The Macro Environment For Financial Markets

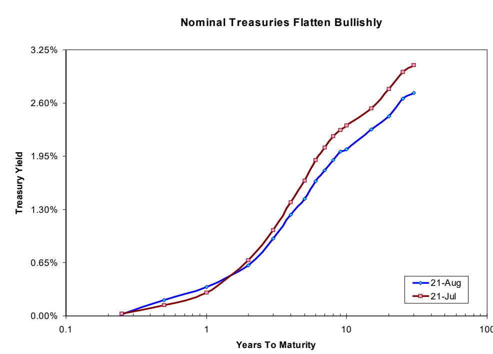
There is news that affects price, news that affects value and news that affects both. The downturn in China and the seeming inability of the Communist Party to address it coherently is news that affects both (as an aside, why do we expect Communists to be adroit managers of an economy?). As such, the principal engine of global growth over the past two decades is going to sputter, and any cursory reading of Chinese history will tell you things can get out hand in a hurry once the central government loses the Mandate of Heaven. This is not a situation amenable to a quick solution, and the rest of the world is going to have to adjust to lower Chinese demand and competition from cheaper Chinese exports. On the other great question of the day, what will the Federal Reserve do, the answer hopefully is nothing in September. If risky assets are being liquidated and put into cash, higher short-term interest rates will necessitate a reduction of commercial banks' balance sheets during a slowdown. We tried that in the 1930s and remember the results as the Great Depression.

The causal chain now is:

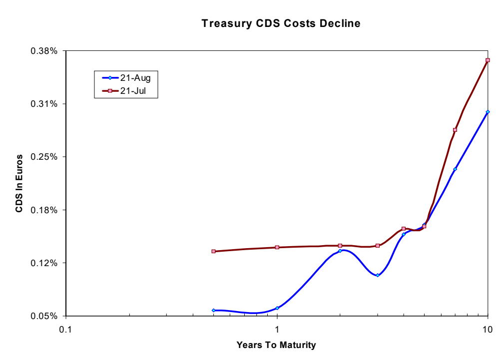
1. Short-term interest rates will remain artificially low globally. The timing of any rate hike in the U.S. has become far more problematic at this point;
2. Disinflationary pressures are dominating inflationary pressures;
3. Inflation expectations as measured by the TIPS market appear poised to at least test and most likely break their January lows;
4. The U.S. yield curve retains its long-term trend toward a bullish flattening, but steepened slightly as short-term rates are falling under the weight of asset liquidation;
5. Short-term borrowers will shift back toward accepting rollover risk;
6. Swap spreads will remain tame until monetary policy indications turn more hawkish; and
7. Credit spreads continue to rise under industry stresses in the energy, mining and media sectors.

Key Market Indications

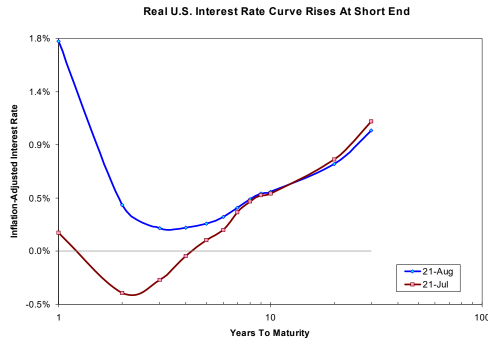
First, the 10-year looks likely to test 1.94%. So saying, the volatility of the last two weeks in currency, commodity and equity markets has not produced the violent flight into the long end of the yield curve we might have seen only a year ago. The memory of last April's swift rejection of negative real sovereign rates remains too fresh in mind for this to occur. As a result, the liquidation of risky assets has moved more into cash than into bonds.



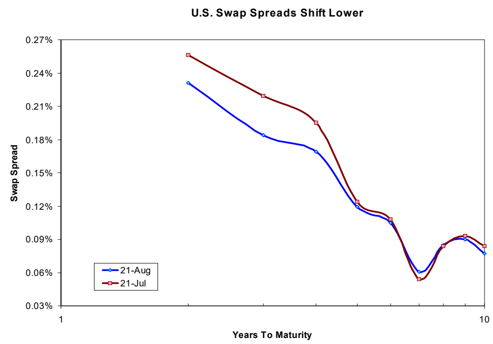
The decline in Treasury CDS costs over the past month reflects an odd combination of higher tax receipts along with expectations of lower nominal debt service costs as markets start to price out the possibility of a short-term rate hike.



