The Macro Environment For Financial Markets

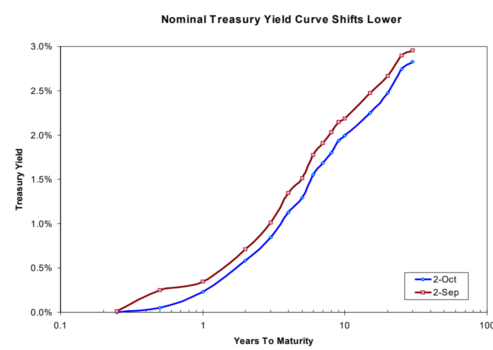
I half expect someone to run out from the Federal Reserve's headquarters onto Constitution Avenue proclaiming they are Napoleon. After all, it is bona fide crazy to keep talking about a rate hike in 2015 when both inflation expectations and labor force indicators are pointing in the other direction, when the global situation remains fragile and when the rest of the world remains on an easing path. The other half of craziness is to argue for fiscal stimulus after the 2009 waste-a-thon. If you want growth, ease the regulatory burden, stop wasting money on crony projects like green-whatever, get out of wars you can't win and won't end, cut taxes on capital returns and stop confusing the living daylights out of everyone with inane public discussions of monetary policy. Rants aside, removing the threat of a rate hike and watching the dollar decline is going to produce a relief rally in risky financial assets with the low-quality assets moving up first.

The causal chain now is:

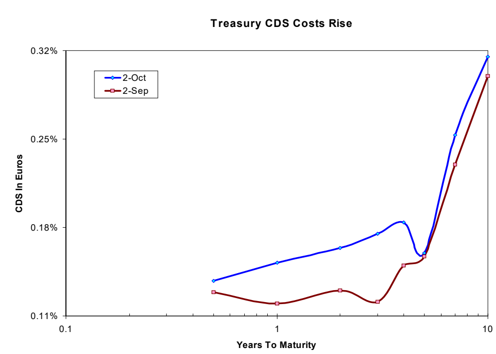
1. Short-term interest rates will rise at some point in the U.S. before the end of time;
2. Disinflationary pressures are dominating inflationary pressures;
3. Inflation expectations as measured by the TIPS market will remain low;
4. The U.S. yield curve retains its long-term trend toward a bullish flattening;
5. Short-term borrowers will continue to accept rollover risk;
6. Swap spreads will remain tame; and
7. Credit spreads are biased toward increasing.

Key Market Indications

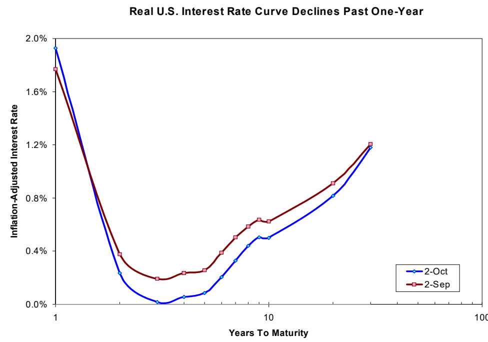
While long-term UST rates get most of the attention, the real driver of the yield curve has been short-term rates. The normalized variable of two-year yields since June has been very high as we lunge from one incorrect certainty to another. For now, the bull market in UST looks intact well into early 2016 or until the next FOMC member says something out of turn, whichever comes first.



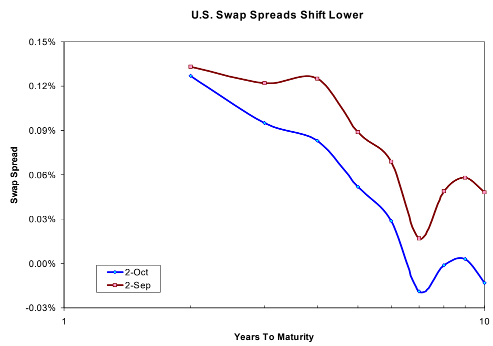
While Congress will raise the debt ceiling rather than allow default, they will continue to play games with the issue. Hence the shift higher in CDS costs for Treasuries. Those who say this is no way to run democratic governments are wrong: This is precisely how democracies operate in the modern world.



