

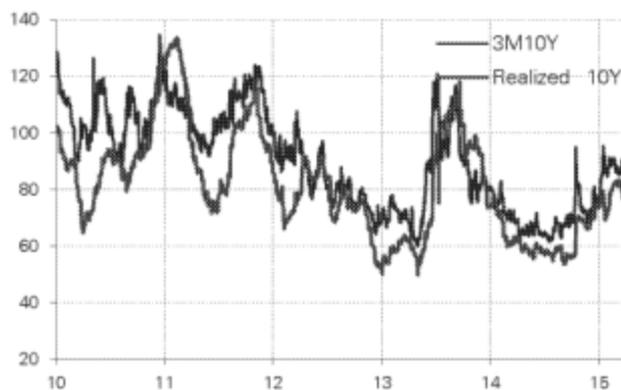


Figure 1: Implied and (3M rolling) realized vol at the short end



Source: Deutsche Bank

Figure 2: Implied and (3M rolling) realized vol at the back end



Source: Deutsche Bank

In the context of latest developments and further injection of uncertainty outlined after the FOMC meeting, we are buyers of tails at the front end of the curve, either outright or financed by selling back-end strangles. We capture this through two different variants of straddle/strangle switches.

- **Sell \$100mn 6M10Y 8bp wide strangles vs. buy \$325mn 3M3Y straddles costless**

The trade is vulnerable to bull flatteners and bear steepeners of the curve at this point with theoretically unlimited downside. We see these two modes as unlikely realization within 2015. Although a massive bull flatten could take place due to prolonged risk-off trade, it is unlikely that expectations of Fed hikes would remain unchanged under these conditions. Similarly, bear steepeners would be consistent with a rapid buildup of inflation and the Fed being caught behind the curve. At this point, there is no indication of the emergence of such a trend; on the contrary, it is difficult to envision the mechanism that could cause a rise in inflation despite seeming improvements in the labor market. Such an outcome is even more difficult to envision in the context of increased foreign demand for US duration. If anything, a rise in rates in the US would make the long-end UST even more attractive in comparison to other European bonds.

An alternative view on the short end of the curve is a possible short-term response to the bimodal market – rates either descend lower to reflect delayed hikes or they align with the consensus reflected in the Fed dots. In this context we recommend 1X2 straddle/strangle switches:

- **Sell \$100mn 6M3Y straddles vs. buy \$200mn 60bp wide 6M3Y strangles costless**

The trade has limited downside with a maximum loss of 30bp running in case of limited rally or selloff, and would benefit from extreme repricing at both sides.

### Hybrid strangles

Given the implicit convexity and exposure of risk assets to policy unwind, positioning in US stocks should be conditioned on expected Fed actions. It is conceivable that, if data support Fed hikes, the belly of the curve could sell off