FORTEM CAPITAL

# FRIDAY NIGHT 'LIGHTS

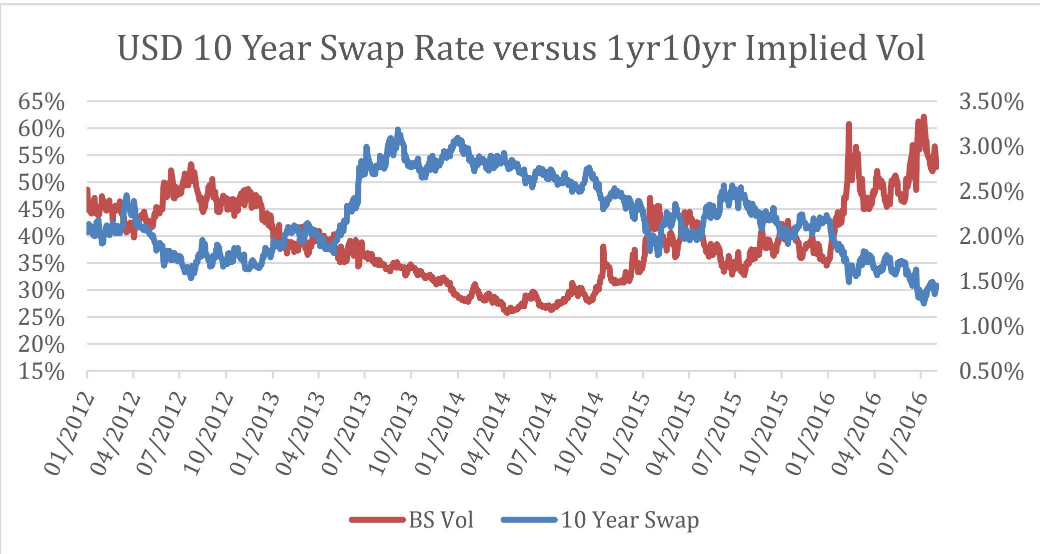
## Income replacement – 1 Year RCB on 10 Year USD Swap

5th August 2016

In the FNL of the 22nd July we discussed ways to play the USD yield curve with a number of cash and derivative based investment suggestions. In this week's FNL we focus in on one of those investment suggestions and provide a little more context as to why we believe that the rationale may currently stack up.

The US economy seems in somewhat of a paradox at the moment, with concerns regarding the state of the global economy having an impact on the US economy leading the doves to maintain a rate hold, whilst the hawks pointing to an improving domestic economy and a desire to achieve sustainable inflation, advocating a rate rise.

As we illustrated in the previous FNL's, the yield curve remains flat versus historical levels and more pointedly 10-year swap rates are at or around all-time lows. Relative to this is the implied volatility of the 1year into 10 year USD swaption (see the Fortem library for a basic guide to Fixed Income options). The chart below plots the 10-year swap rate and Black-Scholes implied volatility from 2012 to now. Quite evidently implied volatilities are, relatively speaking, trading at rich levels and it is with this in mind and perhaps an investment view that rates over the next year will remain at current levels or not drop much further, that we look at an income replacement idea.




So the question to ask is how one can monetize the rich implied volatility levels associated with 10 year USD swap rates, whilst playing a view that over the next year, yields will not fall dramatically.

You may or not recall from the equity world that a reverse convertible involves selling some sort of put option and taking the premium received from that, along with interest received from the issuing bank for giving them your cash for the investment horizon of the product, to provide a terminal guaranteed coupon. Well you can do the same on the USD 10-year swap rate.

