The Macro Environment For Financial Markets

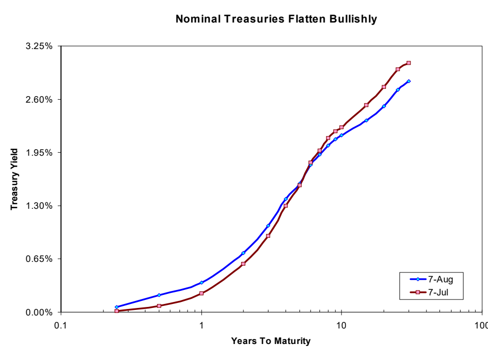
As practicing economist Yogi Berra noted, you can observe a lot just by watching. This week's fun fact is the Eurodollar yield curve is lower now than it was following the May employment situation report released in June, but the Federal Reserve appears to be on target to raise short-term interest rates nevertheless. The one-and-done 25 bp hike will be meaningless, but the effects of the stronger USD and the frictional costs of lower energy and industrial metals prices have been anything but meaningless. Higher short-term rates involve a reduction in the Federal Reserve's balance sheet at a time of rising global disinflationary pressures. And to what end, a possible reduction in demand for skilled labor in certain sectors such as healthcare and information technology? This might be plausible if monetary policy had deterministic outcomes. It does not.

The causal chain now is:

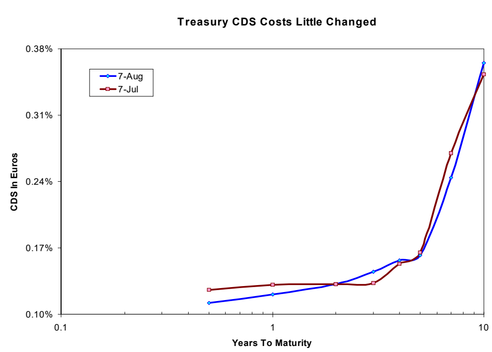
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point, arguably as early as September;
2. Disinflationary pressures are starting to dominate inflationary pressures;
3. Inflation expectations as measured by the TIPS market appear poised to test their January lows;
4. The U.S. yield curve has resumed its long-term bias toward flattening, driven by higher short-term rates as opposed to declining long-term rates;
5. Short-term borrowers have stopped terming out commercial paper into the bond market and once again are accepting rollover risk;
6. Swap spreads will remain tame until monetary policy indications turn more hawkish; and
7. Credit spreads are starting to rise under industry stresses in the energy, mining and media sectors.

Key Market Indications

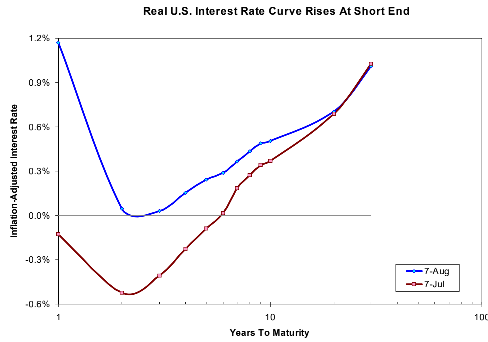
The bullish flattening of the yield curve has put ten-year UST right at the key resistance level of 2.15%. The more the market expects a hike in short-term rates within a still tepid growth environment with declining inflation expectations, the more attractive long-term UST look. In addition, the general sense liquidity will disappear elsewhere in fixed-income markets at the first sign of trouble makes UST compelling.



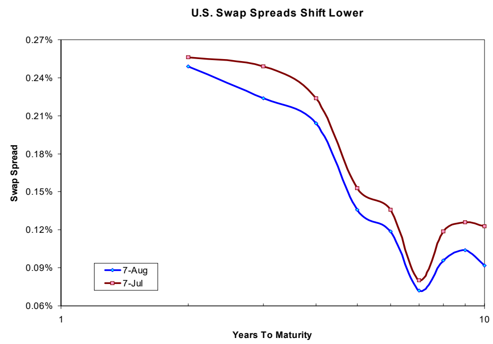
This market continues to have little reason to shift in either direction. This will change only if the federal government finds itself confronted with higher borrowing costs and lower tax receipts.



