The Macro Environment For Financial Markets

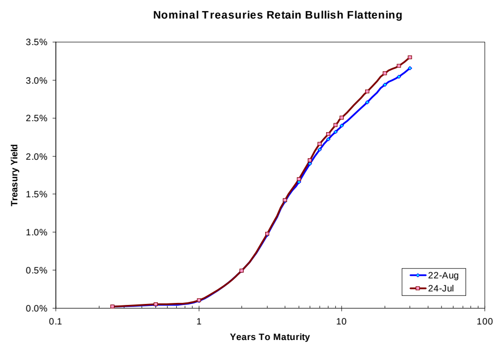
While it is hard to classify anyone's recovery path as robust, the outlook for the U.S. is not negative and the negative outlooks in other major economies such as those of Japan and the Eurozone will encourage easy credit policies there. Those will offset whatever the Federal Reserve may or may not do sometime in 2015 and will lead to carry trades into the USD and to strong relative U.S. performance. While much of the focus on economic slack correctly has been on labor markets, raw material markets are showing the effects of last decade's investment in primary production. Lower physical commodity prices are not synonymous with lower inflation, but they will have the effect of transferring gains from producers to consumers.

The causal chain is now:

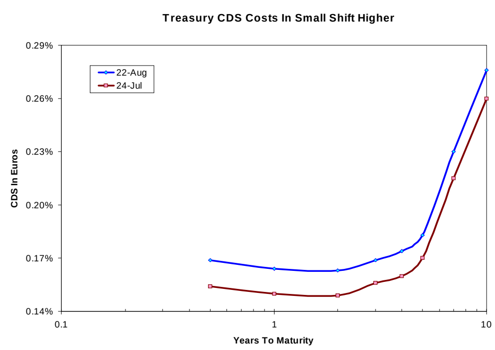
1. Short-term interest rates will remain artificially low and will keep real rates negative below the middle range of the yield curve;
2. The longer-term uptrend in senior sovereign debt remains intact;
3. Inflation expectations as measured by the TIPS market will be forced lower if and when nominal 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 will remain under pressure in the absence of a macroeconomic shock.

Key Market Indications

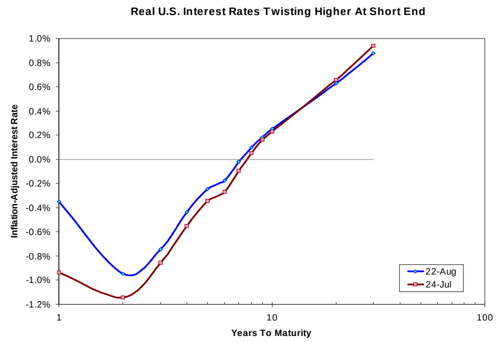
The most significant development in the Treasury yield curve is how the bullish flattening did not dissipate with the renewed move higher in U.S. equities or with the ongoing speculation when the Federal Reserve's first rate hike will be seen. The demand for assets with low capital charges is keeping a bid on long-term Treasuries and other high-quality sovereign debt regardless of other factors historically viewed as bearish.



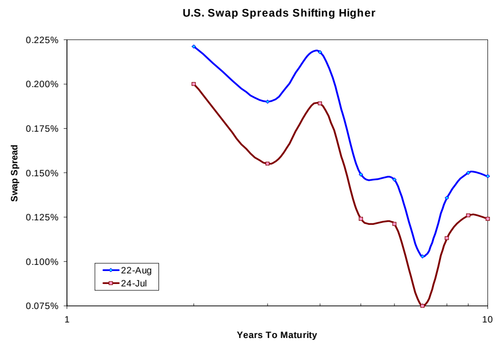
Euro-denominated CDS costs on U.S. Treasuries remain elevated at shorter-dated tenors. The market is pricing in future fiscal dysfunction in Congress, something that no doubt will increase if control of the Senate shifts after the November elections.



