

# European Credit Weekly

## Has the ECB triggered changes in our trades?

- **Not really, just at the margin.** We were and remain constructive; the ECB announcements helped many of our recommendations but we don't think it's time to take profits yet except in a few cases.
- **What are the trades we are referring to?** Read on for a review of the trades we like.

Figure 1. Citi Credit Strategy – Key views & recommendations

	Tactical (View: Long)	Strategic (View: Long)
Cash bonds		<ul style="list-style-type: none"> <li>- Long € &gt; \$ credit</li> <li>- Long Financials &gt; Non-financials</li> <li>- Long subordinated &gt; HY non-fin risk</li> <li>- Releveraged &gt; releveraging credits</li> <li>- Long T2 host CoCos</li> <li>- Long Eurozone &gt; non-Eurozone credits</li> <li>- Long wholesale &gt; deposit banks (UK &amp; US)</li> </ul>
CDS	<ul style="list-style-type: none"> <li>- Sen Fin / Main compression</li> <li>- iTraxx Sub / Sen Fins compression</li> <li>- <b>1x2 Receiver Spreads</b></li> </ul>	<ul style="list-style-type: none"> <li>- Long index flatteners</li> <li>- Main / Crossover decompression</li> </ul>
Options & tranches	<ul style="list-style-type: none"> <li>- Sell European vs. US Vol</li> </ul>	<ul style="list-style-type: none"> <li>- Last squeeze to Jun-15 Series 9 Main equity</li> <li>- Buy SenFin, sell Crossover receivers</li> <li>- Sell 1m no-delta straddles</li> </ul>
Combined strategies	<ul style="list-style-type: none"> <li>- Sell equity protection; sell straddles</li> <li>- Flatteners vs. OTM payers</li> </ul>	<ul style="list-style-type: none"> <li>- Short bond, long CDS spread duration</li> </ul>

Source: Citi Research. Note: New recommendations/trades highlighted in bold. Tactical horizon: 1-3mths. Strategic horizon: >3mths.

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# Has the ECB Triggered Changes in our Trades?

## What moved?

The ECB announcements last week triggered large moves in credit markets, both in cash and (especially) in derivatives. Apart from a sizable tightening across the board, the most significant moves were: 1. Synthetics outperformed cash as investors reached out to indices and options to add risk – given the difficulties of doing so via cash. 2. Financials outperformed corporates. 3. Curves flattened as investors extend maturities. 4. Europe outperformed the US. 5. The options market, generally a hedging instrument for real money investors, saw substantial bullish flows with volatility skews flattening aggressively (as investors rushed to buy receivers and sell payers).

## Our long risk view hasn't changed

We were constructive into the ECB announcements and remain so after them given that they reinforced that the main reason why we were bullish in the first place is not going to go away soon (at least in Europe): the supply-demand imbalance in credit markets created by central bank liquidity support.

## Any change in our trade idea recommendations? Not really

Most of the themes we've been recommending recently, based on the views above, played out well last week. However, only on a few of our recommendations would we take profits. The rest remain intact as we think they've got further to run: the ECB announcements just helped, but not exhausted, many of those trades. We next review the trades and positions we like across cash bonds and derivatives and the few places where our views have changed.

**In cash bonds**, we maintain our strategic bias towards higher beta sectors. However, given the outperformance on high-yield credits year to date, we think that, to the extent investors are able to buy them, less-liquid lower beta bonds have scope to make up lost ground in the near term.

Although cash curves remain relatively flat compared to their synthetic counterparts, we see less reason to avoid taking duration in cash now than previously. The low net supply volumes and tight spreads are likely to mean that investors are pushed along the curve as the year progresses, and we see scope for further flattening from here.

While financials have tightened more than non-financials in basis point terms year-to-date (30bp vs. 20bp on a DV01-weighted basis), we think there's scope for further outperformance. The technical supporting European senior financials seems unlikely to be diminished in the coming months. Net senior financial issuance year-to-date has been deeply negative, and European banks' access to TLRO funding should contribute to a further decline in outstandings of senior bank debt. Net non-financial issuance, on the other hand, has been fairly strong year-to-date, and we expect the expansion to continue over the coming months.

We also believe the US vs. Europe trade in cash has further to go. With our US economists forecasting a pickup in the pace of economic growth over the coming months, pressure on the Fed is likely to increase, even as the ECB is shifting towards further easing.

