DAVIS COMMODITIES LLC

June 2023
Macro Commentary

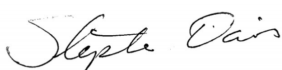
The month of June mirrored that of May with continuing cross-currents that keep the markets on edge. The back-and-forth trade makes it difficult for our trading strategy to be successful as the main objective is to ascertain a longer-term move, establish a position, and wait. With that in mind, there are some notable divergences which could be interesting and highly profitable over the coming two quarters.

The Euro area has seen sticky inflation. Even though levels have been declining, they are still elevated which should prompt the European Central Bank (ECB) to continue raising rates. The ECB will be forced to raise rates even as Germany has already had two negative quarters of GDP, manufacturing Purchasing Managers Index (PMI) is below 50 (showing contraction) in the largest economies, and services PMI has been slowing as well. The chart below left shows manufacturing PMI in Germany, France, and Italy. The chart below right shows services PMI in those same countries. France is showing contraction in services while Germany and Italy are still showing growth.

In addition to the economic data, the recent unrest in France does not bode well for economic growth either. While the dollar may not be able to show strength in the long-term due to the ongoing twin deficits, in the short-term, the Euro looks ripe for a correction lower.

Regarding interest rates in the US, the Federal Reserve (Fed) did not raise rates at their meeting, but used their forecasts for interest rates to do the heavy lifting for them. By showing terminal rates in excess of 5%, the market followed the Fed lead and moved interest rates higher. As of today, the market is expecting ~88% chance of a 25 basis point hike in July with no cuts until June, 2024. In total, futures are implying a terminal rate of near 5.5% for Fed Funds. The data from June and early July continue to support the continued tightening. Despite the non-farm payrolls coming out weaker than expected, the continued lack of disinflation should allow the Fed to raise rates again. What is truly interesting is that while the market has been pricing a higher terminal rate, the 2yr vs 10yr note spread has started to contract and move toward a more normal structure. While we are not involved today, this continues to be a long-term theme. As you can see in the chart below, the 2-10 spread is trying to put in a double bottom. If the lows near -110 continue to hold, a steepening position will be re-established.

Sincerely,



Stephen Davis
July 10, 2023

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