The Macro Environment For Financial Markets

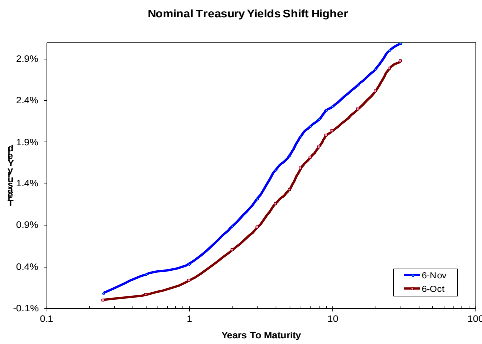
You often hear economies are like supertankers in the sense they have a lot of inertia and do not turn quickly. Nonsense! We have almost two months left to 2015 and just look at how many times the consensus has shifted for the binary decision on what to do with U.S. short-term interest rates. Only a month ago, some were talking about the possibility of a QE4 and no hike in interest rates until April 2016. Now we have a consensus that rate hike will arrive in December. As Yogi Berra said at Bunker Hill, is isn't over until you see the whites of their eyes. It may not be over even then as the effects of a stronger USD and higher federal debt service expenses will be transmitted into the real economy.

The causal chain now is:

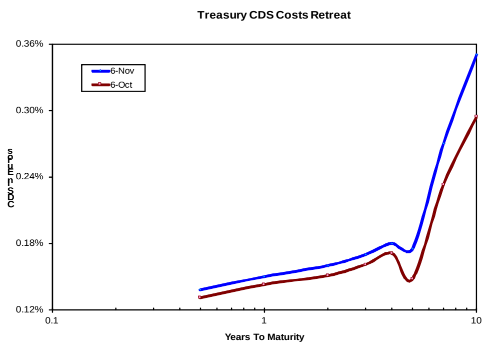
1. Higher short-term interest rates are being priced in starting in December 2015;
2. Disinflationary pressures are dominating inflationary pressures;
3. Inflation expectations as measured by the TIPS market have seen their lows for the immediate duration;
4. The U.S. yield curve will flatten via higher short-term rates;
5. Short-term borrowers will start to term-out their borrowing to reduce rollover risk;
6. Swap spreads will remain tame; and
7. Credit spreads will remain within their recent range.

Key Market Indications

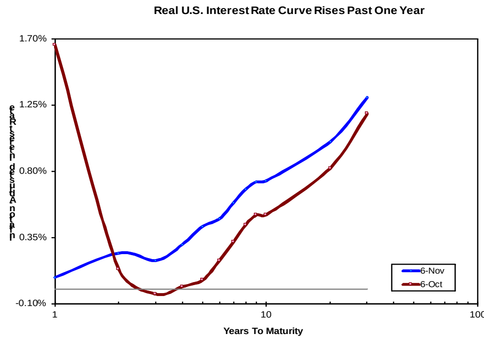
Not only have yields shifted higher, the yield curve has flattened rapidly by virtue of two-year rates moving to their highest levels in more than four years. That diminished carry is going to encourage bondholders to shorten duration in what could turn out to be a short-lived but nasty jump in yields.



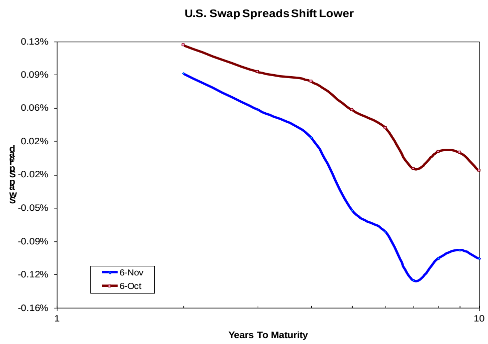
The CDS market for Treasuries is retreating back to its pre-debt ceiling debate levels. It will be interesting to watch this market's reaction to higher U.S. debt service costs. Uncle Sam has been getting financed for free at the short end of the yield curve; that never leads to discipline on the spending side, does it?



