The Macro Environment For Financial Markets

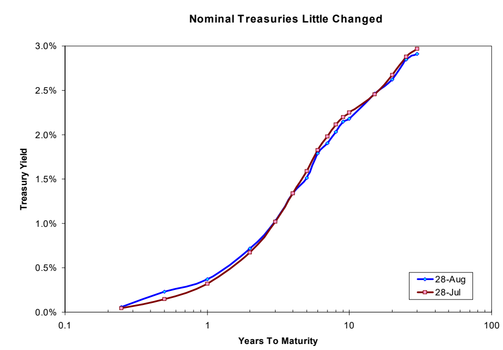
The problem with not paying attention to the man behind the curtain is that is all we have. If we learned anything over the past month it is 1) Officials in China do not understand markets are immune to command-and-control, and 2) The allegedly forward-looking solons, poobahs and assorted mavens of the FOMC have the same excess of fast-twitch muscle fibers as an amateur day-trader. The end result is we are flying in a plane with pilots making rules up as they go along. What, besides everything, could go wrong? The principal task of all central banks at this point is to make sure we do not wind up in a deflationary commercial banking liquidity crisis. For China, this means accepting a lower yuan and getting funds to non-state enterprises. For the U.S. this means not withdrawing short-term funds from the banking system for the time being; this means not only postponing a rate hike but issuing a clear statement of conditions and reasons and stopping all of the extemporaneous free-form chit-chat from FOMC members.

The causal chain now is:

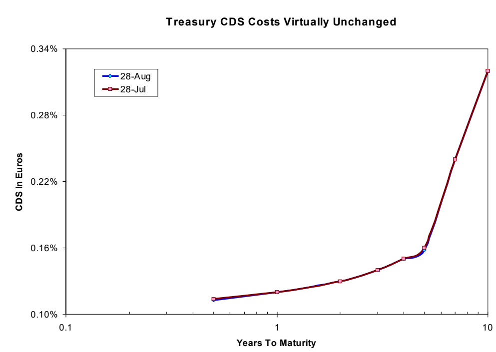
1. Short-term interest rates will remain artificially low globally. The timing of any rate hike in the U.S. has become far more problematic at this point;
2. Disinflationary pressures are dominating inflationary pressures;
3. Inflation expectations as measured by the TIPS market will remain low;
4. The U.S. yield curve retains its long-term trend toward a bullish flattening;
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 will continue to rise under industry stresses in the energy, mining and media sectors.

Key Market Indications

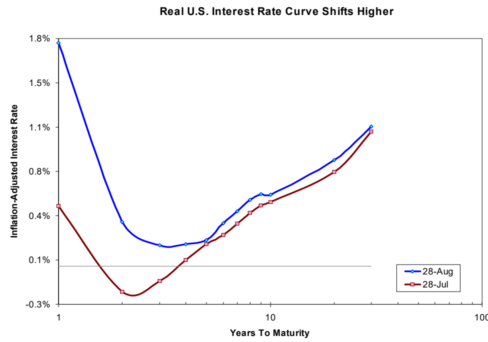
The test of 1.94% was made and was followed by a bounce back over the previous 2.14% resistance level. It is increasingly clear neither UST nor Bunds have recaptured their role as haven assets; they are now seen as return-free risk. The secular bull market remains intact and will flatten further if short-term rates are increased, but further gains will be grudging.



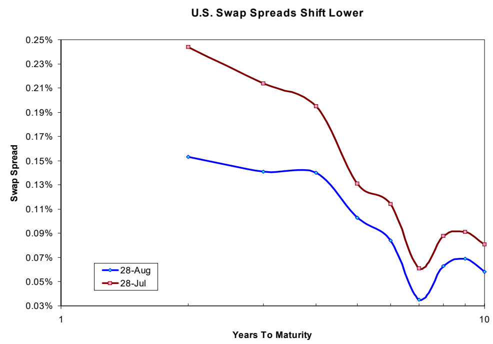
The changes in CDS costs for Treasuries were microscopic over the past month, which is just as well given how the fiscal outlook for the U.S. has not changed much over the past month, either. Either cooler heads are prevailing or the pool of participants in this market has diminished.



