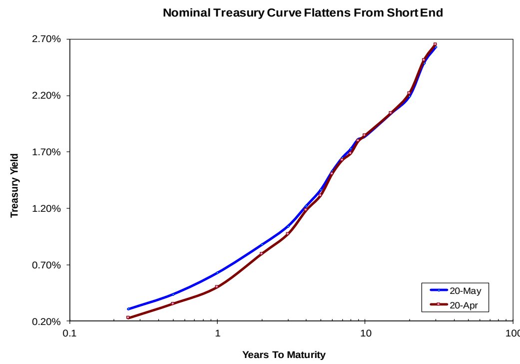
The Macro Environment For Financial Markets

The Federal Reserve's apparent intention to raise a rate at which few non-GSE's trade probably will have no discernible impact on recent trends in inflation expectations. This has been the case since the 1980s, but no one seems to believe three decades' worth of actual data. The move will raise government borrowing costs and will push the USD higher until it causes a funding crisis elsewhere. The last time China was faced with this reality it devalued the CNY in August 2015 and set the stage for the first of two equity market corrections and much related unhappiness. The causal chain now is:

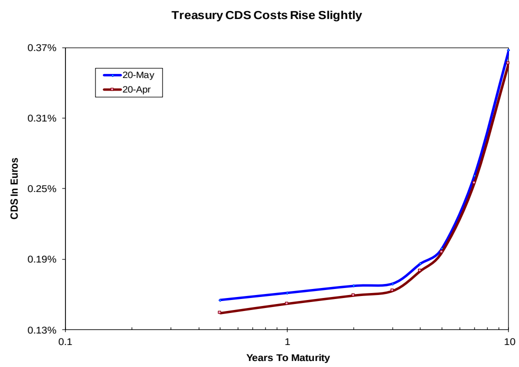
1. The market is back to pricing in a rate hike in June after being told rates will rise in June. People get paid for such genius;
2. Disinflationary pressures will persist globally while inflationary pressures are rising in the U.S.;
3. Inflation expectations as measured by TIPS and inflation swaps have established a strong tradable bottom;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are terming out their short-term debt obligations to reduce rollover risk;
6. Swap spreads are moving higher at the short end of the yield curve but lower at the long end; and
7. CDS costs have moved back into a trading range.

Key Market Indications

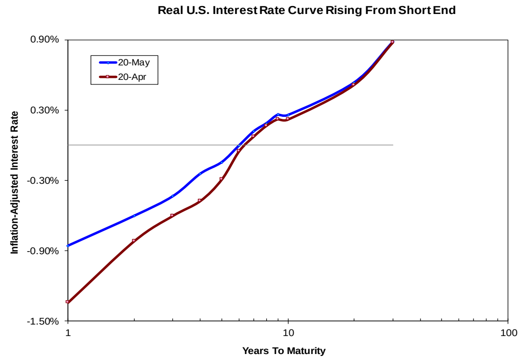
The short end of the yield curve is being pushed higher by expected rate hikes. This actually is a continuation of a trend started in November 2013, just before the first tapering of QE purchases. Treasuries have been in a bull market since then, thanks in large part to the drive lower in global yields. Nothing indicated this past week changes this trend.



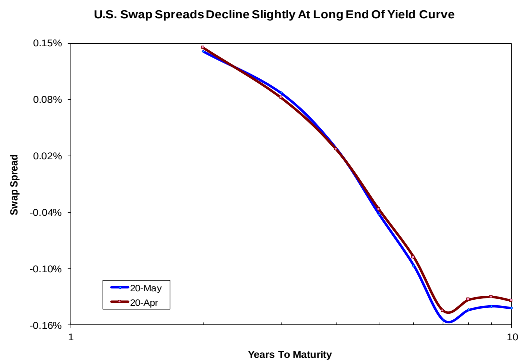
CDS costs shifted higher at the short end of the yield curve. This may be a reaction to the implications of higher short-term UST rates. If the Federal Reserve goes through with its expected rate hikes in 2016, no entity will be affected more than the federal government.