| Rates (bps) | | |
|---|---|---|
| | Current | Week Chge |
| **GBP 1yr** | 45.00 | -6.00 |
| **GBP 3yr** | 41.70 | -6.80 |
| **GBP 5yr** | 48.20 | -6.80 |

| Equity Indices (%) | | |
|---|---|---|
| **FTSE 100** | 6789.68 | 1.13% |
| **S&P 500** | 2174.06 | 0.22% |
| **Nikkei 225** | 16254.45 | -1.90% |
| **Eurostoxx 50** | 2957.49 | -0.81% |

| Currencies (%) | | |
|---|---|---|
| **GBPUSD** | 1.3182 | 0.67% |

| 5yr Credit Spreads (bps) | | |
|---|---|---|
| **Citigroup** | 84.61 | 3.17 |
| **Credit Suisse** | 133.67 | -6.34 |
| **Deutsche** | 211.70 | -10.58 |
| **GS** | 100.85 | 4.52 |
| **HSBC** | 80.18 | -4.47 |
| **JPM** | 63.79 | 1.44 |
| **MS** | 98.75 | 3.92 |

| Commodities (%) | | |
|---|---|---|
| **Gold** | 1344.35 | 0.16% |
| **Oil** | 41.81 | 2.80% |

| 3m Implied (vol pts) | | |
|---|---|---|
| **FTSE 100** | 14.08% | 0.55% |
| **S&P 500** | 12.57% | -0.13% |
| **Nikkei 225** | 22.13% | -1.55% |
| **Eurostoxx 50** | 20.83% | 0.41% |

| 5yr Implied (vol pts) | | |
|---|---|---|
| **FTSE 100** | 19.97% | 0.67% |
| **S&P 500** | 22.02% | 0.32% |
| **Nikkei 225** | 19.98% | -0.67% |
| **Eurostoxx 50** | 19.98% | 0.30% |

*Source Bloomberg / Partner Banks*
*Data as at 5th Aug, 2.30pm*

| Indicative Levels – 6yr | |
|---|---|
| **FTSE 80/110 boost. 65% EKIP** | 235% |
| **FTSE flat, 65% EKIP** | 10.2% |
| **FTSE/S&P 5% step, 60% EKIP** | 8.70% |

*Call us for more details – see below*

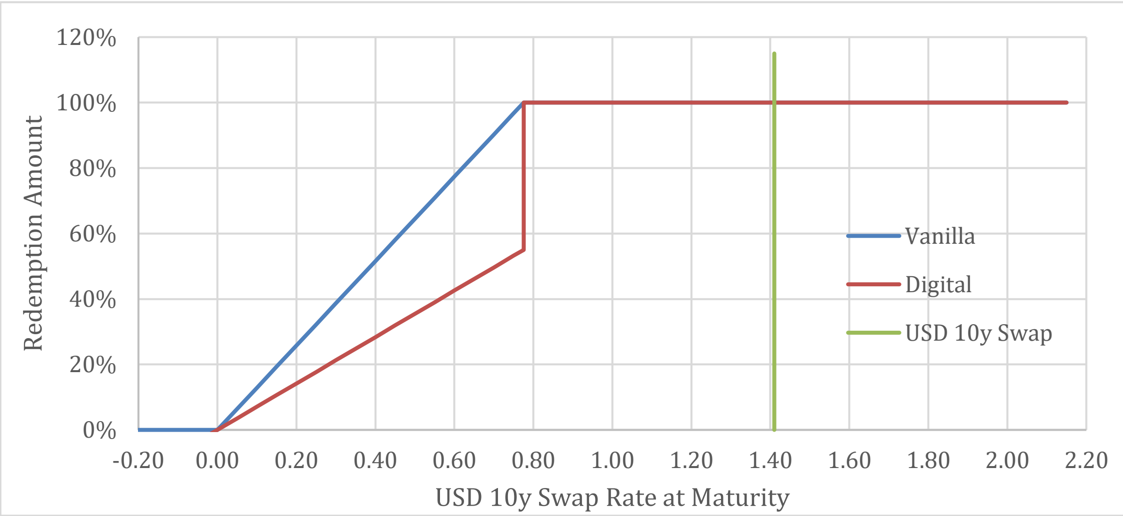
| Upcoming Events | |
|---|---|
| 9th | UK Industrial and Manufacturing Production MoM / YoY |


