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***"The last 3 month average of the LMCI was 2.4! That is crazy bullish.** Consider the selling Z4-5-6 or the sell H5-6-7 vs sell 0.5 M8 trade."*

That was the email I sent to active clients Monday, October 6, shortly after the LMCI came out. And here we are… a 28.5bp rally in EDM7 on the week. Yes – it helped that the FOMC minutes were dovish[1] (or more accurately, not hawkish as expected), and the stock markets tanked, and we had some more ebola. But it all started with the LMCI on Monday. We took profit on two more trades last week, which continues our Q4 surge.

Last week, we spent a little time away from thinking about "considerable," to another word – "reasonable." On Tuesday, Dudley came out and said that forecasts for the Federal Reserve to raise interest rates in mid-2015 are "reasonable." Since he is one of the three people on the FOMC I care about, it gave me a little pause about my call for the FOMC to do nothing for the next 9+ months. I like quantifying as much as possible. Is "reasonable" equivalent to 50%, 75% or 25%? I am not sure, but he mentions that upside risks to growth are limited. All things being equal, I would have thought "reasonable" meant something on the order of 50%. I suppose about 50% is what is priced into the June meeting right now. And he is the one who said recently that the distribution around his projections are wide, so perhaps one shouldn't read too much into "reasonable." Except…

On Thursday, Fischer (another FOMC member I care about) spoke and said, "on the basis of our forecasts of the data ... it looks like markets more or less have it right - somewhere in the middle of the year." At the end of Wednesday, the markets were only pricing in 69bps for the end of

Value on the Curve: (active CA trades):

1. * Take advantage of the flat vol curve between greens and golds.** The "free" crisis trade and various bull steepening trades are available.

2. ▲ Too much curvature around H6 –** We took profit in Z5. I still like H6 vs the level of longer term rates.

3. ** Not enough curvature in the golds. This is still cheap, but now the back blues are starting to look cheap as well.

4. ▼ Too much positive curvature in the greens...** especially vs the slope of the curve and curvature in the blues and golds. I still think this is true, but we are halfway to our P&L targets.

5. * Greens-Blues is too flat. I don't see how we are not tightening in 2017.

Value on the Horizon: ("C" trades):

- **NEW If we get a massive short squeeze, look to set opportunistic shorts.** While I do not think the FOMC will hike "soon," I do think that that they will start hiking later and probably faster.
- **Play for bearish sentiment before FOMC statements and minutes.** The anticipation of bearish news with the hawkish bank presidents will be great. However, the leadership is still dovish. Also, take profit on bearish trades sooner rather than later around these events.
- **Play for increased year-end turn premium on EDZ8.** It's possible the decline in the year-end turn is based on rates being so low. There is a chance the turn could reappear as rates rise.

Noteworthy Levels:

- **Gold pack made a 1 year high.**
- **EDU6-U7 and Z6-Z7 spreads made a 1 year low.**

[1] If you are not an active CA client, my thoughts on the FOMC minutes (that I previously sent during the week via email) are in the Appendix.

2015, so if he thinks the markets have it "more or less right," then that is not really that hawkish, but the "somewhere in the middle of next year" comment seems a little scary if you are a bull... unless you think September is "somewhere in the middle." He also said considerable could refer to 2 to 12 months. I am not sure why he would cap "considerable time" to 12 months. But I am thinking he probably meant that once that is removed, they are within 2 to 12 months of hiking. Because a double dip can not be ruled out. Then on Saturday, he came out and said, "if foreign growth is weaker than anticipated, the consequences for the U.S. economy could lead the Fed to remove accommodation more slowly than otherwise." While this statement is rather obvious, it does lean a little bullish, as factors outside the US weigh in on the FOMC decision-making.

I suppose at the end of the day, **it is all about the data**. Even before we had the geopolitical, foreign exchange, equity market and ebola headwinds, I never thought labor market conditions or inflation were going to accelerate. I will discuss the reasons why in another issue. So the market rates look "reasonable" to me.

Well, one thing that does not look reasonable is how low the long end yields are - especially compared to the curvature in the reds and greens. I'm not saying I don't understand why. I had previously mentioned a number of reasons for the demand for fixed income to outstrip the supply. Those are all valid reasons, and I've now added a few others:

- retiring baby boomers rolling their portfolio into fixed income (Asset Allocation 101 – that's what you are supposed to do as you get older),
- some the US's top trading partners, the EU, Japan and China (to a lesser extent), have slowing growth and some are still pumping in more monetary stimulus,
- theories like PIMCO's "New Neutral,"
- the US trade deficit keeps on growing,
- there is demand as a safe-haven/crisis asset,
- any regulations requiring banks and pension funds to hold more high quality assets, and
- even after tapering ends, the FOMC is still buying and reinvesting their portfolio, and they will keep on reinvesting until they start hiking.[2]

That's a lot of people wanting to buy. Some of these things are not going to change any time soon. But some of it may. I suspect a lot of longer term bulls are feeling comforted because the FOMC implicitly made a second and even stronger "considerable time" pledge on when they will release their $4+trillion portfolio. The latest FOMC Policy Normalization Principles stated they would cease reinvestments *after* they begin increasing the target rate. So not only does the FOMC have to get rid of "considerable," they then have to hike, and then eventually the FOMC will cease reinvestments. The logic by bulls is probably that there is plenty of time to get out before then. So the bulls look out at the current landscape (factors above) and say, "that looks good for being long the long end!" I can see that.

