The Macro Environment For Financial Markets

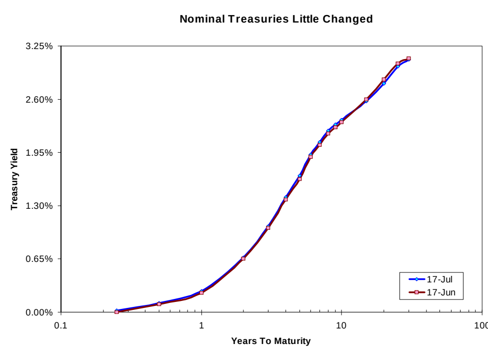
Aging Baby Boomers remember the tedious "Suppose they gave a war and nobody came" poster from the Vietnam era. Let's update that to "Suppose they gave a crisis and nobody soiled themselves." At the end of a Greek situation whose outcome of extend-and-pretend was foreordained as nobody wanted to see what was on the other side of the chasm and at the end of an artificial bubble in Chinese equities that proved you should stay out of rigged casinos, you have stable long-term rates, advancing equity markets and a Federal Reserve determined to raise short-term rates and accept the to-be-real consequences of a surging dollar. Citigroup's Charles Prince famously said that when the music's playing, you have to get up and dance. Markets disagree.

The causal chain now is:

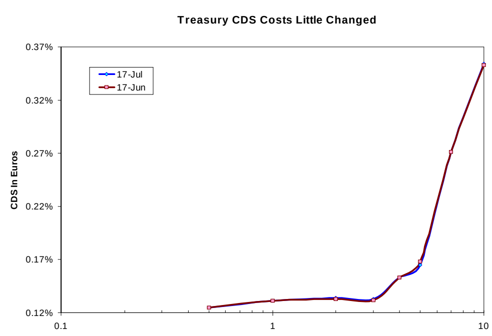
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point, arguably as early as September;
2. Disinflationary pressures have ended without a noticeable shift to rising inflationary pressures;
3. Inflation expectations as measured by the 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, driven by higher short-term rates as opposed to declining long-term 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 remain confined in their trading range until short-term interest rates are pushed higher.

Key Market Indications

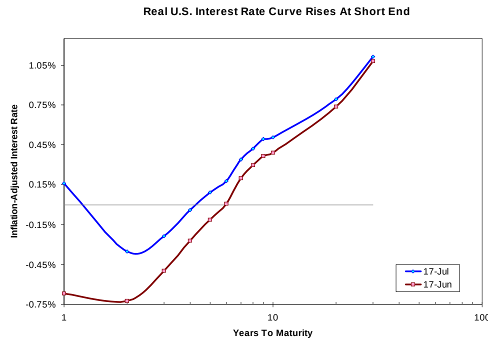
In a coincidence, the yield curve remains almost exactly where it was one month ago, an observation made over the last two weeks as well. The one thing we can conclude is all of the threats about higher short-term rates are doing little to push long-term rates higher. You would need a threat of higher inflation for that. Or, just for the sake of completeness, you could have a reverse Twist to offset the August 2011 campaign. That will not happen.



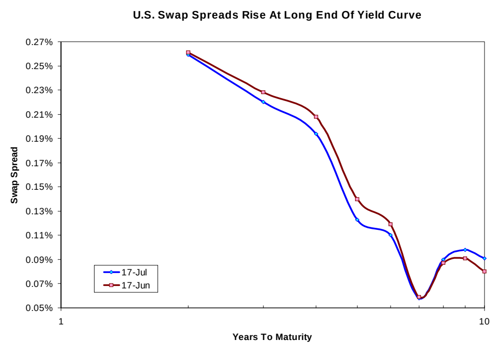
This market continues to have little reason to shift in either direction. The market has stayed almost unchanged over the past month.



