The Macro Environment For Financial Markets

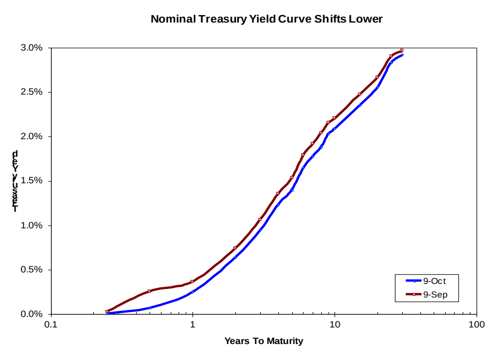
In homage to Ferdinand Foch's possibly apocryphal dispatch from the Marne, "My center is giving way, my right is in retreat; situation excellent. I shall attack." In a week of deteriorating macro forecasts, negative earnings news, corporate downsizings and a realization we will have to continue to rely on ineffectual monetary policies to forestall further contraction, we advanced strongly across of host of risky assets on the belief attack is preferable to retreat. It is, unless a machine-gun nest is blocking your path. What we can establish or actually reestablish from the ZIRP era is anything that yields more than 0% will be overpriced. All it needs to do is continue yielding more than 0% and not present you with a rising default risk.

The causal chain now is:

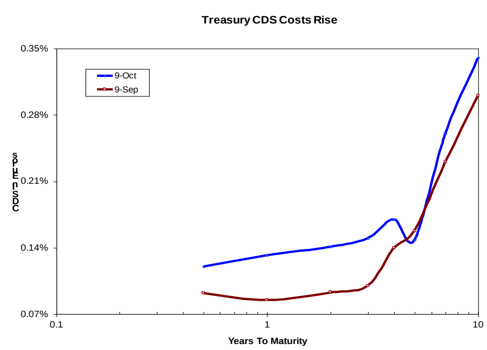
1. Short-term interest rates will rise at some point in the U.S.;
2. Disinflationary pressures are dominating inflationary pressures;
3. Inflation expectations as measured by the TIPS market will remain low;
4. The U.S. yield curve retains its long-term trend toward a bullish flattening;
5. Short-term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

Key Market Indications

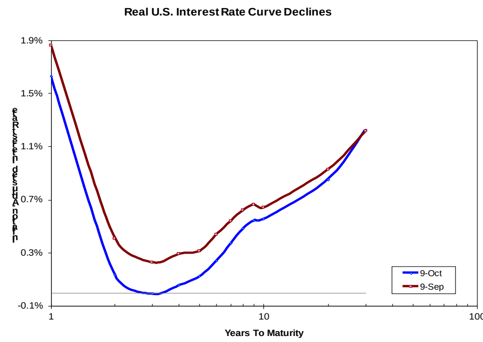
Such is the demand for safety that UST yields remain confined even as the yield curve steepened, equities rallied, TIPS breakevens expanded and stale Treasury data on international holdings show dollar reserves are being sold. Just as a previous generation took years to get used to the idea Treasuries could rally, we now have a generation that will take years to accept the opposite if and when that moment comes.



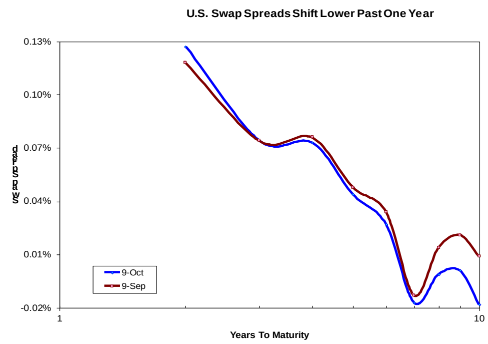
I commented last week, "Those who say this is no way to run democratic governments are wrong: This is precisely how democracies operate in the modern world." That was before this past week's collapse of discipline in House Republican ranks. There is no reason to believe the U.S. will default on Treasuries, but as we have seen, there is no reason to expect a lack of brinksmanship, either. Remember those proposals for the $1 trillion platinum coin?



