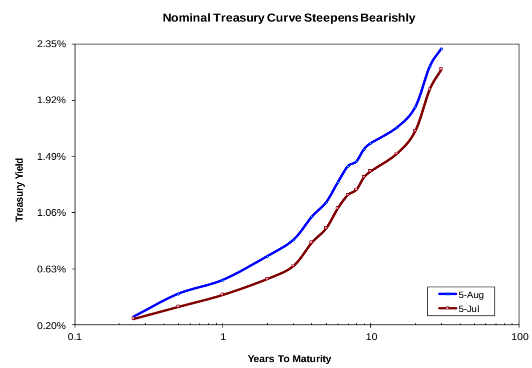
The Macro Environment For Financial Markets

To paraphrase a famous antiwar poster from the 1960s, suppose they gave a market and no one interfered? Imagine all the people and what they will do. But just as the Bank of Japan intervened this past week, the Bank of England did this week, far more aggressively than anyone imagined, and decided the solution to regulation from Brussels was the start of nationalization in the corporate bond market. If all of these policies worked, why have they had to keep administering monetary heroin for the past six years? It is wonderful for portfolio investments, but discourages investment in real plant and equipment. The predictable failure continues and Japan is halfway through its third consecutive Lost Decade. The causal chain remains:

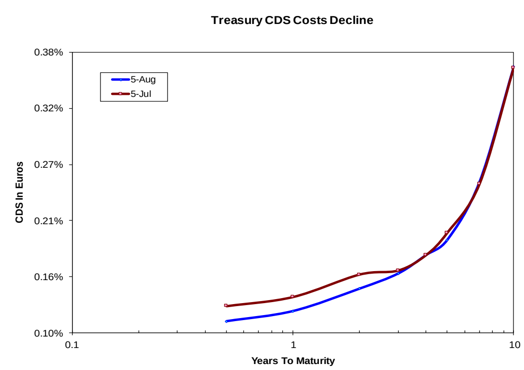
1. The market has no clear idea of if and when U.S. short-term rates will rise;
2. Disinflationary pressures will persist globally;
3. Inflation expectations as measured by TIPS and inflation swaps have ended their downtrend;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are accepting rollover risk once again;
6. Swap spreads are finally moving higher; and
7. CDS costs are breaking resistance as part of a global search for yield.

Key Market Indications

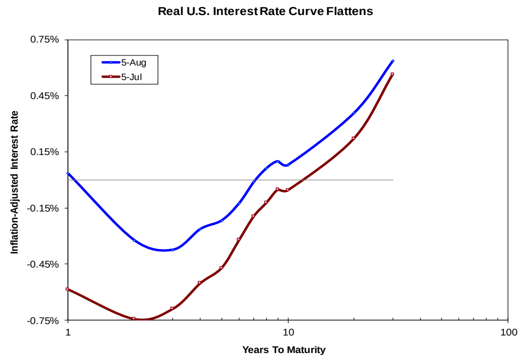
The bull market in UST will be 35 years old next month. This means you have to be a Baby Boomer to remember life in a secular bear market; no Baby Boomees need apply. The small bearish steepening seen this past week as the Japanese bond market choked and sold off toward 0% was checked in part by the Bank of England's expansion of QE. The strong employment report did not have a pronounced effect as the Federal Reserve has managed to confuse everyone as to what their responses to anything will be.



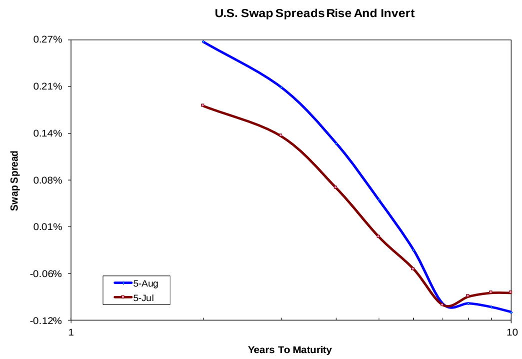
CDS costs declined over the past month, especially at the very shortest tenors. Guess what? The U.S. is not going to default at these debt service costs and Congress is not going to force a budget crisis in an election year.



