The Macro Environment For Financial Markets

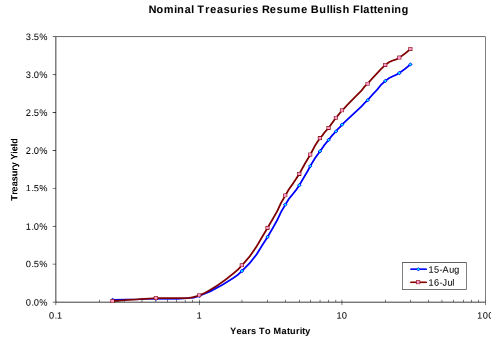
It is best to conceive of investor risk acceptance and aversion as being divided into two linked but non-overlapping pools. Commercial banks increasingly are in the risk-averse pool; regulatory restrictions and capital charges have forced them into accepting the extreme duration risk of sovereign debt as they can hold this asset cheaply and be relatively confident of liquidity on the way out. The lower return on sovereign debt is forcing other investors toward assuming credit risk and, knowingly or otherwise, prospective liquidity risk. When the time comes to sell stocks and high-yield debt, there will not be enough living to bury the dead. The paradox of all this is the best news for those assuming credit and liquidity risks is the same bad news for those assuming duration risk. The idea central banks are going to torpedo both classes of investors and simultaneously increase the cost of government debt service is preposterous: They can keep expanding their balance sheets indefinitely but cannot afford one mistake either in tightening credit or raising short-term interest rates.

The causal chain is now:

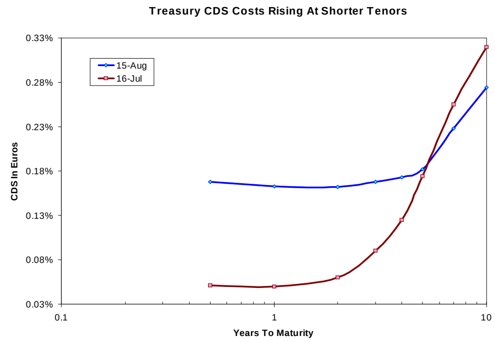
1. Short-term interest rates will remain artificially low and will keep real rates negative below the middle range of the yield curve;
2. The longer-term uptrend in senior sovereign debt has resumed and might hit April-May 2013 levels in the U.S. while continuing lower in the Eurozone;
3. Inflation expectations as measured by the TIPS market have retreated to their support point and will be forced lower if and when nominal UST yields affirm their downtrend;
4. Short-term borrowers will continue to accept rollover risk and keep their effective maturities as short as possible;
5. Swap spreads have stopped increasing, eliminating one impediment to lower corporate bond yields, but are unlikely to retreat significantly over the short-term; and
6. Credit spreads moved back toward first resistance. A further retreat will depend on the lack of a macroeconomic shock.

Key Market Indications

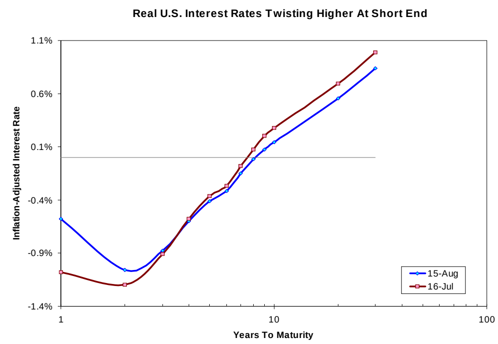
The posited bull trap noted last week reversed quickly on Thursday and Friday as some weaker economic data and the haven bid emerging from Ukraine tensions. The increased demand from commercial banks for low capital-cost assets is leading toward an overweighting of UST and Bunds. If 2.38% hold, the ten-year UST might test the 2.00% level last seen in the spring of 2013.



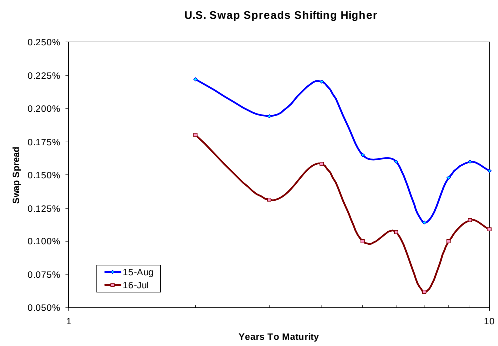
Euro-denominated CDS costs on U.S. Treasuries remain elevated at shorter-dated tenors. The market is pricing in future fiscal dysfunction in Congress, something that no doubt will increase if control of the Senate shifts after the November elections.



