The Macro Environment For Financial Markets

Lost in the collective recognition of the”stronger dollar” is the dollar has been declining against the U.S.’ most important trading partner, China. The yuan has appreciated almost 2% since the first week of June, meaning it has appreciated 8.36% and 8.81% against the euro and yen, respectively. The high demand for liquidity in China as its growth slows is leading to disinvestment by China globally. Beijing is hesitant to double down on its stimulus program as these tend to fuel domestic speculation, but it may have to do so if the yuan keeps moving on its present course and exacerbates global disinflationary trends.

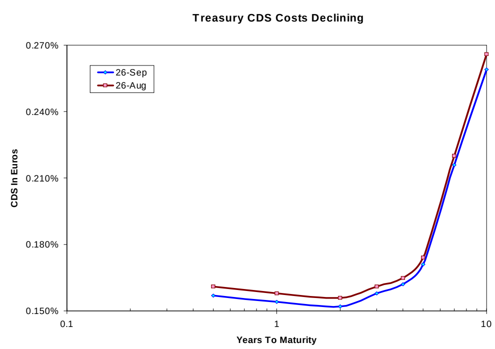
The causal chain is now:

1. Short-term interest rates will remain artificially low even as expectations for future short-term rates rise;
2. Real rates will continue their move higher, especially at the short end of the yield curve, as
3. Inflation expectations as measured by the TIPS market remain subdued;
4. The rise in longer-dated sovereign debt yields has held strong support;
5. The U.S. yield curve should continue its flattening trend from what are historically high levels still;
6. Short-term borrowers will continue to accept rollover risk and keep their effective maturities as short as possible;
7. Swap spreads are in a stable and inverting configuration and will not present an impediment to corporate bonds; and
8. Credit spreads swings will remain exaggerated as CDS have moved away from their original function to being the tool for corporate bond synthesis.

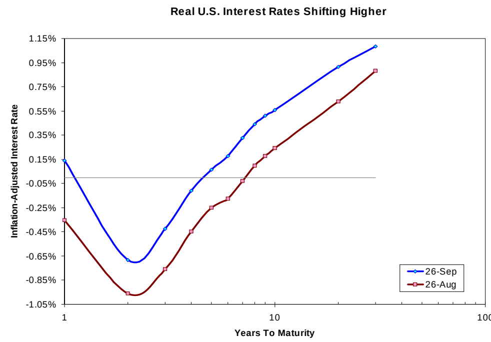
Key Market Indications

The longstanding pattern of long-term yields failing at lower highs remains intact. With the dollar rising and inducing inflows, inflation expectations declining and the Department of Defense letting it be known it will need to finance expanded operations in the Middle East, the Federal Reserve will continue its game of talking short-term rates higher while making sure public debt service levels do not rise.

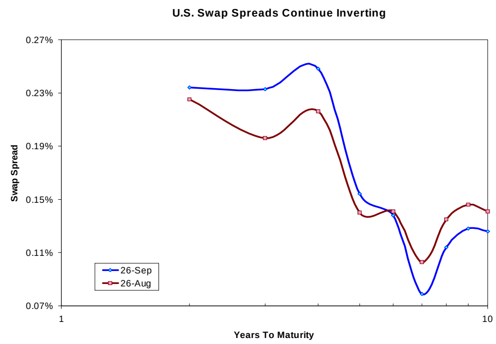
Euro-denominated CDS costs continue their downward shift. As the EUR itself is weaker, the decline in CDS costs represents a significant decline in concern over U.S. finances.



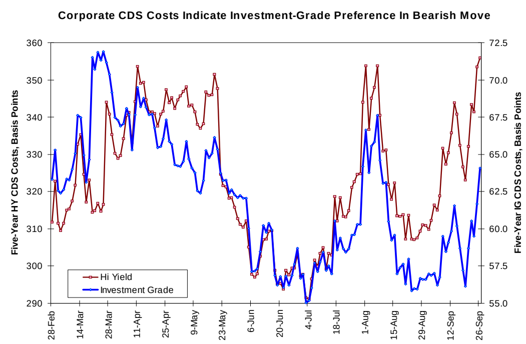
Real rates are negative only in the mid-curve horizon. The short-term continues to be bearish for precious metals. The rise in long-term real rates is not yet bearish for risky financial assets as it has been induced by lower TIPS breakevens more than by a rise in nominal rates.



