The Macro Environment For Financial Markets

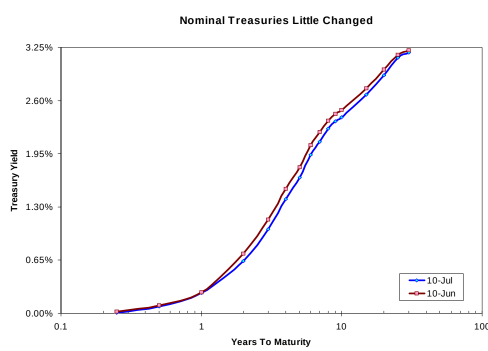
The first person to translate "Market Manipulation For Dummies" into Mandarin may sell only one or two copies, but they will have performed a valuable social service nevertheless. Similarly, everyone with an EM index product owes a debt to the MSCI committee that kept China out of the index for the time being. Now if the lessons learned in China about how it is best to let markets send price signals to participants can be learned elsewhere… What is striking in the month-over-month comparisons in the charts below is how little many key markets have changed relative to their intervening volatility. The risk-on/risk-off game was played fervently over the past month, but at the end of it, we have learned little and will learn little until and unless markets are allowed to operate. The potential for that happening is low as the collective appetite for recognizing losses is low.

The causal chain remains:

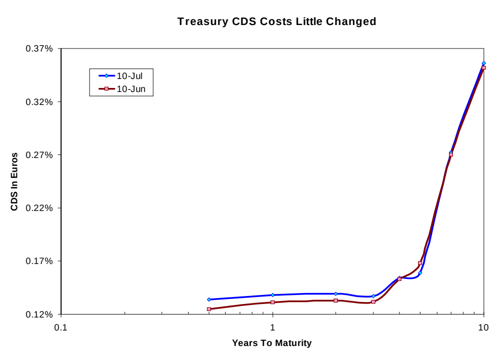
1. Short-term interest rates will remain artificially low globally but will start moving higher in the U.S. at some point, arguably as early as September;
2. Disinflationary pressures have ended;
3. Inflation expectations as measured by the TIPS market will appear to be rising so long as nominal interest 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

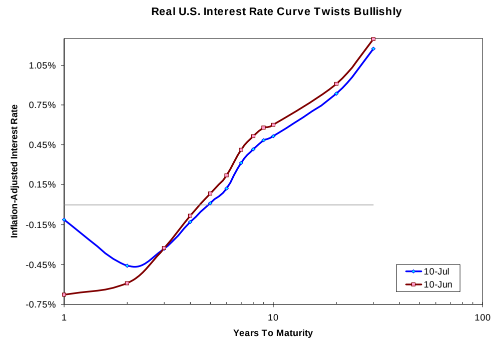
In a coincidence, the yield curve remains almost exactly where it was one month ago, an observation made last week as well. A risk-on move at the end of the week squashed a bullish flattening of the yield curve, as did a prediction by Janet Yellen that Janet Yellen would be inclined to raise short-term rates in 2015, at least according to Janet Yellen.



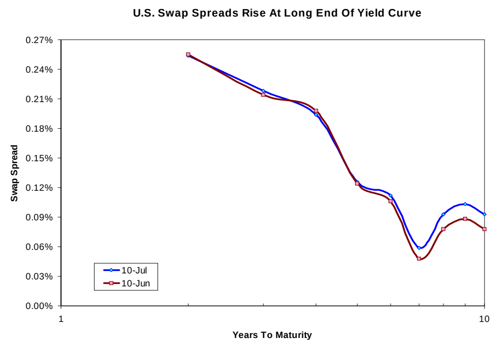
This market continues to have little reason to shift in either direction. The small shift higher in CDS costs at the short end of the yield curve can be ignored once again.



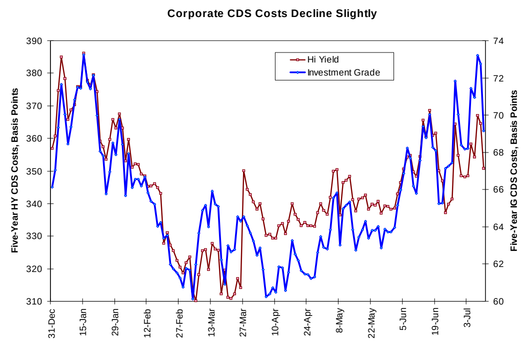
Pseudo-real rates drifted lower past the three-year horizon over the past month, but the moves were small. This shift was insufficient to push risky financial assets higher. The small increase at the one- and two-year maturities has been negative for precious metals.



