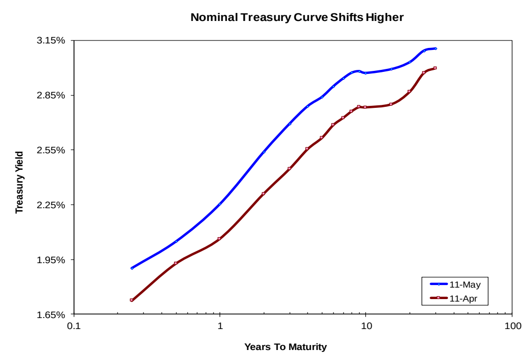
The Macro Environment For Financial Markets

The problem with the inflation-breakout story is higher inflation has yet to materialize and there is no evidence the reduction of unemployment will push inflation higher. Labor is competing with capital and technology and has less pricing power as a factor of production than it once did. In the absence of higher inflation and with the increase in emerging market credit stresses, the argument for further monetary contraction becomes less compelling. The causal chain now is:

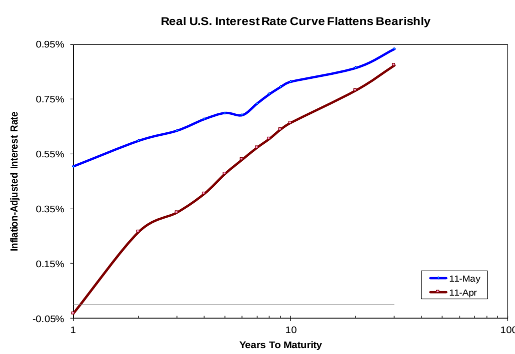
1. The market is pricing in June, September and increasingly December 2018 rate hikes;
2. Inflationary expectations have stopped rising;
3. The yield curve has resumed its flattening trend;
4. Short-term borrowers are accepting rollover risk rather than term-out borrowing in the bond market;
5. Swap spreads continue to invert bullishly; and
6. CDS costs continue to reflect equity market fluctuations more than credit market conditions.

Key Market Indications

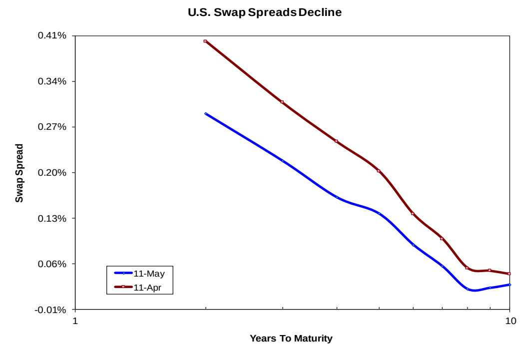
To repeat verbatim from last week: The ten-year UST continues to find strong support in front of 3.05%. Inflation expectations have stopped rising for the time being and the yield curve continues to flatten as the Federal Reserve continues to believe 25 basis points on overnight paper influences long-term economic decisions.



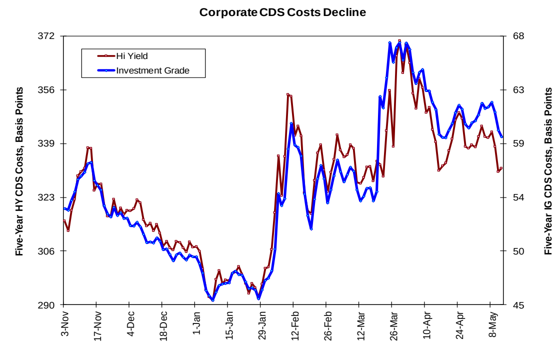
Once again, we can repeat verbatim from a week ago: The pseudo-real yield curve continued to shift higher at the short end of the yield curve. This is a major negative fundamental for gold.



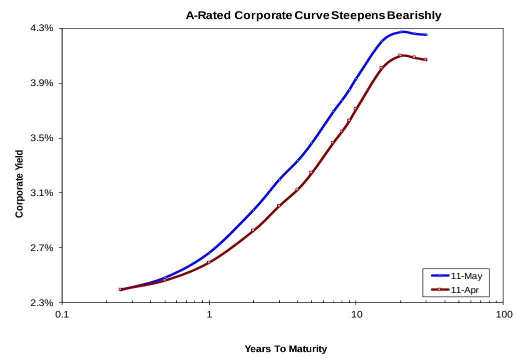
Swap spreads, which rise when floating-rate borrowers want to fix their payments, shifted lower across all tenors, but especially at the short end of the yield curve.



CDS costs continue to reflect movements in equities as correlation trades between stock options and CDS dominate individual issues' credit concerns.



The A-rated corporate yield curve steepened bearishly. Rising LIBOR has not posed a threat to this market yet but must be considered a negative given how it affects carrying costs.



