The Macro Environment For Financial Markets

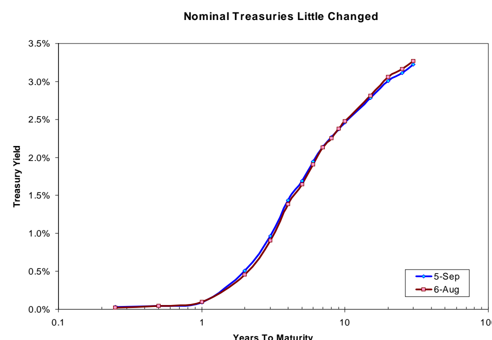
The question whether rising economic growth will translate into rising employment levels, increased personal income and a flatter distribution of both wealth and income should be answered increasingly in the negative. You can have rising industrial output produced at lower cost levels by increasingly automated processes with only a minor increase in labor content. While this may appear deflationary, it is not deflation produced by collapsing demand but rather by increased supply. Critically, these conditions will encourage central banks to keep monetary policy accommodative even though the resulting lower interest rates will favor capital and technology over labor and will lead to increasingly skewed distributions of wealth. A reversal of these accommodative policies would risk deleveraging of the global economy as it has evolved and therefore would be disastrous. The likely outcome will continue to be rising pressure for redistributionist fiscal policies even though these never have been demonstrated to be economically efficient.

The causal chain is now:

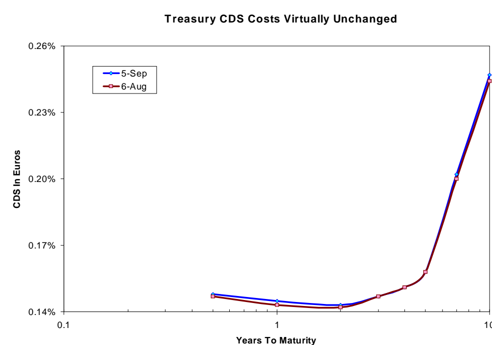
1. Short-term interest rates will remain artificially low and will keep real rates negative below the middle range of the yield curve;
2. The longer-term uptrend in senior sovereign debt is showing strong signs of resistance;
3. Inflation expectations as measured by the TIPS market will remain in the 2.10-2.25% range as long as nominal long-term rates do not rise. A rise in long-dated real rates will be a negative for risky assets;
4. Short-term borrowers will continue to accept rollover risk and keep their effective maturities as short as possible;
5. Swap spreads are in a stable configuration and will not present an impediment to corporate bonds; and
6. Credit spreads, especially for investment-grade bonds, will remain compressed in the absence of a macroeconomic shock. Rising high-yield CDS levels will be a negative for risky assets.

Key Market Indications

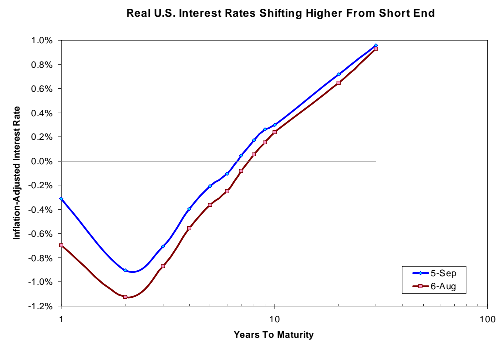
The Treasury yield curve's bullish flattening ended even as the U.S. maintained a rising yield gap to Europe and Japan. When a market fails to move bullishly in the face of bullish conditions, it is a sign of strong long-term resistance. The Friday downturn in yields associated with the employment report may have been a short-term delay in this topping process.



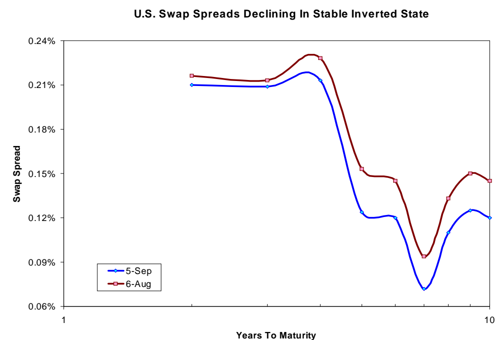
Euro-denominated CDS costs have remained virtually unchanged over the past month as the likelihood of another Congressional impasse on the budget recedes and as the rally in Treasuries has lowered U.S. debt service costs.



