The Macro Environment For Financial Markets

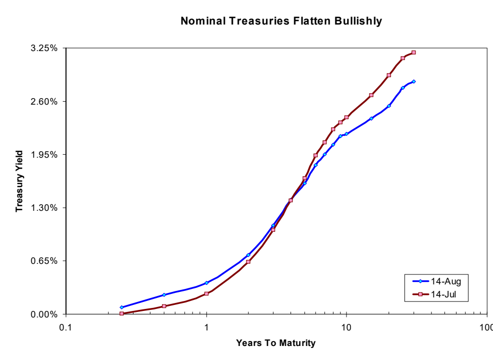
We should ask ourselves whether the upside of lower financial market liquidity is a lower level of panic when markets are shocked; restated, do fewer traders produce less mischief? The unmistakable mess in China and their willingness to impoverish their own citizens' global purchasing power and damage both their competition in export markets and suppliers in their import markets might have had a greater downside if this were, say, 1997 or certainly 2008. Now markets shrug, say they know everything is overvalued but what are you going to do? Speculation rose the Federal Reserve would postpone a rate hike in September; the betting here is they will proceed with this hike out of institutional imperatives and try to justify it with some gibberish about labor market slack before taking the consent-decree route of saying they have done nothing wrong but promise never to do it again.

The causal chain now is:

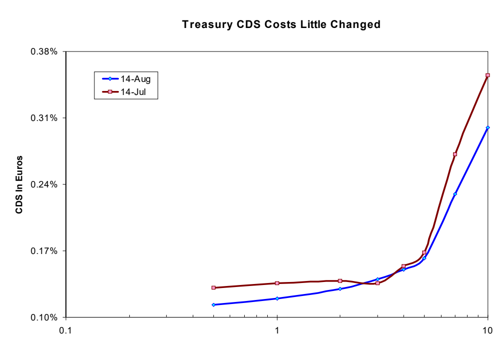
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point;
2. Disinflationary pressures are dominate inflationary pressures;
3. Inflation expectations as measured by the TIPS market appear poised to test their January lows;
4. The U.S. yield 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 are starting to rise under industry stresses in the energy, mining and media sectors.

Key Market Indications

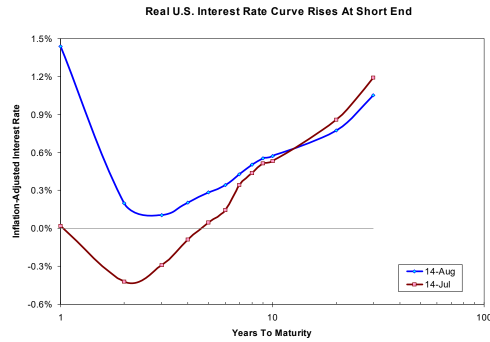
The bullish flattening of the yield curve has put ten-year UST just over key resistance at 2.15%. However, whenever markets do not react as we might expect, the information content is high. A much more bullish move might have been expected given the Chinese shock and the equity selloff outside of the U.S. Instead, rates hit resistance and auctions were received with tepid enthusiasm. The sharp selloff in all long-term sovereign bonds earlier in the year remains fresh in memory.



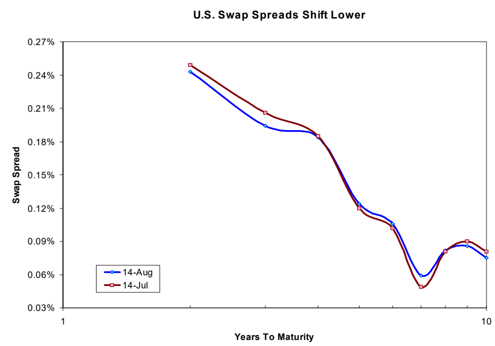
This market continues to have little reason to shift in either direction. This will change only if the federal government finds itself confronted with higher borrowing costs and lower tax receipts.



