# The Macro Environment For Financial Markets

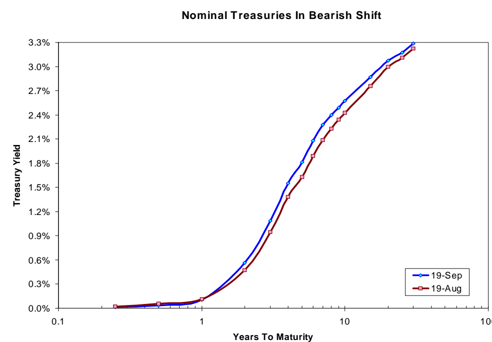
The period between the Asian crisis' start in July 1997 and a rate hike in August 1999 was characterized by the Federal Reserve staying easier than it might have been out of concern for external developments. The U.S. market peaked in March 2000. We are in a similar situation today: Monetary ease, a rising dollar, declining commodity prices, expansive credit conditions, a stronger dollar and stable-to-declining inflation expectations. The U.S. is growing just enough to support earnings stability but not enough to pull operating costs and interest rates higher. Just as stocks become cheap and then get hammered, they get expensive and then disconnect to the upside. We are not yet at that point, but we will get there.

The causal chain is now:

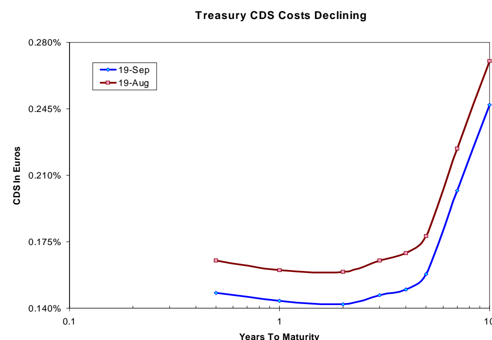
1. Short-term interest rates will remain artificially low even as expectations for future short-term rates rise;
2. Real rates will continue their move higher, especially at the short end of the yield curve, as
3. Inflation expectations as measured by the TIPS market remain subdued;
4. The rise in longer-dated sovereign debt yields has held 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 and inverting 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. The rise in high-yield CDS costs as the immediate threat of higher short-term interest rates receded.

**Key Market Indications**

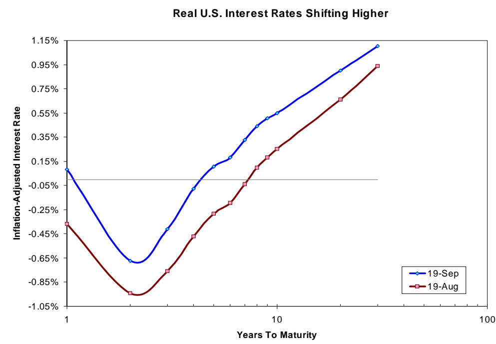
While ten-year notes yields have been rising, they have yet to challenge support at 2.70%. The flattening of the yield curve ongoing since November 2013 has seen higher two-year and lower ten-year yields, and all indications from the swap, swaption and interest rate volatility markets are for this flattening to continue. Duration-neutral bullish flatteners remain attractive.



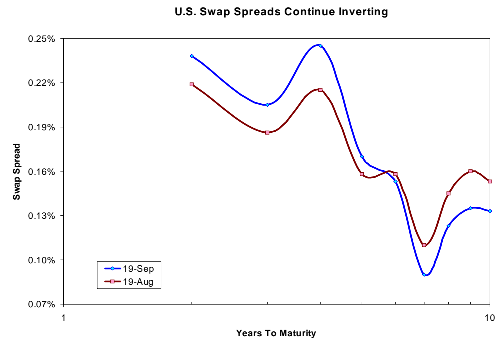

Euro-denominated CDS costs continue their downward shift. As the EUR itself is weaker, the decline in CDS costs represents a significant decline in concern over U.S. finances. Rising interest rate expectations have yet to translate into higher debt service costs for the federal government.



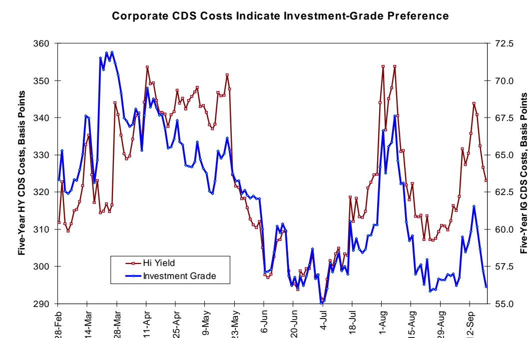
One-year real rates finally turned positive and are negative only in the mid-curve horizon. This continues to be bearish for precious metals. The rise in long-term real rates is not yet bearish for risky financial assets as it has been induced by lower TIPS breakevens more than by a rise in nominal rates.



