Theme #11: Vol to roll

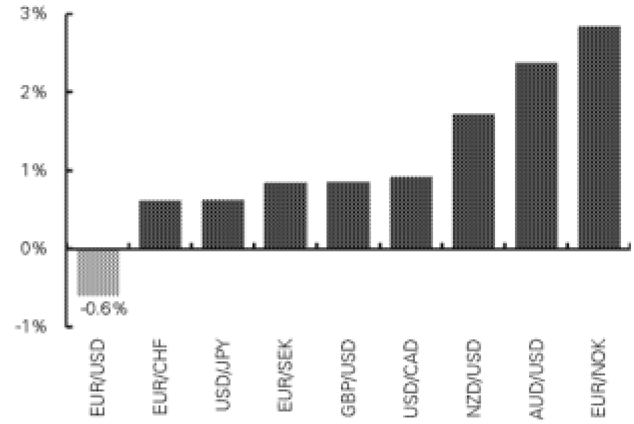
- **We see relative value opportunities in vol surface distortions; specifically buying EUR/USD FVAs, USD/JPY vol swaps and risk reversals, plus AUD/USD puts cheapened with AUD/CAD KOs**

Trade 1: Hedge against event-risks with EUR/USD FVAs: Despite potential catalysts such as the US fiscal impasse and EU political uncertainty, EUR/USD implied vol remained subdued in 2013, and was predominantly driven instead by rates volatility. With the USD10Y Treasury note yield expected to touch 4% on growth acceleration this year EUR/USD implieds should be supported. Correspondingly, this suggests that owning EUR/USD vol remains a useful blunt hedge against tail risks with significant impact on rates volatility in the US and EU. Potential catalysts include growth momentum deceleration in the US, an excessive rates rise following the tapering process forcing the Fed to backpedal, and ECB easing in Q1 on falling inflation expectations. Currently, outright long the vol swap is less attractive given implieds have been well bid since December. Instead, consider owing a 3M in 6M EUR/USD FVA at ~8.50% on the USD vega notional to exploit the flatness of the implied volatility slope (chart 2).

Trade 2: Long JPY volatility on model valuation: Another approach in analyzing volatilities relates to longer-term model valuations. On our framework, USD/JPY 1Y realized vol is estimated at 10.6% (chart 3) but could potentially trend higher. Among its core parameters are the Japanese current account (+ve beta), commodity prices (-ve beta), US core inflation (-ve beta) and the cyclically adjusted P/E ratio for US equities (+ve beta). With the falls in commodities and some eventual improvement in the current account and a higher P/E ratio as the base case for this year, risks to volatility tilt to the upside. Consider owning a 1Y vol swap, offered at ~10.70% of USD notional.

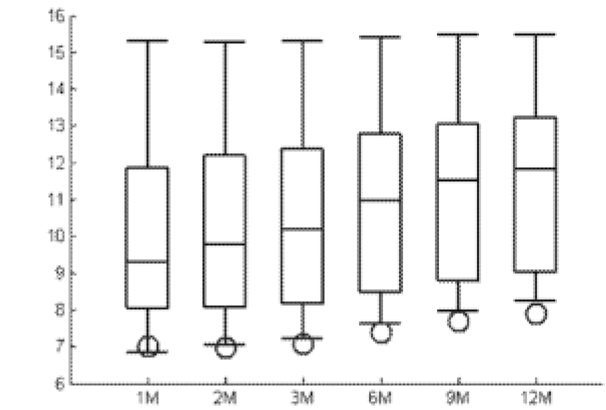
Note also that while we have been consistent advocates of AUD and CAD vol over the past year on our analysis of volumes, policy divergence and growth rebalancing these arguments are gradually becoming less attractive from a valuation perspective. Switching to long USD/JPY vol would seem to offer a better risk/reward payoff.

Changes in 3M implieds over the past year



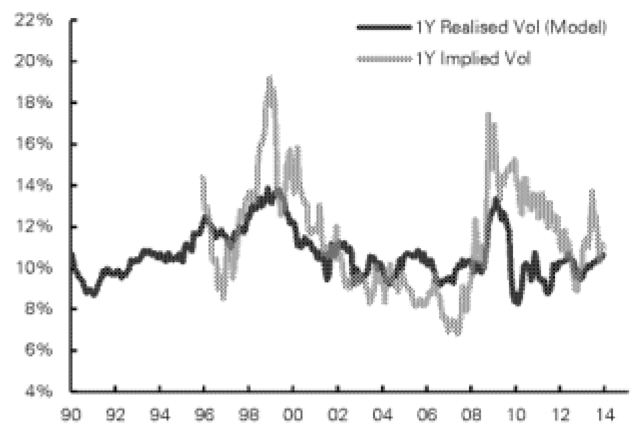
Source: Deutsche Bank, Bloomberg Finance LP

Vol slope for EUR/USD is historically flat



Source: Bloomberg Finance LP. Chart edges correspond to the 5%, 25%, 50%, 75% and 95% percentiles over the past three years, blue circles represent current values.

Modeled 1Y realized USD/JPY vol versus implied



Source: Deutsche Bank, Bloomberg Finance LP