Synchronized Exits?

Date: 2021-08-27

Upcoming Economic Events (Singapore Local Time):

- 2021-08-31 09:00 China NBS PMI (Aug)
- 2021-08-31 17:00 Eurozone CPI (Aug)
- 2021-09-01 22:00 US ISM Manufacturing PMI (Aug)
- 2021-09-03 20:30 US Nonfarm Payrolls (Aug)
- 2021-09-03 22:00 US ISM Services PMI (Aug)
- 2021-09-07 12:30 RBA Interest Rate Decision
- 2021-09-08 22:00 BoC Interest Rate Decision
- 2021-09-09 19:45 ECB Interest Rate Decision
- 2021-09-10 20:30 US CPI (Aug)

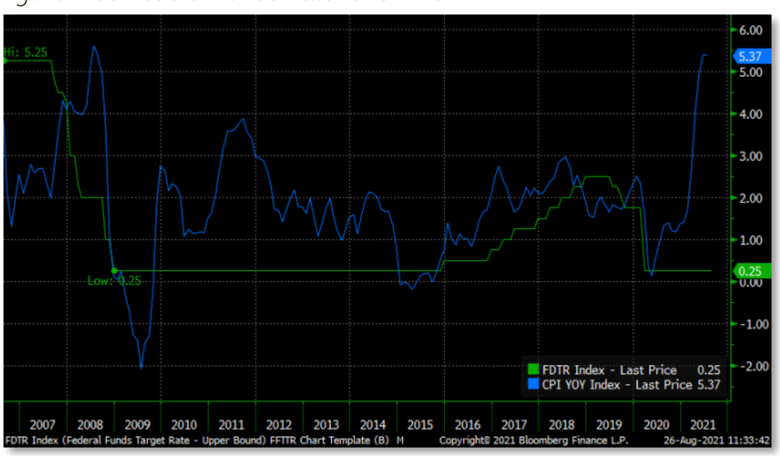
After the Jackson Hole Symposium, investors will be watching major central banks' monetary policy decisions. Given the move made by the Bank of Korea to hike rates by 0.25%, would we see a synchronized tightening by other central banks?

Markets in Focus

Figure 1 South Korea Official Bank Rate vs. CPI YoY

On 26th August 2021, the Bank of Korea (BoK) raised its benchmark interest rates by 0.25% to 0.75%, making it the first major central bank to hike rates since the pandemic outbreak in 2020. The hike was the first tightening move by the BoK since late 2018. Historically, the BoK's rate decisions were in line with South Korea's inflation rate.

Figure 2 US Federal Funds Rate vs. CPI YoY

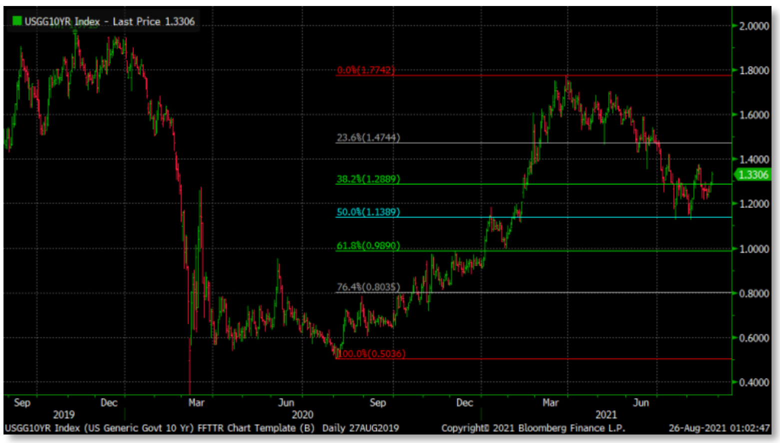


The US has seen a similar, if not more drastic, inflation pickup since 2020. However, the Fed Funds Rate was historically stickier to the downside, as we have seen during the post-Great Financial Crisis period.

Figure 3 US 10-year Treasury Yield (Weekly)

The weekly chart of the US 10-year yield shows its path of reversing from the low in 2020. 50% and 23.6% retracement levels serve as significant resistance and support. The countertrend move since March seems to have completed, and the 10-year yield should resume inching higher.

