The Macro Environment For Financial Markets

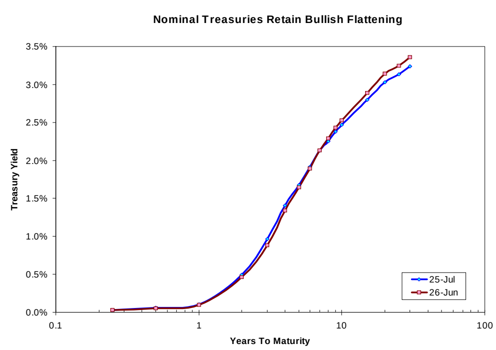
I noted last week the exposure of global economies to markets' continued high valuation levels would force policymakers into defending those valuations until they were pushed to unsustainable levels. Markets are anticipating an end to this defense, and not for the first time. While the longer-term trends toward excess liquidity, bullish flattenings of the yield curve, low swap spreads, tame inflation and low levels of corporate credit risk all remain intact, the impulse to ignore the constant and focus on the speculative is a powerful one. It is almost as if bored traders and policymakers are wishing for higher volatility simply to justify their existence, if little else.

The causal chain is now:

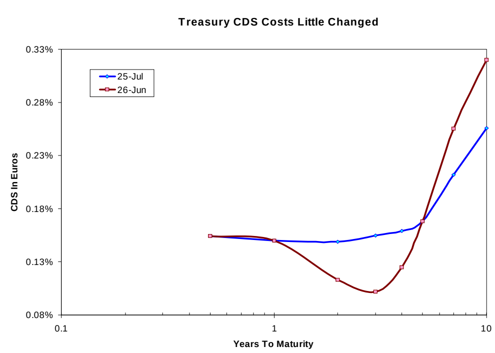
1. Short-term interest rates will remain artificially low and will keep real rates negative below the middle range of the yield curve;
2. The longer-term uptrend in senior sovereign debt remains intact but is facing increasing resistance;
3. Inflation expectations as measured by the TIPS market will threaten the top end of their year-long range and must remain below 2.47% basis the ten-year. This expansion has been driven more by high demand for TIPS than by higher long-term nominal rates.
4. Short-term borrowers will continue to accept rollover risk and keep their effective maturities as short as possible;
5. Swap spreads will not revisit their recent lows for some time and will act to cap the corporate bond rally; and
6. Credit spreads are moving higher in anticipation of waning demand for corporate debt

Key Market Indications

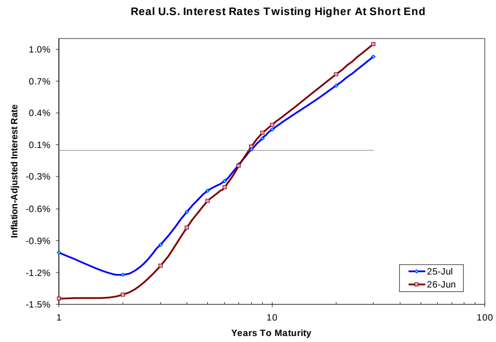
The Treasury yield curve remains in its long-term trend toward a bullish flattening. The ten-year and thirty-year issues have been unable to break formidable resistance at 2.39% and 3.24%, respectively, but this appears to be a matter of time. Not only has the increased speculation of higher short-term rates in 2015 dampened both growth and inflation expectations, it has raised the attractiveness of sovereign debt to risk-averse investors leery of higher valuations for equities and corporate debt.



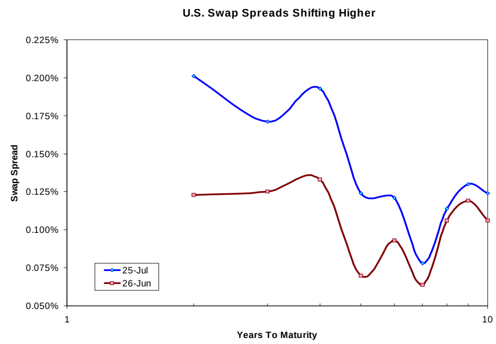
Euro-denominated CDS costs on U.S. Treasuries continue to trade within a very small range. This will continue as the Treasury's borrowing needs continue to shrink and as QE continues, albeit at a lower rate.



