Trading the Turn—SOFR vs Fed Funds

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1mo SOFR vs Fed Funds. Many of the banks got their face blown off being the 'wrong way' on the SOFR/FF convergence trade in September. They were buying 1mo Sep SOFR and selling 1mo Sep Fed funds around -10 expecting a convergence to -8/-7. When the spread got there, they did not cover. With the repo surge, the spread blew out to -23bps and has thus been labeled, "the widow-maker". This trade was akin to the TU/OIS trade that separated large cash from traders that thought 'free carry' and got educated on short discreet options.

Citi is back out saying, effectively "Buy Dec Fed Funds Futures"—with a bunch of other stuff. If Citi is wrong, they can lend ad infinitum into a higher repo rate and get a good chunk of their cash back. For the rest of us, that is a TOUGH option to be short to clip maybe 2-2.5bps (my values).

Citi is advocating a spread tandem in the article: Sell FFX9, Buy FFZ9, Sell FFF0, Buy FFG0

In my opinion, that has way too much going on. There are Fed cut bets in there, relative value month-on-month, etc. The article also does not say WHEN you take profits or losses. Not much help.

To isolate the single issue of year-end risk and relative richness, we look at Nov/Dec/Jan butterflies: yellow line is 1m SOFR (SER) and the white line is the equal-dated Fed Funds fly. Both assume Buy Nov/Jan, Sell 2x Dec.

One of the points here is, "If you think Fed Funds look rich, SOFR looks even richer". I'm sure the Fed has everything under control(-ish). That said, there is no/zero/zip/nada chance that I'm outright buying SOFR futures into year end. Nor will I Sell Nov and Buy Dec SOFR.

I think the way to play this is to Buy Dec/Jan Fed Funds spread and Sell Dec/Jan SOFR spread. Since all legs of this trade are rich, the question is really, “When does the richness come out? And, does it come out uniformly between SOFR and Funds?”

My suggestion is for those who trade the Z/F Funds/SOFR tandem, that you be prepared to carry the Dec legs thru terminal valuation (12/31). Now if something does go haywire with year-end, this package will be a homerun and we simply book it (like what happened in Sep). My theory is that the Fed will, one way or another flood repo liquidity OVER year end and cause a greater decline in JAN SOFR even if Fed Funds futures also trade back to fair value.

Green line is the FF/SOFR futures spread tandem: Buy Dec/Jan FF, Sell Dec/Jan 1mSOFR (note this spread is valued on left-side Y-axis).

I’m a buyer at 1bp. Risk to -0.5bps thru Dec. Take profits above 3bps and look for a net/net P&L of 1-2bps if carried over year end. The big component is the discreet option and the need for the Fed to ‘flood liquidity OVER year-end’—not just up TO year end. And THAT is why we want to be long Jan SOFR vs Funds.

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