
The Macro Environment For Financial Markets

The Wall Street Journal just profiled Roger Waters and the story behind *The Wall*. I prefer the lyrics to his earlier *Brain Damage Eclipse*: “The lunatic is on the grass / The lunatic is on the grass / Remembering games and daisy chains and laughs / Got to keep the loonies on the path.” It does describe the current Federal Reserve well; where else can you get a 9-1 vote one week to do the unexpected followed by seemingly unanimous repudiation of that decision the very next week? Yes, your head explodes with dark forebodings too and I’ll see you on the dark side of the moon. Anyone who wants to trade and invest on what the inferences of this circular firing squad are for global growth is welcome to do so, but you might as well trade off of a Ouija board. Remember, a rate hike will mean shrinkage of available commercial bank credit and a stronger USD. Neither is what the world needs now, far from it.

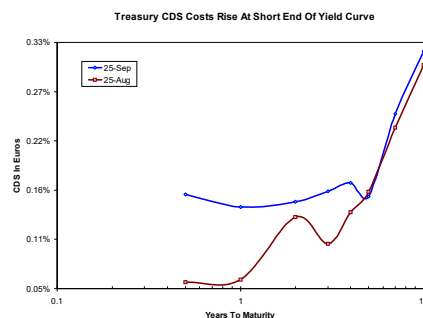
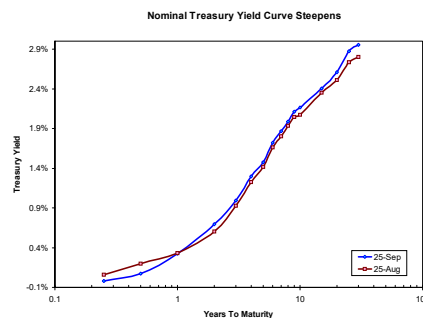
The causal chain now is:

1. Short-term interest rates will rise at some point in the U.S. even as they remain low globally;
2. Disinflationary pressures are dominating inflationary pressures;
3. Inflation expectations as measured by the TIPS market will remain low;
4. The U.S. yield curve retains its long-term trend toward a bullish flattening;
5. Short-term borrowers will continue to accept rollover risk;
6. Swap spreads will remain tame; and
7. Credit spreads are biased toward increasing.

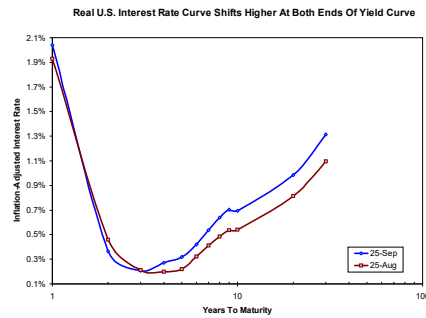
Key Market Indications

The month-over-month snapshot of the UST yield curve depicts a steepening, but this is deceptive. We are going to go back to a flatter yield curve via higher short-term rates and stable-to-lower long-term rates. Such things happen when you raise the overnight rate during a period of declining growth, liquefaction of risky assets and declining inflation expectations.

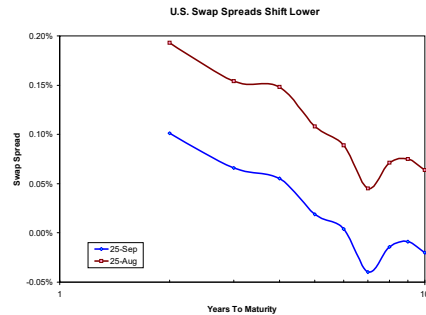
For those who question whether we have gone down the rabbit-hole, consider how John Boehner’s surprise resignation on Friday was discussed in terms of how it affected the prospects for a federal government shutdown. The consensus for now is it reduced the probability of such an outcome. If so, we should see CDS costs on U.S. debt decline. I suppose this is good news.