Figure 4 US 10-year Treasury Yield (Daily)



The daily chart of the US 10-year yield also confirms the bullish view. It retraced precisely 50% of the rally since July 2020. After establishing a local double bottom in July 2021, the 10-year yield looks to be on its way to reaching 1.5% and above.

Figure 5 Eurodollar Dec2023 Future

The December 2023 Eurodollar has completed a neat bear flag pattern. At the current level of 98.95, the market is pricing in a slightly higher than the 1% Libor rate by then. We couldn't help but wonder if the market has underestimated how much and how quickly the Fed would hike interest rates.

Figure 6 Generic 1st Copper Future

Copper lost its 16-month support during a sharp selloff last week, only to quickly rebound to the trendline again. It is at a critical juncture now, as the previous support has turned into resistance, coinciding with the neckline of a broken Head-and-Shoulder top. If Copper cannot break its overhead resistance, we could be seeing another leg down very soon.

Figure 7 MXNUSD

The Mexican Peso is trading in an ascending triangle and getting closer to the apex. We are watching this currency pair as the direction of the next move will soon be apparent when it either breaks above the overhead resistance or breaks below the rising trendline.

Market Views

As the market holds its breath for the upcoming Jackson Hole Symposium, the Bank of Korea's rate hike on Thursday surprised some investors and economists. The BoK also vowed to continue tightening to counter "financial imbalance risks" which deteriorated in July and August and caused more concern than the COVID risk to the growth and inflation outlook.

In recent years, the monetary policies of major central banks have been increasingly synchronized. A blog post by the International Monetary Fund in March 2020 suggested "global cooperation to synchronize monetary policy must be high on the agenda."[1] This certainly held true during the COVID outbreak in early 2020. When countries are recovering and gradually moving back to the "new normal", and when more places are showing signs of rampant inflation, would the "exit strategy" of central banks be just as synchronized? With the world's economies becoming ever more closely integrated, and capital flowing more easily across borders, we agree that cooperation and synchronization do make monetary policies more effective.

Since the 6th July issue where we highlighted that most commodities have rolled over, the last one to throw in the towel was Crude Oil which subsequently pulled back almost 20% from the high. As shown in Figure 6, Copper has also lost its critical support level near 430. There are mounting uncertainties in both forex and

[1] https://blogs.imf.org/2020/03/11/monetary-and-financial-stability-during-the-coronavirus-outbreak/

commodity market. On the contrary, the treasury and interest rate market offers a much clearer picture of what the most probable path for the price action is.

The 10-year treasury yield has rebounded at important Fibonacci support levels, on both weekly and daily charts. The Eurodollar market has also completed the countertrend rally, with December 2023 contract showing the cleanest bear flag pattern completion. Both suggest that yields are likely heading higher across the entire curve.

How to play the theme out

A hypothetical investor can consider the following two trades[2]:

Case Study 1: Long Micro 10-Year Yield Future

If the investor were to long the Micro 10-Year Yield future (10YQ1) at around 1.335 and set the stop at 1.13, below the double bottom low established in July, his maximum loss per contract would be (1.335 – 1.13) x 1000 = 205 USD. An initial target points to 1.475 and subsequently 1.775, resulting in (1.475 – 1.335) x 1000 = 140 USD and (1.775 – 1.335) x 1000 = 440 USD.

Case Study 2: Short Eurodollar December 2023 Future

If the investor were to short the Eurodollar future (EDZ3) at around 98.96 and set the stop at 99.21, his maximum loss per contract would be (99.21 – 98.96) x 2500 = 625 USD. An initial target points to 98.6 and subsequently 98.2, resulting in (98.96 – 98.6) x 2500 = 900 USD and (98.96 – 98.2) x 2500 = 1900 USD.

[2] *Examples cited above are for illustration only and shall not be construed as investment recommendations or advice. They serve as an integral part of a case study to demonstrate fundamental concepts in risk management under given market scenarios.*

Background

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The trainers and researchers in ITS have been regularly speaking on various exchange/broker hosted trading seminars and writing for various research publications over the years. Catering to both aspiring and experienced traders, we want to help in bridging the void between the theoretical and practical aspects of derivative trading, with guidance from our team of seasoned and active traders.

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