The Macro Environment For Financial Markets

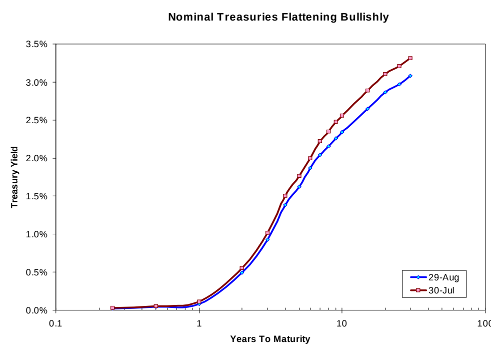
Once upon a time there was a conceit macroeconomic growth led to expanded earnings and higher interest rates, and the relative expected paths of these two developments determined the fundamental value of assets. That was when the world was young and naïve; now we know five years of policies intended to put a safety net under the financial system and encourage spending via easy credit and low interest rates failed to achieve their desired outcomes of increasing output and employment but did a magnificent job of increasing wealth for the wealthy while not increasing income for those dependent thereon. The response now in the face of renewed recessionary forces in the Eurozone, Brazil, Japan and elsewhere is expected to be more of the same that has yet to work. Whether this increases the fundamental value of risky assets is debatable; we can with a high degree of certainty it will increase their prices.

The causal chain is now:

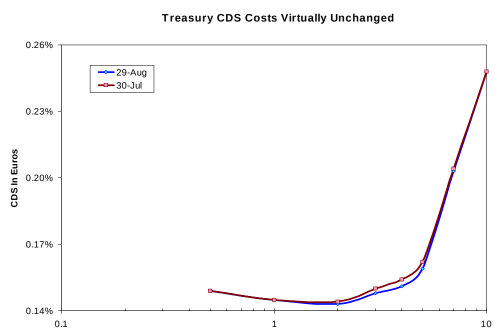
1. Short-term interest rates will remain artificially low and will keep real rates negative below the middle range of the yield curve;
2. The longer-term uptrend in senior sovereign debt remains intact;
3. Inflation expectations as measured by the TIPS market will remain in the 2.00% range as long as the global sovereign debt rally remains intact;
4. Short-term borrowers will continue to accept rollover risk and keep their effective maturities as short as possible;
5. Swap spreads are in a stable configuration and will not present an impediment to corporate bonds; and
6. Credit spreads, especially for investment-grade bonds, will remain compressed in the absence of a macroeconomic shock.

Key Market Indications

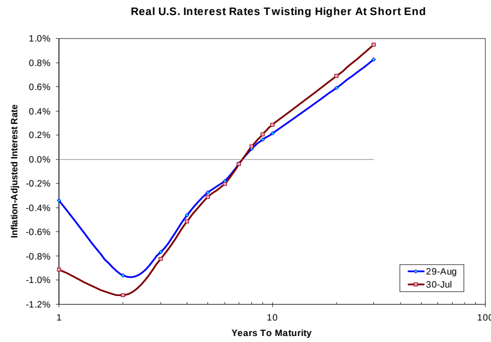
Investing is a relative game, with the rally in the long end of the Treasury market being a perfect illustration. The U.S. has become high-yielding relative to the senior bonds of the Eurozone, with the implied carry trade of borrowing the EUR and lending the USD gaining 6.1% since early May. The bullish flattening of the UST yield curve is bullish for USD-priced risky assets.



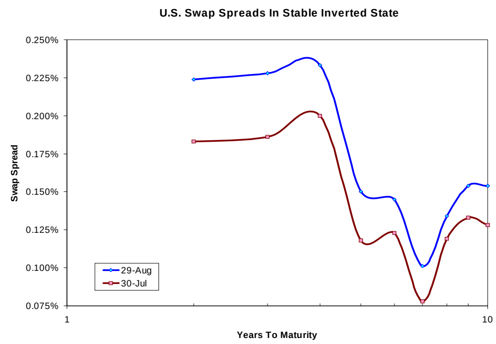
Euro-denominated CDS costs have remained virtually unchanged over the past month as the likelihood of another Congressional impasse on the budget recedes and as the rally in Treasuries has lowered U.S. debt service costs.