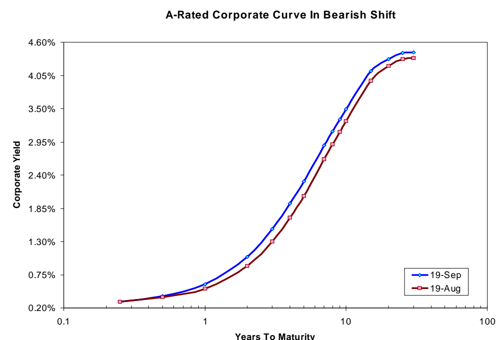

Swap spreads, which rise when floating-rate borrowers want to fix their payments, are increasingly inverted as floating-rate borrowers are trying to fix short-dated and mid-curve payments but are willing to remain floating at the long end of the yield curve. This condition remains supportive for capital market-horizon assets.




I noted last week it was absurd to think prospective default rates were going to increase in a low-interest, high-liquidity, stable-to-higher growth environment. Bond investors who write CDS and buy UST in lieu of the bonds themselves were willing to take lower premia for both investment-grade and high-yield bonds; the IG index is challenging the July lows. As short-term rates and long-term swap spreads are not set to rise any time soon, HY credit spread compression should continue as well.




The A-rated yield curve continues to mimic the Treasury yield curve. Until long-dated swap spreads start to rise or until investment-grade CDS costs move higher, this curve's bearish shift will be limited to that of the Treasury market. The still-low level of real return and declining level of credit risk in investment-grade bonds continues to support equities.



## Market Structure

Only Livestock and Petroleum are not in structural downtrends amongst physical commodity markets. The broad Bloomberg index and the Grain, Soft, and Precious Metals indices are oversold. Ten-year UST and both EAFE and Emerging Markets are in downtrend structures while the S&P 500 and the dollar index have entered bullish consolidations.

| | N-Day Speed | Market Structure | Trend Oscillator | HLC Volatility | Daily Trend Rate For Sep. 22 - 26 |
|---|---|---|---|---|---|
| BBerg | 29 | Trending | -0.657 | 6.1% | -0.13% |
| BBerg Grain | 29 | Trending | -0.528 | 16.2% | -0.20% |
| BBerg Ind. Metl | 29 | Trending | -0.261 | 11.3% | -0.20% |
| BBerg Pre. Metl | 29 | Trending | -0.548 | 9.7% | -0.12% |
| BBerg Softs | 29 | Trending | -0.461 | 15.6% | -0.81% |
| BBerg Nat. Gas | 29 | Trending | -0.085 | 20.4% | -0.27% |
| BBerg Petroleum | 5 | Sideways | -0.026 | 11.5% | |
| BBerg Livestock | 7 | Sideways | -0.018 | 12.8% | |
| Dollar Index | 6 | Sideways | 0.070 | 6.8% | |
| S&P 500 Index | 11 | Transitional | 0.079 | 7.5% | |
| EAFE Index | 24 | Trending | -0.111 | 6.8% | -0.05% |
| EM Index | 29 | Trending | -0.328 | 6.9% | -0.19% |
| Ten-year UST (price) | 29 | Trending | -0.205 | 4.5% | -0.07% |

## Performance Measures

The physical commodity markets remain in their 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. The spot Bloomberg index has retraced all the way to its October 2003 upside breakout; so much for grand super-cycles.

