The Macro Environment For Financial Markets

The wonderful thing about China is they can issue an order to lend to insolvent state enterprises and no one bats an eye. I reckon this postpones some sort of day of reckoning, but the same lesson that applied here during the financial crisis applies there: The money is lost via the misallocation of resources in the bubble; you decide on the timing and distribution of losses during the downturn. If democracies cannot admit to losses, can one-party states? Of course not; the result is going to be the perpetuation of Chinese zombie enterprises exporting underpriced goods simply to cover fixed costs. That will keep global growth lower than it would be otherwise, but unless the whole thing blows up, it will create a marvelous environment for financial assets as the endless spigot of free money will flow into paper rather than into productive plant and equipment.

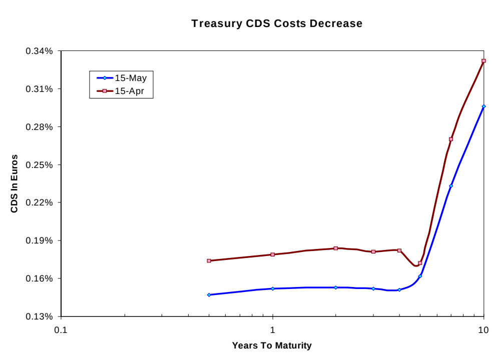
The causal chain is now:

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 are starting to abate, but this will not be a uniform process either across economies or between economic sectors;
3. Inflation expectations as measured by the TIPS market have held below their critical resistance level in front of 2.10%;
4. The selloff in global sovereign bonds appears to be over;
5. The U.S. yield curve will retain its long-term bias toward flattening even as it is in a short-term bearish steepening;
6. Short-term borrowers will continue to accept rollover risk;
7. Swap spreads will remain tame until monetary policy indications turn more hawkish; and
8. Credit spreads will remain well-confined at historically low levels.

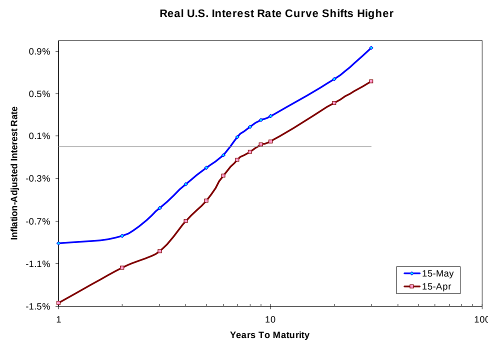
Key Market Indications

We learned three weeks ago no one was going to pay to own ten-year Bunds. We learned last week they will be happy to accept 77 basis points. Given this support, the soft U.S. economic data, the prospect of no rate hikes in 2015 and no upturn in inflation expectations, we should see the recent bearish steepening of the UST yield curve devolve back into its long-term bullish flattening trend.

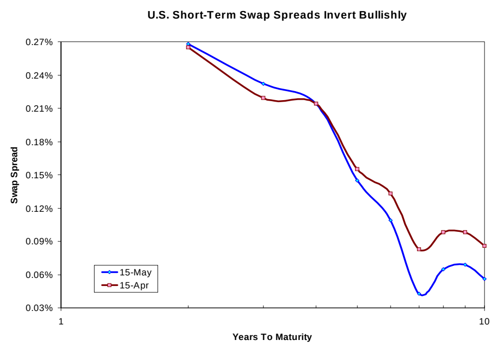
CDS costs shifted lower. We should have reasons for things, and the unexpectedly large U.S. budget surplus in April, thanks to higher capital gain and self-employment tax payments, put federal finances in a better than expected position. Fundamentals: You always can find some. Of course, more money will last in Washington like more water will last in a perforated bucket.



