The Macro Environment For Financial Markets

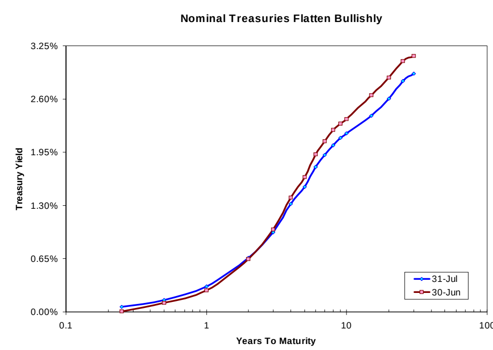
The most recent revision of GDP confirmed what most have felt over the past six years, a very slow-growth economy. Normally, sharp recessions have sharp rebounds, but not this time. The principal reason is we borrowed so much consumption from the future by forcing interest rates artificially low. This raised expectations future interest rates would be high; this discouraged investment and kept productivity growth suppressed. We might as well get used to slow growth because with China on the precipice, the Eurozone spinning its wheels and emerging markets in a funk, it is the best we can achieve.

The causal chain now is:

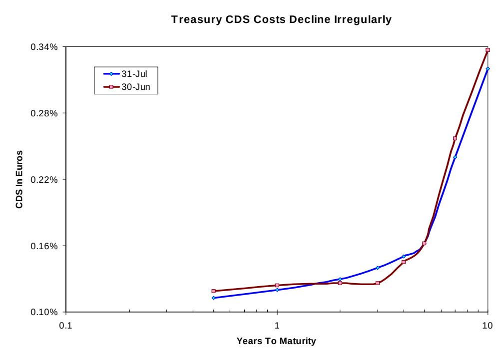
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point, arguably as early as September;
2. Disinflationary pressures have ended without a noticeable shift to rising inflationary pressures;
3. Inflation expectations as measured by the 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 have stopped terming out commercial paper into the bond market and once again are accepting 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

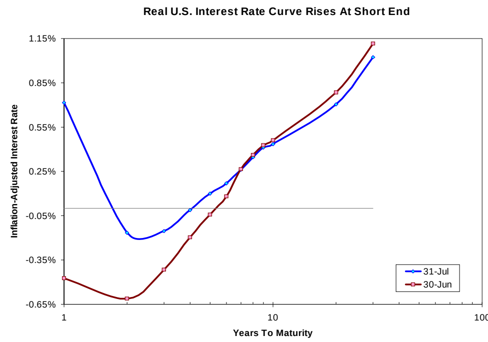
The bullish flattening of the yield curve has put ten-year UST right at the key resistance level of 2.15%. The more the market expects a hike in short-term rates within a still tepid growth environment with declining inflation expectations, the more attractive long-term UST look. In addition, the general sense liquidity will disappear elsewhere in fixed-income markets at the first sign of trouble makes UST compelling.



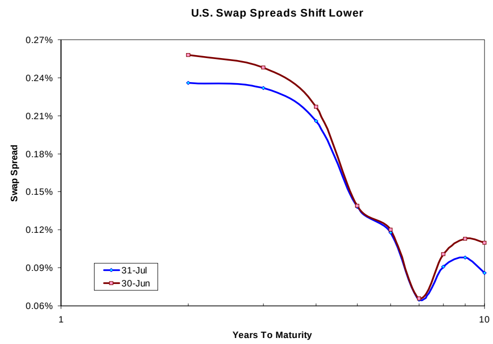
This market continues to have little reason to shift in either direction. Interestingly, though, the long end of this curve has come down over the past month.



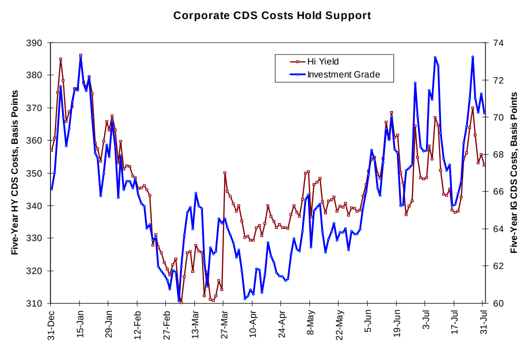
Pseudo-real rates continue to move higher at the short end of the yield curve. However, this did not push the precious metals lower this week. The small decline in long-term pseudo-real rates is supportive for risky financial assets.