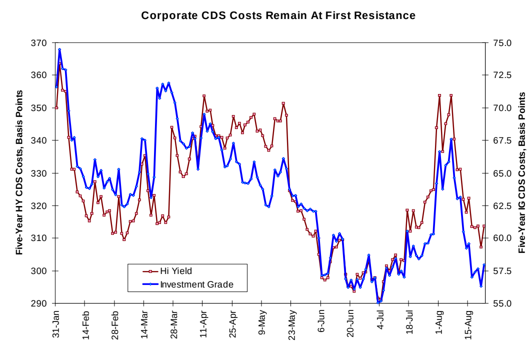
Real rates remain negative out to the seven-year horizon. The increase at short-dated maturities is a negative for precious metals. The decline at longer maturities is minor and while not an impediment to financial assets, it is not a propulsive force, either.



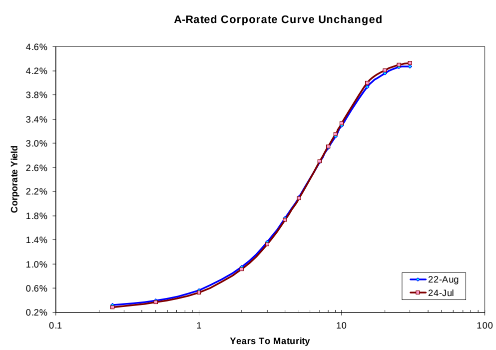
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue to shift higher across tenors with greater increases occurring at the short end. This trend is a definite impediment to further compression in corporate bonds' credit spreads.



Five-year CDS costs for both investment-grade and high-yield bonds remain at the first resistance reached last week. If the drive lower in UST yields resumes 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 did not follow the Treasury's bullish flattening as investors are contemplating future illiquidity in corporate bond markets. However, as long as corporate yield curves do not steepen bearishly, they will remain supportive for equities for the simple reason risk-seeking flows will shift more toward liquid equities and away from less liquid corporate bonds.



Market Structure

Precious Metals, Softs and the Petroleum subindex remain in structural downtrends within physical commodity markets. The S&P 500 reversed into a structural uptrend while the EAFE remain in a downtrend. The dollar index moved into a structural uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For Aug. 25 - 29
BBerg	4	Sideways	0.025	4.8%	
BBerg Grain	15	Transitional	-0.029	16.1%	
BBerg Ind. Metl	19	Transitional	0.103	11.8%	
BBerg Pre. Metl	29	Trending	-0.220	10.7%	-0.12%
BBerg Softs	23	Trending	-0.081	17.9%	-0.16%
BBerg Nat. Gas	16	Transitional	0.005	21.3%	
BBerg Petroleum	29	Trending	-0.248	10.0%	-0.17%
BBerg Livestock	6	Sideways	-0.015	15.0%	
Dollar Index	29	Trending	0.387	3.3%	0.07%
S&P 500 Index	29	Trending	0.178	8.0%	0.28%
EAFE Index	29	Trending	-0.090	7.8%	-0.03%
EM Index	18	Transitional	0.178	7.2%	
Ten-year UST (price)	5	Sideways	0.006	4.2%	

