# The Macro Environment For Financial Markets

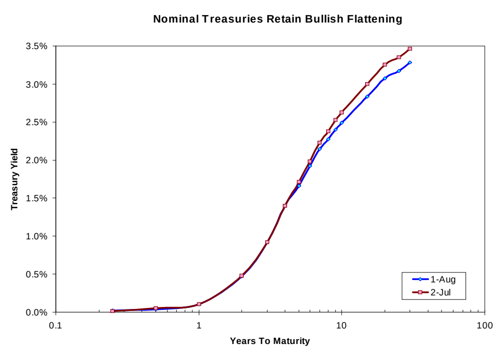
When you get to the endzone, act like you have been there before. When you encounter a risk-off shift at the start of a normal correction, act like you have seen it before. One trigger for the selloff mid-week in Treasuries, higher GDP growth, hardly constitutes bad news, especially when blended with the Federal Reserve's continued reticence to raise rates and trigger financial anxiety. The world has survived Argentine defaults before and always returns to be abused again by that ongoing tragic excuse for a self-governing country. Those who have wished for higher volatility will receive it, at least for the short-term, but while valuations limit the upside and little good news populates the headlines, we simply are not poised for a major downturn.

The causal chain is now:

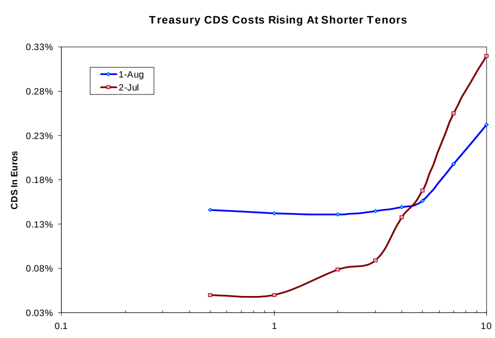
1. Short-term interest rates will remain artificially low and will keep real rates negative below the middle range of the yield curve;
2. The longer-term uptrend in senior sovereign debt remains intact but is facing increasing resistance;
3. Inflation expectations as measured by the TIPS market will 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 and in recognition of the illiquidity created in bond markets by regulatory constraints for commercial banks.

**Key Market Indications**

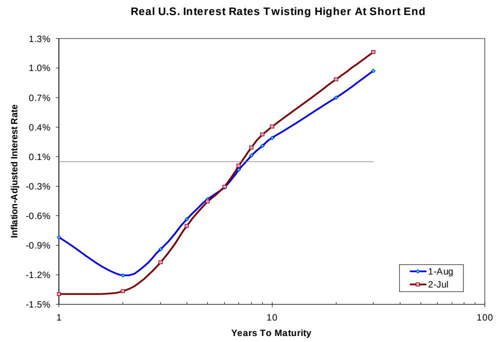
The Treasury yield curve remains in its long-term trend toward a bullish flattening triggered, ironically, by anticipation of higher short-term rates. This has raised risk aversion throughout markets and made high-quality sovereign debt attractive to risk-averse investors whose long-held fears of higher equity and corporate debt valuations finally came to pass.



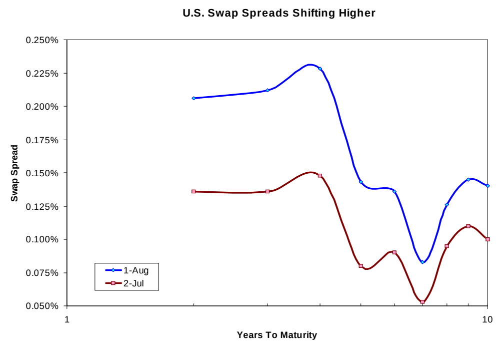

Euro-denominated CDS costs on U.S. Treasuries rose at shorter-dated tenors. While there are no budgetary issues yet, the dysfunction of Congress was on display again, this time in response to immigration-related issues, and that raises the probability of future fiscal squabbles.



