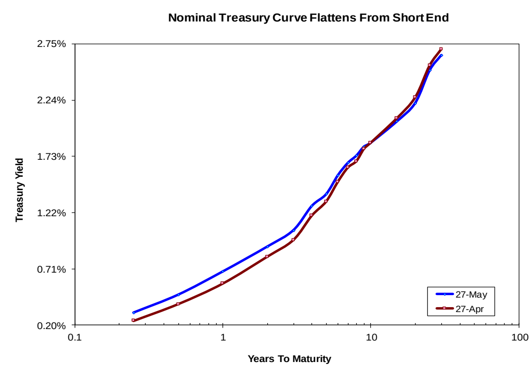
The Macro Environment For Financial Markets

Let's take an uncharacteristic detour into political commentary. Normally at this stage of a U.S. election cycle much verbiage is produced on how to restructure your portfolio in anticipation of electoral changes. They are worth the paper they are printed on, especially if they are Web-based. No such commentary is floating about this year as the two major candidates lack policy consistency and, worse, personal credibility. The best we can hope for is a reprise from British Prime Minister Harold Macmillan's comment to the effect the government will deal with issues as they arise. The causal chain now is:

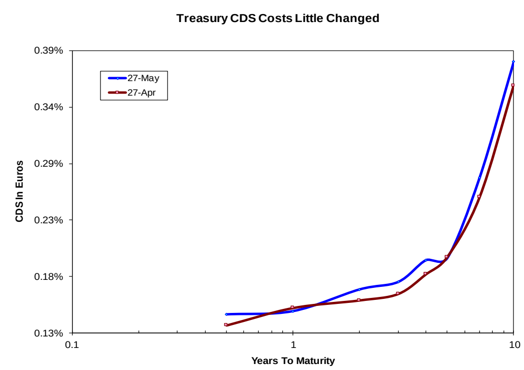
1. The market is pricing in a U.S. rate hike in either June or July;
2. Disinflationary pressures will persist globally;
3. Inflation expectations as measured by TIPS and inflation swaps have paused in their rise since March;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term 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 remain at the low end of a trading range.

Key Market Indications

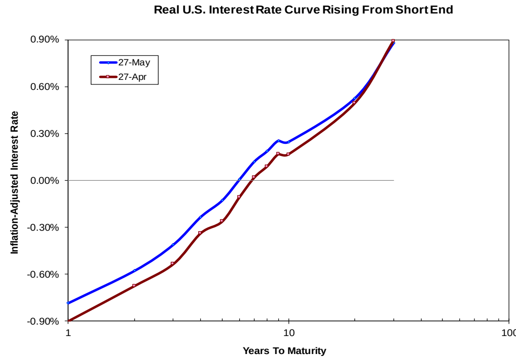
The short end of the yield curve is being pushed higher by expected rate hikes. This actually is a continuation of a trend started in November 2013, just before the first tapering of QE purchases. Treasuries have been in a bull market since then, thanks in large part to the drive lower in global yields. The small rise in long-term rates this past week put them at the top of a recent downtrend channel, nothing more.



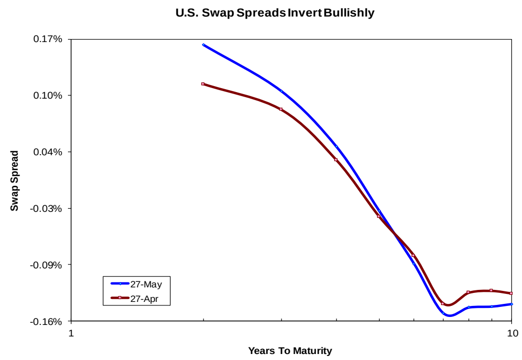
CDS costs changed little over the past month. If the Federal Reserve goes through with its expected rate hikes in June or July, no entity will be affected more than the federal government. Even a small increase in debt service on an $18 trillion debt produces a big increase in net interest payments.