Market Structure

Only Precious Metals and Petroleum are in structural trends amongst physical commodities. Within financial markets, both the EAFE and EM indices joined the dollar index in structural uptrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 14 - 18
BBerg	14	Transitional	0.086	6.8%	
BBerg Grain	29	Trending	-0.042	14.7%	
BBerg Ind. Metl	15	Transitional	0.016	21.4%	
BBerg Pre. Metl	29	Trending	-0.031	9.8%	-0.43%
BBerg Softs	12	Transitional	-0.086	13.8%	
BBerg Nat. Gas	29	Trending	0.058	18.5%	
BBerg Petroleum	29	Trending	0.310	19.1%	0.34%
BBerg Livestock	23	Trending	-0.120	12.4%	-0.18%
Dollar Index	29	Trending	0.295	5.5%	0.03%
S&P 500 Index	17	Transitional	0.168	12.9%	
EAFE Index	26	Trending	0.147	6.4%	0.06%
EM Index	25	Trending	0.054	9.0%	0.21%
Ten-year UST (price)	10	Sideways	-0.012	3.5%	

Performance Measures

Grains turned lower on the WASDE reports; they no doubt will get at least one heat-related rally and one early-frost rally before the North American harvest. The Energy complex shot higher on Iran tensions and the effects of OPEC production cuts. Softs continue to deteriorate on ample supplies while the economically sensitive Industrial Metals are returning to normal trading patterns.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.09%	0.99%	5.30%	9.26%
Grains Sub-Index	-3.61%	-1.27%	5.87%	-3.33%
Corn	-2.37%	0.65%	9.28%	-5.59%
Soybeans	-3.20%	-5.66%	1.10%	0.38%
Wheat	-5.19%	2.09%	6.27%	-3.53%
Energy Sub-Index	2.81%	5.07%	13.22%	22.30%
Petroleum Sub-Index	2.71%	6.50%	23.85%	48.87%
WTI	1.62%	5.64%	29.10%	46.45%
Brent	3.25%	7.58%	28.34%	55.87%
ULSD	3.16%	6.44%	18.54%	49.60%
Gasoline	3.35%	6.08%	11.23%	38.37%
Natural Gas	3.10%	0.85%	-14.85%	-31.78%
Precious Metals Sub-Index	0.71%	-1.39%	1.26%	5.34%
Gold	0.49%	-1.88%	2.55%	6.82%
Silver	1.45%	0.31%	-2.58%	0.98%
Industrial Metals Sub-Index	-0.41%	0.49%	5.61%	25.15%
Copper	0.88%	0.77%	0.32%	21.16%
Aluminum	-3.39%	0.75%	10.98%	20.68%
Nickel	0.21%	0.83%	19.20%	49.63%
Zinc	0.95%	-1.01%	-1.49%	22.67%
Softs Sub-Index	-2.54%	-2.86%	-10.70%	-18.39%
Coffee	-2.57%	0.06%	-10.84%	-19.10%
Sugar	-2.48%	-7.90%	-25.17%	-30.40%
Cotton	-2.59%	1.67%	23.11%	7.38%
Livestock Sub-Index	1.48%	1.02%	-7.59%	-11.89%
Cattle	0.71%	3.15%	-9.10%	-14.80%
Hogs	2.88%	-2.48%	-5.87%	-8.24%

The USD retreated against the CNY, GBP, CHF, CAD and AUD, but continues its advance against the major emerging market currencies. The Federal Reserve will have to pay attention to these downturns, especially against the fragile ARS and TRY; these can cause a funding crisis.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.14%	-3.43%	2.37%	9.96%
Chinese yuan	0.45%	-1.03%	4.84%	8.99%
Japanese yen	-0.25%	-2.38%	3.87%	4.09%
British pound	0.08%	-4.48%	3.25%	5.09%
Swiss franc	0.02%	-4.21%	-0.35%	0.80%
Canadian dollar	0.40%	-1.67%	-0.48%	7.05%
Australian dollar	0.05%	-2.73%	-1.05%	2.22%
Swedish krona	2.38%	-3.21%	-2.54%	3.29%
Norwegian krone	0.74%	-2.85%	2.03%	7.44%
New Zealand dollar	-0.73%	-5.31%	0.96%	1.75%
Indian rupee	-0.69%	-3.01%	-2.83%	-4.39%
Brazilian real	-1.99%	-6.27%	-8.91%	-12.79%
Mexican peso	-0.79%	-6.16%	-1.53%	-3.02%
Chilean peso	0.30%	-3.54%	1.69%	8.42%
Colombian peso	-0.47%	-4.12%	6.06%	3.26%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.07%	-1.33%	2.59%	4.65%

The combination of rising earnings, declining inflation expectations and stable interest rates was enough to support equities. The "pain trade" is going long after the February shock, and a further rally will lead to a resumption of the previous melt-up.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	2.16%	2.39%	6.28%	15.39%
North America	2.47%	3.39%	6.42%	16.14%
Latin America	0.71%	-5.64%	6.19%	10.30%
Emerging Market Free	2.52%	-0.81%	4.12%	19.41%
EAFE	1.64%	1.62%	4.95%	14.46%
Pacific	1.29%	1.95%	5.10%	17.36%
Eurozone	1.07%	1.10%	5.31%	13.11%

Both CTAs and hedge funds rose this week, as has been the case during equity market rallies. The strong CTA gains suggest a substantial long position in the energy markets.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.85%	1.80%	0.23%	1.81%
Newedge Trend	0.94%	0.92%	-0.58%	0.52%
Newedge Short-Term	0.63%	1.31%	0.86%	0.49%
HFR Global Hedge Fund	0.48%	0.24%	0.66%	3.16%
HFR Macro/CTA	1.74%	1.91%	0.32%	3.55%
HFR Macro: Sytematic Diversified CTA	1.94%	2.36%	1.59%	6.41%