macro scan

Thursday, January 9th, 2020

Mark Orsley – Head of Macro Strategy

- ***WTI once again failing at the upper end of its average range on the back of peak Iran tensions***
- ***Lower oil another poor reflation signal***
- ***Year end turn success, healthy ample reserves, and parabolic equities will all lead to reduced Fed repo ops (less liquidity injections coming)***
- ***Own gamma for all the reflation risk catalyst over the next month: TYH0 130/132 call spread screens top***

Obviously the big news is the cooling of tensions between the US and Iran:

- Trump highly conciliatory speech: "ready to embrace peace with all who seek it; make a deal with Iran that makes the world a more peaceful place."
- Pence: Iran is sending messages to militia groups not to move against US targets
- Iran UN Ambassador called for "regional cooperation to restore peace and stability"
- Iran may request help from the US in investigating the Boeing crash yesterday

This whole affair will eventually lead to the US and Iran renegotiating the terms of JCPOA. From Trump's side it tears up an Obama deal he has long criticized, and Iran's economy has been crippled by sanctions so there is willingness to talk on their end as well. Qasem Soleimani was a hard liner so his "removal" makes the negotiations more reasonable.

Could a surprise 2020 outcome (similar to North Korea in 2019) be Trump ratifying a new nuclear treaty with Iran in exchange for sanction removal ahead of the November elections?

The understandable implication to cooling Middle East tensions is lower oil. As we discussed in the year end Costanza piece (who is already in the money on his sale), WTI has been in a range for the past five years with the exception of two episodes. It is therefore noteworthy that once again, WTI failed at the upper end of that range.

Take note that neither the bombing of Saudi Arabia's most important pipeline (Abqaiq) nor a near war between the US and Iran was enough to cause a range breakout. That is usually a signal of a near term market top.

Back on September 30th, we argued to buy the dip in WTI post Abqaiq pipeline attack due to brewing US production issues. Now that WTI has returned back to the upper end of the band, the risk/reward at this point is lower oil back to its mid-point.

For fixed income minded, this will add a new headwind for breakevens.

Big picture, the main takeaway should be that lower oil will be another poor reflation signal. As we discussed on Tuesday, this comes at a time when the risks of a reflation reversal (temporary only) are building:

- Global growth starting to look soggy again – World Bank just cut 2019 and 2020 global growth forecast
- Fed repo operation decision on January 14th – more on that below
- The inking of Phase 1 (or not) – all signs still point to a deal though China's Vice Ag Minister casted some doubts this week
- The January FOMC meeting which could very well see an interest on excess reserve rate HIKE (coupled with reduced repo ops would be a hit to the central bank liquidity theme)
- February 3rd Iowa caucus and the February 11th New Hampshire caucus – both have Bernie near the lead so the far left, market unfriendly candidate could hold the lead into Super Tuesday with building momentum

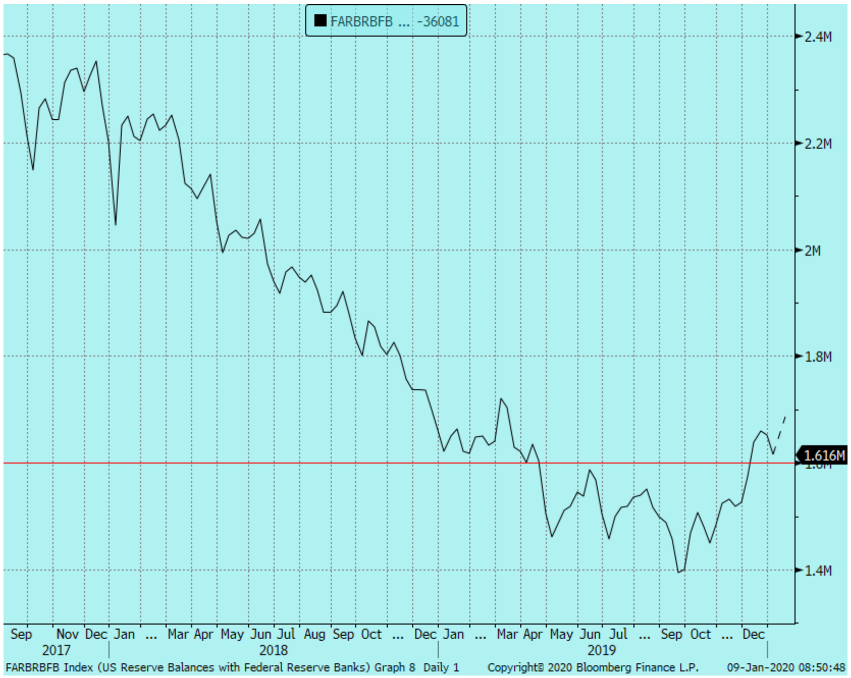
The point is the next month has significant risks for the reflation narrative that became popular into year end and will now feel great with US/Iran tensions easing.

