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## The Macro Environment For Financial Markets

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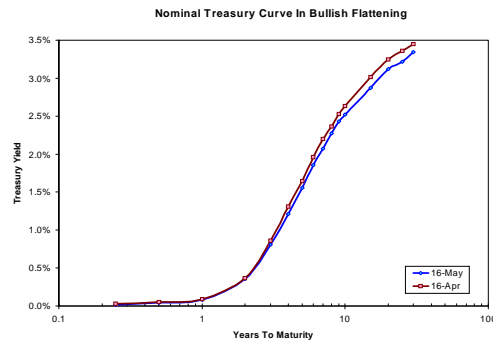
Monetary accommodation can be achieved by increasing the supply of funds, per QE, or by lowering their price. Reduced QE levels in the U.S. have been accompanied by lower short-term rates – constant-maturity one-year UST are yielding below 10 basis points now – and this is perpetuating a steep yield curve. That steepness discourages long-term capital investment and real economic growth but favors financial assets. Any attempt at policy reversal will be disastrous and therefore will be avoided; however, similar logic failed one hundred years ago in the context of European political strife. Mistakes were made then and could be made again today.

The causal chain is now:

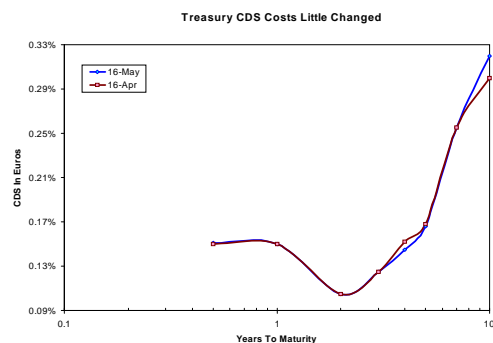
1. Short-term interest rates will remain artificially low and will keep real rates negative below the middle range of the yield curve. Rising levels of risk-aversion will push real long-term rates lower;
2. Nominal long-term rates will test next resistance levels after consolidating recent gains;
3. Inflation expectations as measured by the TIPS market will remain confined in the year-long range;
4. Short-term borrowers will continue to accept rollover risk and keep their effective maturities as short as possible;
5. Swap spreads will shift lower as the demand to fix rates will dissipate; and
6. Credit spreads will continue their downward trend led by investment-grade bonds as investors reluctantly increase their levels of risk acceptance

### Key Market Indications

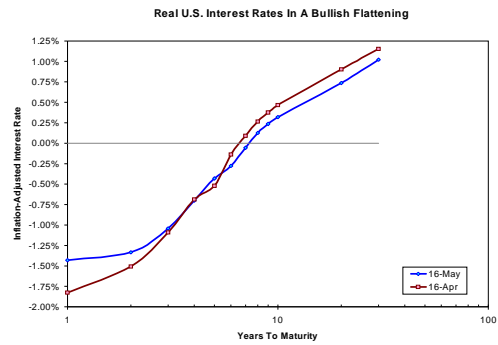
The Treasury yield curve maintained its bullish flattening. Both the ten- and thirty-year bonds breached their primary resistance and are poised to test 2.31% and 3.29%, respectively.



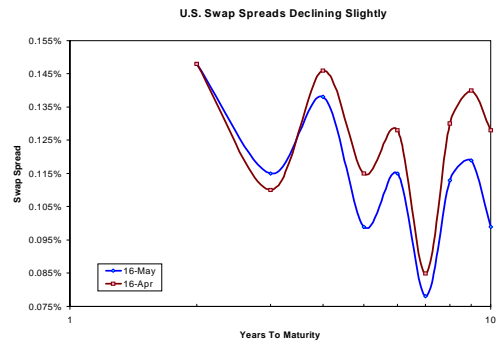
Euro-denominated CDS costs on U.S. Treasuries have been unusually stable as issues of federal finances have receded from the news.



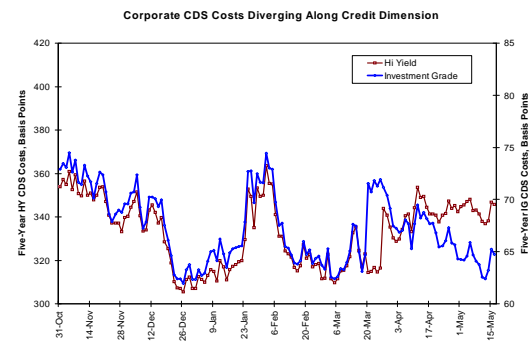
Real rates remain negative out to the seven-year horizon. Levels of risk-aversion as evidenced by higher short-term and lower long-term real rates have declined over the past month. The combination is negative for precious metals and supportive for risky financial assets.



