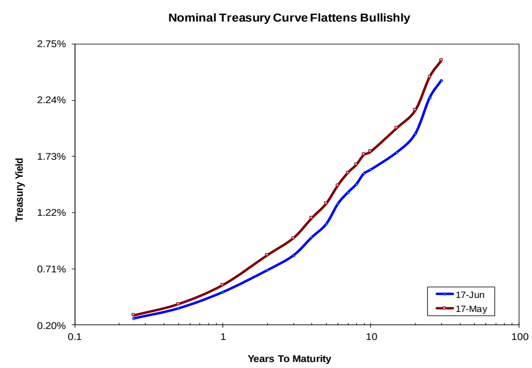
The Macro Environment For Financial Markets

For those unwilling to believe a single deranged assassin can affect history, please review the life and times of Gavrilo Princip. Events in the U.K. this past week may have sealed the "remain" vote in the Brexit referendum, which could trigger a sudden end to the risk-aversion bubble in higher-quality sovereign debt, gold and haven currencies. None of this will change the longer-term problem of the massive misallocation of resources during the post-crisis era. All of the consumption pulled from the future into the immediate past will not be there in the future, and that means slower growth and lower earnings. You cannot cheat the Fates. The causal chain now is:

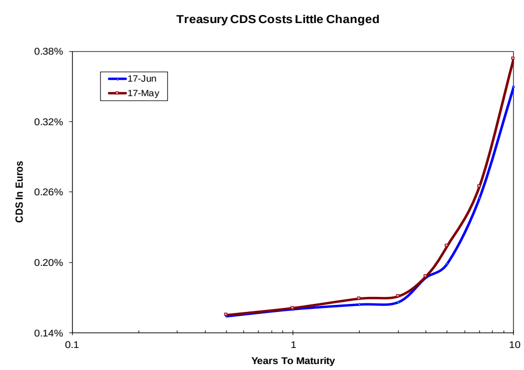
1. The market has no clear idea of if and when U.S. short-term rates will rise;
2. Disinflationary pressures will persist globally;
3. Inflation expectations as measured by TIPS and inflation swaps are turning lower;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term 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; and
7. CDS costs remain at the low end of a trading range.

Key Market Indications

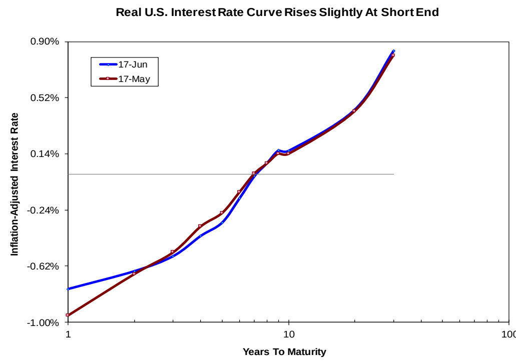
I noted last week the entire global sovereign market is set up for an execution vacuum if and when central banks decide to back away from their counterproductive efforts to drive interest rates lower. As the Federal Reserve, and the Banks of England and Japan all stood pat this past week, we may be starting normalization via inaction soon.



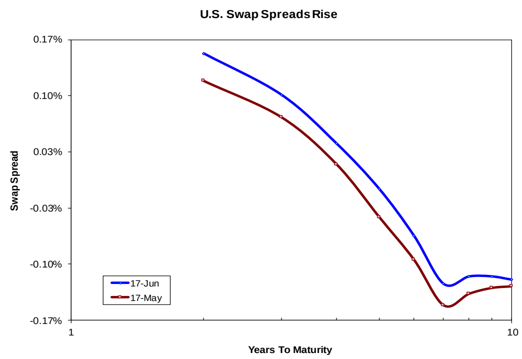
CDS costs changed little over the past month. The reduced prospect of higher U.S. short-term interest rates should have reduced these costs, but few are willing to write protection on U.S. debt for less. At some point this market will have to discount what may be a horrific political outcome after the November elections.