Circling back on the Fed's repo ops, it is almost a certainty (call it 95%) the Fed dials back the liquidity. We expect the removal of the additional liquidity provided in December for the year end turn. To quantify it approximately, that would be ~25% less, with the remaining balance being rolled until we get through the April tax payments.

Clarida just solidified this today with his comment that the "Fed may gradually transition away from active repos, but may need them through the April taxes." This should not surprise us as the Fed has started to show concerns about the "financial stability risks" of their policy; something that should gain notice as S&P's continue to make new highs.

S&P's have risen in a parabolic fashion since the early October "the time has come to increase the Fed's balance sheet" comment by Powell. Note that this current move in late 2019/early 2020 overlays similarly with the late 2017/early 2018 parabolic rally in S&P's (didn't end well). Also note that the MACD (2nd chart) has "lost steam" and the RSI (3rd chart) is moving back into overbought…

Another reason why the Fed will dial back repo ops is that bank reserves have moved back into what the Fed considers "ample." (Dotted line is the highly certain projection where reserves stand post year-end)



Wrapping this up, reflation risks are building, at least temporarily. The recommended ESH0 3300/3400 call spread should be rolled up to take profits and reduce delta.

Further, it may be worthwhile to look at fixed income upside once again on the back of the post Iran sell off.

You can't ignore that the long-term pattern of 10yrs yields is a potential bear flag. 1.95% is key resistance but ideally you want to initiate downside once it gets to 1.92%. <u>10yr yields have failed in the 1.92/1.95% region 14 times</u>. This would suggest the probabilities of the bear flag breaking down are rising…

In addition to the Eurodollar call fly vs. put fly idea on Tuesday, given the short-term risks noted above coming at a time with yield rising post Iran tension cooling; let's explore short-term (gamma) downside in US 10yr futures.

Running Prism's analytical model, the following screen was run:

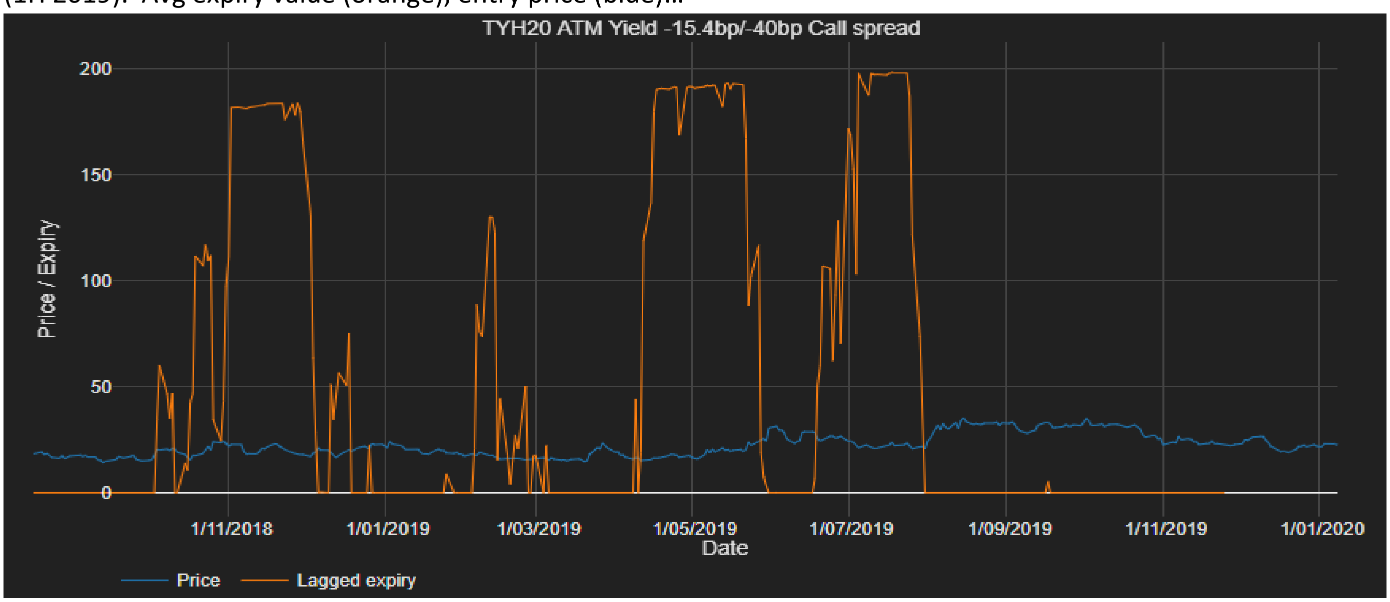
- Only for the March expiry (didn't want anything long dated but wanted to cover the Jan to Feb risk catalysts)
- Structures that were OTM
- Had at least a -10 delta (nothing too wingy)
- Cost less than 0.25 cents or 16/64s (don't want to spend too much premium in case reflation wins out)
- Had a historic leverage ratio of the relative strike of more than 1.0 (something that has historically worked)
- Had a price and vol percentile that were both within the best 50% (better than avg entry point)
- Then sorted by best avg expiry value of the relative strike over the past year (what structures on avg have worked best in the past year when 10yrs have mostly rallied)

