# The Macro Environment For Financial Markets

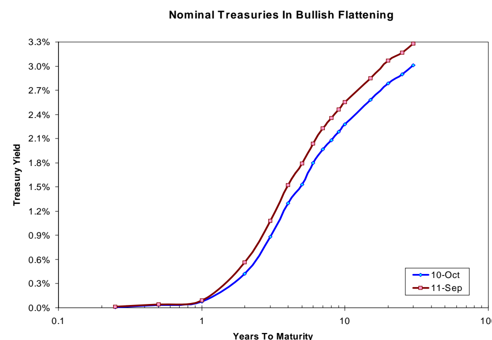
I concluded last week, "Restated, just because QE never could accomplish its macro objectives does not mean its absence will be painless. Indeed, QE's end could be the post-crisis era's great error of omission." The lack of Eurozone QE will shut down the carry trade into the U.S. As this was offsetting the end of U.S. QE, its absence will be felt. While the Federal Reserve is understandably hesitant to be seen blinking at the sight of wobbly global financial markets once again, they have established what they are and the rest of us, per the old chestnut, are simply arguing about the price. The alternative presented by higher U.S. short-term rates is an unstable rise in the dollar and the alternative presented by the lack of Eurozone QE is a descent into deflation. The only path to a win/win outcome is for the U.S. and the Eurozone to coordinate their policies with both sides of the Atlantic remaining easier than they would like. Sometimes you only get one chance to fail; I have likened both Bernanke and Yellen to Churchill's description of Admiral Jellicoe in World War I: "The only man on either side who could lose the war in an afternoon."

The causal chain is now:

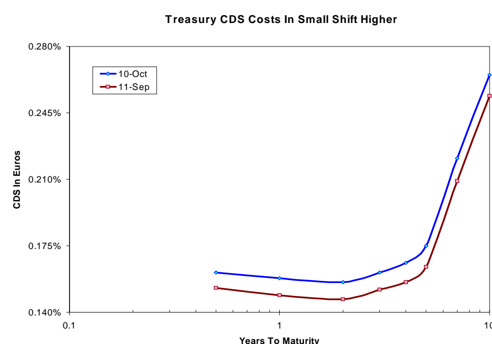
1. Short-term interest rates will remain artificially low even as expectations for future short-term rates rise;
2. Real rates will pause in their move higher at the short end of the yield curve and will be under downward pressure at the long end of the yield curve so long as risk-aversion is rising;
3. Inflation expectations as measured by the TIPS market remain subdued;
4. Sovereign debt yields will resume their decline;
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 does not yet present an impediment to corporate bonds; and
8. Credit spreads swings will remain exaggerated as CDS have moved away from their original function to being the tool for corporate bond synthesis.

**Key Market Indications**

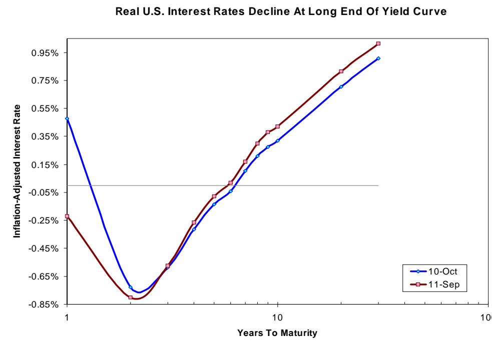
The Treasury yield curve flattened bullishly in typical risk-off fashion. The short-term end of carry trades into the USD will dampen some of the enthusiasm for UST as opposed to non-U.S. sovereign debt. Still, the ten-year could return to the 2% level from whence it rose in May/June 2013 when the idea of tapering QE was floated by then-Federal Reserve chairman Bernanke.



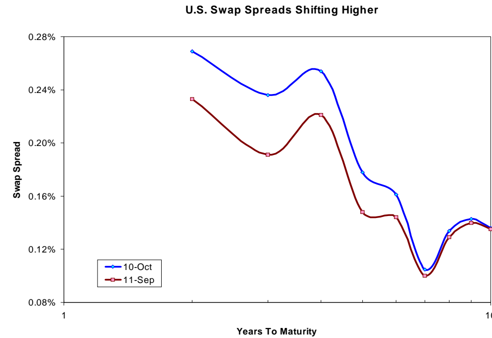

Euro-denominated CDS costs on Treasuries are shifting about within a small range. The U.S. fiscal situation is one of the lowest areas of concern for global markets at present.



