



United States

Rates
Rates Volatility Gov.
Bonds & Swaps

Aleksandar Kocic

Research Analyst

(+ [REDACTED])
[REDACTED]

Derivatives

- No directional cues emerged after the last FOMC meeting. The net effect is essentially a distributional modification, a swelling of the tails – the probabilities of rates moving both higher and lower have increased, at the expense of the likelihood of staying within the range. The novelty of the Fed communication this time was the mechanism whereby Fed consensus is converted into the market dissensus. Fed language became a pure volatility effect.
- In this environment any residual overweight in assets for which valuation has been distorted by monetary policy so far is likely to come under scrutiny and possibly be corrected. That should free some maneuvering space for the Fed and make potential hikes less damaging and thus possibly more likely. As far as an attempt to return vol to the markets, this is mission accomplished.
- We are buyers of tail risk at the short end of the curve in the mid-run:
- **Sell \$100mn 6M10Y 8bp wide strangles vs. buy \$325mn 3M3Y straddles costless**
- **Sell \$100mn 6M3Y straddles vs. buy \$200mn 60bp wide 6M3Y strangles costless**
- In our view, risk assets are at a bifurcation point – their future path depends on the way the economy and stimulus unwind interact with one other. We are buyers of hybrid S&P calls and puts conditioned on different rates responses to the Fed. We recommend:
- **18-Dec-2015 SPX 95% put subject to 5s > ATMF + 25 , offer 1.15%, an 73% discount to vanilla at 4.30%**
- **18-Dec-2015 SPX 103% call subject to 10s < fwd-25bp at expiry, offer 1.00%, a 70% discount to vanilla at 3.37%**

From Fed consensus to market dissensus: Volatility could be here to stay

The last FOMC could be seen as a template for what to expect in the near term. Two parts of the statement cause this. The combined statement reflects the divided subject of the future economic path and sets the terrain for a period of elevated volatility across various market sectors. Lowering of the NAIRU, the dovish side, means either we do not have the right model or, if we do, then we do not know how to calibrate it. It is not even clear that the U3 unemployment rate is the relevant statistic in this context. Either way, this means that there is relatively low confidence regarding the point at which the economy will turn around and the Fed would need to consider hikes seriously. The other side of the Fed's statement is the dots. Despite the dovish overtones conveyed by a lower median, the most relevant message is the emergence of a strong consensus, which is in sharp contrast with previous dot plots. As far as the end of 2015 is concerned, there is consensus that there should be two hikes by the end of the year (and four more in 2016).