

23 January 2020

RV Trade Note: Pay belly of the 1Yx1Y/5Yx5Y/10Yx10Y EUR swap fly on valuations and relative value

On the EUR swap curve, the recent rally has led to a significant richening of the intermediate (10Y) sector versus wings. For instance, the 1Yx1Y/5Yx5Y/10Yx10Y fly has richened around 15bp over the past two weeks and is currently close to the levels last seen around ECB rate cut in September when further ECB easing/Japanisation concerns were at the peak and 10Y Bund yield was at -0.70% (**Exhibit 1**). In our view, this richening has been primarily driven by large scale issuance based receiving in this sector, some real money receiving, and anecdotal evidence of fast money unwinding paid positions in the 10Y sector which were expressed via 2s/5s/10s fly. In a long term relationship, the forward fly is close to the richest levels seen over the past few years, is exhibiting a strong positive convex relationship versus yield, and is trading 10bp too rich in this convex relationship (**Exhibit 2**). The residual is around 11bp in a linear relationship performed over the last six months. **We recommend fading this richness and recommend paying the belly in the EUR 1Yx1Y/5Yx5Y/10Yx10Y 50:50 swap fly.** This trade, however, suffers from negative carry of around 2bp over 3M carry. Other variants of this fly such as paying 10Y in 2s/10s/30s fly are also attractive and incurs marginally lower carry (-1.5bp over 3M). However, we prefer doing it via the forwards as the forward fly itself is trading around 7bp too rich versus 2s/10s/30s fly (**Exhibit 3**).

Relative value investors can, alternatively, focus on fading this richness via a level-and-curve neutral fly. **Exhibit 4** shows that the C&L flies (1Yx1Y/5Yx5Y/10Yx10Y and 2s/10s/30s) are now trading too rich in a short term regression (6M) with the forward fly showing a larger residual.

Exhibit 1: The intermediate sector of the swap curve (10Y) has richened sharply in the recent rally. For instance, the 1Yx1Y/5Yx5Y/10Yx10Y fly is close to its richest level seen during 3Q19 when Bund yield was close to -0.70%

EUR 1Yx1Y/5Yx5Y/10Yx10Y 50:50 swap fly (lhs; bp) and 10Y Bund yield (rhs; %); past 6M;

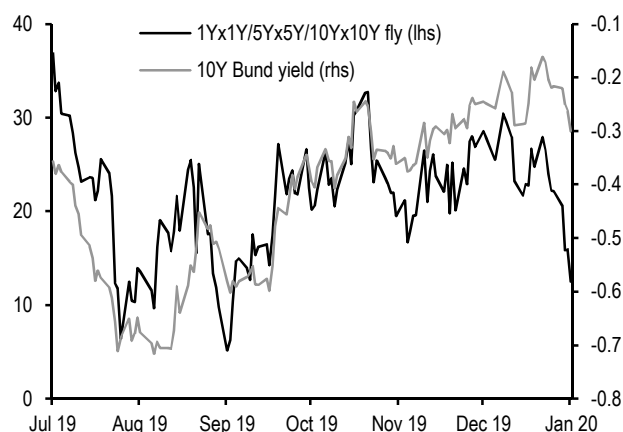


Exhibit 2: These flies have exhibited a strong positive convex relationship versus yields over the long term and currently appear too rich

EUR 1Yx1Y/5Yx5Y/10Yx10Y 50:50 swap fly regressed against 5Yx5Y swap yield; since 1 Jan 2018; bp