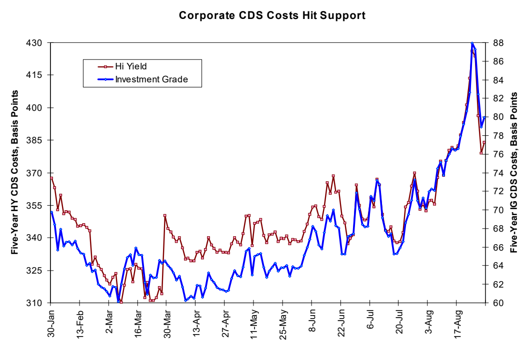
Pseudo-real rates continue to move higher at the short end of the yield curve. This pushed gold lower in the face of a diminished haven bid. Long-term pseudo-real rates have advanced over the past month, and while this did not cause the downturns in capital assets, it did not help matters, either.



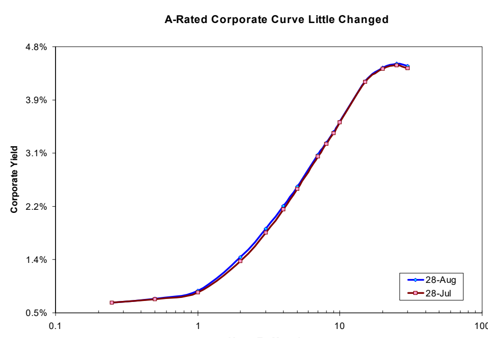
Swap spreads, which rise when floating-rate borrowers want to fix their payments, declined at both the short end of the yield curve over the past month. The decline at the short end reflects a growing sense any hike in short-term rates will be singular and may not occur at all. I might add this last statement is dependent on the last FOMC member standing in front of a microphone.



The surge in CDS costs for both the investment-grade and high-yield indices found support on what has been dubbed Black Monday. However, the uptrend in these costs continues and will remain intact so long as the yield curve flattens with higher expected short-term rates and global growth prospects continue to deteriorate.



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

Industrial Metals and Livestock joined Natural Gas in a structural downtrend, and Precious Metals moved into an uptrend. Only ten-year UST remain in a structural uptrend within the financial markets. The dollar index and all of the major equity indices remain in downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Aug. 31 - Sep. 4
BBerg	15	Transitional	0.031	14.7%	
BBerg Grain	12	Transitional	-0.060	19.7%	
BBerg Ind. Metl	29	Trending	-0.063	18.9%	-0.64%
BBerg Pre. Metl	21	Trending	0.026	15.8%	0.15%
BBerg Softs	14	Transitional	-0.077	17.4%	
BBerg Nat. Gas	29	Trending	-0.217	17.6%	-0.09%
BBerg Petroleum	15	Transitional	0.135	33.9%	
BBerg Livestock	20	Trending	-0.064	13.9%	-0.22%
Dollar Index	29	Trending	-0.057	9.9%	-0.17%
S&P 500 Index	29	Trending	-0.223	16.2%	-0.08%
EAFE Index	29	Trending	-0.340	13.9%	-0.12%
EM Index	29	Trending	-0.367	15.7%	-0.30%
Ten-year UST (price)	29	Trending	0.011	6.6%	0.86%

