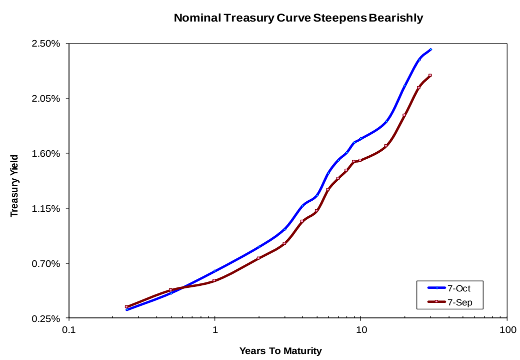
The Macro Environment For Financial Markets

It would be ironic indeed if seven years of extraordinary monetary stimulus failed macroeconomically and led to rising risks in the financial system and was replaced by higher short-term rates to the relief of many. The hint by the ECB it might taper QE to rescue Eurozone banks, the reverse-twist in Japan and the never-ending minuet by the Federal Reserve on when it will hike short-term rates all constitute a tacit but unadmitted recognition they have failed in recent memory. The causal now is:

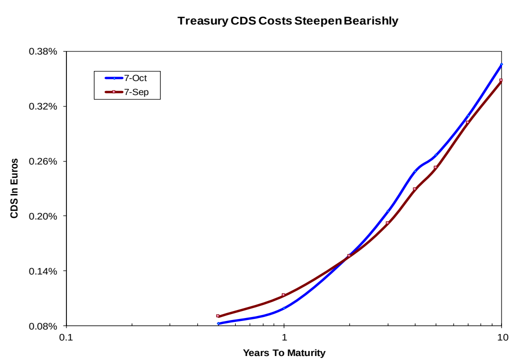
1. The market is pricing in a December increase in U.S. short-term rates;
2. Disinflationary pressures will persist globally;
3. Inflation expectations as measured by TIPS and inflation swaps are in a defined uptrend;
4. The U.S. yield curve retains its long-term bias toward flattening despite a short-term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

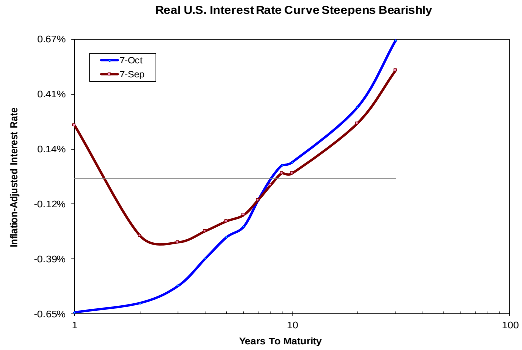
Rising inflation expectations and the increased talk of higher short-term interest rates have led to a bearish steepening of the yield curve over the past month. A stronger USD will not attract capital inflows perforce as USD-denominated assets will become more expensive for foreign investors. This has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



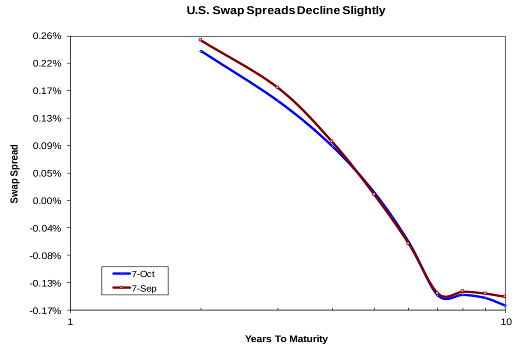
CDS costs on UST continued to decline at the short end of the yield curve even as they rose past two years. This suggests markets are looking at two years or more of a Republican-controlled Congress thwarting the next President, whomever or whatever that may be.



