The Macro Environment For Financial Markets

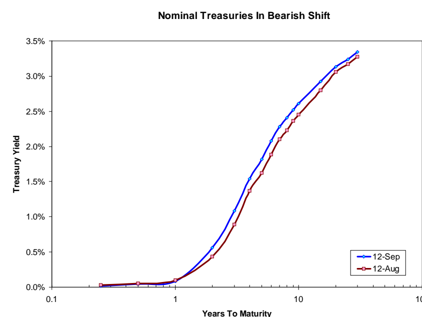
The Federal Reserve is forming a task force on financial asset bubbles. A mirror and a name-tag printed in reverse might be a good place to start an investigation unless they can find someone else who engineered negative real interest rates and financed an explosion in Treasury debt. Markets have been pricing in tighter credit conditions in 2015, and given our newfound concern over asset bubbles and macroprudential claptrap, we should ask how pushing the dollar higher and offsetting laxer credit conditions elsewhere while simultaneously threatening the assets of all those who took the bait over the past five years and pushed out along both credit and maturity curves will contribute to financial stability. The answer, of course, is such action would do anything but maintain stability. The safest bet since 2008 has been to say the FOMC will err on the side of ease. This may be the most prudent bet now as well.

The causal chain is now:

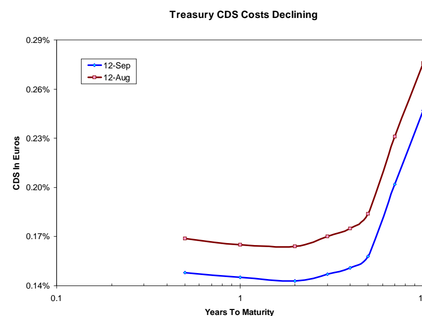
1. Short-term interest rates will remain artificially low even if the FOMC signals tighter credit conditions in 2015;
2. Real rates will continue their move higher, especially at the short end of the yield curve, as
3. Inflation expectations as measured by the TIPS market remain subdued;
4. The rise in longer-dated sovereign debt yields is approaching strong support;
5. The U.S. yield curve should continue its flattening trend from what are historically high levels still;
6. Short-term borrowers will continue to accept rollover risk and keep their effective maturities as short as possible;
7. Swap spreads are in a stable configuration and will not present an impediment to corporate bonds; and
8. Credit spreads, especially for investment-grade bonds, will remain compressed in the absence of a macroeconomic shock. Rising high-yield CDS levels will be a negative for risky assets.

Key Market Indications

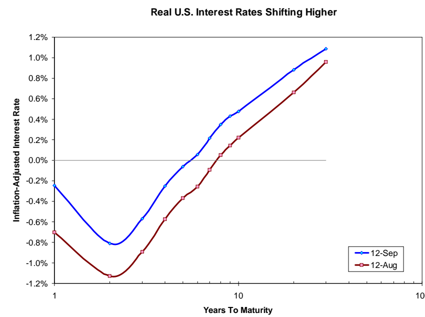
The inability of Treasuries to gain in the face of carry trades into the UST was noted here last week as a sign of strong resistance. The bearish shift in the Treasury curve should test support for the ten-year near 2.70%. The flattening of the yield curve ongoing since November 2013 has seen higher two-year and lower ten-year yields. This condition along with net convexity gains from duration-neutral bullish flatteners should moderate the move toward higher long-term yields.



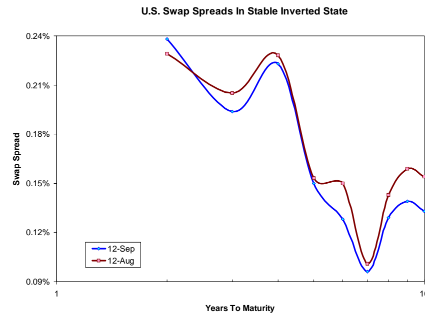
Euro-denominated CDS costs have declined over the past month along with the advance in the USD. Tellingly, this market would be rising if it thought U.S. interest rates would increase to the point where debt service costs would start to be of greater fiscal concern.