[2] I have no idea why they would continue to reinvest when stopping reinvestments could be thought of as an extension of tapering and there are some valid concerns about monetary policy with a massive balance sheet. Maybe they just reinvest in the very short end?

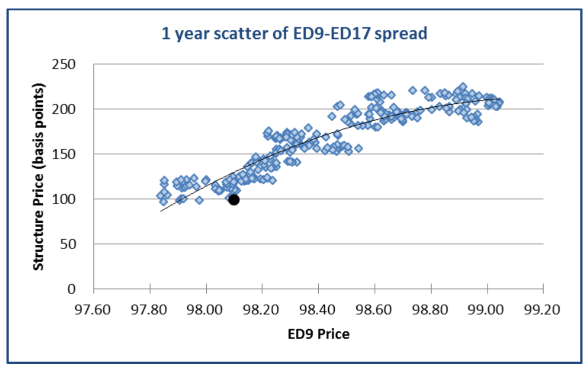
But the thing is, the markets are not static. The various participants in the markets react to the change in markets. At some point, other parts of the curve become more attractive. If I had to borrow money, I would be all over the long end and I'm not sure large corporations wouldn't feel the same. The Treasury may start issuing more longer dated securities, the FOMC may consider other reinvestment options, investors may want to take profit if the returns are too low, etc. Last week, Warren Buffet said, a 30 year mortgage is "a good way to go short the dollar, short interest rates. It is a no-brainer… It's a 30-minute instrument if you've been wrong on interest rates and it's a 30-year instrument if you've been right on interest rates." Sure he owns a huge stake in Wells Fargo (the largest US home lender). But I agree with him and I am sure a lot of potential issuers are as well.

I just can't get that excited about lending the US government money at 2.31 for 10 years. It makes investing with Bill Gross look attractive. Who knows if FF rates will be closer to 1% or 3% at the end of 2016. But one thing I do know is if we keep rallying from here, that probably means the FOMC gets priced out of 2015 and 2016, and I am going to want to own 2017 and beyond.

WARNING: Next week is going to be highly volatile, so proceed with caution! One of my former managers used to say, "be a trader, not an investor." He meant you should trade tactically, rather than hold trades for long periods of time. That is a good piece of advice – especially for volatile markets. Unfortunately, it is difficult for me to do in the context of a weekly newsletter. All I do is present where I see value on the curve. If you like an idea, determine the opportune times to get in and out, based on how the markets are trading.

TRADE IDEA (NEW):

58) Buy 2EZ6 98.125 call vs Sell 4EZ8 97.125 call @ -0.5 (-0.75 settle)



You can do 98.25 vs 97.25 if you prefer slightly OTM strikes. Use any extra premium to buy a few more calls on 2EZ6, just in case. Reasons for doing the trade:

- **This is near the one year low.** I am surprised the curve has not steepened more in last week's big rally. I think there may have been some residual from the PIMCO unwinds. I am a big fan of owning 2017 & 2018 hikes at 1 year lows if we keep rallying. Fischer even implied they will go slowly at first, which leave room for more hikes later.
- **Positive Roll.** Rolls +16bps in your favor in 3 months.
- **The markets are pricing in 1.71 for the end of 2016.** By my estimates, that means they have another 200+bps to go, and we are buying the next two years for 100bps.

- **This is my core view** - that on a rally we steepen. In the past week, Z6 rallied 27bps, and we only steepened 4.5bps. I expect a little more catch-up in the next few weeks if we rally further, or just roll down the curve.
- **If we sell off, no worries**! If the next FOMC meeting ends up being hawkish, or the next payrolls surprises to the upside, equities recover and we have world peace, all the calls go OTM.

I would just do this trade in small size. I like it and think there is value here, but we could get a lot of volatility next week.

