The Macro Environment For Financial Markets

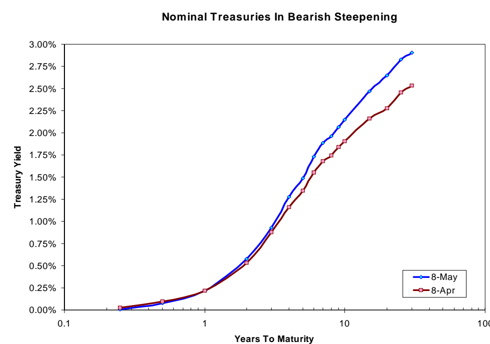
The key difference between Janet Yellen expressing a gratuitous opinion and a market pundit doing likewise is the world is insulated from pundits' warblings but is exposed to those of central planners. Watch what they do: The economic data of the past three months provides little justification for higher short-term rates in the U.S. and two of the major market stresses of the past year, a stronger USD and collapsing crude oil prices are moving into the rearview mirror. The path of least resistance remains as it has since the end of the financial crisis, a combination of slow growth, subpar investment and the diversion of created money from real plant and equipment to financial assets. The net result for investors over this period has been steadily rising returns regardless of which central bank is doing the monetary creation. That is a fact and not a gratuitous opinion.

The causal chain is now:

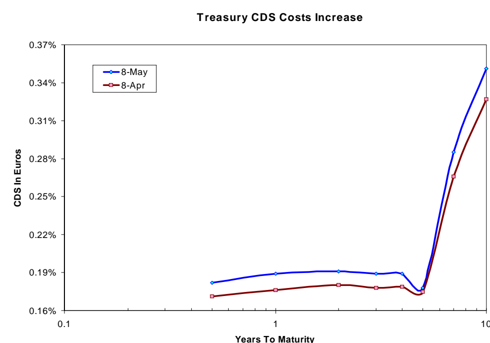
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point;
2. Disinflationary pressures are starting to abate, but this will not be a uniform process either across economies or between economic sectors;
3. Inflation expectations as measured by the TIPS market have held below their critical resistance level in front of 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

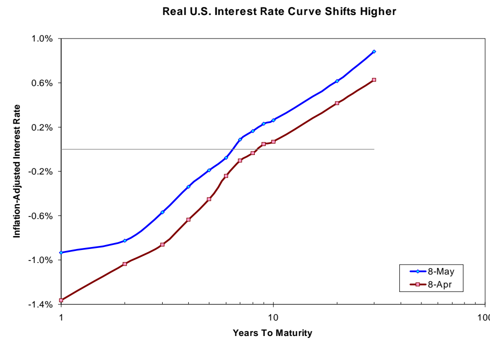
The selloff in Eurozone bonds should not surprise Treasury holders; after all QE1 produced negative Treasury returns in 2009 and QE3 produced negative returns in 2013. Both were secondary corrections in the primary bull market. The Treasury market has to get used to external markets being its primary driver unless the Federal Reserve decides to get cute and raise short-term rates more aggressively than everyone expects. The primary trend of a secular bullish flattening remains intact.



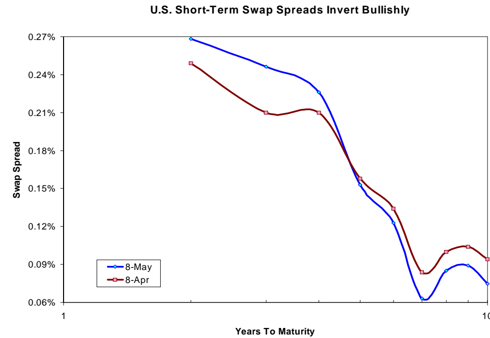
CDS costs shifted higher, but these changes are so minor as to be unimportant. We will need an irruption of dysfunction out of Washington to push these costs higher, and that does not appear likely in 2015.



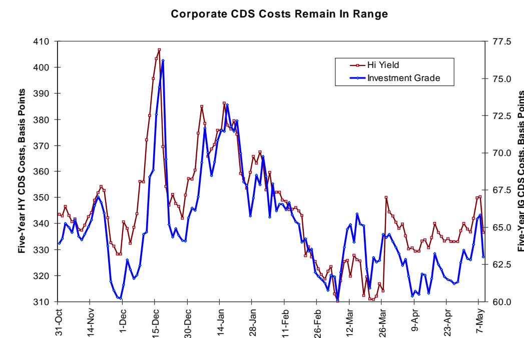
Pseudo-real rates have shifted higher and are negative out to "only" six years at this point. This shift is attributable to the bearish steepening of the nominal UST yield curve. These higher implied real rates were negative for precious metals but have yet to shift to the point where they are negative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



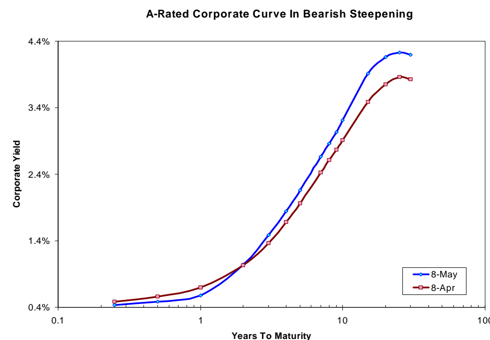
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates. The small shift higher over the past month at the short end of the 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. Only Precious Metals are in a structural downtrend amongst the physical commodities. The dollar index and ten-year UST remain in downtrends while the S&P 500 and EAFE indices remain in tenuous uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 11 - 15
BBerg	29	Trending	0.213	10.3%	0.51%
BBerg Grain	4	Sideways	0.014	12.6%	
BBerg Ind. Metl	29	Trending	0.307	15.0%	0.17%
BBerg Pre. Metl	29	Trending	-0.023	13.6%	-0.15%
BBerg Softs	25	Trending	0.056	17.4%	0.30%
BBerg Nat. Gas	29	Trending	0.234	27.8%	0.52%
BBerg Petroleum	29	Trending	0.146	27.7%	0.36%
BBerg Livestock	28	Trending	0.169	10.5%	0.01%
Dollar Index	29	Trending	-0.237	10.1%	-0.27%
S&P 500 Index	29	Trending	0.112	9.1%	0.28%
EAFE Index	29	Trending	0.110	10.3%	0.16%
EM Index	13	Transitional	-0.171	8.3%	
Ten-year UST (price)	29	Trending	-0.224	6.1%	-1.50%