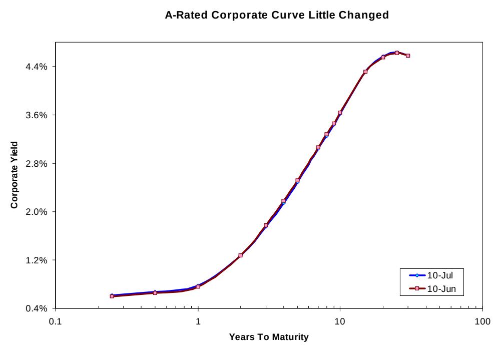
Swap spreads, which rise when floating-rate borrowers want to fix their payments, have moved higher at the long end of the yield curve over the past month. This increased demand to fix long-term payments is a concern for the corporate bond market.



Even though the corporate balance sheets remain in good shape, the ragged uptrend in both high-yield and investment-grade CDS costs since mid-April is noticeable. This may be related to liquidity considerations as the number of single-name CDS contracts continues to decline. Regardless, nothing in this gradual increase can be construed bullishly.



The A-rated yield curve changed little over the past month. Unless long-dated swap spreads or 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

The main Bloomberg index moved into a downtrend, as did Precious Metals and Natural Gas. Within the financial markets, the EAFE and S&P 500 remain in structural downtrends.

	N-Day Speed	Market Structure	Trend Oscillator	HLC Volatility	Daily Trend Rate July 13 - 17
BBerg	29	Trending	-0.122	11.9%	-0.14%
BBerg Grain	5	Sideways	0.037	25.9%	
BBerg Ind. Metl	11	Transitional	-0.049	25.4%	
BBerg Pre. Metl	29	Trending	-0.140	13.5%	-0.23%
BBerg Softs	17	Transitional	0.000	16.1%	
BBerg Nat. Gas	23	Trending	-0.054	31.0%	-0.25%
BBerg Petroleum	29	Trending	-0.309	25.5%	-0.37%
BBerg Livestock	10	Sideways	-0.198	12.7%	
Dollar Index	29	Trending	0.058	10.3%	
S&P 500 Index	27	Trending	-0.071	9.4%	-0.85%
EAFE Index	29	Trending	-0.082	13.3%	-0.10%
EM Index	16	Transitional	-0.224	14.1%	
Ten-year UST (price)	12	Transitional	-0.051	7.6%	

Performance Measures

The large-scale exit of commercial banks from proprietary commodity trading has shown up in liquidity vacuums even in deep markets such as crude oil. Let's stipulate a further growth slowdown in China will reduce demand, but the gearing in the economically important Industrial Metals seems excessive barring something far worse than a downturn in Chinese equities. Moreover, the selling in Softs, Livestock and Natural Gas, still largely a North American market, cannot be explained in fundamental as opposed to financial terms. The liquidity vacuums will be worse during the next recovery as buyers scramble to lock in feedstock costs.

Commodity Total Returns

	Five-Days	One Month	Six Months	One Year
Bloomberg Index	-2.48%	-1.24%	-1.92%	-23.68%
Grains Sub-Index	-0.27%	16.07%	4.30%	-1.09%
Corn	1.46%	21.19%	6.08%	1.38%
Soybeans	-0.78%	13.05%	3.79%	-4.47%
Wheat	-2.46%	12.83%	4.21%	4.05%
Energy Sub-Index	-4.69%	-7.35%	4.76%	-44.32%
Petroleum Sub-Index	-5.54%	-9.43%	11.79%	-46.72%
WTI	-7.12%	-12.42%	2.75%	-51.37%
Brent	-5.71%	-9.61%	11.77%	-51.49%
ULSD	-5.42%	-8.27%	9.11%	-38.38%
Gasoline	-2.68%	-4.70%	32.75%	-36.65%
Natural Gas	-2.01%	-0.43%	-12.46%	-41.72%
Precious Metals Sub-Index	-0.49%	-1.97%	-7.50%	-17.83%
Gold	-0.48%	-1.81%	-6.42%	-13.78%
Silver	-0.52%	-2.45%	-10.47%	-28.89%
Industrial Metals Sub-Index	-3.08%	-5.77%	-7.66%	-22.76%
Copper	-3.55%	-5.42%	-4.25%	-22.78%
Aluminum	-1.86%	-3.12%	-7.96%	-17.06%
Nickel	-7.75%	-14.32%	-23.72%	-42.90%
Zinc	-0.56%	-5.42%	-4.21%	-14.40%
Softs Sub-Index	-0.48%	-2.17%	-18.08%	-27.84%
Coffee	-0.90%	-6.06%	-32.31%	-29.10%
Sugar	0.89%	2.82%	-18.17%	-38.45%
Cotton	-2.77%	1.33%	7.05%	-3.35%
Livestock Sub-Index	-3.07%	-3.07%	-7.38%	-16.84%
Cattle	-2.58%	-2.30%	0.75%	2.02%
Hogs	-3.88%	-4.32%	-19.54%	-42.18%