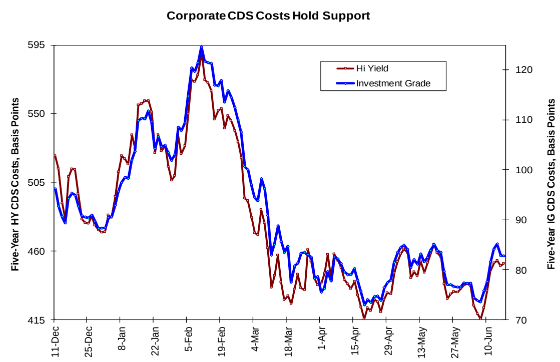
The pseudo-real rate curve shifted slightly higher at the short end of the yield curve over the past month. If this trend persists, it will impede the recent advance in precious metals. To repeat the warning of the last two weeks, the inability of pseudo-real rates to decline at the long end of the yield curve is not at all supportive for equities.



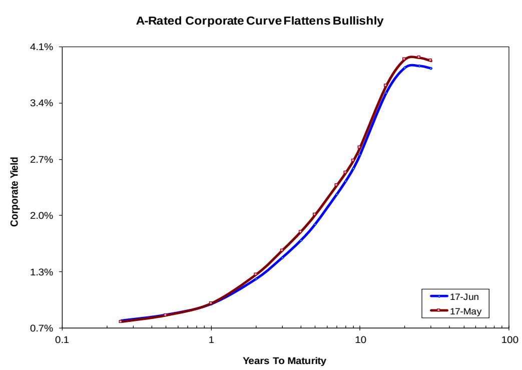
Swap spreads, which rise when floating-rate borrowers want to fix their payments, rose across tenors as floating-rate payors calculate the risk/reward for remaining floating in a negative-rate world is poor.



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

While Grains, Livestock, Natural Gas and the main Bloomberg index remain in structural uptrends, the two metals groups, Softs and Petroleum have exited that state. Within the financials, the dollar index and the EAFE are in structural downtrends. Ten-year UST remain in an uptrend.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate June 20 - 24
BBerg	29	Trending	0.261	10.9%	0.80%
BBerg Grain	29	Trending	0.271	19.8%	0.27%
BBerg Ind. Metl	29	Trending	0.073	17.2%	
BBerg Pre. Metl	29	Trending	0.220	13.6%	
BBerg Softs	5	Sideways	0.067	21.4%	
BBerg Nat. Gas	29	Trending	0.268	20.7%	0.34%
BBerg Petroleum	29	Trending	-0.006	23.4%	
BBerg Livestock	22	Trending	0.001	12.3%	0.05%
Dollar Index	28	Trending	-0.085	6.3%	-0.14%
S&P 500 Index	29	Trending	-0.045	8.8%	
EAFE Index	29	Trending	-0.259	11.6%	-0.08%
EM Index	29	Trending	-0.006	11.0%	
Ten-year UST (price)	29	Trending	0.262	4.2%	0.06%