Performance Measures

The world is going to get a lesson in advanced game theory regarding petroleum prices and it will not like it. Higher prices will keep marginal producers in the game while lower prices will drive them out; this will leave us with a broad trading range. The simple fact of physical commodity markets remains there is too much of everything and no immediate prospects for rising demand to bail producers out.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.68%	4.91%	-11.53%	-23.60%
Grains Sub-Index	0.77%	-4.83%	-7.89%	-33.01%
Corn	0.00%	-6.21%	-8.32%	-36.27%
Soybeans	1.19%	0.03%	-7.28%	-23.18%
Wheat	1.58%	-8.19%	-7.30%	-38.24%
Energy Sub-Index	-0.08%	12.58%	-29.31%	-39.88%
Petroleum Sub-Index	-1.12%	14.28%	-26.18%	-40.00%
WTI	-0.02%	13.39%	-30.57%	-42.73%
Brent	-1.57%	15.06%	-28.20%	-44.04%
ULSD	-1.39%	14.34%	-18.97%	-31.61%
Gasoline	-2.11%	14.50%	-20.98%	-35.87%
Natural Gas	3.42%	7.37%	-38.84%	-43.45%
Precious Metals Sub-Index	1.44%	-0.92%	2.02%	-9.74%
Gold	1.23%	-1.18%	1.41%	-7.99%
Silver	2.05%	-0.20%	3.90%	-15.14%
Industrial Metals Sub-Index	-0.06%	7.77%	-4.81%	-3.85%
Copper	-0.31%	6.84%	-3.77%	-4.87%
Aluminum	-1.46%	6.33%	-10.07%	2.70%
Nickel	3.96%	13.60%	-8.14%	-27.64%
Zinc	0.45%	9.19%	4.20%	13.47%
Softs Sub-Index	1.93%	1.23%	-14.91%	-31.22%
Coffee	0.34%	-2.64%	-30.43%	-37.51%
Sugar	3.95%	4.26%	-13.57%	-35.15%
Cotton	-0.68%	-1.05%	5.11%	-20.42%
Livestock Sub-Index	2.58%	3.74%	-10.45%	-7.92%
Cattle	1.48%	-0.04%	-4.05%	12.10%
Hogs	4.22%	9.83%	-21.92%	-34.41%

To repeat from last two weeks, 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.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.00%	3.88%	-9.84%	-19.08%
Chinese yuan	-0.10%	-0.10%	-1.44%	0.30%
Japanese yen	0.33%	0.31%	-4.09%	-15.11%
British pound	2.03%	3.96%	-2.44%	-8.72%
Swiss franc	0.23%	3.89%	4.07%	-5.39%
Canadian dollar	0.73%	3.94%	-5.72%	-10.27%
Australian dollar	1.03%	3.23%	-8.00%	-15.39%
Swedish krona	1.72%	5.02%	-9.99%	-20.93%
Norwegian krone	1.67%	7.73%	-8.91%	-21.11%
New Zealand dollar	-0.60%	-0.86%	-3.36%	-13.39%
Indian rupee	-0.81%	-2.65%	-3.80%	-6.06%
Brazilian real	1.34%	2.51%	-14.20%	-25.54%
Mexican peso	2.79%	-1.41%	-9.99%	-14.37%
Chilean peso	1.19%	1.27%	-2.93%	-8.21%
Colombian peso	1.55%	5.76%	-10.47%	-19.28%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.05%	-0.01%	-1.76%	-2.81%

You would think bond market resistance, declining earnings growth, rising currency volatility, full valuation in the U.S. and negative realized delta on the call option embedded in convertible bonds would lead to poor equity returns. In a normal world with compelling alternatives, they would. Ergo, we are not in a normal world.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.53%	1.90%	6.46%	9.03%
North America	0.32%	1.68%	5.02%	13.98%
Latin America	2.68%	5.65%	-7.86%	-15.75%
Emerging Market Free	-1.02%	1.56%	5.75%	5.40%
EAFE	0.86%	2.23%	8.76%	2.03%
Pacific	-0.44%	-0.03%	7.85%	10.92%
Eurozone	1.32%	2.29%	10.49%	-3.45%

For the second week in a row, both CTAs and macro hedge funds demonstrated an inability to handle difficult markets. As this is their raison d'être, you would think someone would be concerned, but they do have the always-receding promise that if the bottom drops out one day, they will be a diversifying asset class. Hope springs eternal.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-2.24%	-5.76%	9.65%	27.08%
Newedge Trend	-2.10%	-3.85%	7.63%	19.29%
Newedge Short-Term	-1.45%	-3.55%	2.29%	10.42%
HFR Global Hedge Fund	-0.39%	-0.61%	1.57%	1.15%
HFR Macro/CTA	-0.74%	-3.36%	1.40%	7.36%
HFR Macro: Sytematic Diversified CTA	-1.48%	-4.78%	2.56%	7.01%