The Macro Environment For Financial Markets

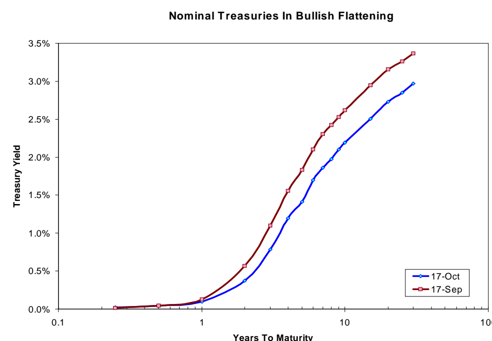
If I ever am asked to give a commencement address, it would consist of, "Never do anything without an upside." However, policymakers have found themselves in this situation. We know that more than five years of QE has done little for output and employment and has led to continuous forward expectations for higher interest rates, not to mention the gross misallocation of resources into the public sector. However, ending QE or in the case of the Eurozone never really undertaking it, can arrest the financial markets and produce absolute damage to the real economy. The path of least resistance therefore involves doing more of what has yet to work, tolerating a few silly tech IPOs and overpriced London townhomes and taxing the gains for the redistributionist programs that allow investor beneficiaries to walk down the street safely. The next round of monetary ease will emerge from the otherwise obtuse Eurozone and from a China where the Party, in a twist to the U.S. Constitution's preamble, is trying to insure domestic tranquility without first securing the blessings of liberty. These funds will find their way into the U.S. via carry trades and will reestablish in due course the health of the financial markets regardless of how poorly the real global economy performs. As markets hold everything else hostage, this and nothing else is what matters. Collectively we have answered the labor union chestnut, "Which side are you on?" rather definitively.

The causal chain is now:

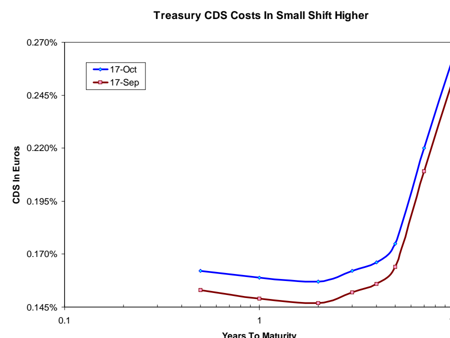
1. Short-term interest rates will remain artificially low and expectations for future short-term rates will be pushed forward once again;
2. Real rates will remain elevated at the short end of the yield curve and will struggle to move lower at the long end of the yield curve until the present spasm of risk-aversion abates;
3. Inflation expectations as measured by the TIPS market remain subdued;
4. Sovereign debt yields will retrace some of their decline but remain in a secular bull market;
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;
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

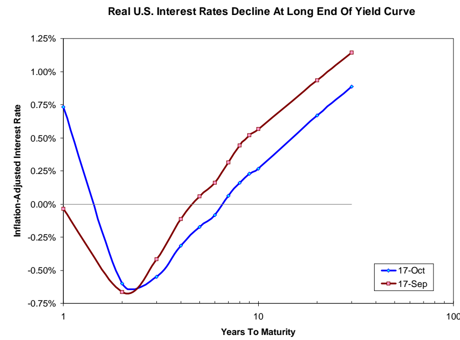
Last week's comment the ten-year Treasury could return to the 2% level from whence it rose in May/June 2013 was fulfilled spectacularly this past week. The selling extreme on Oct. 15th indicates a pullback to the 2.39% level is likely, but we remain within a secular bull market until further notice. With slower growth, a declining U.S. deficit, a possible carry trade into the USD, deflationary pressures and near-zero ST rates, how could it be otherwise?



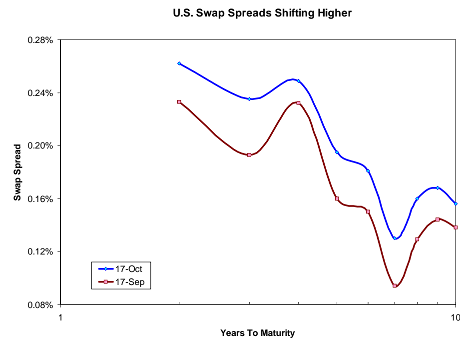
Euro-denominated CDS costs on Treasuries are shifting about within a small range. The U.S. fiscal situation is one of the lowest areas of concern for global markets at present.