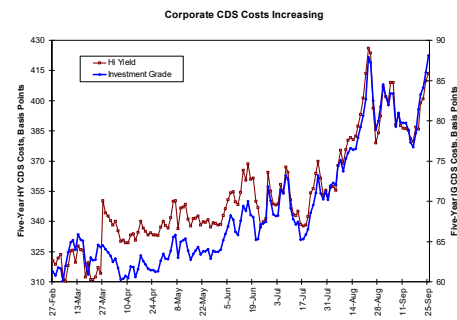
Pseudo-real rates continue to move higher at the short end of the yield curve. As noted last week, this move unlike previous shifts did not push gold prices lower thanks to a haven bid. Long-term pseudo-real rates have advanced over the past month. If this rise persists, it will constitute a headwind for risky financial assets.



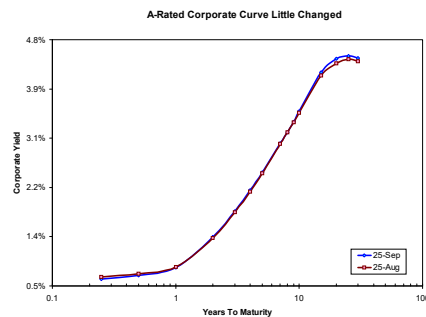
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have shifted lower across the yield curve and have turned negative at all tenors longer than six years save for the 15-year. The last times ten-year swap spreads were negative were prior to QE2 in 2010 and just after the launch of QE3 in 2012.



CDS costs for both the investment-grade and high-yield indices continue to move higher. Both the stronger USD and the anticipation of the next rate hike will keep these costs elevated and will constitute a headwind for risky financial assets.



The A-rated yield curve has changed very little over the past month. As investors search for yield, they will come back into investment-grade debt and push this yield curve lower.



Market Structure

Grains and Precious Metals moved into structural uptrends, while Industrial Metals moved into a downtrend, joining Livestock. Within the financial markets, ten-year UST moved into a structural uptrend, but just barely.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Sep. 28 - Oct. 2
BBerg	20	Trending	-0.011	15.7%	
BBerg Grain	21	Trending	0.169	15.9%	0.40%
BBerg Ind. Metl	21	Trending	-0.194	18.9%	-0.59%
BBerg Pre. Metl	29	Trending	0.119	14.1%	0.09%
BBerg Softs	19	Transitional	0.083	19.8%	
BBerg Nat. Gas	16	Transitional	-0.126	17.0%	
BBerg Petroleum	18	Transitional	-0.023	35.1%	
BBerg Livestock	29	Trending	-0.140	12.7%	-0.22%
Dollar Index	16	Transitional	0.071	8.0%	
S&P 500 Index	13	Transitional	-0.086	15.4%	
EAFE Index	13	Transitional	-0.141	14.5%	
EM Index	13	Transitional	-0.170	13.9%	
Ten-year UST (price)	22	Trending	0.028	5.9%	0.06%

Performance Measures

For all of the negative news associated with growth concerns, a rising USD and declining equities, only Industrial Metals declined this week. The moves higher elsewhere generally reflect short-covering, although the rise in the Petroleum subindex certainly reflects growing expectations U.S. shale production is going to decline. The rise in Grains is starting to reflect concerns over growing conditions in the Southern Hemisphere during the current El Niño.

	Commodity Total Returns			
	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.87%	-0.96%	-10.92%	-25.73%
Grains Sub-Index	3.20%	2.92%	-6.23%	1.58%
Corn	3.12%	3.74%	-7.12%	6.50%
Soybeans	2.54%	0.43%	-5.81%	-1.85%
Wheat	4.31%	4.97%	-1.83%	3.75%
Energy Sub-Index	0.99%	-3.30%	-13.50%	-49.44%
Petroleum Sub-Index	2.04%	-2.35%	-14.70%	-52.23%
WTI	1.51%	-0.60%	-15.76%	-57.41%
Brent	2.00%	-4.99%	-19.33%	-56.55%
ULSD	2.14%	-3.80%	-13.49%	-42.90%
Gasoline	3.07%	0.70%	-5.87%	-41.91%
Natural Gas	-1.68%	-5.76%	-9.76%	-44.57%
Precious Metals Sub-Index	0.42%	1.74%	-6.85%	-8.48%
Gold	0.69%	1.03%	-4.84%	-6.20%
Silver	-0.34%	3.87%	-12.22%	-15.05%
Industrial Metals Sub-Index	-3.39%	-3.66%	-18.63%	-27.34%
Copper	-4.30%	-2.66%	-17.92%	-25.02%
Aluminum	-3.94%	-2.88%	-15.21%	-23.58%
Nickel	2.85%	-1.19%	-25.62%	-42.33%
Zinc	-3.40%	-10.03%	-22.38%	-29.39%
Softs Sub-Index	0.04%	3.45%	-10.99%	-27.27%
Coffee	3.68%	-1.08%	-16.33%	-40.30%
Sugar	6.07%	4.72%	-7.39%	-31.98%
Cotton	0.15%	-3.74%	-5.82%	-1.54%
Livestock Sub-Index	0.28%	-1.63%	-4.53%	-18.10%
Cattle	-0.99%	-6.09%	-12.62%	-12.82%
Hogs	2.53%	6.79%	11.91%	-27.28%

