

Japan Rates

Return of the RV fly trades

The long belly position in 2s5s10s fly we recommended on August 3rd has now outperformed by 7bp (chart1). This position benefited 1) from its positive correlation with market levels through the recent leg of flight-to-quality rally, and 2) from 2s5s flattening: an insurance positioning for the August BoJ hike. As August hike was significantly priced out over the last few days and 2s5s10s richened further relative to the yield level, the trade seems to offer less upside from this level.

With market now pricing in less than 30% of an August hike and offering limited upside from possible delay, it seems no longer necessary to hold a position that aim to profit whether or not there is an August hike. Rather, we shift our focus to relative value positions that seem too rich even on the assumption that BoJ delays hike: for example, 1) selling 1m 2s5s10s receiver swaption fly, and 2) paying 5s7s10s swap fly.

Sell 1m 2s5s10s receiver swaption fly

The general rise in implied volatility across gamma sector is justifiable given increasing uncertainty about the market; however, 5yr swaption volatility seems to have outperformed too much versus decline in rate level. As a result, 2s5s10s conditional bullish fly has lagged behind the swap fly in performance despite high correlation, and seems to offer value in selling (chart2).

Pay 5s7s10s swap fly

One could also pay 5s7s10s swap fly, which also seems to have richened very quickly and appears to offer limited 7-year outperformance from here. The body of 5s7s10s swap butterfly looks too expensive against the wings when regressed against outright 7yr rate, nearly at levels not seen since quantitative easing policy end (chart3). Also, given the expensiveness of 7-year relative to 10-year, it would not be out of line if 10-year found support relative to 7-year even in a further rally. Carry cost to paying this fly is almost flat at -0.3bp/3m.

– Take profit on 2s/5s/10s receiver at -11.5bp (originally recommended @ -4.6bp)

Chart 1: 2s/5s/10 outperformed significantly

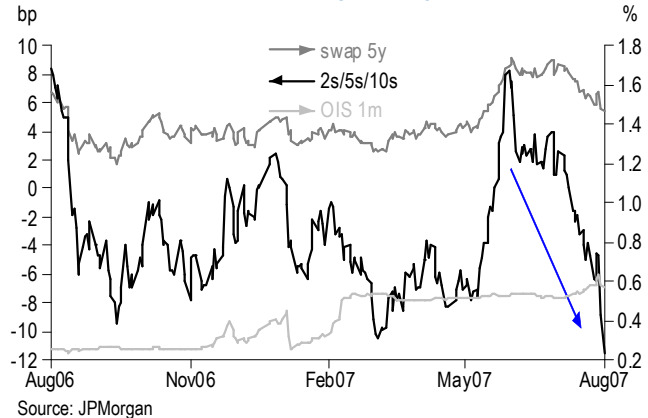


Chart 2: 2s/5s/10s is highly correlated with the yield curve slope

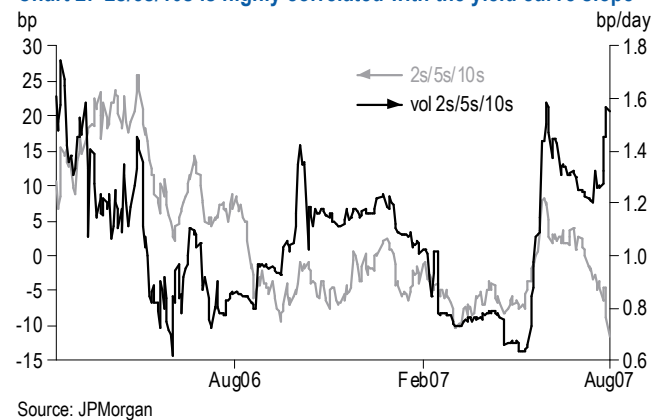
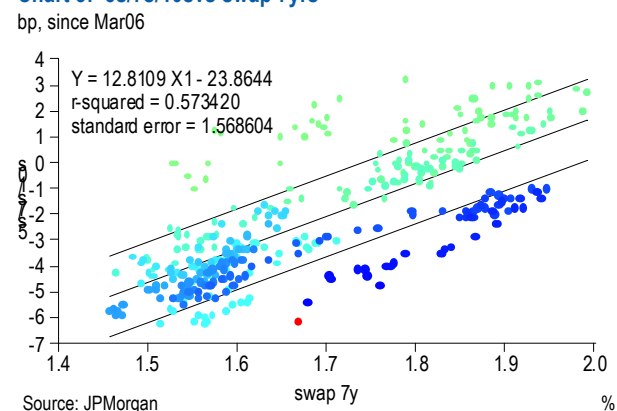


Chart 3: 5s/7s/10svs swap 7yrs



– Sell 1m 2s5s10s receiver swaption fly for duration neutral ratio 2.5:2:0.5 @ 13sen premium

– Pay 5s7s10s @ -6bp

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