

19 February 2021

Trade note: Fade the RV cheapening of 10Y EUR swap

Receive the body of the C&L neutral reds/5Yx5Y/15Yx15Y EUR swap fly

Euro area rates continued their recent sell-off, in line with DM rates, as the reflation theme has gained further traction on the back of strong macro data and optimism on the vaccine deployment. Over the week, **we have seen a strong relative underperformance of 5Yx5Y EUR swaps (Exhibit 1)** which has **led to a sharp cheapening of swap flies centered in 10Y, such as 2s/10s/30s (5s/10s/30s) and various equivalent forward flies (Exhibit 2).**

Exhibit 1: Over the week, we have seen a strong underperformance of 5Yx5Y EUR swaps...

Changes in various forward 5Y swap rates; past 1week; bp

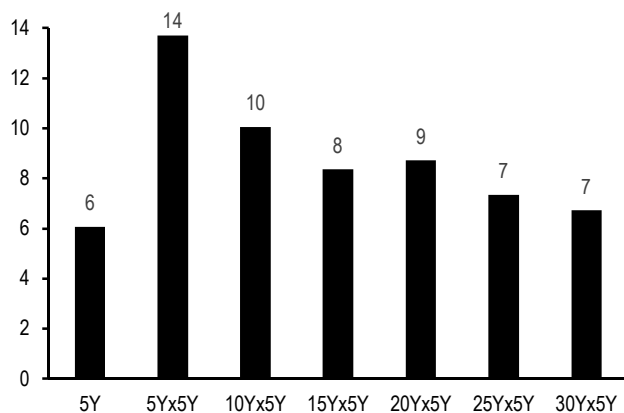
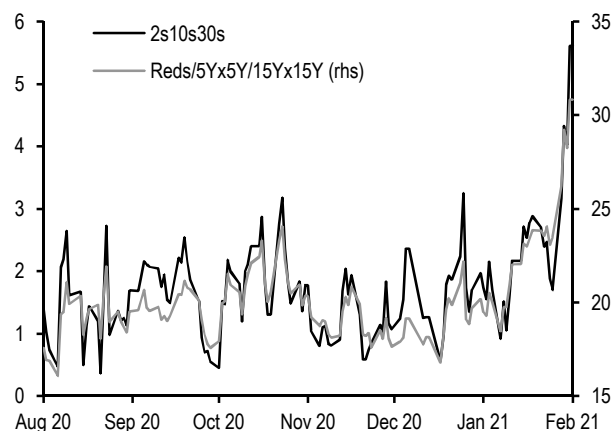


Exhibit 2: ...which has led to a sharp cheapening of swap flies centered in 10Y, such as 2s/10s/30s

2s/10s/30s and Reds/5Yx5Y/15Yx15Y EUR swap fly; past 6M; bp



This cheapening has been excessive as seen in a regression versus the level of yield and the slope of the curve (**Exhibit 3**). We favour fading the cheapness of this sector via receiving the belly of the forward EUR swap fly. We do not believe this to be the beginning of market starting to price volatility moving inwards the curve as, in our view, it is too early in the economic cycle for that dynamic and the RV is expect to mean revert. Therefore, we expect this relative value to fade over the near term. In **Exhibit 4** we list various combinations of forward flies that are trading cheap versus the level and curve. Amongst these, we recommend **receiving the belly of the curve and level neutral 1Yx1Y/5Yx5Y/15Yx15Y EUR swap**

fly. This fly is trading almost 3bp cheap versus level and curve and the carry of receiving this weighted fly is positive (3bp/3M). In Z-score terms, the residual of the fly versus level and curve is almost three standard deviations cheap.

We acknowledge that in a continued sell-off, the beta of the fly to the level of yield could accelerate further indicating that the weighted fly could continue to cheapen, if we use the current 6M betas to secure level-neutrality. Indeed, during prior episodes of large sell-off (Fed taper tantrum, Bund VaR shock, and ECB QE tapering expectations) the 1M beta of the reds/5Yx5Y/15Yx15Y fly to 5Yx5Y had increased up to 60%. Thus, if the current sell-off continues then our choice of using 6M beta (around 20%) is likely to fall short as a level-neutral hedge, giving a long duration bias to the recommended weighted fly. However, given our bullish duration bias from current levels, we continue hedging the directionality of the fly with around 20% beta.

Exhibit 3: We now find the 5Yx5Y sector to be trading cheap and recommending fading the cheapness of this sector via receiving the belly of the forward EUR swap fly

Reds/5Yx5Y/15Yx15Y EUR swap fly regressed against 1) 5Yx5Y EUR swap yields and 2) reds/15Yx15Y EUR swap curve; past 6M; bp

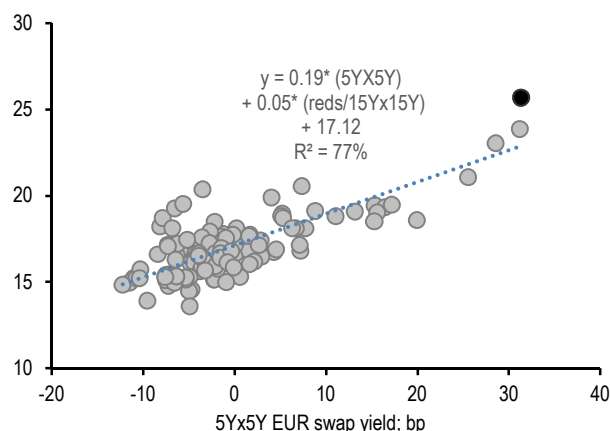


Exhibit 4: Amongst the forward flies that are trading cheap, we recommend receiving the belly of the curve and level neutral 1Yx1Y/5Yx5Y/15Yx15Y EUR swap fly

Regression statistics and carry for various forward fly combinations regressed against the level and curve; past 6M; bp

Structure	Residual	Z-score	R-Sqr	Beta to level	Beta to curve	Weighted fly 3M carry *
1YX1Y/5YX5Y/15YX5Y	3.2	2.7	82%	15%	11%	3
1YX1Y/5YX5Y/20YX5Y	2.9	2.4	77%	23%	2%	3
1YX1Y/5YX5Y/25YX5Y	3.6	2.9	74%	20%	3%	2
1YX1Y/5YX5Y/10YX10Y	2.8	2.8	89%	7%	21%	3
1YX1Y/5YX5Y/15YX15Y	3.2	2.7	77%	19%	5%	3
1YX1Y/5YX5Y/20YX10Y	3.3	2.7	76%	21%	3%	2

*Carry from receiving the belly for curve and level neutral fly

Trade recommendations¹

- **New Trade: Rec 5Yx5Y in reds/5Yx5Y/15Yx15Y swap fly**
- Rec €100mn 5Yx5Y swaps (100% risk, swap start date 23 Feb 2026, swap end date 24 Feb 2031) versus paying €281mn 1Yx1Y swaps (56% risk, swap start date 23 Feb 2022, swap end date 23 Feb 2023) and €24mn 15Yx15Y swaps (68% risk, swap start date 25 Feb 2036, swap end date 23 Feb 2051) to enter into a fly at 25bp. Fly defined as $100 * (5Yx5Y - 0.56 * 1Yx1Y - 0.68 * 15Yx15Y)$;

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