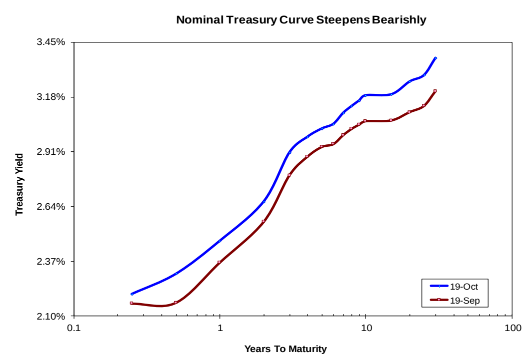
The Macro Environment For Financial Markets

No one knows how much of the recent strength in the U.S. and gains in financial markets were attributable to ZIRP and QE, so it stands to reason no one can know the effects of their unwinding. A reasoned starting point, though, is the former's effect were positive and the latter's effects will be negative. We already are seeing the end of the TINA argument for equity investing, and we will start to see a similar effect both in higher-risk bonds and in longer-dated assets such as real estate. Asking central banks to get the unwinding right is akin to drawing an inside straight on consecutive hands. The causal chain remains:

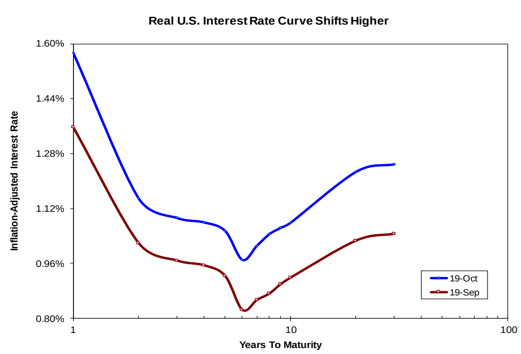
1. The market is pricing in December 2018 and March 2019 rate hikes;
2. Inflationary expectations are consolidating recent increases;
3. The yield curve is entering a steepening trend;
4. Short-term borrowers are accepting rollover risk rather than term-out borrowing in the bond market;
5. Swap spreads remain inverted; and
6. CDS costs are rising.

Key Market Indications

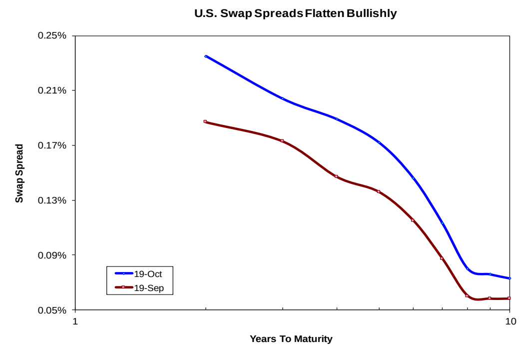
To what extent will the Federal Reserve's inwardly focused rate-hike campaign lead to a recession, a decline in credit demand and an opportunity for them to ride to the rescue of a mistake of their own making? The betting here is that will be the scenario as higher borrowing costs are affecting both housing and autos already.



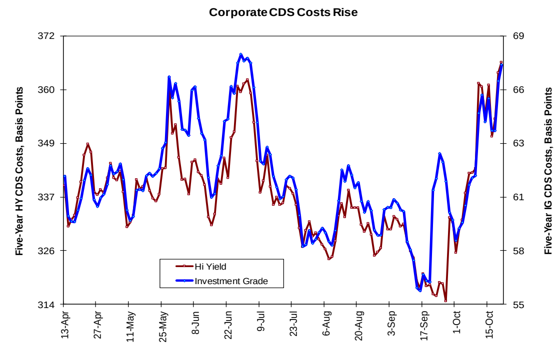
The pseudo-real yield curve shifted higher. The rise at the long yield of this yield curve is sufficient to threaten returns for risky assets.



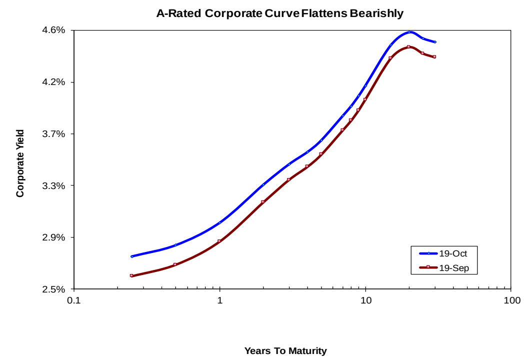
Swap spreads, which rise when floating-rate borrowers want to fix their payments, flattened bearishly. Markets remain more concerned about rising short-term rates than long-term ones.



CDS costs rose along with higher equity volatility. The ongoing mess with Italian sovereign debt is leading to a slow-motion flight to quality within fixed-income markets.



The A-rated corporate yield curve flattened bearishly as short-term corporate rates rose more rapidly than did long-term rates. This remains an asset class with very limited upside and the potential for negative returns if credit spreads expand.



