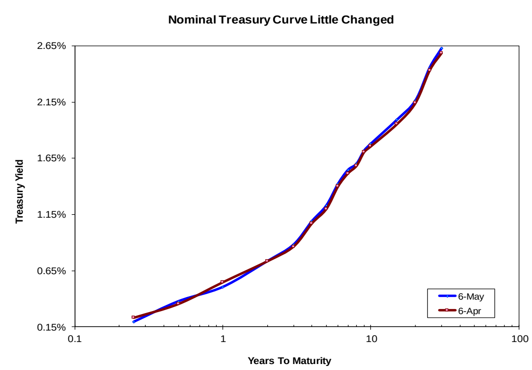
The Macro Environment For Financial Markets

Economies neither grow nor contract in response to previous states. A long period of global torpor does not mandate a future boom, nor vice-versa. If anyone is wondering what will trigger the next round of higher growth, the answer has to be a round of technological innovation as yet unforeseen. If that sounds like an abdication, it really is not. The good news in all of this is the global economy has absorbed a round of policy errors and misallocations of capital larger than anything since the 1930s and has yet to collapse. All it has done is create a non-growing pie beset with rising production efficiencies, AKA good deflation. The downside is it has created a Lost Generation deprived of robust opportunities to establish their human capital. Of course, witnessing how the graduates of American universities understand economics, this loss may have occurred anyway. The causal chain now is:

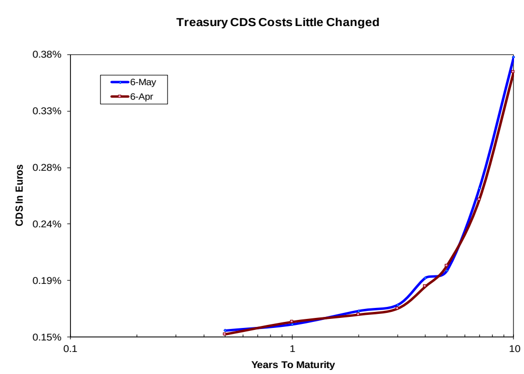
1. The market is reducing bets on higher short-term rates in the U.S. after June;
2. Disinflationary pressures will persist globally while inflationary pressures are rising in the U.S.;
3. Inflation expectations as measured by TIPS and inflation swaps have established a strong tradable bottom;
4. The 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 increased from recent lows, but not alarmingly so.

Key Market Indications

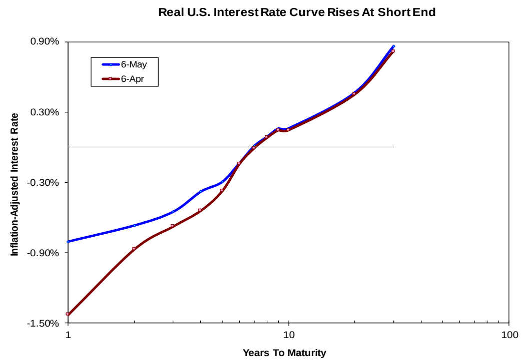
Every now and then economists check their data to see if there is a mistake. After such a check was conducted, I can report the UST yield curve has been virtually unchanged over the past month. The bias should be toward lower yields, which is unusual in an environment where inflation expectations have increased at maturities longer than ten years.



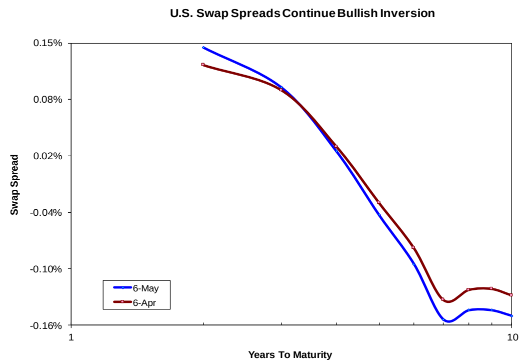
CDS costs have shifted little over the past month. It will be interesting to see if this market reacts to the U.S. election season, presuming, of course, UST buyers can understand what other cannot.