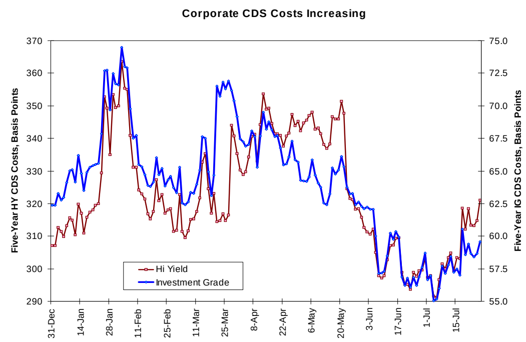
Real rates remain negative out to the seven-year horizon and are near 0% at eight years. The increase at short-dated maturities is a negative for precious metals; the decline at longer maturities remains bullish for risky financial assets.



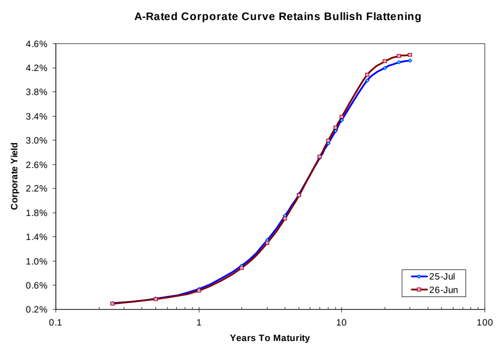
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue to shift higher across tenors with greater increases occurring at the short end. This trend is a definite impediment to further compression in corporate bonds' credit spreads.



Five-year CDS costs for both investment-grade and high-yield bonds broke support and are headed higher. The combination of higher CDS costs and rising swap spreads will lead to higher corporate bond yields unless they are offset by lower Treasury yields.



The A-rated yield curve continues to move similarly to the Treasury yield curve. The resilience here is not being matched by high-yield bonds' yield curves, a sign of increased risk aversion.



Market Structure

The broad Bloomberg index turned trendless; only Softs and Natural Gas remain in downtrends. The dollar index and the MSCI Emerging Market index entered uptrends while the EAFE index moved into a weak downtrend. Ten-year Treasuries remain in a structural uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For July 28 - Aug. 1
BBerg	5	Sideways	0.029	6.3%	
BBerg Grain	7	Sideways	0.000	22.7%	
BBerg Ind. Metl	9	Sideways	0.052	11.8%	
BBerg Pre. Metl	7	Sideways	-0.041	11.1%	
BBerg Softs	27	Trending	-0.024	15.2%	-0.29%
BBerg Nat. Gas	29	Trending	-0.544	19.7%	-0.70%
BBerg Petroleum	7	Sideways	0.056	8.8%	
BBerg Livestock	10	Sideways	-0.023	11.5%	
Dollar Index	29	Trending	0.280	3.0%	0.06%
S&P 500 Index	14	Transitional	0.026	6.7%	
EAFE Index	23	Trending	-0.044	6.4%	-0.03%
EM Index	28	Trending	0.330	5.6%	0.09%
Ten-year UST (price)	29	Trending	0.155	4.2%	0.01%

