The Macro Environment For Financial Markets

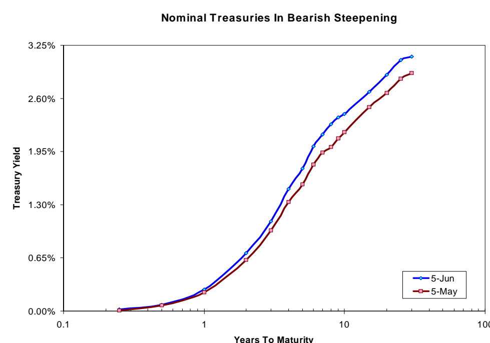
A long-ago professor once wrote why the Pentagon procurement process needed more "waste, fraud and abuse" as if those were actual line items in the budget. The logic was a more streamlined procurement process might be more efficient and lower-cost. A similar argument can be made for the effects of all the post-crisis constraints on financial players; they have resulted in reduced market liquidity, an unnatural preference for sovereign debt and an active discouragement of credit extension. As these measures combined with QE to produce anomalies such as negative interest rates that penalized savers, preserved bad business models and redounded to the benefit of the public sector and financial risk-takers, they have contributed greatly to a policy situation that could scare the wits out of your local bomb squad. When Christine Lagarde suggested the Federal Reserve might want to postpone raising short-term interest rates in 2015, she was really saying the last thing the world needs is to deal with a secular policy change from one major actor when the other major actors are going in the opposite direction. If markets wobble – a statement and not a forecast – funds from risky assets will demand short-term debt. What will the Federal Reserve do then; fight the resulting lower interest rates by reducing its balance sheet? That would be a policy error worthy of the 1930s and then some.

The causal chain is now:

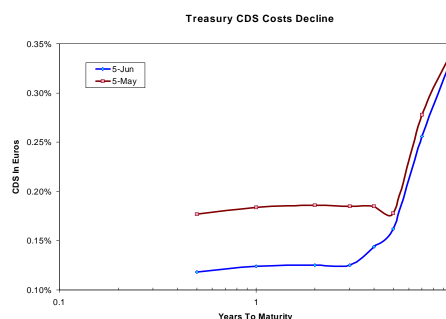
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point;
2. Disinflationary pressures have ended;
3. Inflation expectations as measured by the TIPS market will appear to be rising so long as nominal interest rates continue rising;
4. The 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

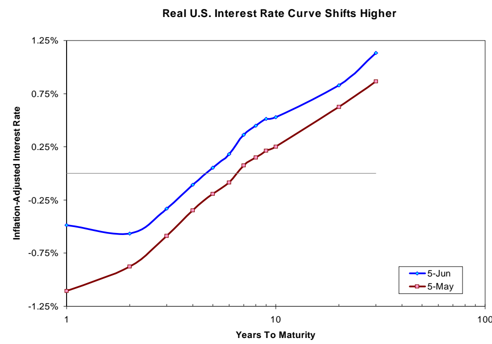
The rise in Eurozone consumer inflation was sufficient to push Bund yields well over the levels seen in December 2014 when Eurozone QE became inevitable and almost to the levels seen in August 2014 when German two-year note yields went negative. The resulting rise in the EUR, reduced with Friday's employment report, provided some cover for the Federal Reserve to raise short-term rates in the U.S. without pushing the USD inordinately higher. The end result for U.S. long-term rates has been a retreat back to September 2014 levels.



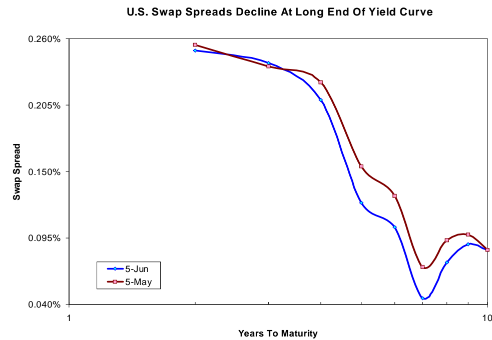
This market has little reason to shift significantly in either direction. Short-term CDS costs priced in EUR declined this week, but the significance of this move is minuscule.



