

A Tale of Two Price Indices

Date: 2021-11-19

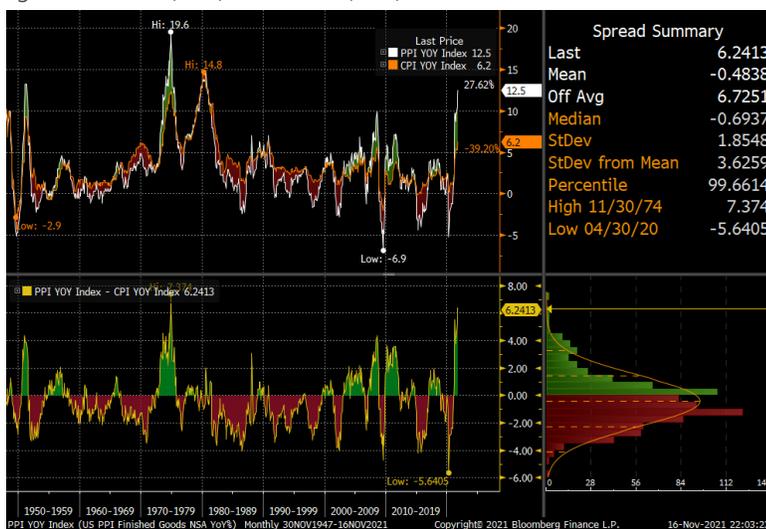
Upcoming Economic Events (Singapore Local Time):

- 2021-11-22 09:30 PBoC Interest Rate Decision
- 2021-11-24 09:00 RBNZ Interest Rate Decision
- 2021-11-24 21:30 US GDP (Q3)
- 2021-11-30 18:00 Eurozone CPI (Nov)
- 2021-11-30 21:00 German HICP (Nov)
- 2021-12-01 21:15 US ADP Employment Change (Nov)
- 2021-12-03 21:30 US Nonfarm Payrolls (Nov)

CPIs in many countries are at multi-decade highs without showing any signs of slowing down. More central banks have joined the [Synchronized Exists](#) and started raising rates. Investors are closely watching economic data of the US and Eurozone to gauge the Fed's and ECB's next course of action.

Markets in Focus

Figure 1 US PPI (YoY) vs. US CPI (YoY)



The gap between the Producer Price Index (PPI) for Finished Goods and the Consumer Price Index (CPI) in the US has reached a whopping 6.24%, the highest since the mid-70s and more than three standard deviations away from the long-term historical average.

Figure 2 Bloomberg Dollar Spot Index



The bulls finally had the upper hand and pushed the US Dollar out of a 12-month consolidation range. As we have iterated many times before, the US Dollar is the single most important asset we are watching. Its move would have huge ramifications on most of the other assets.

Figure 3 South African Rand Spot



The ZAR/USD pair has completed a 12-month Head-and-Shoulder top with stunning symmetry. It is on the verge of breaking out from the neckline as the US Dollar strengthens against the South African Rand.

Figure 4 DXY vs. Goldman Sachs US Financial Conditions Index



The GS US Financial Conditions Index measures the overall financial conditions in the US based on interest rates, exchange rates, equity valuations, and credit spreads. It is at the lowest level since inception, indicating a very loose financial condition. The high correlation with DXY suggests that as the US Dollar strengthens, the financial conditions are likely to tighten.

Figure 5 Generic 1st Soybean Future



Despite the strengthening US Dollar, many agricultural commodities rallied. Soybean has broken out from the strong resistance at the 1280 region. 1400 seems to be a reasonable target if the breakout is confirmed and the rally continues.

Market Views

The gap between the US PPI and CPI is nothing but jaw-dropping. The latest data registered a 6.2% difference between the 12.5% PPI for Finished Goods and the 6.2% CPI in October. The last time we saw this big gap was in the mid-70s when Nixon resigned and Ford became the president.

How did the Great Inflation of the 1970s happen? Many believe it was a combination of easy monetary policies, massive government spending on social welfare and the Vietnam War, budget deficits, high oil prices, and the broken peg between the US Dollar and gold.

What's similar between then and now? Overall financial conditions are historically loose due to easy monetary policies under quantitative easing and low interest rates. The US government has trillions of fiscal spending and sent stimulus checks to all citizens to fight the war on pandemics and recession. Global supply chain issues are not yet resolved, leading to substantial price increases in energy, housing, and food.

We are not suggesting what we see now is the 1970 redux, as other factors such as technology and demographics are undoubtedly deflationary. We know this gap between PPI and CPI will eventually close, either in a nice way or a nasty way. In the nice way, the high cost will work itself out soon, and PPI and CPI both will drop back to less extreme levels, easing the pressure on firms and consumers. In the nasty way, if CPI continues to jump higher, catching up with PPI in the next few months, firms will have no better choice but to pass the costs to consumers.

If CPI does not peak soon, aggressive rate hikes will be more likely on the cards for global central banks. That seems to be what the market is suggesting, especially by the price actions of the US Dollar and short-term interest rate futures. Being long both the US Dollar and agricultural commodities provides a well-balanced portfolio construction for the current non-transitory inflationary environment.

How to play the theme out

A hypothetical investor can consider the following trades¹:

Case Study 1: Short ZAR/USD Future

If the investor were to short the ZAR/USD future (6ZZ1) at around 0.064 and set the stop above 0.068, his maximum loss per contract would be $(0.068 - 0.064) \times 500000 = 2000$ USD. A measured target points to 0.06 and subsequently 0.054, resulting in $(0.064 - 0.06) \times 500000 = 2000$ USD and $(0.064 - 0.054) \times 500000 = 5000$ USD.

Case Study 2: Long Soybean Future

If the investor were to long the Soybean future (ZSF2) at 1280 and set the stop below 1180, his maximum loss would be $(1280 - 1180) \times 50 = 5000$ USD. The initial target points to 1400 and subsequently 1500, resulting in $(1400 - 1280) \times 50 = 6000$ USD and $(1500 - 1280) \times 50 = 11000$ 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.

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

No reproduction, transmission or distribution permitted without consent of **Inspirante Trading Solutions Pte Ltd** (“ITS”). Unauthorized review, dissemination, distribution or copying of this message is strictly prohibited and could subject you and your firm to liability and substantial fines and penalties. If you would like clarification, please email contact@inspirantets.com. The material contained herein is the sole opinion of ITS. This research has been prepared by ITS using information sources believed to be reliable. Such information has not been independently verified and no guarantee, representation, or warranty, express or implied, is made as to its accuracy, completeness, or correctness. It is intended for the sole use by the recipient to whom it has been made available by ITS. The delivery of this report to any person shall not be deemed a recommendation by ITS to affect any transaction in any securities discussed herein. No content provided by ITS, whether contained in this report, the website or otherwise, is providing investment, tax, or legal advice, including but not limited to any advice which is listed as a regulated activity by the Monetary Authority of Singapore. No content should be used or regarded as an offer or solicitation of an offer from ITS to buy or sell securities.

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.