Terminal Rate at 1.75%, You Say?

Date: 2021-12-17

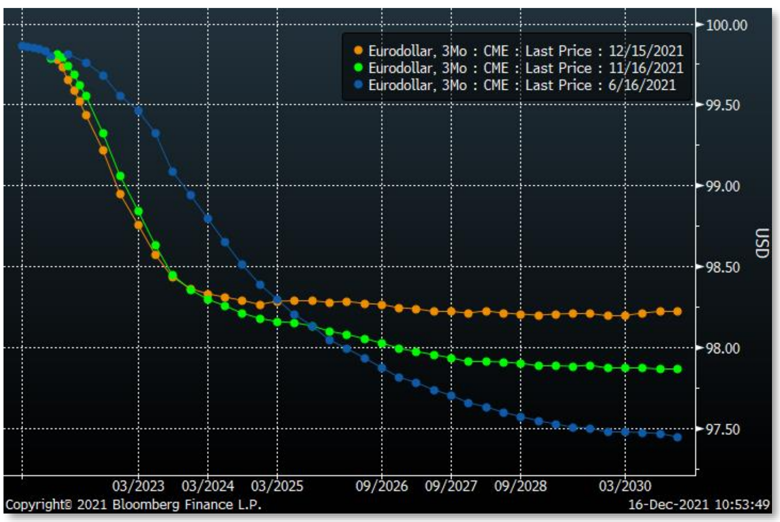
Upcoming Economic Events (Singapore Local Time):

- 2021-12-20 09:30 PBoC Interest Rate Decision
- 2021-12-22 15:00 UK GDP (Q3)
- 2021-12-22 21:30 US GDP (Q3)
- 2021-12-23 21:30 US Durable Goods Orders (Nov)
- 2021-12-24 08:30 Australia Retail Sales (Nov)
- 2021-12-31 09:00 China Manufacturing PMI (Dec)
- 2021-12-31 09:00 China Non-Manufacturing PMI (Dec)

With the last FOMC meeting of the year concluded, we can expect light economic data releases ahead of the holiday season. It is a good time for investors to think about how to position for 2022.

Markets in Focus

Figure 1 Term Structure of the Eurodollar



The Eurodollar curve notably flattened at the backend and steepened at the frontend as compared to six months ago, suggesting the market is pricing in a much quicker rate hike path in the next two years, but a lower terminal rate (1.75% for the three-month Libor) in the long run.

Figure 2 December 2023 Eurodollar Future

The December 2023 Eurodollar future displays a Head-and-Shoulder top with the neckline at 98.2 level (implying a 1.8% Libor rate by the end of 2023).

Figure 3 Green Markets North America Fertilizer Price Index

Fertilizer is a lesser-known market to most investors. Its importance is hugely underappreciated. The Fertilizer Price Index has gone vertical since the beginning of this year, surpassing the previous all-time high in 2008. This high cost will most likely be transmitted to agricultural products and livestock, eventually causing even higher food inflation.

Figure 4 Generic 1st Corn Future

After successfully breaking out from a six-month descending triangle, Corn has subsequently completed a Cup-and-Handle pattern established since August. If the 590-600 resistance level is broken, Corn's uptrend will likely resume at full speed.

Market Views

After officially retiring "transitory" to describe current inflation not long ago, in the last FOMC meeting of the year, the Fed has turned even more hawkish by doubling up the pace of tapering. It is fair to say that the policymakers are now in an inflation-fighting mode.

The remarkable divergence between the PPI and CPI worldwide has not eased. As explained in the November 19 Edition, in our opinion, the most likely outcome in the next few months is for CPI to climb higher as firms pass on high costs to consumers. In other words, higher inflation prints are yet to come.

In this edition, we want to highlight a lesser-known but important market, fertilizers. Human beings have used fertilizers for thousands of years. They replenish the vital nutrients that crops absorb from the soil. Without fertilizers, modern agricultural productivity and crop yields would be nowhere near what they are today.

The Fertilizer Price Index nearly tripled in less than two years, primarily driven by the skyrocketing price of Ammonia, the essential chemicals in fertilizers. The rise in fertilizer prices would have a considerable impact on our daily lives. As the cost of farming goes up, it causes crop prices to go up, which in turn causes livestock and almost every part of our food complex to go up in price, not to mention the potential food shortages in some parts of the world. This is the very definition of food inflation, just with a lag.

Now back to the more familiar interest rate market. The Fed is becoming more hawkish, but the market merely seems to take it half-heartedly. The absolute flatness of the Eurodollar curve from 2024 onwards shows the futures being pinned at 98.25, implying a 1.75% terminal rate for the long run. We could not help but wonder if the market underestimates how severe the inflation situation is and how determined and aggressive the Fed will need to be in rate hikes to contain such inflation.

The terminal Fed Funds rates of the last three cycles are 6.5% in 2000, 5.25% in 2007, and 2.4% in 2019. Is 1.75% really going to be the terminal rate this time, considering the combination of extremely loose monetary and fiscal policies might have overcooked the post-pandemic economy by quite a bit? All we know is, if that turns out not to be the case, the repricing of the Eurodollar market is going to happen rather briskly.