Market Structure

Petroleum reversed into a structural downtrend and was joined by both Grains and Industrial Metals. Ten-year UST exited their structural downtrend. All of the equity indices remain in downtrends with the EAFE being oversold.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Oct. 22 - 26
BBerg	6	Sideways	-0.088	6.8%	
BBerg Grain	22	Trending	-0.005	13.9%	-0.12%
BBerg Ind. Metl	24	Trending	-0.044	18.6%	-0.04%
BBerg Pre. Metl	28	Trending	0.166	10.3%	0.27%
BBerg Softs	29	Trending	0.471	20.7%	0.29%
BBerg Nat. Gas	29	Trending	0.213	18.2%	0.21%
BBerg Petroleum	29	Trending	-0.108	18.5%	-0.81%
BBerg Livestock	17	Transitional	-0.258	9.8%	
Dollar Index	29	Trending	0.128	5.5%	0.09%
S&P 500 Index	29	Trending	-0.330	11.2%	-0.29%
EAFE Index	29	Trending	-0.460	9.3%	-0.48%
EM Index	24	Trending	-0.348	12.0%	-0.77%
Ten-year UST (price)	8	Sideways	-0.037	4.4%	

Performance Measures

The Energy markets tumbled for a second week on a probably misguided association with a stronger USD and weaker global equities. Economically sensitive Industrial Metals turned lower, too, as did the recently strong Grains. Precious Metals rose despite a stronger USD and higher implied short-term real rates as gold once again is acting as a haven asset.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.29%	2.00%	-3.37%	2.57%
Grains Sub-Index	-1.28%	1.05%	-10.02%	-6.95%
Corn	-1.76%	2.90%	-9.53%	-5.81%
Soybeans	-1.23%	1.31%	-18.56%	-16.51%
Wheat	-0.44%	-1.17%	1.69%	3.83%
Energy Sub-Index	-0.42%	2.72%	9.94%	26.40%
Petroleum Sub-Index	-1.49%	0.03%	7.30%	36.52%
WTI	-2.39%	-1.50%	5.36%	40.88%
Brent	-0.97%	1.97%	11.70%	47.04%
ULSD	-0.86%	3.29%	9.31%	30.75%
Gasoline	-1.43%	-4.15%	0.37%	15.29%
Natural Gas	2.44%	10.47%	17.55%	-1.71%
Precious Metals Sub-Index	0.49%	2.40%	-10.02%	-7.27%
Gold	0.59%	2.46%	-8.52%	-4.77%
Silver	0.15%	2.20%	-15.01%	-14.94%
Industrial Metals Sub-Index	-1.09%	-2.12%	-14.86%	-7.88%
Copper	-0.76%	-2.62%	-12.27%	-13.55%
Aluminum	-1.60%	-3.63%	-17.20%	-3.85%
Nickel	-1.62%	-6.00%	-16.14%	5.79%
Zinc	-0.47%	6.94%	-15.47%	-11.14%
Softs Sub-Index	4.35%	16.90%	3.02%	-4.14%
Coffee	4.81%	22.43%	-0.04%	-10.90%
Sugar	6.32%	19.12%	8.02%	-7.79%
Cotton	-0.53%	-1.36%	-5.19%	19.58%
Livestock Sub-Index	-1.29%	-3.69%	2.61%	-6.70%
Cattle	0.56%	-1.25%	9.16%	-1.31%
Hogs	-6.14%	-9.95%	-10.17%	-18.97%

With the exception of a few outliers such as the BRL and NZD, the USD had a strong week on the basis of relatively higher short-term rates going forward. It also seems to be enjoying the advantage of being the best house on a bad block.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.40%	-1.36%	-6.73%	-2.85%
Chinese yuan	-0.10%	-1.16%	-9.38%	-4.55%
Japanese yen	-0.30%	-0.24%	-4.60%	-0.01%
British pound	-0.59%	-0.52%	-7.18%	-0.63%
Swiss franc	-0.31%	-2.89%	-2.48%	-1.98%
Canadian dollar	-0.61%	-1.35%	-3.30%	-4.72%
Australian dollar	0.07%	-1.98%	-7.90%	-9.63%
Swedish krona	-0.32%	-1.30%	-6.52%	-9.61%
Norwegian krone	-0.56%	-0.83%	-5.20%	-3.50%
New Zealand dollar	1.34%	-0.33%	-9.32%	-6.22%
Indian rupee	0.34%	-1.29%	-10.27%	-11.30%
Brazilian real	1.86%	11.22%	-8.78%	-14.55%
Mexican peso	-2.19%	-2.63%	-4.33%	-2.48%
Chilean peso	-0.17%	-0.13%	-12.52%	-8.14%
Colombian peso	0.51%	-1.63%	-11.28%	-5.19%
Bloomberg-JP Morgan Asian dollar index (spot)	0.03%	-0.97%	-6.90%	-3.62%

The correction continues, and while it could have been worse given the drumbeat of negative news, the central takeaway must be lower prices have failed to attract buyers. Expect further downside.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.04%	-6.08%	-0.51%	3.80%
North America	-0.02%	-4.88%	3.15%	9.13%
Latin America	1.61%	8.10%	-10.62%	-5.27%
Emerging Market Free	-0.88%	-5.64%	-16.36%	-10.59%
EAFE	-0.06%	-7.03%	-8.15%	-4.39%
Pacific	-0.41%	-5.71%	-6.09%	-0.86%
Eurozone	-0.26%	-8.94%	-12.42%	-9.30%

Both CTAs and macro hedge funds made modest gains on the week, but continue to fail in their central mission of providing positive diversification for conventional financial assets.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
SocGen CTA	0.15%	-5.51%	-6.42%	-4.95%
SocGen Trend	0.38%	-3.49%	-5.47%	-4.28%
SocGen Short-Term	0.45%	0.17%	0.24%	0.45%
HFR Global Hedge Fund	0.11%	-2.50%	-3.63%	-2.50%
HFR Macro/CTA	0.15%	-3.17%	-3.95%	-3.03%
HFR Macro: Sytematic Diversified CTA	0.58%	-4.20%	-5.51%	-2.22%