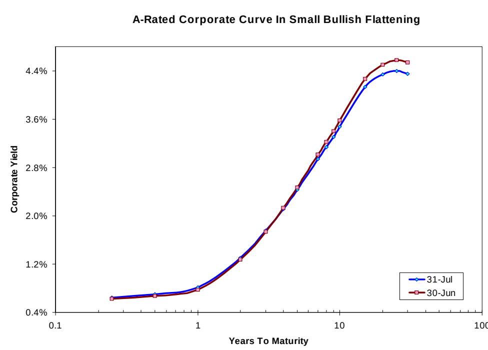
Swap spreads, which rise when floating-rate borrowers want to fix their payments, declined at both the short and long ends of the yield curve over the past month. The small decline at nine- and ten-year tenors is consistent with the decline in long-term UST rates. The decline at the short end reflects a growing sense any hike in short-term rates will be singular.



The continued high level of volatility in CDS indices is related to declining liquidity in the single-name CDS market. On a more fundamental basis, there simply is no reason to expect a deterioration of credit quality outside of the high-yield energy and mining sectors right now, nor is there any reason to believe monetary policy will loosen and lead to a further compression of CDS costs.



The A-rated yield curve is following the UST curve in a small bullish flattening. 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. Conversely, the bullish flattening noted here is supportive of risky financial assets.



Market Structure

The speed of declines amongst physical commodities slowed, but nothing yet suggests an impending set of reversals. Within the financial markets, the EAFE and S&P 500 indices moved into choppy transitional structures. Both the dollar index and ten-year UST remained in uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Aug. 3 - 7
BBerg	29	Trending	-0.526	12.0%	-0.14%
BBerg Grain	29	Trending	-0.343	23.0%	-0.30%
BBerg Ind. Metl	17	Transitional	-0.218	17.2%	
BBerg Pre. Metl	5	Sideways	0.010	16.2%	
BBerg Softs	27	Trending	-0.269	15.9%	-0.79%
BBerg Nat. Gas	23	Trending	-0.122	21.8%	-0.09%
BBerg Petroleum	4	Sideways	-0.046	26.8%	
BBerg Livestock	22	Trending	-0.163	12.9%	-0.10%
Dollar Index	29	Trending	0.095	8.8%	0.15%
S&P 500 Index	17	Transitional	0.016	7.9%	
EAFE Index	16	Transitional	0.048	8.8%	
EM Index	16	Transitional	-0.234	9.8%	
Ten-year UST (price)	29	Trending	0.192	6.2%	0.86%

Performance Measures

The economically important Energy and Industrial Metals indices continued their strong declines as marginal suppliers remain in production. The rain rally seen a month ago in Grains has reversed predictably; as noted at the time, such rallies tend to dissipate as do frost-driven rallies in September. Interestingly, the Precious Metals stabilized even in the face of higher short-term interest rates; the news stories about gold's demise may have marked a short-term peak in bearishness.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.61%	-9.90%	-11.75%	-27.76%
Grains Sub-Index	-3.85%	-12.56%	-6.69%	-10.53%
Corn	-5.48%	-13.42%	-9.47%	-7.16%
Soybeans	-2.56%	-8.73%	-2.89%	-10.76%
Wheat	-2.44%	-15.45%	-3.65%	-11.20%
Energy Sub-Index	-2.35%	-12.59%	-13.06%	-46.85%
Petroleum Sub-Index	-2.43%	-15.23%	-14.50%	-51.09%
WTI	-2.12%	-17.76%	-20.25%	-55.88%
Brent	-3.63%	-15.79%	-16.20%	-55.95%
ULSD	-2.98%	-14.38%	-14.34%	-44.08%
Gasoline	-0.58%	-10.63%	-0.79%	-38.93%
Natural Gas	-2.12%	-4.26%	-8.95%	-37.99%
Precious Metals Sub-Index	1.08%	-5.85%	-13.99%	-19.22%
Gold	0.84%	-6.06%	-13.42%	-15.84%
Silver	1.77%	-5.25%	-15.54%	-28.65%
Industrial Metals Sub-Index	-1.32%	-8.40%	-14.08%	-26.37%
Copper	-0.80%	-10.17%	-8.65%	-26.86%
Aluminum	-1.46%	-6.65%	-16.87%	-22.28%
Nickel	-2.36%	-9.63%	-28.46%	-41.02%
Zinc	-1.91%	-5.36%	-11.98%	-19.80%
Softs Sub-Index	0.00%	-8.04%	-19.87%	-34.52%
Coffee	2.45%	-1.69%	-26.08%	-40.98%
Sugar	-0.89%	-9.43%	-24.52%	-42.31%
Cotton	-0.66%	-4.72%	2.69%	1.98%
Livestock Sub-Index	0.65%	-4.41%	-3.64%	-16.08%
Cattle	1.25%	-5.55%	1.27%	-3.78%
Hogs	-0.47%	-2.18%	-11.47%	-34.82%