TYH0 130/132 call spread for '11/'12 (64s) screens up top

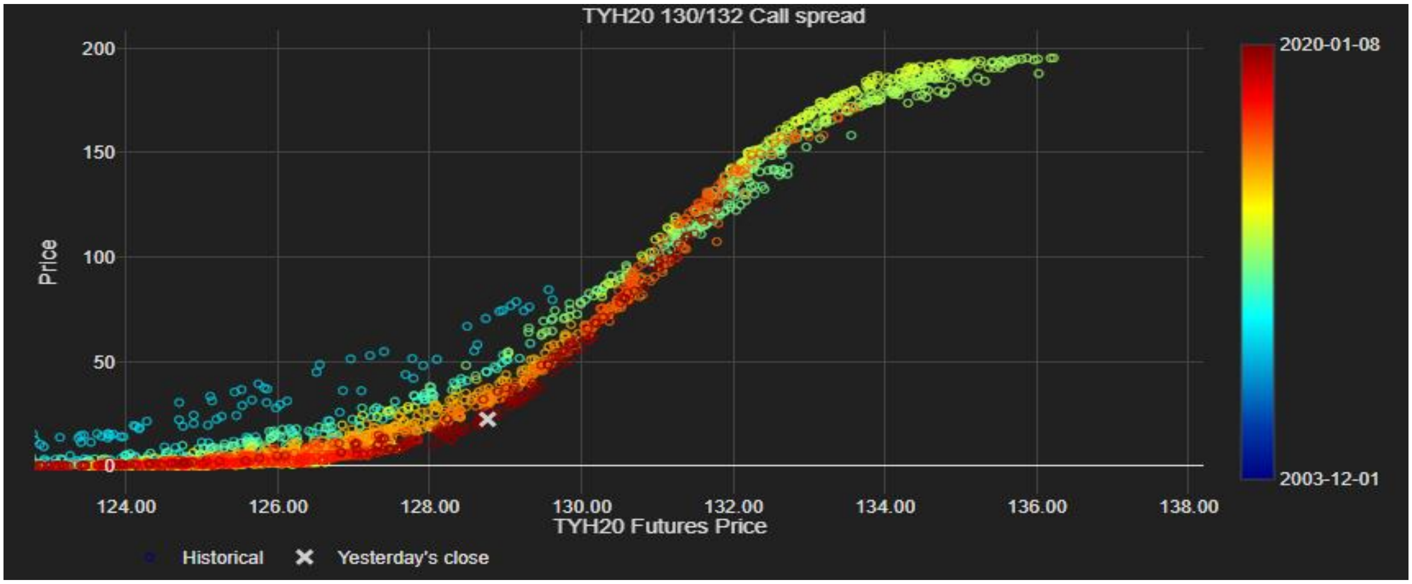
- -17 delta
- Expires in 43 days (Feb 21)
- 9.6 to 1 max payout

Contract	Full Strategy Name	Strike	Futures	TTE	Moneyness	Settlement	Delta	Price	HistLevRatRel [1y]	Price Rel Percentile [1y]	ATM Vol Percentile [1y]	Max Lvg Ratio Rel [1y]	AvgExpValRel [1y]
					,0		.1,	,25	1.0,	,,5	,,5		
TYH20	130/132 Call spread	130	128.766	0.12	-123.4	23.44	0.17	22.5	1.17	0.38	0.31	8.8	48.6
TYH20	130/131.5 Call spread	130	128.766	0.12	-123.4	20.31	0.15	19.5	1.06	0.40	0.31	7.7	40.2
TYH20	130.5/134.5 Call spread	130.5	128.766	0.12	-173.4	18.75	0.14	18.9	1.09	0.28	0.31	14.0	39.5
TYH20	130.5/133.5 Call spread	130.5	128.766	0.12	-173.4	17.19	0.13	17.8	1.22	0.30	0.31	14.9	39.5
TYH20	130.5/132.5 Call spread	130.5	128.766	0.12	-173.4	15.63	0.12	15.4	1.41	0.32	0.31	12.9	37.2
TYH20	130.5/132 Call spread	130.5	128.766	0.12	-173.4	14.06	0.10	13.4	1.39	0.34	0.31	11.1	32.0

As you can see here, this relative strategy has worked out well during periods of risk off (Dec '18) or growth concerns (1H 2019). Avg expiry value (orange), entry price (blue)…



Regressing the price of the structure vs. its futures prices reveals an attractive entry point and risk/reward…



Kind Regards,

Mark Orsley
Head of Macro Strategy, North America

prism^FP

130 West 42nd, 23rd Floor Tel +1 646 205 6193
New York, NY 10019 Cell +1 914 456 9446
United States Email orsley@prismfp.com

#NC2

#substantive