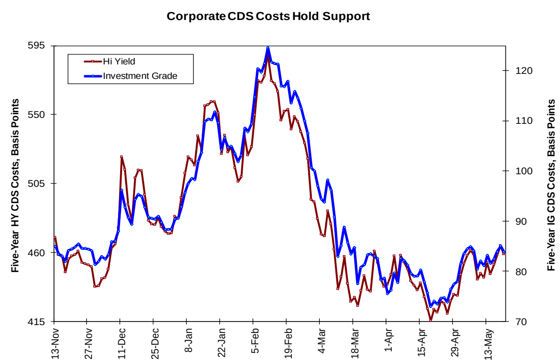
The pseudo-real rate curve continued its recent rise at the short end of the yield curve. These rates remain negative out to seven years. Their rise is inimical to precious metals, but it is doubtful events in the U.S. can offset deeply negative short-term rates elsewhere. Unless long-term pseudo-real rates rise, the shift at the short end of the yield curve will have little effect on risky financial assets.



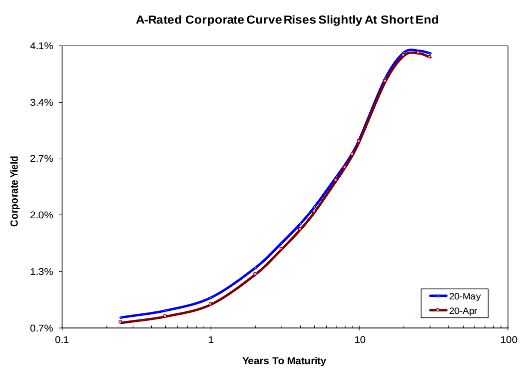
Swap spreads, which rise when floating-rate borrowers want to fix their payments, declined at the long end of the yield curve over the past month and remain inverted. The inversion of this curve is confirmed in the swaption market as well. The belief seems to be that long-term rates will remain constrained even if short-term rates are pushed higher.



Both high-yield and investment-grade CDS indices held support, which is encouraging in the face of higher short-term rates. There is little reason to expect a further narrowing of these spreads through recent resistance levels, and barring either an unexpected increase in short-term rates or an event, there is little reason to expect a greater deterioration, either.



The A-rated corporate yield curve once again mirrored the UST curve as credit spreads remain in a narrow range. The general bull market remains intact, but the potential for further gains is limited.



Market Structure

Only Softs are in a structural uptrend within the physical commodities, and the economically important Industrial Metals index has entered a downtrend. Within the financials, ten-year UST joined the EAFE and EM indices in downtrends while the dollar index has entered an uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 23 - 27
BBerg	12	Transitional	0.030	14.3%	
BBerg Grain	14	Transitional	0.048	21.4%	
BBerg Ind. Metl	29	Trending	-0.226	18.3%	-0.53%
BBerg Pre. Metl	12	Transitional	-0.123	15.2%	
BBerg Softs	29	Trending	0.149	21.2%	0.14%
BBerg Nat. Gas	27	Trending	-0.049	27.7%	
BBerg Petroleum	14	Transitional	0.118	32.2%	
BBerg Livestock	22	Trending	-0.036	11.1%	0.40%
Dollar Index	23	Trending	0.178	6.6%	0.14%
S&P 500 Index	19	Transitional	-0.056	9.6%	
EAFE Index	29	Trending	-0.186	11.1%	-0.19%
EM Index	29	Trending	-0.491	9.9%	-0.24%
Ten-year UST (price)	24	Trending	-0.045	4.9%	-0.20%