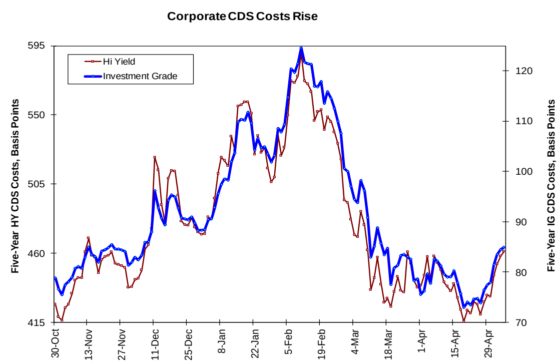
The pseudo-real rate curve continued its recent rise at the short end of the yield curve. These rates remain negative out to six years. Their rise is inimical to precious metals, but it is doubtful events in the U.S. can offset deeply negative short-term rates elsewhere. Rising pseudo-real rates will not pose a threat to risky financial assets until and unless they start to rise at the long end of the yield curve.



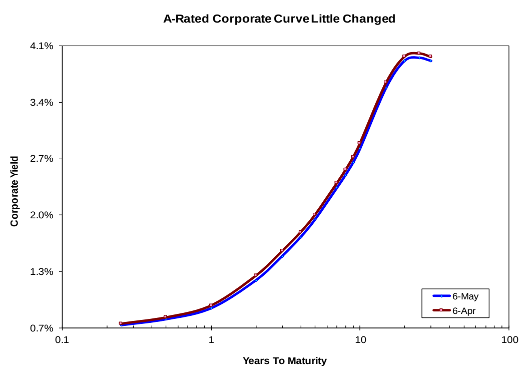
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have shifted higher at the short end of the yield curve over the past month and remain inverted. The inversion of this curve is confirmed in the swaption market as well. The belief seems to be that long-term rates will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



Both high-yield and investment-grade CDS indices turned higher, but not significantly so, in a signal credit spreads had become too tight. This does not appear to be the start of a larger selloff, but just as was the case in the summer of 2015 and again in January, credit markets can and will react negatively to external events, particularly those originating in China.



The A-rated corporate yield curve finally stopped shifting lower as corporate bond buyers retreated from declining credit spreads. The general bull market remains intact, but the potential for further gains is limited.



Market Structure

Even though the main Bloomberg index remains in a structural uptrend, important subindices such as Grains and Industrial Metals have turned lower. Within the financials, all of the equity indices have entered structural downtrends and ten-year UST have moved back into a structural uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate May 2 - 6
BBerg	28	Trending	0.166	14.5%	0.50%
BBerg Grain	9	Sideways	-0.041	20.9%	
BBerg Ind. Metl	29	Trending	-0.003	17.2%	
BBerg Pre. Metl	29	Trending	0.284	15.0%	0.29%
BBerg Softs	23	Trending	0.071	20.7%	0.14%
BBerg Nat. Gas	29	Trending	0.053	30.2%	0.25%
BBerg Petroleum	29	Trending	0.134	31.6%	0.30%
BBerg Livestock	29	Trending	0.111	10.8%	
Dollar Index	18	Transitional	-0.034	7.2%	
S&P 500 Index	22	Trending	-0.095	8.9%	-0.15%
EAFE Index	27	Trending	-0.123	12.3%	-0.19%
EM Index	21	Trending	-0.359	10.5%	-0.24%
Ten-year UST (price)	29	Trending	0.028	4.9%	0.26%

