The Macro Environment For Financial Markets

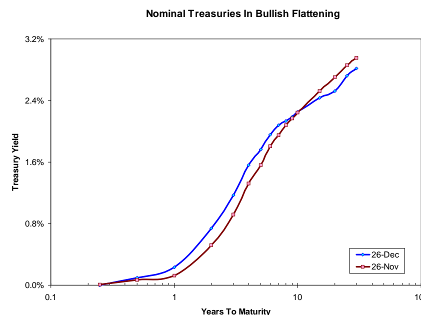
To paraphrase Huey Long's aphorism about Louisiana and good government, one day the Federal Reserve will get a good economy and won't like it as it will remove what has been the institution's *raison d'être* since the financial crisis, trying to solve all economic problems via balance sheet expansion. If they shrink their balance sheet or raise short-term rates significantly, they will – and that's a "will" and not a "might" – destroy the wealth effect they have created, raise public service debt costs and raise the dollar swiftly to the detriment of all those who have USD-denominated debts worldwide. However, if they maintain current policies, they will not have to pay the price of rising inflation. They will use their inability to debauch the currency at the arbitrary rate of 2% per annum and exercise taxation powers delegated specifically to Congress as an excuse to keep policy loose and to keep financial markets buoyant. You can ignore the rant about abusing the power of taxation; I will miss this when it is gone.

The causal chain is now:

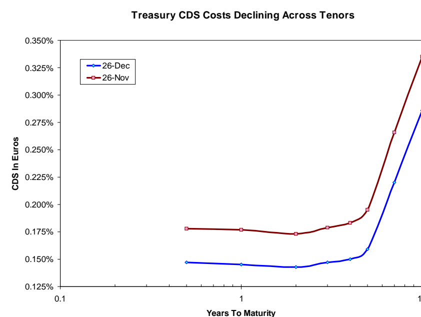
1. Short-term interest rates will remain artificially low globally;
2. Rising implied real rates will exacerbate disinflationary pressures;
3. Inflation expectations as measured by the TIPS market will remain subdued;
4. Sovereign debt yields will decline globally and continue to pressure U.S. long-term 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.

Key Market Indications

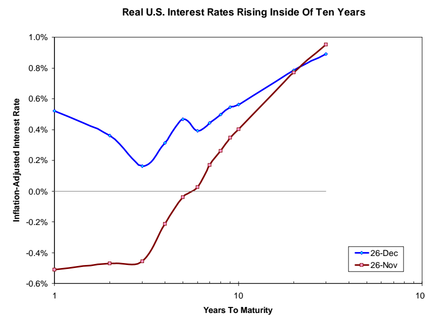
The Treasury yield curve is at its flattest level since August 2009. While rising short-term interest rates are the primary driver of this change, the important work for financial markets is being done at the long end of the yield curve where the primary trend for lower yields remains intact. This is likely to remain the case so long as U.S. long-term rates are high relative to those in the Eurozone and Japan.



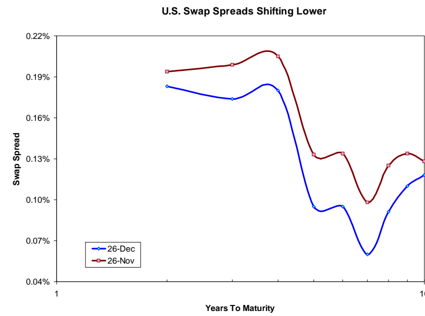
Euro-denominated CDS costs remain low as the prospects for budget battles and government shutdowns recede. This market should remain somnolent well into 2015.



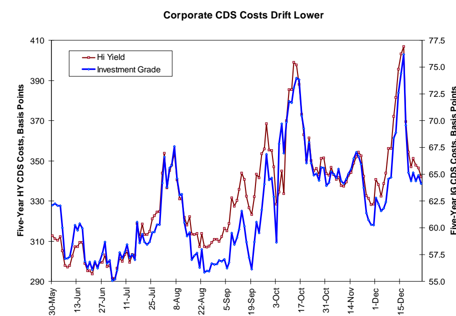
The collapse in inflation expectations and the prospect of higher short-term interest rates have combined to push all implied real rates well into positive territory. It was only a few months ago these were negative out to eight years. The implications for markets remain the same; these are positive for the dollar, negative for precious metals and not negative yet for capital-horizon financial assets.



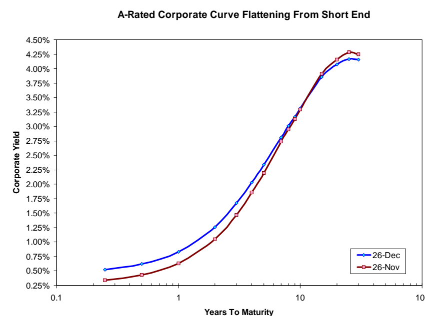
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have shifted lower in a near-parallel fashion over the past month. The market's complacency in the face of rising short-term rates is both worrisome and justifiable simultaneously. Either way, it does not constitute an impediment to either corporate bonds or, by extension, to equities.



