

tightened significantly past 18 months but old metrics of value make no sense in Europe because they rely on history when there was no QE.

While it's hard to get excited about 10y BTPs yielding 3.16% (164bp over 10Y German Bunds) I'd still have 5-10mm 10y BTPs in my portfolio both for the duration and spread compression potential. I prefer 10y over 5y because the recent nearly parallel spread compression has left 5s10s steep relative to 0-5s..

3 reasons I like this trade:

- i) macro investors view ECB QE as a second bite at the cherry. Everyone I talk to wants European risk assets having seen QE in the US.
- ii) ECB QE is probably still 3-6mths away which will keep credit bid. This will be a buy the rumour sell the fact trade
- iii) Credit has been bulletproof during the recent risk selloff because a) ECB QE expectations, b) G3 rate hikes are being pushed into the future while cash has nowhere else to go. This price action is telling - as and when equities recover I think credit continues to tighten

Yields of 10Y Italy, 10y Germany and the Yield Spread  
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2) Tactically position for higher EURUSD - 2 week view (now)  
BUY EUR50mm 2week expiry 1.40 strike European Style EURUSD Calls @ 6bp  
(EUR30,000)

This is a low cost contrarian short term tactical call. Most investors myself included are bullish USD in the medium term (see trade 3) but in the very short term I see EURUSD higher because:

- i) Despite ECB preparing the markets for QE, the price action of EURUSD (broadly unchanged) has been quite bullish compared to what one would expect
- ii) Speculators don't appear long EURUSD to us. Majority are short or flat.
- iii) implied volatility is 5.25% (offer for 2week options) which is very very low historically. So this is a penny option, highly convex, pain trade bet against other speculators betting on QE

If my view is wrong 6bp is lost. If I'm right I'd plan to exit in a week making 4-6x

Scenario Analysis - Premium in bp of EUR notional  
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3) Position for a Stronger Dollar - 1year view (now or soon)  
Buy 1y expiry European style digital binary option on EURUSD struck 5% below spot @ 21% of payout (which I think is too cheap)  
Current strike (spot - 5%) would be 1.3120

At expiry if EURUSD has fallen by more than 5% from current levels the option payout is EUR1mm. Upfront premium is EUR210k.  
The option is liquid and can be unwound at any time.

- i) Yellen has done a poor job of communicating the Fed's thinking but its increasingly clear the Fed will brake later than usual
- ii) Betting on higher US interest rates in the rates market isn't cost effective because the forward curve is already pricing in higher rates
- iii) The Dollar hasn't appreciated yet because short rates in the US haven't risen meaningfully
- iv) THE KEY POINT - FX volatility is very low in currency pairs like EURUSD where central bank policy on each side is increasingly diverging. The low vol makes this bet inexpensive to put on.
- v) Because FX vol is so low betting now or soon with a one year time horizon costs very little. I'd rather be early than late here
- vi) I prefer 1y expiry because this trade could take 6-12mths to play out

1Y EURUSD VOL: Low - but then again most vols are  
What I like about EURUSD is that central bank policy on each side is diverging  
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