Performance Measures

Softs continued their rebound and were joined by the Industrial Metals group. These offset downturns in Precious Metals, and Grains. The downturns in both Grains and Energy are supply-related and carry no economic import. The downturn in Precious Metals is a function of less-negative short-term real rates.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.01%	-4.84%	2.33%	2.17%
Grains Sub-Index	-0.79%	-13.99%	-8.26%	-14.32%
Corn	-2.22%	-17.92%	-17.36%	-27.68%
Soybeans	-0.16%	-11.77%	2.09%	8.20%
Wheat	1.08%	-9.39%	-7.83%	-22.68%
Energy Sub-Index	-0.60%	-6.55%	-1.80%	3.95%
Petroleum Sub-Index	0.78%	-3.68%	5.84%	2.86%
WTI	0.14%	-2.81%	9.88%	4.30%
ULSD	2.31%	-2.92%	-0.85%	-1.51%
Gasoline	0.19%	-6.36%	6.50%	-1.56%
Natural Gas	-4.25%	-13.71%	-18.13%	2.26%
Precious Metals Sub-Index	-0.63%	-1.52%	4.50%	-0.46%
Gold	-0.43%	-1.22%	4.25%	-1.49%
Silver	-1.20%	-2.35%	5.23%	3.28%
Industrial Metals Sub-Index	1.95%	4.08%	10.20%	10.92%
Copper	1.76%	2.29%	0.22%	4.48%
Aluminum	0.66%	5.69%	10.50%	2.61%
Nickel	2.88%	1.36%	34.95%	36.43%
Zinc	4.08%	9.09%	18.00%	24.00%
Softs Sub-Index	1.48%	-6.30%	12.50%	2.56%
Coffee	3.92%	3.83%	49.76%	33.65%
Sugar	1.00%	-6.44%	3.21%	-8.56%
Cotton	-3.53%	-12.69%	-16.12%	-18.14%
Livestock Sub-Index	-0.10%	-0.50%	14.84%	21.17%
Cattle	3.55%	3.89%	17.50%	25.47%
Hogs	-5.53%	-6.95%	12.39%	15.84%

The USD continued to advance on other major currencies save the higher-yielding AUD and the SEK. Although the BRL turned lower, other key emerging market currencies such as the INR, CLP and COP gained on asset-related capital flows.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.70%	-1.46%	-1.78%	1.15%
Japanese yen	-0.49%	0.03%	0.70%	-2.50%
British pound	-0.66%	-0.05%	2.35%	10.30%
Swiss franc	-0.71%	-1.34%	-0.96%	2.75%
Canadian dollar	-0.73%	-0.86%	2.81%	-4.92%
Australian dollar	0.06%	-0.13%	7.52%	1.62%
Swedish krona	0.26%	-1.25%	-5.88%	-4.98%
Norwegian krone	-0.41%	-1.34%	-1.06%	-4.99%
New Zealand dollar	-1.53%	-2.11%	3.90%	5.84%
Indian rupee	0.30%	0.05%	4.98%	-1.66%
Brazilian real	-0.16%	-0.99%	8.65%	0.58%
Mexican peso	0.01%	0.46%	3.24%	-2.65%
Chilean peso	0.82%	-2.27%	-2.37%	-10.25%
Colombian peso	1.03%	1.67%	8.54%	2.04%
Bloomberg-JP Morgan Asian dollar index (spot)	0.14%	0.44%	1.01%	0.16%

While bullish flattenings of the yield curve have been bullish for equities, they trade more in competition with sovereign debt. This has led to a stall in the U.S. and to a weak downtrend in the EAFE that will reverse only in the face of better earnings growth than we have seen so far. The EM index has been one pocket of strength.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.24%	0.69%	9.65%	18.12%
North America	0.10%	1.25%	11.97%	19.67%
Latin America	1.29%	5.31%	24.18%	13.67%
Emerging Market Free	1.47%	4.15%	15.78%	15.31%
EAFE	0.43%	-0.12%	6.40%	15.90%
Pacific	1.16%	2.47%	7.18%	9.48%
Eurozone	-0.22%	-3.36%	5.03%	21.35%

CTA and macro-oriented CTA/hedge fund performance had a second consecutive strong week – isn't this what they are supposed to do? - once again confirming previous observations they are exposed heavily to the long equity trade outside of the Eurozone. The strength in the USD and in high-grade sovereign debt has provided two easy trends to trade as well.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.66%	2.87%	3.46%	3.94%
Newedge Trend	1.00%	1.57%	3.16%	2.95%
Newedge Short-Term	0.43%	0.41%	1.73%	3.16%
HFR Global Hedge Fund	0.49%	0.08%	1.94%	3.99%
HFR Macro/CTA	0.95%	0.43%	0.27%	-0.82%
HFR Macro: Sytematic Diversified CTA	0.87%	0.41%	-2.27%	-0.66%