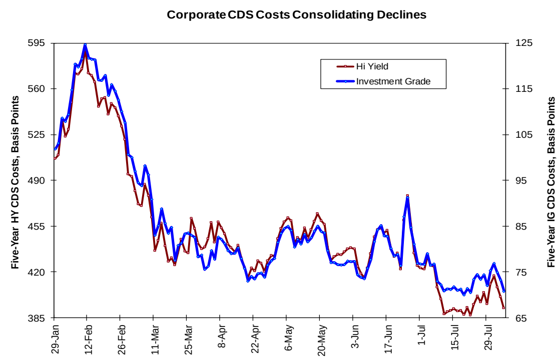
The small shift higher in pseudo-real rates at the long end of the yield curve will not derail risky financial assets yet. Precious Metals have been able to sidestep the rise in U.S. implied short-term real the U.S. as the negative-carry trade in other currencies remains open.



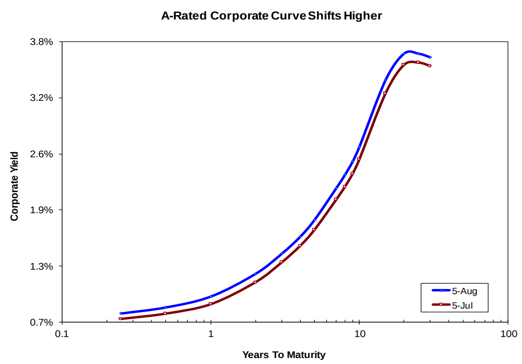
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose inside of seven years and have inverted further. The risk/reward for fixing payments at these levels is a good one.



Both the investment-grade and high-yield CDS indices are consolidating their recent bullish moves. The fact the market ignored the recent selloff in crude oil and the ongoing pressure on banks from negative interest rates tells you there is a lot of demand even at these compressed yields. It also tells you the compensation for assuming risk is sparse.



The A-rated corporate yield curve continues to mirror the UST curve as credit spreads remain in a narrow range. So long as both the European Central Bank and the Bank of England are in the market buying corporate bonds, it will be hard for U.S. investment-grade bonds to sell off very much.



Market Structure

The Petroleum index and main Bloomberg indices remain in structural downtrends amongst physical markets. The EM index joined the EAFE in a structural uptrend, while both ten-year UST and the dollar index entered structural downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate August 8 - 12
BBerg	29	Trending	-0.167	13.0%	-0.45%
BBerg Grain	7	Sideways	0.011	19.5%	
BBerg Ind. Metl	12	Transitional	-0.011	14.5%	
BBerg Pre. Metl	16	Transitional	-0.024	13.7%	
BBerg Softs	16	Transitional	0.161	19.7%	
BBerg Nat. Gas	22	Trending	-0.001	23.4%	
BBerg Petroleum	29	Trending	-0.204	28.3%	-0.60%
BBerg Livestock	10	Sideways	-0.031	14.6%	
Dollar Index	28	Trending	-0.023	7.0%	-0.04%
S&P 500 Index	10	Sideways	0.095	6.8%	
EAFE Index	28	Trending	0.146	11.7%	0.11%
EM Index	29	Trending	0.361	9.6%	0.18%
Ten-year UST (price)	20	Trending	-0.082	5.6%	-0.01%

Performance Measures

We usually do not see such erratic trade in early August; the normal pattern is to wait for a sufficient number of traders to head to the beach where they can whip out their mobile devices to annoy their families and impress no one. But here we are; previously weak crude oil rose, precious metals fell, livestock rallied and even wheat came off a multi-year low. Copper fell, as surely it must when Goldman Sachs called for a "supply storm" in the red metal. Sounds serious. At least the mixture of up-and-down physical commodities and a very mixed currency matrix ended the simplistic commentary trying to explain "commodities" with "the dollar," right?

