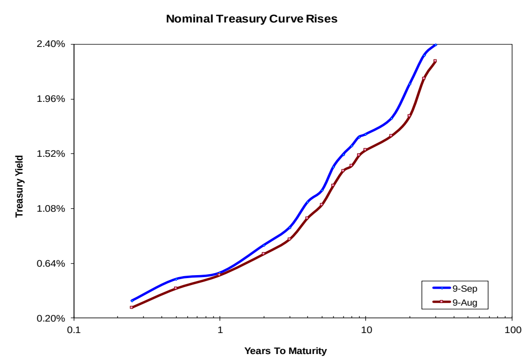
The Macro Environment For Financial Markets

A breakaway gap to the downside after months of sideways trade must be respected. As such, the recent highs in equities could be the last ones seen for the year and maybe longer. However, the prospect of interest rate normalization, however, gradual, should be welcomed by the financial sector and certainly by anyone with pension liabilities or a desire to be a saver as opposed to an investor. The real question is whether the central banks will follow through or back away one more time in the face of market turmoil. Their track record is one-sided in this regard. Moreover, government have been getting accustomed to free borrowing, and they are unlikely to welcome higher interest rates. The causal chain now is:

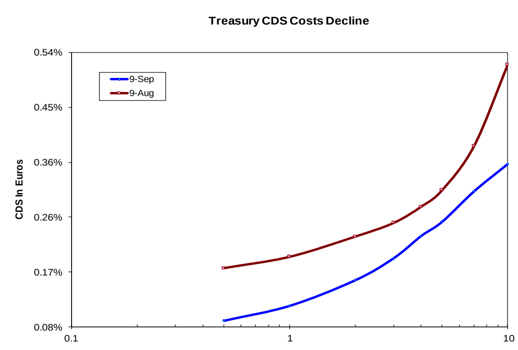
1. The market has no clear idea of when U.S. short-term rates will rise, although December seems the most likely date;
2. Disinflationary pressures will persist globally;
3. Inflation expectations as measured by TIPS and inflation swaps have ended their downtrend;
4. The U.S. yield curve retains its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

Key Market Indications

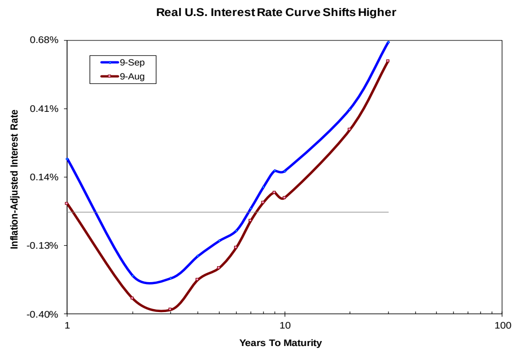
The most significant development for the Treasury market was the ECB calling a timeout on its QE program. If Bunds can turn positive, what other manner of Furies shall be unleashed upon the Earth? The prospect of higher short-term rates in the U.S. was treated as bearish even though the Treasury market did nothing but rally after the last rate hike. Until the ten-year exceeds 1.98%, the bull market is intact.



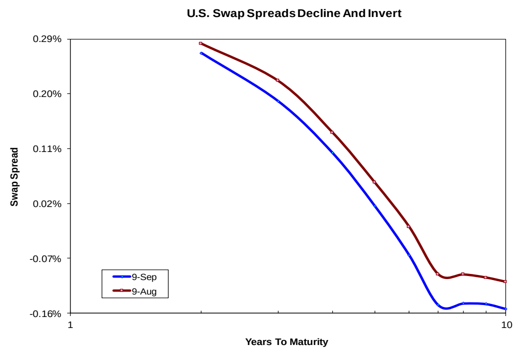
Did the sovereign credit quality of the U.S. government improve markedly over the past month? Probably not, but it is interesting to note how CDS costs fell significantly in the face of rising UST rates. Perhaps rising debt service costs will not matter.