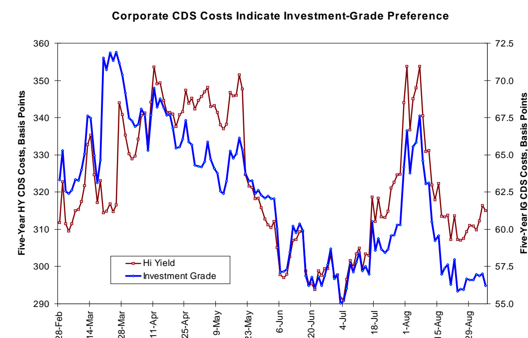
Real rates remain negative out to the six-year horizon, a departure from the 7-8 year horizons seen recently. The increase at short-dated maturities continues to be a negative for precious metals. The rise in long-dated real rates is not yet a concern for financial markets and will not be until nominal rates rise.



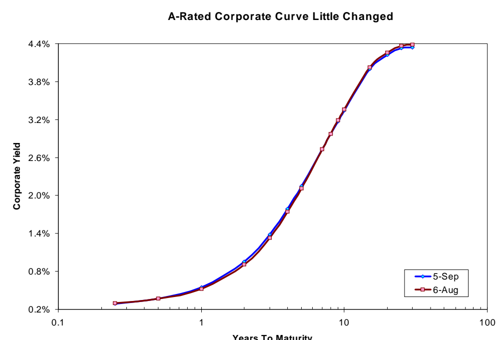
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have started to decline as markets once again abandon insurance against higher interest rates. Their inverted state is consistent with relatively greater demand to fix short-dated payments while remaining willing to pay floating on 5-7 year notes.



While five-year CDS costs for investment-grade are approaching their July lows, those for high-yield bonds have started to increase. This emerging signal of rising risk-aversion is not yet a threat to financial markets; it does, however, indicate a rising preference for more liquid assets given the decreasing capacity of financial intermediaries to take the opposite side of high-yield bond trades.



The A-rated yield curve continues to mimic the Treasury yield curve and, like the UST curve, it has encountered resistance even as the news flow remains positive. However, as long as corporate yield curves do not steepen bearishly, they will remain supportive for equities for the simple reason risk-seeking flows will shift more toward liquid equities and away from less liquid corporate bonds.



Market Structure

With the key exception of Industrial Metals and the minor exception of Livestock, physical commodity markets have turned lower, still more on supply excess than declining demand. The dollar and Emerging Market indices remain in uptrends, but the S&P 500 and EAFE indices have started consolidations.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For Sep. 8 - 12
BBerg	13	Transitional	-0.148	5.1%	
BBerg Grain	23	Trending	-0.188	15.4%	-0.20%
BBerg Ind. Metl	26	Trending	0.135	10.9%	0.14%
BBerg Pre. Metl	29	Trending	-0.230	9.9%	-0.12%
BBerg Softs	23	Trending	-0.028	15.9%	
BBerg Nat. Gas	24	Trending	-0.170	20.5%	-0.27%
BBerg Petroleum	11	Transitional	-0.089	11.2%	
BBerg Livestock	29	Trending	0.170	14.6%	
Dollar Index	29	Trending	0.529	3.8%	0.07%
S&P 500 Index	5	Sideways	0.035	7.6%	
EAFE Index	7	Sideways	-0.012	6.8%	
EM Index	27	Trending	0.261	6.9%	0.18%
Ten-year UST (price)	28	Trending	-0.059	4.9%	