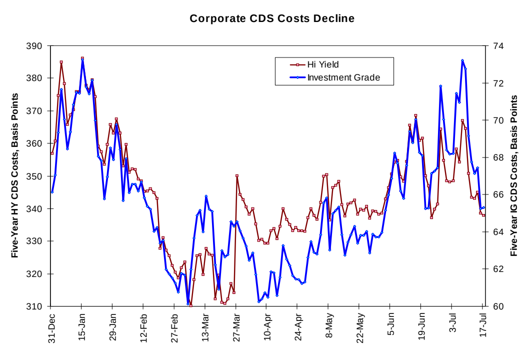
Pseudo-real rates moved higher at the short end of the yield curve; this helped push the precious metals lower. The small shift higher at the long end of the yield curve is trivial for risky financial assets.



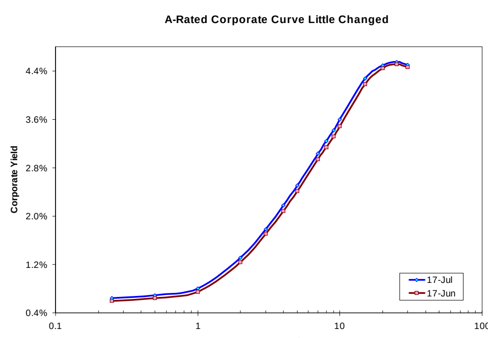
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have moved higher at the long end of the yield curve over the past month, but have started to decline in the belly of the yield curve. This increased demand to fix long-term payments is a concern for the corporate bond market.



The sawtooth uptrend in CDS costs since April has ended. Some of the abrupt decline in CDS costs may be related to the declining liquidity in single-name CDS contracts. Once protection buyers start to sell, who wants or is able to step up and buy?



The A-rated yield curve changed little 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

The main Bloomberg index remains in a downtrend along with Precious Metals and Petroleum. Within the financial markets, the EAFE and S&P 500 indices shifted into uptrends and were joined there by the dollar index and ten-year UST.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate July 20 - 24
BBerg	29	Trending	-0.235	12.2%	-0.14%
BBerg Grain	7	Sideways	-0.088	22.4%	
BBerg Ind. Metl	7	Sideways	-0.033	19.6%	
BBerg Pre. Metl	29	Trending	-0.311	12.9%	-0.23%
BBerg Softs	19	Transitional	-0.079	15.9%	
BBerg Nat. Gas	26	Trending	0.009	29.1%	
BBerg Petroleum	29	Trending	-0.373	25.9%	-0.37%
BBerg Livestock	14	Transitional	-0.110	13.3%	
Dollar Index	29	Trending	0.242	9.3%	0.15%
S&P 500 Index	28	Trending	0.168	9.2%	0.06%
EAFE Index	27	Trending	0.082	12.6%	0.10%
EM Index	5	Sideways	0.008	8.5%	
Ten-year UST (price)	24	Trending	0.005	6.9%	0.86%

Performance Measures

Some restored calm regarding China's future allowed for the industrial metals to stay relatively flat, but we remain in a secular bear market for physical commodities otherwise. Cash-strapped producers need to sell expanding quantities of their output at lower prices to cover fixed costs; this is especially true of state-owned firms and heavily indebted upstream firms in the North American energy industry. Moreover, once CAD-, AUD- or BRL-domiciled producers receive USD for their output, they enjoy higher domestic purchasing power.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.78%	-2.27%	-3.86%	-24.52%
Grains Sub-Index	-2.93%	12.34%	1.90%	-3.72%
Corn	-3.34%	17.14%	1.36%	-0.15%
Soybeans	-1.52%	7.13%	4.50%	-6.81%
Wheat	-3.82%	12.49%	2.28%	-1.10%
Energy Sub-Index	-1.81%	-8.31%	3.78%	-44.73%
Petroleum Sub-Index	-3.52%	-11.14%	7.57%	-48.71%
WTI	-3.78%	-15.06%	-1.05%	-53.96%
Brent	-3.33%	-10.56%	8.26%	-53.00%
ULSD	-4.41%	-11.12%	5.01%	-40.76%
Gasoline	-2.71%	-4.97%	25.49%	-37.37%
Natural Gas	3.38%	0.77%	-5.91%	-36.99%
Precious Metals Sub-Index	-2.79%	-6.46%	-14.20%	-18.29%
Gold	-2.30%	-5.88%	-12.80%	-13.97%
Silver	-4.18%	-8.12%	-18.04%	-29.99%
Industrial Metals Sub-Index	-0.17%	-2.47%	-8.14%	-22.02%
Copper	-1.64%	-3.07%	-4.00%	-22.03%
Aluminum	-0.16%	-0.41%	-10.89%	-18.87%
Nickel	2.13%	-9.63%	-22.78%	-39.40%
Zinc	2.74%	0.86%	-2.62%	-11.82%
Softs Sub-Index	-1.55%	0.88%	-18.94%	-28.21%
Coffee	1.70%	-1.31%	-25.85%	-32.50%
Sugar	-3.63%	3.55%	-25.92%	-40.33%
Cotton	-0.46%	2.07%	10.91%	-3.26%
Livestock Sub-Index	-0.12%	-1.71%	-4.47%	-17.68%
Cattle	-0.92%	-3.12%	3.15%	-0.60%
Hogs	1.33%	0.76%	-16.33%	-41.23%