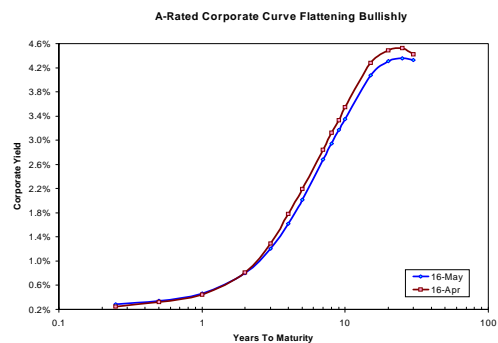
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have declined slightly, but their ranges are too small to be of significance.



Five-year CDS costs for both investment-grade and high-yield paused in their drive lower and continue to diverge as investment-grade CDS costs reflect a preference for lower credit risk to accompany an equally strong preference for duration risk.



The A-rated yield curve has moved similarly to the Treasury yield curve. The bullish flattening still reflects a preference for investment-grade debt over other risky assets.



## Market Structure

Both Treasuries and the S&P 500 remain in uptrends, an unusual combination of late. The physical commodity indices are in weak and divergent trends characterized by the transitional structures in Precious and Industrial Metals and opposite trend in Petroleum and Natural Gas.

|                      | N-Day Speed | Market Structure | Trend Oscillator | HLC Volatility | Daily Trend Rate For May 19-23 |
|----------------------|-------------|------------------|------------------|----------------|--------------------------------|
| DJ-UBS               | 29          | Trending         | -0.154           | 6.1%           |                                |
| DJ-UBS Grain         | 26          | Trending         | -0.190           | 14.9%          | -0.36%                         |
| DJ-UBS Ind. Metl     | 15          | Transitional     | 0.029            | 12.3%          |                                |
| DJ-UBS Prec. Metl    | 18          | Transitional     | -0.021           | 13.6%          |                                |
| DJ-UBS Softs         | 29          | Trending         | -0.105           | 20.3%          | -0.30%                         |
| DJ-UBS Nat. Gas      | 29          | Trending         | -0.256           | 20.9%          | -0.41%                         |
| DJ-UBS Petroleum     | 29          | Trending         | 0.081            | 9.3%           | 0.04%                          |
| DJ-UBS Livestock     | 29          | Trending         | 0.254            | 9.7%           | 0.24%                          |
| Dollar Index         | 29          | Trending         | 0.110            | 3.7%           |                                |
| S&P 500 Index        | 29          | Trending         | 0.054            | 8.8%           | 0.15%                          |
| EAFE Index           | 8           | Sideways         | 0.005            | 5.7%           |                                |
| EM Index             | 19          | Transitional     | 0.258            | 10.9%          |                                |
| Ten-year UST (price) | 29          | Trending         | 0.195            | 4.9%           | 0.23%                          |

## Performance Measures

While only Grains moved lower, the main DJ-UBS index remains in a weak downtrend.

|                                    | Five-Days | One Month | Six Months | One Year |
|------------------------------------|-----------|-----------|------------|----------|
| <b>Dow Jones-UBS</b>               | -0.39%    | -1.77%    | 10.87%     | 2.73%    |
| <b>Grains Sub-Index</b>            | -4.27%    | -2.86%    | 10.95%     | -2.04%   |
| Corn                               | -4.73%    | -3.39%    | 10.67%     | -18.72%  |
| Soybeans                           | -1.48%    | -2.48%    | 18.74%     | 21.36%   |
| Wheat                              | -6.68%    | -3.54%    | 1.16%      | -7.07%   |
| <b>Energy Sub-Index</b>            | 0.71%     | -2.78%    | 15.23%     | 6.15%    |
| Petroleum Sub-Index                | 2.17%     | -0.66%    | 7.29%      | 7.92%    |
| WTI                                | 2.29%     | -0.80%    | 11.28%     | 10.65%   |
| ULSD                               | 1.62%     | -1.55%    | 3.54%      | 2.32%    |
| Gasoline                           | 2.69%     | -0.97%    | 7.44%      | 4.89%    |
| Natural Gas                        | -2.62%    | -7.51%    | 31.34%     | 2.49%    |
| <b>Precious Metals Sub-Index</b>   | 0.60%     | -0.42%    | -0.40%     | -7.92%   |
| Gold                               | 0.44%     | -0.05%    | 1.44%      | -5.59%   |
| Silver                             | 1.09%     | -1.53%    | -5.46%     | -14.44%  |
| <b>Industrial Metals Sub-Index</b> | 0.34%     | 0.76%     | 4.49%      | -1.79%   |
| Copper                             | 2.08%     | 3.73%     | -0.10%     | -5.70%   |
| Aluminum                           | 0.34%     | -5.83%    | -5.61%     | -13.05%  |
| Nickel                             | -4.48%    | 6.00%     | 38.76%     | 26.22%   |
| Zinc                               | 1.51%     | 0.05%     | 8.11%      | 7.14%    |
| <b>Softs Sub-Index</b>             | 1.57%     | -0.73%    | 19.14%     | 6.71%    |
| Coffee                             | 0.63%     | -9.33%    | 65.95%     | 23.36%   |
| Sugar                              | 4.13%     | 3.35%     | -3.88%     | -4.46%   |
| Cotton                             | -2.75%    | -2.73%    | 13.85%     | 2.45%    |
| <b>Livestock Sub-Index</b>         | 0.01%     | 0.11%     | 13.53%     | 21.29%   |
| Cattle                             | -0.01%    | 2.84%     | 10.12%     | 13.47%   |
| Hogs                               | 0.05%     | -3.10%    | 18.57%     | 33.80%   |

