

MI2 Trader: EDs

9th August 2021

Comment

On Friday, we highlighted a nuanced shift in rhetoric from the BoE and surmised that the “trailblazer economy” trades in the UK might be about to be reinvigorated. Part and parcel of that was a recognition that the post-Covid recovery had been short-circuited by the arrival of the delta variant, which wreaked havoc with the government’s optimism for accelerated re-opening measures.

Similarly, with respect to the US, the level of complacency about Covid three months ago was palpable. Clearly, that is no longer the case. Combine Clarida’s mumbling about the delta variant most likely having something to do with the bond rally with headlines about P/L accidents at hedge funds and the hyperbole of the popular press, and it is reasonable to question whether we have seen “peak-fear” for this episode.

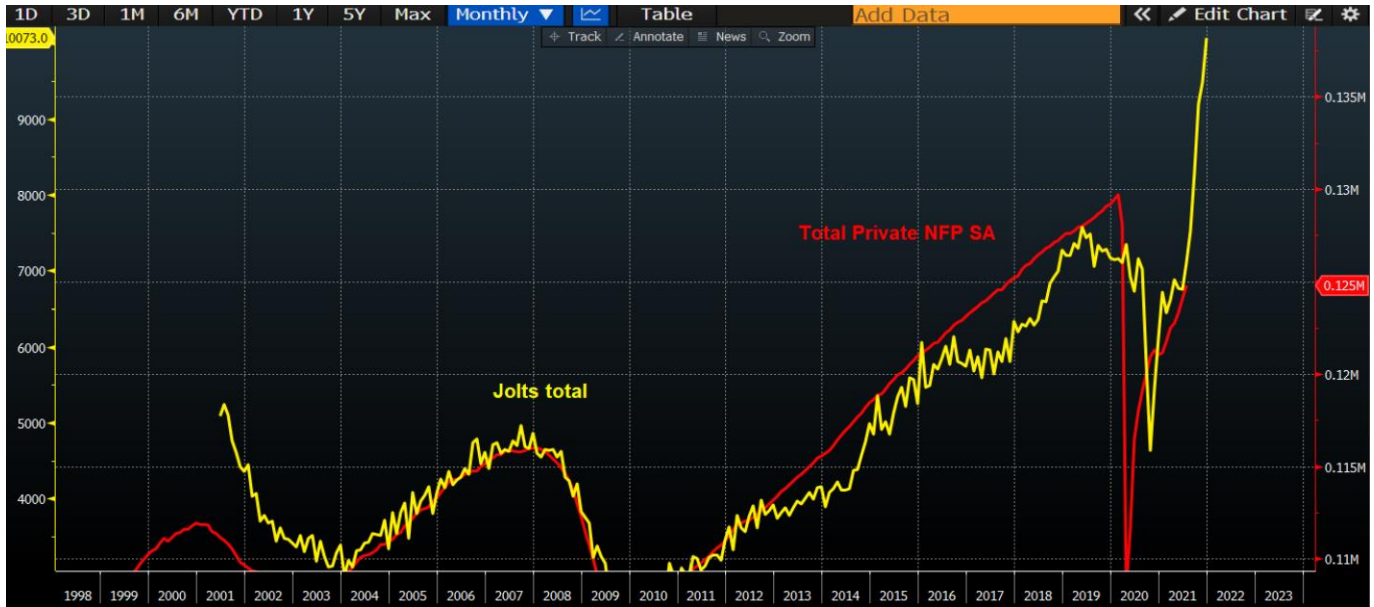


Back in the real world, the whisper number for payrolls turned out to be more accurate than our reliance on the usually reliable data parsing of the ISM and ADP supremos.

