A two-way street for the good ol' mantra

Date: 2022-07-29

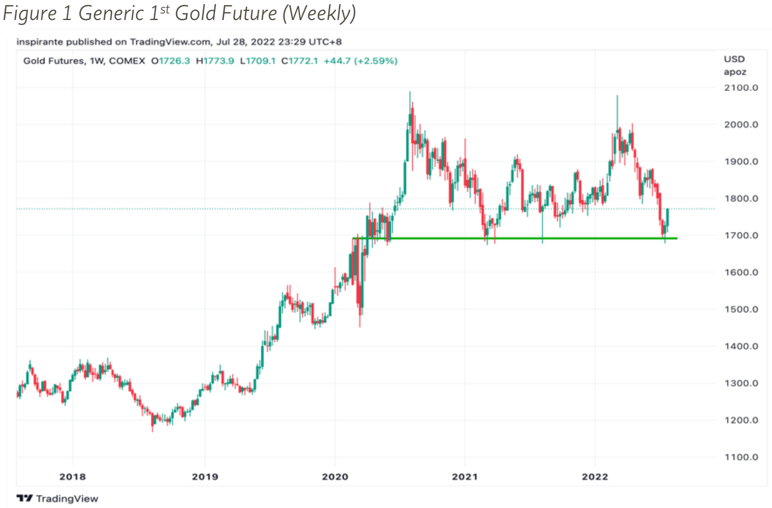
Upcoming Economic Events (Singapore Local Time):

- 2022-08-03 22:00 US ISM Services PMI (July)
- 2022-08-04 19:00 BoE Interest Rate Decision
- 2022-08-05 20:30 US Nonfarm Payrolls (July)
- 2022-08-10 09:30 China CPI (July)
- 2022-08-10 14:00 Germany HICP (July)
- 2022-08-10 20:30 US CPI (July)
- 2022-08-12 22:00 US Michigan Consumer Sentiment Index (August)

With the Fed hiking another 75bps as the market expected, headline inflation numbers still have not shown signs of peaking. However, recession fear has already caused the market to price in the "Fed Pivot" next year.

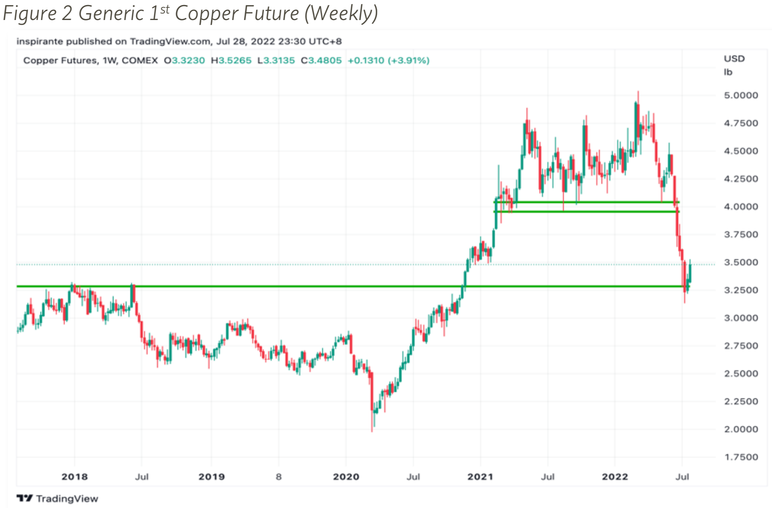
Markets in Focus

Figure 1 Generic 1st Gold Future (Weekly)



After a sharp selloff in June, gold finally found footing and rebounded at the two-year support level near 1700. Gold's lackluster performance this year disappointed many investors who believed that gold was an inflation hedge. It remains to be seen whether gold is forming a double top or continues to consolidate in the 1700 - 2100 range.