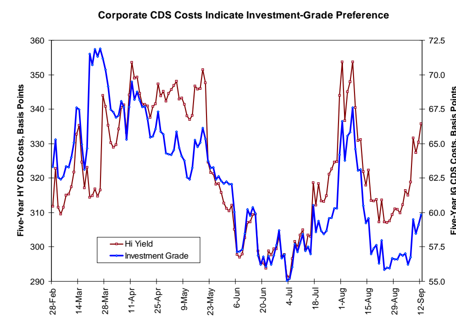
Real rates remain negative out to the five-year horizon, a departure from the 7-8 year horizons seen recently. The increase at short-dated maturities continues to be a negative for precious metals. The rise in long-dated real rates will start to become a concern if it advances another 20-25 basis points to a real ten-year yield of 70 basis points.



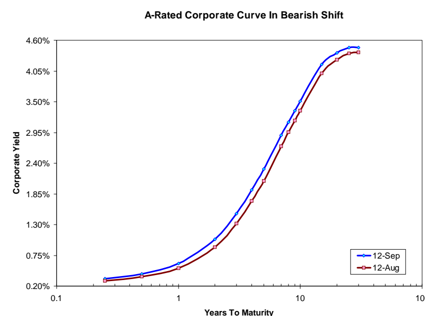
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain in an inverted state consistent with relatively greater demand to fix short-dated payments while remaining willing to pay floating on 5-7 year notes. Swap spreads' stability is another signal significantly higher Treasury yields are unlikely.



The increase in high-yield bonds' CDS levels is becoming difficult to ignore and underscores the problems associated with bond investors selling CDS and buying UST in lieu of buying the more illiquid bonds. It is absurd to think prospective default rates are going to increase in a low-interest, high-liquidity, stable-to-higher growth environment and yet bondholders are demanding higher CDS premia instead of lower bond prices.



The A-rated yield curve continues to mimic the Treasury yield curve and, like the UST curve it has seen a bearish shift. The absolute shift higher in yields has not been accompanied by an increase in credit spreads sufficient to compensate for the higher level of duration risk seen in these markets. As a result, equities with the embedded call option will remain favored over corporate bonds in a higher growth scenario.



Market Structure

Only Livestock and Petroleum are not in structural downtrends amongst physical commodity markets. The broad Bloomberg index is oversold, an unusual situation, as are the Grain and Precious Metals indices. Ten-year UST and Emerging Markets are in downtrend structures while the S&P 500 clings to a weak uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For Sep. 15 - 19
BBerg	27	Trending	-0.540	6.1%	-0.13%
BBerg Grain	27	Trending	-0.434	15.7%	-0.20%
BBerg Ind. Metl	29	Trending	-0.168	11.3%	-0.20%
BBerg Pre. Metl	29	Trending	-0.444	9.9%	-0.12%
BBerg Softs	29	Trending	-0.277	16.8%	-0.81%
BBerg Nat. Gas	27	Trending	-0.092	20.7%	-0.27%
BBerg Petroleum	15	Transitional	-0.203	12.4%	
BBerg Livestock	29	Trending	0.219	15.1%	0.38%
Dollar Index	4	Sideways	-0.008	5.0%	
S&P 500 Index	29	Trending	0.079	7.4%	0.12%
EAFE Index	20	Trending	-0.144	6.7%	
EM Index	29	Trending	-0.222	6.9%	-0.19%
Ten-year UST (price)	29	Trending	-0.311	4.6%	-0.07%