**Contact:**

General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2903 E sales@fortemcapital.com
Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2902 E research@fortemcapital.com

# FRIDAY NIGHT 'LIGHTS

In the payoff diagram outlined below we have plotted the terminal payoff (excluding the guaranteed coupon) for two types of 10 year USD swaps linked reverse convertibles. The vanilla payoff involves selling out of the money puts struck at 55% of current 10-year swap rates and the other is a digital payoff only activated if the 55% knock-in level is breached, but with a strike at current 10-year swap rates. This latter put option might sound familiar to the traditional equity linked structured product buyer, who in investing in such products is inherently selling equity linked knock-in puts. It is the same scenario there as here, in that you are taking advantage of relatively high levels of implied volatility, by implicitly selling implied volatility, by selling puts. Of course the strike and knock in level versus the potential upside investment returns have to be consistent with your investment view for both.




The investment terms for a 1-year RCB product linked to 10 year USD swap rates are as outlined in the below table.

| USD 10 Year Swaps linked reverse convertibles | |
|---|---|
| **USD RCB Vanilla** | 1 Year, Fixed Coupon of **6.5%** paid at maturity<br>Redemption at maturity of: 100%, if 10y USD Swap Rate > Barrier<br>Otherwise Redemption Amount of: 10y USD Swap Rate / Barrier * spot<br>Barrier at 55% of current 10y USD Swap Rate (ref spot: 1.434%) |
| **USD RCB Digital** | 1 Year, Fixed Coupon of **8.2%** paid at maturity<br>Redemption at maturity of: 100%, if 10y USD Swap Rate > Barrier<br>Otherwise Redemption Amount of: 10y USD Swap Rate / Spot<br>Barrier at 55% of current 10y USD Swap Rate (ref spot: 1.434%) |

In summary, if you believe that USD 10-year swap rates won't fall below ~ 79bps in a year's time and wish to monetize relatively rich implied volatility to derive an attractive guaranteed coupon, then a RCB on 10-year swap rates could be an attractive investment proposition. Iterations on USD 10 year rates in terms of currency (Quanto into GBP costs approximately 1% in coupon), tenor and/or barrier levels as well as other sovereign swap plays can be achieved so please do feel free to give the team a call.


**Contact:**

General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2903 E sales@fortemcapital.com
Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2902 E research@fortemcapital.com

## Disclaimer

This factsheet has been issued as a financial promotion by Fortem Capital Limited having been approved for issue by Blackheath Capital Management LLP for the purpose of section 21 of the Financial Services and Markets Acts 2000. Fortem Capital Limited is an appointed representative of Blackheath Capital Management Limited which is authorised and regulated by the Financial Conduct Authority. This factsheet is intended for Professional Investors and Institutional Clients and advisors and should not be communicated to any other person. The information has been prepared solely for information purposes only and is not an offer or solicitation of an offer to buy or sell the product. All information, including prices, analytical data and opinions contained within this factsheet are believed to be correct, accurate and derived from reliable sources as at the date of the factsheet. However, no representation or warranty, expressed or implied is made as to the correctness, accuracy or validity of such information. Fortem Capital Limited assumes no responsibility or liability for any errors, omissions or inaccuracy with respect to the information contained within this factsheet. All price and analytical data included in this factsheet is intended for indicative purposes only and is as at the date of the factsheet. The value of investments and the income from them can go down as well as up and the investor may not get back the amount originally invested. Past performance is not necessarily a guide for the future. The information within this document does not take into account the specific investment objective or financial situation of any person. Investors should refer to the final documentation and any prospectus to ascertain all of the risks and terms associated with these securities and seek independent advice, where necessary, before making any decision to buy or sell. The product may not be offered, sold, transferred or delivered directly or indirectly in the United States to, or for the account or benefit of, any U.S. Person.

**Contact:**

General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2903 E sales@fortemcapital.com
Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2902 E research@fortemcapital.com