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.50%	-2.93%	11.22%	-7.12%
Grains Sub-Index	-1.92%	-7.25%	-4.72%	-14.35%
Corn	-3.06%	-8.64%	-13.07%	-19.76%
Soybeans	-2.84%	-7.85%	13.54%	0.87%
Wheat	2.03%	-4.34%	-13.23%	-23.23%
Energy Sub-Index	0.03%	-5.33%	15.63%	-28.73%
Petroleum Sub-Index	1.45%	-6.99%	18.07%	-27.36%
WTI	0.49%	-9.34%	14.97%	-32.01%
Brent	1.44%	-6.81%	23.73%	-26.23%
ULSD	0.73%	-8.34%	18.90%	-26.84%
Gasoline	4.32%	-0.59%	12.57%	-24.98%
Natural Gas	-3.61%	-0.56%	7.83%	-34.44%
Precious Metals Sub-Index	-1.46%	-1.50%	15.89%	25.05%
Gold	-0.96%	-1.55%	11.45%	21.99%
Silver	-2.60%	-1.38%	27.77%	32.23%
Industrial Metals Sub-Index	-1.00%	2.47%	12.04%	-0.66%
Copper	-3.03%	1.68%	2.42%	-8.82%
Aluminum	-0.19%	-1.57%	8.15%	-0.71%
Nickel	0.75%	8.31%	29.43%	-2.24%
Zinc	0.95%	5.68%	30.69%	19.21%
Softs Sub-Index	3.43%	0.95%	33.91%	39.39%
Coffee	-2.52%	-1.09%	17.47%	1.02%
Sugar	6.83%	4.01%	49.30%	74.57%
Cotton	3.65%	16.64%	28.32%	23.59%
Livestock Sub-Index	1.51%	-4.29%	-8.20%	-15.77%
Cattle	3.41%	3.27%	-1.59%	-15.95%
Hogs	-1.26%	-14.00%	-17.14%	-14.18%

Let's see; Japan engages in QE and the JPY rallies but when the U.K. engages in QE, the GBP falls. Got it. As the sentiment pendulum swings back to the possibility of higher short-term rates in the U.S., the pressure will remain for weaker European currencies. The stronger Latin American equity markets will support the BRL up to a point, but no one should chase that moving car; you might catch it.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.79%	0.09%	-0.65%	1.65%
Chinese yuan	-0.38%	0.39%	-1.29%	-6.77%
Japanese yen	0.24%	-0.08%	14.78%	22.64%
British pound	-1.19%	0.39%	-9.86%	-16.21%
Swiss franc	-1.14%	-0.40%	1.05%	-0.16%
Canadian dollar	-1.08%	-1.46%	5.66%	0.04%
Australian dollar	0.30%	2.09%	7.81%	3.58%
Swedish krona	-0.12%	-0.50%	-1.32%	1.54%
Norwegian krone	-0.73%	-1.18%	0.62%	-2.96%
New Zealand dollar	-0.76%	-0.14%	7.77%	9.72%
Indian rupee	0.33%	1.02%	1.31%	-4.52%
Brazilian real	2.63%	4.35%	23.33%	10.11%
Mexican peso	-0.01%	0.34%	-1.68%	-12.69%
Chilean peso	-0.17%	0.99%	7.30%	3.90%
Colombian peso	1.10%	-1.89%	9.73%	-2.87%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.32%	0.85%	1.42%	-2.47%

When momentum trades hit smaller markets, such as the various Latin American bourses, large gains can occur over small periods of time. And vice-versa. With the U.S. closing at a record, it seems as if the broader indices should have gained more than they did.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.24%	3.38%	16.39%	0.87%
North America	0.41%	4.59%	17.93%	5.43%
Latin America	1.30%	8.76%	40.12%	11.16%
Emerging Market Free	1.44%	6.87%	21.93%	2.14%
EAFE	-1.35%	4.24%	8.86%	-8.28%
Pacific	-1.76%	5.19%	10.79%	-3.17%
Eurozone	-1.37%	5.57%	10.26%	-12.10%

CTAs' declines this week suggest they were on the wrong side of the sovereign yield curve trade. Hedge funds managed to gain, as they generally do when equity markets rise. Index funds perform similarly.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.16%	0.04%	-1.10%	0.97%
Newedge Trend	-0.25%	-0.02%	0.18%	3.66%
Newedge Short-Term	-0.73%	-1.22%	0.76%	3.16%
HFR Global Hedge Fund	0.05%	1.01%	3.96%	-4.28%
HFR Macro/CTA	0.34%	0.14%	-0.23%	-2.94%
HFR Macro: Sytematic Diversified CTA	0.38%	0.43%	1.04%	2.08%