The Macro Environment For Financial Markets

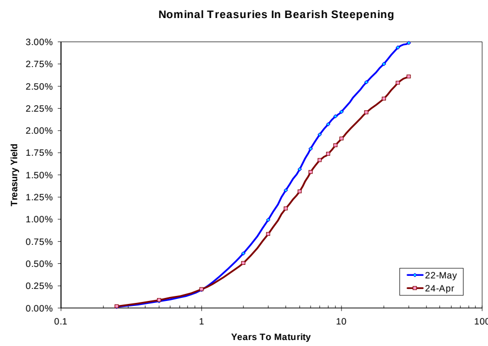
Have you ever wondered why legislatures keep passing new laws instead of simply using up the ones we already have? Boredom, I suppose, which brings me to the observation we keep recycling the same concerns to the point no one is concerned about them with the appropriate measure of seriousness. Take Greek debt, the slowdown in China and the never-ending question when the Federal Reserve will raise short-term interest rates, please. In short order, we will pretend Greece paid its debt, China will use its police-state powers to hide its state-firm insolvencies and the Federal Reserve will find that even talking about higher short-term rates will push the dollar higher quickly and exert a stronger braking effect than some trivial 25 basis point increase in overnight interest rates in a federal funds market no one has to use anymore. These situations are likely to perpetuate boredom, and just as legislatures create mischief via unnecessary activity, traders can create mischief for themselves and others by acting as if some action is superior to no action at all.

The causal chain is now:

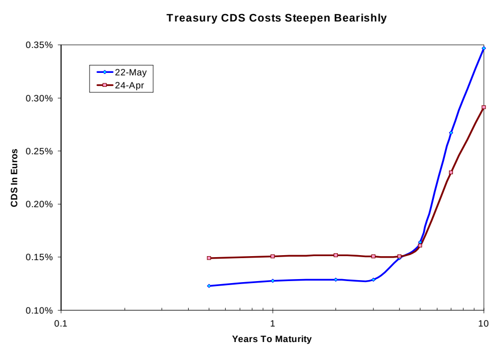
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point;
2. Disinflationary pressures are starting to abate, but this will not be a uniform process either across economies or between economic sectors;
3. Inflation expectations as measured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

Key Market Indications

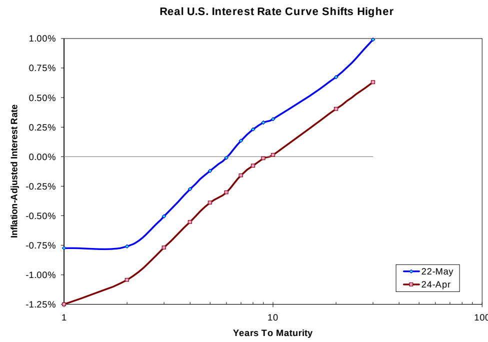
The stall in the recent bearish steepening of the UST yield curve is telling; any move toward higher short-term rates is likely to flatten the yield curve from the short-end while the wider yield spread between the U.S. and Eurozone bonds is likely to cap the long end of the yield curve.



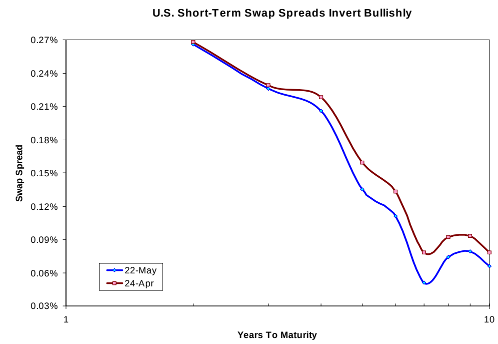
CDS costs have shifted lower at the short end of the yield curve while they have increased at the long end of the yield curve over the past month. In reality, this market has little reason to shift significantly in either direction. Even if the U.S. federal budget picture was to deteriorate suddenly, do you believe the euros these swaps are priced in will be around as a viable alternative?