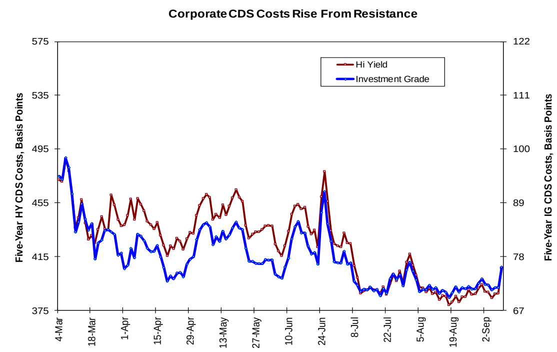
Pseudo-real rates have increased at all maturities over the past month, with the largest increases coming in the mid-curve segment. Precious metals were able to rise in the face of these higher implied short-term real rates in the U.S. as they can reflect continued softness in these rates outside of the U.S. They have a "best-of" option.



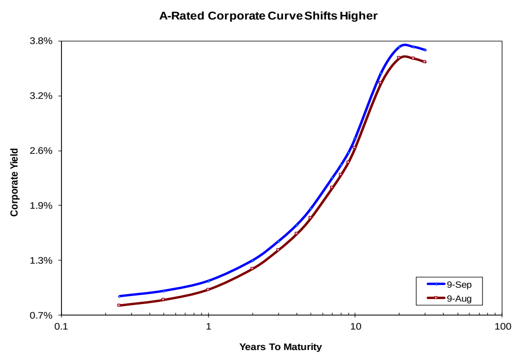
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have declined across all tenors over the past month. The market continues to remain sanguine about interest rates rising from even the modestly higher levels we have seen over the past month.



Did the increased probability of a U.S. rate hike lead to an increase in credit risk? Intrinsically, no, but sales of corporate bonds propel the unwinding of short CDS positions and lead to an apparent rise in credit risk. Restated, credit market mechanics can produce symptoms while never going through the bother of acquiring the disease.



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

Petroleum joined Softs in an uptrend within the physical commodities while Grains exited their downtrend. The dollar index and the S&P 500 joined ten-year UST in a structural downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Sep. 12 - 16
BBerg	24	Trending	-0.050	9.6%	-0.39%
BBerg Grain	24	Trending	0.013	15.4%	
BBerg Ind. Metl	6	Sideways	-0.021	8.3%	
BBerg Pre. Metl	26	Trending	-0.043	12.4%	-0.31%
BBerg Softs	22	Trending	0.072	16.6%	0.45%
BBerg Nat. Gas	29	Trending	-0.028	20.4%	-0.16%
BBerg Petroleum	27	Trending	0.017	25.9%	1.16%
BBerg Livestock	27	Trending	-0.289	13.4%	-0.27%
Dollar Index	29	Trending	-0.003	6.8%	-0.05%
S&P 500 Index	21	Trending	-0.351	6.7%	-0.13%
EAFE Index	16	Transitional	0.004	9.3%	
EM Index	14	Transitional	0.044	10.4%	
Ten-year UST (price)	23	Trending	-0.180	4.9%	-0.09%

