The Macro Environment For Financial Markets

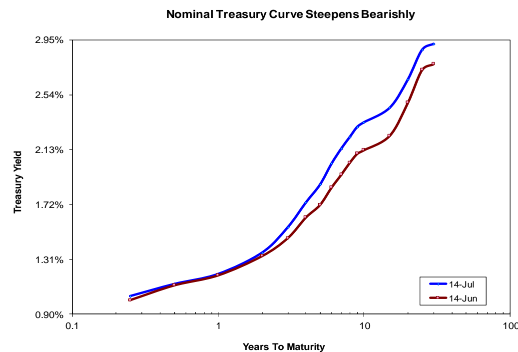
Simons RESEARCH

The most important thing to remember is neither the Federal Reserve nor its sister central banks have any greater insight than the market does. They clearly want to end QE and renormalize short-term rates, but despite a few pockets of tightness in the labor market and exuberant financial markets, there is no justification for any of these moves. Worse, it has become impossible to demonstrate any sort of deterministic outcome between changes in short-term monetary policy and inflation; if there were, inflation would have been much higher by now. The net result is the status quo of supportive monetary policy will remain intact and support the odd combination of a slow-growth economy and richly valued financial markets. The causal chain now is:

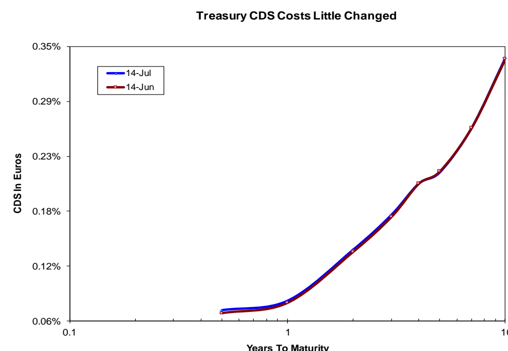
1. The market is starting to price out expectations for another short-term rate hike in the U.S. in 2017;
2. Inflationary expectations have stopped declining, but remain within their longer-term downtrend;
3. The secular flattening trend in the U.S. is encountering resistance as expectations for higher short-term rates fade;
4. Short-term borrowers are close to terming out short-term debt into the bond market;
5. Swap spreads are rising at the short end of the yield curve; and
6. CDS costs remain consistent with a bull market in risky assets.

Key Market Indications

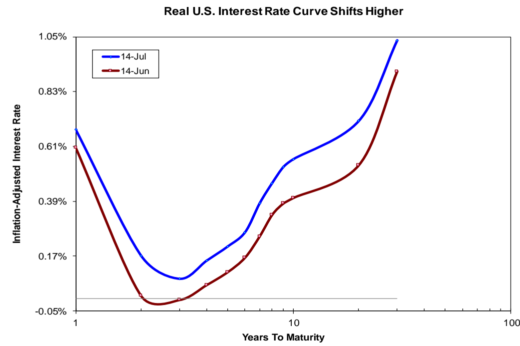
Support for the ten-year UST held at 2.40%, making it likely the month-long selloff related to expectations of an end to QE in the Eurozone was nothing but one more failed downturn. Central banks simply have no simple exit mechanism from QE as their balance sheets are too big to distribute and they are hesitant to drive down the value of their own holdings and raise the cost of servicing government debt.



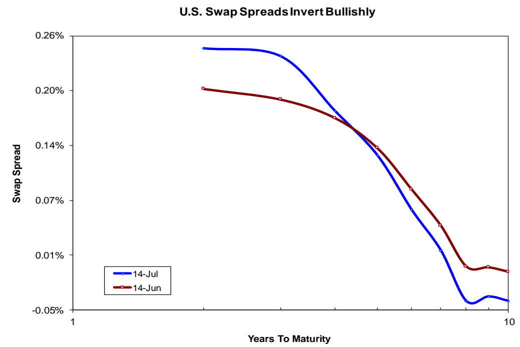
CDS costs on UST have changed little over the past month. This market remains unconcerned about the U.S. debt ceiling.