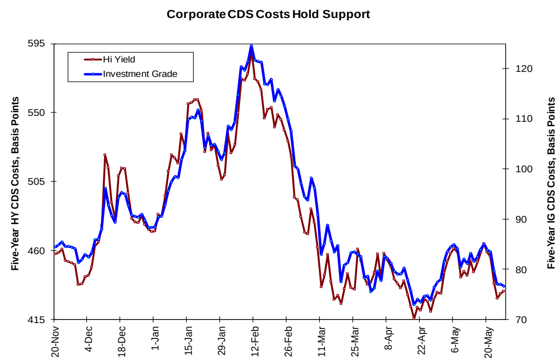
The pseudo-real rate curve continued its recent rise at the short end of the yield curve. These rates remain negative out to "only" five years as opposed to the recently observed seven years. Their rise remains inimical to precious metals. It will take a rise in long-term pseudo-real rates to affect risky financial assets.



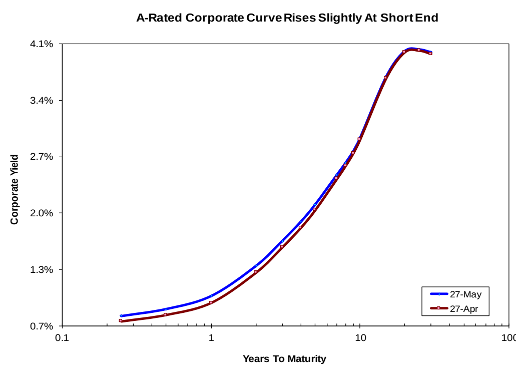
Swap spreads, which rise when floating-rate borrowers want to fix their payments, declined at the long end of the yield curve over the past month and remain inverted as short-tenor swap spreads have moved higher. The inversion of this curve is confirmed in the swaption market as well. The belief seems 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

Natural Gas joined Softs in a structural uptrend and Precious Metals joined the economically important Industrial Metals index in a downtrend. Within the financials, ten-year UST and the EM index remain in downtrends while the S&P 500 joined the dollar index in an uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 31 - June 3
BBerg	12	Transitional	0.054	11.7%	
BBerg Grain	19	Transitional	0.134	20.1%	
BBerg Ind. Metl	29	Trending	-0.117	17.9%	-0.53%
BBerg Pre. Metl	29	Trending	-0.257	15.2%	-0.45%
BBerg Softs	29	Trending	0.141	20.4%	0.14%
BBerg Nat. Gas	22	Trending	0.044	24.2%	0.34%
BBerg Petroleum	6	Sideways	0.034	18.9%	
BBerg Livestock	23	Trending	-0.072	11.1%	
Dollar Index	29	Trending	0.184	6.3%	0.14%
S&P 500 Index	26	Trending	0.161	9.0%	0.60%
EAFE Index	27	Trending	0.039	10.7%	
EM Index	29	Trending	-0.093	10.2%	-0.24%
Ten-year UST (price)	25	Trending	-0.067	4.6%	-0.20%

