The Macro Environment For Financial Markets

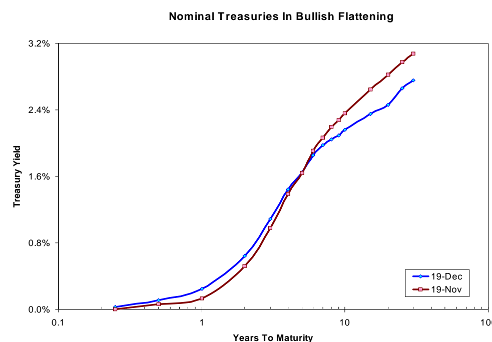
Markets should not discount the same thing twice, but this adage should be changed to, "Markets eventually do not discount the same thing multiple times after pushing the initial discounting to and through an extreme point." That will not fit on a bumper sticker. Thus we saw the odd spectacle of a known break in crude oil continuing to produce real-time reactions in currencies, high-yield bonds, CDS, emerging market currencies and equities until the FOMC stepped in and proclaimed they would raise short-term interest rates someday. This is *mañana* without the sense of urgency, but it matches the ECB's promise to engage in QE someday. In the meantime, the Swiss National Bank effectively promised to join the Bank of Japan in making U.S. policy less critical as the world will remain awash in paper if not liquidity. As long as we agree the energy industry can die only one more time before its next resurrection – it is a cyclical business and is entitled to do this – all we need to do is avoid an outright earnings contraction to maintain the bull market in equities.

The causal chain is now:

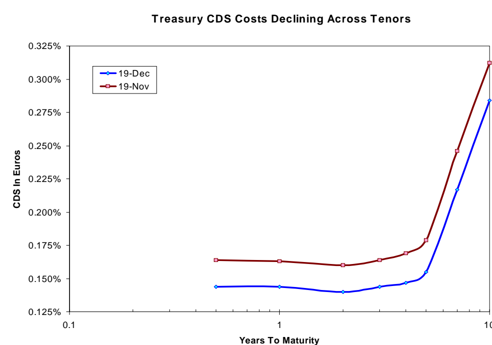
1. Short-term interest rates will remain artificially low globally;
2. Rising implied real rates will exacerbate disinflationary pressures and may argue for a new QE in 2015;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally and continue to pressure U.S. long-term yields lower;
5. The U.S. yield will retain a bias toward a bullish flattening;
6. Short-term borrowers will continue to accept rollover risk;
7. Swap spreads continue their inversion and decline to lower levels, as the market continues to accept long-term duration risk; and
8. Credit spreads will find further declines difficult to achieve barring a new and unexpected round of monetary stimulus. Credit spreads in the energy sector, both high-yield and investment-grade, will rise.

Key Market Indications

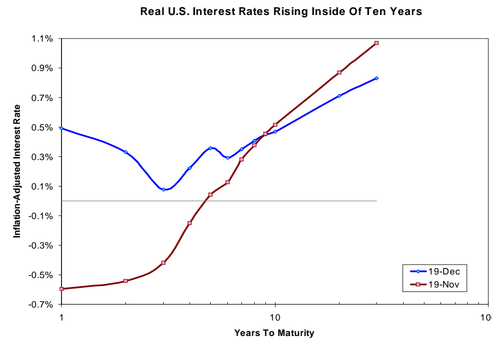
The yield curve continues to flatten as the prospect of higher short-term rates sometime, a high level of risk aversion, rising illiquidity in the corporate bond market and declining inflation expectations are combining to suppress long-term rates. For those who believes Treasuries are the anti-stocks, the largest two-day rally in the stock market since 2011 barely produced a 15 basis point selloff in the ten-year note.



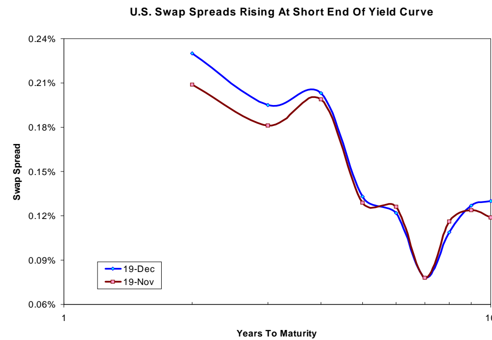
Euro-denominated CDS costs on remain low as the prospects for budget battles and government shutdowns recede. This market should remain somnolent well into 2015.