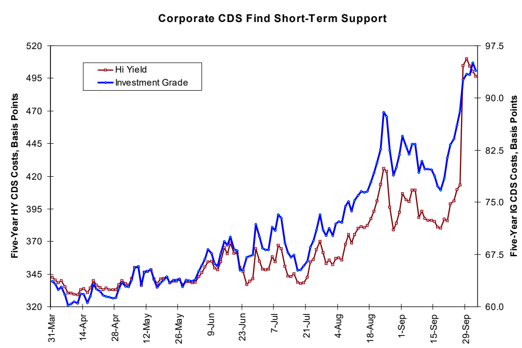
Pseudo-real rates for two years' maturity and longer shifted lower, with the greatest decrease coming in the belly of the curve. A continued decline here will start to remove a headwind for risky financial assets.



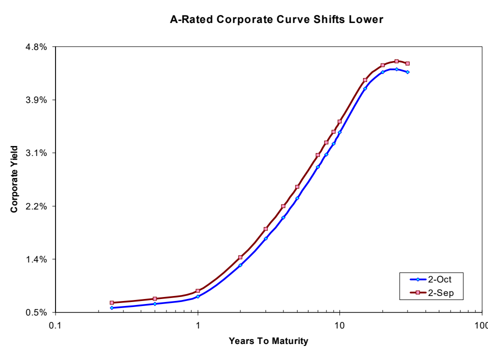
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have shifted lower across the yield curve. As noted last week, the last times ten-year swap spreads were negative were prior to QE2 in 2010 and just after the launch of QE3 in 2012.



CDS costs for both the investment-grade and high-yield indices stopped moving higher, but the trend remains for higher default risk and credit spreads. A weaker USD and anticipation the rate hike will be postponed will remove impediments for risky financial assets.



The A-rated yield curve has changed very little over the past month. As investors search for yield, they will come back into investment-grade debt and continue to push this yield curve lower.



Market Structure

Softs joined Grains and Precious Metals in structural uptrends, while both Natural Gas and Petroleum joined Industrial Metals and Livestock in structural downtrends. Within the financial markets, only ten-year UST are in a structural uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Oct. 5 - 9
BBerg	21	Trending	-0.015	12.8%	-0.14%
BBerg Grain	25	Trending	0.110	16.1%	0.40%
BBerg Ind. Metl	24	Trending	-0.102	18.9%	-0.59%
BBerg Pre. Metl	29	Trending	0.114	14.4%	0.09%
BBerg Softs	20	Trending	0.264	20.2%	1.11%
BBerg Nat. Gas	21	Trending	-0.300	17.7%	-0.51%
BBerg Petroleum	24	Trending	-0.047	38.8%	-0.28%
BBerg Livestock	29	Trending	-0.229	13.7%	-0.22%
Dollar Index	16	Transitional	0.013	8.3%	
S&P 500 Index	18	Transitional	0.021	16.6%	
EAFE Index	18	Transitional	-0.047	14.8%	
EM Index	18	Transitional	0.011	13.8%	
Ten-year UST (price)	27	Trending	0.205	6.3%	0.06%