TRADE IDEA (Sent 10/7):

56) Buy 2x 0EZ5 99.125 call vs Sell 1x 2EZ6 98.125 call @ 0

You are effectively short the Z4-5-6 year fly on a rally. I am not going to write this up, as it is +3.25. Next time I send an email titled "Trade I really like now," please do some. Below is the email I sent Tuesday:

*Because of all the recent PIMCO selling, people seem to be avoiding Z5. This could also be a play for a hawkish minutes (as previously mentioned, the minutes *should* sound hawkish because of all the less-relevant hawks on the FOMC yapping away). This could also be here because there is a very real chance the new phrasing at the October FOMC meeting could have "considerable" removed. However, I no longer care.* ***Even if they remove "considerable", barring an inflation outbreak, the FOMC is not going any time soon. The LMCI at 2.4 for the last 3 meetings basically says to me, that barring some shocking data, they are not moving in the next 9-12 months. There. I said it.***

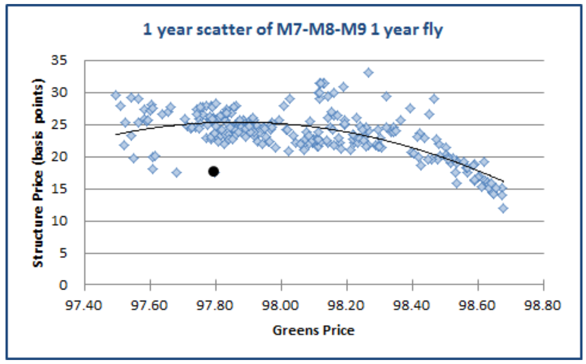
With this trade, you are selling the Z4-5-6 year fly. This structure is currently -27.5 This should easily be below -30 right now. It is only here because of PIMCO, and they seem to be done (no change in OI yesterday). The strikes are at -37.5, but because of the nature of options, you will make money way before we get there. But based on the current curve, this should roll to -50! The nice thing is, if I am right on my view, the current curve is wrong and this should be much lower than -50. The 6 month low is -81. I think Z5-Z6 will stay north of 100 this year (because the bears have to cling to something), which also helps the trade.

Currently the market is -0.5/0. So you can lift the offer and get this done for zero cost. I will do 4 of 4 units there. I am only doing this "small" because I already have 4 units of the 1.5:1. I realize this is similar to selling Z-4-5-6 fly. Well, this is better, because even if I am wrong and the FOMC hikes early, it doesn't matter because all calls will be OTM. This is easily one of the three best trades out there right now.

TRADE IDEA (Sent 10/9):

57) Buy EDM7-M8-M9 1 year fly @ 16.5

I saw a 16 last print and I said I would buy 16.5s. Clients bought 16s, and caught the absolute bottom. This is now 17.5, so I will not write this trade up again. Below is the text of the email and graph I sent Thursday:



The area around M8 looks very rich. So that is why I said to buy 1.5s in the Z7 6mo fly yesterday. However, an "easier" way to get this view on is to buy the M7-M8-M9 1 year fly @ 16 (last trade). The more we rally, the markets should be pricing in a later FOMC. I think H2 2017 should be good for at least a few hikes. I will buy 1.5 of 4 units at 16.5 (you may be able to get better). Let me know where you get this done. Yesterday's close was the 6 month low, and we are 1-1.5bps lower today. I think there is about 6-8 bps in this trade, and makes a lot of sense fundamentally.

TRADE UPDATE:

We booked two more winners. Direction may be hard to predict, but I like taking views on slope and curvature.

There is a lot of value in the trades listed below (rated with "*") so give those a second look.

Trade	Entry	Exit / Close	P&L (bps)	Size [max]	(Sizing) Comments
32) ** Buy 1.5x 0EZ5 99.125 call vs Sell 1x 2EZ6 98.125 call	0 (+1 fill at +1.25)	-0.875	-0.875 (to -2.125)	4 [4]	Less hikes in 2015 and more in 2016 makes a lot of sense on *a rally*. Right now, you can do 1.6:1 for zero, which I think is a good look.
33) Sell 2x EDH5-U5-H6 fly vs Buy EDU5-H6-U6 fly (formerly Buy ArbU5)	-23.5	-29.5	+6	▼0 [8]	Yep… taking into account the -28.5 unwind of the H5 6mo single fly, ArbU5 did get into positive territory, as predicted initially. The definition of "phyrric victory." Call it a Neutral. Trade Closed.
37) * Buy EDU8-H9-U9 6mo fly	2 (+fills at +1.5, +1, +0.5)	1.5	-0.5 (to +1)	20 [20]	There is a small tail probability that this goes much higher on a large bull steepening.
43) Sell EDM7-Z7-M8 fly 6mo fly vs Buy EDM8-Z8-M9 6mo fly	8.5	6.75 (closed 5.5)	1.75 (+9 BUs)	▼0 [10]	Took profit on balance at 7 and 6.5 (10/7). That's another 7 BUs, for 16 total. Trade Closed.
50) * Buy 1.67x 2EZ6 98.25 call vs Sell 1x 4EZ8 97.125 call	-0.25	-0.89	-0.64	8 [10]	I know this lost money, but I would much rather have this position than the other side. Looks like we'll have headline risk for the next few weeks.
51) Sell EDZ4-Z5-Z6 fly	-24.5	-36.5 (closed -35.5)	+12	▼0 [2]	It stopped right at my -37 t/p level after the close. So I'll just pay up to -36.5. 12bps is a nice move. I think this is going lower but I still have the exposure in options. Trade Closed.
52) ** Buy EDZ6-Z7 spread	68	65	-3	1 [2]	It's quite mind-numbing that we could rally so much and not steepen this part of the curve.

