SPECTRA MARKETS

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am FX

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If you can guess what this is, you are even smarter than I thought you were

Current Views

Bullish EURGBP
Long 18MAR 0.8550 EURGBP digital call at 24% (spot ref. 0.8426)

Bullish AUDCAD
Long 22FEB 0.91 AUDCAD call
Cost 26bps, spot ref 0.9050

2/2/22: moved the stop losses on two spot trades to entry point

Short USDCHF @ 0.9300
Original stop loss was 0.9381
Take profit 0.9111

Long AUDUSD 0.7041
Original stop loss was 0.6984
Take profit 0.7219

Parabolic

One of my favorite currency strategists back in the day was Ken Landon of JP Morgan. He published a great piece called the “Landon Lowdown.” One thing he wrote about more than most was the impact of yield curves on FX. If I’m 100% honest, I found it was a framework that applied sometimes and not other times, so it wasn’t always useful but at certain points in the cycle, there was a ton of information in the relative direction and magnitude of changes in yield curves around the world.

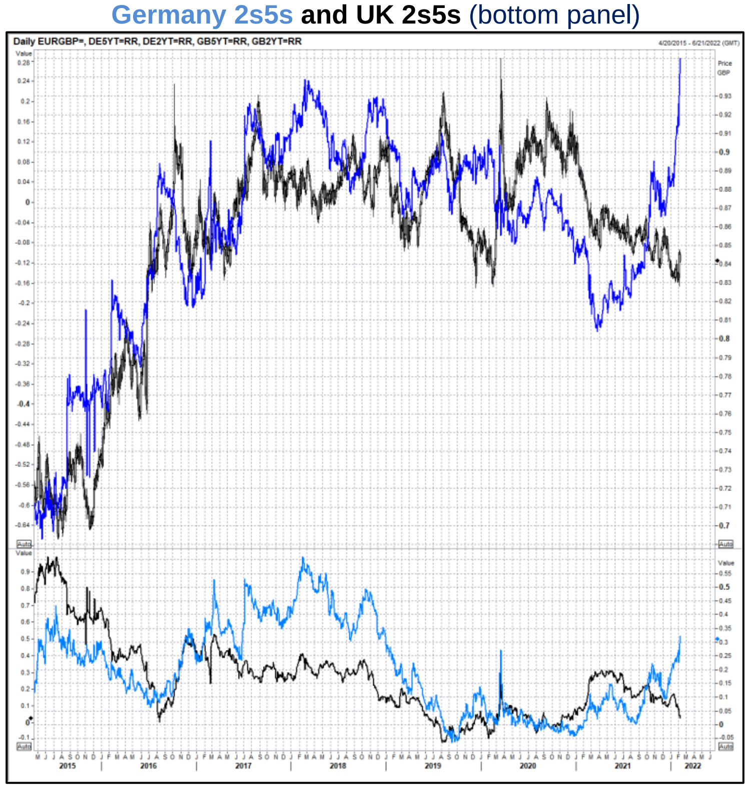
I think this is one of those times where the framework is useful.

BoE communication after the near-miss on 50bps has been more dovish than one might expect. They seem to be worried about hiking into weakness, and they are keen to impress upon the market that this may or may not be the start of a true rate hike cycle. They understand the fragility of the system and how things work in a debt trap. UK rates started their big run last September; the BoE hiking story has been around a while.

In contrast, German rates made a last push lower in Q4 and were still at “nothing to see here!” levels at Christmas. Then whoosh. So the EU rate move is a newer, fresher story. Straight up rate differentials don’t offer much signal for EURGBP right now but take a look at the change in relative yield curves.

The blue line on the top panel shows Germany 2s5s vs. UK 2s5s. The blue line going up is Germany steepening relative to the UK. The black bars are EURGBP. The bottom panel shows 2s5s for each country so you can understand what’s driving the blue line in the top panel.

EURGBP vs. relative 2s5s Germany / UK (top panel)
Germany 2s5s and UK 2s5s (bottom panel)