Performance Measures

The small support seen last week in the broad Bloomberg index was short-lived. Strong downtrends reasserted themselves in Grains, Energy, Precious Metals and Softs; these were offset only in a small way by gains in Industrial Metals and Livestock.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-1.17%	-1.95%	-8.28%	-4.48%
Grains Sub-Index	-3.22%	-3.91%	-23.15%	-20.29%
Corn	-3.59%	-1.95%	-29.71%	-29.41%
Soybeans	-0.70%	-5.83%	-16.00%	-8.38%
Wheat	-6.38%	-5.36%	-22.98%	-23.45%
Energy Sub-Index	-2.70%	-3.92%	-8.96%	-3.92%
Petroleum Sub-Index	-1.25%	-3.47%	-4.89%	-8.97%
WTI	-1.19%	-3.78%	-4.65%	-9.81%
ULSD	-1.15%	-2.27%	-5.68%	-9.46%
Gasoline	-0.73%	-2.29%	-4.74%	-6.95%
Natural Gas	-6.19%	-5.07%	-18.15%	4.67%
Precious Metals Sub-Index	-1.92%	-3.56%	-6.38%	-11.98%
Gold	-1.79%	-3.33%	-5.42%	-8.82%
Silver	-2.31%	-4.25%	-9.11%	-20.72%
Industrial Metals Sub-Index	1.42%	2.06%	11.66%	8.71%
Copper	0.60%	-0.62%	2.86%	-2.95%
Aluminum	0.32%	2.86%	15.40%	6.25%
Nickel	4.94%	5.35%	26.92%	37.83%
Zinc	2.11%	4.19%	14.72%	22.59%
Softs Sub-Index	-2.42%	-2.01%	-16.72%	2.85%
Coffee	-0.97%	7.04%	-4.23%	53.08%
Sugar	-3.60%	-7.06%	-23.20%	-21.50%
Cotton	-3.41%	0.16%	-23.21%	-17.60%
Livestock Sub-Index	7.97%	6.44%	4.58%	17.37%
Cattle	6.43%	6.50%	15.08%	25.60%
Hogs	10.63%	6.35%	-8.36%	6.41%

Only the AUD gained against the USD amongst the majors. While the BRL and COP declined, other Latin currencies such as the MXN and CLP gained, as did the INR. The U.S. employment data may slow the USD's gains in the short-term, but the intermediate term of a European currency carry trade into the USD is established.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.38%	-3.18%	-5.69%	-1.29%
Japanese yen	-0.95%	-2.37%	-2.65%	-4.74%
British pound	-1.63%	-3.31%	-2.36%	4.73%
Swiss franc	-1.39%	-2.37%	-4.73%	1.48%
Canadian dollar	-0.02%	0.74%	1.37%	-3.45%
Australian dollar	0.42%	0.78%	4.37%	2.81%
Swedish krona	-1.49%	-3.02%	-9.55%	-5.91%
Norwegian krone	-1.33%	-0.03%	-4.58%	-2.52%
New Zealand dollar	-0.42%	-1.65%	-1.06%	5.61%
Indian rupee	0.18%	0.73%	2.23%	9.45%
Brazilian real	-0.26%	1.78%	3.43%	3.69%
Mexican peso	0.40%	1.99%	1.58%	2.74%
Chilean peso	0.18%	-1.60%	-4.05%	-13.22%
Colombian peso	-0.74%	-2.15%	5.42%	1.10%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.09%	0.57%	1.10%	2.02%

A downturn at week's end in the Bovespa index pulled Latin American returns lower, but this is not a reversal. The Friday gains in the U.S. and the post-ECB gains in the Eurozone kept returns higher on the week, but both markets are showing signs of trend exhaustion.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.15%	3.36%	5.82%	19.85%
North America	0.18%	4.70%	8.39%	23.60%
Latin America	-0.37%	6.77%	27.21%	20.37%
Emerging Market Free	0.87%	3.42%	16.66%	18.98%
EAFE	0.10%	1.40%	2.16%	14.56%
Pacific	0.35%	1.01%	6.75%	11.05%
Eurozone	1.32%	3.12%	0.39%	19.78%

CTA's and macro-oriented hedge funds' continued bias toward the long equity and dollar trades paid off for a fourth week. The long sovereign debt trade has started to consolidate as it will become exponentially more difficult for yields to decline from current levels. In addition, the prevailing downtrends in physical commodity markets are harder to trade than are uptrends.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.96%	5.95%	8.38%	8.50%
Newedge Trend	1.12%	4.75%	6.92%	7.13%
Newedge Short-Term	0.63%	1.98%	1.44%	4.60%
HFR Global Hedge Fund	0.38%	1.48%	0.66%	5.20%
HFR Macro/CTA	1.24%	2.44%	2.63%	2.51%
HFR Macro: Sytematic Diversified CTA	0.86%	2.07%	0.14%	1.33%