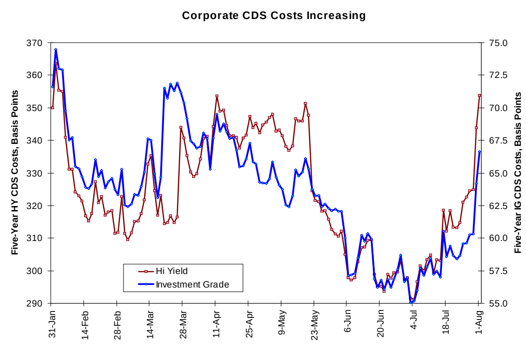
Real rates remain negative out to the seven-year horizon. The increase at short-dated maturities is a negative for precious metals. The decline at longer maturities is normally bullish for risky financial assets, but this factor is overwhelmed easily during risk-off periods.



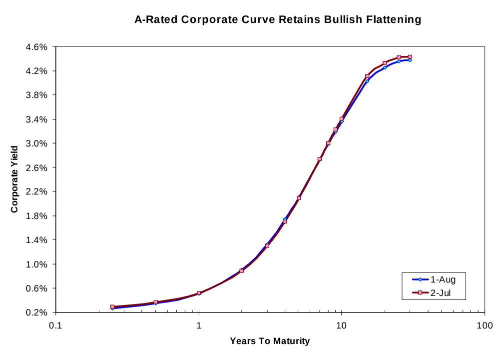

Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue to shift higher across tenors with greater increases occurring at the short end. This trend is a definite impediment to further compression in corporate bonds' credit spreads.




Five-year CDS costs for both investment-grade and high-yield bonds shot higher following the Argentine default. 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. Such an offset is unlikely mathematically.




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**

None of the physical commodity markets are in structural trends. The dollar index and ten-year Treasuries remain structural uptrend, both as risk-off trades. The EAFE remains in a downtrend structure and likely will be joined there soon by the S&P 500 and the EM index.

| | N-Day Speed | Market Structure | Trend Oscillator | HLC Volatility | Daily Trend Rate For Aug. 4 - 8 |
|---|---|---|---|---|---|
| BBerg | 8 | Sideways | -0.162 | 6.0% | |
| BBerg Grain | 8 | Sideways | -0.086 | 17.2% | |
| BBerg Ind. Metl | 12 | Transitional | -0.088 | 12.4% | |
| BBerg Pre. Metl | 16 | Transitional | -0.096 | 11.7% | |
| BBerg Softs | 27 | Trending | 0.066 | 16.4% | |
| BBerg Nat. Gas | 5 | Sideways | 0.011 | 23.8% | |
| BBerg Petroleum | 10 | Sideways | -0.197 | 9.1% | |
| BBerg Livestock | 12 | Transitional | -0.172 | 12.8% | |
| Dollar Index | 29 | Trending | 0.356 | 2.8% | 0.06% |
| S&P 500 Index | 17 | Transitional | -0.298 | 7.8% | |
| EAFE Index | 26 | Trending | -0.317 | 7.1% | -0.03% |
| EM Index | 29 | Trending | -0.043 | 6.0% | |
| Ten-year UST (price) | 29 | Trending | 0.069 | 4.5% | 0.01% |

**Performance Measures**

Softs continued their rebound but all other subindices turned lower including the macro-sensitive Industrial Metals and Energy groups. The downturn in Precious Metals remains a function of less-negative short-term real rates.

**Commodity Total Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| **Bloomberg Index** | -1.71% | -5.31% | -0.96% | 1.16% |
| **Grains Sub-Index** | -2.03% | -10.02% | -12.33% | -14.35% |
| Corn | -2.89% | -13.92% | -21.52% | -27.41% |
| Soybeans | -2.31% | -6.61% | -2.38% | 9.91% |
| Wheat | -0.70% | -7.81% | -11.37% | -24.41% |
| **Energy Sub-Index** | -2.30% | -7.61% | -6.22% | 2.50% |
| Petroleum Sub-Index | -3.22% | -5.18% | 3.28% | -2.03% |
| WTI | -4.12% | -5.44% | 5.58% | -2.10% |
| ULSD | -1.96% | -2.63% | -2.44% | -5.28% |
| Gasoline | -3.38% | -7.99% | 4.27% | -4.61% |
| Natural Gas | 0.29% | -13.58% | -24.52% | 9.18% |
| **Precious Metals Sub-Index** | -0.93% | -2.47% | 3.60% | -0.88% |
| Gold | -0.80% | -2.05% | 3.35% | -1.43% |
| Silver | -1.28% | -3.62% | 4.31% | 1.23% |
| **Industrial Metals Sub-Index** | -1.66% | -0.98% | 11.31% | 7.71% |
| Copper | -0.80% | -1.98% | 1.32% | 1.45% |
| Aluminum | -1.19% | 1.68% | 13.78% | 0.78% |
| Nickel | -4.22% | -7.55% | 32.00% | 29.34% |
| Zinc | -2.14% | 4.36% | 18.79% | 21.04% |
| **Softs Sub-Index** | 0.31% | -1.34% | 8.62% | 3.89% |
| Coffee | 7.37% | 11.96% | 35.30% | 48.35% |
| Sugar | -4.61% | -8.20% | -7.92% | -14.44% |
| Cotton | -3.18% | -12.20% | -19.78% | -20.62% |
| **Livestock Sub-Index** | -3.05% | -5.47% | 12.26% | 18.73% |
| Cattle | -2.38% | -1.11% | 15.90% | 23.84% |
| Hogs | -4.15% | -12.01% | 8.25% | 12.16% |