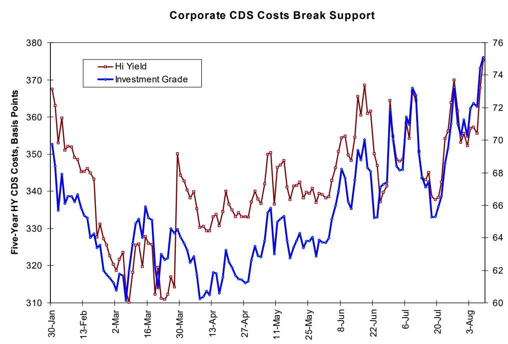
Pseudo-real rates continue to move higher at the short end of the yield curve and are now positive at all maturities. However, this did not push the precious metals lower this week for a second week in a row. The small rise in long-term pseudo-real rates poses a threat to risky financial assets.



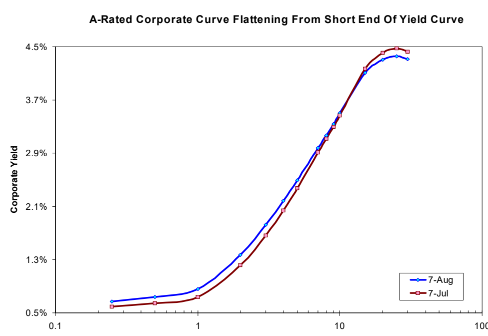
Swap spreads, which rise when floating-rate borrowers want to fix their payments, declined at both the short and long ends of the yield curve over the past month. The small decline at nine- and ten-year tenors is consistent with the decline in long-term UST rates. The decline at the short end reflects a growing sense any hike in short-term rates will be singular.



The continued high level of volatility in CDS indices is related to declining liquidity in the single-name CDS market. It is related to the turmoil in sectors such as energy, mining and media as well. An increase 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 driven by higher short-term rates. 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
Once again, the best that can be said for the physical commodities is the Grains and Precious Metals have moved into bearish consolidations as opposed to outright downtrends. Only ten-year UST remain in a structural uptrend within the financial markets.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Aug. 10 - 14
BBerg	29	Trending	-0.486	12.1%	-0.14%
BBerg Grain	5	Sideways	0.080	15.1%	
BBerg Ind. Metl	22	Trending	-0.273	16.6%	-0.46%
BBerg Pre. Metl	8	Sideways	0.033	15.0%	
BBerg Softs	29	Trending	-0.368	15.2%	-0.79%
BBerg Nat. Gas	27	Trending	-0.056	21.5%	-0.09%
BBerg Petroleum	29	Trending	-0.469	26.1%	-0.63%
BBerg Livestock	9	Sideways	-0.017	13.6%	
Dollar Index	12	Transitional	0.026	8.1%	
S&P 500 Index	19	Transitional	-0.155	7.7%	
EAFE Index	21	Trending	-0.025	8.7%	
EM Index	6	Sideways	-0.083	8.4%	
Ten-year UST (price)	29	Trending	0.169	6.3%	0.86%