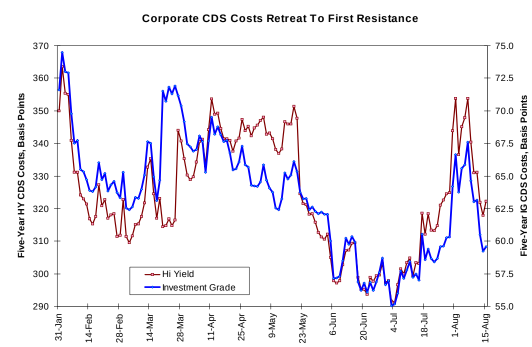
Real rates remain negative out to the eight-year horizon. The increase at short-dated maturities is a negative for precious metals. The decline at longer maturities is normally bullish for risky financial assets. This factor is overwhelmed easily during risk-off periods, but it will reassert itself if and when the geopolitical news stabilizes.



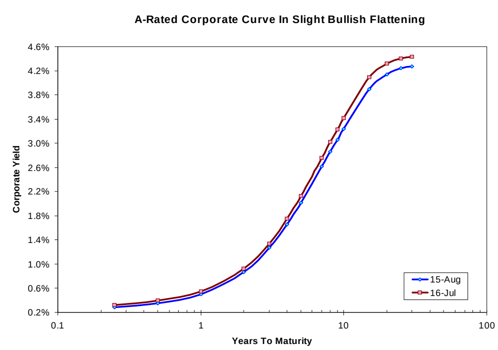
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue to shift higher across tenors with greater increases occurring at the short end. This trend is a definite impediment to further compression in corporate bonds' credit spreads.



Five-year CDS costs for both investment-grade and high-yield bonds narrowed to first resistance. If the drive lower in UST yields continues and the elevated level of swap spreads relaxes, the chase for yield will put downward pressure on these CDS indices barring a significant deterioration in the macroeconomic outlook.



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; there an increased level of risk aversion has pushed yields higher at maturities of two years or less while longer-dated yields remain tame. While the present configuration is not significantly negative for equities, it is not the positive factor it was through July.



Market Structure

Precious Metals and the two energy subindices remain in structural downtrends. While the EM index moved out of a structural downtrend, both the EAFE and the S&P 500 remain in downtrends. The high volatility of ten-year UST prices kept this market in a transitional structure.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For Aug. 18 - 22
BBerg	15	Transitional	-0.184	5.9%	
BBerg Grain	15	Transitional	0.014	16.3%	
BBerg Ind. Metl	16	Transitional	-0.137	12.2%	
BBerg Pre. Metl	25	Trending	-0.090	11.5%	-0.12%
BBerg Softs	18	Transitional	-0.007	19.0%	
BBerg Nat. Gas	12	Transitional	-0.092	21.5%	
BBerg Petroleum	29	Trending	-0.251	9.9%	-0.17%
BBerg Livestock	27	Trending	-0.364	13.6%	-0.34%
Dollar Index	5	Sideways	-0.034	3.2%	
S&P 500 Index	27	Trending	-0.011	8.4%	-0.28%
EAFE Index	29	Trending	-0.219	8.0%	-0.03%
EM Index	16	Transitional	0.095	7.3%	
Ten-year UST (price)	15	Transitional	0.173	5.3%	

