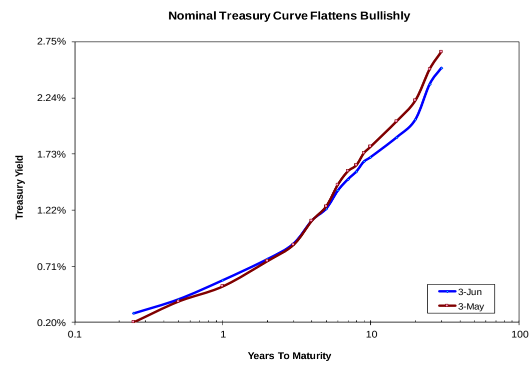
The Macro Environment For Financial Markets

How can the Federal Reserve be transparent if reality does not cooperate? The story of firming labor markets, rising inflationary expectations and a rate hike in July were priced into the market…and then were destroyed by a single number. This stuff happens. On a global macro basis, the good news is we do not have to worry about pacing the USD's rise, and that will take pressure off of emerging markets and off of the Chinese yuan. The bad news is zero- and negative interest rates will remain embedded in the system for the foreseeable future. The causal chain now is:

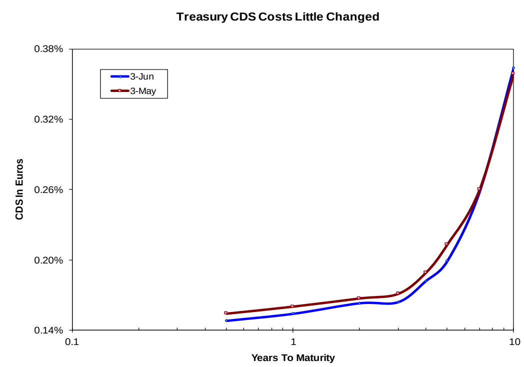
1. The market has no clear idea of if and when U.S. short-term rates will rise;
2. Disinflationary pressures will persist globally;
3. Inflation expectations as measured by TIPS and inflation swaps are turning lower;
4. The U.S. yield curve retains its long-term bias toward flattening;
5. Short-term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

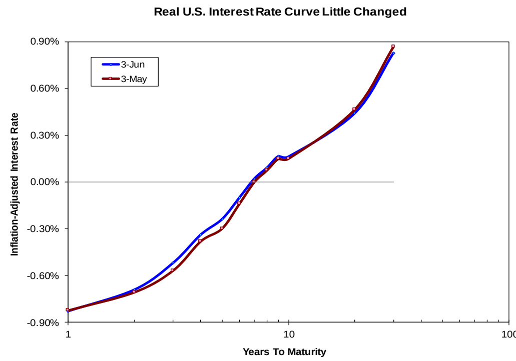
The surprisingly weak May employment report led to a steepening of the yield curve via lower short-term rates, but so long as global sovereign markets continue to rally, the long end of the U.S. yield curve will join the party. Incredibly, U.S. ten-year rates are less than 12 basis points over the February panic low.



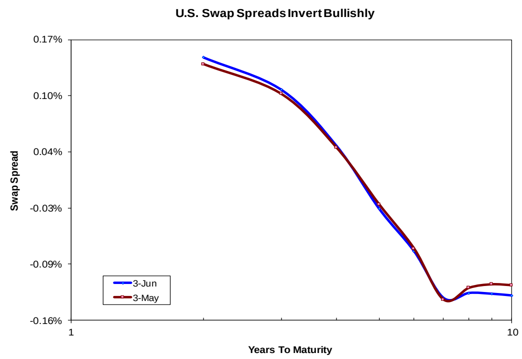
CDS costs changed little over the past month. If and when the Federal Reserve raises short-term interest rates, no entity will be affected more than the federal government. Even a small increase in debt service on an $18 trillion debt produces a big increase in net interest payments.