Performance Measures

I noted last week rallies in both the Petroleum and Industrial Metals indices would be of the short-covering variety, and the one in crude oil was particularly spectacular and further evidence of how hard it is to trade bear markets in physical commodities. Both markets can trade higher to see where buyers start to back away, but these will continue to be secondary advances within powerful secular bear markets. The Precious Metals lost some of their haven bid and moved lower as implied real short-term rates moved higher.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	1.77%	-3.80%	-13.60%	-29.24%
Grains Sub-Index	-1.27%	-4.87%	-11.03%	-14.30%
Corn	-0.60%	-2.87%	-10.98%	-10.20%
Soybeans	-0.45%	-6.26%	-12.07%	-13.52%
Wheat	-4.02%	-6.20%	-7.43%	-18.01%
Energy Sub-Index	6.29%	-6.10%	-17.69%	-49.16%
Petroleum Sub-Index	8.93%	-6.36%	-20.52%	-52.64%
WTI	11.63%	-7.66%	-20.56%	-57.28%
Brent	10.09%	-6.67%	-24.25%	-57.01%
ULSD	7.92%	-1.86%	-19.95%	-43.89%
Gasoline	2.83%	-8.03%	-14.76%	-43.88%
Natural Gas	0.15%	-5.13%	-8.81%	-42.21%
Precious Metals Sub-Index	-2.98%	2.27%	-8.45%	-16.36%
Gold	-2.21%	3.41%	-6.85%	-12.55%
Silver	-5.20%	-0.96%	-12.88%	-26.86%
Industrial Metals Sub-Index	2.19%	-4.74%	-15.46%	-28.75%
Copper	2.07%	-2.63%	-13.29%	-25.78%
Aluminum	3.46%	-3.53%	-14.49%	-26.88%
Nickel	-1.38%	-11.28%	-29.15%	-46.92%
Zinc	2.51%	-8.71%	-13.06%	-24.25%
Softs Sub-Index	0.25%	-1.40%	-16.75%	-34.91%
Coffee	-1.90%	0.72%	-16.79%	-43.85%
Sugar	5.08%	-1.78%	-22.10%	-40.31%
Cotton	-5.84%	-2.47%	-4.23%	-4.92%
Livestock Sub-Index	2.05%	-0.50%	-1.80%	-11.08%
Cattle	0.09%	-1.92%	-0.82%	-1.32%
Hogs	5.73%	2.12%	-3.06%	-26.83%

It might be easy to overlook, but the gains this past week for the MXN, CLP and COP are the first signs the massively battered Latin American markets are attracting funds. Brazil, the largest Latin economy, continued to decline under weight of its corruption scandal and poor commodity prices. The USD advanced against the majors save the JPY, which is reprising its role as a haven.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.77%	1.13%	0.01%	-15.15%
Chinese yuan	-0.01%	-2.82%	-1.83%	-3.85%
Japanese yen	0.27%	1.52%	-1.30%	-14.78%
British pound	-1.93%	-1.42%	0.16%	-7.20%
Swiss franc	-1.77%	-0.12%	-0.54%	-5.04%
Canadian dollar	-0.08%	-2.11%	-5.04%	-17.72%
Australian dollar	-1.95%	-2.25%	-7.64%	-23.34%
Swedish krona	-1.22%	1.29%	-1.43%	-17.56%
Norwegian krone	-1.07%	-1.52%	-7.14%	-25.41%
New Zealand dollar	-3.32%	-3.33%	-13.93%	-22.89%
Indian rupee	-0.50%	-3.40%	-6.49%	-8.54%
Brazilian real	-2.28%	-6.27%	-19.16%	-37.40%
Mexican peso	1.42%	-2.84%	-10.36%	-21.88%
Chilean peso	0.79%	-3.81%	-10.88%	-14.30%
Colombian peso	1.04%	-6.99%	-17.57%	-37.35%
Bloomberg-JP Morgan Asian dollar index (spot)	0.21%	-2.89%	-4.09%	-7.92%

Markets tend to rally back to their breakdown points. Equity markets have a long ways to go in this regard despite strong rallies off of oversold points. Unless the shock of lower Chinese growth turns out to be bullish for earnings, a virtual impossibility, we would need to see another monetary infusion from somewhere to propel equities higher. This is trading by hope.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.47%	-4.85%	-5.12%	-2.62%
North America	1.06%	-4.64%	-4.96%	-0.13%
Latin America	2.26%	-7.32%	-20.43%	-40.62%
Emerging Market Free	1.01%	-7.74%	-15.61%	-22.47%
EAFE	-0.46%	-5.17%	-5.39%	-6.39%
Pacific	-0.61%	-5.04%	-4.99%	-4.61%
Eurozone	0.32%	-5.78%	-5.90%	-7.00%

The ability of CTAs to gain this week is a little surprising given the high level of volatility and some very sharp reversals in key markets. Hedge funds did not handle the volatility very well at all, but the damage was relatively minor.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.15%	1.55%	-2.72%	18.29%
Newedge Trend	0.15%	0.73%	-3.12%	12.28%
Newedge Short-Term	0.21%	-0.38%	-7.11%	2.33%
HFR Global Hedge Fund	-0.65%	-1.69%	-2.69%	-3.38%
HFR Macro/CTA	-0.70%	-1.26%	-3.13%	3.97%
HFR Macro: Sytematic Diversified CTA	-0.51%	-0.34%	-2.81%	5.58%