The Macro Environment For Financial Markets

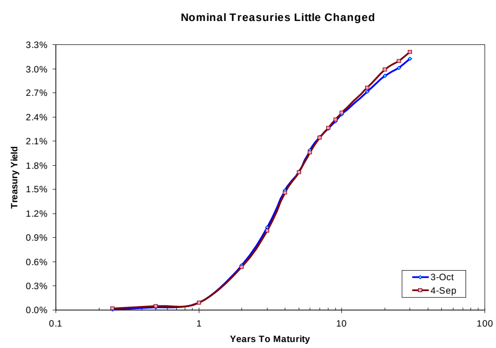
Some things are more important in the negative. The European Central Bank's relative inaction is important not because Eurozone QE would have accomplished there what it failed to accomplish in Japan or in the U.S. but because a lack of it raises deflationary risks. The lack of Eurozone QE will slow the EUR's descent and by extension slow the carry trade into the U.S. that has led to U.S. equity outperformance. The win/win outcome needs a combination of a weaker EUR and an expansion of the Eurozone money supply to offset the lack of liquidity coming into the Eurozone from a China increasingly preoccupied with its own internal rising liquidity preference. The rush toward U.S. policy renormalization in such a global environment could lead to the importation of deflationary pressures and would constitute a policy error. Restated, just because QE never could accomplish its macro objectives does not mean its absence will be painless. Indeed, QE's end could be the post-crisis era's great error of omission.

The causal chain is now:

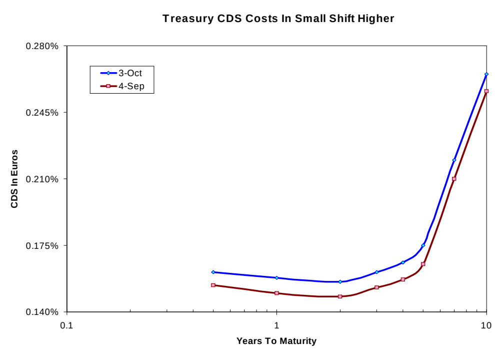
1. Short-term interest rates will remain artificially low even as expectations for future short-term rates rise;
2. Real rates will continue their move higher, especially at the short end of the yield curve, as
3. Inflation expectations as measured by the TIPS market remain subdued;
4. The rise in longer-dated sovereign debt yields has held strong support;
5. The U.S. yield curve should continue its flattening trend from what are historically high levels still;
6. Short-term borrowers will continue to accept rollover risk and keep their effective maturities as short as possible;
7. Swap spreads are in a stable and inverting configuration and does not yet present an impediment to corporate bonds; and
8. Credit spreads swings will remain exaggerated as CDS have moved away from their original function to being the tool for corporate bond synthesis.

Key Market Indications

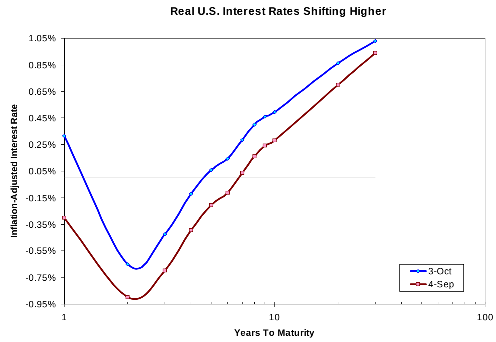
Treasury yields did not move higher on the combination of the ECB disappointment and on U.S. employment data. This suggests the market will continue to be supported by carry trade inflows, that the yield curve will continue to flatten from the short end and that the U.S. inflation picture is being viewed as tame.



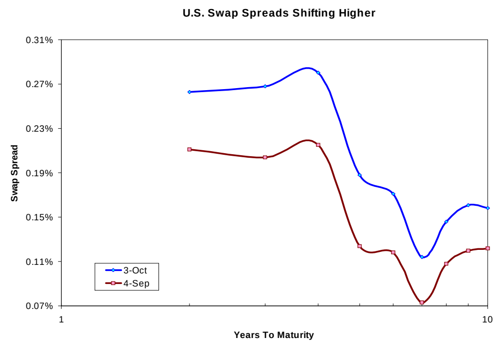
Euro-denominated CDS costs continue their downward shift. As the EUR itself is weaker, the decline in CDS costs represents a significant decline in concern over U.S. finances.



