

## US Rates Alpha

## LRC and Bermudan exposure in a selloff

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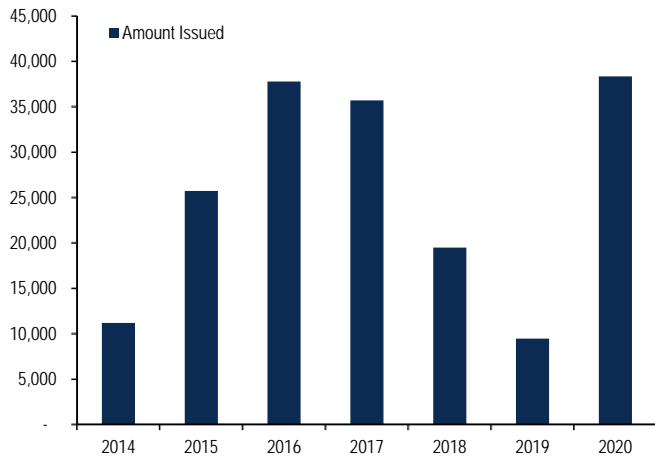
High call volumes for Formosa issues ytd, and record issuance levels to replace these called issues (see Chart 1), create a bimodal distribution of exposures between recent issues and older vintages. Here we look at whether this allows for some offsetting of exposures in vega space.

For illustration purposes we create a portfolio of six yearly callable structures that represent vintage years between 2014 and 2020. For each vintage year we assign a notional that corresponds to the issuance in long dated structures for that year (after accounting for issues that have been called) and take into account prevailing yields for that that year.

We calculate the vega sensitivities for 25bp, 50bp and 100bp, and consider two levels of funding spread, L+100bp and +150bp (see Chart 2). The results (see Exhibit 1) show that indeed there is some offsetting of exposures, particularly as average funding spreads in 2020 are likely to have been slightly higher than historical ones.

We see limited potential for long-dated vega positions to act as a risk-off hedge in a range bound yield environment under a historically flat curve. However, given the structural support for intermediate expiries (see [here](#)), we believe those structural long vega positions around the 5y30y tenor with positive vol carry start to make sense in portfolios (see [here](#)). Significantly, we see potential call volumes in 2021 of the order of \$15bn maximum, materially lower than what was realized in 2020.

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**Chart 1: Total issuance per year since 2014 (\$m)**

Source: BofA Global Research, Bloomberg

**Chart 2: USD LIBOR 3M 20Y Adjusted**

Source: BofA Global Research, Bloomberg

**Exhibit 1: Estimate for Vega sensitivity by vintage and as a function of funding spread and magnitude of the selloff**

Vintage year	Notional (\$m)	lockout	maturity	Yield	100 spread			150 spread		
					Vega Diff 25bps (k)	Vega Diff 50bps (k)	Vega Diff 100bps(k)	Vega Diff 25bps (k)	Vega Diff 50bps (k)	Vega Diff 100bps(k)
2020	35,996	5	30	3.30%	3,755	2,510	-6,355	-1,304	-7,614	-20,516
2019	6,133	4	29	4.50%	1,519	3,069	5,498	1,677	2,852	3,732
2018	18,921	3	28	4.50%	5,360	9,132	18,085	5,076	10,367	13,938
2017	23,195	2	27	4.30%	4,599	11,142	21,546	6,275	11,603	16,488
2016	13,124	1	26	4.20%	2,877	6,823	13,573	4,099	7,637	10,538
2015	1,971	1	25	4.40%	308	736	1,873	625	1,229	1,983
2014	800	1	24	4.50%	49	206	636	208	427	786
<b>Total</b>					<b>18,467</b>	<b>33,618</b>	<b>54,856</b>	<b>16,656</b>	<b>26,501</b>	<b>26,949</b>

Source: BofA Global Research



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