Performance Measures
The economically important Energy and Industrial Metals indices continued their strong declines as marginal suppliers remain in production and demand growth is affected negatively by China's slowdown. While the effects of USD strength on various commodity returns are far more irregular than is supposed commonly, a stronger USD encourages cash-starved producers to sell more USD-denominated commodities at a lower price simply to acquire greenbacks. This is a self-reinforcing cycle.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.42%	-8.91%	-11.39%	-28.93%
Grains Sub-Index	1.42%	-11.08%	-5.24%	-10.36%
Corn	0.47%	-14.26%	-9.57%	-6.54%
Soybeans	2.45%	-5.77%	1.38%	-10.79%
Wheat	2.25%	-11.37%	-2.94%	-11.67%
Energy Sub-Index	-3.98%	-11.94%	-13.80%	-49.56%
Petroleum Sub-Index	-6.48%	-16.07%	-17.34%	-54.27%
WTI	-6.90%	-17.57%	-21.44%	-58.81%
Brent	-6.57%	-16.57%	-19.76%	-58.88%
ULSD	-2.85%	-12.06%	-16.17%	-45.88%
Gasoline	-8.41%	-15.89%	-6.28%	-44.25%
Natural Gas	3.02%	0.65%	-3.49%	-38.75%
Precious Metals Sub-Index	0.07%	-5.32%	-11.88%	-19.47%
Gold	-0.09%	-5.69%	-11.53%	-16.96%
Silver	0.52%	-4.26%	-12.85%	-26.73%
Industrial Metals Sub-Index	-1.81%	-7.20%	-13.88%	-27.69%
Copper	-1.31%	-8.08%	-8.84%	-26.90%
Aluminum	-1.81%	-6.59%	-15.91%	-25.41%
Nickel	-2.20%	-4.20%	-27.71%	-42.77%
Zinc	-3.03%	-7.72%	-12.97%	-20.60%
Softs Sub-Index	-2.55%	-7.87%	-22.35%	-34.02%
Coffee	2.04%	1.23%	-23.97%	-35.96%
Sugar	-4.31%	-14.10%	-28.87%	-44.08%
Cotton	-3.77%	-5.69%	-2.94%	-3.30%
Livestock Sub-Index	1.38%	-0.02%	-1.46%	-11.67%
Cattle	1.78%	-1.32%	0.93%	1.86%
Hogs	0.63%	2.41%	-5.15%	-32.10%

The currency markets keep discounting the same news twice; interestingly, the reaction to the employment report was far less USD-bullish than we might have expected. A few currencies such as the AUD, INR and NZD gained on the week, but the European majors and the Latin American currencies continue to decline.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.15%	-0.40%	-3.16%	-17.94%
Chinese yuan	0.00%	0.00%	0.61%	-0.79%
Japanese yen	-0.28%	-1.37%	-4.51%	-17.82%
British pound	-0.84%	0.19%	1.81%	-7.97%
Swiss franc	-1.79%	-3.79%	-6.12%	-7.62%
Canadian dollar	-0.30%	-3.24%	-5.06%	-16.79%
Australian dollar	1.51%	-0.44%	-4.92%	-19.99%
Swedish krona	-1.61%	-2.90%	-4.63%	-21.22%
Norwegian krone	-1.07%	-1.36%	-7.91%	-24.49%
New Zealand dollar	0.46%	-0.44%	-10.66%	-21.88%
Indian rupee	0.50%	-0.56%	-2.58%	-4.05%
Brazilian real	-2.45%	-9.15%	-20.99%	-34.56%
Mexican peso	-0.30%	-2.23%	-8.19%	-17.81%
Chilean peso	-0.80%	-4.11%	-7.89%	-14.77%
Colombian peso	-1.94%	-8.36%	-19.45%	-35.55%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.15%	-0.99%	-1.95%	-4.92%

The long-running trading range in the U.S., frustrating though it may be, is outperforming the EAFE and EM indices by a wide margin in USD terms. All trading ranges end at some point. The reasons for equities to crack are well-known, but they have not cracked yet. "Yet" is starting to look like the operative word.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.97%	1.43%	3.00%	6.24%
North America	-1.25%	-0.35%	1.62%	8.98%
Latin America	-4.13%	-9.51%	-14.32%	-33.46%
Emerging Market Free	-1.79%	-4.50%	-7.92%	-13.48%
EAFE	-0.54%	4.33%	5.22%	2.17%
Pacific	-0.33%	-0.18%	6.51%	2.84%
Eurozone	0.19%	9.93%	6.03%	3.78%

The positive numbers for the various CTA indices mask the business' secular decline. The exit of commercial banks from proprietary trading operations and the prevalence of bear markets prone to quick reversals are going to make this a much smaller business. Hedge funds continue to struggle when equities do not rise.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.20%	3.68%	-0.76%	25.87%
Newedge Trend	0.76%	2.88%	-1.44%	17.79%
Newedge Short-Term	0.17%	1.00%	-5.52%	4.13%
HFR Global Hedge Fund	-0.29%	0.01%	0.48%	0.11%
HFR Macro/CTA	-0.20%	2.55%	-0.73%	7.71%
HFR Macro: Sytematic Diversified CTA	0.17%	4.01%	-0.96%	8.30%