Figure 2 Generic 1st Copper Future (Weekly)



We flagged out the potential bearish case for copper back in May due to hawkish central bank stances and a strong US Dollar. The copper price has fallen off the cliff since the 4.00 level was broken. Like gold, the extended down-move was finally reversed at the significant support level around 3.25. However, if this level cannot hold, the next potential support is only at 2.50.

Figure 3 Soybean Oil Future (December 2022 Contract)

Soybean oil is among the first agriculture commodities to have meaningfully rebounded after the past few weeks' relentless selloffs. It has not only found its support at the long-term trendline but also broken out from an inverted Head-and-Shoulder, suggesting that the short-term bottom is already in. The outlook will be even more bullish if the follow-through price action can break the 63 – 64 resistance level.

Figure 4 Soybean Meal Future (December 2022 Contract)

Soybean meal has decidedly broken out from a six-month bull flag and resumed its rally. Together with soybean oil, it does present the possibility that the recent soft commodity selloff is largely over. Fundamental issues on food shortage are likely once again to be the main driver of pushing up the prices.

Figure 5 Lean Hog Future (December 2022 Contract)

Lean hog has exhibited some very neat technical patterns since last year. After breaking out from the uptrend channel in May, it has consolidated in a rectangle range for three months. It is now at the upper resistance of the range and could be breaking out soon. We still maintain a bullish bias on meat products because the cost of feed continues to go up.

Market Views

“Unsurprisingly,” the Fed delivered another 75bps rate hike in the July FOMC meeting. Even though this was fully anticipated and priced in by the market, if we were to put it in historical context, it is still quite something to behold. Before the current hiking cycle, the last time Fed hiked 75bps was in 1994. Moreover, Fed hiked two 75bps consecutively for the first time since the 1980s. And it is highly likely they have not been done yet! This just proves the sheer determination of the Fed, and many other central banks, to tame this multi-decade high inflation.

There are few wiser saying in the market than “Don’t fight the Fed.” It has truly stood the test of time and market cycles since the beginning of the quantitative easing (QE) era. For many investors, however, the implicit understanding of this mantra is not to fight the Fed only on the way up. On the other hand, we argue that it is equally valid on the way down when the Fed is aggressively and decisively tightening the financial conditions to curb growth and excessive demand. Looking at the Short-Term Interest Rate markets (Eurodollar and Fed Funds futures), the market has already priced in the “Fed Pivot,” i.e., the first full rate cut, in early 2023. We couldn’t help but wonder if the market has once again gotten ahead of itself and vastly underestimated Fed’s willingness to do more if needed.

Comes with the “Fed Pivot” anticipation is the “Bad news is good” market phenomenon that investors are all too familiar with. Risk assets rallied on worse-than-expected economic data, which reinforced their prior belief. Indeed, many assets have had a decent rally after a dismal first half. We believe that the real stuff, i.e., energy, base metals, and agricultural commodities, have a much better chance to sustain the upmove than the equities, simply because the world is still very short of those, notably energy and food. Many commodity charts are showing signs of bottom reversals. Investors should acknowledge the possibility that we could have a recession AND high commodity prices simultaneously. In that regard, instead of fighting the Fed and chasing equity bear market rallies, we believe commodities offer a much more attractive risk/reward at this point.

How to play the theme out

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

Case Study 1: Long Soybean Oil Future

If the investor were to long the Soybean Oil future (ZLZ2) at 63 and set the stop below 58, his maximum loss per contract would be (63 - 58) x 600 = 3000 USD. An initial target points to 68 and subsequently 78, resulting in (68 – 63) x 600 = 3000 USD and (78 - 63) x 600 = 9000 USD.

Case Study 2: Long Lean Hog Future

If the investor were to long the Lean Hog future (HEZ2) at 87.5 and set the stop below 84.8, his maximum loss per contract would be (87.5 – 84.8) x 400 = 1080 USD. An initial target points to 90 and subsequently 92, resulting in (90 – 87.5) x 400 = 1000 USD and (92 – 87.5) x 1000 = 1800 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