The Macro Environment For Financial Markets

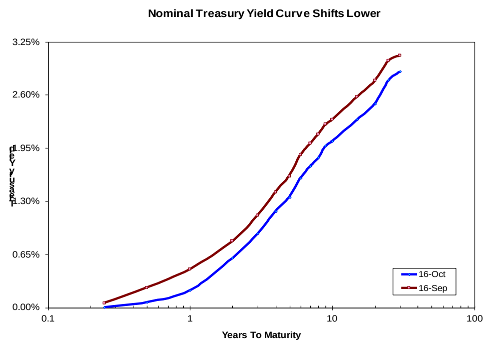
While economies do not need to grow as opposed to remaining static, growth creates the opportunities for improving living standards and for creating the opportunities for innovation to thrive. Stasis and redistribution do not, and while these are demonstrable assertions, it is striking to observe participants on the national political stage who can utter inanities to the contrary and not be consigned to the proverbial dustbin of history. The odd corollary to slow growth is how the policies to counter it have rewarded the holders of financial representations of enterprises as opposed to the enterprises themselves. Therefore, the more we try to “stimulate,” the greater inequalities of outcomes grow and the more acceptable demands for redistribution become. It is a vicious cycle but one that can persist for a very long time.

The causal chain now remains:

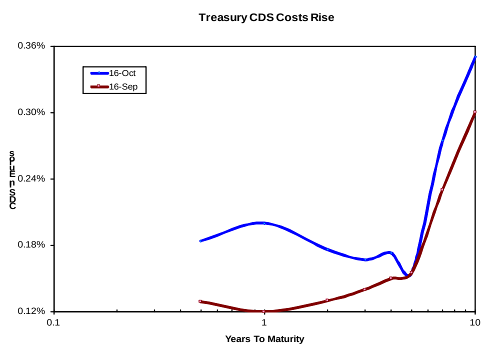
1. Short-term interest rates will rise at some point in the U.S., but probably not in 2015;
2. Disinflationary pressures are dominating inflationary pressures;
3. Inflation expectations as measured by the TIPS market will remain low;
4. The U.S. yield curve retains its long-term trend toward a bullish flattening;
5. Short-term borrowers will continue to accept rollover risk;
6. Swap spreads will remain tame; and
7. Credit spreads will remain within their recent elevated range.

Key Market Indications

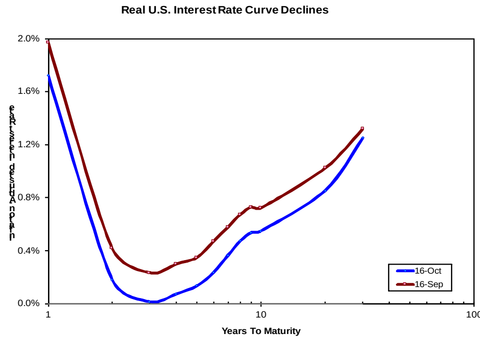
Such is the demand for safety that UST yields declined again in the face of rising equities. The continued removal of a hike in short-term rates no doubt helps as does declining inflation expectations, but the idea of the ten-year hovering near 2% almost one year after the end of QE3 is strange indeed. If you show a market in an uptrend it will not go lower, it will resume moving higher, and that has been the story since the end of the financial crisis.



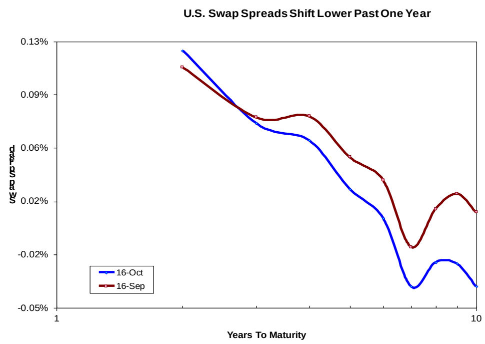
Can an entity borrow at 0% and reduce its fiscal deficit while seeing its credit increasingly questioned? Yes, if it is the U.S. government once again playing games with the debt ceiling. The human capacity for foolishness is unbounded.