53) * Buy EDH6-U6 spread vs sell 3x Z6-M7-Z7 fly	18.5	21.5	+3	3 [6]	When will the M7 (greens) seller reduce?
54) * Sell EDZ6-M7-Z7 fly vs Buy Z7-M8-Z8 fly	8.5 (+3 fill at 9.5)	8	+0.5 (to +1.5)	4 [8]	7s look about right, but it could collapse on a big enough rally.
55) ** Sell EDH5-H6-H7 1 year fly vs sell 0.5x EDM8 @ 4853.5	4853.5 (+1 fill at 4856.5)	4854	-0.5 (to +2.5)	▲2 [2]	Added 1 unit on 10/7 at 48.565. This is my core view on the curve right now.
56) Buy 2x 0EZ5 99.125 call vs Sell 1x 2EZ6 98.125 call	0	+3.25	+3.25	4 [4]	Added 4 units on 10/7 because the level was so absurd – how can this be zero offered? I was going to lump into Trade 32, but not all clients joined in, so I need a separate accounting for that trade. The Z4-5-6 fly should go below -40, so no worries.
57) ** Buy EDM7-M8-M9 1 year fly	16.5	17.5	1.5	1.5 [4]	Clients bought 16s on the dip on 10/9. It's beautiful when you catch the absolute bottom and get filled there.
58) ** Buy 2EZ5 98.125 call vs Sell 4EZ6 97.125 call	-0.5 tbd			1 [2]	Another representation of my core view. But owning 2017 and 18 for 100 bps *on a rally* seems like a good view.

2013 Trades Closed in 2014 (9 total): Winners: 8, Losers: 0, Neutral: 0, DK: 1

2014 Trades Closed (49 total, including 2 Winners and 1 Neutral above):
Winners: 28, Losers: 7, Neutral: 5, DK: 9

Trade Table Notes:
The Table shows the list of active trades. The Trade List (and in particular with the specified the sizing) is not intended to be traded as a "book". As new readers are constantly being added, the Trade List highlights the best available positions (in my opinion) on the curve *at that point in time*. Trades are removed as profit is taken, or when a trade ceases to provide value (which may result in a loss).

APPENDIX

WEEKLY EMAIL RECAP:

On Tuesday 10/7, I sent out:

"Even if they remove "considerable", barring an inflation outbreak, the FOMC is not going any time soon. The LMCI at 2.4 for the last 3 meetings basically says to me, that barring some shocking data, they are not moving in the next 9-12 months. There. I said it."

And of course, we got the bullish minutes on Wednesday 10/8:

"I just skimmed thought the relevant parts. This is unequivocally bullish for reasons to be elaborated on later: The bears seemed to be isolated. There was no indication of policy change any time soon, although I suppose it's still possible they take out "considerable". But overall, it is up to the data, and the data says 2.4 LMCI and 1.5 core PCE. They will do nothing for a while, regardless of what happens to "considerable". I said this yesterday, but today is the support."

Later that day:

"The reason this minutes was very bullish was because there was some anticipation of a debate on language change or shift in sentiment - especially since tapering is about to end at the October meeting. So this could have been a good time to plan ahead and discuss what changes could be upcoming. There was basically nothing:

** "several participants" had some objection for "considerable". Well, we knew going in that there were 6 notable bears, so "several" seems small. The rebuttal sounded like Yellen at the press conference - that this phrase was data dependent.*

** "A number of participants also noted that changes to the forward guidance might be misinterpreted as a signal of a fundamental shift in the stance of policy that could result in an unintended tightening of financial conditions." as previously mentioned, game theory dictates that they can not remove the phrase, unless they have some way of calming down the markets.*

** "It was generally agreed that when changes to the forward guidance become appropriate, they will likely present communication challenges, and that caution will be needed to avoid sending unintended signals about the Committee's policy outlook." So now, it's looking like they may keep "considerable" in the statement because they seem overly concerned about sending an unintended signal.*

That having been said, the next payroll will be very important - if we get another big drop in the UR, a lot of the more "traditional" members may start joining the bears. However, in my mind, that LMCI has been so absurdly low, I think the bar is set relatively high for a guidance change right now."