Hold tight

Date: 2022-04-09

Upcoming Economic Events (Singapore Local Time):

- 2022-04-13 10:00 RBNZ Interest Rate Decision
- 2022-04-13 22:00 BoC Interest Rate Decision
- 2022-04-14 19:45 ECB Interest Rate Decision
- 2022-04-14 22:00 US Michigan Consumer Sentiment Index (Apr)
- 2022-04-18 10:00 China GDP (Q1)
- 2022-04-20 09:15 PBoC Interest Rate Decision
- 2022-04-27 20:30 US GDP (Q1)

Global central banks' tightening seems to be at full speed as the Fed finally joined the bandwagon in its last meeting. The notable exception is the PBoC which may still ease further to boost the Chinese economy. The policy divergence is worth keeping an eye on.

Markets in Focus

Figure 1 Generic 1st E-mini Dow Jones Future

Since the middle of March, the Dow Jones index experienced two weeks of a relief rally, which is typical after the market was short-term oversold. It is also a result of the market living through the initial gyration and knee-jerk selling to the geopolitical news. However, the index failed to recoup 35000 above the channel support line, which has now turned into overhead resistance.

Figure 2 Generic 1st E-mini Russell 2000 Index Future

Similarly, the Russell 2000 index could not stay above 2100, a critical support level for more than twelve months. This has become a resistance that has rejected the index's advance multiple times since the beginning of the year. The index will likely find its support only near the 1900 region.

Figure 3 MXN/USD

The MXN/USD pair has been trading in a rectangle range for more than a year. Its recent rally towards the top end of the range was again rejected. As the Fed becomes more hawkish to tighten the financial conditions, the US Dollar is likely to strengthen further against EM currencies such as the Mexican Peso.

Figure 4 AUD/USD

The Australian Dollar has kept its relative strength against the US Dollar lately because of the very strong price actions of the entire commodity space. However, 0.76 has proven to be an important level for AUD/USD. Tighter financial conditions, hence a stronger US Dollar, could set back this pair in the near term.

Figure 5 AUD/NZD

The Australian Dollar has also been outperforming its closest neighbor, the New Zealand Dollar, on a relative basis, as seen by the AUD/NZD pair reaching the upper trendline of its massive eight-year descending triangle. It further suggests that the Australian Dollar is likely to underperform for the next few months.

Market Views

Bill Dudley, former president of the New York Fed, stated on Wednesday (6th April) that "*if stocks don't fall, the Fed needs to force them.*"[1] The idea is that financial conditions need to be meaningfully tightened to curb inflation and prevent the economy from overheating further. As Fed Chairman Powell has clearly expressed in the March FOMC press conference, "*policy works through financial conditions. That's how it reaches the real economy.*"

How could the financial conditions be tightened? Higher short-term interest rates, higher bond yields, wider credit spreads, a stronger US Dollar, and last but not least, a lower stock market. It is not hard to see that rate hikes are but one of the tools to achieve the goal. So far, the interest rate market has already priced in a very aggressive rate hike path (close to 300bps) for the Fed in 2022. The long-end bond yields have had one of the fastest rises in history. Credit spreads are still well contained, and the US Dollar has strengthened against most other currencies.

The problem, however, lies in the resilience of the stock market. After the initial selloff in Q1, the US stock market has rebounded sharply since mid-March. S&P 500 and Dow Jones are both only 6% off their recent all-time highs clipped at the beginning of the year. Financial conditions cannot be meaningfully tightened when the stock market remains elevated at this level. What this means for many equity investors is that the "Fed Put" they subconsciously clinch on could still be quite far down below.

How to play the theme out

A hypothetical investor can consider the following trades[2]:

Case Study 1: Short Micro E-mini Dow Jones Index Future

If the investor were to short the Micro E-mini Dow Jones Index future (MYMM2) at 34500, and set the stop above 35500, his maximum loss per contract would be (35500 – 34500) x 0.5 = 500 USD. An initial target points to 32500 and subsequently 30000, resulting in (34500 – 32500) x 0.5 = 1000 USD and (34500 – 30000) x 0.5 = 2250 USD.

Case Study 2: Short Micro AUD/USD or AUD/NZD

If the investor were to short the Micro Australian Dollar future (M6AM2) at around 0.747 and set the stop above 0.767, his maximum loss per contract would be (0.767 – 0.747) x 10000 = 200 USD. An initial target points to 0.73 and subsequently 0.7, resulting in (0.767 – 0.73) x 10000 = 370 USD and (0.767 – 0.7) x 10000 = 670 USD. Alternatively, to reduce the US Dollar exposure, the investor could construct a short AUD/NZD pair by selling 1 Micro Australian Dollar future (M6AM2) and buying 1 Micro New Zealand Dollar future (M6NM2) at a rate of 1.088. The stop would be above 1.1, and the target would be below 1.03.

[1] *https://www.bloombergquint.com/gadfly/if-stocks-don-t-fall-the-fed-needs-to-force-them, accessed on 8th April, 2022.*
[2] *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

 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 effect 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.