Performance Measures

The downturn in the broad Bloomberg commodity index continued as only the economically unimportant Softs subindex and the Grains subindex turned higher. Signs of slower growth in East Asia and in the Eurozone are pushing the economically sensitive Industrial Metals index lower. The implications of this for continued loose credit policies globally are clear.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.27%	-2.77%	-5.35%	-2.96%
Grains Sub-Index	0.39%	-1.23%	-13.59%	-13.80%
Corn	3.83%	-1.61%	-20.09%	-24.47%
Soybeans	-3.02%	-3.06%	-6.43%	2.49%
Wheat	-0.36%	2.81%	-12.71%	-18.88%
Energy Sub-Index	-2.38%	-4.06%	-8.42%	0.51%
Petroleum Sub-Index	-1.62%	-4.02%	-3.59%	-4.49%
WTI	-1.67%	-5.86%	-1.81%	-5.21%
ULSD	-1.01%	-0.33%	-6.04%	-6.19%
Gasoline	-1.84%	-4.65%	-5.14%	-5.33%
Natural Gas	-4.28%	-4.13%	-19.15%	8.67%
Precious Metals Sub-Index	-0.80%	-1.98%	-4.15%	-8.19%
Gold	-0.37%	-0.36%	-1.50%	-4.95%
Silver	-2.08%	-6.51%	-11.31%	-17.12%
Industrial Metals Sub-Index	-1.33%	-1.09%	5.72%	-0.31%
Copper	-2.04%	-2.36%	-4.62%	-7.32%
Aluminum	-1.51%	0.22%	9.95%	-5.18%
Nickel	0.55%	-0.12%	28.14%	22.46%
Zinc	-1.09%	-1.32%	8.41%	9.40%
Softs Sub-Index	1.23%	1.75%	1.92%	-2.24%
Coffee	4.39%	9.52%	18.73%	42.29%
Sugar	-1.36%	-6.19%	-11.03%	-17.43%
Cotton	0.22%	-5.00%	-21.62%	-26.48%
Livestock Sub-Index	-2.59%	-9.13%	2.08%	8.18%
Cattle	-1.50%	-4.26%	7.28%	14.12%
Hogs	-4.40%	-16.38%	-4.41%	0.26%

The GBP retreated as the U.K.'s bias toward higher short-term rates made it an outlier amongst the majors. The JPY lost some of its risk-off haven bid, but the EUR built on last week's resilience and in all likelihood has ended its downturn. The USD retreated elsewhere with the exception of the CLP as it, too, lost much of its haven bid.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.07%	-1.23%	-2.23%	0.40%
Japanese yen	-0.31%	-0.66%	-0.43%	-4.88%
British pound	-0.48%	-2.63%	-0.13%	6.71%
Swiss franc	0.31%	-0.76%	-1.23%	2.60%
Canadian dollar	0.70%	-1.27%	0.62%	-5.42%
Australian dollar	0.51%	-0.51%	3.21%	1.97%
Swedish krona	0.94%	-0.20%	-5.63%	-4.80%
Norwegian krone	1.64%	1.21%	-0.95%	-3.70%
New Zealand dollar	0.27%	-3.23%	1.42%	5.10%
Indian rupee	0.76%	-1.14%	1.91%	1.11%
Brazilian real	1.03%	-1.81%	5.73%	3.57%
Mexican peso	1.33%	-0.97%	1.04%	-1.95%
Chilean peso	-0.22%	-3.39%	-5.25%	-11.47%
Colombian peso	0.28%	-0.85%	7.06%	0.89%
Bloomberg-JP Morgan Asian dollar index (spot)	0.40%	0.53%	0.51%	0.94%

Just as the previous week's risk-off stance ended with Ukraine news on a Friday, this week's retracement of loss also ended with Ukraine news on a Friday. There is no fundamental reason to expect global equities to take out July's highs this week.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	1.47%	-1.39%	5.46%	16.54%
North America	1.31%	-0.58%	7.58%	20.11%
Latin America	2.97%	-0.02%	18.86%	11.88%
Emerging Market Free	2.86%	1.07%	14.44%	15.10%
EAFE	1.71%	-2.57%	2.43%	11.56%
Pacific	2.69%	-0.19%	8.72%	9.58%
Eurozone	0.76%	-5.12%	-3.17%	11.65%

CTA's and macro-oriented hedge funds' continued bias toward the long equity trade and, apparently, toward long high-quality sovereign debt, paid off in a rebound week. While lending ten-year Bunds and UST under 96 and 235 basis points, respectively, are intrinsically risky trades, they have been correlated negatively to equities in the short-term and therefore have been a position diversifier.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.44%	-0.93%	4.37%	0.88%
Newedge Trend	0.89%	-0.86%	3.07%	1.19%
Newedge Short-Term	1.02%	0.84%	0.59%	3.16%
HFR Global Hedge Fund	0.79%	-0.57%	0.50%	3.37%
HFR Macro/CTA	0.56%	-0.20%	0.54%	-0.77%
HFR Macro: Sytematic Diversified CTA	0.65%	-0.67%	-1.41%	-0.89%