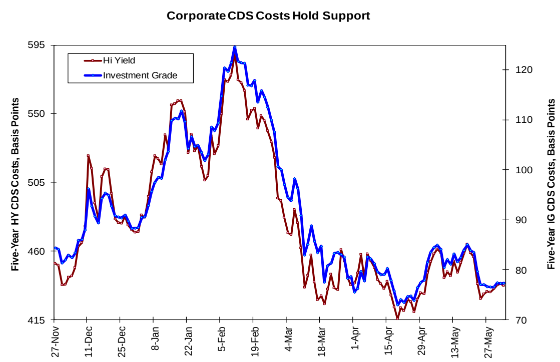
The pseudo-real rate curve has changed little over the course of the past month. However, its one-day decline at the short end supported the precious metals. More important, though, the inability of pseudo-real rates to decline at the long end of the yield curve is not at all supportive for equities.



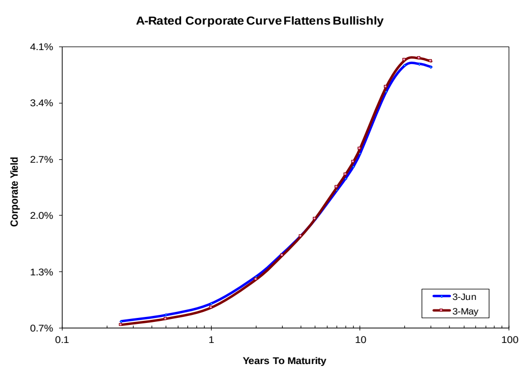
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have changed little over the past month as well. The inversion of this curve is confirmed in the swaption market. The belief seems to be that long-term rates will remain constrained.



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

Both Precious and Industrial Metals remain in downtrends, while Grains, Softs, Livestock and Natural Gas are in uptrends. Within the financials, the dollar index reversed into a downtrend, ten-year UST into an uptrend and none of the stock indices are in downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate June 6 - 10
BBerg	12	Transitional	0.142	11.6%	
BBerg Grain	23	Trending	0.218	19.5%	0.27%
BBerg Ind. Metl	29	Trending	-0.044	16.1%	-0.53%
BBerg Pre. Metl	29	Trending	-0.122	14.1%	-0.45%
BBerg Softs	29	Trending	0.331	19.0%	0.14%
BBerg Nat. Gas	24	Trending	0.187	22.5%	0.34%
BBerg Petroleum	6	Sideways	-0.028	22.5%	
BBerg Livestock	25	Trending	0.091	11.3%	0.05%
Dollar Index	29	Trending	-0.078	6.5%	-0.14%
S&P 500 Index	28	Trending	0.144	9.1%	0.60%
EAFE Index	29	Trending	0.069	10.6%	
EM Index	29	Trending	0.071	10.0%	
Ten-year UST (price)	26	Trending	0.169	4.7%	0.06%

Performance Measures

The Petroleum indices fell despite a weaker dollar. However, the other major subindices rallied, with Natural Gas moving up more than 11%. Replace coal and nuclear with natural gas and this is what you get in the summertime. While the main Bloomberg index has returned 19.7% since its January low, it still remains more than 8% below its first retracement level. If we are headed back into a bull market in physical commodities, something not at all a given considering China's lackluster prospective demand growth, we have a long ways to go.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	2.10%	4.29%	7.34%	-13.57%
Grains Sub-Index	3.45%	8.92%	11.35%	6.50%
Corn	2.46%	10.17%	8.75%	6.34%
Soybeans	4.85%	9.93%	24.13%	21.98%
Wheat	3.33%	5.66%	1.56%	-7.43%
Energy Sub-Index	1.26%	8.39%	-3.24%	-35.41%
Petroleum Sub-Index	-1.29%	8.96%	-2.82%	-35.17%
WTI	-1.73%	9.51%	-8.12%	-41.33%
Brent	-0.96%	9.09%	0.41%	-35.99%
ULSD	-1.19%	10.77%	0.20%	-32.62%
Gasoline	-1.17%	5.84%	-5.66%	-27.26%
Natural Gas	11.49%	6.41%	-9.57%	-38.13%
Precious Metals Sub-Index	1.24%	-4.65%	16.74%	2.83%
Gold	1.66%	-3.95%	16.92%	4.46%
Silver	0.14%	-6.46%	15.96%	-1.81%
Industrial Metals Sub-Index	1.20%	-4.31%	5.64%	-20.71%
Copper	0.51%	-4.75%	2.13%	-23.48%
Aluminum	-0.83%	-5.82%	3.05%	-16.06%
Nickel	1.18%	-10.90%	-4.75%	-35.59%
Zinc	6.14%	4.89%	29.94%	-10.51%
Softs Sub-Index	5.24%	10.17%	9.17%	13.68%
Coffee	4.62%	6.61%	-1.43%	-14.49%
Sugar	7.64%	15.41%	19.25%	38.52%
Cotton	-0.63%	1.39%	0.00%	-3.30%
Livestock Sub-Index	3.88%	3.57%	6.90%	-10.76%
Cattle	2.13%	4.18%	0.83%	-17.56%
Hogs	5.79%	2.80%	15.14%	0.56%