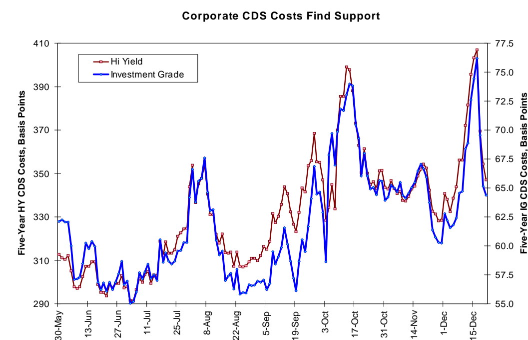
The increase in shorter-dated implied real rates is an artifact of the collapse in breakevens; when risk-averse funds seek safety, they do it in nominal Treasuries and not in TIPS. Rising short-term real rates are a negative for precious metals, which acted like anything but a risk-haven this past week. Long-term real rates have yet to rise to the point where they imperil returns on risky financial assets.



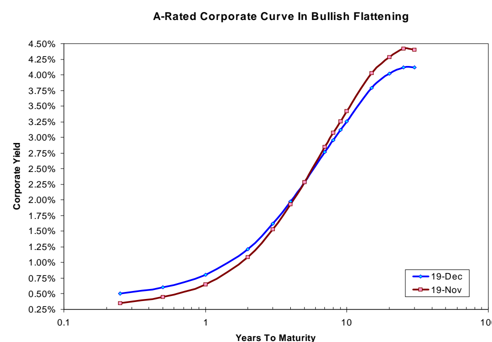
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain inverted, but with small increases at the shorter-dated tenors. This is consistent with the longer-term expectations for a bullish flattening of the yield curve regardless of whether short-term rates are tweaked higher sometime in 2015.



Both the IG and HY CDS indices are established a support level; no style points will be awarded. Lost in the erratic moves is these indices have been on an uptrend since June even as corporate balance sheets outside of the energy sector remain strong and monetary policy remains accommodative. What is measured as rising default risk is really the rising cost of bond market illiquidity.



The A-rated yield flattened bullishly but once again continues to steepen relative to the UST yield curve. This relative steepening actually is a headwind for risky financial assets but it is easy to overlook.



Market Structure

Grains moved back into a structural uptrend, but Precious Metals exited theirs. The other physical indices remain in their structural downtrends. Ten-year Treasuries remain in their uptrend while the violence in the S&P 500 turned it into a transitional structure.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 22 - 26
BBerg	29	Trending	-0.328	11.9%	-0.15%
BBerg Grain	24	Trending	0.192	19.0%	0.49%
BBerg Ind. Metl	29	Trending	-0.207	14.3%	-0.14%
BBerg Pre. Metl	25	Trending	-0.039	22.6%	
BBerg Softs	29	Trending	-0.262	14.8%	-0.33%
BBerg Nat. Gas	29	Trending	-0.363	25.1%	-0.58%
BBerg Petroleum	4	Sideways	0.029	53.0%	
BBerg Livestock	29	Trending	-0.381	12.1%	-0.29%
Dollar Index	10	Sideways	0.108	8.7%	
S&P 500 Index	16	Transitional	0.107	12.2%	
EAFE Index	29	Trending	-0.141	10.5%	-0.63%
EM Index	29	Trending	-0.365	9.2%	-0.06%
Ten-year UST (price)	29	Trending	0.132	5.4%	0.02%