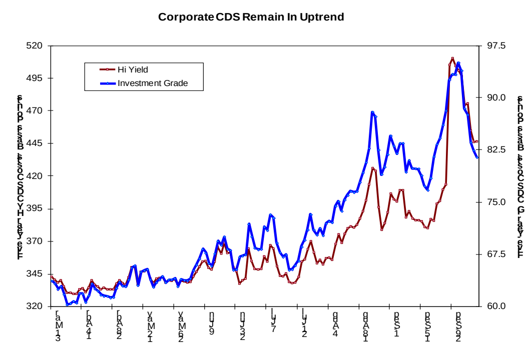
Pseudo-real rates shifted lower for all maturities inside of 30 years over the past month and returned to negative levels for the three-year note. These declining real rates at the short end of the curve will support all manner of commodity-linked assets.



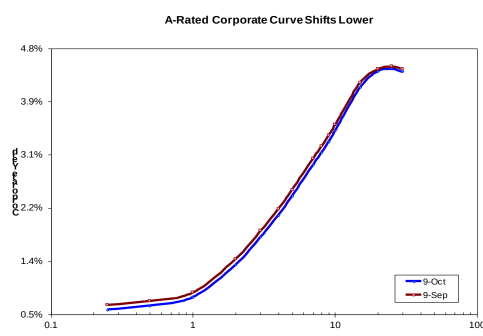
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have shifted lower for tenors longer than one year. Ten-year swap spreads remain negative, a condition extant before the launches of both QE2 and QE3.



CDS costs for both the investment-grade and high-yield indices declined sharply but remain within their uptrends of the past five months. These declines reflect both the effects of a weaker USD and a decreased expectation for higher short-term rates.



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

Only Natural Gas remains in a structural downtrend amongst the physical commodities. All of the stock indices have joined ten-year UST in structural uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate Oct. 12 -16
BBerg	26	Trending	0.220	12.9%	0.07%
BBerg Grain	27	Trending	0.051	16.1%	0.40%
BBerg Ind. Metl	25	Trending	0.123	20.9%	0.31%
BBerg Pre. Metl	29	Trending	0.231	14.0%	0.09%
BBerg Softs	29	Trending	0.437	20.1%	1.11%
BBerg Nat. Gas	24	Trending	-0.122	17.5%	-0.51%
BBerg Petroleum	25	Trending	0.172	30.3%	0.10%
BBerg Livestock	29	Trending	0.022	13.6%	
Dollar Index	16	Transitional	-0.128	8.1%	
S&P 500 Index	24	Trending	0.185	15.5%	0.11%
EAFE Index	20	Trending	0.287	14.0%	0.06%
EM Index	23	Trending	0.395	14.1%	0.11%
Ten-year UST (price)	29	Trending	0.068	6.0%	0.06%