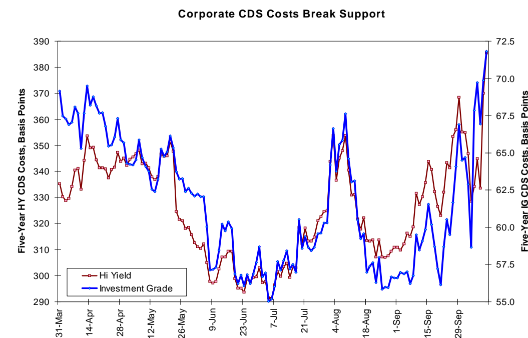
Real rates are twisting higher at the short end of the yield curve and lower at the long end. The decline at the long end of the yield curve will have to proceed further to restore the attractiveness of risky financial assets. This is quite doable as nominal yields are under pressure and breakevens have stopped their decline.



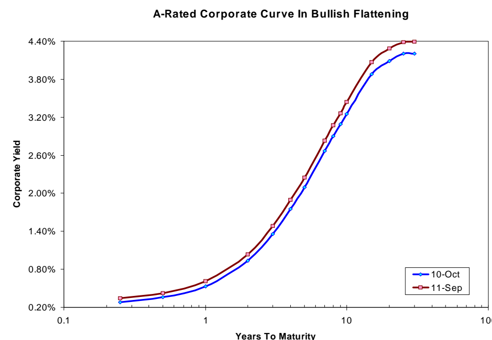

Swap spreads, which rise when floating-rate borrowers want to fix their payments, are increasingly inverted as floating-rate borrowers are trying to fix short-dated and mid-curve payments but are willing to remain floating at the long end of the yield curve. Short-term swap spreads are likely to decline quickly if the Federal Reserve signals the long-anticipated 2015 rate hike will be delayed due to financial market and global macro concerns.




The upside breakout in both investment-grade and high-yield CDS costs is a matter of increasing concern as short CDS positions often are hedged imperfectly with either short equity option volatility or the stocks themselves. This mechanism is allowing even small changes in absolute default risk to be magnified in both the corporate bond and equity markets at a time when corporate cash positions remain flush and debt is easy to service.




The A-rated yield curve flattened bearishly along with the Treasury curve. This flattening will lag that of the UST curve as much of the Treasury rally is being driven by risk-averse flows and corporate bonds are being affected by rising credit default swap prices. Until and unless swap spreads rise or TIPS breakevens start moving materially higher, investment-grade underperformance should be relatively minimal.



## Market Structure

While the Petroleum and Natural Gas indices remain in structural downtrends and the Softs index reversed into an uptrend, the general move in physical commodities has been into bearish consolidations. The S&P 500 and EAFE indices are oversold, but the EM index has moved into a bearish consolidation. Ten-year UST are in a structural uptrend once again.

| | N-Day Speed | Market Structure | Trend Oscillator | HLC Volatility | Daily Trend Rate For Oct. 13 - 17 |
|---|---|---|---|---|---|
| BBerg | 8 | Sideways | -0.041 | 8.7% | |
| BBerg Grain | 8 | Sideways | 0.006 | 19.4% | |
| BBerg Ind. Metl | 6 | Sideways | -0.017 | 13.0% | |
| BBerg Pre. Metl | 8 | Sideways | 0.049 | 16.2% | |
| BBerg Softs | 29 | Trending | 0.237 | 19.8% | 0.77% |
| BBerg Nat. Gas | 24 | Trending | -0.103 | 21.2% | -0.27% |
| BBerg Petroleum | 28 | Trending | -0.412 | 16.5% | -0.28% |
| BBerg Livestock | 17 | Transitional | 0.064 | 13.1% | |
| Dollar Index | 4 | Sideways | 0.046 | 7.9% | |
| S&P 500 Index | 29 | Trending | -0.402 | 9.7% | -0.21% |
| EAFE Index | 29 | Trending | -0.747 | 9.1% | -0.05% |
| EM Index | 5 | Sideways | -0.120 | 11.6% | |
| Ten-year UST (price) | 29 | Trending | 0.327 | 4.8% | 0.02% |

## Performance Measures

While the petroleum markets continued to sink on excess production, the other physical commodity markets either consolidated their downturns or, in the case of economically unimportant Softs, reversed into an actual uptrend. Such consolidative action is typical at the end of a long downtrend in Grains. Precious Metals rose on prospects for real short-term interest rates to start declining. Tellingly, the economically sensitive Industrial Metals consolidated as well; such action is inconsistent with a growing negative outlook for global manufacturing.

