Market Thoughts, Central Banks, CPI, and Kimchi
June 10, 2018, Arthur Bass

This week the Fed is expected to tighten 25bp, the ECB to discuss ending QE (maybe), and the BoJ to continue its stimulus. We will also get CPI, retail sales, and President Trump meets with Kim Jong Un. The World Cup also begins Thursday, but that will probably be more of a trading distraction. Core CPI has been greater than 2% the past two months and is expected to rise from 2.1% to 2.2%, although the year earlier levels were influenced by the "transitory factors" Yellen frequently referenced, such as cell phone plans. Monthly core CPI is expected to rise 0.2% vs unrounded 0.098% last month. We previously stated the Fed's biggest risk is that they achieve their goal with inflation, and continue to feel that is the case, as the market could be forced to price in a more aggressive tightening path. As seen below, fed fund futures are pricing substantially lower rates than the median Dot for both 2019 and 2020, obviously reflecting markets banking on an end to the tightening cycle.

FOMC March Dots for Fed Effective:

	Median	Central Tendency	Fed fund futures	Spread to Median
2018:	2.1%	2.1-2.4	FFF9 97.77 = 2.23%	12bp higher
2019:	2.9%	2.8-3.4	FFF0 97.375= 2.625%	27.5bp lower
2020:	3.4%	3.1-3.6	FFF1 97.33 = 2.67%	73bp lower

The table above shows that Fed Fund futures are pricing in 27.5bp lower rates for 2019 than the median Dot and 73bp lower for 2020.

One of the key points to be gained from the Fed meeting is whether the June Dots will project one or two additional moves this year following the expected move this week. The March Dots indicated one additional move, but responses were not far from two. Recent Fed comments have implied there could be a 4th Dot for 2018. Fed fund futures are currently pricing in 1.25 additional moves assuming the Fed tightens this week. Incoming NY Fed President Williams recently stated, "The Federal Open Market Committee has indicated a total of three to four rate increases this year and further gradual rate increases over the next two years will be appropriate. I view this to be the right direction for monetary policy." Fed Governor Brainard, a traditional dove, has shifted in recent comments, stating, "I continue to view gradual increases in the federal funds rate as the appropriate path, although I will remain vigilant for the emergence of risks and prepared to adjust if conditions change."

Another key point from the meeting will be if the Fed follows through on the 20bp increase in IOER that was discussed in the minutes to the May meeting. Fed funds have been trading 5bp under IOER. If the 5bp spread to IOER continues, FFN8 would be 98.10 if the Fed tightens in June. The fact FFN8 settled 98.09 indicates the market is pricing the spread as 4bp, assuming IOER is only raised 20bp.

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TECHNICALLY, it remains to be seen whether the recent rally in EDU0 was the beginning of a new move or merely a bear market correction. **EDU0** fell almost 140bp from September to May, and the two week rally retraced slightly less than a 38.2% Fibonacci correction. Both MACD and stochastics are again negative, and RSI is relatively neutral at 48. Green Sep broke through the steep downtrend line on the rally, but is still within a shallower sloped downward channel. I am leaning toward the bear market correction camp, and will look for a test of the May low of 96.82. With three central bank meetings, CPI and Trump, there should be enough news to provide some directionality.

EDU0

TYU8 is also within a shallower downward channel, but the oscillators are more balanced. Stochastics are negative but MACD still positive. RSI is neutral at 51. Immediate support is at Thursday's low of 119-04. I also view the recent move in TYU as a bear market correction, but with less conviction than EDU0.

TYU8

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E$ Midcurves on front contracts launch Sunday evening

As seen in the link below, the CME is introducing short dated options on front contracts Sunday evening. There will be July, August and September expirations on the Z8, H9 and M9 contracts.

http://www.cmegroup.com/trading/interest-rates/stir/eurodollar-options.html

TRADE IDEAS

Downside Trades in Green July/Sep

2en8 96.875/96.625 put spread settles 4.25
2en8 96.875/96.625/96.375 put fly settles 3.75

2eu8 96.875/96.625/96.50 broken put fly settles 5.25
2eu8 96.875/96.625/96.375 put fly settles 4.25
2eu8 96.875/96.75 put spread settles 3.25
ref EDU0 96.985

Midcurves vs Greens Downside

The key assumption behind this strategy is that short Sep (EDU9) will have difficulty getting a lot below 96.87 because EDU9 only has four quarterly meetings beyond September. At current fra/ois, if we price the Fed going in June and September (0eu8 options expire 12 days before the 9/26 meeting), 75% prob of going in December, and 50% prob of March, next June & next Sep, EDU9 would be 96.93. Green Sep would have four additional meetings to price in.

2eu8 96.875/96.625 vs 0eu8 96.875/96.625 put spd cal settles 2.75bp 2eu over
2eu8 96.75/96.50 vs 0eu8 96.875/96.625 put spd cal settles 0.25bp 2eu8 over
2eu8 96.75/96.50 vs 0eu8 96.875/96.75 put spd cal settles 1.75bp 2eu8 over 25bp vs 12.5bp wide
Ref EDU9 97.075 EDU0 96.985

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Fed go June/Skip September

Fed go June/on hold Sep => EDU8 97.71 @ current fra/ois.

EDU8 97.625/97.75 call 1x2 settles 0.75bp

Upside breakeven is 96.8675.

The 1x2 does have a risk if the Fed skips both June and Sep, although skipping June seems a very low probability at this time. EDU8 would be ~ 97.96 if the Fed skips both meetings.

Alternative trade:

EDN/EDU8 97.625/97.75 call spread calendar settles 1.25bp

At current fra/ois, assuming the Fed moves this week, we need to price in less than 35% probability of a move in September by July expiration for EDU8 to be above the 97.625 strike, although it did get to 97.64 at the height of the Italy scare. For 0.5bp more than the 1x2, one does not have the upside exposure from the Fed on hold in June. EDU8 currently 97.535.

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