What's next after tapering?

Date: 2021-11-05

Upcoming Economic Events (Singapore Local Time):

- 2021-11-10 09:30 China CPI (Oct)
- 2021-11-10 21:30 US CPI ex Food & Energy (Oct)
- 2021-11-12 23:00 US Michigan Consumer Sentiment Index (Nov)
- 2021-11-15 10:00 China Retail Sales (Oct)
- 2021-11-17 15:00 UK CPI (Oct)
- 2021-11-17 21:30 US CPI (Oct)

In the closely watched November FOMC meeting, the Fed has finally announced the start of tapering. The market is now debating what happens next? Would rate hikes follow soon?

Markets in Focus

Figure 1 Generic 1st Russell 2000 Index Future

Russell 2000 index followed the other major US equity indices to break out from a 9-month consolidation range, confirming our observation from the Oct 28th issue.

Figure 2 Bloomberg Dollar Spot Index

The bulls and bears of the US Dollar are still fighting around the 1160 level on the Bloomberg Dollar Index. After temporarily falling back to the trading range, the US Dollar has managed to break out above the level once again. Would the Dollar bulls finally have the upper hand this time?

Figure 3 Generic 1st Gold Future

The 20-month gigantic descending triangle top still holds for Gold. The overhead resistance and headwinds from the Dollar strength have caused the price advance to be rejected at 1800 area.

Figure 4 BRL/USD

After breaking out from a 4-year Cup-and-Handle, the Brazilian Real sharply weakened against the US Dollar, causing this pair to explode high in early 2020. Since then, BRL/USD has been consolidating in a symmetric triangle for 18 months. We are watching this closely for a potential breakout and continuation of the rally.

Figure 5 Eurodollar Jun 2023 Future

Back in [early August](), we have discussed a case study on the June 2023 Eurodollar contract. We believed the Fed would hike rates more and faster than what the market was pricing in then. The interest rate market has re-adjusted its expectations now, pricing in more than four 25bps hikes by the middle of 2023.

Market Views

The long-anticipated tapering decision has finally come during FOMC's November meeting. The Fed will soon begin reducing the pace of its monthly bond purchases by $15 billion per month and plan to end the purchases altogether by the middle of next year.

What's next? This is the question to be answered, and it will lead us to rethink our portfolio construction. In early August, we argued that inflation was coming "faster, higher, and stronger than expected." Therefore, the Fed would likely make more aggressive rate hike decisions. Back then, the June 2023 Eurodollar future was still trading above 99.3. Now it has plunged to as low as 98.75, suggesting two more 25bps hikes have been priced in.

Looking into FOMC's latest meeting minutes, we couldn't help but notice that even though the Fed has slightly changed its view on inflation, it doesn't seem to be in a rush to normalize rates. Is the market getting a bit too ahead of itself? After all, the current inflation is more "supply-push" than "demand-pull." The entire global supply chain is still disrupted, as exemplified by congested seaports and high shipping costs. In other words, the economic recovery, despite the rosy-looking data, might not be as robust as we have hoped for, and it could quickly falter if the central banks withdrew their support too fast or mishandled the normalization process.

Maybe investors should give more credits to the Fed for their patience on its rate hike plan and beware of consensus that might swing from one extreme to the other. Concerning our case studies of put spreads on June 2023 Eurodollar, we believe it is a good time to wind up the positions, at least partially for now. At this level, the risk/reward is no longer as attractive as when we first initiated the positions.

How to play the theme out

A hypothetical investor can consider the following trades[1]:

Case Study 1: Long Micro E-mini Russell 2000 Index Future

If the investor were to long the Micro E-mini Russell 2000 Index future (M2KZ1) at around 2385 and set the stop below 2200, his maximum loss per contract would be (2385 – 2200) x 5 = 925 USD. A measured target points to 2670, resulting in (2670 – 2385) x 5 = 1425 USD.

Case Study 2: Short Micro Gold Future

If the investor were to short the Micro Gold future (MGCZ1) at 1764 and set the stop above 1850, his maximum loss would be (1850 – 1764) x 10 = 860 USD. A measured target points to 1700 and subsequently 1600, resulting in (1764 – 1700) x 10 = 640 USD and (1764 – 1600) x 10 = 1640 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 3: Exit half position on Eurodollar June 2023 99x98.5 Put Spread

If the investor had established the Eurodollar June 2023 99x98.5 vertical put spread (EDM3 9900P – EDM3 9850P) at 0.08, he could exit half the position now at 0.19 for more than 130% of the premium paid in August, even though EDM3 future's price has not reached our lower strike yet.

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.

Disclaimer and Warning

The opinions and statements contained in the above commentary do not constitute an offer or a solicitation, or a recommendation to implement or liquidate an investment or to carry out any other transaction. It should not be used as a basis for any investment decision or other decision. Any investment decision should be based on appropriate professional advice specific to your needs. This content has been produced by Inspirante Trading Solutions Pte Ltd. CME Group has not had any input into the content and neither CME Group nor its affiliates shall be responsible or liable for the same.

CME Group does not represent that any material or information contained herein is appropriate for use or permitted in any jurisdiction or country where such use or distribution would be contrary to any applicable law or regulation.