**Commodity Total Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| **Bloomberg Index** | 0.16% | -2.55% | -13.33% | -7.46% |
| **Grains Sub-Index** | 2.38% | -2.91% | -29.76% | -23.94% |
| Corn | 3.33% | -1.33% | -35.32% | -28.42% |
| Soybeans | 1.11% | -6.38% | -24.50% | -10.73% |
| Wheat | 2.63% | -0.79% | -28.97% | -33.29% |
| **Energy Sub-Index** | -3.79% | -5.47% | -15.53% | -8.39% |
| Petroleum Sub-Index | -3.49% | -7.17% | -14.13% | -13.13% |
| WTI | -4.31% | -6.01% | -12.88% | -10.64% |
| ULSD | -2.27% | -6.95% | -13.37% | -14.66% |
| Gasoline | -4.48% | -8.14% | -15.86% | -11.15% |
| Natural Gas | -4.48% | -1.33% | -18.87% | 0.94% |
| **Precious Metals Sub-Index** | 2.52% | -2.36% | -9.10% | -8.08% |
| Gold | 2.41% | -0.79% | -7.49% | -3.90% |
| Silver | 2.84% | -7.00% | -13.85% | -19.52% |
| **Industrial Metals Sub-Index** | 0.88% | -4.03% | 0.50% | -0.01% |
| Copper | 1.22% | -2.30% | -0.26% | -7.28% |
| Aluminum | 0.77% | -5.24% | -0.31% | -4.65% |
| Nickel | -1.09% | -11.13% | -6.70% | 15.85% |
| Zinc | 2.15% | 1.55% | 12.82% | 17.81% |
| **Softs Sub-Index** | 3.58% | 7.26% | -12.96% | 0.82% |
| Coffee | 6.73% | 19.43% | 4.23% | 72.04% |
| Sugar | 0.67% | 1.41% | -21.84% | -31.71% |
| Cotton | 2.61% | -5.73% | -21.93% | -18.02% |
| **Livestock Sub-Index** | 0.27% | 1.75% | 4.93% | 16.39% |
| Cattle | -0.35% | 3.80% | 17.59% | 24.89% |
| Hogs | 1.48% | -1.97% | -11.26% | 4.69% |

I noted last week the ECB's forbearance in moving toward a more aggressive easing is signaling the policy divergence between the U.S. and elsewhere is about to stop widening. This was combined by a confused signal U.S. monetary policy may change in response to global equity market downturns. The net result was long USD liquidation, a process that will resume if a more serious global downturn leads to unwinding of dollar loans.

**Currency Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| Euro | 0.89% | -2.24% | -9.06% | -6.60% |
| Chinese yuan | 0.14% | -0.02% | 1.33% | -0.24% |
| Japanese yen | 1.95% | -0.74% | -5.69% | -8.82% |
| British pound | 0.64% | -0.83% | -4.22% | 0.68% |
| Swiss franc | 1.09% | -2.13% | -8.42% | -4.76% |
| Canadian dollar | 0.40% | -2.33% | -2.35% | -7.15% |
| Australian dollar | 0.13% | -5.12% | -7.72% | -8.10% |
| Swedish krona | 0.60% | -1.81% | -9.67% | -10.09% |
| Norwegian krone | 0.24% | -2.55% | -8.92% | -7.23% |
| New Zealand dollar | 0.66% | -5.01% | -9.99% | -5.65% |
| Indian rupee | 0.45% | -0.62% | -2.06% | 0.04% |
| Brazilian real | 1.21% | -5.79% | -9.15% | -10.24% |
| Mexican peso | 0.06% | -2.13% | -3.10% | -2.87% |
| Chilean peso | 0.93% | -0.27% | -8.12% | -16.06% |
| Colombian peso | -1.06% | -3.69% | -6.42% | -7.95% |
| Bloomberg-JP Morgan Asian dollar index (spot) | 0.23% | -1.02% | -0.60% | -1.09% |

The downturn in equities was probably less of a function of a weak macro outlook - these are not GDP futures – but in the realization governments and central banks have tired of their post-crisis playbook. The lack of more aggressive European credit easing will slow the carry trade into the U.S. market.

**Equity Total Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| **MSCI World Free** | -2.87% | -6.11% | -0.43% | 7.87% |
| North America | -3.16% | -4.92% | 4.42% | 13.89% |
| Latin America | 1.70% | -8.81% | -1.36% | -2.82% |
| Emerging Market Free | -0.70% | -7.78% | -1.24% | 0.35% |
| EAFE | -2.41% | -7.91% | -7.21% | -0.40% |
| Pacific | -1.06% | -6.40% | -0.89% | -1.42% |
| Eurozone | -3.31% | -9.65% | -11.89% | -2.48% |

CTA performance remained positive on the week, suggesting they finally broke their over-reliance on long equity positions and their hesitance to be aggressively short in physical markets such as crude oil. The same cannot be said for global hedge funds and macro-oriented CTAs.

**CTA/Hedge Fund Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| Newedge CTA | 1.03% | 2.62% | 12.93% | 15.44% |
| Newedge Trend | 0.60% | 0.98% | 7.36% | 10.59% |
| Newedge Short-Term | 0.52% | 1.81% | 3.31% | 9.94% |
| HFR Global Hedge Fund | -0.88% | -2.47% | -1.26% | 2.07% |
| HFR Macro/CTA | -0.09% | 0.34% | 3.50% | 3.35% |
| HFR Macro: Sytematic Diversified CTA | 0.22% | 0.52% | 2.37% | 2.35% |