The Macro Environment For Financial Markets

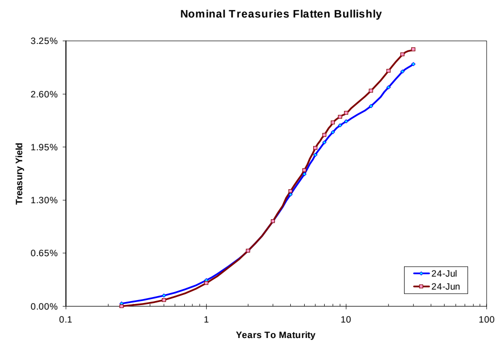
The Great Recession ended more than six years ago but perceptions have yet to confirm reality. We still have the spectacle of declining long-term rates, collapsing physical commodity prices, declining inflation expectations, rising employment statistics matched with poor personal income growth and corporate earnings struggling to grow and apparently vulnerable to increases in the dollar. The good news is the U.S. is outperforming the rest of the world; the bad news is we need the rest of the world to join the upward trend. In the meantime, the Federal Reserve is going to raise short-term interest rates to preserve whatever is left of the institution's credibility, and as night follows day this will necessitate a reduction in its balance sheet.

The causal chain now remains:

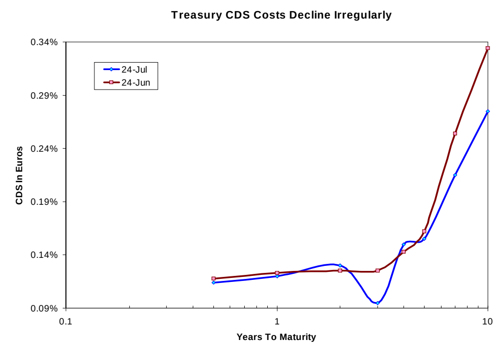
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point, arguably as early as September;
2. Disinflationary pressures have ended without a noticeable shift to rising inflationary pressures;
3. Inflation expectations as measured by the 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

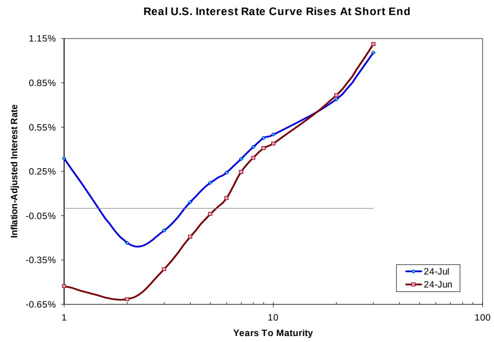
The long-term trend toward a bullish flattening of the UST curve is creeping back as expectations for higher short-term rates intersect with the return of the haven bid. The key resistance level of 2.15% is only 11 basis points away, a perfectly absurd state of affairs given the impending liftoff in short-term rates.



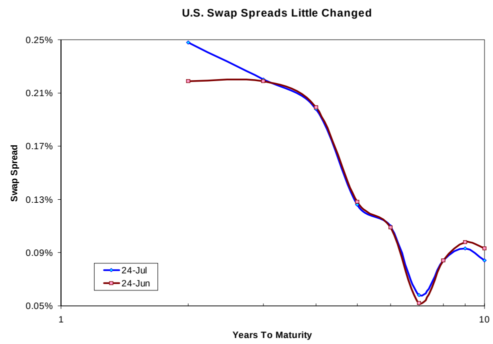
This market continues to have little reason to shift in either direction. Interestingly, though, the long end of this curve has come down over the past month.



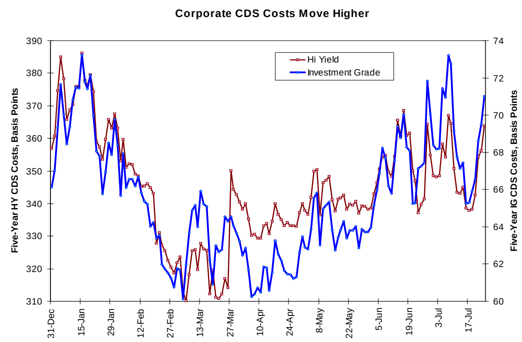
Pseudo-real rates continue to move higher at the short end of the yield curve; this continues to push precious metals lower. Only two- and three-year pseudo-real rates are negative now.