Performance Measures

The Petroleum indices rallied in the face of a stronger dollar. This should not be surprising as individual commodity/currency correlations of returns are statistically insignificant. Precious Metals moved lower in the face of higher short-term implied real rates, and the Industrial Metals continued to decline in the face of a persistent supply overhang given the slowdown in Chinese import demand.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.48%	2.20%	4.27%	-17.08%
Grains Sub-Index	0.37%	4.25%	6.19%	0.52%
Corn	0.96%	5.08%	3.66%	0.01%
Soybeans	0.87%	7.85%	22.32%	17.12%
Wheat	-1.47%	-1.30%	-8.11%	-13.70%
Energy Sub-Index	2.25%	4.83%	-7.91%	-38.56%
Petroleum Sub-Index	3.31%	8.55%	-4.53%	-35.90%
WTI	3.22%	8.71%	-9.99%	-41.67%
Brent	2.48%	8.06%	-2.93%	-37.65%
ULSD	5.69%	12.22%	-2.54%	-34.71%
Gasoline	2.86%	5.77%	-2.95%	-25.51%
Natural Gas	-1.64%	-7.37%	-22.54%	-48.63%
Precious Metals Sub-Index	-2.05%	0.69%	17.54%	1.69%
Gold	-1.49%	1.94%	17.54%	3.79%
Silver	-3.50%	-2.45%	17.27%	-4.14%
Industrial Metals Sub-Index	-0.58%	-7.14%	5.40%	-23.64%
Copper	-0.89%	-9.37%	1.28%	-27.81%
Aluminum	0.85%	-6.69%	6.01%	-16.71%
Nickel	-1.65%	-6.64%	1.65%	-34.09%
Zinc	-1.20%	-2.36%	19.42%	-16.48%
Softs Sub-Index	0.07%	2.30%	4.13%	4.60%
Coffee	-4.15%	1.11%	-1.40%	-11.26%
Sugar	1.98%	10.36%	9.75%	23.43%
Cotton	1.74%	-3.15%	0.15%	-3.86%
Livestock Sub-Index	-1.88%	3.30%	1.21%	-14.34%
Cattle	-1.07%	5.43%	-3.03%	-17.86%
Hogs	-2.78%	0.94%	8.48%	-7.55%

I noted last week the currency market was starting to believe short-term interest rates in the U.S. would rise relative to the rest of the world in response to rising inflationary pressures. That materialized, and we should expect more of the same as the June FOMC meeting approaches. Only the GBP and BRL firmed, both for political reasons. The Brexit vote is starting to resemble the old Quebec separatists who surely would have demanded a recount had they won.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.75%	-0.65%	5.43%	1.17%
Chinese yuan	-0.26%	-1.23%	-2.51%	-5.27%
Japanese yen	-1.38%	-0.28%	11.49%	10.17%
British pound	0.95%	1.19%	-4.54%	-6.66%
Swiss franc	-1.49%	-1.83%	2.82%	-5.36%
Canadian dollar	-1.32%	-3.49%	1.78%	-6.90%
Australian dollar	-0.67%	-7.34%	-0.23%	-8.29%
Swedish krona	-0.80%	-2.23%	4.85%	0.39%
Norwegian krone	-1.51%	-2.51%	3.76%	-9.09%
New Zealand dollar	-0.15%	-3.07%	3.06%	-7.42%
Indian rupee	-1.00%	-1.82%	-1.86%	-5.37%
Brazilian real	0.35%	0.24%	5.24%	-14.73%
Mexican peso	-0.96%	-5.82%	-9.86%	-17.19%
Chilean peso	-0.07%	-4.55%	2.80%	-12.51%
Colombian peso	-1.95%	-5.06%	0.36%	-18.20%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.54%	-2.00%	-1.19%	-5.31%

U.S. equities had every reason to move sharply lower this past week and failed to do so. This normally is supportive, but it also has the feeling of despair. The answer to the question of "sell and do what?" has been lacking for several years.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.35%	-2.33%	-1.94%	-6.70%
North America	0.36%	-2.16%	-0.62%	-2.64%
Latin America	-3.55%	-6.98%	1.99%	-19.20%
Emerging Market Free	-1.32%	-7.40%	-5.99%	-22.07%
EAFE	0.33%	-3.93%	-4.90%	-12.90%
Pacific	0.40%	-4.54%	-4.38%	-11.39%
Eurozone	-0.26%	-3.71%	-5.70%	-13.92%

It was a bad week for both CTAs and hedge funds as UST reversed, the dollar was strong on the upside, equity indices turned lower and U.S. short-term interest rate expectations. Aren't professional traders supposed to live for this stuff?

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.66%	-5.02%	-4.16%	-4.64%
Newedge Trend	-1.54%	-3.90%	-0.85%	-2.38%
Newedge Short-Term	-1.06%	-2.46%	1.71%	-1.89%
HFR Global Hedge Fund	-0.17%	-0.70%	-3.28%	-7.93%
HFR Macro/CTA	-1.22%	-2.40%	-2.74%	-3.74%
HFR Macro: Sytematic Diversified CTA	-2.47%	-4.72%	-2.01%	-1.63%