Performance Measures

Gasoline was down almost 8% last week and up 6.75% this week. Precious Metals rose in the face of higher implied short-term real rates. Recently weak Grains rose across the board despite the prospects of record harvests in the U.S. The combination of higher expected short-term interest rates, a sideways USD and a downturn in equities being supportive of physical commodities is explained best by overall risk reduction trades leading to short-covering in these markets. If risk managers are doing their job well, they have no friends.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.35%	-0.01%	5.25%	-5.29%
Grains Sub-Index	4.13%	-0.91%	-6.93%	-11.26%
Corn	5.34%	2.43%	-10.86%	-18.86%
Soybeans	3.88%	-0.13%	10.51%	11.81%
Wheat	2.22%	-8.27%	-21.99%	-24.59%
Energy Sub-Index	3.91%	2.05%	9.71%	-24.07%
Petroleum Sub-Index	5.64%	1.69%	6.09%	-21.42%
WTI	6.20%	1.27%	4.00%	-26.41%
Brent	5.66%	1.63%	10.54%	-19.00%
ULSD	3.63%	0.38%	10.79%	-22.03%
Gasoline	6.75%	4.44%	-3.02%	-19.61%
Natural Gas	-0.61%	3.10%	22.65%	-33.27%
Precious Metals Sub-Index	1.60%	-1.12%	9.89%	23.40%
Gold	1.33%	-0.62%	5.22%	20.10%
Silver	2.25%	-2.28%	22.89%	31.74%
Industrial Metals Sub-Index	-0.04%	-1.87%	2.88%	-5.35%
Copper	0.83%	-2.72%	-7.55%	-15.98%
Aluminum	-2.32%	-4.92%	-0.53%	-7.27%
Nickel	4.64%	0.53%	16.49%	-0.82%
Zinc	-2.08%	2.38%	26.34%	23.63%
Softs Sub-Index	1.28%	-0.71%	26.78%	35.50%
Coffee	-0.16%	7.72%	13.82%	17.34%
Sugar	2.10%	1.49%	29.77%	58.49%
Cotton	1.33%	-2.20%	21.59%	8.92%
Livestock Sub-Index	-2.40%	-5.75%	-16.93%	-18.74%
Cattle	0.76%	-8.86%	-16.10%	-19.72%
Hogs	-6.45%	-1.25%	-18.33%	-17.24%

The recently retreating JPY gained on a haven trade once again while commodity-linked currencies such as the AUD, CAD, BRL and MXN all fell despite a positive week for physical commodities. As the USD has gone through several reversals of sentiment as to the course of short-term rates and as both the ECB and BOJ are tiring of their loose policies, the currency world is going to be exceptionally volatile and through the end of the year.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.69%	1.04%	2.13%	0.23%
Chinese yuan	-0.07%	-0.44%	-2.57%	-4.59%
Japanese yen	1.20%	-0.79%	10.38%	17.34%
British pound	-0.20%	2.03%	-6.68%	-13.67%
Swiss franc	0.54%	0.58%	2.22%	-0.01%
Canadian dollar	-0.43%	0.54%	1.53%	1.61%
Australian dollar	-0.42%	-1.72%	0.73%	7.45%
Swedish krona	1.09%	0.46%	-0.56%	-1.16%
Norwegian krone	0.86%	1.88%	3.26%	-0.40%
New Zealand dollar	0.52%	2.20%	10.07%	14.51%
Indian rupee	0.22%	0.25%	0.81%	-0.40%
Brazilian real	-0.53%	-3.93%	12.70%	15.45%
Mexican peso	-1.69%	-2.44%	-6.01%	-10.97%
Chilean peso	0.18%	-2.70%	0.73%	2.77%
Colombian peso	0.59%	2.26%	9.13%	6.64%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.28%	-0.58%	-0.29%	-0.10%

The analogy of equity markets being to central banks what screaming infants are to harried parents is so ingrained in traders' minds no one has contemplated whether equities could survive a bout of positive interest rates.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.51%	-1.46%	6.60%	7.76%
North America	-2.32%	-2.10%	8.68%	11.38%
Latin America	-2.83%	-3.33%	18.73%	23.14%
Emerging Market Free	1.12%	1.32%	17.71%	15.49%
EAFE	-0.13%	1.00%	8.16%	2.03%
Pacific	1.40%	-0.38%	10.03%	10.81%
Eurozone	-0.59%	0.45%	3.92%	0.56%

Both CTAs and hedge funds managed gains on the week, suggesting they were somehow positioned short bonds, had minimal exposure to long equities, were short the dollar and biased long in the physical commodities. Why they would have had these positions is a mystery.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.17%	-2.19%	-2.63%	0.58%
Newedge Trend	0.97%	-1.75%	-1.84%	3.63%
Newedge Short-Term	0.59%	-2.68%	-3.74%	1.69%
HFR Global Hedge Fund	0.54%	0.58%	4.25%	-1.02%
HFR Macro/CTA	0.62%	-1.18%	-1.40%	-1.32%
HFR Macro: Sytematic Diversified CTA	1.09%	-1.80%	-1.30%	2.43%