Options on Treasury Futures as TBA Alts? For PIPELINE Hedgers In This Market- YES

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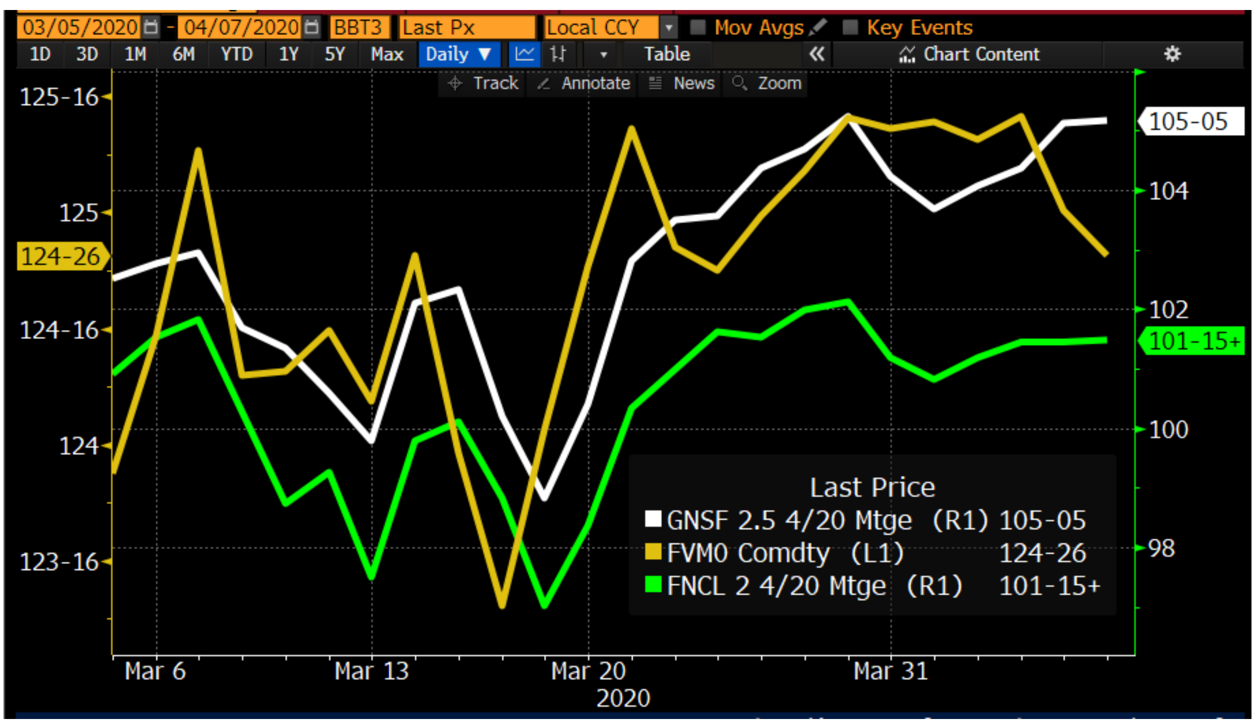
Illiquid TBA trading with bid/asks reaching 4-5/32s from mid. Ultra-wide TBA-roll markets. Margin calls and cash whipsawing. Uncertainty on when loans will close. Fallout.

Every one of those characteristics IS an amplified cost to the pipeline hedger (or, any short option trader). BUT, along with the market maladies, comes better profit margins on closed loans.

Most pipeline hedgers are 'delta' hedgers; hedgers of pull-through-expectation adjusted risk. The 'proposition bet' of pipeline hedging is: "The cost of maintaining a hedge in the pipe will be outweighed by the profit of the closed and sold loan."

