The Macro Environment For Financial Markets

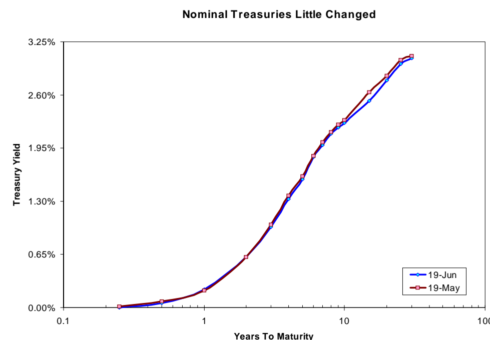
There's an old saying that to a hammer all problems look like nails. To a central banker, all problems look addressable by small changes in short-term interest rates despite decades of evidence to the contrary. Both the yield curve and the exchange value of the dollar (or euro, if you happen to be ensconced in Frankfurt) do an excellent job of trumping targeted short-term rates. While almost eight years of extraordinary policies going back to the August 2007 backstopping of BNP-Paribas by the ECB have done little to achieve desired macroeconomic outcomes, we cannot extrapolate the inverse and say policy reversals will be harmless. They almost certainly would qualify for the SNAFU acronym in its classic incarnation. And so we do nothing as that is both the path of least resistance and of the least potential damage. Run a thought experiment for yourself: What would the world look like if we kept on the path of stagnant growth for another decade? Would it end badly or would we just adjust our expectations accordingly and find out we could live with less? My bet is the latter.

The causal chain is:

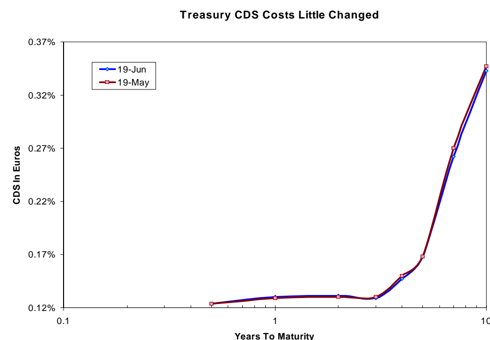
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point;
2. Disinflationary pressures have ended;
3. Inflation expectations as measured by the TIPS market will appear to be rising so long as nominal interest rates continue rising and vice-versa;
4. The U.S. yield curve has resumed its long-term bias toward flattening, but this will be a tenuous process until the next drumbeat of expectation for higher short-term interest rates;
5. Short-term borrowers are terming out commercial paper into the bond market in an attempt to lower rollover risk;
6. Swap spreads will remain tame until monetary policy indications turn more hawkish; and
7. Credit spreads will not rise significantly barring event risk until short-term interest rates are pushed higher.

Key Market Indications

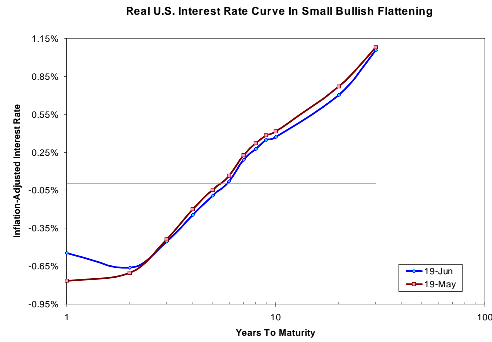
Markets move to the point of maximum confusion; this is part of their DNA. Last week's pullback in UST yields linked to both the predictable dovish stance of the FOMC and Eurozone-induced risk-aversion needs to be confirmed to avoid the April-June rise in ten-year yields from establishing a bearish trend. The key level for the ten-year remains 2.66%.



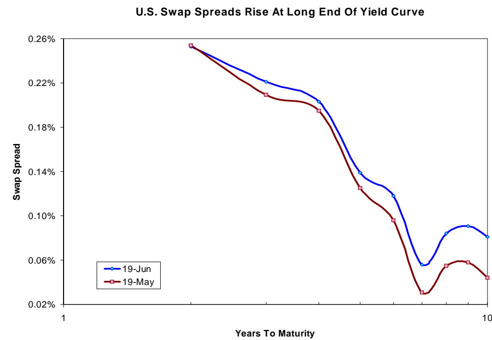
This market has little reason to shift significantly in either direction, so it finally gave up the ghost and remained unchanged on the month.