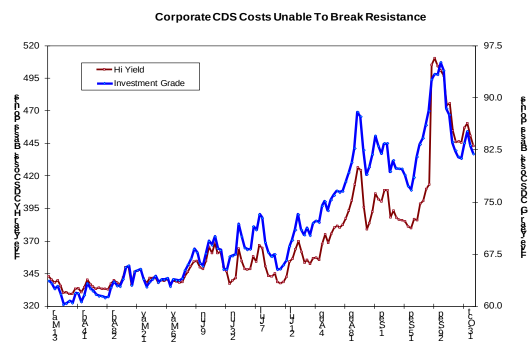
Pseudo-real rates have shifted strongly lower over the past month but none of them were negative as of Friday. A further decline at the long end of this yield curve will support risky financial assets.



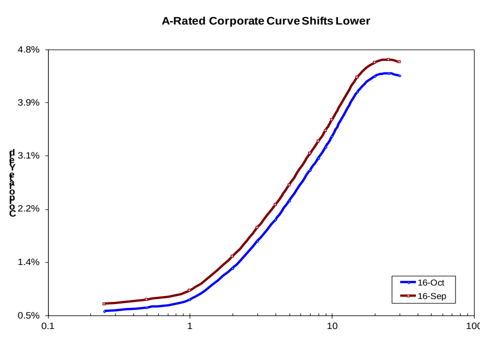
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue to decline for tenors longer than one year. Ten-year swap spreads remain negative, a condition extant before the launches of both QE2 and QE3. Such a condition makes any official talk of higher short-term rates borderline irresponsible.



CDS costs for both the investment-grade and high-yield indices have been unable to decline through resistance. While the removal of the threat of higher short-term rates is a positive for these markets, the prospects for low growth and a diminished capacity for corporations to issue new debt will more than offset the effects of monetary accommodation.



The A-rated yield curve has started to decline with a parallel shift as the effects of declining swap spreads, expectations of lower short-term rates and the retreat in CDS costs noted above have opened the way for slightly greater risk acceptance.



Market Structure

None of the physical commodities are in structural downtrends at present; the main index plus Petroleum and both Precious and Industrial Metals are in uptrends. The dollar index is in a downtrend while ten-year UST and both the S&P 500 and the EAFE are in uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Oct. 19 - 23
BBerg	27	Trending	0.109	12.4%	0.07%
BBerg Grain	29	Trending	-0.051	15.6%	
BBerg Ind. Metl	28	Trending	0.066	19.6%	0.31%
BBerg Pre. Metl	29	Trending	0.312	14.3%	0.09%
BBerg Softs	4	Sideways	-0.018	20.5%	
BBerg Nat. Gas	10	Sideways	-0.072	18.1%	
BBerg Petroleum	27	Trending	0.037	29.5%	0.10%
BBerg Livestock	29	Trending	0.045	14.1%	
Dollar Index	29	Trending	-0.132	7.5%	-0.50%
S&P 500 Index	24	Trending	0.223	14.1%	0.11%
EAFE Index	23	Trending	0.268	13.4%	0.06%
EM Index	4	Sideways	0.068	11.6%	
Ten-year UST (price)	29	Trending	0.113	5.8%	0.06%

