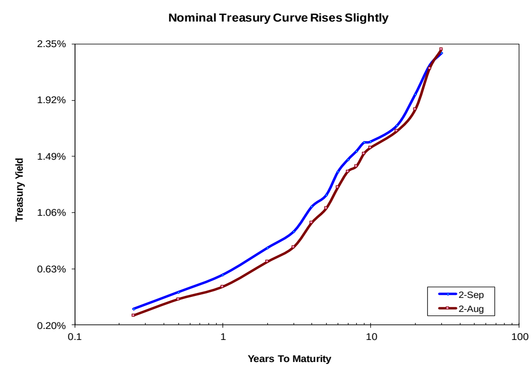
The Macro Environment For Financial Markets

If loose lips sink ships, the FOMC could reenact Pearl Harbor. The simple fact of the matter is the global economy is laboring under the slack capacity produced by bad business models being allowed to operate, by the constraints of high leverage, by suffocating regulation and the political misallocation of resources and unfavorable demographics throughout the OECD world. Twenty-five basis points is unimportant. A stronger dollar could be damaging, but this has yet to materialize as the U.S. keeps backing away from inducing it. However, officials cannot stop increasing uncertainty about future action, and this, too, is deleterious to growth. The causal chain remains:

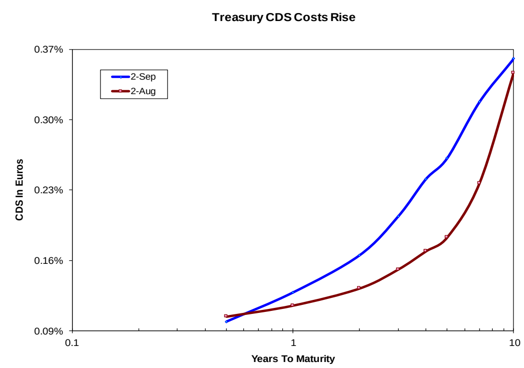
1. The market has no clear idea of when U.S. short-term rates will rise, although December seems the most likely date;
2. Disinflationary pressures will persist globally;
3. Inflation expectations as measured by TIPS and inflation swaps have ended their downtrend;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are terming out short-term debt into the bond market;
6. Swap spreads have stopped rising; and
7. CDS costs remain suppressed as part of a global search for yield.

Key Market Indications

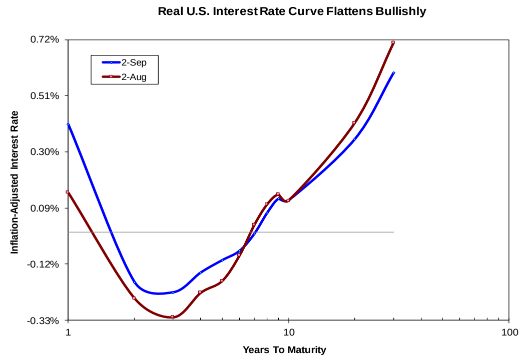
There used to be a cottage industry dedicated to analyzing UST rates from the perspective of auctions, deficits, and other so-called fundamentals. What fools! The market is being influenced more by the implied cross-currency swaps from external markets than anything else. Even ruminations of higher short-term rates are bullish as they imply reduced credit demands.



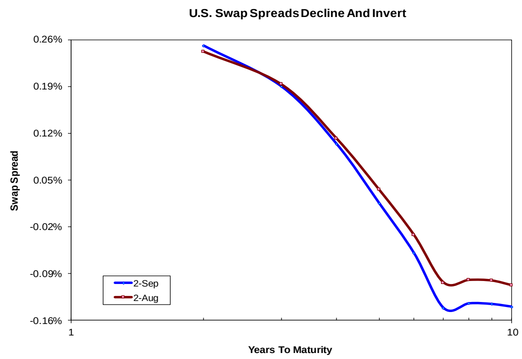
While the thinness of the sovereign CDS market is such we should not engage in over-analysis, the rise in CDS costs over the past month is puzzling. At the risk of detouring into politics, this seems to be a better explanation than anything intrinsic to markets.



