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Derivative Focus

CROSS-ASSET

Erratum: Conditional Euribor bull flatteners

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Research analysts

Quantitative Strategies

Nick Firoozye - NIplc
nick.firoozye@nomura.com
+44 20 7102 1660

Qilong Zhang - NIHK
qilong.zhang@nomura.com
+852 2252 6191

Already full up on steepeners? Try some front-end bull flatteners for a change

Positioning in Europe is at an extreme owing to the significant carry found in steepening trades. But at the same time, slopes are similarly at an extreme with 2s30s at levels not seen since 2003. In this risky mix, we recommend front-end Euribor bull flatteners (Mar expiry), which can be entered into at decent levels with positive carry. Although there are other OTC flatteners with positive carry (e.g., small amounts in short-dated 2s5s bull flatteners and 5s10s bear flatteners), there are few that have such decent carry over short horizons, meanwhile benefiting from adjustments to further ECB accommodation.

***The risks were incorrectly reported for a 1000 lot trade in the original document. They have been corrected in this document.**

Trade Idea: Sell 5000 lots ERH5C 99.875 / Buy 5000 lots 2RH5C 99.375 for 15.5 ticks (EUR1.937mn, ref ERH5 at 99.44). Expected 3m Carry of 1.79 ticks EUR224k**,** expected carry to term of 13.8 ticks.

Trade: Front-end flatteners

Since the ECB's action the curve has moved increasingly to incorporate further accommodation. Nonetheless, the significant appeal of long-end steepeners has meant that many clients hold many steepeners. Meanwhile, the curve slope is nearing all-time steep levels with 10s30s and 5s30s both close to early 2004 levels (where it was only steeper in mid-2003 and early-1999). Although there are flatteners to help offset this risk, few offer the decent pickup of this trade.

Fig. 1: Package price of 15.5 ticks, with carry of 1.79 ticks over 3m

Decent carry even if flattening does not happen

EUR Mid-Curve Bull Flattener: Mar-15 Expiry, White-Green		
BBG Code	**ERH5C 99.875**	**2RH5C 99.375**
Underlying Futures	Mar 2015	Mar 2017
Position	Short	Long
Implied Rate %	0.178	0.578
Futures Price	99.823	99.423
Strike	99.875	99.375
Option Price (ticks)	2.50	18.00
Package Price (ticks)		**15.50**
Aged 3-month		
Aged Price (ticks)	1.53	18.82
Carry (ticks)	-0.97	0.82
Package Carry (ticks)		**1.79**
Package Carry (%)		11.6%

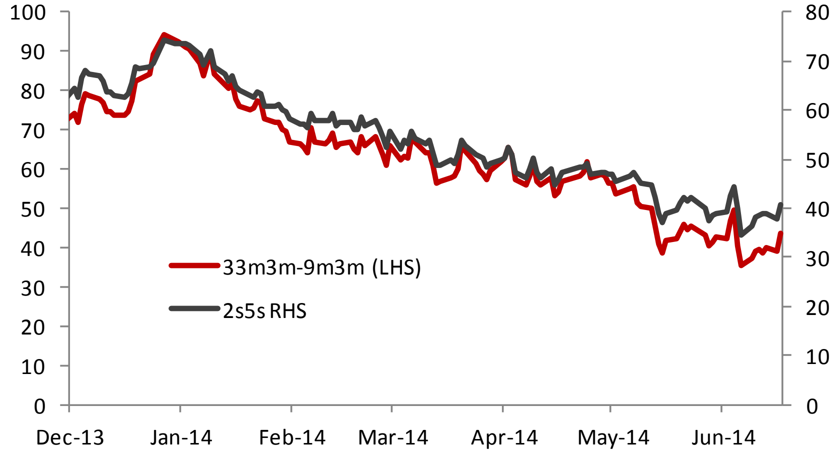
Source: Nomura Research

Figure 1 shows that the short leg contributes little to the actual cost of the trade, and it is a major source of the carry (since the Whites mostly carry negatively). All the carry figures presented are for a 3m horizon (where the underlying futures roll into Dec contracts). We note that there are approximately 4.4 ticks more carry over the following 3m horizon, and 7.6 ticks over the 3m until expiry or a total of 13.8 ticks to expiry.

Although the ECB's delivery of nearly as much policy action as the market had expected resulted in an immediate post-meeting flattening, recent trends have reversed this and entry levels on the trade (3rd-11th contract, corresponding to 33m3m-9m3m FRA spread) are close to mid-May levels (see Figure 2).

Fig. 2: 3rd-11th Contract and 2s5s slope. Post ECB flattening has been largely retraced

Entry levels close to mid-May



Source: Nomura Research

The current futures (ERH5-ERH7) spread is 40bp, while it ages into the spot (ERZ4-ERZ6) spread of 11.7bp. Meanwhile, the strike spread of 50bp gives considerable leeway for selloffs, as we see in Figure 3.