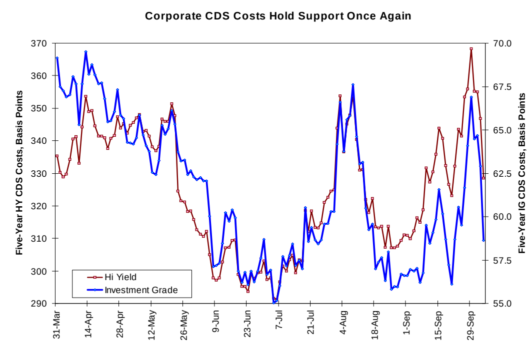
Real rates are negative only in the mid-curve horizon. The short-term continues to be bearish for precious metals. The rise in long-term real rates is not yet bearish for risky financial assets as it has been induced by lower TIPS breakevens more than by a rise in nominal rates.



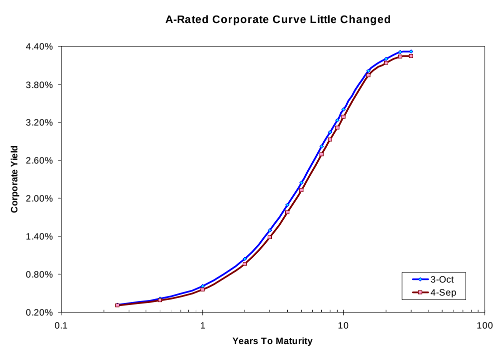
Swap spreads, which rise when floating-rate borrowers want to fix their payments, are increasingly inverted as floating-rate borrowers are trying to fix short-dated and mid-curve payments but are willing to remain floating at the long end of the yield curve. So long as this inversion persists, the corporate bond and equity markets will be able to absorb higher short-term swap spreads without a great deal of concern. A shift toward higher swap spreads at the 7-10 year horizon will be a concern, however.



The skepticism about the rise in CDS costs noted here last week may have been understated; their decline this week should not be interpreted as a sudden repricing of U.S. corporate default risk any more than their previous rise should have been. Until we see a solid increase in CDS costs combined with higher swap spreads, higher nominal rates and higher TIPS breakevens, we should not view anything emanating from the corporate bond market as being bearish.



The A-rated yield curve retains its modestly bearish steepening relative to the UST yield curve. Until long-dated swap spreads start to rise more than anything seen to-date, this relative shift should be small.



Market Structure

Several of the physical markets, including Grains and Precious Metals, are moving into bearish consolidation structures as is the main Bloomberg index. The EM and EAFE indices are oversold, which suggests any bounce will be short-term and not a reversal.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate For Sep. Oct. 6 - 10
BBerg	6	Sideways	-0.088	8.7%	
BBerg Grain	5	Sideways	0.003	15.2%	
BBerg Ind. Metl	29	Trending	-0.401	12.0%	-0.20%
BBerg Pre. Metl	6	Sideways	-0.118	14.8%	
BBerg Softs	29	Trending	0.097	18.5%	-0.81%
BBerg Nat. Gas	24	Trending	0.045	20.7%	-0.27%
BBerg Petroleum	29	Trending	-0.398	14.7%	-0.28%
BBerg Livestock	13	Transitional	0.094	13.7%	
Dollar Index	14	Transitional	0.266	6.6%	
S&P 500 Index	29	Trending	-0.141	8.0%	-0.21%
EAFE Index	29	Trending	-0.738	7.5%	-0.05%
EM Index	29	Trending	-0.756	7.9%	-0.19%
Ten-year UST (price)	29	Trending	0.093	4.4%	

