

US Rates Trade Recommendation

Sell 1m10y straddles

- 1m10y vol has run up 35bp/annum over the past 3 weeks.
- In order for vol to sustain at these levels, the continuous backup in rates should persist at the current pace.
- We do not anticipate the backup in rates to continue in the near-term, let alone continue at the current pace.
- Therefore we recommend selling 1m10y straddles at the current 90bp/annum on a delta-hedged basis.

Neela Gollapudi

+1-212-723-3075

neela.gollapudi@citi.com

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Sell 1m10y straddles

We recommend selling 1m10y straddles for the following reasons:

- Implied vols backed up about 35bp/annum in three weeks. If the backup in rates does not persist, there is room for a quick collapse in implieds. The short gamma trade is premised on view that the selloff will not continue near-term.
- The selloff will likely not continue because the market is voting against it:
 - Nominal rates have not backed up Wednesday despite significant paying from mortgage accounts.
 - The 3y1y part of the yield curve (blues on the Eurodollar curve) was the point where rates moved the most. This suggests that what changed materially on Tuesday is Fed expectations in 2016. Should expectations evolve further along these lines, it is not obvious that the long-end of the rate curve should selloff materially.
 - Indeed inflation breakevens fell sharply in the 10y sector on Wednesday. This suggests that the market might consider a 2016 move in the Fed funds rate as earlier than previously expected.
 - Also, equities backed off their rally on Tuesday, and actually fell Wednesday, limiting their gain for the two days. Granted they are already up a lot for the year. This suggests that the equity market might not hold up if 2016 expectations continue to evolve further in the same direction.
 - Skew in the interest-rate vol market is not being bid-up. At best, it is holding steady.
 - Given all of these cross-winds, it is unlikely that the Fed will taper QE faster than what the market currently expects.
 - The market will likely come to the above conclusion sooner than later, and stop pushing interest-rates ahead of schedule. This argument is not as circular as it sounds. Once the market comes to terms with this reality, gamma is likely to collapse.
 - For the sake of reference, our outlook for the 10y Treasury yield at the end of the quarter is 2%, and at the end of 2013 is 2.50%.
 - We are happy to sell gamma 1m10y at the current 90bp/annum. 1m5y gamma has run up more, but is more volatile, and therefore we mildly prefer selling 1m10y to selling 1m5y.
 - We prefer selling 1m expiries to selling 3m expiries given that the vol surface is locally inverted.
 - Our target on this trade is 20bp/annum, and stop loss is 10bp/annum.
 - We would hold this position on a daily delta-hedged basis.

Appendix A-1

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