The Macro Environment For Financial Markets

In the grand spirit of amateurs talking tactics while pros talk logistics, Greece gets all of the headlines while the unwinding of China's equity bubble and the Peoples' Bank's easier-credit responses thereto will have greater overall importance. This will create a yuan carry trade eventually to offset the Federal Reserve's first rate hike. As that move and others will force the USD higher, it will cap how much the Federal Reserve will be willing and able to do as a much stronger USD will have negative effects on U.S. manufacturing and exports. In addition, any weakness in the China effectively will allow China to export disinflationary pressures. These developments should arrest the bearish shift at the long end of the U.S. yield curve. However, "should" is a dangerous word in financial markets.

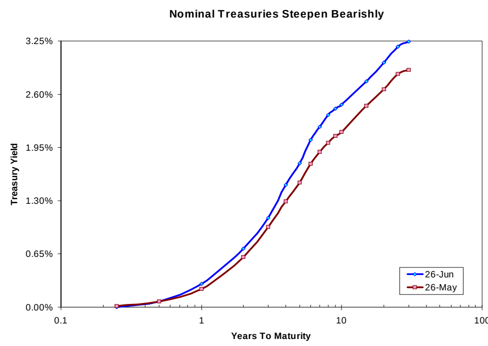
The causal chain is:

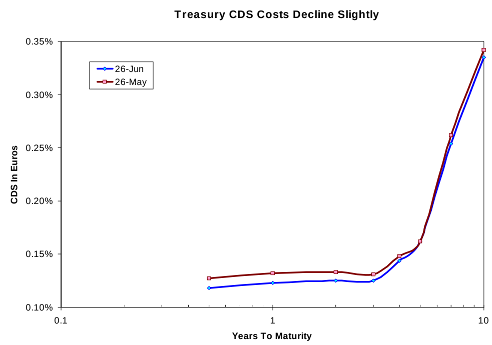
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point, arguably as early as September;
2. Disinflationary pressures have ended;
3. Inflation expectations as measured by the TIPS market will appear to be rising so long as nominal interest rates continue rising and vice-versa;
4. The U.S. yield curve has resumed its long-term bias toward flattening, but this will be a tenuous process until the next drumbeat of expectation for higher short-term interest rates;
5. Short-term borrowers are terming out commercial paper into the bond market in an attempt to lower rollover risk;
6. Swap spreads will remain tame until monetary policy indications turn more hawkish; and
7. Credit spreads will not rise significantly barring event risk until short-term interest rates are pushed higher.

Key Market Indications

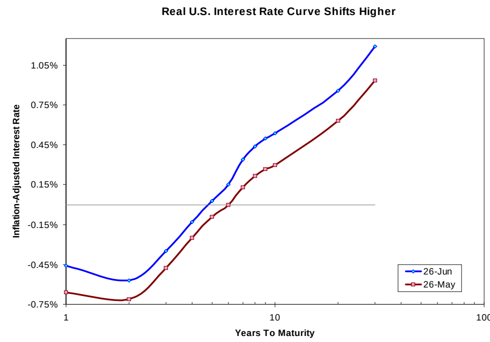
While ten-year UST have held their key support level of 2.66%, this is starting to feel like praying a stop level will hold. The one thing guaranteed to lose bond managers their jobs is being long duration when rates start to rise. The observed rapidity of recent selloffs signals the absence of long-term buyers willing to buy dips. This leaves the haven bid as the largest source of buying, and as the Greek situation does not seem to be scaring anyone anymore, how big can that haven bid be?

This market continues to have little reason to shift in either direction. The small shift lower in CDS costs at the short end of the yield curve can be ignored.

