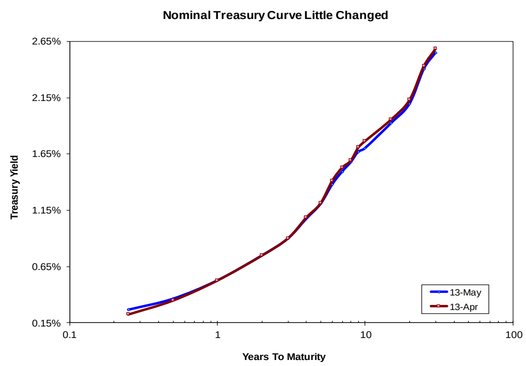
The Macro Environment For Financial Markets

Real estate investors frequently make the mistake of confusing the asset's permanence with profitability. Wrong; just because the building is there does not make it profitable. The same applies for retail sales; just because consumers consume does not mean you can make money in retailing. While this squeeze on margins is nothing more than Microeconomics 101, the implications are scary as they imply one more sector where labor will be replaced by technology and capital. As Barbra Streisand might have warbled, "People who replace people are the most valuable people in the world." The non-valuable people will then demand government transfer payments, which will be enabled by negative interest rates, but that is a story for another day. The causal chain now is:

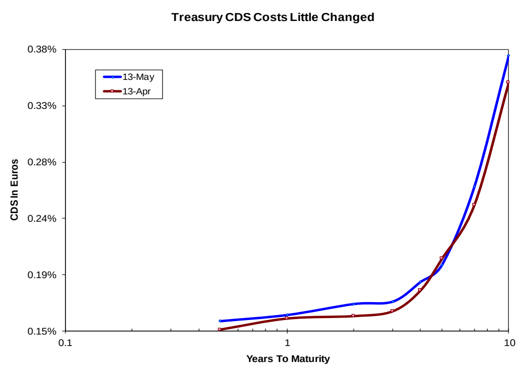
1. The market has stopped reducing bets on higher short-term rates in the U.S. after June. Yes, this is schizophrenic, but it is what it is
2. Disinflationary pressures will persist globally while inflationary pressures are rising in the U.S.;
3. Inflation expectations as measured by TIPS and inflation swaps have established a strong tradable bottom;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are terming out their short-term debt obligations to reduce rollover risk;
6. Swap spreads are moving higher at the short end of the yield curve but lower at the long end; and
7. CDS costs have moved back into a trading range.

Key Market Indications

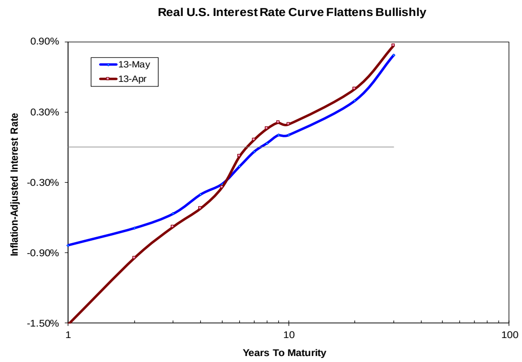
This is the second consecutive week wherein month-over-month changes in the UST yield curve have been minor. Long-term rates are being held down by high levels of risk-aversion and by the relative attractiveness of UST rates relative to other major bond markets, while short-term rates are being bid slightly higher by FOMC chatter.



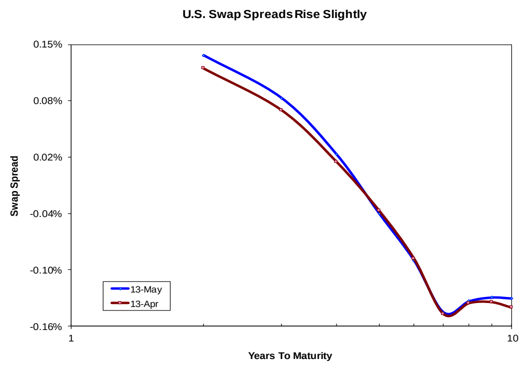
CDS costs have shifted little over the past month. It will be interesting to see if this market reacts to the U.S. election season, presuming, of course, UST buyers can understand what others cannot.