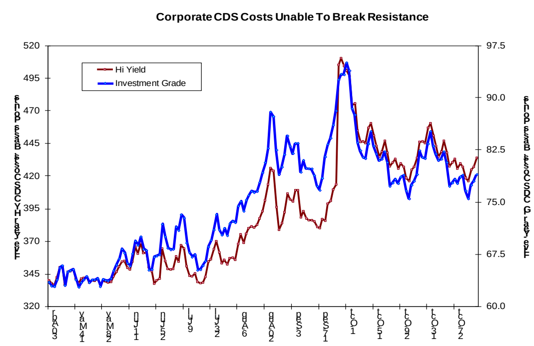
Pseudo-real rates remain lower at the short end of the yield curve over the past month. However, nominal yields at longer maturities have pulled implied real rates higher. While these have not reached the level where they will threaten financial asset returns, they are moving in that direction.



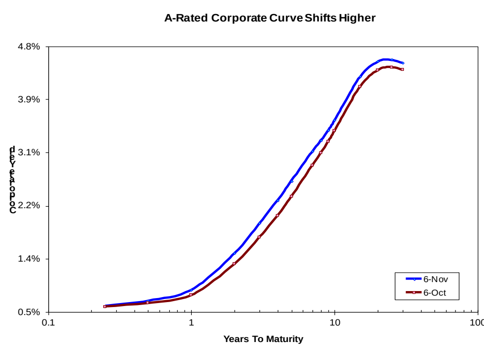
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue to decline for tenors longer than one year. Spreads of five years' tenor and longer are negative, a decisively complacent stance on interest rates.



CDS costs for both the investment-grade and high-yield indices remain unable to decline through resistance. If this is all CDS costs have been able to decline given renewed monetary accommodation, then we should conclude corporate bonds remain highly vulnerable to any outburst of negative macro news.



The A-rated yield curve has shifted higher, but nowhere near as much as has the artificially low UST yield curve. If this curve starts steepening bearishly, it will be a negative for risky financial assets.



Market Structure

All of the physical subindices are either in structural downtrends or bearish consolidations. Ten-year UST remain in a structural downtrend while the S&P 500 and the dollar index remain in uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Nov. 9 - 13
BBerg	28	Trending	-0.288	11.5%	-0.30%
BBerg Grain	21	Trending	-0.088	13.2%	-0.31%
BBerg Ind. Metl	28	Trending	-0.194	19.2%	-0.30%
BBerg Pre. Metl	29	Trending	-0.417	13.6%	-0.81%
BBerg Softs	14	Transitional	-0.064	18.6%	
BBerg Nat. Gas	6	Sideways	0.052	35.8%	
BBerg Petroleum	27	Trending	-0.098	27.4%	-0.15%
BBerg Livestock	24	Trending	-0.381	13.8%	-0.47%
Dollar Index	29	Trending	0.426	7.2%	0.03%
S&P 500 Index	29	Trending	0.296	11.2%	0.11%
EAFE Index	8	Sideways	-0.105	10.1%	
EM Index	12	Transitional	-0.079	9.6%	
Ten-year UST (price)	29	Trending	-0.356	5.4%	-0.04%

