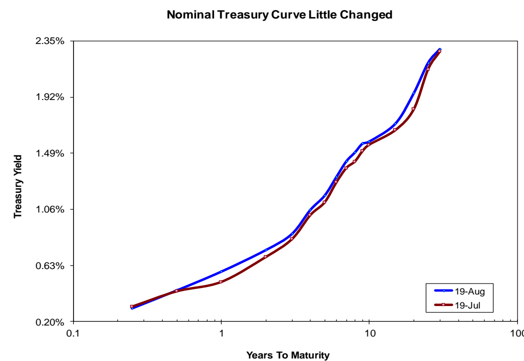
The Macro Environment For Financial Markets

Phil Knight, the founder of Nike, should be the next Federal Reserve chairman. That crowd needs his famous "Just do it!" tagline. This week's prattle, capped off by a paper – and really, what flies off the summer-reading shelves faster than a discourse on monetary policy? – by John Williams of the San Francisco Fed on rates and inflation. Let's not mince words: The ability of central banks to influence inflation, output, unemployment and the exchange value of any currency has been found wanting. Their dot-plots have been exercises in self-degradation. Either raise rates or keep them where they are; in either case, just take credit for producing the ultimate action. And stop talking so much. The causal chain remains:

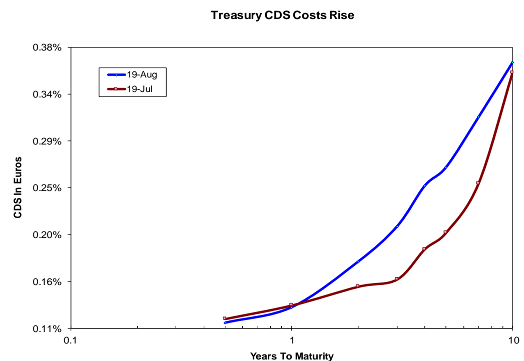
1. The market has no clear idea of if and when U.S. short-term rates will rise;
2. Disinflationary pressures will persist globally;
3. Inflation expectations as measured by TIPS and inflation swaps have ended their downtrend;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are accepting rollover risk once again;
6. Swap spreads are finally moving higher; and
7. CDS costs remain suppressed as part of a global search for yield.

Key Market Indications

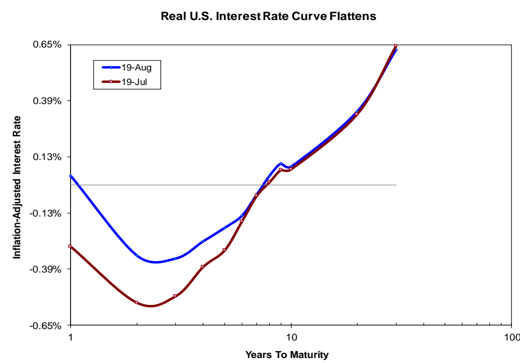
Markets move to the point of maximum confusion as both buyers and sellers converge on a satisficing price. Such is the case for UST at present. Even though yields are rising, this looks for all of the world like a bullish consolidation. The rest of the world would find higher UST yields too attractive to ignore.



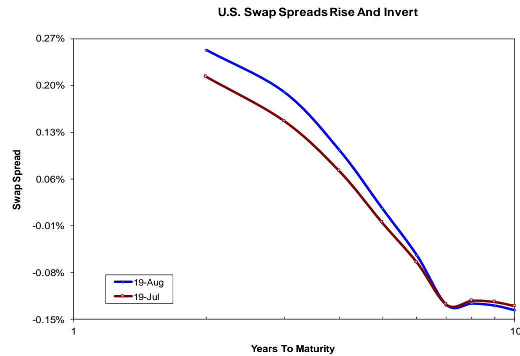
While the thinness of the sovereign CDS market is such we should not engage in over-analysis, the rise in CDS costs over the past two weeks is puzzling. At the risk of detouring into politics, this seems to be a better explanation than anything intrinsic to markets.