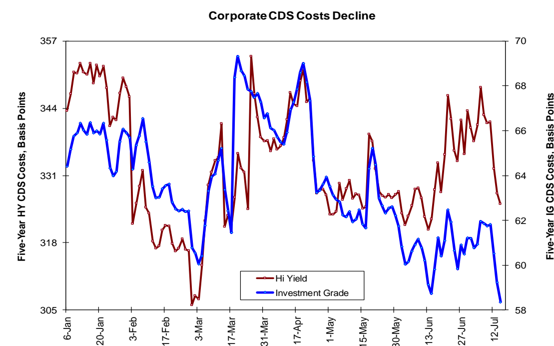
The pseudo-real yield curve shifted higher across the maturity spectrum, but unlike previous episodes, this did not push either precious metals or risky financial assets lower as the increases were the result of declining inflation expectations and not of rising implied real rates.



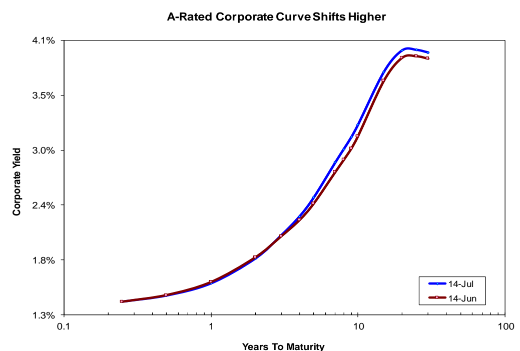
Swap spreads, which rise when floating-rate borrowers want to fix their payments, shifted higher at the short end of the yield curve in response to perceptions of greater central bank tightening. They declined at the long end of the yield curve in response to declining inflation expectations.



CDS costs declined sharply for both the investment-grade and high-yield indices. This reflected declining inflation expectations and a belief increases in short-term rates will not be as rapid as supposed only one month ago.



The A-rated corporate yield curve shifted slightly higher. This remains a bull market with limited upside potential.



Market Structure

Livestock joined Grains and Industrial Metals in structural uptrends amongst the physical commodities. Ten-year UST joined the dollar index in structural downtrends amongst the financials, while both the EM and EAFE indices moved into structural uptends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate July 17 - 21
BBerg	29	Trending	0.184	9.8%	0.07%
BBerg Grain	29	Trending	0.151	19.8%	0.10%
BBerg Ind. Metl	29	Trending	0.245	11.9%	0.39%
BBerg Pre. Metl	29	Trending	-0.199	13.2%	-0.15%
BBerg Softs	11	Transitional	0.170	20.8%	
BBerg Nat. Gas	13	Transitional	-0.040	23.8%	
BBerg Petroleum	13	Transitional	0.097	28.1%	
BBerg Livestock	27	Trending	0.093	14.9%	0.22%
Dollar Index	25	Trending	-0.262	5.8%	-0.09%
S&P 500 Index	18	Transitional	0.134	7.6%	
EAFE Index	21	Trending	0.167	8.2%	0.05%
EM Index	24	Trending	0.377	8.1%	0.06%
Ten-year UST (price)	29	Trending	-0.187	4.8%	-0.05%

