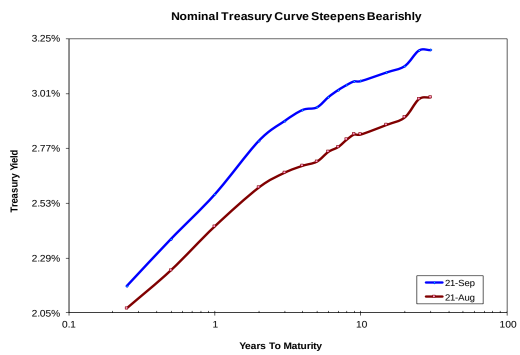
The Macro Environment For Financial Markets

Let's stipulate risky financial assets are absolutely expensive. Let's also remind ourselves risk-aversion does not rise when growth is strong, when monetary policies remain accommodative by historic standards and when fiscal policies are stimulative. As we saw this week, even the slightest whiff of reasonable behavior in the trade wars could lead to a swift decrease in risk-aversion. The causal chain now is:

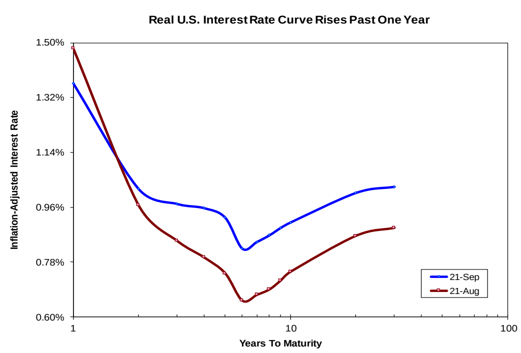
1. The market is pricing in September and December 2018 rate hikes;
2. Inflationary expectations are rising;
3. The yield curve is starting to exit its secular flattening trend;
4. Short-term borrowers are accepting rollover risk rather than term-out borrowing in the bond market;
5. Swap spreads continue to invert bullishly; and
6. CDS costs are declining separate from equity movements, especially for high-yield bonds.

Key Market Indications

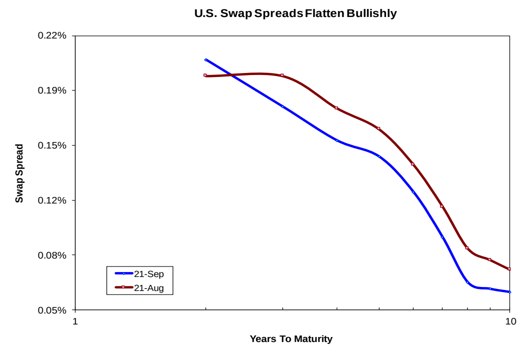
It remains important to remember in pre-crisis days long-term yields would be much higher. However, with central banks are the major holders and banks required to hold "riskless" sovereign debt, the potential for a strong selloff has been diminished greatly. Accordingly, the selloff in USTs is proceeding at an unusually slow pace.



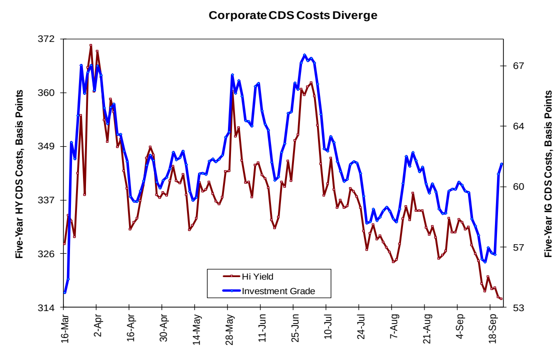
The pseudo-real yield curve rose at all tenors past one year as nominal interest rates climbed faster than did breakevens. The rise at the long end of this curve is not yet a threat to risky financial assets.



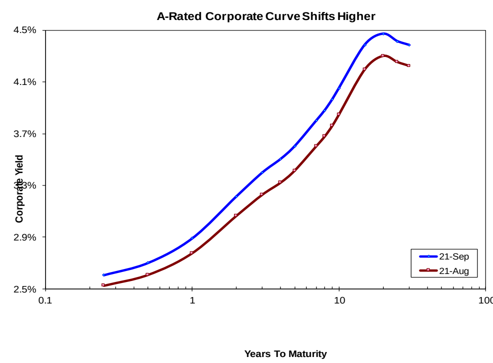
Swap spreads, which rise when floating-rate borrowers want to fix their payments, flattened bullishly. The swap market remains complacent about the prospect for higher long-term yields.



CDS costs diverged sharply, with the high-yield index continuing to decline and the investment-grade index jumping. The high-yield index should be considered the primary indicator here as credit quality is set at the margin.



The A-rated corporate yield curve shifted higher in parallel to the Treasury curve. However, this market remains as confined as credit spreads and long-term UST rates are offsetting each other.



