The Macro Environment For Financial Markets

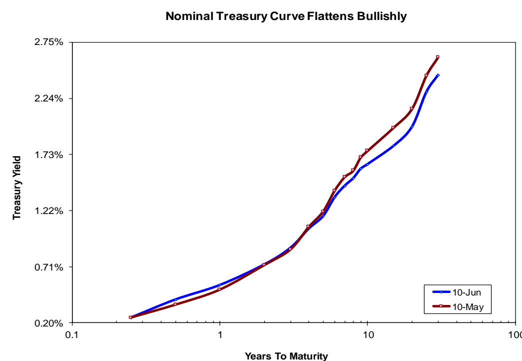
Simons Research

Financial markets are at their St. Augustine moment: Raise short-term rates, but not just yet. It has become obvious the central banks have created massive misallocations of capital and, worse, are absolutely killing commercial banks, life insurers, pension funds and anyone else who remembers the days when lenders and not borrowers got paid. That said, no one knows how to stop the madness and brings the bonds home for Christmas, or some other ghastly mixed metaphor. The causal chain now is:

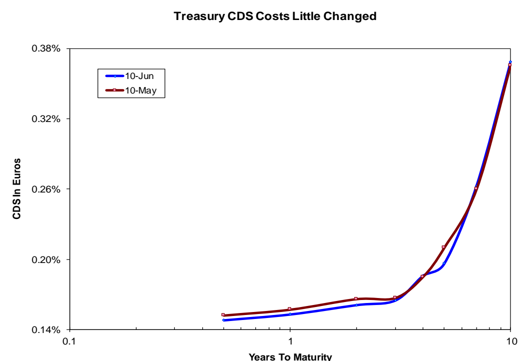
1. The market has no clear idea of if and when U.S. short-term rates will rise;
2. Disinflationary pressures will persist globally;
3. Inflation expectations as measured by TIPS and inflation swaps are turning lower;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term borrowers are terming out their short-term debt obligations to reduce rollover risk, but this will change again soon;
6. Swap spreads are finally moving higher at the long end of the yield curve; and
7. CDS costs remain at the low end of a trading range.

Key Market Indications

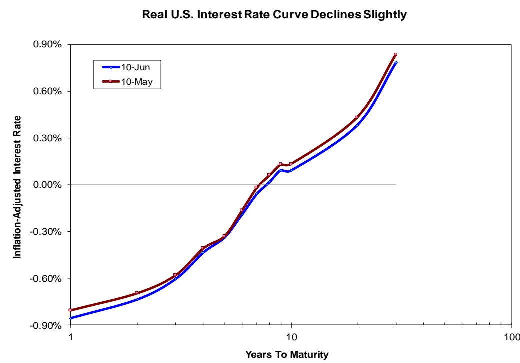
To state the obvious, as long as global sovereign markets continue to rally, the long end of the U.S. yield curve will join the party. The entire global sovereign market is set up for an execution vacuum if and when central banks decide to back away from their counterproductive efforts to drive interest rates lower. A "leave" Brexit vote could set up a violent "buy the rumor/sell the news" trade.



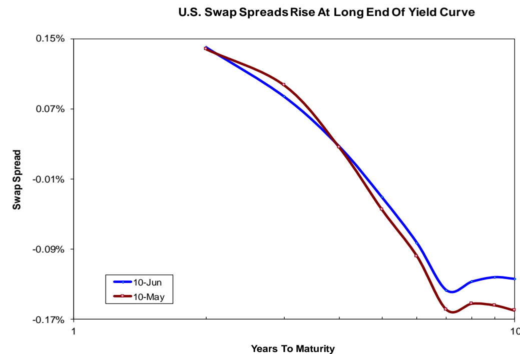
CDS costs changed little over the past month. If and when the Federal Reserve raises short-term interest rates, no entity will be affected more than the federal government. Even a small increase in debt service on an $18 trillion debt produces a big increase in net interest payments.