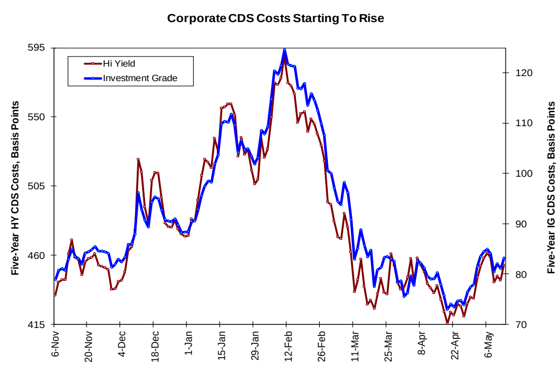
The pseudo-real rate curve continued its recent rise at the short end of the yield curve. These rates remain negative out to seven years. Their rise is inimical to precious metals, but it is doubtful events in the U.S. can offset deeply negative short-term rates elsewhere. The decline in long-term pseudo-real rates actually is supportive of risky financial assets.



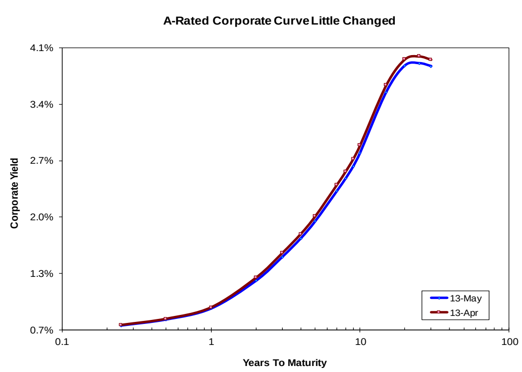
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have shifted higher at the short end of the yield curve over the past month and remain inverted. The inversion of this curve is confirmed in the swaption market as well. The belief seems to be that long-term rates will remain constrained even if short-term rates are pushed higher.



Both high-yield and investment-grade CDS indices actually declined on the week even though they rose on Friday's downturn in equities. There is little reason to expect a further narrowing of these spreads through recent resistance levels, and barring either an unexpected increase in short-term rates or an event, there is little reason to expect a greater deterioration, either.



The A-rated corporate yield curve remains halted as the UST curve has been little changed and credit spreads are in a narrow range. The general bull market remains intact, but the potential for further gains is limited.



Market Structure

Only Softs and Livestock are in structural uptrends. Within the financials, the EAFE and EM indices remain in downtrends while ten-year UST remain in an uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 16 - 20
BBerg	9	Sideways	0.062	15.6%	
BBerg Grain	11	Transitional	0.085	21.7%	
BBerg Ind. Metl	29	Trending	-0.188	18.1%	
BBerg Pre. Metl	4	Sideways	0.003	13.1%	
BBerg Softs	29	Trending	0.229	20.1%	0.14%
BBerg Nat. Gas	9	Sideways	-0.053	23.2%	
BBerg Petroleum	10	Sideways	0.094	34.8%	
BBerg Livestock	29	Trending	0.158	11.1%	0.40%
Dollar Index	22	Trending	0.079	6.8%	
S&P 500 Index	6	Sideways	-0.092	8.5%	
EAFE Index	29	Trending	-0.165	12.0%	-0.19%
EM Index	27	Trending	-0.390	10.5%	-0.24%
Ten-year UST (price)	29	Trending	0.150	4.7%	0.26%