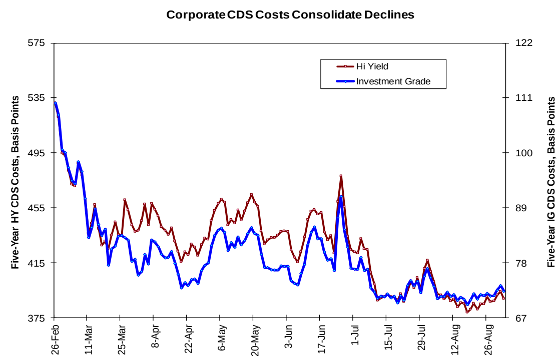
Pseudo-real rates at the long end of the yield curve have stopped rising, but this is not the case at the short end of the yield curve. Precious metals were able to rise in the face of these higher implied short-term real rates in the U.S. as they can reflect continued declines in these rates outside of the U.S. They have a “best-of” option.



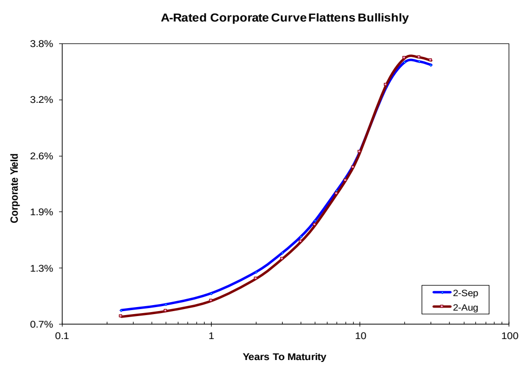
Swap spreads, which rise when floating-rate borrowers want to fix their payments, fell at tenors longer than two years. The market continues to remain sanguine about interest rates rising from even the modestly higher levels we have seen over the past month.



Both the investment-grade and high-yield CDS indices are consolidating their recent declines. So long as central banks are active in the corporate bond market, the ability of all credit spreads to rise will be limited. Moreover, as no credit shocks are imminent and even dodgy borrowers can refinance, why should CDS costs rise?



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

Only the economically unimportant Softs are in an uptrend within the physical commodities. The financials are largely sideways, with only ten-year UST within a structural trend at all.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Sep. 6 - 9
BBerg	22	Trending	-0.182	10.1%	-0.39%
BBerg Grain	21	Trending	-0.185	15.4%	-0.22%
BBerg Ind. Metl	28	Trending	-0.167	11.7%	-0.23%
BBerg Pre. Metl	29	Trending	-0.105	12.8%	-0.31%
BBerg Softs	28	Trending	0.092	18.1%	0.45%
BBerg Nat. Gas	29	Trending	-0.081	21.0%	-0.16%
BBerg Petroleum	23	Trending	-0.092	26.1%	
BBerg Livestock	25	Trending	-0.329	13.7%	-0.27%
Dollar Index	29	Trending	0.040	7.0%	
S&P 500 Index	4	Sideways	0.036	7.1%	
EAFE Index	11	Transitional	0.064	9.5%	
EM Index	5	Sideways	0.055	7.6%	
Ten-year UST (price)	29	Trending	-0.081	5.1%	-0.09%