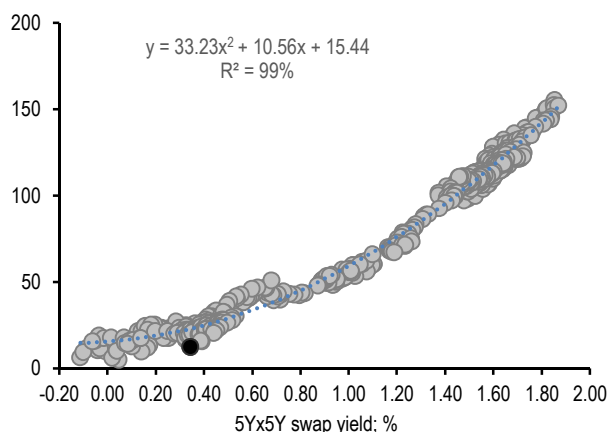


Exhibit 3: The forward fly also appears too rich versus similar fly (2s/10s/30s)

EUR 1Yx1Y/5Yx5Y/10Yx10Y 50:50 swap fly regressed against EUR 2s/10s/30s 50:50 swap fly; past 6M; bp

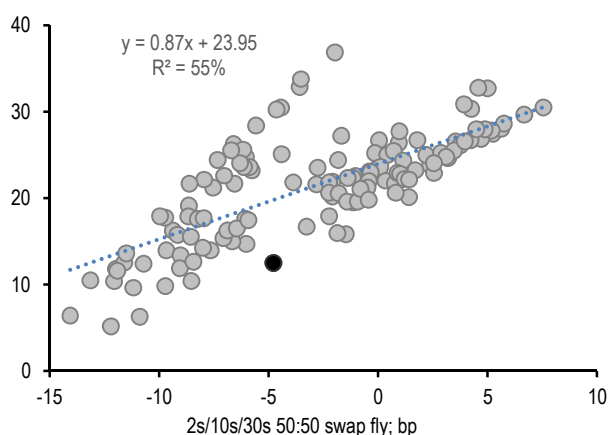
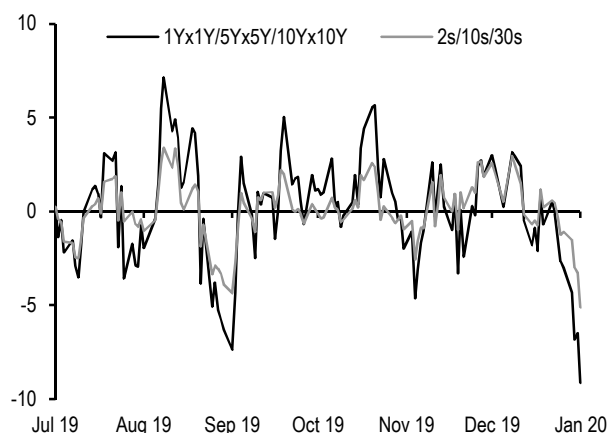


Exhibit 4: We also favour paying 5Yx5Y in a 1Yx1Y/5Yx5Y/10Yx10Y level-and-curve neutral fly as a pure relative value trade

Residual from regressing (a) 1Yx1Y/5Yx5Y/10Yx10Y((b) 2s/10s/30s)) 50:50 swap fly regressed against 5Yx5Y (10Y) swap yield and 1Yx1Y/10Yx10Y (2s/30s) swap curve; past 6M; bp



Reg equation:

- (a) $Y = 11.49(5Yx5Y) + 31.93(1Yx1Y/10Yx10Y) - 19.3$; $R^2 = 78\%$; $SE = 2.9bp$.
- (b) $Y = 41.1(10Y) - 12(2s/10s) - 7.4$; $R^2 = 91\%$; $SE = 1.6bp$.

Trade Recommendations

- Pay the belly of the 1Yx1Y/5Yx5Y/10Yx1Y 50:50 swap fly

- Pay €100mn 5Yx5Y swaps (100% risk, start date 27 Jan 2025, end date 27 Jan 2030) versus receiving €251.8mn 1Yx1Y swaps (50% risk, start date 27 Jan 2021, end date 27 Jan 2022) and €26.2mn 10Yx10Y swaps (50% risk, start date 27 Jan 2030, end date 27 Jan 2040) to enter into a 50:50 swap fly at 11.6bp (defined as $2 \times 5Yx5Y - 1Yx1Y - 10Yx10Y$);

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