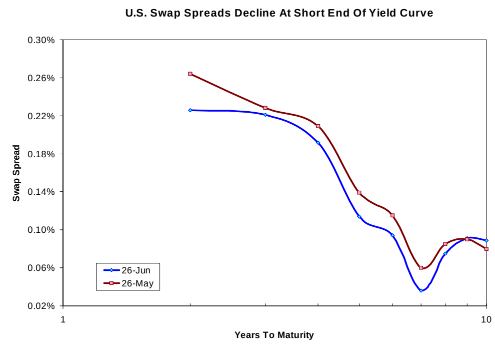




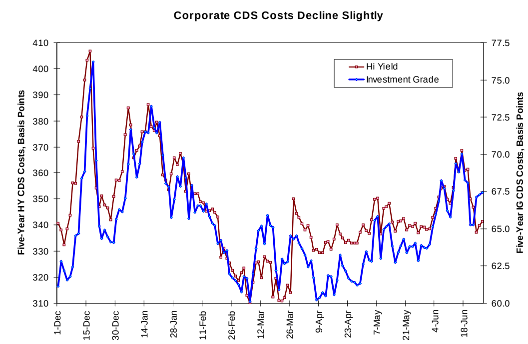
Pseudo-real rates shifted higher along the maturity spectrum along with nominal yields. This shift is negative for risky financial assets and for precious metals. However, we do need to remind ourselves these rates are negative out to four years, and in any other time and place, that would be considered wildly stimulative.



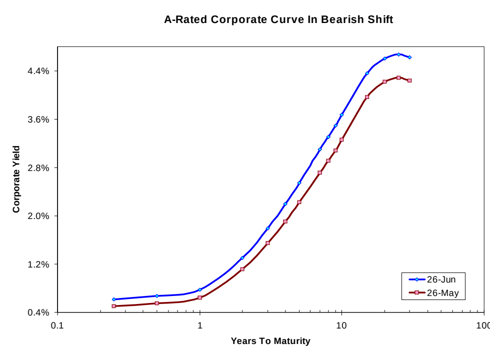
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have moved lower at the short end of the yield curve over the past month. This increased willingness to remain floating on short-term payment risk is at odds with the consensus short-term rates will be rising in the fourth quarter.



Maybe UST rates are rising and maybe the stock market is moving toward a correction, but this does not mean balance sheets are about to deteriorate. Both investment-grade and high-yield CDS levels have held support and declined over the past week.



The A-rated yield curve steepened bearishly over the past month. Unless long-dated swap spreads or CDS costs decline unexpectedly, the potential for a bullish shift in investment-grade corporate bonds will remain slight. That in turn will cap the ability of equities to rise independently of actual earnings growth.



Market Structure

Grains moved into a structural uptrend, and that was sufficient to push the main Bloomberg index out of its structural downtrend. Within the financial markets, both the S&P 500 and ten-year UST moved into structural downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate June 29 - July 13
BBerg	12	Transitional	0.047	9.7%	
BBerg Grain	28	Trending	0.384	17.3%	0.18%
BBerg Ind. Metl	4	Sideways	-0.023	14.1%	
BBerg Pre. Metl	29	Trending	-0.157	12.2%	-0.37%
BBerg Softs	15	Transitional	0.041	14.3%	
BBerg Nat. Gas	25	Trending	-0.035	30.3%	-1.49%
BBerg Petroleum	26	Trending	-0.043	23.1%	-0.37%
BBerg Livestock	29	Trending	-0.413	9.3%	-0.37%
Dollar Index	24	Trending	-0.003	10.1%	-0.26%
S&P 500 Index	23	Trending	-0.023	7.4%	-0.85%
EAFE Index	29	Trending	-0.014	10.6%	-0.10%
EM Index	11	Transitional	0.012	7.4%	
Ten-year UST (price)	24	Trending	-0.187	6.5%	-0.09%

