

European Rates Alpha

Close short US vs EUR rates vol

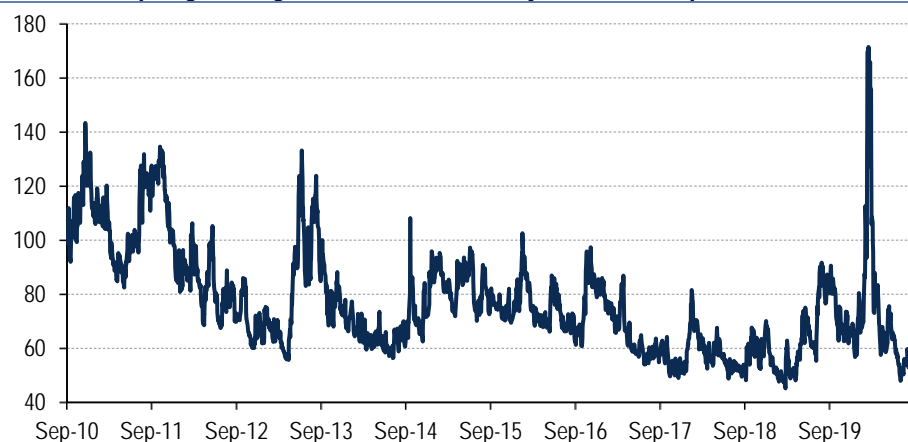
1m10y US vol reaches record low, while EUR vol stays bid

We close our short [6m10y US vol vs 6m2y EUR vol](#) initiated on Apr 14th. We received €475K at initiation, and now pay €275K to unwind it. The position expressed our view that short dated EUR rates could remain volatile while USD implied vol had potential to decline on a Europeanization of the US volatility grid. This week, 1m10y US implied vol reached its lowest level on record (Chart 1).

Fed drove collapse in US vol, elections to support 1m10y

US volatility is making fresh record lows driven by the Fed's unwillingness to consider negative rates and its introduction of the Flexible Average Inflation Targeting (FAIT) regime, effectively pinning front-end rates at their current levels for years to come. This is consistent with the process of Europeanization of US rates and vols that we discussed earlier in [Rates volatility and the zero lower bound](#). Indeed, we observed a collapse of spreads of the US volatility grid to the European grid between the start of the year (see Table 1) and the present (see Table 2).

Chart 1: After spiking to its highest level since '09, 1m10y US vol has collapsed to lowest on record



Source: BofA Global Research

We now find it prudent to lighten up on the short gamma exposure in long tails.

- The [asymmetry of outcomes in rates](#) space (tilted to higher yields medium term) means vol on 10-30y tails can find some support at current levels.
- By generating a pickup in the inflation risk premium, FAIT may ultimately provide some support for intermediate expiries on long tails. This could then trickle down to shorter dated expiries on 10-30y tails.
- Near term, there is scope for delivered to stay supported by the ebb and flow of polling data and election headlines. We had recommended to [fade the election vol premia](#), but after the recent collapse of short gamma, and as the election risk event comes into 1m expiries, we turn more neutral on 1m10y vol.

Continued overleaf...

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Rates Research
Europe

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

EUR: delivered vol in top left could stay higher than in US

For the first time since early 2014 (before the ECB cut rates to negative), EUR implied vol trades higher than US implied vol in the top left (Table 2). Unlike in the US, short dated EUR rates have been somewhat more volatile lately, as the EUR appreciation revived the potential for additional Deposit rate cuts by the ECB. While the Fed appears to have closed the door to negative rates and therefore to any additional cut from here, the ECB is striving to keep that option alive, to fend off further currency appreciation.

Additionally, front-end Euribor rates have rallied by more than generally expected over the last couple of months, as banks took-up substantial amounts of liquidity via the ECB TLTRO III operations. While Euribor fixings may remain low over coming months, the futures beyond mid 2021 have the potential to be quite volatile, as the favourable TLTRO III rate is currently set to end in Jun21 (see discussion on Euribor forecasts [here](#)).

Table 1: Spread between US and European swaption grids (bp)

2 January 2020

	1y	2y	3y	5y	7y	10y	30y
1m	16.9	29.5	31.9	25.8	22.5	19.1	8.0
3m	22.0	32.4	33.2	28.8	23.2	19.4	8.7
6m	29.2	35.5	34.3	29.0	23.7	19.0	8.8
1y	36.2	37.1	34.8	28.1	23.1	18.5	7.4
2y	36.7	35.0	30.5	24.6	20.2	16.0	5.9
3y	31.1	27.9	24.9	20.7	17.2	13.6	4.8
4y	25.3	22.9	20.8	18.0	15.0	11.6	4.1
5y	21.2	19.2	17.9	15.2	12.4	9.3	3.3
10y	7.9	6.0	5.9	4.8	3.9	2.2	1.7
15y	3.5	3.1	2.4	1.7	1.5	-0.1	3.3
30y	-0.3	-0.5	-0.5	-0.3	0.4	2.0	12.2

Source: BofA Global Research; Bloomberg

Table 2: Spread between US and European swaption grids (bp)

Current spread

	1Y	2Y	3Y	5Y	7Y	10Y	30Y
1M	-1.3	0.2	0.8	-0.1	7.7	8.4	9.5
3M	-1.9	-0.8	0.8	2.6	8.0	13.9	15.8
6M	-1.9	-0.7	1.5	4.7	10.9	14.3	13.4
1Y	0.0	1.1	3.7	7.4	11.7	14.2	10.9
2Y	4.0	4.9	6.9	8.7	10.9	11.8	8.1
3Y	6.3	6.3	7.0	10.1	11.1	10.3	6.8
4Y	7.5	8.9	9.3	10.0	10.5	9.1	6.3
5Y	7.4	9.2	10.1	10.0	9.6	7.8	5.1
10Y	7.8	7.2	7.6	6.4	6.6	5.3	3.8
15Y	4.9	5.1	4.4	3.6	3.8	3.9	3.4
30Y	0.6	1.4	0.8	-0.1	0.4	2.1	11.9

Source: BofA Global Research; Bloomberg

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