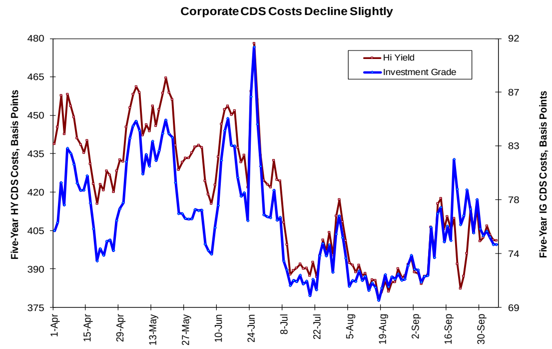
The pseudo-real yield curve declined at the short end of the yield curve. However, the threat of higher short-term real rates in the Eurozone affected gold's "best-of" option negatively and induced a selloff. Long-term implied real rates have yet to increase to the point where they pose a direct threat to risky financial assets.



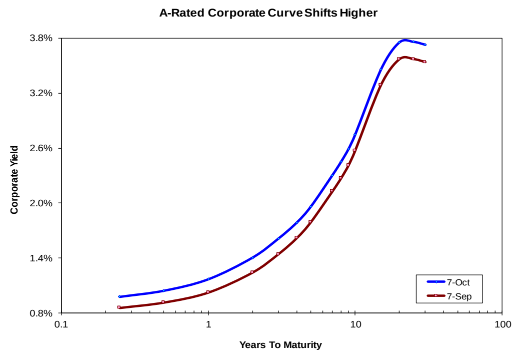
Swap spreads, which rise when floating-rate borrowers want to fix their payments, shifted lower and remain bullishly inverted. This has been a very persistent pattern for the past five years. Floating-rate payors are not in any demonstrable hurry to fix their payments.



CDS costs turned lower with gains in the energy and banking sectors. Investors continue to look at wildly overpriced corporate bonds as being a risk-averse trade.



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, Natural Gas and the main Bloomberg index joined Industrial Metals in structural uptrends while Precious Metals entered a downtrend within the physical commodity markets. The dollar index reversed into an uptrend while ten-year UST entered a downtrend and the EM index entered an uptrend within the financials.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Oct. 10 - 14
BBerg	29	Trending	0.165	9.8%	0.16%
BBerg Grain	24	Trending	-0.018	16.7%	
BBerg Ind. Metl	29	Trending	0.123	11.3%	0.35%
BBerg Pre. Metl	29	Trending	-0.476	13.6%	-0.37%
BBerg Softs	7	Sideways	0.007	20.6%	
BBerg Nat. Gas	29	Trending	0.254	20.9%	0.12%
BBerg Petroleum	29	Trending	0.259	25.6%	0.60%
BBerg Livestock	4	Sideways	0.019	19.8%	
Dollar Index	26	Trending	0.169	6.2%	0.22%
S&P 500 Index	6	Sideways	-0.029	8.5%	
EAFE Index	7	Sideways	-0.059	11.8%	
EM Index	21	Trending	0.095	11.2%	0.05%
Ten-year UST (price)	29	Trending	-0.142	4.9%	-0.19%