Performance Measures

Physical commodities do not go to zero, and as producers have floored production in Grains, buyers here and in the economically less-sensitive Softs and Livestock markets have moved in to fix prices. The economically more important Industrial Metals and the Petroleum markets continue to slide on the weight of excess production and Precious Metals are moving lower on expected increases in real short-term rates.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.98%	-5.47%	-12.40%	-7.22%
Grains Sub-Index	0.64%	-9.70%	-31.98%	-26.61%
Corn	0.08%	-9.20%	-37.80%	-32.28%
Soybeans	0.22%	-10.69%	-25.80%	-13.58%
Wheat	2.42%	-9.25%	-31.75%	-34.50%
Energy Sub-Index	-2.89%	-2.96%	-10.13%	-2.25%
Petroleum Sub-Index	-4.22%	-6.09%	-9.57%	-9.68%
WTI	-4.06%	-3.20%	-6.93%	-7.92%
ULSD	-3.19%	-7.41%	-10.64%	-11.56%
Gasoline	-4.40%	-6.32%	-9.76%	-4.95%
Natural Gas	0.25%	4.99%	-11.59%	13.37%
Precious Metals Sub-Index	-2.39%	-7.46%	-10.54%	-12.98%
Gold	-1.85%	-5.87%	-8.59%	-9.15%
Silver	-4.05%	-12.16%	-16.23%	-23.52%
Industrial Metals Sub-Index	-1.41%	-8.17%	2.00%	-0.55%
Copper	-1.22%	-5.39%	-0.76%	-9.28%
Aluminum	-1.76%	-9.00%	2.28%	-3.67%
Nickel	-2.59%	-15.59%	0.12%	15.99%
Zinc	-0.07%	-5.55%	11.59%	17.90%
Softs Sub-Index	4.33%	-3.95%	-10.87%	-3.59%
Coffee	10.99%	4.27%	6.25%	64.43%
Sugar	-0.72%	-5.37%	-24.57%	-30.51%
Cotton	0.94%	-2.86%	-26.32%	-23.60%
Livestock Sub-Index	0.99%	-0.11%	5.32%	15.55%
Cattle	2.33%	2.21%	18.86%	25.37%
Hogs	-1.53%	-4.36%	-12.06%	1.84%

Only the CLP prevented a third clean sweep for the USD in four weeks; even the CNY retreated against the USD. The USD money-market yield curve continues steepen even as the note-horizon yield curve flattens. The ECB's forbearance in moving toward a more aggressive easing is signaling the policy divergence between the U.S. and elsewhere is about to stop widening.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.32%	-4.82%	-8.78%	-8.10%
Chinese yuan	-0.21%	0.03%	1.17%	-0.31%
Japanese yen	-0.43%	-4.53%	-5.31%	-11.38%
British pound	-1.70%	-2.96%	-3.77%	-1.13%
Swiss franc	-1.66%	-5.15%	-7.92%	-7.04%
Canadian dollar	-0.80%	-3.17%	-1.86%	-8.10%
Australian dollar	-1.03%	-7.19%	-6.03%	-7.65%
Swedish krona	-0.15%	-3.77%	-10.13%	-12.81%
Norwegian krone	-1.03%	-4.71%	-8.00%	-8.75%
New Zealand dollar	-1.30%	-6.75%	-9.13%	-6.38%
Indian rupee	-1.03%	-1.76%	-2.79%	1.39%
Brazilian real	-1.56%	-9.01%	-7.27%	-10.23%
Mexican peso	-0.31%	-2.89%	-2.76%	-2.45%
Chilean peso	0.16%	-1.51%	-6.78%	-16.24%
Colombian peso	-0.48%	-5.16%	-3.00%	-6.88%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.55%	-1.55%	-0.36%	-1.13%

The Friday stabilization of the U.S. stock market pulled it back to the top of its incipient downtrend channel. To the extent U.S. outperformance has been driven by carry trade inflows, its gains have come at the expense of the World Ex-U.S. The World Ex-U.S. will not be pulled higher over the longer-term by any U.S. gains.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.88%	-4.19%	0.81%	11.32%
North America	-0.88%	-2.15%	4.89%	18.55%
Latin America	-4.60%	-15.37%	-0.75%	-2.96%
Emerging Market Free	-2.58%	-9.24%	1.65%	1.98%
EAFE	-3.43%	-7.26%	-5.06%	1.52%
Pacific	-3.27%	-7.03%	-0.83%	-0.95%
Eurozone	-4.08%	-7.41%	-9.08%	2.05%

CTA performance continued to improve with some countertrend bounces within longer-term downtrends; reinforcing the notion many CTAs are hesitant to be aggressively short physical markets. Hedge fund performance continues to struggle with the downturn in equity markets and with the sideways movement in sovereign debt markets.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.26%	3.10%	14.07%	13.29%
Newedge Trend	0.16%	1.20%	7.92%	8.65%
Newedge Short-Term	-0.06%	1.00%	2.70%	7.67%
HFR Global Hedge Fund	-0.86%	-1.67%	-0.97%	2.46%
HFR Macro/CTA	-0.12%	1.23%	3.31%	2.87%
HFR Macro: Sytematic Diversified CTA	0.01%	0.47%	1.57%	0.75%