Both the IG and HY CDS indices are declining from the support levels established two weeks ago. As the energy sector remains the only one under significant pressure, no increases of significance can be expected until swap spreads rise. The small drifts higher in these markets represent 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

Precious Metals moved out of their structural uptrend and Petroleum entered a bearish consolidation. Ten-year Treasuries moved out of their structural uptrend as well; nothing else changed in the financial indices.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Dec. 29 - Jan. 2
BBerg	29	Trending	-0.392	11.6%	-0.15%
BBerg Grain	27	Trending	0.161	18.4%	0.49%
BBerg Ind. Metl	29	Trending	-0.320	13.8%	-0.14%
BBerg Pre. Metl	29	Trending	-0.021	21.8%	
BBerg Softs	6	Sideways	-0.096	12.0%	
BBerg Nat. Gas	29	Trending	-0.653	24.6%	-0.58%
BBerg Petroleum	5	Sideways	-0.054	28.0%	
BBerg Livestock	4	Sideways	0.048	10.5%	
Dollar Index	13	Transitional	0.132	7.8%	
S&P 500 Index	19	Transitional	0.162	11.2%	
EAFE Index	29	Trending	-0.084	10.2%	-0.63%
EM Index	29	Trending	-0.208	9.1%	-0.06%
Ten-year UST (price)	29	Trending	-0.023	5.5%	

Performance Measures

Warm weather in December is nice unless you happen to be long natural gas or upstream equities. With the exception of trivial gains in Precious Metals, the Petroleum index and the economically unimportant Livestock index, 2014 is ending with a continuation of bear markets in the physical commodities. This is unlikely to change in January.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.88%	-5.72%	-21.63%	-16.53%
Grains Sub-Index	-1.27%	4.95%	-11.13%	-7.14%
Corn	0.91%	6.69%	-12.12%	-10.58%
Soybeans	1.03%	3.12%	-15.41%	-4.23%
Wheat	-6.79%	5.58%	-1.42%	-6.80%
Energy Sub-Index	-5.86%	-19.21%	-42.24%	-38.43%
Petroleum Sub-Index	0.47%	-15.67%	-45.41%	-42.39%
WTI	0.79%	-17.18%	-46.43%	-41.23%
ULSD	0.36%	-11.94%	-37.28%	-37.68%
Gasoline	-0.30%	-16.61%	-45.92%	-42.37%
Natural Gas	-16.16%	-25.31%	-34.93%	-29.64%
Precious Metals Sub-Index	0.34%	2.17%	-13.42%	-6.76%
Gold	0.04%	1.69%	-9.60%	-1.77%
Silver	1.34%	3.80%	-24.09%	-20.42%
Industrial Metals Sub-Index	-1.49%	-4.31%	-9.28%	-7.42%
Copper	-1.38%	-1.12%	-11.44%	-16.61%
Aluminum	-2.75%	-7.99%	-3.61%	-3.22%
Nickel	-2.02%	-5.94%	-19.69%	6.36%
Zinc	1.39%	-2.91%	-2.53%	0.44%
Softs Sub-Index	-2.05%	-9.26%	-21.96%	-9.02%
Coffee	-3.30%	-10.05%	-6.66%	32.67%
Sugar	-1.93%	-5.71%	-30.71%	-30.12%
Cotton	1.33%	2.58%	-15.81%	-18.89%
Livestock Sub-Index	1.57%	-5.14%	-7.16%	10.93%
Cattle	2.49%	-3.99%	3.08%	20.96%
Hogs	-0.40%	-7.56%	-23.04%	-4.22%

The longer-term bull market for the USD remains very much intact. A reasonable question has to be why it has not been even stronger given rising incentives for reverse carry trades. The most likely answer is the market fears a dollar-weakening measure past a point and effectively has embedded a short call option into long USD positions.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.38%	-2.58%	-10.50%	-11.01%
Chinese yuan	0.13%	-1.20%	0.19%	-2.25%
Japanese yen	-0.67%	-2.14%	-15.44%	-12.88%
British pound	-0.44%	-1.48%	-8.63%	-5.20%
Swiss franc	-0.32%	-2.66%	-9.51%	-9.21%
Canadian dollar	-0.23%	-3.27%	-8.07%	-8.42%
Australian dollar	-0.11%	-5.00%	-13.73%	-8.71%
Swedish krona	-1.53%	-5.81%	-14.21%	-16.62%
Norwegian krone	-1.38%	-8.54%	-17.84%	-17.72%
New Zealand dollar	0.00%	-1.44%	-11.63%	-4.97%
Indian rupee	-0.42%	-2.70%	-5.39%	-2.21%
Brazilian real	-0.36%	-6.28%	-17.70%	-11.82%
Mexican peso	-0.80%	-6.74%	-11.55%	-11.09%
Chilean peso	0.55%	-1.46%	-9.59%	-13.70%
Colombian peso	-3.01%	-8.62%	-20.42%	-18.96%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.22%	-1.48%	-2.91%	-2.79%

Should equities go down in the face of a firming U.S. economy, accommodative global monetary policies and poor alternatives? No; this will remain true in January as well. Look for the U.S. to outperform the EAFE, which will outperform emerging markets in turn.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.75%	-0.94%	0.53%	7.68%
North America	0.92%	0.40%	6.42%	14.54%
Latin America	0.24%	-12.23%	-18.59%	-11.98%
Emerging Market Free	0.88%	-5.78%	-7.79%	-1.43%
EAFE	0.47%	-3.11%	-7.98%	-2.13%
Pacific	0.65%	-2.32%	-5.34%	-0.95%
Eurozone	0.61%	-3.67%	-10.48%	-4.35%

A short week with no reversals of significance produced strong gains for both CTAs and hedge funds. It might be easy to assume positions were being marked for year-end returns and thus would be vulnerable to profit-taking at the start of the year, but this did not seem to be the case.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.03%	3.76%	19.22%	19.21%
Newedge Trend	0.93%	2.81%	13.31%	15.12%
Newedge Short-Term	0.67%	1.46%	7.92%	10.02%
HFR Global Hedge Fund	1.48%	-1.00%	-2.48%	-0.58%
HFR Macro/CTA	1.13%	0.48%	5.29%	5.20%
HFR Macro: Sytematic Diversified CTA	1.42%	1.35%	5.09%	2.84%