

Trade Idea: initiate 3m 10s30s bull steepeners

Initiate 3m 10s30s conditional bull steepeners

We recommend initiating 3m 10s30s conditional bull steepeners to position for carry with a limited downside in a market selloff scenario.

Levels

We buy \$100mn of 3m10y ATMF-1bp receivers vs \$45.5mn 3m30y receivers for zero cost. The trade carries positively by about \$435K over 3 months. Our target is P&L of +\$250K and our stop loss is the loss of \$125K.

Rationale

The recent richening of 30y vol to 10y vol allows initiating costless bulls steepeners at the strike spread about 4.8bp flat to spot (Chart 1). The trade carries attractively, as a result. Table 1 ranks bull steepeners by vol/adjusted carry defined as the ratio of breakeven curve flattening, which offsets 3m carry on the trade, to realized volatility of the underlying curve. The 3m 10s30s trade looks most attractive if evaluated by this metric.

Unlike carry trades expressed using outright longs/steepeners, our trade should have a flat terminal P&L if rates rise from these levels. We also expect the curve to steepen in a market rally driven by either weak economic data or dovish Fed communication. Indeed, we estimate that today's Eurodollar curve implies a terminal Fed Funds rate of about 3% after adjustments for term premiums and LIBOR/OIS basis. This looks too low, in our view, even if we assume a permanent decline in potential GDP growth. As a result, further deterioration of growth expectations is more likely to cause the market to reprice the timing and pace of Fed hikes rather than the terminal rate, which should result in a rally led by the belly as opposed to the back end of the curve.

Table 1: Vol-adjusted carry of conditional bull steepeners

Curve	3m 5s10s	3m 5s30s	3m 7s30s	3m 10s30s	6m 5s10s	6m 5s30s	6m 7s30s	6m 10s30s
Spot curve, bp	95.9	168.8	119.6	73.0	95.9	168.8	119.6	73.0
Fwd curve, bp	90.3	157.6	111.3	67.3	84.8	146.5	103.0	61.7
Strike curve, bp	91.1	158.5	112.3	67.4	85.9	149.2	105.7	63.4
Pick-up vs spot, bp	4.8	10.4	7.3	5.6	10.0	19.6	13.9	9.5
3m carry, bp	4.8	10.4	7.3	5.6	3.7	6.1	4.1	2.4
BE flattening, bp	4.8	10.4	7.3	5.6	5.9	10.0	7.0	4.3
3m RV, bp	12.9	22.6	17.3	11.0	13.1	22.8	17.2	11.0
BE/RV ratio	0.37	0.46	0.42	0.51	0.45	0.44	0.41	0.39

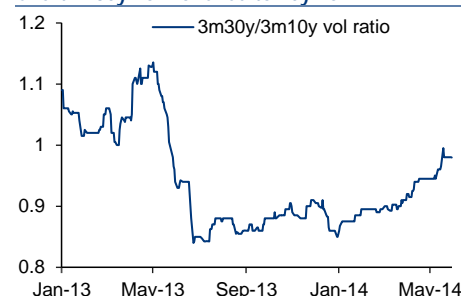
Note: As of May 30, 2014. The pick-up vs spot is defined as the spread between spot curve and costless strike curve. We compare trades by our reward-risk ratio, defined as the ratio of 3m breakeven flattening of the underlying forward curve to 3m realized vol of this curve. The 3m breakeven flattening is defined as the flattening of the curve that exactly offsets 3m carry P&L. Red indicates the three trades with the highest reward-risk ratio. Transaction costs are not taken into account.

Source: BofA Merrill Lynch Global Research



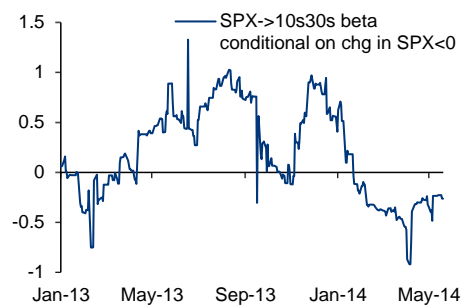
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Chart 1: 30y vol richened to 10y vol



Source: BofA Merrill Lynch Global Research

Chart 2: 10s30s tended to steepen when stocks cheapened



Note: The chart shows the 3m rolling one-sided beta of daily changes in 10s30s curve on daily returns of S&P 500, conditional on days of negative returns on S&P.

Source: BofA Merrill Lynch Global Research

We expect a similar price action on any dovish Fed communication. We argued in [The Fed's new conundrum](#) that the recent decline in long-dated forward rates has been driven, in part, by increased uncertainty about the Fed reaction function, as increased perceived risk to the front end could have prompted investors to reallocate to the back end. Any dovish Fed communication may therefore lead to a reverse reallocation, and may not only cause the front end to rally, but also result in a selloff at the backend.

Risks

One risk to our trade is a risk-off market move, which could lead to curve bull flattening. However, the recent empirical one-sided beta of the 10s30s curve to stocks on days where the stock market sold off has been negative, implying a curve steepening response to stock selloffs (Chart 2).

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Link to Definitions

Macro

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