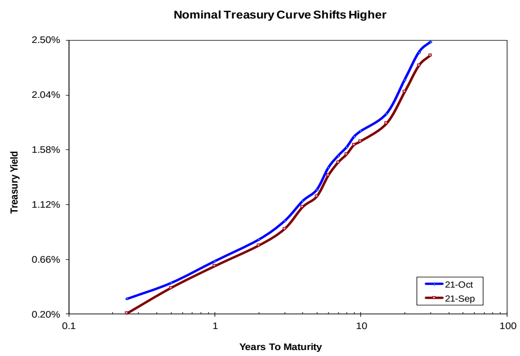
The Macro Environment For Financial Markets

Future historians will look back at the postwar period and conclude the liberal economic order created in the 1940s and expanded through the 1990s led to the greatest expansion of wealth and prosperity ever and people hated it. How else can we explain the rising global consensus against factor mobility? The benefits are massive but diffuse; the costs are concentrated and therefore politically visible. The impending cartelization of the global economy and the enshrinement of crony capitalism, a given in the U.S. after the November election, will work until the proverbial peasantry figures out where the grain is stored. Historically, they always do. The causal now remains:

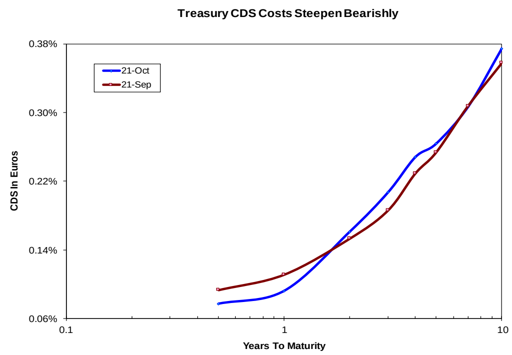
1. The market is pricing in a December increase in U.S. short-term rates;
2. Disinflationary pressures will persist globally but are rising in the U.S.;
3. Inflation expectations as measured by TIPS and inflation swaps are in a defined uptrend;
4. The U.S. yield curve retains its long-term bias toward flattening despite a 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 remain compressed.

Key Market Indications

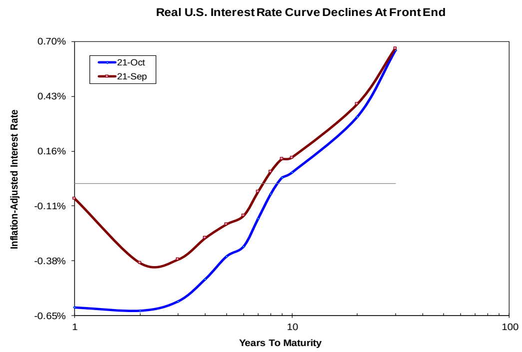
Rising inflation expectations and the increased talk of higher short-term interest rates have led to a bearish shift of the yield curve over the past month. A stronger USD will not attract capital inflows perforce as USD-denominated assets will become more expensive for foreign investors. This has been a truism for decades and has been ignored for at least as long.



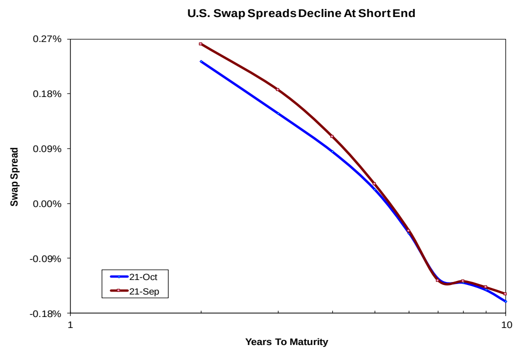
CDS costs on UST continued to decline at the short end of the yield curve even as they rose past two years. This suggests markets are looking at two years or more of a Republican-controlled Congress thwarting the next President, whomever or whatever that may be.



