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CC: Paul Morris <[REDACTED]>, Vahe Stepanian <[REDACTED]>, Ariane Dwyer <[REDACTED]>, Richard Kahn <[REDACTED]>
Subject: RE: Higher rates in Europe - timely [C]
Date: Thu, 30 Apr 2015 12:31:47 +0000
Inline-Images: image001.jpg; image002.png; image003.jpg

Classification: **Confidential**

I wanted to share some thoughts on the risk reward for European fixed income. At yesterday's close, 10y EUR swaps and 10y bunds were up 0.098% and 0.122% respectively. For a holder of 10y sovereign German bond (DBR 0 ½ 02/15/25), yesterday's MTM movement represented the yield its owner would have earned for about 7 years. The equivalent movement for the 30y German bond (DBR 2 ½ 08/15/46) represents about 6 years of yield.

This begs the question of whether market participants who own European government debt will rethink the risk reward of that investment. Is such an asset worth owning once one realizes such a daily blip in interest rates has the potential to wipe out multiple years of yield?

The options below allow investors to position for a lift-off in European swap rates with limited downside of premium paid.

From: Daniel Sabba
Sent: Wednesday, April 29, 2015 11:57 AM
To: 'jeffrey E.'
Cc: Paul Morris; Vahe Stepanian; Ariane Dwyer; 'Richard Kahn'
Subject: Higher rates in Europe - timely [C]
Importance: High

Classification: **Confidential**

This is timely given this morning's moves... EUR swap rates are up dramatically and markets are fluid - the pricing below is as of last night's close.

Trade Rationale:

- Yields in the Eurozone have fallen since the start of 2014, and the commencement of the ECB's 1.1 trillion EUR quantitative easing program in March has fueled the decline to a greater degree than anticipated
- This drop is highlighted in Chart 1, which shows the historical performance of the 10yr and 30 yr EUR Swap rate and 10y and 30y German bund yields. The chart also shows the 5 and 15 year average yield for the 30y EUR Swap rate
- Investors are now questioning if these unprecedented lows are sustainable and how they can position themselves for a rise in European rates
- To articulate this view, investors can purchase CMS caps on the 30yr EUR swap rate that provides a linear payout on the 30yr EUR Swap rate if it rises above the strike. In this trade, even a small retracement to the historical norm provides a meaningful payout
- A retracement to 5y historical averages would yield a payout of ~6x on 1y 1% strike caps, while a retracement to 15y historical average would yield a payout of ~12x.
- In the below table we have included indicative pricing (as of 4/28 close) for 1 and 2yr expiries, and 1.00%, 1.25% and 1.50% strikes. In addition, for the 1y CMS cap struck at 1.00%, we have included a terminal payout diagram and a chart showing the strike and breakeven level on the 30yr EUR Swap 1 year chart (Chart 2)

Chart 1 (time series of European rates)

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Indicative Transaction Terms:

Client buys: CMS Cap on 30y EUR CMS rate, Single Look at Expiry
Terminal Payout: Notional * max (Terminal CMS rate – strike, 0)

Currency	EUR	EUR	EUR	EUR	EUR	EUR
Strike	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
Expiry	1y	2y	1y	2y	1y	2y
Tail	30y	30y	30y	30y	30y	30y
ATMF	0.94%	1.07%	0.94%	1.07%	0.94%	1.07%
Offer (mid) bps	26 (23)	46 (40)	16 (14)	34 (30)	10 (8)	25 (21)
Break Even	1.26%	1.46%	1.41%	1.59%	1.60%	1.75%

Terminal Payout Chart for 1% strike CMS Caps on 30y

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Chart 2 (EUR 30y swap rates and breakeven for the 1y CMS cap struck at 1.00%,)

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Please note these transaction terms are indicative.

Regards,
Daniel

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