Performance Measures

Listening to OPEC about crude oil production is like listening to FOMC members about interest rates. In both cases you will end up confused and misdirected. The most interesting physical commodities continue to be the precious metals as real interest rates decline. While the declines elsewhere are modest and Livestock is moving higher slowly, we are reminded that cash-strapped producers still need to maintain production in a vain hope of covering their fixed costs. That means the secular bear market in physical commodities is very much with us.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.35%	2.34%	-11.81%	-23.53%
Grains Sub-Index	-1.13%	1.23%	-5.74%	-6.77%
Corn	-1.57%	-0.13%	-7.19%	-4.26%
Soybeans	1.30%	3.47%	-4.93%	-5.24%
Wheat	-3.34%	1.13%	-1.57%	-7.55%
Energy Sub-Index	-4.14%	-0.13%	-20.73%	-44.66%
Petroleum Sub-Index	-4.86%	3.05%	-22.15%	-45.72%
WTI	-4.65%	5.01%	-23.11%	-50.19%
Brent	-4.52%	4.29%	-25.47%	-49.64%
ULSD	-5.79%	-0.86%	-23.04%	-39.67%
Gasoline	-5.06%	0.54%	-14.65%	-35.62%
Natural Gas	-2.05%	-8.29%	-15.57%	-44.90%
Precious Metals Sub-Index	2.23%	4.58%	-1.83%	-5.80%
Gold	2.35%	3.98%	-1.92%	-4.98%
Silver	1.87%	6.27%	-1.56%	-8.34%
Industrial Metals Sub-Index	-1.19%	0.71%	-15.80%	-23.19%
Copper	-0.43%	0.73%	-13.62%	-20.24%
Aluminum	-2.71%	-4.55%	-17.01%	-24.85%
Nickel	0.84%	9.38%	-16.22%	-33.56%
Zinc	-1.99%	6.19%	-19.74%	-21.67%
Softs Sub-Index	-0.50%	10.18%	-5.97%	-27.49%
Coffee	-4.37%	6.34%	-14.51%	-45.92%
Sugar	-0.49%	21.97%	-2.74%	-22.06%
Cotton	3.64%	5.45%	-0.23%	1.85%
Livestock Sub-Index	0.66%	1.29%	-2.61%	-17.08%
Cattle	1.53%	0.76%	-8.70%	-12.87%
Hogs	-0.83%	2.22%	9.70%	-24.38%

All it took for the NZD to jump was for the RBNZ to state it would not be cutting rates; the opposite has been happening for the NOK and SEK. The BRL continues to sink under the country's mismanagement. The USD finally turned in a mixed performance against the other majors, with the EUR and AUD declining and the JPY, GBP, CHF and CAD rising.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.09%	0.51%	5.45%	-11.41%
Chinese yuan	-0.14%	0.27%	-2.47%	-3.63%
Japanese yen	0.69%	0.95%	-0.35%	-10.98%
British pound	0.76%	-0.36%	3.37%	-4.03%
Swiss franc	0.83%	1.84%	0.24%	-1.17%
Canadian dollar	0.24%	2.00%	-5.61%	-12.82%
Australian dollar	-0.98%	0.93%	-6.91%	-17.04%
Swedish krona	-0.57%	0.14%	4.19%	-13.28%
Norwegian krone	-0.39%	0.39%	-4.46%	-19.31%
New Zealand dollar	1.82%	6.93%	-11.24%	-14.42%
Indian rupee	-0.12%	2.54%	-3.87%	-4.58%
Brazilian real	-4.09%	-2.39%	-23.02%	-36.98%
Mexican peso	0.04%	0.75%	-7.63%	-17.45%
Chilean peso	0.45%	0.32%	-9.34%	-12.50%
Colombian peso	-0.50%	2.87%	-13.91%	-28.26%
Bloomberg-JP Morgan Asian dollar index (spot)	0.19%	1.13%	-3.50%	-5.43%

The short-covering rally in Latin America did not last very long as Brazil continues to provide reasons to avoid it. Equities elsewhere moved higher as the TINA argument reemerged; with bonds overpriced and cash yielding zero or less, equities are the last man standing. That's some praise.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.60%	2.00%	-4.51%	8.31%
North America	0.79%	1.83%	-3.44%	9.85%
Latin America	-3.74%	0.25%	-21.88%	-31.68%
Emerging Market Free	0.71%	5.34%	-16.15%	-8.32%
EAFE	0.29%	2.26%	-6.19%	5.90%
Pacific	0.35%	4.32%	-8.65%	4.78%
Eurozone	0.41%	1.37%	-5.07%	6.35%

A casual reader of business news might conclude running a macro hedge fund is a loser's game. Ah, but we have the effects of the survivor bias to look forward to in coming years as the current crop of universe-masters gets winnowed in a most Darwinian fashion. Most investors have done better and with lower fees (albeit with less entertainment) with the classic buy-and-hold.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.44%	-2.77%	-10.89%	9.74%
Newedge Trend	-0.86%	-1.46%	-8.59%	6.99%
Newedge Short-Term	-0.42%	-1.54%	-8.61%	-2.17%
HFR Global Hedge Fund	-0.10%	-0.95%	-5.39%	-0.55%
HFR Macro/CTA	-0.43%	-1.72%	-7.26%	0.06%
HFR Macro: Sytematic Diversified CTA	0.43%	-0.78%	-7.59%	1.80%