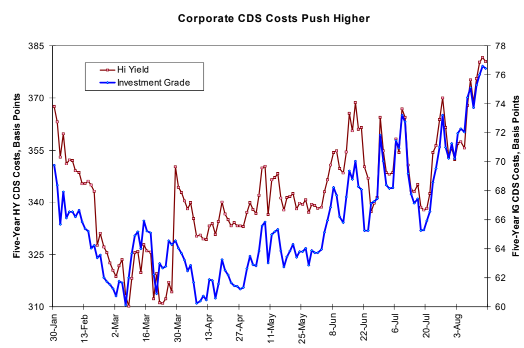
Pseudo-real rates continue to move higher at the short end of the yield curve and are now positive at all maturities. However, this did not push the precious metals lower this week for a third week in a row. Long-term pseudo-real rates have declined as an artifact of the continued decline in long-term interest rates.



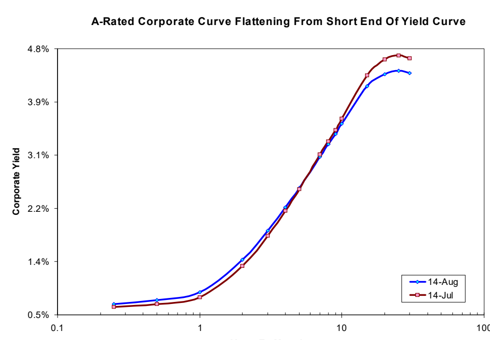
Swap spreads, which rise when floating-rate borrowers want to fix their payments, declined at both the short and long ends of the yield curve over the past month. The small decline at nine- and ten-year tenors is consistent with the decline in long-term UST rates. The decline at the short end reflects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



The continued increase in corporate bond CDS costs is related to the turmoil in sectors such as energy, mining and media. Slower growth in China and downward price pressure from their exports are a negative for earnings. The rise in corporate bond risk is a negative for financial markets, period.



The A-rated yield curve is following the UST curve in a small bullish flattening driven by higher short-term rates. 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 hard moves lower in the physical commodities have taken all but the Grains, Softs and Natural Gas out of structural downtrends and put them into consolidations. Only ten-year UST remain in a structural uptrend within the financial markets. The EM index has fallen into a structural downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Aug. 17 - 21
BBerg	4	Sideways	-0.025	13.6%	
BBerg Grain	29	Trending	-0.294	22.3%	-0.31%
BBerg Ind. Metl	4	Sideways	0.000	21.9%	
BBerg Pre. Metl	11	Transitional	0.081	15.2%	
BBerg Softs	29	Trending	-0.055	15.5%	-0.79%
BBerg Nat. Gas	28	Trending	-0.045	19.1%	-0.09%
BBerg Petroleum	5	Sideways	-0.041	26.4%	
BBerg Livestock	14	Transitional	-0.009	13.3%	
Dollar Index	12	Transitional	-0.088	8.9%	
S&P 500 Index	26	Trending	-0.040	8.8%	
EAFE Index	26	Trending	-0.164	9.4%	
EM Index	26	Trending	-0.485	10.1%	-0.30%
Ten-year UST (price)	27	Trending	0.099	5.8%	0.86%