Performance Measures

One of life's great mysteries is how grain markets are surprised by USDA reports on a consistent basis. Why have all of those Landsat photos if they do not work? Both Industrial and Precious Metals turned lower, while the other physical markets turned higher. Did I mention these various rallies in physical commodities occurred in the face of a stronger dollar? This should not be surprising as individual commodity/currency correlations of returns are statistically insignificant.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	1.29%	5.09%	2.57%	-19.70%
Grains Sub-Index	2.93%	4.63%	6.84%	-1.26%
Corn	3.51%	2.31%	4.43%	-2.43%
Soybeans	2.93%	10.47%	21.93%	12.58%
Wheat	2.38%	1.57%	-6.32%	-11.68%
Energy Sub-Index	3.55%	9.41%	-12.18%	-41.34%
Petroleum Sub-Index	4.54%	10.19%	-7.78%	-38.92%
WTI	3.49%	10.27%	-14.92%	-44.26%
Brent	4.74%	10.37%	-5.28%	-40.39%
ULSD	4.82%	12.27%	-8.26%	-39.78%
Gasoline	5.97%	7.71%	-1.65%	-27.82%
Natural Gas	0.05%	6.61%	-27.75%	-50.34%
Precious Metals Sub-Index	-1.82%	3.56%	18.15%	1.68%
Gold	-1.65%	3.09%	17.39%	3.52%
Silver	-2.25%	4.79%	19.90%	-3.57%
Industrial Metals Sub-Index	-3.35%	-2.47%	1.42%	-26.98%
Copper	-3.71%	-4.05%	-2.81%	-29.99%
Aluminum	-4.16%	-1.57%	2.88%	-21.47%
Nickel	-4.75%	-3.23%	-7.89%	-39.08%
Zinc	0.02%	0.79%	17.86%	-19.77%
Softs Sub-Index	4.21%	9.77%	7.01%	2.51%
Coffee	4.50%	4.22%	6.57%	-14.99%
Sugar	6.36%	10.15%	9.26%	15.59%
Cotton	-1.95%	1.02%	-3.14%	-10.51%
Livestock Sub-Index	0.97%	2.47%	8.27%	-12.82%
Cattle	1.19%	0.01%	1.46%	-17.03%
Hogs	0.69%	5.44%	20.31%	-5.13%

Only a small gain in the NOK prevented a second consecutive week of the USD gaining against every currency listed here. The currency market is starting to believe short-term interest rates in the U.S. will rise relative to the rest of the world in response to rising inflationary pressures even as the fixed-income markets are ignoring this threat at the long end of the yield curve.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.83%	0.31%	4.98%	-0.40%
Chinese yuan	-0.55%	-0.82%	-2.42%	-5.01%
Japanese yen	-1.39%	0.65%	12.87%	9.68%
British pound	-0.43%	1.13%	-5.72%	-8.76%
Swiss franc	-0.31%	-0.89%	3.14%	-6.03%
Canadian dollar	-0.24%	-0.95%	2.96%	-7.59%
Australian dollar	-1.29%	-4.99%	2.02%	-10.38%
Swedish krona	-1.33%	-1.31%	5.11%	-0.12%
Norwegian krone	0.04%	0.38%	5.76%	-9.96%
New Zealand dollar	-0.82%	-2.08%	3.59%	-9.47%
Indian rupee	-0.33%	-0.19%	-1.01%	-4.14%
Brazilian real	-0.89%	-1.00%	8.94%	-13.98%
Mexican peso	-1.66%	-4.08%	-8.18%	-15.99%
Chilean peso	-3.75%	-2.90%	1.96%	-12.88%
Colombian peso	-1.15%	0.52%	2.77%	-20.16%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.41%	-1.19%	-0.25%	-4.90%

Equity investors once again are pulling back in the face of rising valuations. While the logical course of action should be to accept the long-term trading range for what it is, we are programmed to do something rather than nothing. This is a formula for over-trading and underperforming.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.32%	-1.73%	-0.49%	-7.13%
North America	-0.36%	-1.48%	2.27%	-1.76%
Latin America	0.07%	-2.33%	10.84%	-17.97%
Emerging Market Free	-1.12%	-5.54%	-2.13%	-20.82%
EAFE	-0.26%	-1.41%	-2.82%	-12.94%
Pacific	-0.74%	-3.71%	-1.96%	-12.11%
Eurozone	-0.25%	-1.53%	-3.86%	-14.22%

CTAs' managed a small gain, as did hedge funds. Neither is likely to slow down or reverse these two classes of alternative investments' declines as institutions withdraw funds.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.24%	-3.83%	-0.78%	-2.38%
Newedge Trend	-0.04%	-2.53%	1.97%	0.14%
Newedge Short-Term	-0.08%	-0.79%	3.85%	0.09%
HFR Global Hedge Fund	0.17%	0.24%	-3.07%	-7.34%
HFR Macro/CTA	0.24%	-0.49%	-0.96%	-2.14%
HFR Macro: Sytematic Diversified CTA	0.14%	-1.75%	1.69%	0.91%