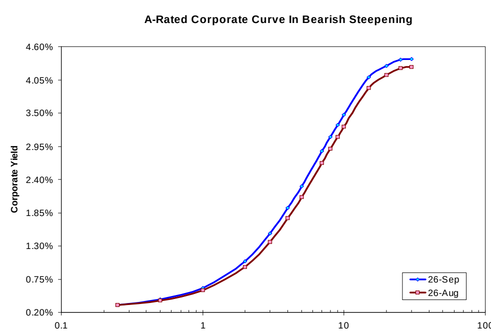
Swap spreads, which rise when floating-rate borrowers want to fix their payments, are increasingly inverted as floating-rate borrowers are trying to fix short-dated and mid-curve payments but are willing to remain floating at the long end of the yield curve. This condition remains supportive for capital market-horizon assets.



Are CDS costs a barometer of default risk or simply as a tradable proxy for general corporate credit risk? The latter is indicated as these spreads have become the preferred tool for creating synthetic corporate bonds. Anyone who believes CDS represent a fair market price for default should ask themselves whether investment-grade default risk really rose 14.2% last week.



The A-rated yield curve has been mimicking the Treasury yield curve for several months, but it has started to steepen bearishly relative to the UST yield curve under the weight of higher investment-grade CDS costs. Until long-dated swap spreads start to rise this relative shift should be small.



Market Structure

Only Livestock, Precious Metals and Petroleum are not in structural downtrends amongst physical commodity markets. The broad Bloomberg index and the Grain, Soft, and Industrial Metals indices are oversold. Ten-year UST and both EAFE and Emerging Markets are oversold within downtrend structures while the S&P 500 and the dollar index remain in bullish consolidations.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For Sep. 29 - Oct. 3
BBerg	29	Trending	-0.529	6.6%	-0.13%
BBerg Grain	29	Trending	-0.596	15.1%	-0.20%
BBerg Ind. Metl	29	Trending	-0.385	11.3%	-0.20%
BBerg Pre. Metl	4	Sideways	-0.025	15.1%	
BBerg Softs	29	Trending	-0.145	17.0%	-0.81%
BBerg Nat. Gas	29	Trending	0.056	20.2%	-0.27%
BBerg Petroleum	9	Sideways	-0.024	11.6%	
BBerg Livestock	5	Sideways	0.024	10.5%	
Dollar Index	9	Sideways	0.159	6.5%	
S&P 500 Index	15	Transitional	-0.070	7.5%	
EAFE Index	29	Trending	-0.401	7.0%	-0.05%
EM Index	29	Trending	-0.623	7.4%	-0.19%
Ten-year UST (price)	29	Trending	-0.090	4.2%	-0.07%