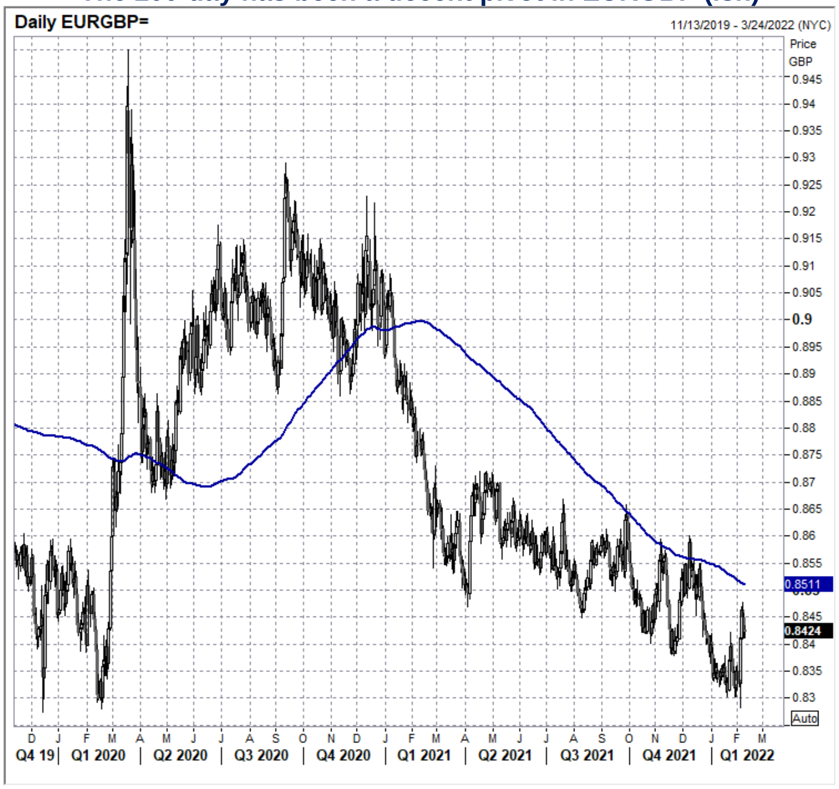


HT The Real Shim Shady

Why does this make sense? As a general rule, steeper yield curve means “good hikes” or the central bank is hiking into a strong, reflationary economy. Flattening means the market does not think the hikes will persist and it’s more likely the central bank is hiking into weakness[1]. At the extreme, the inversion of the yield curve is one of the best predictors of recession and so the flatter one curve gets relative to another getting steeper, you would expect that things look somewhat rosier in the place that’s steepening. I view this as bullish EURGBP, and you can see that’s how it has traded since 2015 or so.

This is not a tick-for-tick correlation where you just assume EURGBP is going to be 300 points higher tomorrow. You need to give it a bit of time and room. As a spot trade, I would say long here (0.8426) with a stop at 0.8340 makes sense but the **much better play is to buy 18MAR 0.8500 calls or 18MAR 0.8550 digitals**. The chart has plenty of open air above the 200-day (currently 0.8511, see below). I chose 18MAR because that is the Friday after the next Bank of England meeting (and FOMC). Probably a good catalyst to own. That third week of March is going to be pretty epic. I have added the 0.8550 digi to the sidebar I think it’s a 4.5-star idea (higher conviction than average). It costs 24% (indicative price off 0.8426 spot).

The 200-day has been a decent pivot in EURGBP (ish)



CPI

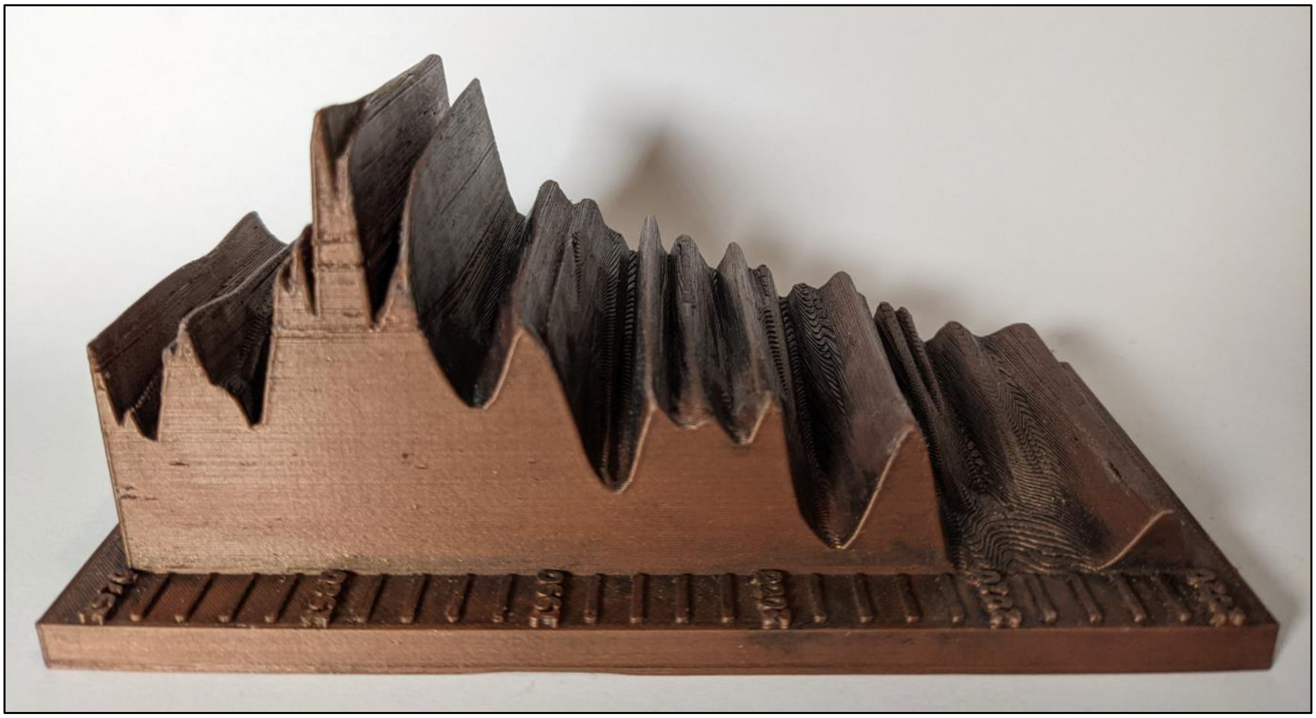
Finally, the vibe into US CPI is risky asset bullish and USD bearish. I think I feel the same way, but the unanimity is starting to make me nervous.

Have a multidimensional day.

good luck ⇅ be nimble

[1] This is a simplified but accurate explanation. There are other drivers of the yield curve but most agree the primary drivers of YC shape are expectations and risk premium.

50 years of US yields, 3D printed!



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