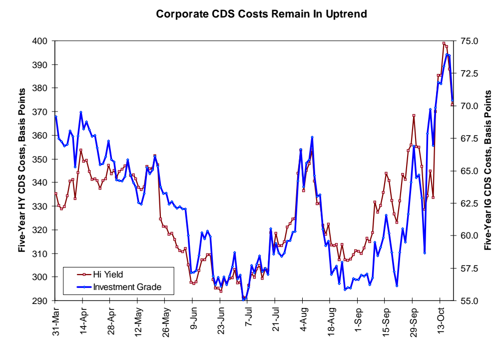
Real rates are twisting higher at the short end of the yield curve and lower at the long end. The decline at the long end of the yield curve will have to proceed further to restore the attractiveness of risky financial assets. The decline in LT implied real rates will slow until nominal LT rates start to rise again, which is a negative for risky financial assets. The jump higher in ST implied real rates will remain intact with lower ST inflation expectations and will continue to pressure precious metals.



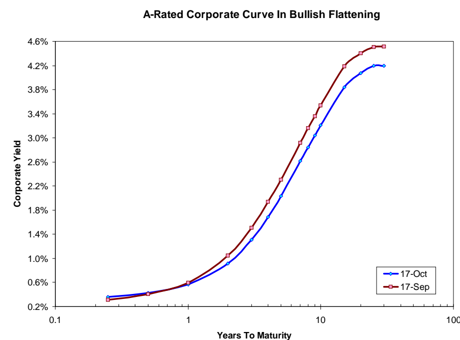
Swap spreads, which rise when floating-rate borrowers want to fix their payments, are increasingly inverted as floating-rate borrowers are trying to fix short-dated and mid-curve payments but are willing to remain floating at the long end of the yield curve. Short-term swap spreads are likely to decline 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 remains intact. It is easy to lose sight of how compressed these spreads have been; the next resistance levels for IG and HY bonds are 77.5 and 432.5 bp, respectively. As short CDS positions often are hedged imperfectly with either short equity option volatility or the stocks themselves, these costs are transmitted into equity prices. Small changes in absolute default risk thus are magnified in both the corporate bond and equity markets. Worse, bond market illiquidity, a residue of Dodd-Frank and other "reforms," exacerbates illiquidity and leads to wider CDS spreads than would exist otherwise.



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

Large intraday ranges and swift reversals have collapsed most markets into sideways structures. The Petroleum and Natural Gas indices remain in structural downtrends and Softs in an uptrend. The S&P 500 remains in a downtrend and ten-year UST remain in an uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For Oct. 20 - 24
BBerg	10	Sideways	-0.102	8.9%	
BBerg Grain	14	Transitional	0.134	19.0%	
BBerg Ind. Metl	10	Sideways	-0.060	14.7%	
BBerg Pre. Metl	10	Sideways	0.051	15.8%	
BBerg Softs	29	Trending	0.141	20.0%	0.77%
BBerg Nat. Gas	25	Trending	-0.160	22.0%	-0.27%
BBerg Petroleum	29	Trending	-0.433	20.2%	-0.28%
BBerg Livestock	19	Transitional	-0.140	13.2%	
Dollar Index	9	Sideways	-0.039	9.9%	
S&P 500 Index	29	Trending	-0.287	13.1%	-0.21%
EAFE Index	4	Sideways	0.018	19.6%	
EM Index	10	Sideways	-0.135	12.5%	
Ten-year UST (price)	29	Trending	0.228	8.4%	0.02%