Performance Measures

The phrase "trading like a commodity" is meant to convey inexplicable volatility, and commodities have been trading like commodities over the past two months. While low prices do not induce short-term demand, they can induce inventory accumulation and production cutbacks, such as those announced by Glencore in the metals markets. The large number of unrelated markets rallying simultaneously is attributable, of course, to the effects of fund-related flows far more than to any changes in expected fundamental supply/demand balances. The ease with which the markets have lifted, however, suggests the secular bear market in physical commodities is near an end.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	3.55%	2.34%	-8.49%	-22.98%
Grains Sub-Index	-0.51%	1.02%	-5.66%	-2.19%
Corn	-1.67%	-1.10%	-5.21%	1.34%
Soybeans	1.33%	1.33%	-4.61%	-3.51%
Wheat	-0.78%	5.00%	-5.01%	-1.00%
Energy Sub-Index	6.07%	1.70%	-11.93%	-44.17%
Petroleum Sub-Index	7.44%	6.11%	-12.39%	-45.15%
WTI	8.87%	9.79%	-13.78%	-49.67%
Brent	8.21%	5.46%	-16.09%	-49.83%
ULSD	4.77%	1.49%	-12.98%	-37.82%
Gasoline	5.65%	4.50%	-3.80%	-34.63%
Natural Gas	2.21%	-9.45%	-9.73%	-44.88%
Precious Metals Sub-Index	2.20%	5.87%	-4.29%	-6.83%
Gold	1.70%	4.77%	-4.30%	-5.85%
Silver	3.64%	9.05%	-4.26%	-9.88%
Industrial Metals Sub-Index	4.38%	-1.24%	-13.62%	-22.92%
Copper	3.81%	-1.61%	-12.16%	-20.72%
Aluminum	3.12%	-2.67%	-12.22%	-21.16%
Nickel	4.68%	1.86%	-17.37%	-36.87%
Zinc	8.73%	0.81%	-18.01%	-22.42%
Softs Sub-Index	5.17%	9.95%	-3.61%	-27.91%
Coffee	5.87%	12.92%	-8.17%	-45.95%
Sugar	5.99%	15.01%	1.12%	-21.35%
Cotton	2.44%	-2.41%	-6.83%	-3.41%
Livestock Sub-Index	3.25%	-0.37%	-4.07%	-18.84%
Cattle	4.53%	-3.53%	-9.95%	-14.31%
Hogs	1.15%	5.53%	7.97%	-26.83%

The USD declined against all other currencies measured here save the JPY, a recent haven-bid refuge. The advances were particularly strong for the beaten-up Latin American currencies and for higher-yielding and commodity-linked majors such as the AUD, NOK and NZD.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.27%	1.35%	6.56%	-10.50%
Chinese yuan	0.19%	0.52%	-2.20%	-3.38%
Japanese yen	-0.30%	0.19%	0.26%	-10.34%
British pound	0.90%	-0.30%	4.14%	-4.93%
Swiss franc	1.03%	1.45%	1.66%	-0.75%
Canadian dollar	1.60%	2.43%	-2.84%	-13.60%
Australian dollar	4.13%	4.53%	-4.63%	-16.48%
Swedish krona	1.93%	2.40%	6.86%	-11.91%
Norwegian krone	3.64%	1.73%	0.38%	-19.87%
New Zealand dollar	3.97%	4.53%	-11.64%	-15.01%
Indian rupee	1.20%	2.59%	-3.84%	-5.68%
Brazilian real	4.51%	0.45%	-18.75%	-36.27%
Mexican peso	1.99%	2.40%	-8.17%	-18.21%
Chilean peso	1.67%	1.64%	-9.13%	-12.54%
Colombian peso	5.24%	8.50%	-12.94%	-28.72%
Bloomberg-JP Morgan Asian dollar index (spot)	1.36%	1.71%	-3.28%	-5.66%

I commented last week we should expect the beaten-up emerging markets in general and Latin American markets in particular to rally. For now, we have to consider the upward moves to be short-covering rallies but as the advances are occurring in the face of a great deal of known bad news, they must be respected.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	4.18%	3.03%	-4.27%	3.76%
North America	3.45%	3.78%	-3.42%	5.28%
Latin America	9.50%	7.19%	-17.52%	-33.47%
Emerging Market Free	6.92%	6.37%	-14.79%	-12.35%
EAFE	5.36%	1.86%	-5.60%	1.37%
Pacific	5.35%	2.27%	-7.94%	1.52%
Eurozone	6.14%	1.55%	-5.80%	0.79%

CTAs must have been trapped on the short side of both the physical markets and equity indices in this week's short-covering rallies. Global hedge funds, always tilted toward the long side of the equity markets, were the sole gainers amongst the professional traders.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-2.48%	-2.57%	-7.71%	11.75%
Newedge Trend	-1.12%	-1.07%	-5.98%	8.15%
Newedge Short-Term	-1.04%	-2.02%	-7.91%	-0.50%
HFR Global Hedge Fund	0.89%	-0.81%	-4.77%	-2.85%
HFR Macro/CTA	-1.38%	-1.63%	-6.50%	-0.18%
HFR Macro: Sytematic Diversified CTA	-2.53%	-1.96%	-7.30%	1.27%