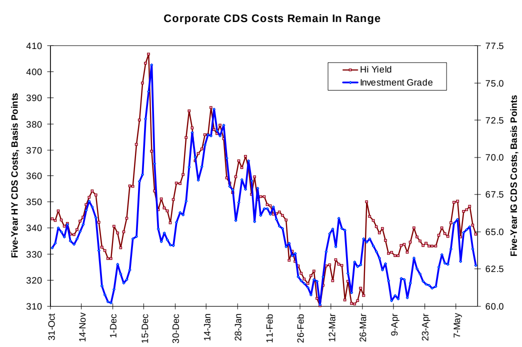
Pseudo-real rates have shifted higher and are negative out to “only” six years at this point. This shift is attributable to the bearish steepening of the nominal UST yield curve. These higher implied real rates have yet to shift to the point where they are negative for risky financial assets. Interestingly, precious metals rose even as implied real short-term rates in the U.S. rose, suggesting the buying interest is coming out of China as financial stresses rise there.



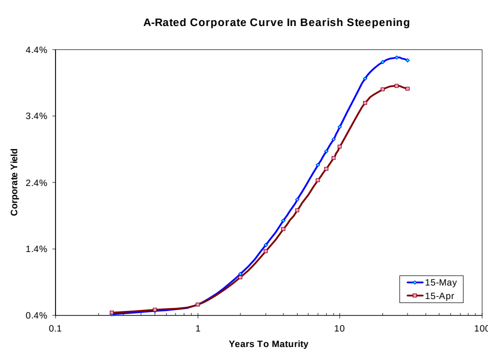
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates. The small shift higher over the past month at the short end of the yield curve is too minor to constitute a major fundamental shift in this market’s assessment of interest rate risks.



Both investment-grade and high-yield CDS costs remain in their trading ranges. The postponement of a rate hike should maintain this downward drift barring a more serious macro shock.



The A-rated yield curve has steepened bearishly over the past month, but this shift has been quite small. Unless CDS costs and swap spreads increase, this should not present any sort of headwind for equities.



Market Structure

The main Bloomberg index remains in a structural uptrend. Only Grains are in a structural downtrend amongst the physical commodities. The dollar index and ten-year UST remain in downtrends while the S&P 500 index remains in an uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 18 - 22
BBerg	29	Trending	0.244	10.2%	0.51%
BBerg Grain	29	Trending	-0.041	13.7%	-0.20%
BBerg Ind. Metl	7	Sideways	-0.050	13.3%	
BBerg Pre. Metl	29	Trending	0.248	13.8%	0.26%
BBerg Softs	25	Trending	-0.016	17.3%	
BBerg Nat. Gas	29	Trending	0.290	29.0%	0.52%
BBerg Petroleum	7	Sideways	0.010	23.3%	
BBerg Livestock	29	Trending	0.144	10.5%	0.01%
Dollar Index	29	Trending	-0.347	10.1%	-0.27%
S&P 500 Index	29	Trending	0.120	8.6%	0.28%
EAFE Index	13	Transitional	0.143	10.0%	
EM Index	13	Transitional	0.032	8.4%	
Ten-year UST (price)	29	Trending	-0.131	6.6%	-1.50%

Performance Measures

One of the more welcome developments in the world of physical commodities is their increasing dispersion of returns; they are not being driven higher or lower by financial flows but are differentiating along fundamental lines as they should. Still, key commodities such as copper and crude oil appear to be pushed higher still by fund inflows. Until there are uniform external factors such as a demand shock from China or a supply shock in the energy markets, we should see return differentiation continue.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	1.20%	3.46%	-9.78%	-22.08%
Grains Sub-Index	0.99%	-1.93%	-8.41%	-28.75%
Corn	0.69%	-5.49%	-8.88%	-31.45%
Soybeans	-2.36%	-1.88%	-8.27%	-24.76%
Wheat	6.13%	4.45%	-6.91%	-28.52%
Energy Sub-Index	2.15%	6.25%	-24.30%	-38.74%
Petroleum Sub-Index	1.31%	4.49%	-20.94%	-40.35%
WTI	0.32%	3.54%	-26.66%	-43.71%
Brent	0.83%	3.87%	-22.50%	-44.56%
ULSD	2.42%	5.88%	-12.56%	-30.77%
Gasoline	2.99%	6.11%	-14.74%	-35.52%
Natural Gas	4.85%	12.08%	-33.79%	-38.54%
Precious Metals Sub-Index	4.02%	3.44%	3.58%	-6.65%
Gold	3.06%	1.84%	2.14%	-5.58%
Silver	6.67%	7.93%	7.69%	-10.37%
Industrial Metals Sub-Index	-1.23%	4.69%	-5.00%	-5.93%
Copper	0.14%	5.58%	-2.31%	-7.30%
Aluminum	-2.12%	1.54%	-10.06%	0.47%
Nickel	-2.28%	11.19%	-11.47%	-27.82%
Zinc	-2.90%	3.45%	1.17%	8.72%
Softs Sub-Index	-1.16%	0.72%	-17.66%	-33.45%
Coffee	2.67%	-2.23%	-30.87%	-32.22%
Sugar	-3.95%	-2.20%	-17.09%	-40.04%
Cotton	1.03%	5.61%	10.98%	-16.71%
Livestock Sub-Index	0.10%	5.33%	-12.50%	-8.11%
Cattle	0.59%	2.21%	-5.62%	12.53%
Hogs	-0.61%	10.35%	-24.53%	-35.09%