The USD gained against the European currencies save the SEK but retreated against the CAD, JPY and a wide range of minor currencies. The incipient drive to weaken the EUR continues to raise the possibility of a euro carry trade.

|   | Five-Days | One Month | Six Months | One Year |
|---|-----------|-----------|------------|----------|
| <b>Currency Returns</b>                       |           |           |            |          |
| Euro  | -0.47%    | -0.88%    | 1.39%      | 6.30%    |
| Japanese yen                                  | 0.35%     | 0.72%     | -1.49%     | 0.75%    |
| British pound                                 | -0.24%    | 0.08%     | 4.36%      | 10.09%   |
| Swiss franc                                   | -0.71%    | -1.22%    | 2.26%      | 8.08%    |
| Canadian dollar                               | 0.34%     | 1.38%     | -3.98%     | -6.13%   |
| Australian dollar                             | -0.02%    | -0.12%    | -0.18%     | -4.57%   |
| Swedish krona                                 | 0.12%     | 0.51%     | 0.74%      | 1.63%    |
| Norwegian krone                               | -0.39%    | 0.65%     | 3.20%      | -1.68%   |
| New Zealand dollar                            | 0.16%     | 0.02%     | 3.50%      | 5.77%    |
| Indian rupee                                  | 2.11%     | 2.73%     | 6.18%      | -6.80%   |
| Brazilian real                                | -0.09%    | 1.29%     | 2.22%      | -8.50%   |
| Mexican peso                                  | 0.35%     | 1.25%     | -0.07%     | -4.85%   |
| Chilean peso                                  | 0.74%     | 0.98%     | -6.06%     | -12.84%  |
| Colombian peso                                | -1.11%    | 0.15%     | -0.38%     | -4.41%   |
| Bloomberg-JP Morgan Asian dollar index (spot) | 0.29%     | 0.38%     | -0.17%     | -1.35%   |

Equity indices continue to struggle at resistance as their principle support of low bond yields has been discounted, but they have no incentive to retreat. As the upside is capped, the downside remains unusually vulnerable to event risk.

|                             | Five-Days | One Month | Six Months | One Year |
|-----------------------------|-----------|-----------|------------|----------|
| <b>Equity Total Returns</b> |           |           |            |          |
| MSCI World Free             | 0.17%     | 1.56%     | 5.30%      | 14.52%   |
| North America               | 0.04%     | 1.08%     | 5.45%      | 15.98%   |
| Latin America               | 1.79%     | 4.86%     | 4.00%      | -5.50%   |
| Emerging Market Free        | 2.52%     | 3.16%     | 3.67%      | 1.31%    |
| EAFE                        | 0.35%     | 2.23%     | 5.08%      | 12.49%   |
| Pacific                     | 0.48%     | 0.69%     | -2.87%     | -1.68%   |
| Eurozone                    | -0.29%    | 1.58%     | 7.79%      | 23.93%   |

CTAs continued their monthly gains, but macro funds remain mired in poor performance exacerbated by the downward convergence of interest rates and the spillover effect for currencies, long-term bonds and equities.

|                               | Five-Days | One Month | Six Months | One Year |
|-------------------------------|-----------|-----------|------------|----------|
| <b>CTA/Hedge Fund Returns</b> |           |           |            |          |
| Newedge CTA                   | 0.27%     | 2.03%     | -1.22%     | -8.86%   |
| Newedge Trend                 | 0.08%     | 0.65%     | 0.57%      | -5.34%   |
| Newedge Short-Term            | 0.81%     | -2.66%    | 2.86%      | -2.71%   |
| HFR Global Hedge Fund         | -0.25%    | 0.01%     | 0.89%      | 1.50%    |
| HFR Macro/CTA                 | -0.17%    | -0.43%    | -1.40%     | -4.26%   |
| HFR Macro:                    | -0.14%    | -0.41%    | -2.01%     | -3.99%   |
| Systematic Diversified CTA    |           |           |            |          |