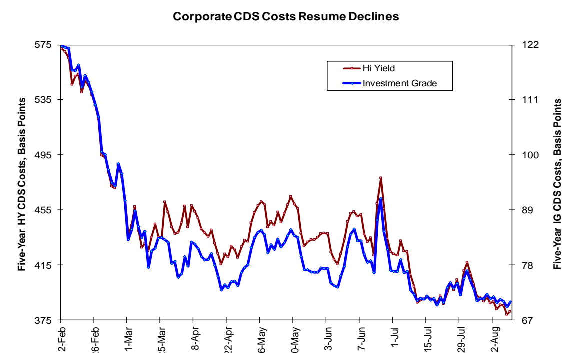
Pseudo-real rates at the long end of the yield curve have changed little over the past month. Precious Metals have been able to sidestep the rise in U.S. implied short-term real the U.S. as the negative-carry trade in other currencies remains open.



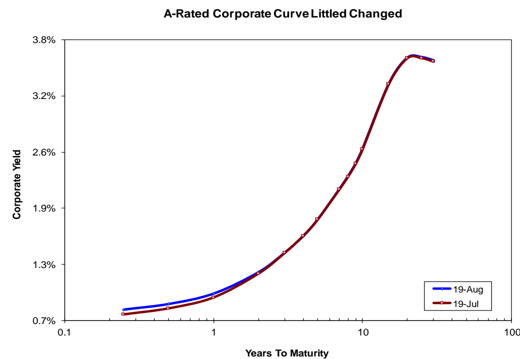
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose across the maturity spectrum. The risk/reward for fixing payments remains attractive.



Both the investment-grade and high-yield CDS indices resumed their bullish trends. It is difficult to sell when two major central banks are buying without much in the way of a P/L statement. Moreover, as no credit shocks are imminent and even dodgy borrowers can refinance, why should CDS costs rise?



The A-rated corporate yield curve continues to mirror the UST curve as credit spreads remain in a narrow range. So long as both the European Central Bank and the Bank of England are in the market buying corporate bonds, it will be hard for U.S. investment-grade bonds to sell off very much.



Market Structure

The Petroleum and main Bloomberg index moved into structural uptrends while both Natural Gas and Softs entered downtrends. The EM index and the EAFE exited structural uptrends and ten-year UST joined the dollar index in a structural downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate August 22 - 26
BBerg	29	Trending	0.142	11.0%	0.28%
BBerg Grain	12	Transitional	0.094	16.6%	
BBerg Ind. Metl	14	Transitional	-0.004	12.3%	
BBerg Pre. Metl	18	Transitional	-0.100	13.2%	
BBerg Softs	25	Trending	-0.051	17.9%	-0.17%
BBerg Nat. Gas	29	Trending	-0.221	20.2%	-0.96%
BBerg Petroleum	29	Trending	0.316	25.9%	1.75%
BBerg Livestock	15	Transitional	-0.008	13.5%	
Dollar Index	29	Trending	-0.251	6.6%	-0.04%
S&P 500 Index	14	Transitional	0.047	5.4%	
EAFE Index	4	Sideways	-0.024	8.8%	
EM Index	4	Sideways	-0.035	8.5%	
Ten-year UST (price)	26	Trending	-0.049	5.3%	-0.09%