Performance Measures

The shorthand but unscientific definition of a bull or bear market being a 20% change will need to be revised if the Petroleum markets keep trading as they have since July. Gasoline down almost 8% on the week? It is interesting to see some relative strength in both the precious and industrial metals; these economically sensitive markets are signaling physical commodity declines are far more a function of lingering slack production capacity than of declining demand.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.34%	-1.01%	6.03%	-6.00%
Grains Sub-Index	-0.53%	-3.37%	-7.49%	-10.29%
Corn	1.08%	-1.76%	-12.51%	-16.67%
Soybeans	-1.52%	-2.23%	9.49%	9.62%
Wheat	-2.02%	-8.56%	-20.30%	-22.64%
Energy Sub-Index	-6.19%	1.98%	13.94%	-26.93%
Petroleum Sub-Index	-6.86%	4.03%	8.94%	-25.82%
WTI	-6.80%	4.06%	7.07%	-30.92%
Brent	-6.61%	5.00%	12.71%	-23.27%
ULSD	-6.54%	4.92%	13.71%	-25.42%
Gasoline	-7.98%	0.81%	0.25%	-25.00%
Natural Gas	-4.36%	-3.42%	31.80%	-32.45%
Precious Metals Sub-Index	1.01%	-1.75%	8.56%	21.31%
Gold	0.07%	-1.29%	3.68%	17.47%
Silver	3.32%	-2.83%	22.18%	31.32%
Industrial Metals Sub-Index	-0.19%	-2.60%	0.69%	-1.46%
Copper	-0.31%	-4.02%	-9.55%	-11.46%
Aluminum	-3.13%	-3.34%	-1.15%	-4.56%
Nickel	2.50%	-6.26%	6.77%	-0.46%
Zinc	2.11%	4.36%	26.59%	29.63%
Softs Sub-Index	0.12%	2.83%	29.41%	41.06%
Coffee	4.53%	3.59%	18.48%	14.96%
Sugar	-2.08%	-0.81%	33.59%	63.77%
Cotton	-0.35%	-11.64%	19.40%	7.75%
Livestock Sub-Index	-2.95%	-5.60%	-15.77%	-19.81%
Cattle	-4.46%	-12.03%	-16.59%	-21.83%
Hogs	-0.93%	4.23%	-14.96%	-17.06%

While the focus remains on the Federal Reserve's never-ending melodrama, the JPY declined 2% on the week and the recently weak GBP gained 1.2%. It will be interesting to see if the Bank of Japan gets surprised by its weak-yen policy succeeding. The USD is going to remain choppy until the FOMC picks a direction and a reason and goes with both of them.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.38%	-0.61%	2.65%	-0.63%
Chinese yuan	-0.16%	-0.80%	-1.94%	-4.86%
Japanese yen	-2.00%	-2.92%	9.20%	15.79%
British pound	1.20%	-0.47%	-5.57%	-13.11%
Swiss franc	-0.28%	-1.70%	1.62%	-1.19%
Canadian dollar	0.08%	0.90%	3.26%	2.12%
Australian dollar	0.12%	-0.47%	3.81%	7.59%
Swedish krona	-1.22%	-0.85%	0.26%	-1.78%
Norwegian krone	-0.63%	1.28%	4.12%	-0.93%
New Zealand dollar	0.69%	0.59%	9.15%	14.78%
Indian rupee	0.35%	-0.13%	1.08%	-0.94%
Brazilian real	0.27%	0.07%	19.56%	15.48%
Mexican peso	0.08%	1.92%	-4.05%	-9.43%
Chilean peso	-0.52%	-2.37%	2.18%	2.95%
Colombian peso	-1.56%	5.65%	9.16%	8.04%
Bloomberg-JP Morgan Asian dollar index (spot)	0.11%	-0.56%	1.24%	-0.26%

One year ago, the equity markets were coming out of the first yuan shock. The World index has gained 11.62% in USD terms since then, with the Eurozone markets bringing up the rear. The ECB's free money has benefited non-Eurozone markets.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.54%	1.27%	9.53%	11.62%
North America	0.58%	1.50%	11.68%	13.78%
Latin America	0.51%	4.74%	30.75%	26.41%
Emerging Market Free	-0.10%	2.87%	19.25%	16.20%
EAFE	0.48%	2.64%	9.72%	4.66%
Pacific	-0.21%	1.69%	8.56%	11.17%
Eurozone	1.03%	4.53%	7.14%	3.10%

Both CTAs and hedge funds closed August poorly as the dollar reversed, physical commodities declined, bonds traded poorly and equities pulled back into Friday's employment report. You really can't expect professional traders to handle this, can you?

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.73%	-3.33%	-5.71%	0.98%
Newedge Trend	-0.68%	-3.40%	-4.28%	2.52%
Newedge Short-Term	-1.50%	-3.47%	-4.22%	0.78%
HFR Global Hedge Fund	-0.06%	0.20%	3.63%	-1.36%
HFR Macro/CTA	-0.51%	-1.55%	-2.63%	-2.34%
HFR Macro: Sytematic Diversified CTA	-0.98%	-2.85%	-3.37%	0.61%