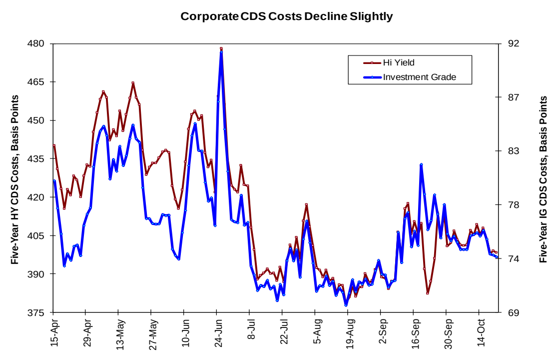
The pseudo-real yield curve declined again at the short end of the yield curve. They also stopped rising at the long end of the yield curve. The combination supported both precious metals and risky financial assets.



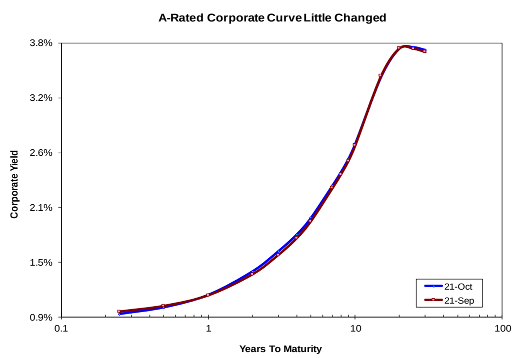
Swap spreads, which rise when floating-rate borrowers want to fix their payments, continue to shift lower at the short end of the yield curve and remain bullishly inverted. This has been a very persistent pattern for the past five years. Floating-rate payors are not in any demonstrable hurry to fix their payments.



CDS costs continue to drift lower despite expectations for higher short-term rates. So long as the credit stresses of major energy- and financial-sector borrowers do not deteriorate, and there is no indication they will, the potential for higher CDS costs will remain very limited.



The A-rated corporate yield curve has remained within an extremely narrow range as the small rise in UST yields has been offset by a decline in credit spreads. As long as central banks are buying investment-grade bonds, this market will remain non-indicative of actual investment fundamentals.



Market Structure

Grains and the main Bloomberg index joined Natural Gas in structural uptrend amongst physical commodities. The dollar index remained in an uptrend, the EAFE remains in a downtrend, joined by ten-year UST, and the EM index reversed into an uptrend amongst the financials.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Oct. 24 - 28
BBerg	29	Trending	0.132	9.5%	0.16%
BBerg Grain	29	Trending	0.156	16.6%	0.17%
BBerg Ind. Metl	29	Trending	-0.193	12.2%	-0.38%
BBerg Pre. Metl	7	Sideways	0.030	7.4%	
BBerg Softs	14	Transitional	-0.022	15.6%	
BBerg Nat. Gas	29	Trending	0.114	21.0%	0.12%
BBerg Petroleum	7	Sideways	0.026	18.3%	
BBerg Livestock	9	Sideways	0.076	14.4%	
Dollar Index	29	Trending	0.396	5.6%	0.22%
S&P 500 Index	23	Trending	-0.059	8.3%	
EAFE Index	21	Trending	-0.089	10.0%	-0.32%
EM Index	29	Trending	0.065	9.5%	0.10%
Ten-year UST (price)	23	Trending	-0.096	4.2%	-0.77%