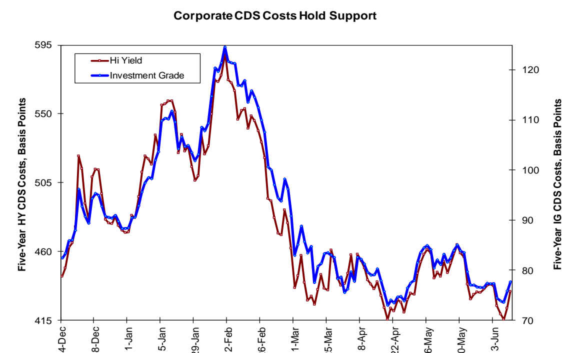
The pseudo-real rate curve has changed little over the course of the past month. Their strongly negative levels at the short-end of the yield curve are supportive for precious metals. To repeat last week's warning, the inability of pseudo-real rates to decline at the long end of the yield curve is not at all supportive for equities.



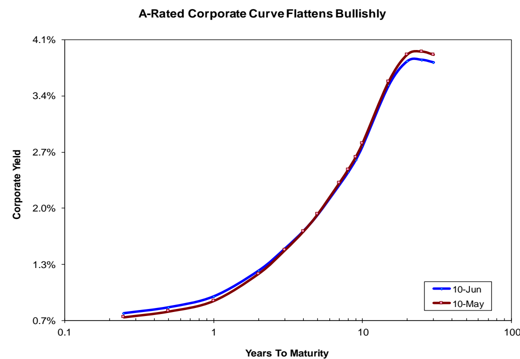
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose at the long of the yield curve as floating-rate payors are taking advantage of the opportunity to fix rates.



Both high-yield and investment-grade CDS indices continued to hold support. 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 continues to mirror 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

Within the physical markets, only Precious and Industrial Metals are not in structural uptrends. Within the financials, the dollar index remains in a downtrend where it is joined by the EAFE. Ten-year UST remain in an uptrend and were joined there by the S&P 500.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate June 13 - 17
BBerg	27	Trending	0.323	12.3%	0.80%
BBerg Grain	29	Trending	0.311	20.1%	0.27%
BBerg Ind. Metl	29	Trending	0.026	16.6%	
BBerg Pre. Metl	27	Trending	0.160	13.3%	
BBerg Softs	29	Trending	0.439	20.2%	0.14%
BBerg Nat. Gas	29	Trending	0.332	22.5%	0.34%
BBerg Petroleum	29	Trending	0.121	26.5%	0.71%
BBerg Livestock	29	Trending	0.145	11.7%	0.05%
Dollar Index	26	Trending	-0.016	5.9%	-0.14%
S&P 500 Index	29	Trending	0.107	8.5%	0.60%
EAFE Index	29	Trending	-0.081	10.6%	-0.08%
EM Index	29	Trending	0.171	10.7%	
Ten-year UST (price)	25	Trending	0.253	4.3%	0.06%