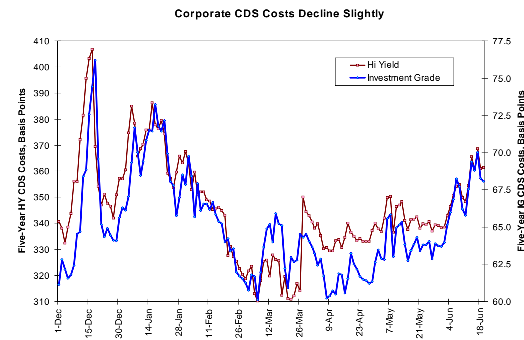
Pseudo-real rates have flattened somewhat bullishly over the past month. This is supportive for risky financial assets, but not strongly so. Conversely, the small rise at the short end of this yield curve is not sufficient to squelch any buying in precious metals. We need to remind ourselves that negative implied real rates out to five years are unusually stimulative by any and all historic standards.



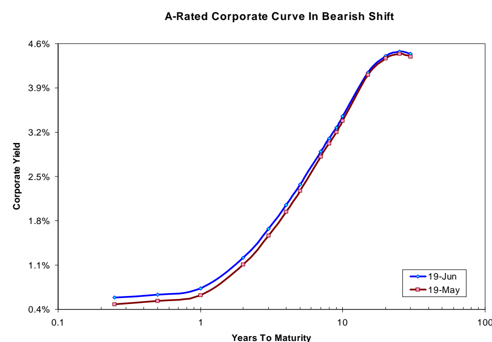
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have moved higher at the long end of the yield curve over the past month. This decreased willingness to remain floating on long-term payment risk is not overtly bearish as it simply may signal weak longs exiting bullish positions.



Both investment-grade and high-yield CDS costs found support at February levels. This continued the pattern of corporate credit risk moving in conjunction with expected changes in short-term interest rates. As U.S. growth rates have not turned lower and as monetary policy has yet to turn tighter, there is little reason to expect any sort of sharp increase in corporate credit risk barring an event.



The A-rated yield curve has shifted bearishly over the past month, mostly at the short end of the yield curve. Unless the rise in long-dated swap spreads ends soon or unless CDS costs decline unexpectedly, the potential for a bullish shift in investment-grade corporate bonds will remain slight. That in turn will cap the ability of equities to rise independently of actual earnings growth.



Market Structure

All of the physical commodity indices save for Grains and Softs are in structural downtrends. Financial markets have turned more mixed as only the EAFE and dollar indices are in structural downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate June 22 - 26
BBerg	29	Trending	-0.187	10.2%	-0.35%
BBerg Grain	14	Transitional	-0.069	15.1%	
BBerg Ind. Metl	29	Trending	-0.441	13.7%	-0.44%
BBerg Pre. Metl	29	Trending	-0.014	13.0%	-0.37%
BBerg Softs	14	Transitional	-0.195	14.1%	
BBerg Nat. Gas	29	Trending	-0.013	31.9%	-1.49%
BBerg Petroleum	25	Trending	-0.037	22.7%	-0.37%
BBerg Livestock	29	Trending	-0.357	9.4%	-0.37%
Dollar Index	23	Trending	-0.148	10.7%	-0.26%
S&P 500 Index	22	Trending	0.022	7.5%	
EAFE Index	29	Trending	-0.111	10.7%	-0.10%
EM Index	6	Sideways	0.023	7.9%	
Ten-year UST (price)	21	Trending	0.038	6.7%	