**Commodity Total Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| **Bloomberg Index** | -1.50% | -4.73% | -10.11% | -6.83% |
| **Grains Sub-Index** | -3.29% | -11.14% | -28.97% | -24.52% |
| Corn | -2.07% | -10.77% | -33.18% | -31.75% |
| Soybeans | -2.87% | -8.16% | -18.57% | -10.73% |
| Wheat | -5.57% | -15.61% | -35.59% | -31.98% |
| **Energy Sub-Index** | 0.21% | -2.39% | -6.90% | -3.10% |
| Petroleum Sub-Index | 0.37% | -2.82% | -4.83% | -6.41% |
| WTI | 0.31% | -1.63% | -3.34% | -6.78% |
| ULSD | -0.92% | -4.17% | -7.18% | -8.15% |
| Gasoline | 2.18% | -1.04% | -3.08% | -1.28% |
| Natural Gas | -0.18% | -1.34% | -11.75% | 2.07% |
| **Precious Metals Sub-Index** | -1.94% | -5.81% | -9.99% | -11.73% |
| Gold | -1.21% | -4.97% | -9.04% | -8.92% |
| Silver | -4.10% | -8.30% | -12.76% | -19.54% |
| **Industrial Metals Sub-Index** | -1.57% | -4.37% | 8.92% | 3.17% |
| Copper | -0.48% | -4.08% | 4.81% | -7.02% |
| Aluminum | -2.71% | -4.70% | 11.63% | 1.72% |
| Nickel | -3.44% | -5.34% | 9.38% | 24.62% |
| Zinc | -0.09% | -3.47% | 15.00% | 18.09% |
| **Softs Sub-Index** | -3.64% | -7.04% | -19.84% | -8.12% |
| Coffee | -3.55% | -4.99% | -1.00% | 41.42% |
| Sugar | -3.19% | -12.77% | -25.26% | -30.43% |
| Cotton | -5.31% | -2.70% | -24.80% | -18.77% |
| **Livestock Sub-Index** | -0.76% | 7.98% | -1.13% | 15.23% |
| Cattle | -0.35% | 6.27% | 12.61% | 22.42% |
| Hogs | -1.51% | 10.90% | -17.06% | 5.71% |

The USD rally was less monotonic than the previous week as the GBP had a relief rally and the CAD advanced. However, the European Central Bank and Bank of Japan remain determined to drive the EUR and JPY lower, respectively, and the USD remains attractive on both an interest rate and a relative asset return basis.

**Currency Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| Euro | -1.03% | -3.69% | -7.26% | -5.18% |
| Japanese yen | -1.56% | -5.61% | -6.16% | -8.79% |
| British pound | 0.12% | -1.98% | -1.53% | 1.60% |
| Swiss franc | -0.81% | -3.36% | -6.39% | -3.21% |
| Canadian dollar | 1.19% | -0.19% | 2.51% | -6.37% |
| Australian dollar | -1.25% | -4.05% | -1.29% | -5.44% |
| Swedish krona | -0.44% | -3.91% | -10.49% | -11.37% |
| Norwegian krone | 0.14% | -2.97% | -5.00% | -8.24% |
| New Zealand dollar | -0.25% | -3.42% | -5.01% | -2.89% |
| Indian rupee | -0.28% | -0.24% | 0.21% | 1.56% |
| Brazilian real | -1.23% | -5.12% | -0.78% | -7.03% |
| Mexican peso | 0.37% | -1.23% | 0.57% | -3.84% |
| Chilean peso | -0.65% | -2.60% | -4.63% | -16.78% |
| Colombian peso | 1.28% | -3.59% | 1.92% | -4.49% |
| Bloomberg-JP Morgan Asian dollar index (spot) | -0.22% | -0.71% | 0.92% | -0.41% |

The U.S. remains the most attractive of major indices by virtue of capital inflows, but these returns increasingly are coming at the expense of markets elsewhere. The carry trade into the USD is contributing as well to the flattening of the U.S. yield curve.

**Equity Total Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| **MSCI World Free** | 0.64% | 0.49% | 6.48% | 13.42% |
| North America | 1.04% | 1.36% | 9.07% | 18.61% |
| Latin America | 0.10% | -3.68% | 18.54% | 2.20% |
| Emerging Market Free | -0.66% | -2.58% | 13.18% | 5.96% |
| EAFE | 0.04% | -0.81% | 2.74% | 6.28% |
| Pacific | -0.92% | -2.93% | 6.68% | 2.27% |
| Eurozone | 0.38% | 1.70% | 0.19% | 8.90% |

CTA's and macro-oriented hedge funds' had their second consecutive bad week, for reasons that are somewhat mysterious given the lack of reversals in the prevailing trends. Perhaps professional traders are taking the ongoing strength in the USD and in U.S. equities as an excuse for remaining aggressively long global equities. Skill this is not.

**CTA/Hedge Fund Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| Newedge CTA | -2.26% | 3.04% | 10.11% | 6.75% |
| Newedge Trend | -1.92% | 2.34% | 6.96% | 5.28% |
| Newedge Short-Term | -0.10% | 0.50% | 1.15% | 5.26% |
| HFR Global Hedge Fund | -0.05% | 0.83% | 0.87% | 4.08% |
| HFR Macro/CTA | -0.05% | 2.60% | 3.35% | 2.10% |
| HFR Macro: Sytematic Diversified CTA | -0.55% | 1.13% | -0.10% | 0.01% |