

How will the Fed's hawkishness impact markets?

Date: 2021-10-08

Upcoming Economic Events (Singapore Local Time):

- 2021-10-13 20:30 US CPI ex Food & Energy (Sep)
- 2021-10-14 09:30 China CPI (Sep)
- 2021-10-15 10:00 China Retail Sales (Sep)
- 2021-10-15 20:30 US Retail Sales (Sep)
- 2021-10-15 22:00 US Michigan Consumer Sentiment Index (Oct)
- 2021-10-18 10:00 China GDP (Q3)
- 2021-10-20 09:30 PBoC Interest Rate Decision
- 2021-10-21 16:00 Eurozone Markit PMI Composite (Oct)

Investors are feeling edgy amidst the global energy crisis and rapidly rising bond yields with pervasive signs of inflation. Could the market still have underestimated how hawkish the central banks need to be?

Markets in Focus

Figure 1 MXN/USD Weekly



The long-term chart of MXN/USD displays a curious pattern of a sharp depreciation of the Peso, followed by a rising wedge, the breaking of which leads to the next leg down. The latest round of such a pattern started in early 2020. We are at the “breaking” point now.

Figure 2 MXN/USD Daily



We have been closely watching MXN/USD pair since the end of August. It is now apparent that the historical pattern is likely to repeat, and we could soon be witnessing another significant depreciation of the Mexican Peso against the Greenback.

Figure 3 Generic 1st Silver Future



Silver has been trading in a giant descending triangle for more than a year after the initial run-up to 30 when global central banks unleashed unprecedented easing measures in early 2020. Currently at the critical support level of around 22.5, Silver needs to bounce back from here quickly and strongly, or we could see its price back in the teens.

Figure 4 Generic 1st Nasdaq Future



The rapid rising of yields is a strong headwind for US tech darlings, as we see Nasdaq plunged to the bottom of the 15-month uptrend channel. In previous cases, Nasdaq always sharply rebounded at the trendline support and continued to make new all-time highs. The question is, would it hold this time?

Market Views

The impact of the Fed's hawkishness is gradually rippling through the markets. As indicated in the [August 31 edition](#), we believe the major central banks are likely to cooperate and synchronize in their monetary policy normalizations to counter rampant inflations. This week, the Reserve Bank of New Zealand hiked interest rates by 0.25% to 0.5%.

Meanwhile, energy shortage in most parts of the world has sent energy prices skyrocketing. It even spilled over to edible oils such as Malaysian Palm Oil, which has surpassed the high in 2008 and is trading in uncharted territory now. This situation is adding fuel to the inflation fire (pun intended). As a result, bond yields rapidly rose across the curve, and equities did not take this too kindly. The US Dollar also kept strengthening as a risk-off move.

Let us entertain a simple thought experiment. Assume the Fed carries through its tapering plan, trying to put a lid on inflation, Dollar and bonds yields would rise. It threatens the debt-laden economy and equity market when companies' margin has already compressed due to high costs. If a deeper equity market correction happens, employment will be at risk, and the Fed will likely step back in again.

On the other hand, if the Fed softens its hawkish stance, the market will probably shake off the recent hiccup and continue to go higher, especially commodity prices, thanks to a weaker US Dollar. Consequently, firms will have to pass more of the high costs to consumers, causing even broader and more concerning inflation. If that happens, an overheating economy might lead the Fed to taper eventually.

The current situation between the central banks and the market is a classic example of a "Mexican Standoff." A sustainable victory will remain elusive to either side. Therefore, without more clarity in the path forward, we prefer our portfolio not to be overly exposed to the US Dollar, which we firmly believe is the most important thing to watch. We could, however, carefully construct trades that help us hedge the Dollar exposure and hopefully work in both scenarios.

How to play the theme out

A hypothetical investor can consider the following two trades¹:

Case Study 1: Short MXN/USD Future

If the investor were to short the MXN/USD Future (6MZ1) at around 0.049 and set the stop above 0.051, his maximum loss per contract would be $(0.051 - 0.049) \times 500000 = 1000$ USD. An initial target points to 0.044 and subsequently 0.04, resulting in $(0.049 - 0.044) \times 500000 = 2500$ USD and $(0.049 - 0.04) \times 500000 = 4500$ USD.

¹ 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.

Case Study 2: Long Micro Silver Future

The investor could long Silver as a hedge against short MXN/USD. If he were to long the Micro Silver Future (SILZ1) at 22.6, and set the stop at 20, his maximum loss would be $(22.6 - 20) \times 1000 = 2600$ USD. The initial target points to 25 and subsequently 28, resulting in $(25 - 22.6) \times 1000 = 2400$ USD and $(28 - 22.6) \times 1000 = 5400$ USD.

Background

Inspirante Trading Solutions Pte Ltd (“ITS”) was incorporated in Singapore in July 2020. Founded by the partners of Synergy Link Capital Pte Ltd (“SLC”) to consolidate their initiatives in FinTech solutions, research, and training programs for different market participants, while SLC continues its focus in proprietary trading. ITS focuses on providing clients bespoke trading solutions such as algo trading systems, risk management systems, research reports, education, and training courses. With a strong technical background, unparalleled understanding, and insights from the actual market practitioners, ITS managed to obtain FinTech certification recognized by the Monetary Authority of Singapore within two months of incorporation. ITS is now actively collaborating with various trading groups, exchanges, and brokers in multiple countries.

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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