The long-liquidation phase of the USD should come to an end soon as the consensus U.S. short-term rates are not going to increase anytime soon has been discounted and no one else is poised to reduce their own monetary stimulus. This would argue for some prolonged trading ranges in the currency world, marked with threats of further competitive devaluation. Such an outcome would be just fine for both financial assets and economic stability.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	2.25%	7.18%	-8.02%	-16.48%
Chinese yuan	0.05%	-0.02%	-1.28%	0.37%
Japanese yen	0.43%	-0.09%	-2.18%	-14.82%
British pound	1.76%	5.96%	0.55%	-6.33%
Swiss franc	1.54%	5.27%	5.32%	-2.75%
Canadian dollar	0.47%	2.30%	-5.88%	-9.40%
Australian dollar	1.29%	4.58%	-7.74%	-14.13%
Swedish krona	0.81%	6.56%	-9.21%	-19.76%
Norwegian krone	2.31%	7.07%	-7.18%	-18.58%
New Zealand dollar	-0.20%	-1.55%	-5.52%	-13.53%
Indian rupee	0.66%	-1.80%	-2.80%	-6.65%
Brazilian real	-0.74%	1.06%	-12.95%	-25.94%
Mexican peso	0.75%	1.78%	-9.45%	-13.65%
Chilean peso	1.48%	3.53%	-0.07%	-7.08%
Colombian peso	-2.46%	3.88%	-10.57%	-20.24%
Bloomberg-JP Morgan Asian dollar index (spot)	0.22%	0.33%	-1.19%	-2.50%

Yes, the S&P 500 is at an all-time high, but the total return since December 29, 2014 has been all of 2.33%. Gains in the World Ex-U.S. index in USD terms have been a much higher 9.23%, but that would have seemed very unlikely at the start of the year given the greenback's then-strong condition. This is why you diversify.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.82%	1.71%	6.63%	10.04%
North America	0.40%	0.81%	4.89%	14.57%
Latin America	0.79%	5.58%	-3.78%	-15.41%
Emerging Market Free	0.85%	0.80%	6.29%	4.17%
EAFE	1.47%	3.12%	9.40%	3.65%
Pacific	2.05%	1.63%	8.65%	11.30%
Eurozone	0.71%	2.90%	10.63%	-0.92%

Performance remains very mixed in the CTA and hedge fund world, but within the context of heightened bond and currency volatility, short-term resistance in crude oil and only grudging advances in equities, the small gains seen this week in global hedge funds and in short-term/trend-following CTAs are acceptable.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.18%	-7.90%	8.15%	25.41%
Newedge Trend	0.35%	-5.21%	7.22%	18.11%
Newedge Short-Term	1.04%	-2.95%	2.74%	10.31%
HFR Global Hedge Fund	0.27%	-0.92%	1.95%	1.30%
HFR Macro/CTA	-0.38%	-4.20%	0.58%	6.31%
HFR Macro: Sytematic Diversified CTA	-0.49%	-6.26%	1.41%	5.85%