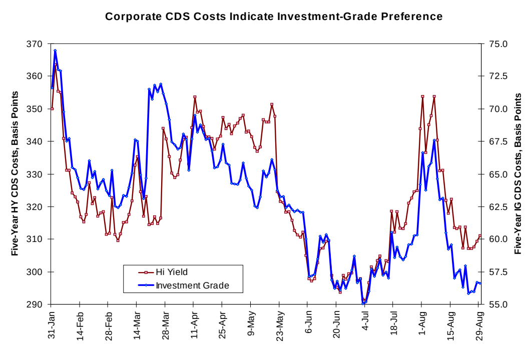
Real rates remain negative out to the seven-year horizon. The increase at short-dated maturities is a negative for precious metals. The decline at longer maturities is minor and while not an impediment to financial assets, it is not a propulsive force, either.



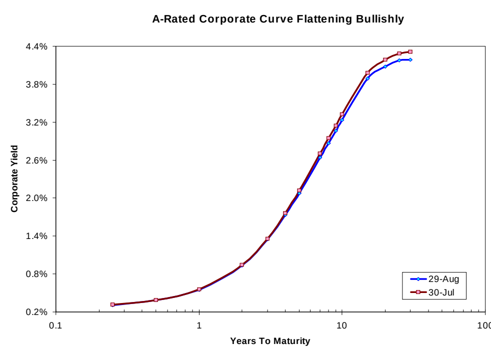
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have remained stable over the last two weeks following an earlier shift higher. Their inverted state is consistent with greater demand to fix short-dated payments while remaining willing to pay floating on 5-7 year notes.



Five-year CDS costs for both investment-grade and high-yield bonds remain at the first resistance reached two weeks ago. The decline in Treasury yields predictably has redounded to the benefit of investment-grade bonds first as many portfolio managers are using the combination of long UST/short CDS as a substitute for long IG bond positions. The compressed state of these CDS levels and the relative concentration of the CDS market make them vulnerable to event risk.



The A-rated yield curve's bullish flattening is minor relative to that of the Treasury yield curve. 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

The physical commodity markets have entered a consolidation phase with the economically unimportant Softs in an uptrend and Precious Metals in a downtrend. The S&P 500 and the dollar index remain within their uptrends, and the Emerging Market index reversed into an uptrend structure.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For Sep. 2 - 5
BBerg	20	Trending	0.021	5.4%	
BBerg Grain	16	Transitional	-0.053	15.6%	
BBerg Ind. Metl	22	Trending	0.070	11.0%	
BBerg Pre. Metl	29	Trending	-0.133	9.8%	-0.12%
BBerg Softs	23	Trending	0.073	18.2%	0.47%
BBerg Nat. Gas	13	Transitional	0.107	22.0%	
BBerg Petroleum	7	Sideways	0.066	9.1%	
BBerg Livestock	29	Trending	-0.028	14.0%	
Dollar Index	29	Trending	0.389	3.4%	0.07%
S&P 500 Index	29	Trending	0.256	7.5%	0.28%
EAFE Index	29	Trending	0.014	7.7%	
EM Index	22	Trending	0.196	6.9%	0.18%
Ten-year UST (price)	9	Sideways	0.089	3.6%	

