The Macro Environment For Financial Markets

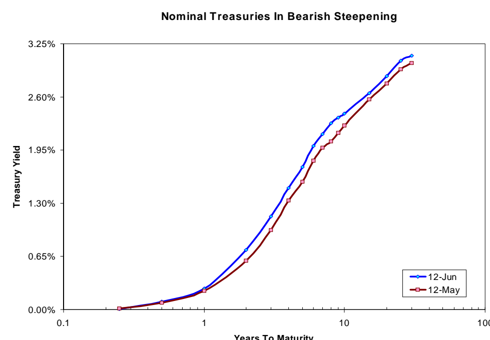
I keep returning to Churchill's comment about Admiral Jellicoe in World War I: The only man on either side who could lose the war in an afternoon. This applies very well to Janet Yellen and to a lesser extent all of her central banking colleagues here and abroad. Almost seven years of extraordinary measures could be demolished by raising borrowing costs for the federal government and the outsized gains seen for all assets could evaporate in a negative-sum liquidation frenzy as the consequences of financial regulation come home to roost. And for what, to end the overpricing of allegedly risk-averse assets such as negative-yield bonds, a few private equity excesses and rising labor demand in fields such as technology and health care as if any of those can be addressed by a 25 basis point rate hike? The one encouraging aspect of this has been the coordination amongst central banks to preempt the rise in the USD; that and not some piddling rate hike should be our concern. Let's face it; if your business depends on 0% overnight money, you have a very bad business indeed.

The causal chain remains:

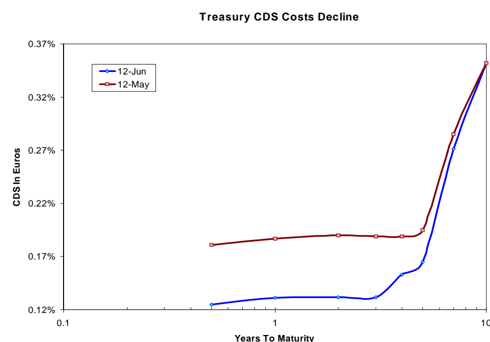
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point;
2. Disinflationary pressures have ended;
3. Inflation expectations as measured by the TIPS market will appear to be rising so long as nominal interest rates continue rising;
4. The U.S. yield curve has resumed its long-term bias toward flattening, but this time via higher short-term rates;
5. Short-term borrowers are terming out commercial paper into the bond market in an attempt to lower rollover risk;
6. Swap spreads will remain tame until monetary policy indications turn more hawkish; and
7. Credit spreads are at a resistance level that can be broken if sovereign rates continue to rise.

Key Market Indications

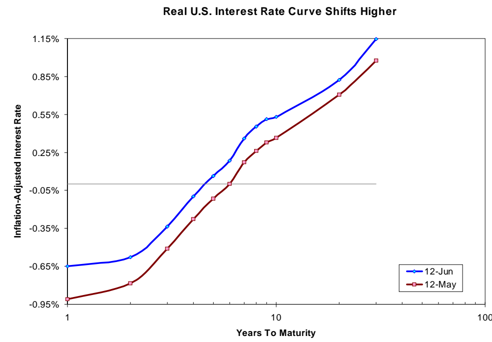
While this is not a bear market in bonds, one of their most salient trading characteristics has been on display over the past two weeks, and that is no one ever wants to step in a lend at the high yield. Stocks form spike bottoms; bonds do not. After all, stock traders can blame lower prices on something or someone, but bond traders have no excuses for being long duration and extension risk when yields rise.



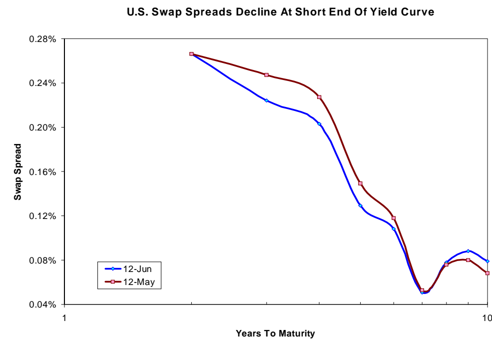
This market has little reason to shift significantly in either direction. Short-term CDS costs priced in EUR declined again this week, but the significance of this move is minuscule. Somewhat amusingly, S&P affirmed the U.S. credit at AA+ with a stable outlook; their long training in MBS rating has come in handy.