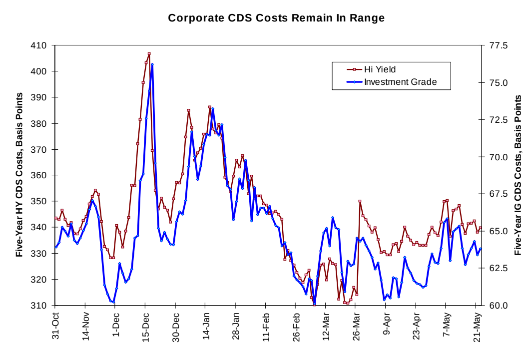
Pseudo-real rates have shifted higher and are negative out to "only" six years at this point. This shift is attributable to the bearish steepening of the nominal UST yield curve. These higher implied real rates have yet to shift to the point where they are negative for risky financial assets. The negative relationship between higher short-term implied real rates and precious metals returned after their one-week disruption from what were likely Chinese purchases of gold.



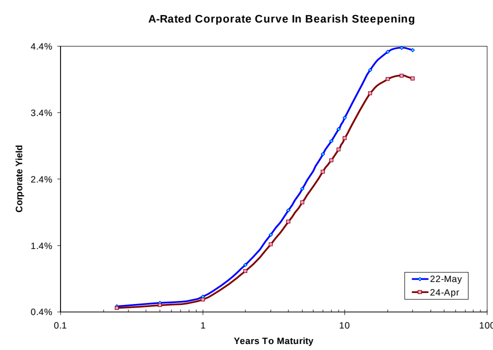
Swap spreads, which rise when floating-rate borrowers want to fix their payments, remain strongly inverted as floating-rate payors are willing to stay floating on the long end but are willing to pay to lock in ultralow short-term rates. The market remains complacent, perhaps dangerously so, over stable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



Both investment-grade and high-yield CDS costs remain 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 has turned sideways with only Precious Metals and Natural Gas in structural uptrends and the Softs in a downtrend. Within the financials, only the S&P 500 index is in a structural uptrend while nothing is in a downtrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 26 - 29
BBerg	29	Trending	-0.057	10.0%	
BBerg Grain	11	Transitional	-0.029	15.9%	
BBerg Ind. Metl	29	Trending	-0.180	14.9%	
BBerg Pre. Metl	29	Trending	0.077	14.1%	0.26%
BBerg Softs	27	Trending	-0.279	17.6%	-1.10%
BBerg Nat. Gas	29	Trending	0.101	30.2%	0.52%
BBerg Petroleum	12	Transitional	-0.039	21.4%	
BBerg Livestock	6	Sideways	0.046	10.3%	
Dollar Index	29	Trending	0.022	10.3%	
S&P 500 Index	29	Trending	0.104	8.3%	0.28%
EAFE Index	17	Transitional	0.048	9.4%	
EM Index	17	Transitional	-0.012	7.8%	
Ten-year UST (price)	6	Sideways	0.011	6.6%	