Performance Measures

If commodities were pushed higher on the back of financial flows, something we saw a lot of in the past decade, they will fall once we hit a strong risk-off patch. If commodities were rising on supply disruptions, as in the case of crude oil, or haven purchases, as in the case of the precious metals, then they can continue to rally so long as external events persist. Until we see more solid evidence of rising physical demand signaling the need for renewed investment in productive capacity, this bullish phase should be treated as a secondary rally within a longer-term bear market.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.07%	5.32%	13.58%	-11.42%
Grains Sub-Index	2.06%	8.40%	14.36%	10.13%
Corn	1.30%	8.45%	10.67%	9.92%
Soybeans	4.62%	11.22%	33.86%	28.27%
Wheat	-0.32%	4.42%	-1.19%	-6.55%
Energy Sub-Index	2.05%	6.23%	10.29%	-35.14%
Petroleum Sub-Index	0.90%	4.26%	10.47%	-35.13%
WTI	1.07%	4.79%	6.57%	-41.03%
Brent	1.94%	5.24%	18.02%	-34.88%
ULSD	1.96%	7.49%	19.53%	-31.25%
Gasoline	-2.76%	-2.02%	-6.64%	-31.42%
Natural Gas	6.07%	13.38%	4.52%	-37.13%
Precious Metals Sub-Index	3.56%	0.40%	20.09%	8.02%
Gold	2.66%	0.09%	18.40%	7.76%
Silver	5.90%	1.18%	24.51%	8.27%
Industrial Metals Sub-Index	0.30%	1.96%	4.49%	-19.39%
Copper	-3.93%	-2.10%	-4.46%	-25.17%
Aluminum	1.88%	2.39%	4.68%	-13.64%
Nickel	5.03%	3.18%	1.89%	-33.00%
Zinc	4.63%	10.33%	33.37%	-4.12%
Softs Sub-Index	5.09%	14.72%	18.97%	19.42%
Coffee	7.72%	5.26%	9.38%	-6.43%
Sugar	4.92%	17.54%	33.69%	49.53%
Cotton	1.45%	6.99%	1.82%	0.10%
Livestock Sub-Index	-0.10%	1.47%	7.36%	-8.58%
Cattle	-0.38%	-1.13%	2.99%	-17.97%
Hogs	0.18%	4.36%	12.06%	7.62%

The downtrend in the USD reversed fairly abruptly on Friday's equity selloff/bond rally as it took on the haven role occupied recently by the JPY. The week saw a strange combination; currencies such as the EUR, GBP, SEK and NOK sold off while the CHF, CAD, NZD, BRL and COP all rallied strongly. This is about as non-thematic as you can get.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	-1.02%	-1.06%	2.83%	-0.64%
Chinese yuan	0.27%	-0.69%	-2.20%	-5.43%
Japanese yen	-0.41%	2.15%	13.64%	14.69%
British pound	-1.80%	-1.28%	-5.96%	-8.20%
Swiss franc	1.14%	1.15%	2.36%	-3.46%
Canadian dollar	1.20%	0.99%	6.59%	-4.13%
Australian dollar	0.08%	0.14%	1.26%	-5.00%
Swedish krona	-2.02%	-1.81%	2.50%	-0.58%
Norwegian krone	-1.22%	-0.69%	4.47%	-6.17%
New Zealand dollar	1.39%	4.36%	4.46%	-2.04%
Indian rupee	0.75%	-0.12%	-0.06%	-4.37%
Brazilian real	3.15%	1.66%	11.49%	-8.82%
Mexican peso	-0.22%	-3.45%	-7.73%	-17.14%
Chilean peso	-0.01%	-0.70%	2.97%	-7.68%
Colombian peso	1.63%	0.11%	9.33%	-14.94%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.40%	-0.42%	-0.02%	-4.57%

How did we get to the point where the best thing for stocks was rising interest rates? This replaces the previous puzzle of how equity investors started rooting for higher crude oil prices. Right now, too much of a good thing is not wonderful for global equities.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.75%	2.07%	3.27%	-3.45%
North America	-0.17%	1.02%	3.64%	0.49%
Latin America	0.29%	-4.43%	11.95%	-15.02%
Emerging Market Free	1.05%	2.38%	5.63%	-13.36%
EAFE	-1.72%	-0.26%	-1.54%	-10.37%
Pacific	-0.20%	2.81%	0.47%	-7.43%
Eurozone	-2.96%	-0.44%	-2.46%	-11.95%

CTAs and hedge funds both posted gains for a third consecutive week. As equities struggled globally and currencies were mixed, it would appear both classes of traders were riding the bullish trend in global bonds.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	1.80%	1.51%	-0.40%	0.68%
Newedge Trend	1.38%	0.78%	2.42%	2.86%
Newedge Short-Term	1.12%	0.38%	4.64%	0.58%
HFR Global Hedge Fund	0.46%	1.78%	-0.64%	-5.85%
HFR Macro/CTA	0.87%	0.21%	-0.42%	-1.95%
HFR Macro: Sytematic Diversified CTA	1.92%	0.33%	1.66%	2.25%