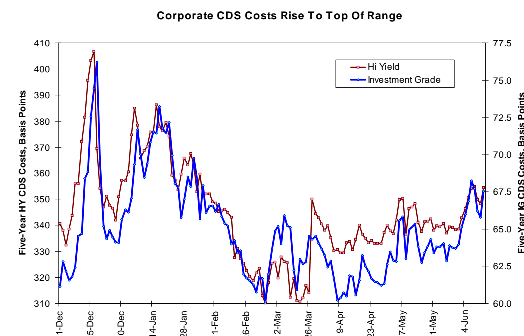
Pseudo-real rates continue to rise and are now negative out to "only" four years at this point. The rise over the past month has been a function of both increasing nominal rates and to a much lower rise in breakevens. Implied real rates have not increased sufficiently at the long end to pose a threat to risky financial assets, but they have increased enough at the short end to dampen demand for precious metals.



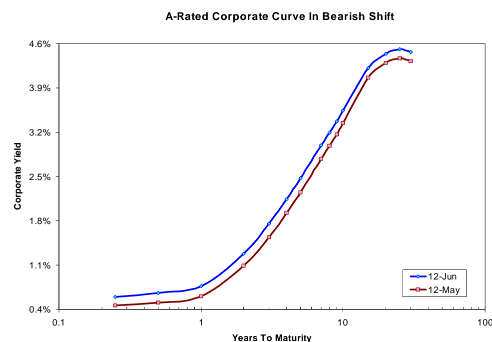
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end. They have shifted lower at the short end of the yield curve as well, most likely in response to the small increase in those rates.



Both investment-grade and high-yield CDS costs remain have moved to the top of their trading ranges since February. While the prospect of higher short-term rates had not pushed either index higher over the interim, the move higher in UST yields has had the effect of pushing less-liquid corporate bond yields higher and in turn raising the CDS component of synthetic corporate bonds.



The A-rated yield curve has steepened bearishly over the past month. If the observed rise in CDS costs is augmented by rising swap spreads, these yields will reduce the longstanding undervaluation of equities vis-à-vis arguably overvalued corporate bonds.



Market Structure

All of the physical commodity indices save for Petroleum and Industrial Metals are in structural downtrends as are all of the financial indices. Essentially there is too much of everything but expected liquidity.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate June 15 - 19
BBerg	29	Trending	-0.195	10.1%	-0.35%
BBerg Grain	21	Trending	-0.093	16.7%	-0.16%
BBerg Ind. Metl	6	Sideways	-0.059	13.7%	
BBerg Pre. Metl	29	Trending	-0.169	12.9%	-0.37%
BBerg Softs	29	Trending	-0.194	15.8%	-1.10%
BBerg Nat. Gas	29	Trending	-0.062	32.2%	-1.49%
BBerg Petroleum	21	Trending	0.006	21.7%	
BBerg Livestock	29	Trending	-0.270	8.8%	-0.37%
Dollar Index	29	Trending	-0.034	10.6%	-0.26%
S&P 500 Index	27	Trending	-0.087	7.6%	-0.13%
EAFE Index	29	Trending	-0.101	10.9%	-0.10%
EM Index	29	Trending	-0.429	8.8%	-0.14%
Ten-year UST (price)	20	Trending	-0.146	6.6%	-0.19%