Performance Measures

As noted last week, the broad Bloomberg index has formed a rounded bottom of significance on the weekly chart. This has been driven by advances in the energy markets. However, the Precious Metals markets turned sharply lower under the threat of higher short-term interest rates and neither Grains nor Livestock have emerged from their primary bearish trends.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.36%	1.95%	8.53%	-5.65%
Grains Sub-Index	-0.01%	-1.59%	-7.98%	-13.56%
Corn	0.90%	-0.34%	-10.53%	-18.24%
Soybeans	0.29%	-2.37%	5.39%	7.73%
Wheat	-1.80%	-2.15%	-21.08%	-29.73%
Energy Sub-Index	4.73%	8.59%	18.63%	-18.93%
Petroleum Sub-Index	2.96%	7.89%	15.07%	-20.10%
WTI	3.26%	7.24%	12.60%	-28.12%
Brent	3.53%	7.33%	17.54%	-17.57%
ULSD	2.67%	8.89%	23.57%	-16.35%
Gasoline	1.28%	9.64%	7.32%	-15.66%
Natural Gas	9.88%	10.51%	30.26%	-18.55%
Precious Metals Sub-Index	-6.31%	-7.37%	3.17%	7.96%
Gold	-4.94%	-6.17%	0.05%	7.57%
Silver	-9.54%	-10.24%	11.87%	8.43%
Industrial Metals Sub-Index	-1.81%	2.92%	11.19%	-1.37%
Copper	-2.12%	3.42%	2.67%	-11.68%
Aluminum	0.11%	6.19%	9.08%	1.18%
Nickel	-3.63%	-1.80%	18.36%	-4.39%
Zinc	-2.37%	1.22%	31.48%	24.13%
Softs Sub-Index	0.11%	4.38%	35.24%	33.74%
Coffee	-2.34%	-2.06%	16.41%	1.77%
Sugar	1.83%	13.64%	51.84%	56.61%
Cotton	-1.61%	-3.02%	12.18%	8.24%
Livestock Sub-Index	0.73%	-9.31%	-22.25%	-26.03%
Cattle	2.93%	-2.16%	-14.94%	-18.58%
Hogs	-3.12%	-19.98%	-32.88%	-37.24%

Renewed speculation of higher short-term rates in the U.S. pushed the USD higher against all but the BRL and MXN, both of which have traded as political barometers of late. The threat of a "hard Brexit" pushed the GBP lower and led to a flash-crash of sorts on Friday. Score another one for macroprudential regulation, a synonym for obtuse regulators raising financial risks in the name of lowering them.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.30%	-0.34%	-1.56%	-0.32%
Chinese yuan	-0.04%	0.11%	-3.27%	-4.73%
Japanese yen	-1.58%	-1.20%	5.08%	16.54%
British pound	-4.15%	-6.80%	-11.54%	-18.83%
Swiss franc	-0.62%	-0.79%	-2.22%	-0.40%
Canadian dollar	-1.27%	-3.10%	-1.14%	-1.80%
Australian dollar	-1.07%	-1.19%	1.03%	5.19%
Swedish krona	-0.61%	-2.13%	-5.31%	-4.39%
Norwegian krone	-0.77%	1.67%	3.43%	2.07%
New Zealand dollar	-1.78%	-3.96%	5.59%	8.26%
Indian rupee	-0.11%	-0.48%	-0.33%	-2.59%
Brazilian real	1.28%	-0.77%	14.52%	20.64%
Mexican peso	0.44%	-4.77%	-7.38%	-13.72%
Chilean peso	-1.85%	-1.22%	1.99%	1.44%
Colombian peso	-1.54%	-2.27%	6.15%	-0.93%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.46%	-0.78%	-0.94%	-1.10%

Equity market had some reasons to sell off further this week, such as expectations for higher short-term rates and a stronger USD, but did not take any of them. The question of "sell and do what?" has yet to be answered.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.72%	-1.78%	7.13%	6.36%
North America	-0.70%	-1.42%	7.10%	9.75%
Latin America	3.27%	-1.76%	22.29%	21.24%
Emerging Market Free	1.29%	-1.06%	15.17%	10.48%
EAFE	-0.77%	-2.38%	7.17%	1.00%
Pacific	0.27%	-0.61%	12.45%	8.78%
Eurozone	-0.82%	-3.13%	6.20%	-1.93%

CTAs had another losing week, suggesting they found themselves on the wrong side of volatility in the currency, fixed-income and precious metals markets. Non-macro hedge funds managed some small gains, but macro-oriented funds had another losing week.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.67%	-5.15%	-6.69%	-2.52%
Newedge Trend	-1.53%	-3.77%	-4.79%	0.96%
Newedge Short-Term	-0.79%	-2.78%	-5.15%	0.60%
HFR Global Hedge Fund	0.27%	0.20%	3.48%	0.22%
HFR Macro/CTA	-0.33%	-0.88%	-1.76%	-0.57%
HFR Macro: Sytematic Diversified CTA	-1.14%	-1.82%	-2.41%	2.41%