Performance Measures

The most surprising outcome of last week's volatility and change in monetary expectations was the meager advance in the Precious Metals index; that it did not do better has to be considered a negative sign. Buyers' fixing of prices in Grains continues to support those markets; no further downturn should be expected there until the Southern Hemisphere growing season gets underway. The economically important indices such as Industrial Metals and the Energy index remain under pressure from the intractable combination of declining demand growth and excess supply. Past downturn patterns in crude oil suggest we are not yet at a tradable bottom.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.64%	-1.71%	-14.69%	-8.70%
Grains Sub-Index	3.73%	4.15%	-28.64%	-22.52%
Corn	4.19%	4.98%	-32.08%	-26.81%
Soybeans	3.15%	-0.58%	-24.98%	-9.60%
Wheat	3.51%	8.75%	-29.71%	-32.27%
Energy Sub-Index	-3.29%	-8.77%	-19.70%	-10.88%
Petroleum Sub-Index	-3.87%	-11.09%	-18.66%	-16.17%
WTI	-3.64%	-9.71%	-16.74%	-13.17%
ULSD	-2.91%	-8.83%	-17.88%	-17.16%
Gasoline	-3.61%	-13.34%	-20.22%	-14.60%
Natural Gas	-2.01%	-3.14%	-22.28%	-0.15%
Precious Metals Sub-Index	1.12%	0.68%	-6.34%	-10.21%
Gold	1.42%	1.84%	-4.36%	-5.98%
Silver	0.16%	-2.87%	-12.17%	-21.80%
Industrial Metals Sub-Index	-0.85%	-3.33%	-0.74%	-1.02%
Copper	-1.04%	-2.85%	-1.36%	-9.08%
Aluminum	2.08%	-0.58%	2.90%	-0.70%
Nickel	-4.18%	-11.81%	-13.23%	8.83%
Zinc	-2.92%	-1.33%	7.74%	13.50%
Softs Sub-Index	-2.04%	6.21%	-13.56%	-2.22%
Coffee	-4.42%	18.34%	-0.65%	67.36%
Sugar	0.42%	5.19%	-20.92%	-33.43%
Cotton	-1.72%	-2.16%	-24.85%	-19.18%
Livestock Sub-Index	-1.49%	1.00%	2.58%	14.20%
Cattle	-0.15%	4.00%	18.64%	25.12%
Hogs	-4.05%	-4.51%	-17.31%	-1.21%

I noted last week the Federal Reserve's quick backtracking and the unwinding of dollar carry trade positions would push the USD against major currencies. The USD will advance against an array of emerging market currencies until the current risk-off period ends and a more stable hierarchy of short-term interest rates expectations is established.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.05%	-0.81%	-7.62%	-6.68%
Chinese yuan	0.09%	0.24%	1.53%	-0.46%
Japanese yen	0.73%	1.39%	-4.20%	-8.39%
British pound	0.11%	-1.12%	-4.17%	-0.45%
Swiss franc	1.14%	-0.54%	-6.67%	-4.64%
Canadian dollar	-0.69%	-2.47%	-2.43%	-8.76%
Australian dollar	0.67%	-2.40%	-6.28%	-9.26%
Swedish krona	0.78%	-0.14%	-8.05%	-10.82%
Norwegian krone	-0.54%	-1.44%	-8.53%	-9.37%
New Zealand dollar	1.37%	-2.16%	-7.56%	-6.64%
Indian rupee	-0.18%	-0.86%	-1.87%	-0.36%
Brazilian real	-0.26%	-3.18%	-8.16%	-11.62%
Mexican peso	-0.32%	-2.06%	-3.52%	-5.52%
Chilean peso	0.96%	1.77%	-4.99%	-15.78%
Colombian peso	-0.71%	-4.36%	-6.45%	-9.01%
Bloomberg-JP Morgan Asian dollar index (spot)	0.23%	-0.29%	-0.26%	-1.45%

To the extent the global equity downturn was precipitated by expectations a monetary response to slower growth would not be forthcoming, a reversal of those expectations and unattractive fixed-income alternatives can arrest that decline. However, the call option embedded in equities is unlikely to become attractive at current volatility levels, and this along with reduced growth expectations will cap the upside.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.80%	-6.85%	-2.09%	4.26%
North America	-0.89%	-6.01%	1.81%	10.19%
Latin America	-0.70%	-9.11%	-2.15%	-5.97%
Emerging Market Free	-1.28%	-7.93%	-1.35%	-2.85%
EAFE	-0.65%	-8.14%	-7.64%	-3.86%
Pacific	-2.18%	-6.85%	-3.20%	-6.35%
Eurozone	0.26%	-9.46%	-11.42%	-4.78%

CTA performance remained positive on the week, surprisingly so given the volatility and lack of strong trends outside of the energy markets. Hedge funds, with their much greater reliance on equity strategies, continued their underperformance.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.72%	4.58%	13.77%	12.79%
Newedge Trend	0.19%	2.44%	7.80%	9.14%
Newedge Short-Term	1.64%	3.87%	4.76%	11.71%
HFR Global Hedge Fund	-1.66%	-3.80%	-2.32%	-0.51%
HFR Macro/CTA	-0.99%	-0.29%	2.73%	1.71%
HFR Macro: Sytematic Diversified CTA	-0.59%	0.97%	1.84%	1.22%