

US Rates Trade Recommendation

Recommend a 6m30y Payer 1by2

- This trade is targeted at those that expect the Fed to start tapering QE, and consequently expect interest rates to backup.
- We recommend investors enter a 6m30y Payer 1by2, with the two legs struck @ atmf+25bp and @ atmf+51bp respectively, cash-flat. Terminal breakeven on the 30y Swap rate is 3.94.
- Those that do not like open-ended downside on the upper-end of the trade's positive payoff range could consider buying an additional 6m30y Payer (1 unit notional), struck @ atmf+76bp, for 67 cents of premium. This version of the trade offers a roughly 7.75 to 1 max payoff.

Neela Gollapudi

+1-212-723-3075

neela.gollapudi@citi.com

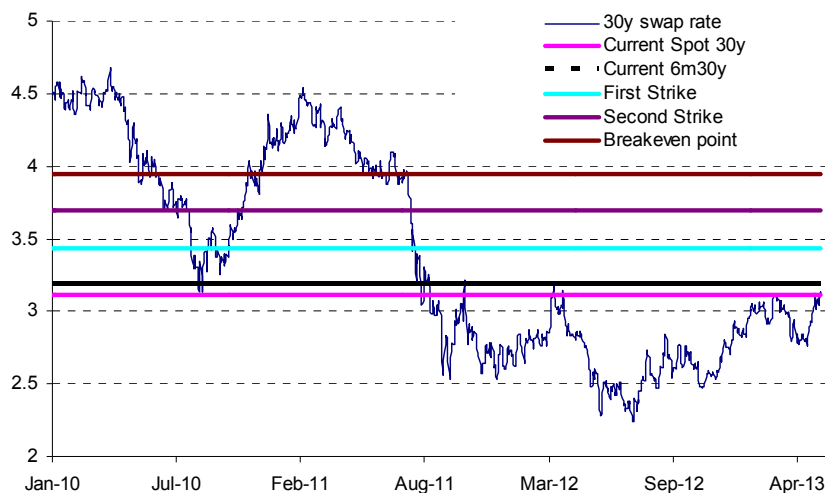
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Recommend a 6m30y Payer 1by2

- The best time to initiate a 1by2 in Payer form is when rates have run-up sharply, and we expect will either pause, or reverse course in the near term. In our judgment, our near-term outlook for rates in general is either neutral or bullish.
- This trade is targeted at those that expect the Fed to start tapering QE, and consequently expect interest rates to backup.
- A 1by2 type structure protects against adverse effects if rates stay at current levels or decline from here.
- A tapering initiated selloff is likely to be a bear-flattener, with the backup in 30y rates more modest than the backup in 10y rates. The behavior of rates on Wednesday May 22nd is a good template. Therefore, if one were initiating a 1by2 type structure, 30y tails are a better choice.
- The terminal breakeven on the trade is 3.95 – a level last seen just before the 2011 August rally, immediately following the debt-ceiling debate.

Figure 1. Terminal breakeven 30y swap rate is at 3.95 – a level last seen around the Debt-ceiling deal in August 2011.



Source: Citi Research

- Additionally, for intermediate horizons, the mark-to-market is likely to be less adverse in the 30y sector as the skew is unlikely to deliver. For comparison, current implied skew in 6m30y is 12.7bp/annum (6m30y Vol @ atm+100bp minus 6m30y Vol @ atmf), while delivered skew over the past 3 months is 16.9bp/annum and delivered skew over the past 18 months is “negative 17.1bp/annum”. We expect delivered skew to be somewhere in between the experience of the past 3 months and the experience of the past 18 months – leaning towards the 18 month case.

Figure 2. Pnl (\$mm) for the 6m30y “long 100mm atmf+25 Payer” by “short 200mm atmf+51 Payer”, for various rate and vol shocks – instantaneously and after 3 months; Rate shocks are in bp and Vol shocks are in bp/annum

Instantaneous shocks

		bp Vol Shocks							bp Vol Shocks				
		-10	-5	0	5	10			-10	-5	0	5	10
Rate Shocks	100	(4.64)	(5.03)	(5.46)	(5.91)	(6.38)	Rate Shocks	100	(3.53)	(3.75)	(4.02)	(4.32)	(4.63)
	75	(1.79)	(2.38)	(2.95)	(3.51)	(4.07)		75	(0.41)	(0.86)	(1.31)	(1.75)	(2.18)
	50	(0.08)	(0.67)	(1.25)	(1.81)	(2.37)		50	1.03	0.59	0.17	(0.25)	(0.66)
	25	0.47	0.08	(0.35)	(0.81)	(1.28)		25	0.91	0.75	0.54	0.29	0.02
	0	0.42	0.25	0.00	(0.30)	(0.65)		0	0.43	0.45	0.42	0.33	0.20
	-25	0.26	0.22	0.10	(0.08)	(0.31)		-25	0.18	0.22	0.24	0.23	0.19
	-50	0.15	0.16	0.11	0.01	(0.13)		-50	0.10	0.12	0.14	0.16	0.15
	-75	0.11	0.11	0.10	0.05	(0.04)		-75	0.08	0.09	0.10	0.11	0.11

Source: Citi Research

- A modest 7.5bp of roll between 6m30y and spot 30y should offer additional buffer against an early selloff.
- The risk to the trade is that selloff goes beyond the breakeven level in rates @ 3.95 on spot 30Y. We expect 30y rates to be better behaved than 10y rates on a selloff that accompanies Fed tapering, as distinct from selloffs that might occur if the market loses confidence in the Fed.
- Those that are uncomfortable having unlimited downside exposure beyond atmf+76bp could consider buying an additional 100mm 6m30y Payer struck @ atmf+76bp for 67 cents of premium. This translates to a roughly 3.35bp of yield basis points of the underlying 30y at current rate levels. Given the max payoff of 26bp of yield, the upfront cost makes this three-legged structure a 7.75 to 1 max payoff.

Trade details are given below:

Figure 3. Trade Details

Notional (\$mm)		Relative Strike	atmf	Absolute Strike	Premium	Delta	Vega	Gamma
+100.0	6m30y Payer	+25	3.185	3.435	2,574,523	(58,873)	52,144	1,120
-200.0	6m30y Payer	+51	3.185	3.695	(2,574,523)	65,967	(79,586)	(1,534)
Net					0	7,094	(27,443)	(414)

Source: Citi Research; Pricing is indicative as of late-day 5/23;

We look to hold the trade to expiry, and therefore look to capture the entire 26bp of max payoff. Our stop loss is 13bp of 30y Swap duration, or about \$2.6mm.

Appendix A-1

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