Performance Measures

The physical commodity markets are in an unusual combination of higher supply, slower demand growth and decreasingly supportive financial market conditions. Moreover, investors in commodity products are faced with a large number of increasingly deep carries within downtrends; only WTI is a significant exception. These conditions create dual headwinds for these investors and discourage artificial price supports by non-commercial players.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.85%	-3.51%	-10.07%	-6.16%
Grains Sub-Index	-4.79%	-8.86%	-26.40%	-23.71%
Corn	-4.92%	-10.21%	-32.75%	-31.52%
Soybeans	-3.55%	-6.34%	-14.94%	-12.51%
Wheat	-6.12%	-10.82%	-31.19%	-27.44%
Energy Sub-Index	-1.23%	-2.79%	-7.99%	-4.89%
Petroleum Sub-Index	-2.36%	-4.20%	-5.52%	-9.16%
WTI	-1.44%	-3.56%	-2.76%	-9.48%
ULSD	-2.75%	-3.99%	-6.79%	-10.47%
Gasoline	-2.60%	-3.05%	-6.77%	-6.52%
Natural Gas	1.64%	0.80%	-13.72%	2.47%
Precious Metals Sub-Index	-2.84%	-5.54%	-11.56%	-8.54%
Gold	-2.82%	-5.72%	-10.81%	-6.12%
Silver	-2.87%	-5.02%	-13.72%	-15.30%
Industrial Metals Sub-Index	-3.47%	-0.15%	10.50%	6.74%
Copper	-1.99%	-0.57%	5.32%	-3.15%
Aluminum	-3.24%	1.05%	13.51%	4.97%
Nickel	-6.05%	-1.58%	15.93%	30.49%
Zinc	-4.99%	0.08%	13.60%	18.23%
Softs Sub-Index	-4.88%	-5.52%	-20.68%	-5.64%
Coffee	-6.82%	-4.45%	-11.46%	40.09%
Sugar	-6.06%	-11.49%	-24.68%	-27.90%
Cotton	5.74%	5.67%	-19.61%	-14.16%
Livestock Sub-Index	-1.56%	7.58%	-0.16%	15.86%
Cattle	-1.88%	6.09%	11.59%	23.42%
Hogs	-1.00%	10.13%	-14.16%	5.88%

Only a small gain in the EUR prevented a clean sweep for the USD against other currencies. Both the JPY and CHF, carry trade-funding currencies both, are replacing the USD in global carry trades and are mitigating the damage to equities that might have existed otherwise. The long USD trade is getting quite crowded, is overbought technically and is at-risk to any dovish move by the FOMC this week.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.09%	-3.04%	-6.76%	-2.53%
Japanese yen	-2.10%	-4.73%	-4.27%	-7.27%
British pound	-0.36%	-3.24%	-2.11%	2.93%
Swiss franc	-0.23%	-2.74%	-6.34%	-0.28%
Canadian dollar	-1.92%	-1.51%	0.23%	-6.94%
Australian dollar	-3.63%	-2.49%	0.56%	-2.52%
Swedish krona	-0.33%	-3.41%	-10.59%	-8.43%
Norwegian krone	-1.28%	-2.86%	-6.48%	-7.53%
New Zealand dollar	-2.10%	-3.36%	-4.36%	0.17%
Indian rupee	-0.42%	0.71%	0.92%	4.74%
Brazilian real	-4.16%	-2.65%	0.71%	-2.75%
Mexican peso	-1.70%	-0.92%	-0.11%	-1.50%
Chilean peso	-1.00%	-2.73%	-3.38%	-15.32%
Colombian peso	-3.11%	-6.05%	2.47%	-3.80%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.46%	-0.09%	0.51%	0.62%

The retracement of global equity indices was led by Brazil as investors realized a Silva government might not be a welcome alternative to a Rousseff government. The U.S. remains the most attractive of major indices by virtue of capital inflows, but a pause in the global equity rally is almost a given at this juncture.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.16%	2.03%	5.35%	15.67%
North America	-1.09%	2.81%	7.54%	20.15%
Latin America	-6.72%	-1.05%	20.85%	7.41%
Emerging Market Free	-3.15%	-0.02%	14.67%	10.18%
EAFE	-1.27%	0.86%	2.19%	9.47%
Pacific	-1.63%	-0.54%	6.15%	6.00%
Eurozone	-1.36%	3.34%	0.22%	13.12%

CTA's and macro-oriented hedge funds' continued bias toward long positions in global equities and sovereign debt was insufficient to offset the long dollar trade. The prevailing downtrends in physical commodity markets are harder to trade than are uptrends and the reluctance to join this side of the trade affected performance negatively.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.11%	6.42%	9.85%	7.94%
Newedge Trend	-1.02%	4.71%	7.03%	6.32%
Newedge Short-Term	-0.24%	0.92%	0.63%	5.38%
HFR Global Hedge Fund	-0.12%	1.51%	0.77%	4.51%
HFR Macro/CTA	0.12%	3.19%	3.44%	2.44%
HFR Macro: Sytematic Diversified CTA	-0.54%	2.09%	0.60%	0.88%