The euro/yen cross-rate showed once again how haven assets such as the yen can be very risky once the risk-off trade ends. That is temporary; the longer-term signal in the currency markets is going to remain the pressure on resource-linked currencies such as the CAD and AUD and on EM currencies in general and Latin American currencies in particular.

Currency Returns

	Five-Days	One Month	Six Months	One Year
Euro	0.43%	-1.43%	-5.68%	-17.98%
Chinese yuan	-0.06%	-0.06%	-0.09%	-0.12%
Japanese yen	0.01%	-0.08%	-3.61%	-17.46%
British pound	-0.34%	-0.08%	2.28%	-9.43%
Swiss franc	0.18%	-0.77%	8.11%	-4.94%
Canadian dollar	-0.66%	-3.18%	-5.40%	-15.86%
Australian dollar	-1.02%	-4.06%	-8.72%	-20.75%
Swedish krona	0.32%	-1.96%	-4.20%	-19.56%
Norwegian krone	-0.26%	-3.07%	-3.30%	-22.92%
New Zealand dollar	0.52%	-6.61%	-13.58%	-23.75%
Indian rupee	0.06%	0.70%	-2.00%	-5.04%
Brazilian real	-0.82%	-1.33%	-15.39%	-29.73%
Mexican peso	0.11%	-1.75%	-6.75%	-17.33%
Chilean peso	-1.59%	-2.44%	-4.85%	-14.51%
Colombian peso	-1.35%	-5.47%	-9.58%	-30.58%
Bloomberg-JP Morgan Asian dollar index (spot)	-0.19%	-0.45%	-1.28%	-4.25%

While the Eurozone markets rose on the prospects for another extend-and-pretend deal for Greece to be lubricated with more easy money, the Asia/Pacific region has to come to grips with what is likely to be a more pronounced slowdown in Chinese growth. The EM markets' underperformance should continue.

Equity Total Returns

	Five-Days	One Month	Six Months	One Year
MSCI World Free	-0.04%	-1.73%	5.01%	2.95%
North America	-0.19%	-1.54%	2.49%	6.26%
Latin America	-1.26%	-3.67%	-6.90%	-26.18%
Emerging Market Free	-3.22%	-3.98%	-1.49%	-9.78%
EAFE	0.20%	-2.02%	9.23%	-1.92%
Pacific	-3.44%	-2.98%	6.43%	-0.18%
Eurozone	2.99%	-0.94%	12.59%	-3.41%

The ability of trend-followers to gain this week is interesting considering the swift transfer between risk-on and risk-off positions and the pronounced difficulties all professional traders have had this year in handling volatility. Let's be generous and probably incorrect in chalking this up to skill.

CTA/Hedge Fund Returns

	Five-Days	One Month	Six Months	One Year
Newedge CTA	0.20%	-0.88%	-3.95%	18.22%
Newedge Trend	0.32%	-0.79%	-3.52%	12.27%
Newedge Short-Term	1.15%	-2.39%	-3.91%	4.37%
HFR Global Hedge Fund	-0.59%	-1.30%	0.84%	-1.41%
HFR Macro/CTA	0.53%	-0.72%	-1.98%	4.76%
HFR Macro: Sytematic Diversified CTA	1.13%	-0.57%	-3.40%	3.29%