Performance Measures

The Industrial Metals and Grains subindices declined, but advances in Softs, Livestock, Precious Metals and Energy were sufficient to push the broad Bloomberg index higher and end, for the time being, its two-month downtrend.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.92%	-0.40%	-5.51%	-2.92%
Grains Sub-Index	-1.24%	-0.47%	-17.15%	-19.23%
Corn	-1.82%	0.26%	-24.02%	-29.73%
Soybeans	-1.70%	-3.23%	-13.17%	-7.44%
Wheat	0.22%	2.42%	-11.95%	-20.18%
Energy Sub-Index	2.11%	0.66%	-5.69%	-0.07%
Petroleum Sub-Index	1.33%	-1.34%	-2.90%	-5.53%
WTI	1.99%	-1.66%	-2.18%	-5.46%
ULSD	0.89%	-0.48%	-4.73%	-7.29%
Gasoline	1.30%	-0.12%	-3.05%	-5.52%
Natural Gas	4.04%	5.93%	-12.11%	9.95%
Precious Metals Sub-Index	0.46%	-1.62%	-4.34%	-10.65%
Gold	0.56%	-0.57%	-2.72%	-8.01%
Silver	0.17%	-4.63%	-8.87%	-18.03%
Industrial Metals Sub-Index	-0.20%	1.20%	9.70%	8.35%
Copper	-1.94%	-2.15%	-0.81%	-2.37%
Aluminum	1.64%	5.65%	16.35%	7.07%
Nickel	0.24%	2.01%	26.63%	34.07%
Zinc	0.27%	0.62%	12.00%	19.89%
Softs Sub-Index	2.78%	0.80%	-9.18%	5.39%
Coffee	7.39%	2.26%	6.22%	57.59%
Sugar	-0.96%	-5.26%	-19.12%	-16.71%
Cotton	0.59%	5.22%	-16.74%	-14.99%
Livestock Sub-Index	3.98%	-3.55%	-0.03%	11.38%
Cattle	3.01%	-2.93%	7.79%	18.00%
Hogs	5.65%	-4.57%	-9.97%	2.54%

The global hunt for yield has turned back toward emerging markets with the result the BRL, INR, and MXN all gained on the USD while the USD firmed against the EUR, CHF and JPY. The CAD, AUD and GBP all firmed against the USD on expected short-term interest rate differentials.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.83%	-2.07%	-4.85%	-0.82%
Japanese yen	-0.13%	-1.89%	-2.20%	-5.51%
British pound	0.16%	-2.04%	-0.88%	7.06%
Swiss franc	-0.48%	-1.23%	-4.13%	1.38%
Canadian dollar	0.60%	-0.24%	1.71%	-3.18%
Australian dollar	0.24%	-0.47%	4.65%	4.58%
Swedish krona	-1.12%	-1.94%	-8.34%	-5.76%
Norwegian krone	-0.48%	0.86%	-3.13%	-1.69%
New Zealand dollar	-0.56%	-1.67%	-0.32%	7.62%
Indian rupee	0.26%	-0.62%	2.05%	13.73%
Brazilian real	1.86%	-0.21%	4.85%	5.53%
Mexican peso	0.40%	-0.13%	1.26%	2.10%
Chilean peso	-0.76%	-3.70%	-4.89%	-13.11%
Colombian peso	0.19%	-3.21%	6.55%	1.08%
Bloomberg-JP Morgan Asian dollar index (spot)	0.13%	0.31%	1.50%	2.17%

While the drive lower in Eurozone yields and the prospects of a euro carry trade have supported the U.S. among the senior markets, the Latin American markets have surged even further on the prospects of a Rousseff defeat in Brazil.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.78%	0.51%	5.94%	21.06%
North America	0.88%	1.94%	9.03%	24.69%
Latin America	4.41%	4.31%	27.05%	24.96%
Emerging Market Free	0.50%	0.91%	14.80%	21.54%
EAFE	0.62%	-1.58%	1.57%	15.93%
Pacific	-0.39%	-1.55%	6.51%	13.52%
Eurozone	1.76%	-2.33%	-1.90%	18.28%

CTA's and macro-oriented hedge funds' continued bias toward the long equity trade paid off for a third week. In addition, the continued moves lower in senior sovereign debt yields and the strength of the USD against the EUR benefited trend-followers. As trends are never this easy and as August trading, much like December trading, often is reversed during the following month, performance may take a hit in the first week of September.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	2.10%	2.17%	7.30%	7.53%
Newedge Trend	1.67%	1.83%	5.59%	5.84%
Newedge Short-Term	0.42%	0.69%	-0.26%	2.56%
HFR Global Hedge Fund	0.23%	0.30%	0.43%	5.22%
HFR Macro/CTA	0.54%	0.21%	1.37%	1.34%
HFR Macro: Sytematic Diversified CTA	0.82%	-0.07%	-0.86%	-0.11%