Performance Measures

Primary commodity producers outside of the U.S. whose expenses are in local currencies and whose revenues are in USD have one more incentive to maintain high production levels. Only three markets rose last week, aluminum, natural gas and wheat, and all of those remain in strong primary downtrends. Unless we see supply shocks from weather or war, we will be dependent on higher demand growth to end the secular bear trend. That trend is much stronger than realized commonly; the total return of the main Bloomberg index is at August 2002 levels. It was called the Dow Jones-AIG index then and passed through being called the Dow Jones-UBS index. Commodities for the long run this is not.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.51%	-6.34%	-18.11%	-27.55%
Grains Sub-Index	-1.71%	-1.54%	-3.34%	-10.96%
Corn	-2.42%	-2.55%	-2.10%	-10.25%
Soybeans	-2.09%	-2.60%	-9.04%	-15.66%
Wheat	0.24%	2.75%	6.32%	-1.44%
Energy Sub-Index	-2.08%	-9.85%	-28.33%	-49.34%
Petroleum Sub-Index	-3.41%	-9.19%	-27.95%	-46.82%
WTI	-4.21%	-10.60%	-30.16%	-51.51%
Brent	-4.25%	-10.01%	-31.81%	-51.04%
ULSD	-2.18%	-8.77%	-27.90%	-41.58%
Gasoline	-1.32%	-5.03%	-17.13%	-34.52%
Natural Gas	1.68%	-11.39%	-28.55%	-56.30%
Precious Metals Sub-Index	-4.95%	-6.22%	-9.43%	-7.60%
Gold	-4.70%	-5.90%	-8.75%	-7.47%
Silver	-5.63%	-7.12%	-11.30%	-7.83%
Industrial Metals Sub-Index	-1.49%	-7.22%	-25.40%	-28.99%
Copper	-3.26%	-7.12%	-23.58%	-26.46%
Aluminum	3.23%	-5.64%	-22.42%	-30.23%
Nickel	-4.34%	-8.37%	-33.10%	-38.54%
Zinc	-3.01%	-9.94%	-30.78%	-27.87%
Softs Sub-Index	-1.39%	1.21%	-4.19%	-20.63%
Coffee	-2.64%	-10.52%	-16.00%	-41.56%
Sugar	-0.41%	0.84%	-3.20%	-16.34%
Cotton	-2.62%	0.08%	-7.83%	-3.12%
Livestock Sub-Index	-5.57%	-7.32%	-14.78%	-23.68%
Cattle	-4.80%	-1.75%	-13.04%	-16.56%
Hogs	-7.09%	-16.82%	-17.12%	-35.29%

The problem with no-brainer trades such as going long the USD is you are left wondering at each step of the way whether the news is discounted fully or not. As the FOMC is mindful of the braking effects of a strong USD, they could signal a “one-and-done” interest rate hike and renew speculation they might be willing to cut rates in the face of any economic softness.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-2.41%	-4.71%	-5.34%	-13.20%
Chinese yuan	-0.57%	0.04%	-2.41%	-3.79%
Japanese yen	-2.04%	-2.36%	-2.98%	-6.43%
British pound	-2.43%	-1.14%	-1.27%	-4.92%
Swiss franc	-1.74%	-3.84%	-8.88%	-3.19%
Canadian dollar	-1.70%	-2.04%	-9.45%	-14.15%
Australian dollar	-1.33%	-1.72%	-11.62%	-17.71%
Swedish krona	-2.12%	-5.57%	-5.73%	-14.73%
Norwegian krone	-2.13%	-4.56%	-14.24%	-20.75%
New Zealand dollar	-3.75%	-0.31%	-12.98%	-15.17%
Indian rupee	-0.76%	-0.53%	-3.38%	-6.61%
Brazilian real	2.31%	2.22%	-19.48%	-31.81%
Mexican peso	-1.82%	-0.91%	-8.61%	-18.86%
Chilean peso	-1.17%	-2.70%	-12.57%	-15.45%
Colombian peso	0.18%	0.77%	-18.37%	-27.40%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.74%	-0.06%	-4.61%	-5.92%

The underperformance of non-U.S. indices in USD terms has a vicious-cycle element built into it: Their underperformance has an inverse leading relationship to USD strength.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.02%	4.02%	-2.67%	2.29%
North America	0.91%	5.60%	0.43%	4.00%
Latin America	0.85%	-0.18%	-24.62%	-31.01%
Emerging Market Free	0.56%	2.94%	-16.52%	-11.60%
EAFE	-1.54%	1.51%	-7.43%	-0.44%
Pacific	-1.38%	3.15%	-8.55%	-0.13%
Eurozone	-1.33%	2.59%	-5.86%	1.18%

CTAs returned to their usual habit of losing investors’ money in bear markets for the physicals. Hedge funds struggled as well and continue to make news mostly for big-name operations closing up shop or laying off operational staff.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.71%	-1.66%	-3.26%	6.89%
Newedge Trend	-1.37%	-1.58%	-3.91%	5.28%
Newedge Short-Term	-0.12%	0.58%	-4.76%	-1.80%
HFR Global Hedge Fund	-0.02%	0.87%	-3.68%	-1.85%
HFR Macro/CTA	0.32%	0.30%	-2.40%	-0.44%
HFR Macro: Sytematic Diversified CTA	-0.20%	-0.60%	-2.15%	1.13%