Performance Measures

Last week's grain rally was reversed in part, as such July rallies often are after a few raindrops fall. The secondary rally in the Energy subindex continues, but the primary downtrend remains here. The economically sensitive Industrial Metals subindex continues to advance under signs of stable demand in China.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	1.12%	1.85%	-6.66%	-4.04%
Grains Sub-Index	-3.47%	1.49%	-2.21%	-4.36%
Corn	-4.12%	-3.94%	-2.65%	-4.31%
Soybeans	-1.36%	5.50%	-8.63%	-9.09%
Wheat	-4.51%	6.16%	8.11%	0.92%
Energy Sub-Index	4.47%	2.22%	-16.23%	-9.71%
Petroleum Sub-Index	4.63%	4.02%	-14.75%	-7.58%
WTI	5.34%	3.51%	-15.53%	-11.85%
Brent	4.64%	2.68%	-14.83%	-8.35%
ULSD	4.51%	5.34%	-11.26%	-3.12%
Gasoline	3.50%	6.32%	-16.71%	-0.81%
Natural Gas	4.01%	-2.43%	-20.26%	-15.12%
Precious Metals Sub-Index	1.94%	-2.86%	-1.57%	-12.64%
Gold	1.48%	-2.24%	0.76%	-8.52%
Silver	3.31%	-4.64%	-7.86%	-22.44%
Industrial Metals Sub-Index	1.49%	5.25%	1.61%	14.27%
Copper	1.68%	4.43%	1.35%	18.21%
Aluminum	-0.29%	3.09%	6.05%	13.44%
Nickel	7.33%	7.01%	-6.50%	-8.31%
Zinc	-0.36%	10.30%	2.03%	24.61%
Softs Sub-Index	1.14%	1.59%	-20.47%	-22.28%
Coffee	3.75%	6.24%	-14.88%	-17.36%
Sugar	1.08%	5.00%	-31.64%	-28.66%
Cotton	-2.91%	-3.93%	-6.88%	-10.21%
Livestock Sub-Index	0.33%	0.63%	8.89%	11.62%
Cattle	3.14%	0.23%	12.84%	20.87%
Hogs	-4.16%	0.87%	2.57%	-1.62%

The USD managed to decline across the board this past week as expectations for higher short-term rates dissipated rapidly. The effects were pronounced in both the EM currencies and in commodity-linked currencies such as the AUD and CAD.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.61%	2.25%	8.20%	3.15%
Chinese yuan	0.45%	0.24%	1.85%	-1.35%
Japanese yen	1.24%	-2.62%	1.48%	-6.38%
British pound	1.61%	2.72%	8.72%	-1.84%
Swiss franc	0.05%	0.79%	5.00%	1.81%
Canadian dollar	1.83%	4.77%	4.20%	1.96%
Australian dollar	3.04%	3.26%	4.75%	2.62%
Swedish krona	1.43%	4.76%	7.75%	2.28%
Norwegian krone	2.21%	2.88%	4.21%	2.17%
New Zealand dollar	0.91%	1.18%	3.44%	2.06%
Indian rupee	0.23%	-0.24%	5.66%	3.83%
Brazilian real	3.19%	3.01%	1.94%	2.30%
Mexican peso	3.00%	2.02%	23.75%	4.49%
Chilean peso	1.50%	0.38%	0.67%	-0.98%
Colombian peso	2.00%	-3.07%	-2.73%	-3.67%
Bloomberg-JP Morgan Asian dollar index (spot)	0.71%	-0.04%	2.63%	-0.45%

The removal of higher inflation expectations and the threat of continuously higher short-term rates both in the U.S. and in the Eurozone was all equity markets needed to rebound. The effects were particularly strong in Latin American following Lula's conviction in Brazil.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	1.83%	1.42%	10.86%	17.45%
North America	1.51%	1.20%	8.85%	15.86%
Latin America	6.82%	6.80%	13.71%	17.66%
Emerging Market Free	4.60%	4.09%	18.69%	24.16%
EAFE	2.39%	0.79%	13.44%	19.67%
Pacific	2.62%	0.84%	8.80%	16.82%
Eurozone	2.28%	1.88%	19.02%	28.76%

Both CTAs and hedge funds managed gains this week, returning to their pattern of advancing during equity rallies.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.91%	-3.46%	-5.62%	-14.04%
Newedge Trend	1.48%	-3.21%	-3.39%	-10.62%
Newedge Short-Term	0.85%	-0.47%	-4.94%	-12.45%
HFR Global Hedge Fund	0.52%	0.53%	2.37%	5.55%
HFR Macro/CTA	0.70%	-0.36%	0.10%	-3.23%
HFR Macro: Sytematic Diversified CTA	0.66%	-1.45%	-1.90%	-7.80%