Performance Measures

One often-overlooked attribute of physical commodity markets is they cannot go bankrupt or be priced at zero. This is why bear market rallies are so vicious; all it takes is some evidence of price support or of supply reductions for buyers to fix prices. This happened in Softs, Natural Gas and Livestock over the past week, but has yet to happen in the more economically indicative Industrial Metals.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.25%	-5.84%	-11.54%	-6.85%
Grains Sub-Index	-2.56%	-12.33%	-31.97%	-27.90%
Corn	-2.56%	-11.44%	-36.62%	-33.94%
Soybeans	-4.88%	-11.13%	-24.04%	-15.38%
Wheat	-0.05%	-15.84%	-35.83%	-35.68%
Energy Sub-Index	0.97%	-3.48%	-8.24%	0.16%
Petroleum Sub-Index	0.04%	-4.05%	-6.33%	-5.31%
WTI	2.06%	-1.56%	-3.49%	-3.12%
ULSD	-0.75%	-5.73%	-8.95%	-8.21%
Gasoline	-1.54%	-3.82%	-5.78%	-2.54%
Natural Gas	3.23%	-2.11%	-12.71%	10.48%
Precious Metals Sub-Index	-0.50%	-6.71%	-7.69%	-12.41%
Gold	-0.10%	-5.59%	-6.20%	-9.46%
Silver	-1.72%	-10.03%	-12.00%	-20.57%
Industrial Metals Sub-Index	-1.96%	-6.06%	5.14%	0.22%
Copper	-1.81%	-3.95%	-0.17%	-8.95%
Aluminum	-1.61%	-7.74%	7.91%	-1.92%
Nickel	-4.48%	-9.80%	7.13%	19.52%
Zinc	-0.43%	-4.14%	13.33%	15.52%
Softs Sub-Index	3.48%	-7.36%	-15.34%	-6.26%
Coffee	4.52%	-7.53%	-1.94%	49.06%
Sugar	4.81%	-7.69%	-26.68%	-27.09%
Cotton	-3.88%	-7.03%	-28.05%	-23.83%
Livestock Sub-Index	1.25%	5.14%	-0.50%	14.37%
Cattle	2.14%	5.37%	13.17%	22.84%
Hogs	-0.39%	4.55%	-16.91%	2.84%

The USD rally has its second clean-sweep in three weeks as the divergence between U.S. monetary policies and those elsewhere, save China, pushed the greenback higher. The USD money-market yield curve is steepening even as the note-horizon yield curve is flattening. Such a degree of consensus, here on the 2015 arrival of higher short-term rates, usually is self-defeating.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.13%	-3.67%	-7.96%	-5.97%
Chinese yuan	0.23%	0.43%	1.34%	-0.10%
Japanese yen	-0.23%	-4.79%	-6.63%	-9.42%
British pound	-0.23%	-1.75%	-2.01%	1.30%
Swiss franc	-1.11%	-3.56%	-6.98%	-4.32%
Canadian dollar	-1.71%	-1.81%	-0.47%	-7.57%
Australian dollar	-1.79%	-5.81%	-5.00%	-6.39%
Swedish krona	-1.58%	-4.26%	-11.01%	-11.74%
Norwegian krone	-1.62%	-4.31%	-6.28%	-7.37%
New Zealand dollar	-3.27%	-5.59%	-8.44%	-5.13%
Indian rupee	-0.54%	-1.18%	-1.62%	1.51%
Brazilian real	-2.14%	-6.55%	-4.84%	-7.21%
Mexican peso	-1.76%	-2.60%	-2.37%	-2.86%
Chilean peso	-0.40%	-2.07%	-7.46%	-16.31%
Colombian peso	-2.27%	-4.26%	-2.28%	-5.71%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.33%	-1.05%	0.56%	-0.55%

While the U.S. market has benefited from carry trade-induced capital inflows, these are more effective at pushing a market relatively as opposed to absolutely higher. Unless there is concrete evidence of an absolute earnings slowdown, the present pullback will be but one more temporary episode.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.77%	-2.13%	4.79%	12.48%
North America	-1.50%	-1.08%	8.02%	18.34%
Latin America	-3.57%	-7.93%	10.09%	0.74%
Emerging Market Free	-2.82%	-5.65%	7.91%	4.95%
EAFE	-2.18%	-3.69%	0.16%	4.47%
Pacific	-0.84%	-3.35%	5.31%	0.80%
Eurozone	-2.74%	-3.31%	-3.34%	6.74%

CTA's and macro-oriented hedge funds rebounded, suggesting they had abandoned their over-reliance on long equity positions and were riding the long USD and flatter yield curve trends. CTA performance improved with some countertrend bounces within longer-term downtrends; this underscores the reluctance of so many CTAs to be aggressively short physical markets.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.38%	3.52%	13.87%	11.28%
Newedge Trend	0.83%	2.32%	8.99%	8.23%
Newedge Short-Term	1.11%	2.14%	3.77%	7.31%
HFR Global Hedge Fund	-0.70%	-0.40%	0.45%	3.52%
HFR Macro/CTA	0.44%	1.78%	3.82%	2.81%
HFR Macro: Sytematic Diversified CTA	0.79%	0.91%	1.65%	0.71%