So much for the theory the FOMC's decision not to raise rates was motivated by a fear of EM currencies declining further. With the exception of the INR, all currencies listed here declined against the USD, many significantly. If other countries start following Norway's lead and cut rates while the U.S. raises them, the USD rally could accelerate until such time as non-U.S. equity markets start outperforming.

	Currency Returns			
	Five-Days	One Month	Six Months	One Year
Euro	-0.91%	-2.80%	2.05%	-12.20%
Chinese yuan	-0.16%	0.60%	-2.54%	-3.73%
Japanese yen	-0.51%	-1.46%	-0.91%	-9.82%
British pound	-2.29%	-3.23%	2.02%	-6.97%
Swiss franc	-1.07%	-4.11%	-2.02%	-3.36%
Canadian dollar	-0.83%	-0.01%	-4.13%	-16.70%
Australian dollar	-2.30%	-1.49%	-10.47%	-20.06%
Swedish krona	-1.98%	-0.53%	0.89%	-14.30%
Norwegian krone	-4.23%	-3.49%	-8.03%	-24.92%
New Zealand dollar	-0.22%	-1.37%	-16.05%	-19.42%
Indian rupee	0.46%	0.74%	-5.91%	-7.84%
Brazilian real	-0.76%	-9.02%	-19.48%	-38.93%
Mexican peso	-1.88%	1.40%	-11.70%	-21.13%
Chilean peso	-3.03%	0.20%	-11.63%	-14.71%
Colombian peso	-2.91%	4.38%	-17.30%	-34.33%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.92%	-0.29%	-4.86%	-7.61%

There are many ways to produce an equity rally. Increasing confusion is not on that list nor are events such as the smashing of the European auto sector following the VW revelations. An increase in U.S. short-term rates in the face of slowing global growth and a stronger USD will push returns lower.

	Equity Total Returns			
	Five-Days	One Month	Six Months	One Year
MSCI World Free	-2.19%	0.84%	-7.96%	-4.08%
North America	-1.63%	3.37%	-6.02%	-1.24%
Latin America	-5.70%	-4.17%	-22.92%	-40.24%
Emerging Market Free	-4.86%	0.36%	-17.54%	-20.88%
EAFE	-3.09%	-3.00%	-10.95%	-8.40%
Pacific	-2.48%	-0.46%	-13.33%	-7.84%
Eurozone	-3.38%	-5.09%	-11.44%	-10.00%

CTAs finally enjoyed a strong week, suggesting they embraced the short side of the equity markets. Hedge funds continued to struggle, as is their wont in bear markets.

	CTA/Hedge Fund Returns			
	Five-Days	One Month	Six Months	One Year
Newedge CTA	2.62%	-1.76%	-5.68%	14.37%
Newedge Trend	1.78%	-1.18%	-5.61%	9.89%
Newedge Short-Term	0.83%	-0.70%	-7.25%	1.00%
HFR Global Hedge Fund	-1.14%	-0.05%	-4.27%	-4.34%
HFR Macro/CTA	0.38%	-0.75%	-5.10%	1.09%
HFR Macro:	1.72%	-1.17%	-4.50%	4.45%
Systematic Diversified CTA				