Performance Measures

The Petroleum indices continued to rally in the face of a stronger dollar. A series of small supply disruptions can outweigh a weak financial correlation trade every time. Precious Metals continued to move lower in the face of higher short-term implied real rates. The move higher in the grain markets, also in the face of a stronger USD, is starting to look interesting given predictions for a hot and dry summer in the U.S. Midwest. These markets have not had a prolonged summer rally since 2012.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	0.71%	-0.04%	5.56%	-15.20%
Grains Sub-Index	2.97%	3.66%	9.78%	6.33%
Corn	4.63%	5.38%	8.68%	7.18%
Soybeans	1.15%	5.53%	21.37%	17.23%
Wheat	2.95%	-1.41%	-0.98%	-4.03%
Energy Sub-Index	0.56%	2.33%	-5.80%	-37.08%
Petroleum Sub-Index	1.15%	4.85%	-2.82%	-35.55%
WTI	1.91%	5.68%	-8.06%	-41.13%
Brent	1.33%	4.18%	-0.71%	-37.04%
ULSD	0.64%	7.71%	1.43%	-34.04%
Gasoline	-0.20%	1.85%	-4.67%	-26.52%
Natural Gas	-1.72%	-6.58%	-20.19%	-44.21%
Precious Metals Sub-Index	-2.70%	-6.68%	14.41%	0.43%
Gold	-3.12%	-5.88%	14.01%	1.83%
Silver	-1.58%	-8.68%	15.20%	-3.69%
Industrial Metals Sub-Index	1.52%	-7.12%	5.27%	-20.97%
Copper	2.85%	-7.40%	2.79%	-23.49%
Aluminum	0.46%	-7.79%	5.76%	-14.75%
Nickel	-0.97%	-11.00%	-6.12%	-34.23%
Zinc	1.80%	-2.09%	20.42%	-15.31%
Softs Sub-Index	1.37%	5.39%	6.60%	12.16%
Coffee	-2.72%	-0.14%	-1.84%	-13.12%
Sugar	2.64%	7.37%	16.27%	30.18%
Cotton	4.24%	0.82%	2.66%	-1.42%
Livestock Sub-Index	0.03%	1.45%	3.07%	-14.40%
Cattle	-0.87%	4.26%	-2.53%	-18.88%
Hogs	1.03%	-1.61%	12.45%	-6.29%

The USD's uniform advance of the past two weeks has dissipated as the CAD, INR, CLP and above all the GBP managed to firm. The interest rate divergence trade has been absorbed and the question now is how much further and faster the U.S. will be willing to push its short-term rates higher. The evidence from 2015 suggests the answer is "not much."

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.97%	-1.83%	4.93%	1.94%
Chinese yuan	-0.25%	-1.03%	-2.61%	-5.54%
Japanese yen	-0.15%	1.04%	11.32%	12.10%
British pound	0.83%	0.55%	-2.75%	-4.76%
Swiss franc	-0.44%	-2.37%	3.57%	-4.55%
Canadian dollar	0.71%	-3.24%	2.69%	-4.37%
Australian dollar	-0.55%	-5.39%	-0.15%	-7.08%
Swedish krona	-0.43%	-3.08%	4.61%	1.85%
Norwegian krone	-0.10%	-2.10%	4.44%	-6.82%
New Zealand dollar	-0.95%	-2.12%	2.57%	-7.78%
Indian rupee	0.61%	-0.87%	-0.41%	-4.49%
Brazilian real	-2.50%	-2.34%	6.51%	-13.06%
Mexican peso	-0.70%	-6.28%	-10.00%	-17.28%
Chilean peso	0.81%	-2.74%	3.77%	-10.10%
Colombian peso	-0.62%	-4.47%	1.13%	-17.45%
Bloomberg-JP Morgan Asian dollar index (spot)	0.00%	-1.54%	-0.88%	-4.91%

Last week's comment the U.S. market failed to sell off on bad news was a "tell." However, nothing yet suggests sufficient earnings momentum exists to propel any of the equity indices out of their two year-long trading ranges.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	2.28%	0.73%	0.44%	-3.32%
North America	2.31%	0.35%	1.58%	-0.23%
Latin America	-0.96%	-8.72%	5.07%	-16.51%
Emerging Market Free	2.97%	-3.97%	-1.21%	-18.47%
EAFE	2.24%	-0.92%	-2.31%	-9.97%
Pacific	1.09%	-2.41%	-1.55%	-9.84%
Eurozone	3.31%	0.41%	-3.66%	-8.18%

CTAs and hedge funds both posted gains on the week. This has been a consistent pattern when equity indices advance, and vice-versa. Neither class of professional trader has been able to outperform the unmanaged MSCI index over the past year.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.55%	-1.77%	-4.02%	-5.04%
Newedge Trend	0.65%	-1.26%	-0.64%	-2.08%
Newedge Short-Term	0.80%	-0.51%	2.17%	-1.45%
HFR Global Hedge Fund	0.77%	0.14%	-2.59%	-7.23%
HFR Macro/CTA	0.38%	-1.23%	-2.52%	-4.05%
HFR Macro: Sytematic Diversified CTA	0.84%	-1.72%	-1.15%	-1.47%