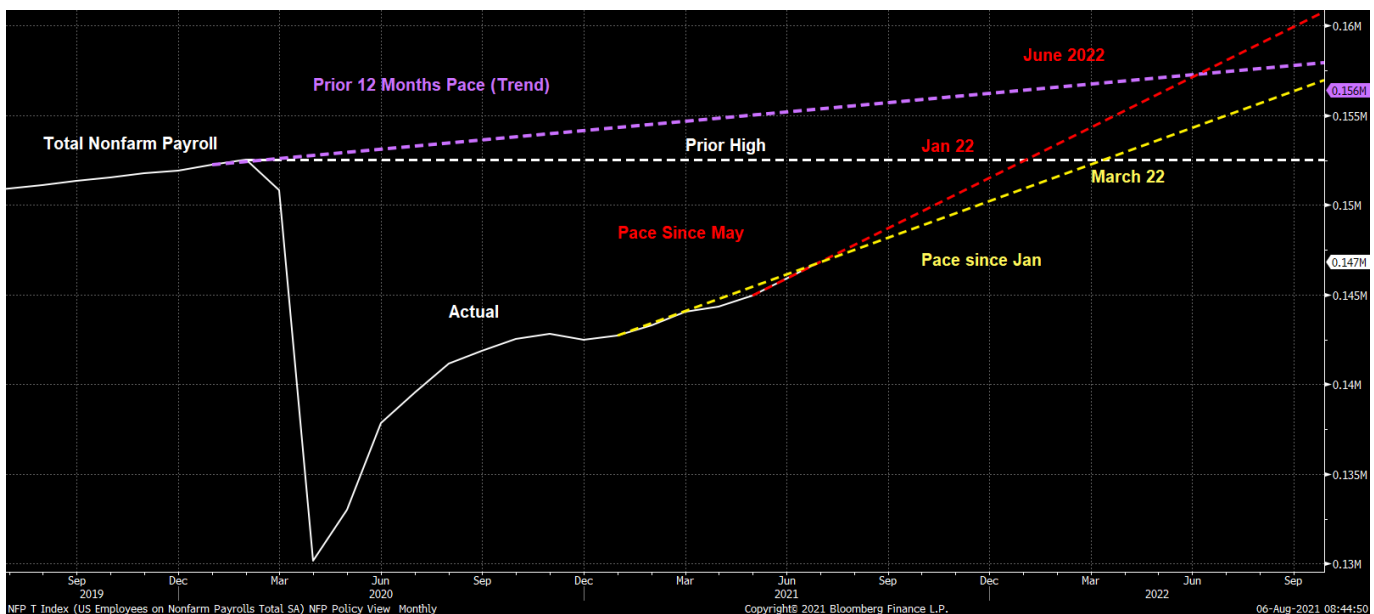
“Bottlenecks in hiring continue to hold back stronger gains, particularly in light of new COVID-19 concerns tied to viral variants. These barriers should ebb in coming months, with stronger monthly gains ahead as a result.”

With Friday’s high print and today’s JOLTS data, which we literally can’t fit on the charts, our hope for transitory weakness in employment to provide better entry levels into “strong growth” trades has essentially evaporated.

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Indeed, after NFP, we updated our output gap/employment “MI2 dot-plot” that we discussed in our latest video. The result is a six-month acceleration in the optimistic (red) assumption of when we will hit trend employment and a nine-month move in the more conservative trend (yellow).



This brings the Dudley scenario back into play:

“Stage three (of the inflation process) will arrive when the economy reaches full employment, and inflation has reached 2% and is expected to keep climbing. At this point, the Fed will start increasing short-term interest rates. The tightening process will probably have to happen quite briskly — perhaps at a rate of about 2 percentage points a year — given that there will be a long way to go

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from near zero to a level that would make monetary policy restrictive. If inflation were to surprise on the high side, the Fed might have to move even faster."

-Bill Dudley, 23rd February

Trade

If the above is a correct interpretation, and the Fed really does go 200bps a year, then the bear-curve flattening is just beginning. This makes the front end of the market the place to focus your mind. The chart below, which we first showed you at the start of the year, shows a longer-term history of ED11, which is currently March 2024 ("MI2 Trader: Eurodollars Timber?" 12th Jan)



Zooming in and looking at our preferred point on the curve of December 2023, we are using the outside-week reversal in EDZ3 as our trigger. There are two or three possible variations to the trade. The first is the simplest: sell EDZ3 ~99.00 with a target of somewhere close to 98.00 and a stop above last week's high, giving you a better than 4:1 pay-out on a multi-month timeframe. Roll down and carry are against you, of course, but if we just saw peak fear, that should be no material impediment. The second version is not easily executed at scale but captures the idea quite nicely: EDZ3 98.50 / 98.00 put spreads give a roughly 6:1 pay-out at official rates over 2%. Swaption traders can capture something similar with variations on this theme; for example, the 1y2y 1.50% strike payers or 1.25% -1.75% payer spreads.



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