Performance Measures

Gasoline returned more than 10% this week. It used to take a low-level nuclear strike on the U.S. Gulf Coast to produce such a move. This jump alone was enough to propel the main Bloomberg index higher and it helped initiate some short-covering in Grains and Industrial Metals because, hey, they all are commodities, aren't they? Let's not forget The Wall Street Journal's discovery the live cattle (the industry term is slaughter cattle, so score one for the marketing guys) future is absolutely useless for commercial purposes. After the last bank prop desk closes and the last investor pulls out of hedge funds, all of these contracts will be consigned to a padded room filled with HFT traders.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.60%	1.92%	13.67%	-1.57%
Grains Sub-Index	2.35%	0.35%	-3.55%	-8.54%
Corn	3.23%	-0.50%	-11.90%	-16.10%
Soybeans	2.32%	1.67%	14.71%	12.60%
Wheat	1.09%	-0.36%	-11.84%	-20.03%
Energy Sub-Index	6.05%	5.34%	26.23%	-17.73%
Petroleum Sub-Index	8.49%	9.78%	29.45%	-10.79%
WTI	8.37%	8.68%	27.36%	-13.66%
Brent	8.32%	10.16%	35.18%	-8.32%
ULSD	7.71%	9.05%	33.62%	-11.83%
Gasoline	10.16%	12.09%	18.07%	-13.68%
Natural Gas	-0.82%	-6.34%	16.86%	-36.28%
Precious Metals Sub-Index	-0.40%	0.25%	14.76%	18.06%
Gold	0.23%	1.13%	10.47%	15.26%
Silver	-1.89%	-1.78%	26.52%	25.01%
Industrial Metals Sub-Index	1.16%	-0.21%	8.68%	2.61%
Copper	1.21%	-3.09%	1.74%	-6.68%
Aluminum	0.73%	3.31%	4.34%	3.57%
Nickel	0.47%	-0.66%	17.11%	0.01%
Zinc	2.18%	1.74%	27.46%	26.59%
Softs Sub-Index	-0.25%	-1.94%	32.85%	30.91%
Coffee	0.90%	-2.71%	11.22%	1.30%
Sugar	0.31%	0.94%	52.11%	73.18%
Cotton	-3.70%	-6.38%	16.60%	1.19%
Livestock Sub-Index	-0.92%	-0.18%	-9.54%	-13.63%
Cattle	-3.73%	2.04%	-8.33%	-17.18%
Hogs	3.21%	-3.07%	-11.38%	-6.95%

The USD continues its decline against most majors. This is not a case of the forex markets issuing an "in your face" to the Federal Reserve so much as a recognition higher USD rates will lead to underperformance by U.S. assets. The implication here is the interest rate parity model has broken down in the face of so many negative interest rates and non-functioning measures of short-term real rates.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.46%	2.76%	1.75%	1.84%
Chinese yuan	-0.26%	0.65%	-1.97%	-3.87%
Japanese yen	1.08%	5.89%	12.38%	23.53%
British pound	1.20%	-0.27%	-9.24%	-16.61%
Swiss franc	1.45%	2.61%	3.11%	0.53%
Canadian dollar	0.62%	1.16%	6.95%	2.00%
Australian dollar	-0.33%	1.64%	6.70%	3.80%
Swedish krona	0.82%	2.70%	0.76%	1.65%
Norwegian krone	-0.10%	3.56%	4.12%	0.81%
New Zealand dollar	1.04%	3.11%	9.65%	10.17%
Indian rupee	-0.26%	0.07%	2.10%	-2.67%
Brazilian real	-0.40%	1.40%	25.49%	8.97%
Mexican peso	0.22%	1.54%	0.00%	-8.77%
Chilean peso	-1.65%	-1.40%	6.00%	5.61%
Colombian peso	2.54%	2.45%	17.44%	5.78%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.29%	0.70%	1.76%	-0.21%

The temptation to overanalyze a one-week pullback in an August market should be resisted. However, the renewed speculation U.S. short-term interest rates may rise was sufficient to derail both Latin American equities and currencies. The dollar carry trade has been important to both markets.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.18%	1.69%	12.94%	7.72%
North America	0.06%	1.33%	15.95%	6.86%
Latin America	-0.63%	4.52%	43.65%	21.60%
Emerging Market Free	0.09%	5.09%	25.16%	11.38%
EAFE	-0.58%	3.70%	11.85%	-2.93%
Pacific	-0.99%	3.47%	15.01%	5.23%
Eurozone	-0.81%	4.04%	8.36%	-2.59%

CTAs had another bad week, suggesting they found themselves on the wrong side of the petroleum complex and most likely equities. Hedge funds continue to justify investors' withdrawals.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.59%	0.31%	-2.96%	0.26%
Newedge Trend	-1.24%	-0.18%	-2.23%	3.15%
Newedge Short-Term	-0.89%	-0.96%	-1.22%	4.34%
HFR Global Hedge Fund	0.10%	0.85%	5.05%	-3.04%
HFR Macro/CTA	-0.60%	0.45%	-0.91%	-2.63%
HFR Macro: Sytematic Diversified CTA	-0.83%	0.81%	-1.01%	2.34%