While the Federal Reserve never was going to risk a too-strong USD by pushing short-term rates rapidly higher, the currency market was pricing in such a move and paid the price after the employment report. The USD fell strongly on the week against all of the majors but the GBP. Oddly, the USD's downturn works very much to the benefit of the CNY as it removes the need for China to spend down reserves defending it.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	2.27%	-1.12%	3.90%	0.82%
Chinese yuan	0.25%	-0.84%	-2.31%	-5.37%
Japanese yen	3.55%	0.07%	15.09%	16.63%
British pound	-0.72%	-0.12%	-4.13%	-5.36%
Swiss franc	1.93%	-2.19%	1.78%	-4.31%
Canadian dollar	0.65%	-1.65%	3.23%	-3.75%
Australian dollar	2.58%	-1.58%	0.35%	-5.39%
Swedish krona	2.56%	-1.03%	4.18%	1.98%
Norwegian krone	2.00%	-0.60%	3.80%	-5.20%
New Zealand dollar	3.84%	0.64%	4.02%	-2.71%
Indian rupee	-0.33%	-1.24%	-0.89%	-4.99%
Brazilian real	2.39%	0.89%	6.57%	-11.16%
Mexican peso	-0.63%	-5.27%	-10.12%	-16.53%
Chilean peso	0.32%	-2.13%	2.62%	-8.19%
Colombian peso	1.71%	-3.50%	4.13%	-14.61%
Bloomberg-JP Morgan Asian dollar index (spot)	0.76%	-0.72%	-0.43%	-4.27%

One of the emerging themes for the second half of 2016 will be a long-term switch from U.S. outperformance to underperformance vis-à-vis the rest of the world. This will reemerge more strongly after the expected interest rate divergence trade returns.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	0.20%	1.64%	1.58%	-3.73%
North America	0.20%	2.12%	3.71%	0.30%
Latin America	2.23%	-3.61%	8.87%	-14.69%
Emerging Market Free	1.06%	-0.39%	0.69%	-15.72%
EAFE	0.19%	0.84%	-1.82%	-9.91%
Pacific	1.51%	0.90%	-1.67%	-8.09%
Eurozone	-0.43%	0.84%	-2.33%	-11.21%

CTAs and hedge funds both posted gains for a second consecutive week. This has been a consistent pattern when equity indices advance, and vice-versa. Interestingly, the unexpected reversal in the USD did not clip either class of trader's performance.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.42%	-2.12%	-5.15%	-3.33%
Newedge Trend	0.46%	-1.57%	-1.37%	-0.35%
Newedge Short-Term	0.30%	-0.59%	1.79%	-0.28%
HFR Global Hedge Fund	0.49%	0.74%	-2.26%	-6.89%
HFR Macro/CTA	0.03%	-1.48%	-2.94%	-3.75%
HFR Macro: Sytematic Diversified CTA	-0.01%	-2.54%	-2.16%	-1.34%