The currency picture turned much more mixed as the GBP, AUD and NZD rose and the EUR traded sideways. However, the weakness in emerging market currencies in general and South American currencies in particular remains. The MXN diverged from its Latin neighbors, but this is likely a short-term affair. Until the Federal Reserve signals a policy reversal, the USD will remain in a general bull market.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.00%	-1.46%	-3.15%	-17.97%
Chinese yuan	0.00%	-0.14%	0.81%	-0.58%
Japanese yen	-0.06%	-1.12%	-5.10%	-17.02%
British pound	0.74%	-0.57%	3.88%	-7.49%
Swiss franc	-0.35%	-3.19%	-3.95%	-5.95%
Canadian dollar	-0.32%	-4.56%	-4.03%	-16.69%
Australian dollar	0.36%	-5.18%	-6.34%	-21.38%
Swedish krona	-0.46%	-3.92%	-3.57%	-20.03%
Norwegian krone	0.27%	-4.03%	-6.52%	-23.18%
New Zealand dollar	0.21%	-2.56%	-9.76%	-22.45%
Indian rupee	-0.15%	-0.76%	-3.64%	-5.58%
Brazilian real	-1.94%	-9.31%	-20.28%	-33.84%
Mexican peso	0.98%	-2.30%	-7.71%	-17.95%
Chilean peso	-1.61%	-4.88%	-6.17%	-14.85%
Colombian peso	-0.96%	-9.53%	-16.42%	-34.85%
Bloomberg-JP Morgan Asian dollar index (spot)	0.03%	-1.20%	-1.46%	-4.89%

There is no alternative to the TINA argument. Each rapid downturn over the past ten months has fizzled as potential sellers disappear. The only primary directional trend in global equity markets remains the downward one in emerging markets.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	1.17%	1.83%	6.74%	5.50%
North America	1.27%	1.67%	6.23%	9.16%
Latin America	1.23%	-8.35%	-8.39%	-30.34%
Emerging Market Free	-0.90%	-6.87%	-4.55%	-13.07%
EAFE	1.02%	2.08%	7.55%	0.15%
Pacific	0.49%	-0.08%	7.30%	1.08%
Eurozone	0.63%	3.96%	7.92%	-0.10%

CTAs continue to struggle in choppy downward markets. The only saving grace is their numbers are declining and trades will be less crowded. Hedge funds managed small gains as small bullish trends in fixed-income markets and modest equity gains established a favorable environment.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.01%	3.26%	-4.21%	20.18%
Newedge Trend	0.01%	0.85%	-4.25%	13.45%
Newedge Short-Term	-0.42%	0.50%	-6.64%	4.31%
HFR Global Hedge Fund	-0.32%	-0.04%	1.52%	-0.70%
HFR Macro/CTA	0.37%	2.83%	-0.54%	6.56%
HFR Macro: Sytematic Diversified CTA	0.72%	4.13%	-2.27%	6.88%