Performance Measures

Rain makes grain. It also makes mud and delays both planting and harvesting. However, just as early-frost rallies in the fall inevitably disappoint the longs, these sorts of rallies tend to fizzle as well. However, the grain rally underscores one more time why it is difficult to make money being short in bear markets; the rallies tend to come from nowhere, push out the weak hands and then roll over and die.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	1.30%	0.36%	-5.02%	-25.82%
Grains Sub-Index	9.12%	9.77%	-8.78%	-18.72%
Corn	9.41%	8.43%	-10.92%	-21.13%
Soybeans	4.92%	9.99%	-4.64%	-20.39%
Wheat	15.33%	13.70%	-7.79%	-7.70%
Energy Sub-Index	-0.69%	-0.45%	-2.56%	-43.84%
Petroleum Sub-Index	-0.17%	0.58%	0.87%	-44.94%
WTI	-0.53%	1.98%	-2.32%	-47.71%
Brent	0.11%	-1.43%	-3.40%	-49.89%
ULSD	-0.23%	-2.29%	0.59%	-37.21%
Gasoline	0.09%	3.84%	14.02%	-38.12%
Natural Gas	-2.34%	-3.73%	-15.44%	-45.36%
Precious Metals Sub-Index	-2.38%	-2.54%	-2.38%	-15.37%
Gold	-2.39%	-1.23%	-2.08%	-11.28%
Silver	-2.34%	-6.09%	-3.11%	-26.55%
Industrial Metals Sub-Index	0.88%	-4.64%	-9.24%	-17.81%
Copper	2.35%	-5.29%	-6.55%	-17.35%
Aluminum	0.61%	-3.34%	-10.72%	-14.53%
Nickel	-2.10%	-1.86%	-19.48%	-34.91%
Zinc	-0.83%	-6.98%	-6.76%	-9.34%
Softs Sub-Index	3.78%	0.71%	-15.25%	-33.86%
Coffee	2.57%	5.82%	-24.90%	-33.12%
Sugar	3.46%	-4.01%	-20.30%	-45.98%
Cotton	5.65%	5.44%	7.65%	-9.10%
Livestock Sub-Index	-1.40%	-5.44%	-11.40%	-17.96%
Cattle	-1.43%	-1.39%	-1.56%	0.40%
Hogs	-1.35%	-11.50%	-26.37%	-42.88%

The delaying action on the dollar rally noted last week failed this week as the greenback gained everywhere except against the CNY. Logic says the Federal Reserve will not be able to talk short-term interest rates higher and the USD lower simultaneously; cynicism says they will try. Put your money on cynicism.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.63%	2.70%	-8.34%	-17.96%
Chinese yuan	0.00%	-0.09%	0.06%	0.25%
Japanese yen	-0.92%	-0.61%	-2.86%	-17.86%
British pound	-0.86%	2.35%	1.21%	-7.52%
Swiss franc	-1.69%	2.15%	5.81%	-4.25%
Canadian dollar	-0.45%	0.92%	-5.63%	-13.25%
Australian dollar	-1.51%	-1.03%	-5.74%	-18.68%
Swedish krona	-2.24%	2.07%	-5.40%	-18.84%
Norwegian krone	-1.45%	-1.03%	-4.72%	-21.72%
New Zealand dollar	-0.78%	-5.19%	-11.65%	-21.92%
Indian rupee	-0.13%	0.53%	-0.12%	-5.50%
Brazilian real	-1.01%	0.77%	-14.70%	-29.80%
Mexican peso	-1.35%	-1.68%	-5.41%	-16.33%
Chilean peso	-0.36%	-3.36%	-4.26%	-13.44%
Colombian peso	-1.19%	-1.47%	-8.39%	-27.09%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.48%	-0.37%	-0.77%	-3.65%

While the EM and EAFE indices gained on the week, this was largely a one-day wonder that was failing hard by Friday. Everything feels like the start of a bear market; perhaps the only thing saving us from this fate is investors have been trained to buy and hold once again and the alternatives remain unappealing.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.13%	-0.07%	4.18%	4.73%
North America	-0.37%	0.00%	1.74%	8.27%
Latin America	-0.63%	0.33%	-4.70%	-22.41%
Emerging Market Free	0.85%	-4.00%	4.36%	-3.77%
EAFE	0.91%	-0.19%	8.22%	-0.42%
Pacific	0.33%	-1.89%	9.71%	3.84%
Eurozone	2.78%	2.37%	7.66%	-3.63%

This week's gains by CTAs and macro hedge funds confirm the long dollar trade remains intact. This trade probably is associated with a growing bearish tilt in sovereign bonds even though that is a difficult trade when every hiccup out of Greece can trigger a haven rally.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.09%	-2.73%	0.59%	20.31%
Newedge Trend	0.38%	-2.96%	0.02%	13.61%
Newedge Short-Term	-0.66%	-3.07%	-2.49%	5.22%
HFR Global Hedge Fund	0.08%	-0.38%	2.67%	0.13%
HFR Macro/CTA	0.85%	-0.05%	0.93%	6.38%
HFR Macro: Sytematic Diversified CTA	0.75%	-0.25%	0.14%	5.36%