

Subject: Fw: Hi Jeffrey - follow-up on options for rates steepness in USD [I]
From: Stewart Oldfield <[REDACTED]>
Date: Tue, 14 Oct 2014 16:03:26 -0400
To: Daniel Sabba <[REDACTED]>

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you may as well keep me copied on these. Paul will set up a meeting for both of us with Jeffrey in the next couple of weeks. Looks like you may have a trade right off the bat. Nice

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Stewart Oldfield, CFA, CAIA
Director

Deutsche Bank Trust Company Americas
Deutsche Asset & Wealth Management
345 Park Avenue, 10154-0004 New York, NY, USA
Tel. +1(212)454-2881
Email [REDACTED]

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From: Paul Morris/db/-
dbcom@DBAMERICAS

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Date: 10/14/2014 03:47
PM

Subject: Fw: Hi Jeffrey - follow-up on options for rates steepness in
USD [I]

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From Daniel Sabba/db/-
dbcom
:

To:
jeevacation@gmail.com,

Cc: Paul Morris/db/dbcom@DBAMERICAS, Vahe Stepanian/db/-
dbcom@DBAmericas,
Tazia Smith/db/dbcom@DBAMERICAS,
[REDACTED]

Date 10/14/2014 03:44
PM
:

Subj Hi Jeffrey - follow-up on options for rates steepness in USD
[C]

ect:

Classification: Confidential

Jeffrey,

It was a pleasure to talk today and looking forward to meeting when you get back to NY. Please see below for the rationale of the 5s10s steepener trade - I just repriced this for USD 1bn notional. As discussed, you pay 15bps upfront

for an at-the-money-forward (ATMF) CMS option struck at 54.5bps. The current spot is at 71bps, so it is 16.5bps above the ATMF strike. Last week, before the FOMC minutes were released, the spot was 20bps above the ATMF strike level. The current roll is not as high as last week but, it still represents very cheap optionality which carries roll benefit and unlimited upside in the event of curve steepening at expiry.

Purchase options on USD curve steepness (CMS 5s10s ATMF curve caps)

USD curve steepness close to 5 year lows:
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Indicative terms:

Notional	USD 1bn
Client buys	CMS curve cap on 5s10s in USD
Expiry	1 year
CMS 5s10s Strike	ATMF (54.5bps)
CMS 5s10s Spot	71bps
Upfront premium offer (mid):	15bps (13.5bps)
Terminal Payout:	Notional*Max (CMS 5s10s Terminal Rate-Strike, 0)
Settlement:	Cash

Trade Rationale and Implementation:

Potential catalysts for steepening in the short term frame include:
Economic recovery and a pick up in inflation expectations, which are likely to be a prerequisite for the market to sustainably price a Fed tightening cycle
Conversely, given inflation breakevens are currently depressed,

if a negative economic shock were to happen, it could imply a more accommodative Fed, which is commonly associated with a steeper curve

rates Deutsche Bank research on total return bond fund returns and

among derivate positioning suggests US steepeners are less crowded
real money investors

While a steepening view can be articulated in various delta-one ways, CMS curve caps allow clients to express a steepening view with limited downside, where the maximum downside is the premium paid. The terminal payout is $\text{Notional} * \text{Max}(\text{Terminal Rate} - \text{Strike}, 0)$

Because forwards are currently inverted, clients are able to purchase options with a higher positive roll from forwards to spot than the premium initially paid

Overview on current market dynamics:

This year's USD interest rate curve flattening in 5s10s can be decomposed into

three distinct phases:

- (i) the market repricing Fed tapering in the 10y sector
- (ii) China's intervention on USDCNY, building up official foreign reserves
- (iii) increase of deflation and QE expectations out of Europe

Hypothetical PnL at Expiry

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One 1y10y/10y swap rate vs. 1y5y/5y swap rate (as of 10/07/2014)

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Positioning research suggests steepeners are less crowded among real money investors

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(DB GM Research: Global Fixed Income Weekly ? 10/03/14)

Please note all prices are indicative and subject to change without notice.

Best regards,

Daniel

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Daniel Sabba
Director | Key Client Partners

Deutsche Bank Securities Inc
Deutsche Asset & Wealth Management
345 Park Avenue, 26th Floor
New York, NY 10154
Tel. +1 212 454 0857
Mobile +1 [REDACTED]
Email [REDACTED]

Derivatives are financial transactions based upon one or more predetermined market factors where periodic payments (or a one-time lump-sum payment) are made by each of the parties to the transaction based upon the value of the market factor or factors. The amount of the payment(s) will either be set at a

fixed amount or fluctuate as the value of the underlying market factor fluctuates. The underlying market factors are items or variables which are subject to market fluctuations; for example, interest rates, currency exchange

rates, assets, stock prices, stock index levels, commodities or a combination of one or more of these factors. Derivatives are normally used either as a hedging device or as an investment vehicle. Over-the-counter (OTC) derivative transactions involve numerous risks including, among others, market, counterparty default and illiquidity risk. In certain transactions, you could

lose your entire investment or incur unlimited loss.
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