Performance Measures

It seemed by the end of the previous week the general rally in physical commodities was simply a momentum-driven affair. If we add in mounting evidence of very poor global growth, no visible supply disruptions and the various algorithms that trade physical commodities off of currency rates, we had the makings of this week's sharp downturns. It appears as if the January-April rebound in physical commodities was a secondary uptrend within what is still very much a secular bear market.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.48%	7.42%	-2.03%	-20.13%
Grains Sub-Index	-2.56%	5.76%	0.22%	-3.62%
Corn	-3.63%	4.63%	-3.05%	-6.07%
Soybeans	0.49%	12.95%	17.41%	6.12%
Wheat	-5.06%	-1.26%	-13.89%	-8.02%
Energy Sub-Index	-3.88%	11.70%	-19.26%	-42.95%
Petroleum Sub-Index	-4.02%	12.89%	-17.84%	-42.50%
WTI	-2.93%	13.95%	-22.64%	-47.41%
Brent	-4.22%	13.45%	-15.85%	-44.54%
ULSD	-3.40%	15.63%	-18.39%	-42.95%
Gasoline	-6.37%	7.26%	-15.35%	-31.42%
Natural Gas	-3.40%	7.61%	-27.15%	-46.11%
Precious Metals Sub-Index	-0.27%	8.49%	18.95%	7.56%
Gold	0.28%	5.76%	18.89%	8.35%
Silver	-1.63%	16.17%	18.63%	4.97%
Industrial Metals Sub-Index	-4.79%	2.94%	0.03%	-25.69%
Copper	-5.67%	0.12%	-4.73%	-27.33%
Aluminum	-5.04%	5.52%	3.38%	-21.24%
Nickel	-4.07%	5.42%	-6.58%	-36.04%
Zinc	-2.68%	4.32%	12.52%	-22.54%
Softs Sub-Index	-1.69%	4.41%	4.05%	-0.31%
Coffee	2.47%	0.88%	-0.56%	-13.45%
Sugar	-3.55%	5.96%	7.85%	8.85%
Cotton	-3.04%	6.10%	0.05%	-7.36%
Livestock Sub-Index	2.38%	0.27%	1.43%	-12.90%
Cattle	5.05%	-0.90%	-5.15%	-16.88%
Hogs	-0.52%	1.64%	12.99%	-5.65%

Just when the divergence trade seemed dead and emerging market currencies were rising, the USD managed to gain against every currency listed, and in a week when economic data were fairly soft. The majors with negative interest rates are finding a bound on their implied real rates, and this should stem their rise.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-0.41%	0.04%	6.17%	0.50%
Chinese yuan	-0.28%	-0.23%	-2.19%	-4.55%
Japanese yen	-0.58%	2.49%	14.95%	11.52%
British pound	-1.27%	2.15%	-4.16%	-5.37%
Swiss franc	-1.30%	-1.72%	3.38%	-5.80%
Canadian dollar	-2.73%	1.39%	3.08%	-6.67%
Australian dollar	-3.12%	-3.07%	4.59%	-7.57%
Swedish krona	-1.31%	0.13%	7.17%	1.02%
Norwegian krone	-1.88%	1.41%	5.67%	-9.38%
New Zealand dollar	-2.09%	0.10%	4.71%	-8.88%
Indian rupee	-0.34%	0.16%	-1.19%	-4.53%
Brazilian real	-1.89%	4.00%	7.62%	-13.34%
Mexican peso	-3.87%	-1.20%	-5.94%	-14.03%
Chilean peso	-0.65%	1.46%	5.23%	-8.00%
Colombian peso	-3.65%	4.16%	-2.25%	-20.21%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.87%	-0.66%	-0.22%	-4.82%

One of the characteristics of the bull market has been an unwillingness to push valuations beyond reason; everyone has seen the movie. We get the sort of pullbacks seen this past week and they will last until investors remember they have no choice but to take risk to make any sort of positive return.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.54%	0.92%	-2.25%	-4.86%
North America	-0.66%	-0.11%	-1.02%	-0.59%
Latin America	-5.72%	5.88%	8.42%	-18.27%
Emerging Market Free	-4.10%	-0.31%	-4.65%	-20.40%
EAFE	-2.99%	2.71%	-4.25%	-11.36%
Pacific	-3.13%	4.43%	-1.92%	-10.31%
Eurozone	-2.32%	2.69%	-6.59%	-12.07%

CTAs' poor performance continues, suggesting an overreliance on rising equities, a weaker USD and stronger physical commodities. Hedge funds unsurprisingly turned lower along with global equities.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-1.37%	-5.15%	-0.17%	-3.56%
Newedge Trend	-0.69%	-3.35%	2.62%	-0.27%
Newedge Short-Term	-0.31%	-1.15%	4.29%	-0.76%
HFR Global Hedge Fund	-0.75%	0.23%	-4.03%	-7.57%
HFR Macro/CTA	-1.01%	-0.66%	-0.42%	-2.81%
HFR Macro: Sytematic Diversified CTA	-0.91%	-2.36%	2.41%	0.21%