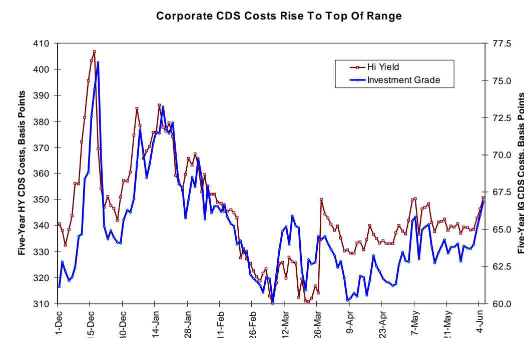
Pseudo-real rates continue to rise and are now negative out to "only" four years at this point. The rise over the past month has been a function of both increasing nominal rates and to a much lower rise in breakevens. Implied real rates have not increased sufficiently at the long end to pose a threat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



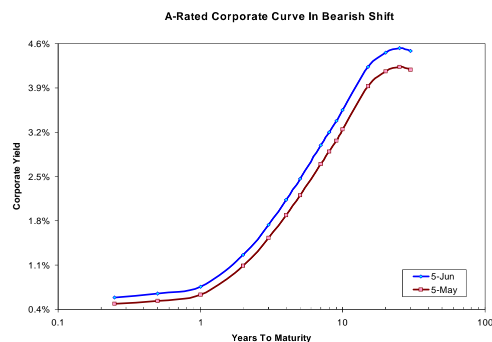
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates. The market remains complacent, perhaps dangerously so, over stable long-term 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

The main Bloomberg index and all subindices save Grains and Petroleum are in structural downtrends. Within the financials, all of the equity indices have moved into structural downtrends while the dollar index is on the cusp of one.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate June 8 - 12
BBerg	29	Trending	-0.243	10.2%	-0.35%
BBerg Grain	16	Transitional	0.018	17.3%	
BBerg Ind. Metl	29	Trending	-0.327	14.5%	-0.61%
BBerg Pre. Metl	29	Trending	-0.206	14.3%	-0.37%
BBerg Softs	29	Trending	-0.149	17.4%	-1.10%
BBerg Nat. Gas	29	Trending	-0.212	30.4%	-1.49%
BBerg Petroleum	19	Transitional	-0.070	22.4%	
BBerg Livestock	29	Trending	-0.115	9.2%	-0.37%
Dollar Index	29	Trending	0.089	10.5%	
S&P 500 Index	28	Trending	-0.099	8.1%	-0.13%
EAFE Index	26	Trending	-0.264	10.6%	-0.10%
EM Index	26	Trending	-0.501	9.0%	-0.14%
Ten-year UST (price)	15	Transitional	-0.217	6.8%	

Performance Measures

Being short agricultural commodities in a summer bear market is like being short natural gas during the late winter: You are just asking for a weather story. Once we settle the ones for grains and a related one for coffee out, we will find ourselves back in the primary downtrend. The more economically sensitive and important markets in the metals and in energy are dealing with the combination of excess supply capacity, cash-strapped producers and slowing demand growth. None of those require monetary excuses such as changes in the USD, short-term interest rates or increases in inflation expectations.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.69%	-4.28%	-10.64%	-24.77%
Grains Sub-Index	3.19%	0.52%	-12.43%	-25.37%
Corn	2.56%	-0.62%	-12.40%	-27.20%
Soybeans	0.40%	-4.77%	-10.87%	-25.75%
Wheat	8.39%	10.83%	-12.64%	-19.50%
Energy Sub-Index	-2.42%	-5.71%	-19.39%	-43.66%
Petroleum Sub-Index	-2.55%	-4.84%	-13.55%	-42.31%
WTI	-1.94%	-3.85%	-18.79%	-45.50%
Brent	-3.02%	-6.81%	-16.12%	-46.80%
ULSD	-4.11%	-7.44%	-8.73%	-34.00%
Gasoline	-1.59%	-1.07%	-3.45%	-36.03%
Natural Gas	-1.97%	-8.67%	-35.87%	-51.23%
Precious Metals Sub-Index	-2.49%	-2.56%	-2.12%	-9.77%
Gold	-1.82%	-2.19%	-2.11%	-7.17%
Silver	-4.29%	-3.59%	-2.19%	-17.38%
Industrial Metals Sub-Index	-0.40%	-9.99%	-10.97%	-13.27%
Copper	-1.30%	-8.26%	-7.28%	-13.09%
Aluminum	0.57%	-12.45%	-13.84%	-10.11%
Nickel	4.40%	-8.00%	-22.22%	-32.00%
Zinc	-2.75%	-11.91%	-5.79%	-0.28%
Softs Sub-Index	1.92%	-3.52%	-16.95%	-29.92%
Coffee	7.09%	1.09%	-27.64%	-27.54%
Sugar	0.58%	-5.49%	-19.58%	-40.35%
Cotton	-0.53%	-4.10%	6.68%	-16.20%
Livestock Sub-Index	-1.40%	-0.44%	-9.43%	-9.48%
Cattle	-0.46%	0.40%	-1.65%	10.01%
Hogs	-2.79%	-1.68%	-22.36%	-35.68%