Performance Measures

Logistical constraints in Canadian rails and the potential for a Russian wheat embargo moved the Grains higher, but with the exception of the economically unimportant Softs, the downtrends continue. As we are moving into two weeks of holiday trading, it would not be at all unusual to see positions closed and profits taken, and that could lead to some interesting bear market rallies, particularly in the energy markets. The overall impetus for lower prices remains intact, however, with producers needing to generate revenue to cover fixed costs and Chinese import demand slowing.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.90%	-8.00%	-20.42%	-14.80%
Grains Sub-Index	1.15%	6.15%	-11.56%	-8.18%
Corn	0.74%	6.56%	-14.18%	-12.67%
Soybeans	-1.45%	-0.64%	-16.89%	-6.86%
Wheat	4.25%	14.23%	2.14%	-4.22%
Energy Sub-Index	-4.20%	-22.71%	-39.36%	-34.57%
Petroleum Sub-Index	-1.63%	-23.44%	-44.23%	-40.02%
WTI	-1.59%	-25.34%	-44.63%	-38.03%
ULSD	-1.85%	-18.44%	-37.13%	-36.06%
Gasoline	-2.08%	-23.44%	-44.82%	-40.35%
Natural Gas	-8.44%	-21.39%	-28.45%	-22.09%
Precious Metals Sub-Index	-3.08%	-0.76%	-13.21%	-5.58%
Gold	-2.17%	-0.20%	-9.31%	-0.88%
Silver	-6.02%	-2.60%	-24.14%	-18.57%
Industrial Metals Sub-Index	-2.18%	-6.08%	-6.17%	-3.85%
Copper	-1.69%	-4.77%	-7.62%	-12.53%
Aluminum	-1.52%	-7.91%	-1.28%	0.54%
Nickel	-6.47%	-6.34%	-15.99%	6.51%
Zinc	-0.44%	-5.35%	-0.96%	4.34%
Softs Sub-Index	0.25%	-7.47%	-18.60%	-6.44%
Coffee	0.40%	-8.39%	-4.91%	38.72%
Sugar	0.00%	-6.90%	-31.01%	-28.88%
Cotton	0.58%	2.30%	-19.23%	-18.93%
Livestock Sub-Index	-1.39%	-7.79%	-6.08%	10.23%
Cattle	-1.28%	-7.00%	4.91%	20.13%
Hogs	-1.62%	-9.45%	-22.31%	-4.48%

Last week's order of the USD weakening against the minors and gaining on the emerging market currencies reversed this week as the Federal Reserve gave its best Rorschach test of when short-term rates would rise and the Swiss National Bank imposed a negative deposit rate. The longer-term bull market for the USD remains very much intact.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.87%	-2.59%	-10.13%	-10.48%
Chinese yuan	-0.53%	-1.61%	0.13%	-2.41%
Japanese yen	-0.63%	-1.28%	-14.69%	-12.76%
British pound	-0.57%	-0.36%	-8.29%	-4.54%
Swiss franc	-2.08%	-2.77%	-9.16%	-8.77%
Canadian dollar	-0.16%	-2.23%	-6.74%	-8.07%
Australian dollar	-1.42%	-5.66%	-13.49%	-8.31%
Swedish krona	-2.44%	-4.46%	-13.41%	-14.77%
Norwegian krone	-0.18%	-7.84%	-16.90%	-16.47%
New Zealand dollar	-0.22%	-1.17%	-10.97%	-5.27%
Indian rupee	-1.59%	-2.11%	-5.08%	-1.87%
Brazilian real	-0.20%	-3.31%	-16.24%	-11.38%
Mexican peso	1.13%	-6.70%	-10.78%	-11.18%
Chilean peso	1.22%	-1.70%	-8.89%	-13.13%
Colombian peso	4.76%	-5.95%	-18.01%	-15.59%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.55%	-1.11%	-2.70%	-2.59%

It may not seem as if the World index has declined in USD terms over the past six months, but that is the case. The Federal Reserve's non-commitment on interest rates was sufficient to offset all of the headwinds and frictional costs in the market and lead to gains. While this cannot last forever, it has lasted for almost six years now.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	2.53%	-0.31%	-0.81%	8.75%
North America	3.56%	0.78%	5.43%	15.57%
Latin America	3.84%	-9.31%	-20.01%	-12.26%
Emerging Market Free	0.69%	-4.49%	-8.80%	-2.00%
EAFE	0.87%	-2.05%	-9.71%	-0.98%
Pacific	-0.12%	-2.31%	-5.98%	-0.14%
Eurozone	0.82%	-1.24%	-13.32%	-3.43%

The dependence of hedge funds as an asset class on rising equities was demonstrated again this week as they rose during a period of high turmoil and low liquidity in currencies and commodities. Perhaps short-term CTAs should have done better in this environment, but they failed to do so.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.35%	4.32%	18.55%	19.52%
Newedge Trend	-0.01%	3.34%	12.62%	15.20%
Newedge Short-Term	-0.41%	1.30%	7.33%	9.73%
HFR Global Hedge Fund	0.07%	-1.17%	-3.04%	-0.68%
HFR Macro/CTA	0.47%	0.05%	4.78%	4.72%
HFR Macro: Sytematic Diversified CTA	0.65%	0.88%	4.91%	2.72%