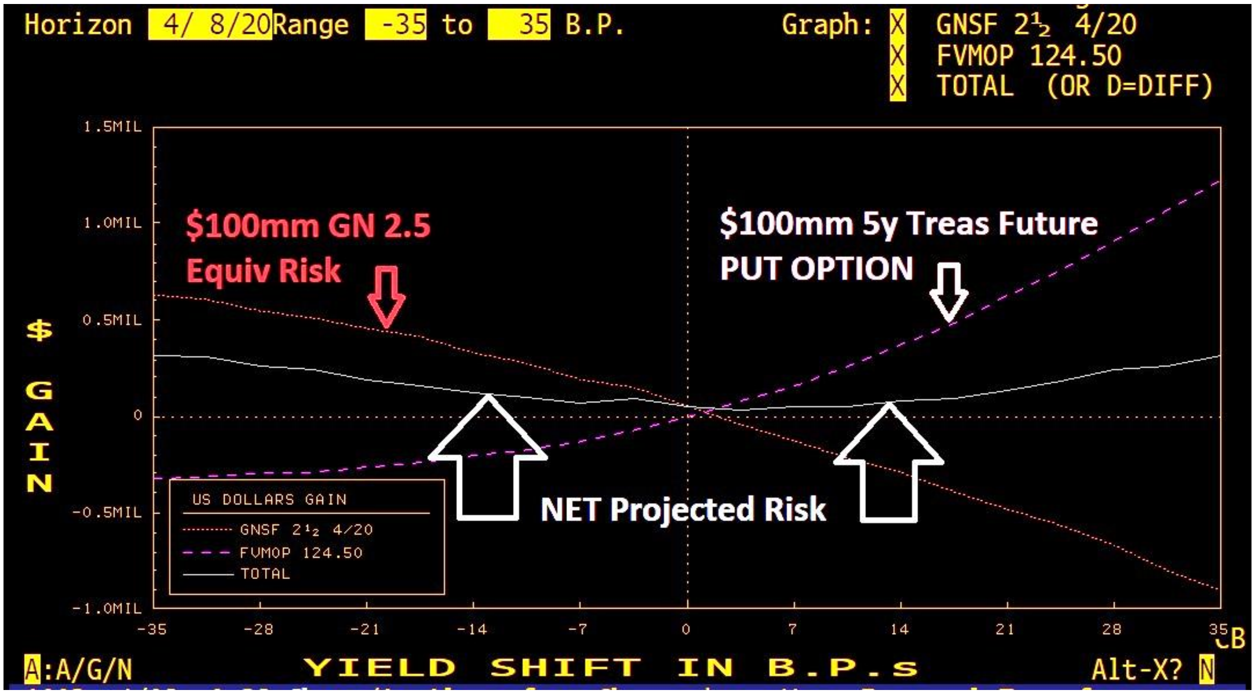
When the costs, and uncertainty of costs, increase markedly, the pipeline hedger should consider becoming an 'option broker' instead of a 'delta hedger'. With horrific liquidity in TBAs, and TBA options near impossible to source at any price, there is incentive to take mortgage:Treasury basis exposure. It helps to make this decision when the Federal Reserve is buying both TBAs and Treasuries hand-over-fist.

Without ANY scaling (for duration differences), 5-year Treasury Futures have largely mapped the performance of TBAs (30yr GN 2.5s and 30yr UMBS 2s shown below) Chart & Data Source: Bloomberg