Performance Measures

The decline in the Industrial Metals subindex remains a concern as it reflects continued oversupply and lackluster demand growth in China. The overall trends in the Energy and Grains subindices remain higher, however, and this will keep the main Bloomberg index' advance intact regardless of any short-term strength in the USD against the major European currencies and against the CAD and AUD.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.27%	2.14%	3.83%	-1.26%
Grains Sub-Index	0.41%	3.49%	-8.31%	-9.31%
Corn	-0.49%	4.78%	-9.71%	-14.49%
Soybeans	2.27%	3.12%	0.71%	10.18%
Wheat	-1.54%	2.43%	-18.39%	-23.38%
Energy Sub-Index	-0.72%	10.48%	10.86%	-10.34%
Petroleum Sub-Index	0.38%	12.26%	8.46%	-11.05%
WTI	0.34%	13.33%	7.02%	-18.64%
Brent	0.10%	12.09%	9.91%	-9.07%
ULSD	0.13%	11.25%	13.62%	-8.23%
Gasoline	1.45%	11.48%	3.82%	-6.05%
Natural Gas	-3.41%	5.96%	18.75%	-11.59%
Precious Metals Sub-Index	0.79%	-7.34%	2.45%	8.66%
Gold	0.98%	-5.49%	2.45%	8.29%
Silver	0.30%	-11.67%	2.44%	9.08%
Industrial Metals Sub-Index	-1.92%	-3.46%	-0.48%	-0.38%
Copper	-1.04%	-5.09%	-8.49%	-12.41%
Aluminum	-2.96%	-0.90%	-2.98%	5.95%
Nickel	-5.03%	-6.72%	8.66%	-6.79%
Zinc	0.15%	-0.90%	17.58%	26.34%
Softs Sub-Index	-0.69%	-0.77%	27.68%	33.24%
Coffee	0.46%	3.13%	21.80%	19.28%
Sugar	-0.87%	0.07%	42.11%	52.52%
Cotton	-2.12%	-1.40%	8.24%	9.58%
Livestock Sub-Index	2.59%	-8.27%	-19.04%	-28.01%
Cattle	4.55%	-4.63%	-9.03%	-22.91%
Hogs	-0.88%	-14.40%	-32.35%	-35.89%

Hidden in the EUR and CHF's weakness and a decline in commodity-linked major currencies such as the CAD and AUD was a strong rise in the BRL and MXN. It is facile to dismiss the latter as an artifact of the U.S. election as it is justifiable entirely by expected interest rate differentials.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.80%	-2.73%	-3.58%	-4.01%
Chinese yuan	-0.57%	-1.45%	-4.21%	-6.18%
Japanese yen	0.37%	-3.35%	5.45%	15.54%
British pound	0.35%	-6.12%	-14.58%	-20.65%
Swiss franc	-0.34%	-1.99%	-1.86%	-3.43%
Canadian dollar	-1.45%	-1.73%	-4.48%	-1.45%
Australian dollar	-0.13%	-0.21%	-1.68%	5.52%
Swedish krona	-0.82%	-4.03%	-8.69%	-6.59%
Norwegian krone	-0.35%	0.17%	-0.56%	-0.67%
New Zealand dollar	1.04%	-2.57%	3.60%	6.77%
Indian rupee	-0.26%	0.20%	-0.74%	-2.64%
Brazilian real	1.58%	1.60%	11.83%	24.84%
Mexican peso	2.22%	6.16%	-6.05%	-10.43%
Chilean peso	0.63%	-0.19%	-0.18%	4.13%
Colombian peso	-0.38%	-1.35%	0.30%	0.93%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.18%	-1.47%	-2.14%	-2.25%

The ability of equities to post even small gains in light of expectations for rising interest rates must mean, by definition, expectations are rising at last for earnings. Before we get too far ahead of ourselves, let's remember all alternatives remain poor.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.46%	-0.99%	2.04%	4.44%
North America	0.45%	-0.81%	3.70%	8.28%
Latin America	4.15%	10.01%	17.24%	33.55%
Emerging Market Free	1.59%	0.71%	8.70%	8.96%
EAFE	0.49%	-1.29%	-0.70%	-1.60%
Pacific	1.15%	-0.85%	3.71%	6.32%
Eurozone	0.45%	0.59%	-1.87%	-4.35%

The best news for professional traders has to be *The Wall Street Journal's* week-long series extolling passive indexation. Both CTAs and hedge funds gained on the week, most likely a decline in the euro and a rise in emerging market currencies and equities.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.51%	-0.98%	-5.35%	-2.40%
Newedge Trend	0.44%	-1.05%	-3.82%	0.96%
Newedge Short-Term	-0.32%	-2.25%	-5.89%	0.05%
HFR Global Hedge Fund	0.30%	0.53%	2.60%	-0.09%
HFR Macro/CTA	0.20%	0.25%	-2.57%	-0.20%
HFR Macro: Sytematic Diversified CTA	-0.03%	-1.49%	-3.67%	1.73%