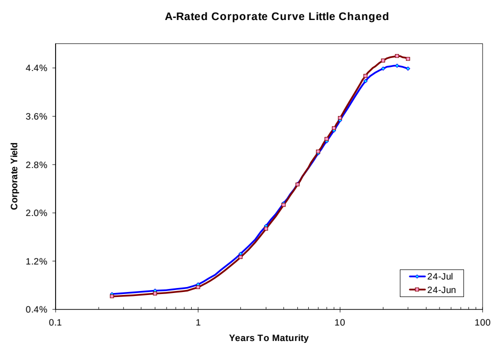
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have changed little over the past month. The small decline at nine- and ten-year tenors is consistent with the decline in long-term UST rates.



The decline in CDS costs lasted all of one week and has been followed by a jump back toward support levels. The increasing volatility of this indicator is related to declining liquidity in the single-name CDS market.



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

Only Industrial Metals and Livestock within physical commodities are not in structural downtrends. Within the financial markets, the EAFE and S&P 500 indices shifted into downtrends. Both the dollar index and ten-year UST remained in uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate July 27 - 31
BBerg	28	Trending	-0.490	12.3%	-0.14%
BBerg Grain	29	Trending	-0.152	22.6%	-0.30%
BBerg Ind. Metl	12	Transitional	-0.196	17.8%	
BBerg Pre. Metl	29	Trending	-0.481	13.8%	-0.23%
BBerg Softs	24	Trending	-0.311	16.0%	-0.79%
BBerg Nat. Gas	22	Trending	-0.071	22.1%	-0.09%
BBerg Petroleum	29	Trending	-0.434	26.0%	-0.37%
BBerg Livestock	18	Transitional	-0.174	12.8%	
Dollar Index	29	Trending	0.140	8.6%	0.15%
S&P 500 Index	28	Trending	-0.088	9.1%	-0.04%
EAFE Index	29	Trending	-0.038	11.9%	-0.08%
EM Index	11	Transitional	-0.292	9.0%	
Ten-year UST (price)	27	Trending	0.098	6.7%	0.86%

Performance Measures

Every physical commodity subindex save Lean Hogs declined this past week. The uniformity of the declines suggests financial flows were more causal than anything related to fundamental supply balances; after all, the “too much of everything” description of physical commodity markets has been increasingly valid for more than a year. While a rebound from such a situation is inevitable, we need to keep in mind financially stressed sellers need to sell greater quantities at lower prices to cover their fixed costs. This is bearish for physical commodities as is their abandonment by those who bit on the argument they were an asset class.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-4.39%	-7.15%	-7.75%	-27.70%
Grains Sub-Index	-6.06%	1.99%	-3.22%	-8.28%
Corn	-6.60%	5.65%	-4.47%	-4.23%
Soybeans	-4.15%	0.94%	1.12%	-10.63%
Wheat	-7.63%	-2.20%	-4.27%	-8.03%
Energy Sub-Index	-4.35%	-12.21%	-2.48%	-46.77%
Petroleum Sub-Index	-4.67%	-15.70%	1.99%	-51.14%
WTI	-5.99%	-20.53%	-5.19%	-56.77%
Brent	-4.14%	-14.78%	2.21%	-54.98%
ULSD	-2.39%	-13.70%	0.57%	-42.62%
Gasoline	-5.06%	-10.03%	16.43%	-40.07%
Natural Gas	-3.44%	-0.72%	-13.39%	-37.51%
Precious Metals Sub-Index	-3.71%	-7.91%	-17.74%	-20.03%
Gold	-4.19%	-7.59%	-16.35%	-16.41%
Silver	-2.33%	-8.82%	-21.45%	-30.04%
Industrial Metals Sub-Index	-4.06%	-7.61%	-9.84%	-27.14%
Copper	-4.55%	-9.20%	-4.97%	-27.44%
Aluminum	-3.31%	-5.00%	-13.06%	-23.19%
Nickel	-1.76%	-11.61%	-21.86%	-42.01%
Zinc	-5.56%	-4.63%	-7.66%	-20.04%
Softs Sub-Index	-4.42%	-5.66%	-20.48%	-33.59%
Coffee	-4.79%	-9.51%	-28.60%	-37.86%
Sugar	-6.02%	-6.49%	-27.35%	-44.19%
Cotton	-0.89%	0.08%	10.87%	-1.66%
Livestock Sub-Index	-1.90%	-2.71%	-3.42%	-18.79%
Cattle	-3.35%	-6.15%	1.22%	-6.20%
Hogs	0.91%	3.75%	-10.77%	-37.59%