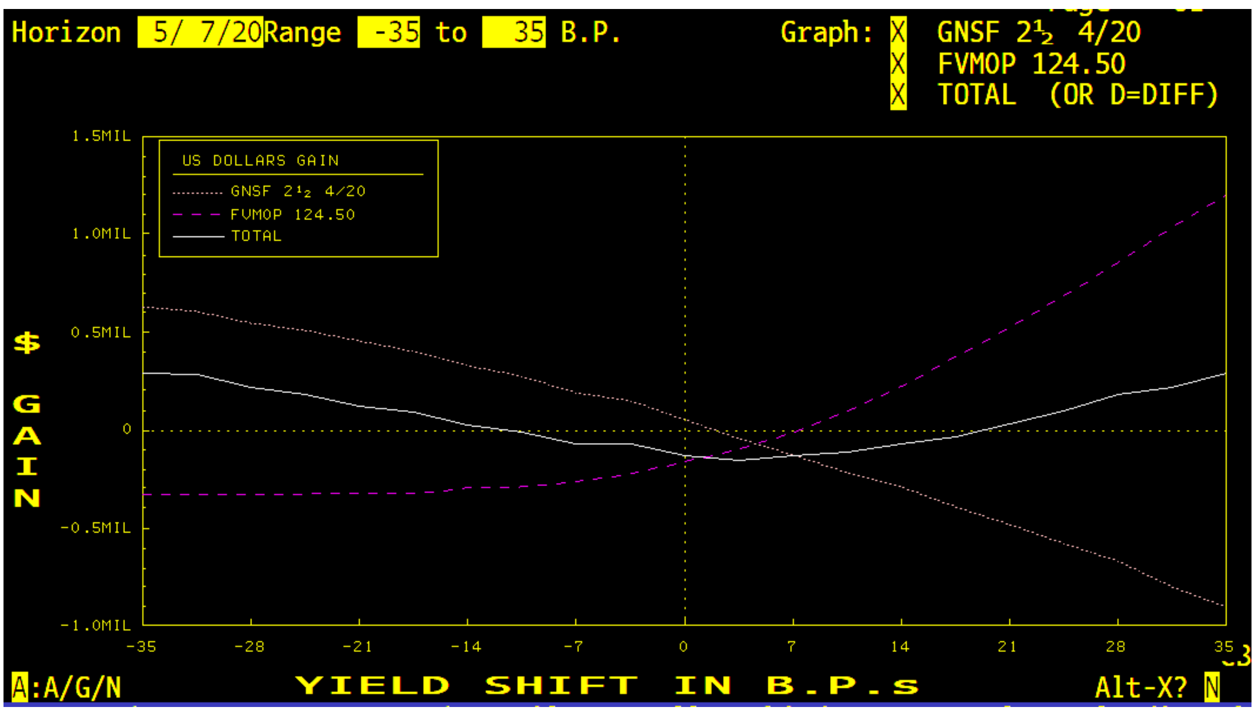


Of course, hedging a negatively convex TBA with a positively convex Treasury *future* is a job for a full-time, in-and-out trader. But what about using a PUT OPTION on a Treasury future? Is a PUT OPTION on a Treasury future a similar enough exposure over a range of interest rates?

Chart & Data Source: Bloomberg



Of course, these are options. So, over the course of time (1 month shown below) there is decay.



What does a PUT OPTION approach cost? The option used above has a cost of 10.5/32s—about the bid/ask spread of $100mm GN 2.5s at many points in the last month.

There are many different strategies that may be deployed using Options on Treasury Futures.

The option strategy in the risk graphs above is simple: BUY a PUT OPTION—that's it. Pay the premium for the option and there is NEVER a margin call.

Secondary marketing divisions and pipeline hedgers tend to be very process-oriented. In the ultra-simple example above, the pipe hedger would buy $1mm face of PUTs for every $1mm in GN 2.5s normally sold.

But what if it's UMBS 2s for May, or 2.5s for June? Or, it's a stack of both Agency and Ginnie coupons and varied closing horizons?

No problem. The PUT OPTION selection criteria is based upon expected forward closing date, coupon, agency, etc. If these assumptions change, the PUT OPTIONs may be adjusted in ***liquid markets.*** The quantities, strikes and expiration dates are already modeled by FIG and we can offer clients an automated process that fits the various risk systems run in different secondary operations. Or, we can use Bloomberg defaults to keep OAS-adjusted risk parameters on the mark as new information influences market changes.

Want to see a full work-up of comparative cost analysis or have specific requests? Please reach out. PUT OPTIONs on Treasury Futures are being deployed by an increasing number of our pipeline clients already. The mortgage:treasury basis risk is nothing compared to today's costs of getting in and out of TBAs—and the insane cash requirements for margin calls.

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QUESTIONS?

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