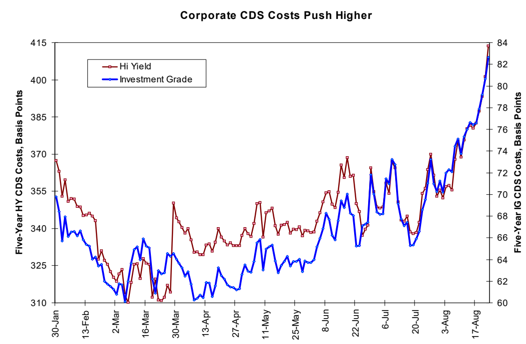
Pseudo-real rates continue to move higher at the short end of the yield curve and are now positive at all maturities. Gold has been rising in the face of these higher rates for a month now, which indicates dominance of its haven role over anything related to monetary conditions. Long-term pseudo-real rates have declined as an artifact of the continued decline in long-term interest rates.



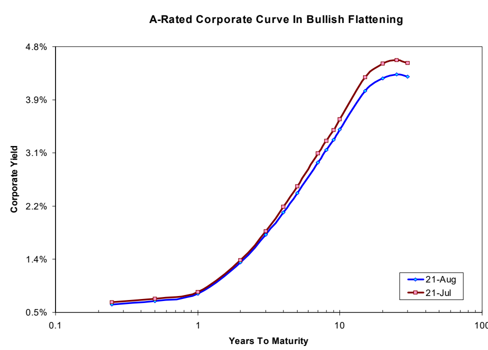
Swap spreads, which rise when floating-rate borrowers want to fix their payments, declined at both the short end of the yield curve over the past month. The decline at the short end reflects a growing sense any hike in short-term rates will be singular and may not occur at all.



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. 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 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 dollar index, dominated by the euro, has entered a downtrend and all of the equity indices are oversold.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Aug. 24 - 28
BBerg	10	Sideways	-0.205	12.3%	
BBerg Grain	11	Transitional	-0.076	26.3%	
BBerg Ind. Metl	8	Sideways	-0.081	17.5%	
BBerg Pre. Metl	16	Transitional	0.229	15.4%	
BBerg Softs	10	Sideways	-0.132	16.5%	
BBerg Nat. Gas	29	Trending	-0.291	18.4%	-0.09%
BBerg Petroleum	10	Sideways	-0.264	24.5%	
BBerg Livestock	15	Transitional	-0.194	12.8%	
Dollar Index	21	Trending	-0.249	8.2%	-0.17%
S&P 500 Index	29	Trending	-0.656	9.4%	-0.08%
EAFE Index	29	Trending	-0.636	9.2%	-0.12%
EM Index	29	Trending	-0.932	10.5%	-0.30%
Ten-year UST (price)	29	Trending	0.272	5.6%	0.86%

