Food for thought

Date: 2022-06-17

Upcoming Economic Events (Singapore Local Time):

- 2022-06-22 14:00 UK CPI (May)
- 2022-06-27 20:30 US Durable Goods Orders (May)
- 2022-06-29 20:00 Germany HICP (June)
- 2022-06-29 20:30 US GDP Annualized (Q1)
- 2022-07-01 17:00 Eurozone HICP (June)
- 2022-07-04 22:00 US ISM Manufacturing PMI (June)
- 2022-07-05 12:30 RBA Interest Rate Decision

Many central banks have already made aggressive moves in rate hikes. Investors should watch the Eurozone data closely as the unprecedented inflation has put the ECB to one of the most challenging tests since its inception.

Markets in Focus

Figure 1 US Dollar Index (Weekly)

The US Dollar has broken out from an 8-year symmetrical triangle in the latest risk-off Dollar rally. The breakout happened in April and was confirmed by the subsequent retest of the triangle's upper resistance, which now has become a strong support at 102. A rapidly rising US Dollar threatens risk assets, especially commodities and emerging markets.

Figure 2 EUR/USD (Weekly)

EUR/USD has bounced off its significant support level at around 1.04, which has held since 2015. Even though Euro is the largest constituent in the US Dollar Index, as shown in Figure 1, the EUR/USD pair has not yet broken this support. Euro will quickly strengthen if the ECB starts to get more hawkish to try to curb record-high inflation in Europe.

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Figure 3 Soybean Meal September 2022 Future

The September 2022 Soybean Meal contract has formed a well-defined Head-and-Shoulder (H&S) top. The neckline suggests that 390 is the key level to watch, breaking of which would complete the H&S pattern and start the next leg lower.

Figure 4 Soybean November 2022 Future

The November 2022 Soybean contract looks more bullish than Soybean Meal. Its uptrend is still intact as it has broken out from the symmetrical triangle, backtested, and resumed climbing higher. Soybean is among the few commodities that have not experienced substantial drawdowns in the recent risk-off moves.

Market Views

Global central banks were at the very center of the stage in the past two weeks. The Federal Reserve hiked its benchmark interest rate by 75bps, the biggest since 1994. “If we don’t see progress… that could cause us to react. Soon enough, we will be seeing some progress,” said Fed Chairman Powell at the FOMC post-meeting press conference. The message cannot be any clearer. The Fed is determined to bring soaring inflation under control, with all necessary tools at its disposal. Until the goal is achieved, we could not dismiss the possibility of a series of similarly aggressive hikes. A recession, unfortunately, may be the unintended collateral damage. Many even argue that only a recession can bring us out of the inflation trap.

On Thursday, the Swiss National Bank (SNB) unexpectedly hiked interest rates by 50bps, the first hike since 2007. The SNB has shifted its focus from taming a strong Swiss Franc to curbing inflation. At the same time, the European Central Bank (ECB) held an emergency monetary policy meeting after bond yields surged for many governments in the Eurozone, especially Italy, a reminiscence of the European Sovereign Debt Crisis in the mid-

2010s. The difference in "perceived hawkishness" between the Fed and the ECB makes Euro sitting at the decade low against the greenback. Perhaps not for long, not until the ECB pivots.

It is plainly obvious now that most of the central banks are in the "whatever-it-takes" mode to fight inflation we have not seen in many decades. Without getting too academic, we should note the distinct differences in the cost-push vs. demand-pull factors that resulted in inflation. The former occurs when producers have to raise prices due to increased production costs. It occurs on the supply side. The latter arises when growth in demand outpaces growth in supply, leading prices to surge. The current inflation, unfortunately, is a combination of both. We have all sorts of shortages, pushing up the prices of raw materials and labor costs. The supply chain is still disrupted, and some argue that globalization is being reversed. On the other hand, we have hugely increased aggregate demand from households, businesses, governments, and foreigners, due to the unprecedented post-pandemic stimulus injected into the economy.

The most commonly used tightening tool so far is to increase the benchmark interest rates in an attempt to cool down the overall economic activities. Unfortunately, rate hikes help very little in solving the supply-side issues. That is probably why central banks need to be as aggressive as possible to pull the trigger on the demand side of the equation. Economists call it "demand destruction."

However, in economics, the reality is always much more complex than the textbook assumes. Is it really possible to kill the demand for energy as people still need to fill the tank to go to work? What to do with the need to stay warm to survive the winter? And then there is food. People in some countries are running out of food. There are basic human needs to meet for survival. Arguably, rate hikes have limited effects even on the demand side of the equation to tame inflation.

The recent market rout has inevitably dragged down all risk assets, including most commodities such as energy and agriculture. We are still long-term bulls on energy and food prices. The current substantial correction in agriculture commodities excited us as the opportunity to re-establish the long positions may be very near.

How to play the theme out

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

Case Study 1: Long Soybean Future

If the investor were to long the Soybean Oil future (ZSX2) at 1537 and set the stop below 1510, his maximum loss per contract would be (1537 – 1510) x 50 = 1350 USD. An initial target points to 1600 and subsequently 1650, resulting in (1600 – 1537) x 50 = 3150 USD and (1650 – 1537) x 50 = 5650 USD.

Case Study 2: Long EUR/USD Future

If the investor were to long the EUR/USD future (6EU2) at 1.056 and set the stop below 1.04, his maximum loss per contract would be (1.056 – 1.04) x 125000 = 2000 USD. An initial target points to 1.08 and subsequently 1.12, resulting in (1.08 – 1.056) x 125000 = 3000 USD and (1.12 – 1.056) x 125000 = 8000 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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