TraderORyan | May 3, 2022 @ 1200 EDT

Long SPY calls before FOMC decision tomorrow, use a modest position size

- Technical setup favors a short-term bounce after the significant market decline
- FOMC decision unlikely to have negative surprises, and April CPI may suggest that inflation has peaked
- A short-term rally likely, either after FOMC decision tomorrow or following the May 11 release of April CPI

Our trade

- Bought SPY calls near open today, will double the position if market declines significantly from current level

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Situation

Significant market decline, high inflation, macro uncertainty, favorable setup, potential catalysts

- Nasdaq 100 has declined 22% from its Nov 2021 high. S&P 500 dropped 14% from its Jan 2022 high, now at a price to 2022 earnings ratio of 18, approaching its long-term average of 15 to 20 (depending on how far back you look)
- Investors anxious about high inflation, uncertain path of Fed tightening, Russia/Ukraine war, and China lockdown
- SPY Feb 24 intraday low retested but held going into FOMC decision tomorrow
- Market sentiment stabilized, with VIX, 52-week high/low, high-yield spread, put/call ratio all showing divergence, as broad market intraday moved below Feb 24 intraday low on Monday, May 2
- FOMC decision and April CPI release could significantly move the market, given the excessive negative sentiment

Analysis

FOMC decision has been priced in, softer April CPI likely, a significant short-term bounce likely but its duration uncertain

- Fed rate and balance sheet decision largely priced in. Negative surprises unlikely
  - Investors have priced in a 100% chance of a 50 bps hike tomorrow, a 94% chance of a 75 bps hike in June, a $95bn/month balance sheet reduction, and Fed funds rate (25-50 bps now) to exceed 3% by the end of 2022
  - To retain credibility, Fed needs to show resolve to fight inflation. But at the same time, Fed has to ensure that its action will not precipitate instability in the global financial market
  - Fed has been prepping the market and will take what market gives. But with the war, Eurozone at the brink of recession, China lockdown, supply disruptions, Fed is unlikely to be more hawkish than market expects
  - FOMC decision tomorrow will likely lay out a clear path for rate hikes and balance sheet reductions
  - Removal of some uncertainty and lack of a negative surprise will likely prompt a strong short-term rally
- April CPI release on May 11 may create the impression that inflation has peaked
  - Major commodity prices, except food, have either declined or stabilized from early March highs - crude has moved sideways, copper down 15%, aluminum down 20%, and lumber down 8%
  - Wages continue to move up slowly but lag CPI, and are unlikely to move CPI higher from the current level
  - Market turmoil, China lockdown, Eurozone weakness will likely keep consumer sentiment and demand in check. Service component of CPI unlikely to move much higher when consumers are looking to tighten their budgets
  - Inflation will likely remain high given the lag b/w goods prices and wages/commodity prices, but the base effect – CPI jumped from 2.6% to 4.2% from March 2021 to April 2021 and moved higher to 7% by Dec 2021 – will likely make April 2022 and subsequent CPI look better
  - Current level of crude and wheat price historically produced far less inflation than current CPI indicates. While certainly a risk factor, the effect of the Russia/Ukraine war on inflation has been exaggerated
  - China lockdown and supply chain disruptions are major risk factors, but high inventory levels at corps will likely cushion the blow, and the lockdown is likely short-term
- However, durability of the bounce is uncertain. It could last for days, but it could also be short-lived – inflation likely to remain high for a while, tightening has begun and will continue, and the economy likely to slow down further

Conclusion

- Odds favor a significant rally after FOMC decision or following a softer April CPI, but please tread with caution

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