How to play the theme out

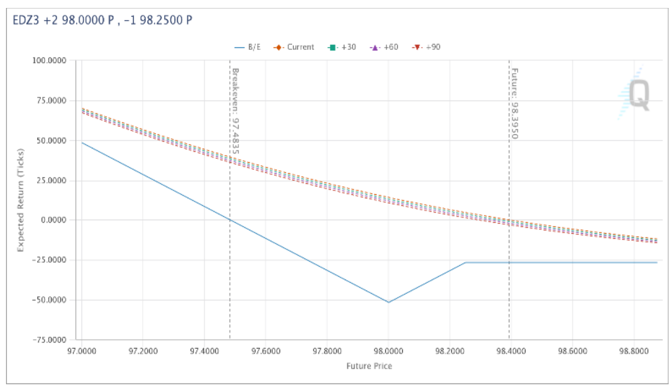
A hypothetical investor can consider the following trades[1]:

Case Study 1: Long Corn Future

If the investor were to long the Corn future (ZCH2) at around 589 and set the stop at 550, his maximum loss per contract would be (589 – 550) x 50 = 1950 USD. An initial target points to 650 and subsequently 700, resulting in (650 – 589) x 50 = 3050 USD and (700 – 589) x 50 = 5550 USD.

Case Study 2: Short EDZ3 98.25x98 1:2 Put Ratio Spread

If the investor were to short EDZ3 98.25x98 1:2 Put Ratio Spread (short 1 EDZ3 P98.25, long 2 EDZ3 P98), the premium paid was 0.25 points (0.25 x 2500 = 625 USD). The maximum loss would be 0.5 points (0.5 x 2500 = 1200 USD), and it happens if EDZ3 expires at 98 (implying a 2% Libor rate). The breakeven point is 97.48, which means the spread would be profitable if the Libor rate is above 2.52% by December 2023.



[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.*

The Rearview Mirror

A look into history could help us position better for the future. This section provides a rundown of market moves across major asset classes between early October and December.

Figure 5 Generic 1st E-mini Dow Future

The Omicron episode caused the Dow Jones Industrial Average index to pull back more than 5%, only to sharply reverse back to near all-time high, as the fear of the new variant eased in the market. Depending on the exact stops placed, our long position established in October escaped the selloff by a hair's breadth.

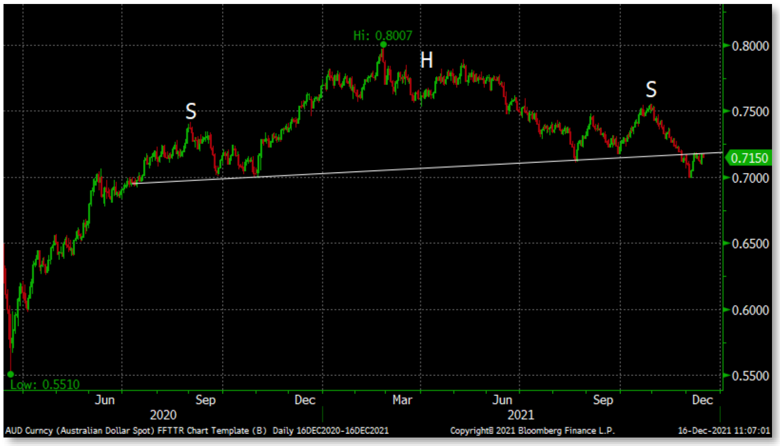
Figure 6 Generic 1st Russell 2000 Index Future

The Russell 2000 Index fell hard back into the trading range and has essentially gone nowhere since February 2021. Even the most recent recovery has been notably weaker than the other major US indices. It turned out to be a false breakout in early November.

Figure 7 Bloomberg US Dollar Index

The US Dollar continued to inch higher after several back-and-forths along the way. It has just broken out from a symmetrical triangle. As the Fed becomes more hawkish, the US Dollar will likely strengthen further.

Figure 8 AUD/USD Spot



The massive Head-and-Shoulder top of the AUD/USD pair was validated by the breakdown in early December, followed by a retest and reject at the neckline. 0.7 is a critical technical and psychological level that, once broken, could mean AUD/USD will likely go much lower. We are still comfortable with our short position established in [early December]().

Figure 9 MXN/USD Spot

MXN/USD also broke the 0.048 support level, retested, and rejected. Our short position from [early October]() have not been challenged yet.

Figure 10 ZAR/USD Spot

Shortly after we flagged out the bearish setup of ZAR/USD in [November](), this pair nosedived and decidedly broke down from the neckline at 0.065 area.

Figure 11 Generic 1st Gold Future

Gold is still unable to catch a bid, even as inflation is running hot. It makes people start questioning if Gold is still the inflation hedge nowadays. Unfortunately, our short position were stopped out in the November spike, only to see Gold quickly fall back into the descending triangle again.

Figure 12 Generic 1st Silver Future

The price action of Silver looks even more miserable than Gold. After failing to sustain the breakout from an inverted Head-and-Shoulder bottom, it plunged to the fifteen-month support level at 22.

Figure 13 Generic 1st Soybean Future

Soybean price has not gone anywhere since we established the long position in November. However, as we elaborated in the Market View, we are still bullish on agricultural commodities next year. The chart pattern also looks like Soybean is about to launch at any moment.

Figure 14 Generic 1st KC Wheat Future

With the completion of the Cup-and-Handle pattern in late October, we established long position in KC Wheat. Since then it has gone up nearly 18%, surpassing our initial targets.

Figure 15 US 10 Year Yield

Our bullish call on the US 10 Year Yield in late September was spot on as the yield went up to as high as 1.7, reaching our initial target in less than a month.

Figure 16 US 30 Year Yield

Early December's drop in the US 30 Year Yield turned out to be a false breakdown. As the equity market quickly recovered from the selloff, the yield went back to above 1.8. We are still holding our short position as a hedge against potential heightened market volatility or risk-off events.

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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