Third time's the charm?

Date: 2022-09-09

Upcoming Economic Events (Singapore Local Time):

- 2022-09-14 14:00 UK CPI (August)
- 2022-09-15 19:00 BoE Interest Rate Decision
- 2022-09-15 20:30 US Retail Sales (August)
- 2022-09-16 22:00 US Michigan Consumer Sentiment Index (September)
- 2022-09-22 02:00 Fed Interest Rate Decision
- 2022-09-22 11:00 BoJ Interest Rate Decision
- 2022-09-27 20:30 US Durable Goods Orders (August)

Another 75bps rate hike is on the table for the upcoming FOMC meeting. That would bring the Fed Funds rate to above 3%. What happens next?

Markets in Focus

Figure 1 US Dollar Index (Monthly)

The US Dollar index just clipped the two-decade high above 110. Both emerging market (EM) and developed market (DM) currencies have got hit. A strong US Dollar and high energy prices are a double whammy that spells trouble for many debt-laden and importing economies. Note the three distinct Dollar spikes since the 1970s, two decades apart from one another. How high can it go this time?

Figure 2 Generic 1st Gold Future (Weekly)

Gold has been utterly disappointing for investors who believed it to be an inflation hedge. As we are still in the greatest inflation environment since the 1970s, gold is trading at the same level as April 2020! Positive real yields and a strong US Dollar are certainly headwinds for gold, which could be forming a two-year double top. The 1700 support level has halted two major declines in 2021. Maybe the third time is the charm?

Figure 3 US 10y2y Treasury Yield Curve (Monthly)

The US 10y2y treasury yield curve is the most inverted since 2001, driven by the fact that the front-end of the curve has priced in aggressive rate hikes. It is currently near the floor between -0.1% and -0.5%, which marked the bottom in both 1989 and 2000. Would this floor hold for the third time?

Figure 4 December 2022 Wheat Future

Since late 2021, wheat has formed three well-defined symmetrical Head-and-Shoulder (H&S) patterns. In early 2022, when the inverted H&S bottom was broken out, wheat price went up 58% in three months. Subsequently, after the H&S top was broken down in June, price dropped 30% in two months. Right now, we could be looking at the third time that an H&S was broken out, and wheat price will take off soon.

Figure 5 December 2022 WTI Crude Oil Future

Crude oil has been consolidating within a $10 range for the past two months. However, the critical support level at 84 was broken on Wednesday. It seems the bears might finally have the upper hand.

Market Views

Joining many other major central banks, the European Central Bank (ECB) raised interest rates by an unprecedented 75bps and signaled further hikes to come. It is still unclear, though, how raising interest rates could solve the severe energy shortage that is wreaking havoc on many European countries. As winter approaches, the energy crisis we see is likely to worsen.

The US is facing a somewhat different inflation issue on the other side of the North Atlantic Ocean. Economic activities are still overheating in the US, and the Fed is trying to use its policy tools to curb demand and growth in the hope of bringing down inflation. To us, the current market felt more like the 2000 Dotcom era. It was an equity market valuation bubble, not so much a credit bubble event like the 2008 Great Financial Crisis that had posed systemic risks to the entire financial system. The implications are that the Fed will probably tolerate much more equity market pains, and beyond rate hikes, there's more in its toolbox.

In our opinion, a bear steepener, namely the bear steepening of the treasury yield curve, could be one of the potential tools. It means lifting the long end of the yield curve much more than the short end. Legendary investor Stanley Druckenmiller recently offered a very sobering observation that in US history, "once inflation gets above 5%, it's never come down unless the Fed Funds rate is higher than the CPI." We wonder how feasible it is to have interest rates anywhere near the headline CPI under the current environment. On the other hand, bear steepening could hypothetically tighten financial conditions while keeping the short-term funding market behaving normally.

As an added benefit, bear steepening might also help ease the stress of a rapidly strengthening US Dollar. Many other central banks have been stuck between a rock and a hard place for the better part of the year. They are confronted with tough choices between raising rates quickly (thus risking recessions) and losing control of the local currencies as the US Dollar ripped higher. Bear steepening caps the short end rate at 3-4% and lets the long end do more of the heavy lifting from there on, thus providing other central banks a much-needed breather.

How to play the theme out

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

Case Study 1: Long US 10y2y Treasury Yield Spread

If the investor were to long the US 10y2y treasury yield spread (buy 10YU2 and sell 2YYU2) at -0.2 and set the stop below -0.5, his maximum loss per spread would be (-0.2 – (-0.5)) x 1000 = 300 USD. An initial target points to 0.5 and subsequently 1.5, resulting in (0.5 – (-0.2)) x 1000 = 700 USD and (1.5 – (-0.2)) x 1000 = 1700 USD.

Case Study 2: Long Wheat

If the investor were to long wheat future (ZWZ2) at 840 and set the stop below 780, his maximum loss per spread would be (840 – 780) x 50 = 3000 USD. An initial target points to 950 and subsequently 1050, resulting in (950 – 840) x 50 = 5500 USD and (1050 – 840) x 50 = 10500 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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