Performance Measures

You cannot grow grains in secret and yet the USDA reports continually wrong-foot the markets. In an opposite vein, cotton and coffee surprised markets with expected supply shortfalls. Neither the economically important Petroleum or Industrial Metals indices declined by as much as we might have expected following the Chinese news; this highlights once again the difficulty of trading physical commodities from the short side. Try though we might, we cannot push them to zero.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.14%	-9.10%	-13.50%	-28.07%
Grains Sub-Index	-2.68%	-12.72%	-8.66%	-12.41%
Corn	-2.15%	-14.83%	-11.31%	-11.10%
Soybeans	-4.85%	-10.58%	-5.61%	-12.81%
Wheat	-0.73%	-11.25%	-5.09%	-10.28%
Energy Sub-Index	0.25%	-11.69%	-17.76%	-48.19%
Petroleum Sub-Index	0.15%	-15.33%	-21.47%	-52.86%
WTI	-2.68%	-20.17%	-27.37%	-58.73%
Brent	0.04%	-16.09%	-24.48%	-57.53%
ULSD	1.05%	-10.44%	-20.18%	-44.20%
Gasoline	4.39%	-9.42%	-5.60%	-39.88%
Natural Gas	0.50%	-0.95%	-6.77%	-37.62%
Precious Metals Sub-Index	1.95%	-2.93%	-10.48%	-18.08%
Gold	1.70%	-3.72%	-9.65%	-15.85%
Silver	2.64%	-0.67%	-12.72%	-24.66%
Industrial Metals Sub-Index	-0.38%	-8.25%	-15.08%	-26.88%
Copper	0.58%	-7.45%	-10.20%	-24.66%
Aluminum	-0.69%	-7.72%	-16.53%	-24.69%
Nickel	-1.89%	-8.93%	-28.19%	-44.19%
Zinc	-1.67%	-11.16%	-15.82%	-21.16%
Softs Sub-Index	3.91%	-6.83%	-20.32%	-31.30%
Coffee	7.83%	4.40%	-20.11%	-32.20%
Sugar	0.19%	-15.50%	-29.63%	-43.17%
Cotton	6.73%	-0.27%	2.80%	2.47%
Livestock Sub-Index	-0.09%	-1.30%	-1.03%	-9.35%
Cattle	-1.13%	-2.31%	0.16%	2.52%
Hogs	1.87%	0.62%	-2.57%	-27.87%

If anyone looked at the right-angle on Swiss franc charts in January and said, “markets don’t move like that,” they were proven wrong in the Chinese case this past week. The ensuing turmoil increased speculation the U.S. would postpone its first rate hike, and that led to USD weakness against European currencies even as Latin American and Asian currencies continued their declines.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.29%	0.91%	-2.17%	-16.88%
Chinese yuan	-2.84%	-2.85%	-2.22%	-3.73%
Japanese yen	-0.06%	-0.73%	-4.69%	-17.59%
British pound	0.97%	0.04%	1.82%	-6.26%
Swiss franc	0.84%	-3.17%	-4.49%	-7.09%
Canadian dollar	0.33%	-2.75%	-4.75%	-16.70%
Australian dollar	-0.53%	-0.98%	-5.07%	-20.82%
Swedish krona	3.04%	-0.14%	-1.05%	-19.39%
Norwegian krone	0.56%	-1.50%	-7.97%	-25.11%
New Zealand dollar	-1.13%	-2.50%	-12.72%	-22.91%
Indian rupee	-1.83%	-2.48%	-4.38%	-6.52%
Brazilian real	0.70%	-9.84%	-18.61%	-34.92%
Mexican peso	-1.33%	-4.35%	-8.85%	-20.17%
Chilean peso	-1.03%	-6.15%	-9.18%	-15.58%
Colombian peso	-1.86%	-10.24%	-20.14%	-37.13%
Bloomberg-JP Morgan Asian dollar index (spot)	-2.02%	-2.91%	-3.95%	-7.39%

The long-running trading range in the U.S. continues to outperform the EAFE and EM indices by a wide margin in USD terms. This can persist for a surprisingly long time; lost in the collective memory is the extent to which now-odiferous markets such as Brazil outperformed the U.S. for almost the entire decade of the 2000s.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.11%	-1.25%	0.97%	4.14%
North America	0.69%	-0.93%	0.20%	7.21%
Latin America	-2.45%	-14.25%	-17.58%	-35.64%
Emerging Market Free	-2.31%	-7.83%	-10.84%	-17.22%
EAFE	-1.35%	-1.76%	2.21%	-0.46%
Pacific	-1.67%	-1.53%	3.00%	0.28%
Eurozone	-2.33%	-1.95%	1.52%	-0.39%

The whole premise of the alternative investment industry is to profit from higher volatility and to generate alpha independent of market direction. They handled the market disruptions of the past week poorly by definition.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.98%	3.37%	-1.42%	22.58%
Newedge Trend	-0.96%	1.87%	-2.16%	15.41%
Newedge Short-Term	-0.63%	-0.79%	-6.39%	1.90%
HFR Global Hedge Fund	-0.55%	-1.25%	-0.41%	-0.84%
HFR Macro/CTA	-0.74%	0.32%	-1.37%	6.79%
HFR Macro: Sytematic Diversified CTA	-0.58%	1.73%	-1.72%	7.42%