The One-Two Punch

Date: 2021-12-03

Upcoming Economic Events (Singapore Local Time):

- 2021-12-07 11:30 RBA Interest Rate Decision
- 2021-12-08 23:00 BoC Interest Rate Decision
- 2021-12-10 21:30 US CPI (Nov)
- 2021-12-10 23:00 US Michigan Consumer Sentiment Index (Dec)
- 2021-12-16 03:00 Fed Interest Rate Decision
- 2021-12-16 16:30 SNB Interest Rate Decision
- 2021-12-16 20:00 BoE Interest Rate Decision
- 2021-12-16 20:45 ECB Interest Rate Decision
- 2021-12-17 11:00 BoJ Interest Rate Decision

Investors will be focusing on global central banks' interest rate decisions in the next two weeks. The market is gauging if their rate normalization paths will be affected amid the emergence of the Omicron variant and heightened volatilities.

Markets in Focus

Figure 1 Generic 1st E-mini Russell 2000 Index Future

The Russell 2000 Index fell hard back into the 10-month trading range after a false breakout in early November. The equity market seems to have priced in the Omicron variant and the Fed's acknowledgment of the increased risk of persistent inflation.

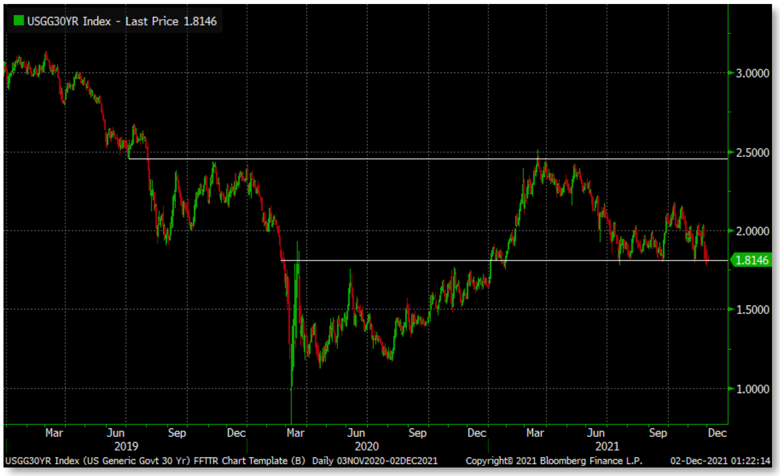
Figure 2 AUD/USD Spot

The US Dollar continues to strengthen, especially against the emerging market and commodity currencies. The AUD/USD pair has completed a 15-month Head-and-Should top and is currently on the verge of breaking lower.

Figure 3 Generic 1st Gold Future

Gold, the traditional inflation hedge, continues its lackluster performance as it registered a series of lower lows. A hawkish Fed and a strong Dollar are certainly headwinds for gold. The price action since the 2018 low resembles the 2009-2012 period. Could gold be facing another multi-year bear market?

Figure 4 US 30 Year Treasury Yield (Daily)



After being rejected at the 2.5% resistance level back in March, the US 30-year Treasury yield continued lower and is now sitting at the 1.81% support, breaking of which would lead to the long-end Treasury yield back to 1.2% level.

Figure 5 US 30 Year Treasury Yield (Weekly)

The weekly chart of the US 30-year Treasury yield demonstrates a remarkably consistent downtrend. It turned down at one standard deviation (s.d.) above the regression mean, and one s.d. below the mean also points to the 1.2% level.

Market Views

A couple of unexpected twists-and-turns happened in the market over the past two weeks. Fed Chairman Jerome Powell told Congress that the Fed is finally retiring the word "transitory" to describe inflation. In early May, we already put ourselves categorically in the "inflation-not-transitory" camp, based on evidence from the central bank policies and various assets' price actions. In acknowledging the increased risks of higher and more persistent inflation, the Fed turns more hawkish and paves the path to potentially sooner rate hikes.

Meanwhile, a second punch to the market came from the new Omicron variant. Crude Oil, among other commodities, is down almost 25% from the recent high in less than two months. On 26 Nov alone, it plunged more than 14%, one of the largest single-day drops in history! The market started to worry about the economic recovery as infection cases spiked in Europe, and countries like Isreal and Japan imposed border controls again.

The hawkish tilt by the Fed and the spread of Omicron have delivered a one-two punch to a thinner-than-usual market near the year-end holiday, leading to selloffs and heightened volatility in various asset classes. Naturally, investors would be looking for safe havens, only to be disappointed by gold ever since its initial rally in the first half of 2020. Fortunately, the long-end Treasury bonds still offered investors some protection even with inflation running hot at the moment.

How to play the theme out

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

Case Study 1: Short Micro AUD/USD Future

If the investor were to short the Micro AUD/USD future (M6AZ1) at around 0.71 and set the stop above 0.75, his maximum loss per contract would be (0.75 – 0.71) x 10000 = 400 USD. A measured target points to 0.62 and subsequently 0.55, resulting in (0.71 – 0.62) x 10000 = 900 USD and (0.71 – 0.55) x 10000 = 1600 USD.

Case Study 2: Short Micro 30-Year Yield Future

If the investor were to short the Micro 30-Year Yield future (30YZ1) at 1.81 and set the stop above 2.25, his maximum loss would be (2.25 – 1.81) x 1000 = 440 USD. The initial target points to 1.2, resulting in (1.81 – 1.2) x 1000 = 610 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.

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