Market Structure

The main Bloomberg index joined Petroleum in a structural uptrend while Grains remain in a structural downtrend. The dollar index joined ten-year UST in a structural downtrend. All of the stock indices remain in non-trending structures.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Sep. 24 - 28
BBerg	24	Trending	0.139	7.4%	0.11%
BBerg Grain	29	Trending	-0.087	15.0%	-0.22%
BBerg Ind. Metl	23	Trending	0.200	17.3%	
BBerg Pre. Metl	15	Transitional	0.003	10.3%	
BBerg Softs	19	Transitional	-0.062	15.2%	
BBerg Nat. Gas	29	Trending	0.009	13.0%	
BBerg Petroleum	29	Trending	0.159	17.5%	0.07%
BBerg Livestock	4	Sideways	-0.010	8.2%	
Dollar Index	25	Trending	-0.146	5.6%	-0.08%
S&P 500 Index	13	Transitional	0.170	6.5%	
EAFE Index	16	Transitional	0.309	8.6%	
EM Index	19	Transitional	0.167	9.8%	
Ten-year UST (price)	29	Trending	-0.378	3.1%	-0.09%

Performance Measures

The combination of lower trade tensions and evidence of solid economic growth led to a nearly complete set of rising returns amongst commodity markets. Only the economically unimportant Softs subindex declined. Still, the returns on physical commodities have been completely lackluster over the past year.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.40%	1.02%	-2.53%	1.13%
Grains Sub-Index	1.86%	-1.70%	-10.67%	-10.31%
Corn	1.61%	-1.36%	-11.96%	-10.72%
Soybeans	2.06%	-0.77%	-19.39%	-18.00%
Wheat	2.05%	-2.59%	3.33%	-0.35%
Energy Sub-Index	3.32%	2.56%	11.69%	23.86%
Petroleum Sub-Index	1.77%	3.06%	12.31%	38.86%
WTI	2.97%	3.71%	11.35%	45.43%
Brent	0.87%	3.55%	16.02%	48.12%
ULSD	0.84%	1.04%	11.44%	26.63%
Gasoline	2.24%	2.68%	7.90%	22.32%
Natural Gas	8.14%	1.11%	10.03%	-13.29%
Precious Metals Sub-Index	0.39%	-1.42%	-12.22%	-10.12%
Gold	0.06%	-0.83%	-11.74%	-8.20%
Silver	1.58%	-3.48%	-13.89%	-16.24%
Industrial Metals Sub-Index	5.86%	1.57%	-4.28%	-1.14%
Copper	8.04%	5.11%	-5.47%	-4.48%
Aluminum	2.73%	-0.06%	4.67%	-1.43%
Nickel	4.71%	-1.28%	2.20%	26.66%
Zinc	7.49%	-0.97%	-20.45%	-14.33%
Softs Sub-Index	-1.94%	1.17%	-13.98%	-20.33%
Coffee	0.24%	-4.43%	-19.26%	-32.14%
Sugar	-2.79%	6.94%	-14.67%	-25.92%
Cotton	-3.26%	-2.90%	0.13%	18.53%
Livestock Sub-Index	0.60%	8.08%	6.84%	0.89%
Cattle	0.31%	6.91%	8.11%	-0.68%
Hogs	1.37%	11.10%	4.47%	3.14%

Only the INR and JPY declined against the USD; the JPY case reflects lower demand for a haven asset. The currency market is discounting the worst case for any trade war and refuses to believe the Federal Reserve is going to continue raising short-term rates in response to U.S. domestic conditions with international banking considerations taking a back seat.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.07%	1.54%	-4.77%	-1.61%
Chinese yuan	0.15%	-0.14%	-7.79%	-3.89%
Japanese yen	-0.47%	-2.03%	-5.81%	-0.10%
British pound	0.03%	1.33%	-7.56%	-3.74%
Swiss franc	1.01%	2.80%	-0.94%	1.24%
Canadian dollar	0.93%	0.94%	-0.10%	-4.56%
Australian dollar	1.92%	-1.06%	-6.12%	-8.06%
Swedish krona	2.57%	3.07%	-7.27%	-9.66%
Norwegian krone	1.32%	3.13%	-5.55%	-4.26%
New Zealand dollar	2.11%	0.12%	-7.48%	-8.49%
Indian rupee	-0.48%	-3.29%	-9.69%	-10.26%
Brazilian real	3.03%	-0.02%	-19.19%	-22.52%
Mexican peso	0.32%	0.68%	-2.08%	-5.04%
Chilean peso	3.50%	-0.11%	-8.78%	-5.89%
Colombian peso	0.77%	-0.69%	-4.98%	-2.82%
Bloomberg-JP Morgan Asian dollar index (spot)	0.35%	-0.43%	-5.99%	-2.94%

I noted last week how equity indices ignored numerous opportunities to sell off sharply. This left the upside as the path of least resistance if there was a continued possibility of a resolution to the trade wars.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	1.56%	1.92%	9.53%	13.00%
North America	0.85%	2.31%	8.71%	18.44%
Latin America	4.64%	2.30%	-15.09%	-11.72%
Emerging Market Free	2.28%	0.93%	-11.34%	-2.53%
EAFE	2.91%	2.59%	0.66%	4.58%
Pacific	3.33%	3.03%	2.04%	8.11%
Eurozone	3.26%	1.58%	1.07%	0.10%

Both CTAs and macro hedge funds lost on the week, a rare development in a rising global equity environment. This suggests they were on the wrong side of the bond selloff and continued to be long the USD.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
SocGen CTA	-0.43%	-1.26%	-0.88%	0.93%
SocGen Trend	-0.25%	-0.97%	-1.44%	-0.65%
SocGen Short-Term	0.38%	-0.47%	0.06%	1.21%
HFR Global Hedge Fund	0.21%	0.16%	-0.91%	0.63%
HFR Macro/CTA	-1.14%	-1.90%	-1.55%	-0.93%
HFR Macro: Sytematic Diversified CTA	-1.18%	-1.97%	-1.00%	1.62%