The USD continued to advance across the board on a generalized risk retrenchment. This has yet to produce a wave of dollar carry trade unwinding in emerging markets, but the potential definitely exists if anticipation of higher short-term rates in the U.S. continues to build.

**Currency Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| Euro | -0.02% | -1.84% | -0.72% | 1.67% |
| Japanese yen | -0.75% | -1.05% | -1.59% | -2.99% |
| British pound | -0.91% | -1.92% | 3.16% | 11.25% |
| Swiss franc | -0.11% | -2.03% | -0.55% | 3.42% |
| Canadian dollar | -0.95% | -2.60% | 1.86% | -5.22% |
| Australian dollar | -0.89% | -1.95% | 6.39% | 4.34% |
| Swedish krona | -0.55% | -2.45% | -4.58% | -3.66% |
| Norwegian krone | -0.90% | -1.69% | 0.22% | -5.15% |
| New Zealand dollar | -0.46% | -2.95% | 5.32% | 7.89% |
| Indian rupee | -1.77% | -1.81% | 2.27% | -1.21% |
| Brazilian real | -1.24% | -2.47% | 8.09% | 2.06% |
| Mexican peso | -1.79% | -1.82% | 2.68% | -2.72% |
| Chilean peso | -1.84% | -3.68% | -2.32% | -10.15% |
| Colombian peso | -1.38% | -0.82% | 9.10% | 1.23% |
| Bloomberg-JP Morgan Asian dollar index (spot) | -0.17% | -0.15% | 0.94% | 0.55% |

Anticipation of an earlier than expected rise in U.S. short-term rates combined with the Argentine default and some high-profile earnings misses in the technology sector. A selloff in corporate debt and the potential for a liquidity vacuum there pushed global equities lower.

**Equity Total Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| **MSCI World Free** | -2.41% | -2.71% | 8.31% | 14.70% |
| North America | -2.60% | -2.25% | 9.50% | 15.48% |
| Latin America | -3.48% | 1.60% | 20.77% | 10.30% |
| Emerging Market Free | -1.67% | 1.41% | 15.36% | 14.31% |
| EAFE | -2.13% | -3.38% | 6.59% | 13.57% |
| Pacific | -0.58% | 0.65% | 9.37% | 11.43% |
| Eurozone | -3.36% | -7.20% | 3.61% | 14.67% |

CTA's and macro-oriented hedge funds had been riding the long side of equity markets and had a bad week. The net damage was offset by continued strength in the USD and in high-grade sovereign debt; these have been favored positions.

**CTA/Hedge Fund Returns**

| | Five-Days | One Month | Six Months | One Year |
|---|---|---|---|---|
| Newedge CTA | -0.26% | 1.78% | 5.16% | 4.24% |
| Newedge Trend | -0.11% | 0.85% | 4.20% | 3.06% |
| Newedge Short-Term | -0.13% | -0.38% | -0.73% | 3.02% |
| HFR Global Hedge Fund | -0.82% | -0.88% | 1.12% | 3.31% |
| HFR Macro/CTA | -0.38% | 0.52% | -0.15% | -0.40% |
| HFR Macro: Sytematic Diversified CTA | -1.02% | -0.35% | -3.25% | -0.97% |