Performance Measures

The primary downtrends in grains, livestock and soft commodities returned, but the economically more import energy and industrial metals indices managed to advance as did gold. One of the odder phenomena was the weather-related reversal in natural gas; trading a thirty-day forward-start fixed-price commodity up and down on daily fluctuations in cooling degree-days is a study in over-reaction.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.33%	-4.52%	-8.37%	-25.35%
Grains Sub-Index	-1.87%	-2.82%	-16.18%	-25.86%
Corn	-2.40%	-3.74%	-17.34%	-28.57%
Soybeans	-0.77%	-2.39%	-11.88%	-25.62%
Wheat	-2.46%	-1.31%	-18.23%	-18.68%
Energy Sub-Index	2.70%	-3.93%	-9.42%	-43.90%
Petroleum Sub-Index	1.72%	-1.82%	-0.04%	-43.56%
WTI	1.42%	-0.94%	-3.66%	-46.99%
Brent	1.04%	-3.66%	-3.77%	-48.29%
ULSD	1.11%	-5.85%	-0.14%	-35.69%
Gasoline	3.91%	3.12%	12.63%	-35.78%
Natural Gas	6.16%	-10.44%	-30.27%	-48.86%
Precious Metals Sub-Index	0.44%	-5.49%	-3.20%	-11.15%
Gold	0.95%	-3.84%	-2.59%	-7.82%
Silver	-0.98%	-9.88%	-4.93%	-20.58%
Industrial Metals Sub-Index	-0.56%	-7.63%	-9.55%	-12.07%
Copper	-0.52%	-8.41%	-7.00%	-11.84%
Aluminum	-0.80%	-6.89%	-11.68%	-10.13%
Nickel	-0.39%	-6.18%	-20.82%	-28.57%
Zinc	-0.37%	-7.68%	-3.10%	-0.33%
Softs Sub-Index	-1.98%	-8.19%	-17.18%	-31.54%
Coffee	-2.14%	-4.37%	-28.62%	-30.96%
Sugar	-2.80%	-9.14%	-20.89%	-42.75%
Cotton	-0.12%	-4.34%	4.78%	-16.43%
Livestock Sub-Index	-1.82%	-3.23%	-9.11%	-14.30%
Cattle	0.15%	0.00%	0.40%	6.20%
Hogs	-4.83%	-8.01%	-24.03%	-40.96%

Maybe King Canute could not shout back the tide, but Haruhiko Kuroda could shout back the JPY. The most important task facing the central banks is preventing a USD surge if and when the Federal Reserve signals its first rate hike. If this means engineering a softer CNY to support both the EUR and JPY, then let it be done.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.37%	0.47%	-9.60%	-16.87%
Chinese yuan	-0.09%	0.01%	-0.32%	0.17%
Japanese yen	1.82%	-2.85%	-3.76%	-17.58%
British pound	1.91%	-0.70%	-0.99%	-8.08%
Swiss franc	1.17%	0.04%	3.77%	-3.26%
Canadian dollar	0.99%	-2.46%	-6.01%	-11.90%
Australian dollar	1.42%	-3.07%	-6.26%	-17.98%
Swedish krona	2.45%	1.87%	-7.75%	-18.23%
Norwegian krone	2.49%	-3.47%	-5.23%	-22.74%
New Zealand dollar	-0.89%	-5.15%	-10.20%	-19.60%
Indian rupee	-0.48%	0.17%	-2.76%	-7.50%
Brazilian real	0.73%	-3.21%	-14.92%	-28.48%
Mexican peso	2.00%	-0.43%	-4.16%	-15.75%
Chilean peso	0.70%	-4.56%	-2.15%	-12.33%
Colombian peso	3.82%	-5.71%	-4.79%	-25.83%
Bloomberg-JP Morgan Asian dollar index (spot)	0.28%	-0.54%	-1.40%	-3.80%

While this past week saw minor gains in equity indices save for the EM index, it felt as if equities were struggling against rising bond yields and a decided increase in risk-aversion. Investors have trained themselves to believe selling is a waste of time as the taxes are certain and the alternatives are poor. However, not selling and being willing to buy are two very different things.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.61%	-0.53%	7.18%	5.09%
North America	0.12%	-0.13%	5.96%	9.54%
Latin America	2.07%	-6.07%	-1.33%	-23.69%
Emerging Market Free	-0.22%	-4.53%	5.57%	-4.67%
EAFE	1.39%	-1.14%	9.11%	-1.27%
Pacific	1.02%	-1.08%	10.32%	5.52%
Eurozone	1.39%	-1.09%	6.96%	-6.91%

CTAs continue to struggle as it is very hard to get aggressively bearish on new-crop grains moving into growing season, as the energy complex continues to exhibit high levels of volatility and as expected gains in the USD fizzled. Macro hedge funds managed to gain with the stabilization in equity indices and the rise in global sovereign yields.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.05%	-1.92%	2.53%	22.04%
Newedge Trend	-1.02%	-1.75%	1.55%	14.62%
Newedge Short-Term	-0.23%	-0.23%	-0.12%	7.57%
HFR Global Hedge Fund	0.04%	0.17%	3.45%	0.33%
HFR Macro/CTA	0.32%	0.35%	2.01%	6.16%
HFR Macro: Sytematic Diversified CTA	-0.46%	-0.75%	1.36%	5.73%