Performance Measures

Natural Gas continues to move lower on the anticipated effects of El Niño, and while U.S. crude oil production is declining, world crude oil supply is filling the breach. Just when the supply imbalance for sugar seemed intractable, the market rallied 9% on the week, and just when Glencore dominated global headlines for the better part of two hours, the Industrial Metals found some short-term support. Once again, trading a bear market in physical commodities is not the mirror image of trading a bull market.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.68%	-1.16%	-11.82%	-25.63%
Grains Sub-Index	-0.28%	4.28%	-7.84%	0.52%
Corn	0.06%	5.92%	-5.98%	6.65%
Soybeans	-1.69%	0.03%	-9.16%	-4.99%
Wheat	1.08%	7.15%	-6.04%	3.03%
Energy Sub-Index	-2.74%	-6.26%	-15.71%	-49.38%
Petroleum Sub-Index	-1.20%	-4.92%	-14.71%	-51.33%
WTI	-0.35%	-2.81%	-16.51%	-56.38%
Brent	-1.04%	-6.77%	-18.64%	-55.32%
ULSD	-1.66%	-6.49%	-12.95%	-42.48%
Gasoline	-2.75%	-4.04%	-6.61%	-41.65%
Natural Gas	-6.84%	-9.88%	-18.23%	-47.09%
Precious Metals Sub-Index	-0.32%	1.23%	-6.62%	-8.13%
Gold	-0.79%	0.27%	-5.61%	-6.92%
Silver	1.01%	4.07%	-9.39%	-11.73%
Industrial Metals Sub-Index	1.07%	-2.07%	-17.38%	-24.79%
Copper	1.84%	-0.17%	-15.38%	-22.70%
Aluminum	-0.96%	-3.44%	-16.00%	-21.93%
Nickel	0.75%	1.50%	-23.53%	-38.39%
Zinc	3.15%	-7.56%	-21.75%	-26.68%
Softs Sub-Index	4.83%	8.62%	-7.84%	-28.06%
Coffee	1.30%	5.03%	-16.86%	-46.06%
Sugar	9.03%	16.72%	-3.87%	-23.48%
Cotton	-0.82%	-3.76%	-6.80%	-2.29%
Livestock Sub-Index	-2.81%	-4.97%	-7.69%	-21.90%
Cattle	-4.11%	-8.19%	-16.42%	-18.57%
Hogs	-0.61%	1.04%	10.20%	-28.06%

The USD declined against all other currencies measured here; this is one week after it rose across the board with the exception of the INR. As the world remains in an environment of competitive devaluation, no one should expect long-running trends for 2015:Q4.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.19%	-0.10%	3.09%	-11.47%
Chinese yuan	0.40%	0.11%	-2.50%	-3.42%
Japanese yen	0.57%	0.35%	-0.16%	-9.58%
British pound	0.03%	-0.75%	2.40%	-5.95%
Swiss franc	0.82%	-0.24%	-1.21%	-1.80%
Canadian dollar	1.41%	0.89%	-4.51%	-15.17%
Australian dollar	0.30%	0.09%	-7.21%	-19.97%
Swedish krona	0.69%	0.93%	3.33%	-14.04%
Norwegian krone	1.80%	-1.53%	-4.56%	-23.02%
New Zealand dollar	0.72%	1.31%	-14.37%	-18.62%
Indian rupee	0.98%	1.08%	-4.60%	-5.96%
Brazilian real	1.08%	-4.37%	-20.60%	-36.57%
Mexican peso	1.27%	0.40%	-10.46%	-20.15%
Chilean peso	1.77%	0.32%	-10.69%	-13.38%
Colombian peso	1.80%	5.08%	-14.78%	-33.34%
Bloomberg-JP Morgan Asian dollar index (spot)	0.46%	-0.11%	-4.77%	-6.90%

If expectations of higher short-term rates in the U.S. and a stronger USD were bearish, the opposite should be bullish barring a complete economic collapse. If so, we should expect the beaten-up emerging markets in general and Latin America in particular to rally. Call it a dash-to-trash.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.90%	-0.31%	-6.89%	-1.28%
North America	1.03%	0.10%	-5.44%	0.79%
Latin America	2.70%	-2.35%	-22.51%	-35.57%
Emerging Market Free	1.93%	1.22%	-17.41%	-16.69%
EAFE	0.69%	-0.96%	-9.15%	-4.49%
Pacific	0.96%	-0.05%	-10.53%	-3.68%
Eurozone	0.28%	-2.68%	-11.23%	-6.33%

CTAs eked out another gain despite the reversals in currencies and equities. This leaves sovereign bonds as the likely source of returns. Hedge funds continue to bleed, although their continued dependence on strong equity markets could lead to a stabilization of returns.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.19%	1.19%	-5.15%	13.68%
Newedge Trend	0.16%	0.70%	-5.46%	9.04%
Newedge Short-Term	-0.67%	-0.49%	-6.84%	0.65%
HFR Global Hedge Fund	-0.77%	-1.49%	-4.89%	-4.15%
HFR Macro/CTA	-0.08%	-0.67%	-4.54%	1.22%
HFR Macro: Sytematic Diversified CTA	-0.11%	-0.14%	-4.38%	4.51%