Fig. 3: Enter into the flattener at steep strikes

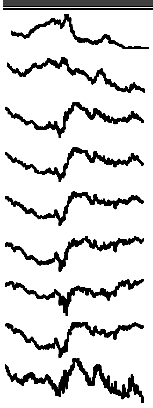
Carry is largely from curve positioning

	Short ERH5C 99.875	Long 2RH5C 99.375	Spread (bp)
Spot	21.7	33.4	11.7
Forward	17.8	57.8	40.0
Strike	12.5	62.5	50.0

Source: Nomura Research

The spread itself is highly correlated with the 2s5s slope as we see in Figure 4 with a correlation of 98% in levels, or a 91% correlation with 2s10s. The sparkline plots on the left clearly show a similar time-series profile of the spread to these two slopes, with slightly less correspondence with 5s10s. And, unlike the Whites-Reds slopes, this Whites-Greens has little similarity with the 2-5-10 fly, which has come under considerable receiving pressure lately.

Fig. 4: 3rd-11th Contract spread is most highly correlated with 2s10s and 2s5s



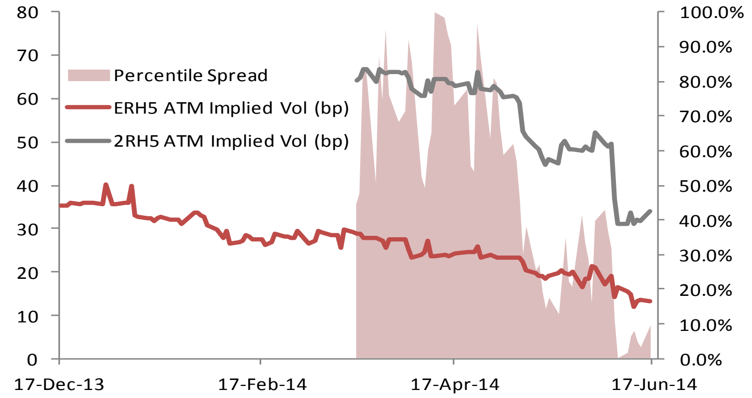
10y History	Spread	Current	High	Low	Mean	Volatility	Z-Score	Correlation to Spread
	9m3m	**0.28**	5.46	0.26	2.21	138.6	**-1.39**	
	33m3m	**0.72**	5.02	0.65	2.83	116.0	**-1.82**	
	33m3m-9m3m	**43.5**	187.6	-78.2	62.8	52.0	**-0.37**	
	2s5s	**40.6**	116.3	-44.1	46.4	32.3	**-0.18**	**0.98**
	2s10s	**124.9**	203.4	-59.4	101.1	57.8	**0.41**	**0.91**
	5s10s	**84.3**	98.1	-21.5	54.7	27.7	**1.07**	**0.76**
	10s30s	**74.5**	77.2	-56.7	34.6	21.5	**1.86**	**0.36**
	2s30s	**199.4**	238.6	-74.2	135.6	72.1	**0.88**	**0.84**
	2s5s10s	**-43.7**	33.7	-49.5	-8.3	16.9	**-2.10**	**0.62**

Source: Nomura Research

Figure 5 shows that although both vols have been falling lately, the fall has been far more precipitous in the midcurves. Consequently, the spread between the two is close to all-time lows, at a percentile of just under 10%. This should indicate that entry levels are relatively attractive.

Fig. 5: ERH5 vols and 2RH5 vols

Vol spreads are near their all-time lows (cheapest)



Source: Quikstrike.com, Nomura Research

In terms of risks for the trade, as we see in Figure 6, the trade is modestly short parallel shifts in the curve (which we believe unlikely to happen in this dovish regime), is short theta, short gamma and long vega. All risks are to a full-rate model (which is not calibrated to the Dec-17 future). Many futures traders may prefer the simpler Bachelier (Normal) model, where overall trade delta and gamma would depend on correlations.

Fig. 6: Trade Risks

Modestly long vega and short gamma

EUR Mid-Curve Bull Flattener: Mar-15 Expiry, White-Green (5000 Contracts)									
Contract Name	Contracts	Futures Price	Strike	Price (ticks)	Premium €	Delta €/bp	Vega €/bp	Theta €/day	Gamma €/bp2
ERH5C 99.875	**-5000**	99.823	99.875	2.50	-312,500	52,180	-37,353	1,305	-5,531
2RH5C 99.375	**5000**	99.423	99.375	18.00	2,250,000	-81,763	43,311	-4,111	1,763
					1,937,500	**-29,584**	**5,958**	**-2,806**	**-3,768**

Source: Nomura Research

Because of the recent positive correlation between rates and vol, the mark-to-market from any bearish surprises should be buffered by the positive vega, but of course holding the contract until term is likely to result in further gains, because of the large positive carry.

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Appendix A-1

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