Let's make this simple. The GBP advanced because the Bank of England is going to raise rates along with the U.S. and the CNY stayed flat because the Party wanted it this way. Everything else outside of the CLP fell as the U.S. signaled its willingness, for this week at least, to accept a stronger dollar.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-2.97%	-4.47%	-6.69%	-19.93%
Chinese yuan	0.00%	0.00%	0.18%	-0.09%
Japanese yen	-1.06%	-0.53%	-5.26%	-18.46%
British pound	0.53%	-1.47%	3.22%	-8.78%
Swiss franc	-2.37%	-4.11%	-8.52%	-6.67%
Canadian dollar	-2.42%	-5.74%	-7.95%	-17.03%
Australian dollar	-1.01%	-4.88%	-10.23%	-21.17%
Swedish krona	-2.62%	-6.29%	-6.00%	-21.11%
Norwegian krone	-2.01%	-6.30%	-6.72%	-24.06%
New Zealand dollar	-2.96%	-6.58%	-16.13%	-24.71%
Indian rupee	-0.12%	1.01%	-2.77%	-5.19%
Brazilian real	-0.88%	-4.12%	-16.85%	-29.17%
Mexican peso	-1.34%	-4.22%	-8.19%	-18.39%
Chilean peso	0.13%	-1.29%	-2.76%	-12.62%
Colombian peso	-3.18%	-7.62%	-14.72%	-32.10%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.44%	-0.84%	-1.97%	-4.24%

The Chinese "crisis" – and why is everything non-critical a crisis? – blew over after the authorities essentially threatened sellers with a blindfold and a cigarette. No thanks; I don't smoke. Along with the latest Greek farce, this allowed everyone outside of woebegone Latin America to advance. Self-delusion is quite useful in the not-so-grand scheme of things.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	2.16%	1.19%	7.82%	5.12%
North America	2.24%	0.89%	6.09%	8.96%
Latin America	-0.31%	-3.21%	-6.61%	-27.11%
Emerging Market Free	1.15%	-2.10%	0.04%	-8.97%
EAFE	2.04%	1.68%	10.65%	-0.49%
Pacific	3.48%	0.75%	10.72%	2.41%
Eurozone	0.97%	3.36%	11.39%	-2.33%

Two consecutive weeks of gains by professional traders appears to be attributable to long USD and long equity positions along with short positions in key commodities such as crude oil and gold.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.46%	-0.83%	-3.48%	19.11%
Newedge Trend	1.51%	0.65%	-2.40%	13.87%
Newedge Short-Term	0.58%	-1.01%	-3.51%	4.96%
HFR Global Hedge Fund	1.21%	-0.18%	2.48%	-0.12%
HFR Macro/CTA	1.71%	0.69%	0.06%	6.41%
HFR Macro: Sytematic Diversified CTA	2.01%	1.08%	-1.05%	5.52%