Performance Measures

Only the Industrial Metals subindex advanced on the week. The weakness in the other commodity subindices are supply-related and are not to be construed as a signal of macro-related declines in demand.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.23%	-3.00%	-6.36%	-3.61%
Grains Sub-Index	-0.82%	-1.26%	-15.95%	-16.57%
Corn	-1.46%	-0.84%	-22.24%	-26.61%
Soybeans	-0.95%	-3.83%	-9.96%	-3.74%
Wheat	-0.22%	1.48%	-14.38%	-19.37%
Energy Sub-Index	-0.20%	-3.68%	-7.65%	-0.79%
Petroleum Sub-Index	-1.05%	-5.77%	-4.05%	-5.38%
WTI	-1.66%	-7.55%	-3.35%	-6.10%
ULSD	-0.73%	-3.29%	-6.15%	-6.98%
Gasoline	0.11%	-4.73%	-4.10%	-5.73%
Natural Gas	1.99%	2.11%	-15.80%	6.87%
Precious Metals Sub-Index	-1.66%	-2.99%	-6.76%	-11.30%
Gold	-1.99%	-1.92%	-4.78%	-8.50%
Silver	-0.67%	-6.01%	-12.17%	-19.09%
Industrial Metals Sub-Index	2.78%	-0.29%	9.70%	4.06%
Copper	3.15%	-1.02%	-0.09%	-4.09%
Aluminum	3.16%	2.71%	13.34%	0.68%
Nickel	0.41%	-2.52%	30.09%	27.02%
Zinc	3.59%	-1.79%	13.51%	14.51%
Softs Sub-Index	-1.67%	-1.27%	-8.40%	2.64%
Coffee	-3.00%	2.23%	1.18%	45.80%
Sugar	-1.76%	-8.75%	-18.43%	-16.56%
Cotton	2.84%	1.27%	-17.43%	-16.08%
Livestock Sub-Index	-1.13%	-10.07%	-0.45%	8.37%
Cattle	-0.51%	-8.01%	6.53%	14.64%
Hogs	-2.19%	-13.42%	-9.47%	-0.06%

Only a small advance in the INR prevented a clean sweep for the USD against all currencies in the table. The relative attractiveness of U.S. assets and the still-unsubstantiated belief the Federal Reserve will begin tightening credit in early 2015 are pushing the greenback higher.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.23%	-1.72%	-3.97%	-1.26%
Japanese yen	-1.56%	-2.26%	-1.88%	-5.46%
British pound	-1.08%	-2.52%	-0.80%	6.24%
Swiss franc	-1.13%	-1.31%	-3.28%	0.68%
Canadian dollar	-0.72%	-1.40%	1.09%	-4.24%
Australian dollar	-0.27%	-1.02%	3.12%	2.99%
Swedish krona	-1.22%	-1.68%	-6.37%	-6.17%
Norwegian krone	-0.40%	0.53%	-2.33%	-2.32%
New Zealand dollar	-1.43%	-2.29%	0.26%	6.44%
Indian rupee	0.49%	-0.37%	2.63%	6.88%
Brazilian real	-0.76%	-2.84%	2.80%	6.93%
Mexican peso	-0.73%	-1.49%	0.66%	0.34%
Chilean peso	-1.00%	-3.15%	-4.90%	-12.15%
Colombian peso	-2.07%	-4.07%	6.16%	-0.45%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.27%	0.06%	0.95%	1.47%

The anticipation the Federal Reserve will move at some point to tighten credit conditions has created a relative performance advantage for the U.S. versus other major indices. The stronger USD continues to invite a euro carry trade that would perpetuate this relative performance advantage.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	1.33%	-0.63%	6.17%	18.84%
North America	1.70%	0.45%	9.41%	22.49%
Latin America	1.24%	-1.37%	21.64%	18.68%
Emerging Market Free	0.82%	1.01%	15.10%	20.79%
EAFE	0.77%	-2.23%	1.62%	13.70%
Pacific	0.29%	-0.30%	6.89%	13.81%
Eurozone	1.10%	-4.28%	-2.82%	12.86%

CTA's and macro-oriented hedge funds' continued bias toward the long equity trade paid off for a second week. The long sovereign debt trade did not retrace previous weeks' gains significantly, a plus for performance, and funds apparently were on the right side of what has been a long dollar trade.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.93%	0.80%	6.80%	4.73%
Newedge Trend	1.28%	0.56%	4.67%	3.80%
Newedge Short-Term	-0.61%	0.84%	-0.39%	3.05%
HFR Global Hedge Fund	0.66%	0.21%	0.82%	4.59%
HFR Macro/CTA	0.85%	0.60%	1.02%	0.82%
HFR Macro: Sytematic Diversified CTA	0.35%	-0.06%	-1.35%	-0.40%