How many cross-currents can one set of markets have in one week? The stronger report on Eurozone inflation pushed the EUR higher while the JPY continues to decline while the Latin American currencies sell off sharply while the USD ended the week with a strong rebound against the previously strong EUR.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	1.17%	-0.63%	-9.52%	-18.64%
Chinese yuan	-0.08%	0.05%	-0.81%	0.83%
Japanese yen	-1.18%	-4.59%	-3.32%	-18.48%
British pound	-0.14%	0.58%	-1.99%	-9.22%
Swiss franc	0.06%	-1.40%	4.16%	-5.14%
Canadian dollar	0.08%	-3.01%	-8.11%	-12.21%
Australian dollar	-0.29%	-4.02%	-8.33%	-18.38%
Swedish krona	1.65%	-0.35%	-9.82%	-20.50%
Norwegian krone	-2.24%	-4.67%	-9.98%	-24.71%
New Zealand dollar	-0.84%	-6.76%	-8.61%	-17.08%
Indian rupee	0.11%	-0.49%	-3.09%	-6.94%
Brazilian real	1.16%	-2.74%	-17.63%	-28.01%
Mexican peso	-2.12%	-2.35%	-8.61%	-18.11%
Chilean peso	-2.96%	-4.28%	-3.91%	-13.37%
Colombian peso	-3.47%	-8.88%	-11.65%	-27.90%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.50%	-1.23%	-1.49%	-3.79%

Earnings expectations are an opinion, but rising interest rates, exceptional currency volatility and policy confusion are facts. Alas, slowing Chinese demand is an opinion as well. The prospect of rising short-term interest rates in such an environment can overwhelm any upturn in macro expectations and push global equities lower.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.02%	-0.36%	2.67%	4.50%
North America	-0.58%	0.20%	1.96%	9.07%
Latin America	-0.52%	-8.90%	-11.68%	-21.44%
Emerging Market Free	-2.08%	-6.01%	0.75%	-2.51%
EAFE	-1.71%	-1.22%	3.81%	-2.06%
Pacific	-2.34%	-2.10%	7.63%	5.38%
Eurozone	-0.62%	-0.53%	0.33%	-8.02%

The poor one-week performances of both CTAs and hedge funds suggest they were caught on the wrong side of both the sharp decline and reversal in the USD as well as the massive selloff in sovereign bonds. While declaiming about the lack of market liquidity is fashionable, the real problem has been all major trades have been crowded.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.95%	-2.50%	3.89%	25.81%
Newedge Trend	-1.67%	-1.75%	2.80%	17.40%
Newedge Short-Term	-1.10%	-1.14%	0.26%	8.66%
HFR Global Hedge Fund	-0.24%	-0.14%	2.19%	0.80%
HFR Macro/CTA	-1.30%	-0.49%	0.75%	6.72%
HFR Macro: Sytematic Diversified CTA	-1.32%	-0.91%	1.13%	7.11%