

European Rates Alpha

Long top left EUR rates vol vs top right in USD

Trade: long 6m2y EUR straddle vs 6m10y USD straddle

We recommend buying €100m 6m2y ATM EUR straddle, funded by selling \$21.5m 6m10y ATM 6m10y ATM USD straddle. We choose the USD notional in a way that makes the position Vega neutral. We receive €475K at initiation. We target a Pnl of €600K, with a stop at -€400K. The position expresses our view that short dated EUR rates can remain volatile in the coming months, and that funding the position in USD space makes sense given the greater potential for a normalisation of implied vols there. The risk to the trade is a rise in another spike in realised volatility for 10y US rates.

Scope for EUR rates gamma to rise in short tails

Given the macro & inflation outlook, the ECB is unlikely to officially hike rates anytime soon. However, we see several factors that can drive volatility higher in the front-end:

- There is scope for a meaningful rally in front-end rates as a result of the scheduled decline in the rate charged by the ECB on TLTRO III operations (it could be as low as ECB Depo-25bp over the period of Jun20 to Jun21, ie -75bp if the Depo rate is unchanged). The market does not appear to be pricing much effect from that. Jul20 ECB date Eonia, which [we still like to receive](#), is currently trading at -48bp, just 3bp below spot fixing. The risk to that position is tighter credit conditions for banks. However, vol in 2y swap rates could still rise as FRA-OIS spreads would then widen.
- There could also be a reassessment of rate cut expectations (Chart 1). The low in Eonia forwards is at -55bp (in Mar21). While the ECB has shown a clear preference for QE as first line of response to the Coronavirus shock, it has not ruled out cuts for when the outbreak is controlled and more needs to be done to support the recovery.
- Should the recovery start in Q3 and be stronger than expected, the ECB may then envisage tweaks to its tiering system given the substantial increase in excess liquidity that will have taken place. The market may also turn its focus to the ECB's strategy review, creating uncertainty over the outlook for short rates.

While Europeanization of USD vol points to lower gamma

With the Fed now at the zero low bound (ZLB), we expect USD rates volatility to drift lower. The case is intuitive at the front-end of the curve. However, we argue the low vol environment should also propagate further out the curve, and see scope for gamma on 10y tails to decline further from their recent spike (Chart 2):

- Liquidity conditions have improved and continued QE purchases will support further normalization in the trading environment
- The flattening pressure that lower neutral rate expectations put on the curve should serve as an amplifier of the ZLB effect in the long end (Chart 3). This would be akin to what was observed in EUR between 2011 and 2014, after the ECB cut rates to zero (Chart 4) and our discussion on the Europeanisation of the USD vol cube [here](#).
- Should the Fed need to deliver further easing, we think [Yield Curve Control](#) has good chances of being implemented. This would be a clear bearish factor for 10y vol.

14 April 2020

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Timestamp: 14 April 2020 03:04PM EDT

Chart 1: Repricing of Eonia forwards: from pricing significant cuts right before the March ECB meeting, to now a trough at just 10bp below spot

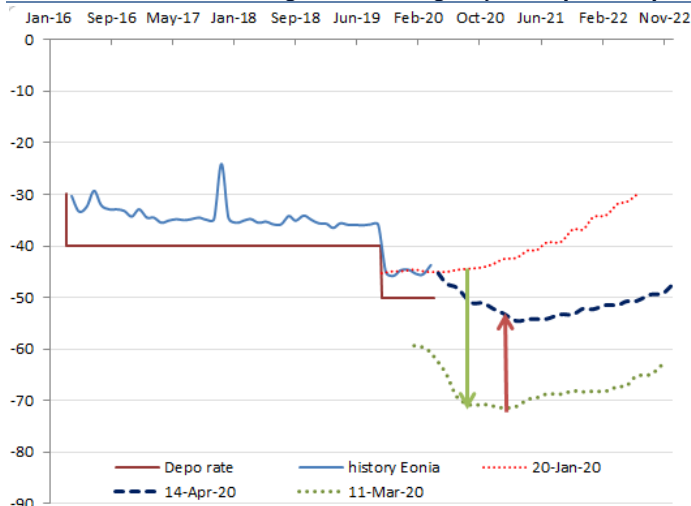


Chart 2: Scope for 6m10y USD rates vol to decline towards recent lows



Chart 3: Expected bull steepening of the US 2s10c curve (y axis in bp) is contingent on neutral rate expectations

Dashed blue curve corresponds to a 2.5-2.75% assumption, orange curve to 1.75-2%

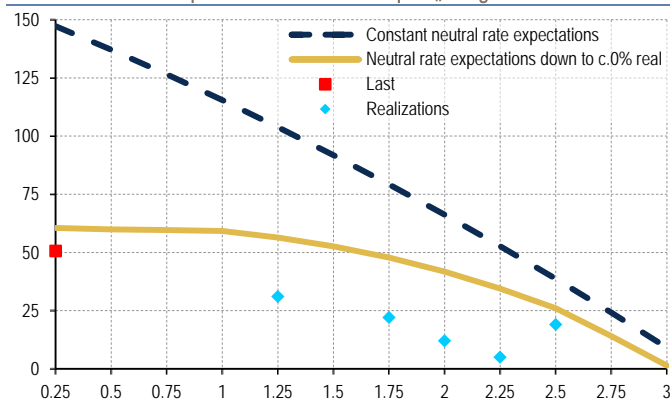
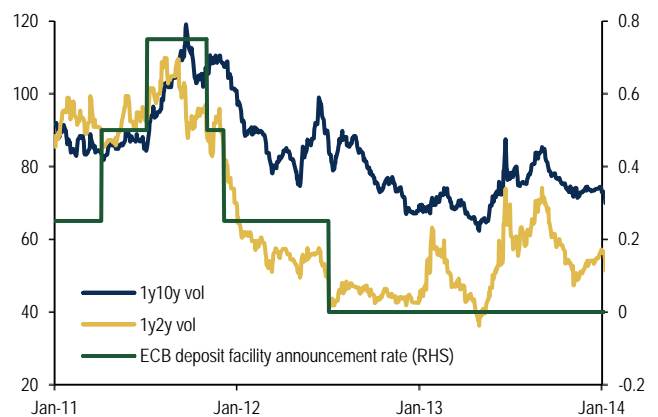


Chart 4: Euro swaptions 1y10y and 1y2y normal volatility (bp) versus the ECB deposit facility announcement rate (%)



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