The strongest feature of the currency world this past week was the annihilation of the Latin American currencies. Funny what years of economic mismanagement can do when combined with the prospects of higher U.S. rates and the downturn in physical commodities. Interestingly, the EUR managed a small gain on the USD, GBP and CHF. It is not a one-way trade, which is probably for the best given the German phobia over currency weakness.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.42%	-1.97%	-2.26%	-18.42%
Chinese yuan	0.00%	-0.04%	0.74%	-0.24%
Japanese yen	0.23%	0.03%	-4.32%	-17.76%
British pound	-0.59%	-1.26%	2.85%	-8.70%
Swiss franc	-0.15%	-3.03%	-6.23%	-6.26%
Canadian dollar	-0.59%	-5.10%	-4.41%	-17.66%
Australian dollar	-1.21%	-5.48%	-8.11%	-22.69%
Swedish krona	0.80%	-4.02%	-3.21%	-20.47%
Norwegian krone	-0.38%	-4.30%	-4.88%	-24.40%
New Zealand dollar	0.78%	-4.53%	-11.42%	-23.27%
Indian rupee	-0.89%	-0.69%	-4.07%	-6.15%
Brazilian real	-4.98%	-7.65%	-22.99%	-33.78%
Mexican peso	-2.09%	-4.72%	-10.39%	-20.32%
Chilean peso	-2.29%	-4.32%	-5.59%	-14.77%
Colombian peso	-3.22%	-10.28%	-16.22%	-35.28%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.61%	-1.35%	-2.34%	-5.16%

One of the hallmarks of the post-crisis equity world has been earnings growth is not necessary for higher prices; all that was needed was the reasonable expectation of earnings stability and a bet the embedded call option would prevail. A few more weeks of mega-cap stocks missing their numbers will change this in a hurry, and not for the better.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.97%	-2.13%	3.67%	1.80%
North America	-2.26%	-1.80%	2.11%	4.86%
Latin America	-7.00%	-11.10%	-15.02%	-34.29%
Emerging Market Free	-3.28%	-7.74%	-6.51%	-13.46%
EAFE	-1.50%	-2.66%	6.19%	-2.71%
Pacific	-1.01%	-2.61%	7.28%	1.07%
Eurozone	-0.87%	-2.06%	6.94%	-4.51%

If physical commodities rose as rapidly as they fell this past week, CTA returns would have been higher. There is always an asymmetry of risk assumption in every market. The decline in global hedge funds probably is attributable to the long bias for equities, especially after the previous week’s gains.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.01%	0.49%	-4.32%	18.26%
Newedge Trend	0.42%	0.51%	-4.17%	13.04%
Newedge Short-Term	-0.33%	-1.38%	-5.97%	4.27%
HFR Global Hedge Fund	-0.36%	-1.18%	1.58%	-0.68%
HFR Macro/CTA	0.32%	-0.10%	-0.82%	6.14%
HFR Macro: Sytematic Diversified CTA	0.42%	0.32%	-2.34%	5.22%