Performance Measures

Individual commodity/currency correlations of returns are not very strong and certainly are not very stable over time, but that does not preclude short-term episodes such as seen this week between USD strength and physical commodity weakness. Barring wheat and the CNY, it was a clean sweep in the dollar-up/commodities-down matrix. Neither broad trend should exhibit significant continuation as we have seen the effects of supply destruction in petroleum markets and the Federal Reserve's unwillingness to trigger a stronger dollar, but both are secular trends that define the paths of least resistance.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.70%	1.85%	-13.21%	-24.39%
Grains Sub-Index	-1.42%	-2.89%	-10.35%	-29.80%
Corn	-1.50%	-5.14%	-10.31%	-31.53%
Soybeans	-3.04%	-4.89%	-12.40%	-29.63%
Wheat	0.83%	3.26%	-6.56%	-26.29%
Energy Sub-Index	-2.38%	4.83%	-27.29%	-40.44%
Petroleum Sub-Index	-1.55%	4.04%	-23.62%	-41.97%
WTI	-1.35%	3.74%	-29.42%	-45.63%
Brent	-2.02%	2.99%	-25.71%	-46.01%
ULSD	-2.51%	4.07%	-15.43%	-32.55%
Gasoline	-0.32%	6.34%	-15.85%	-36.44%
Natural Gas	-4.91%	7.44%	-37.79%	-40.70%
Precious Metals Sub-Index	-2.06%	3.05%	1.06%	-8.89%
Gold	-1.74%	1.43%	0.31%	-7.35%
Silver	-2.91%	7.67%	3.07%	-13.84%
Industrial Metals Sub-Index	-4.92%	1.00%	-11.78%	-11.47%
Copper	-3.88%	5.01%	-7.25%	-10.75%
Aluminum	-4.90%	-2.92%	-16.26%	-5.83%
Nickel	-9.09%	0.16%	-24.23%	-36.66%
Zinc	-5.09%	-2.79%	-6.18%	2.61%
Softs Sub-Index	-5.62%	-4.08%	-21.70%	-33.52%
Coffee	-8.17%	-11.62%	-35.79%	-36.49%
Sugar	-4.50%	-2.22%	-22.69%	-40.99%
Cotton	-5.30%	0.61%	5.71%	-19.29%
Livestock Sub-Index	-0.14%	6.68%	-12.44%	-8.36%
Cattle	-0.07%	4.22%	-5.73%	12.23%
Hogs	-0.24%	10.55%	-24.15%	-35.29%

I commented last week 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. That arrived with a vengeance as the oft-repeated but yet seen move higher in U.S. short-term rates remains on the table. Until this speculation is confirmed, we should not expect the USD rally to be very strong.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-3.83%	2.69%	-11.49%	-19.35%
Chinese yuan	0.15%	-0.04%	-0.89%	0.61%
Japanese yen	-1.88%	-1.34%	-2.69%	-16.29%
British pound	-1.51%	3.01%	-1.38%	-8.18%
Swiss franc	-2.89%	2.97%	2.44%	-5.23%
Canadian dollar	-2.16%	-0.33%	-8.14%	-11.30%
Australian dollar	-2.63%	0.88%	-9.22%	-15.21%
Swedish krona	-2.41%	4.01%	-11.38%	-21.51%
Norwegian krone	-4.43%	3.35%	-11.35%	-22.21%
New Zealand dollar	-2.21%	-4.64%	-7.02%	-14.66%
Indian rupee	-0.01%	-1.08%	-2.50%	-7.97%
Brazilian real	-3.14%	-2.70%	-17.71%	-28.38%
Mexican peso	-1.69%	1.16%	-10.53%	-15.64%
Chilean peso	-2.09%	1.76%	-2.11%	-9.27%
Colombian peso	-3.08%	-0.05%	-13.32%	-23.54%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.28%	-0.22%	-1.31%	-3.00%

How can a market that keeps hitting nominal highs feel like it is struggling? The answer in the U.S. is earnings growth remains poor and the lack of compelling alternatives is not a reason to buy existing earnings with abandon. The weakness in Latin American markets is going to resume its self-reinforcing status with weaker Latin currencies.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.11%	1.37%	5.24%	9.17%
North America	0.20%	0.93%	3.73%	13.47%
Latin America	-5.45%	-0.77%	-15.23%	-19.61%
Emerging Market Free	-0.49%	-0.76%	4.33%	2.40%
EAFE	-0.59%	2.05%	7.65%	3.03%
Pacific	-0.41%	-0.08%	9.90%	11.82%
Eurozone	-0.60%	3.27%	6.13%	-2.20%

Both CTAs and hedge funds managed gains over the week, suggesting a decreased reliance on long equity positions, a willingness to be short bonds and crude oil and exposure to a stronger USD.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.10%	-5.74%	8.16%	26.68%
Newedge Trend	0.77%	-3.28%	6.66%	19.14%
Newedge Short-Term	0.45%	-1.51%	2.65%	10.95%
HFR Global Hedge Fund	0.47%	-0.25%	2.21%	2.10%
HFR Macro/CTA	0.87%	-2.58%	1.25%	7.90%
HFR Macro: Sytematic Diversified CTA	0.74%	-4.34%	1.84%	7.37%