Performance Measures

Only gold is showing any support, which has to be more of a "there is no alternative trade" than a financial trade as implied real short-term rates are rising. The other physical commodities are pricing in declining demand in China and its Asian periphery combined with suppliers willing to accept a lower price in order to meet fixed costs. As demand will not go to zero and as suppliers will shut down at some point, we know prices will not go to zero, either. However, until economic growth turns higher, something not in the immediate offing, demand will not rise in response to lower prices in the short-term and all rallies in the Energy and Industrial Metals indices will be short-covering bursts.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.82%	-5.87%	-13.88%	-29.97%
Grains Sub-Index	-1.21%	-6.25%	-8.42%	-13.44%
Corn	0.47%	-6.64%	-8.64%	-10.20%
Soybeans	-2.94%	-7.82%	-10.55%	-14.24%
Wheat	-1.51%	-2.47%	-1.79%	-13.13%
Energy Sub-Index	-6.59%	-12.20%	-20.63%	-51.52%
Petroleum Sub-Index	-7.20%	-15.20%	-23.30%	-56.34%
WTI	-7.04%	-17.56%	-27.00%	-61.46%
Brent	-7.69%	-16.86%	-26.90%	-60.92%
ULSD	-6.01%	-10.49%	-22.28%	-47.69%
Gasoline	-7.70%	-12.26%	-10.67%	-45.34%
Natural Gas	-5.13%	-3.86%	-13.47%	-40.18%
Precious Metals Sub-Index	3.25%	6.47%	-4.23%	-13.10%
Gold	4.22%	6.78%	-3.50%	-9.87%
Silver	0.56%	5.59%	-6.26%	-22.25%
Industrial Metals Sub-Index	-2.59%	-5.98%	-16.72%	-30.81%
Copper	-2.31%	-3.81%	-13.38%	-28.92%
Aluminum	-2.18%	-6.00%	-17.12%	-28.68%
Nickel	-3.77%	-9.85%	-29.44%	-46.49%
Zinc	-3.42%	-9.67%	-15.64%	-26.41%
Softs Sub-Index	-3.58%	-3.69%	-20.29%	-34.25%
Coffee	-10.41%	0.99%	-19.97%	-38.90%
Sugar	-2.25%	-7.11%	-27.85%	-43.48%
Cotton	1.46%	3.52%	1.74%	1.60%
Livestock Sub-Index	-2.67%	-0.78%	-1.76%	-10.81%
Cattle	-2.04%	-0.18%	3.27%	0.67%
Hogs	-3.83%	-1.87%	-9.78%	-28.85%

If fixed-income markets are uncertain about the Federal Reserve, the European currencies and the JPY are not: They are acting as if short-term rates in the U.S. will be moving lower as risky assets are converted into cash. The commodity-linked and emerging market currencies continue to decline as their terms of trade continue to deteriorate.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	2.49%	4.12%	0.45%	-14.27%
Chinese yuan	0.04%	-2.81%	-2.07%	-3.71%
Japanese yen	1.86%	1.52%	-2.65%	-14.90%
British pound	0.33%	0.88%	1.53%	-5.34%
Swiss franc	3.07%	1.25%	0.34%	-3.71%
Canadian dollar	-0.77%	-1.83%	-4.69%	-17.04%
Australian dollar	-0.85%	-1.39%	-6.23%	-21.36%
Swedish krona	1.85%	2.35%	0.73%	-17.51%
Norwegian krone	0.35%	-0.99%	-7.07%	-25.00%
New Zealand dollar	2.12%	0.92%	-11.15%	-20.46%
Indian rupee	-1.25%	-3.46%	-5.34%	-7.83%
Brazilian real	-0.49%	-9.37%	-17.75%	-35.18%
Mexican peso	-3.61%	-5.79%	-11.17%	-22.84%
Chilean peso	-1.96%	-6.71%	-10.77%	-16.63%
Colombian peso	-3.68%	-10.87%	-19.57%	-38.26%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.68%	-3.38%	-4.06%	-8.00%

The long-running trading range in the U.S. broke decisively to the downside as external turmoil and the continued declines in key sectors pulled the U.S. lower. The conditions pulling global equities lower are unlikely to reverse anytime soon, meaning we have further to decline in the U.S.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-5.28%	-6.92%	-5.27%	-2.90%
North America	-5.75%	-6.85%	-6.12%	-0.85%
Latin America	-5.32%	-15.99%	-21.40%	-41.26%
Emerging Market Free	-5.93%	-13.34%	-15.95%	-22.84%
EAFE	-4.53%	-7.03%	-3.91%	-6.00%
Pacific	-4.09%	-7.20%	-3.60%	-4.55%
Eurozone	-5.21%	-7.70%	-4.72%	-6.96%

The equal-weighted CTA index gained on the week, but it was another poor week in volatile markets for both CTAs and hedge funds. The saving grace is they lost less than equities did, which gives them something of a diversification claim.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.13%	2.16%	-0.71%	21.10%
Newedge Trend	-0.56%	0.52%	-1.81%	14.58%
Newedge Short-Term	-0.82%	-1.81%	-6.42%	2.58%
HFR Global Hedge Fund	-0.75%	-2.26%	-1.54%	-2.33%
HFR Macro/CTA	-0.32%	-1.15%	-1.93%	5.54%
HFR Macro: Sytematic Diversified CTA	0.31%	0.37%	-1.56%	7.41%