Performance Measures

The downturns in the economically important Industrial Metals and Energy indices signal the continuing inability of expected global demand growth to absorb the supplies induced by last decade's price increases. Outside of some short-covering and commitment-filling in soybeans, the only small pocket of buying in the physical commodities was in gold and silver as the postponement of a U.S. rate hike kept implied real short-term rates negative.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-0.74%	-2.89%	-8.11%	-26.72%
Grains Sub-Index	0.29%	-1.85%	-16.50%	-26.07%
Corn	0.00%	-2.81%	-17.74%	-28.77%
Soybeans	3.93%	2.20%	-7.76%	-23.07%
Wheat	-3.53%	-4.65%	-22.77%	-22.33%
Energy Sub-Index	-0.78%	-1.16%	-8.15%	-44.39%
Petroleum Sub-Index	-1.66%	0.45%	-2.16%	-45.31%
WTI	-0.79%	2.60%	-5.82%	-47.52%
Brent	-2.30%	-1.88%	-6.35%	-50.67%
ULSD	-1.34%	-3.44%	-1.20%	-37.90%
Gasoline	-2.42%	3.79%	10.94%	-38.70%
Natural Gas	2.15%	-6.10%	-23.86%	-46.10%
Precious Metals Sub-Index	1.88%	-1.89%	0.12%	-12.65%
Gold	1.93%	-0.48%	0.26%	-8.91%
Silver	1.74%	-5.67%	-0.06%	-23.08%
Industrial Metals Sub-Index	-3.55%	-7.67%	-11.99%	-17.02%
Copper	-4.03%	-9.40%	-10.93%	-16.71%
Aluminum	-2.87%	-6.15%	-13.52%	-14.71%
Nickel	-3.17%	-2.98%	-19.16%	-32.63%
Zinc	-3.65%	-8.43%	-7.11%	-6.93%
Softs Sub-Index	-3.25%	-9.14%	-20.07%	-34.94%
Coffee	-3.20%	-8.49%	-29.34%	-30.27%
Sugar	-4.31%	-12.85%	-24.40%	-47.68%
Cotton	-1.18%	-1.81%	3.14%	-16.75%
Livestock Sub-Index	-1.50%	-3.80%	-9.36%	-15.41%
Cattle	-0.08%	0.05%	1.35%	5.50%
Hogs	-3.78%	-9.60%	-25.67%	-42.52%

I commented last week the most important task facing the central banks is preventing a USD surge if and when the Federal Reserve signals its first rate hike. So far, so good on this front. However, until and unless monetary stimulus outside of the U.S. ends, the only way to effect this goal will be to keep postponing the inevitable increase in U.S. interest rates.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.76%	1.81%	-7.17%	-16.58%
Chinese yuan	-0.02%	-0.04%	0.19%	0.32%
Japanese yen	0.55%	-1.65%	-2.62%	-16.93%
British pound	2.07%	2.39%	1.64%	-6.78%
Swiss franc	1.23%	2.11%	7.28%	-2.55%
Canadian dollar	0.46%	-0.27%	-5.43%	-11.81%
Australian dollar	0.53%	-1.81%	-4.40%	-17.30%
Swedish krona	0.78%	2.76%	-4.71%	-17.49%
Norwegian krone	0.43%	-2.48%	-4.65%	-20.76%
New Zealand dollar	-1.06%	-5.91%	-10.95%	-20.72%
Indian rupee	0.78%	0.17%	-0.41%	-5.47%
Brazilian real	0.71%	-1.93%	-14.15%	-28.09%
Mexican peso	0.36%	-1.07%	-4.89%	-15.14%
Chilean peso	-0.05%	-4.51%	-3.38%	-11.97%
Colombian peso	-1.05%	-2.62%	-10.07%	-26.27%
Bloomberg-JP Morgan Asian dollar index (spot)	0.35%	-0.26%	-0.51%	-3.20%

The good news is the U.S. remains more attractive than either the EAFE or EM indices. The bad news is the upside in the U.S. is constrained by slow earnings growth and the certainty the next move in interest rates is higher. There is no alternative to the argument there is no alternative.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.28%	-1.40%	4.83%	3.98%
North America	0.72%	-0.67%	3.06%	8.66%
Latin America	1.17%	-3.95%	-3.86%	-23.10%
Emerging Market Free	-0.43%	-6.06%	4.39%	-4.79%
EAFE	-0.40%	-2.52%	7.74%	-2.72%
Pacific	-0.36%	-2.15%	10.05%	3.47%
Eurozone	-0.66%	-3.62%	5.38%	-8.65%

Professional traders continue to find their task difficult; sometimes they resemble poker players who need to be dealt four aces to win. The lack of continuity in financial markets has made it difficult to trade on overarching financial themes, and the dominant bearish trends in physical markets are always subject to bursts of short-covering.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	-0.51%	-1.53%	1.91%	20.86%
Newedge Trend	-0.87%	-2.55%	0.79%	13.60%
Newedge Short-Term	-1.13%	-2.01%	-1.29%	6.36%
HFR Global Hedge Fund	-0.17%	-0.15%	3.20%	0.07%
HFR Macro/CTA	-0.73%	0.08%	0.79%	5.61%
HFR Macro: Sytematic Diversified CTA	-0.57%	-0.31%	0.13%	5.04%