and relationship breaks. Contemplate that for a second: The last people on Earth you should expect to handle difficult markets well are the only people on Earth paid to handle markets at all. This is what happens when people singing from the same hymnal play a zero-sum game.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-2.70%	-3.02%	16.23%	31.31%
Newedge Trend	-1.95%	-2.70%	11.54%	21.01%
Newedge Short-Term	-1.09%	-1.89%	4.62%	10.83%
HFR Global Hedge Fund	-0.60%	0.10%	2.19%	1.31%
HFR Macro/CTA	-2.13%	-2.89%	3.22%	7.63%
HFR Macro: Sytematic Diversified CTA	-2.47%	-3.60%	5.29%	8.03%