Performance Measures

I noted last week if commodities were pushed higher on the back of financial flows, something we saw a lot of in the past decade, they would fall once we hit a strong risk-off patch. This has not happened in strong fashion yet, but the downturn in the Petroleum subindex suggests it is approaching. We are still in a secondary upturn at best in the physical markets, and this will not change until Chinese demand growth recovers. Those waiting for that even in an economy with a bad debt overhang may be waiting for quite a while. While they are cooling their heels, they should remember physical commodities are not an investment asset, they are process inputs.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.24%	4.57%	14.71%	-10.97%
Grains Sub-Index	0.51%	8.55%	14.43%	10.37%
Corn	3.53%	11.21%	14.80%	13.80%
Soybeans	-1.33%	8.79%	29.26%	21.78%
Wheat	-2.34%	3.50%	-2.76%	-5.40%
Energy Sub-Index	-1.58%	2.25%	13.40%	-35.66%
Petroleum Sub-Index	-2.44%	-1.54%	11.70%	-35.65%
WTI	-2.28%	-0.80%	7.94%	-41.92%
Brent	-2.46%	0.17%	20.19%	-35.00%
ULSD	-2.14%	-0.48%	21.49%	-31.80%
Gasoline	-3.06%	-7.66%	-7.38%	-31.86%
Natural Gas	1.22%	16.68%	13.04%	-37.70%
Precious Metals Sub-Index	1.20%	3.72%	21.96%	7.29%
Gold	1.49%	3.11%	21.37%	7.29%
Silver	0.46%	5.33%	23.19%	6.91%
Industrial Metals Sub-Index	0.40%	2.96%	4.74%	-16.09%
Copper	1.09%	-0.15%	-3.24%	-21.18%
Aluminum	2.60%	4.17%	5.72%	-8.77%
Nickel	1.51%	6.49%	2.60%	-29.76%
Zinc	-5.08%	6.00%	29.61%	-5.54%
Softs Sub-Index	1.48%	12.08%	22.11%	26.93%
Coffee	2.87%	12.96%	14.59%	-0.56%
Sugar	0.79%	16.18%	30.10%	57.50%
Cotton	1.32%	6.55%	3.19%	2.62%
Livestock Sub-Index	-0.73%	2.66%	9.59%	-7.87%
Cattle	-4.09%	-4.15%	-0.65%	-21.26%
Hogs	2.76%	10.31%	23.13%	14.94%

The JPY rallied strongly once again as the Bank of Japan stepped away from more failed actions. When the answer always appears to be "lend the JPY," the trade will end, and soon. Moving beyond that, the currency markets continue to be non-thematic and highly anecdotal. The search for the best house on the bad block may reveal they are all teardowns.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.23%	-0.32%	4.17%	-0.53%
Chinese yuan	-0.37%	-1.01%	-1.57%	-5.73%
Japanese yen	2.70%	4.78%	17.67%	18.50%
British pound	0.71%	-0.73%	-3.64%	-9.32%
Swiss franc	0.51%	2.14%	3.77%	-3.96%
Canadian dollar	-0.86%	0.12%	8.09%	-5.17%
Australian dollar	0.19%	0.85%	3.62%	-4.67%
Swedish krona	-0.25%	-0.90%	2.81%	-2.66%
Norwegian krone	-1.06%	-2.16%	4.84%	-8.42%
New Zealand dollar	-0.09%	3.49%	5.19%	0.89%
Indian rupee	-0.48%	-0.31%	-0.99%	-4.42%
Brazilian real	0.11%	2.13%	13.53%	-10.52%
Mexican peso	-1.09%	-3.00%	-9.50%	-19.02%
Chilean peso	-0.09%	0.73%	3.54%	-6.80%
Colombian peso	-1.29%	0.10%	11.20%	-15.26%
Bloomberg-JP Morgan Asian dollar index (spot)	0.02%	-0.30%	0.52%	-4.50%

The continued push lower in global interest rates and central banks' tacit admission more of the same will not work has returned equities' focus to expected earnings growth. That is not at all encouraging at present, but recent history shows the TINA argument will prevail once again.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-1.72%	-0.04%	1.72%	-5.39%
North America	-1.11%	1.42%	3.09%	-0.41%
Latin America	-0.31%	-1.62%	12.58%	-14.62%
Emerging Market Free	-2.05%	0.92%	2.18%	-14.46%
EAFE	-2.76%	-2.59%	-3.95%	-11.35%
Pacific	-3.31%	-0.98%	-2.22%	-10.16%
Eurozone	-2.67%	-2.84%	-5.47%	-13.72%

While CTAs managed gains on the week, hedge funds returned to their established habit of losing when equity markets decline. Some are more hedged than others.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.06%	1.44%	-0.86%	0.47%
Newedge Trend	0.42%	1.43%	2.15%	3.48%
Newedge Short-Term	1.21%	2.82%	6.37%	3.98%
HFR Global Hedge Fund	-0.82%	0.60%	-1.10%	-6.69%
HFR Macro/CTA	-0.60%	-0.29%	-1.47%	-2.82%
HFR Macro: Sytematic Diversified CTA	-0.27%	0.24%	0.81%	1.62%