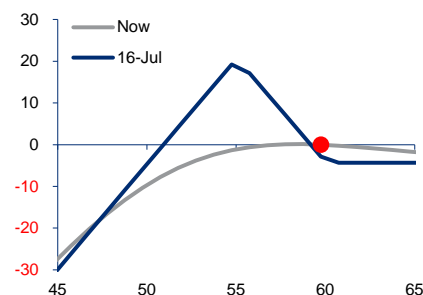
**Where we have reversed our views, at least in the short term, is in the relative value between cash and synthetics.** We've long advocated that synthetics had more tightening upside than cash. The higher liquidity of the synthetic index market and the limited (when not negative) net new issuance have pushed investors to search for longs in the synthetic market. The recent outperformance of synthetics though has been too pronounced and we expect synthetics to trade soft, with investors replacing synthetic with cash longs. Thus, we'd be adding longs in cash here, not in synthetics. However, we realize this may be easier said than done, given that the underperformance of cash is probably due to the less liquid part of the market: low beta bonds which are a large part of the market.

Figure 2. Cash and synthetic spreads

	Level	1m change
€ iBoxx IG	92	-1
iTraxx IG*	63	-9
€ iBoxx HY	296	-8
Xover	232	-27

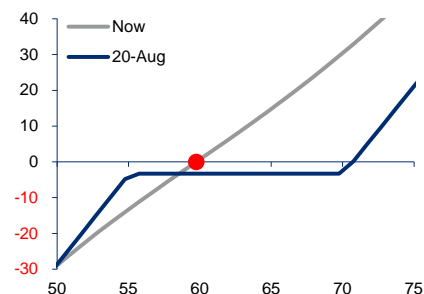
Source: Citi Research, iBoxx, Markit. In bp. \* 60% Non-Fin, 30% Senior Fin, 10% Sub Fin.

Figure 3. Main July Receiver 1x2 (55-60bp strikes) - [Link to the pricing tool](#).



Source: Citi Research. X-axis: Main spreads in bp. Y-axis: Trade P&L in cents of the high strike receiver bought.

Figure 4. Main August Bearish risk reversal (55-70bp strikes) - [Link to the pricing tool](#).



Source: Citi Research. X-axis: Main spreads in bp. Y-axis: Trade P&L in cents of the each option notional.

In **derivatives**, the most attractive places to source **long risk** exposures are, in our view:

- **Senior Financials** – the rationale here is the same as in cash.
- **Short dated default risk** (via [1y equity tranches](#)) since we believe liquidity measures will have the highest impact in keeping default rates very low. Near-term default risk still looks more attractive to us than market risk.
- **Long dated super senior risk** should be, in the medium term, one of the main beneficiaries of the recent tightening as tight spreads slowly remove investors' reluctance to use tranches. If there is anything which is "dislocated" pricing-wise in the derivatives space then it is super senior spreads, with correlations at all-time highs. Moreover, if the ECB eventually buys senior financial bonds, we think that'll help the more systemic (i.e. senior) part of the tranche market to outperform.
- **1x2 receiver spreads** to position for synthetic index spreads drifting, but not gapping, tighter in the near term (Figure 3)<sup>1</sup>. By selling OTM receivers, this trade takes advantage of the extremely flat (when not inverted) receiver skew which has resulted from investors' rush to buy receivers last week.

**Relative value-wise**, we haven't changed our views:

- **Long risk Senior Financials vs. Main** – Our target at the beginning of the year was for Senior Financials to trade well inside Main, and we think we'll get there at some point.
- **Long risk Main vs. Crossover** – the Crossover to Main spread ratio was one of the few relative value metrics barely moving last week. We think that, as spreads tighten, the potential for this [trade](#) to play out increases as investors become more willing (forced?) to lever up investment grade returns.
- **5s10s flatteners** – Both in [Main](#) and in [Senior Financials](#), this is one of our highest conviction trades. We expect investors to continue extending maturities as spreads tighten. 3s5s should also benefit from this trend, but we think 3s5s have less upside if we tighten and more downside if we widen.
- In options, we still like to sell [short dated no-delta straddles](#) to play a range-bound view. Although the performance wasn't good last week, the trade is still well in the money since January. We also think that [selling longer dated European credit vol](#) is one of the best short-term trades right now after barely falling last week in a backdrop of tightening spreads and falling vols in all other asset classes. We like selling long-dated European credit vol outright, [vs. US credit vol](#) or vs. any other asset class.

Finally, although not massive fans of **hedging** anything right now, we think investors looking for near-term synthetic hedges should look at [bearish risk reversals](#) (buying an OTM payer and selling an OTM receiver – Figure 4). The near-term synthetic tightening potential is not huge in our view; moreover, as real money investors are running little or no hedges, they might be forced to put on hedges if spreads were to widen (Iraq?); i.e. a gap wider in synthetics is probably more likely than a gap tighter (although our base view is a grind tighter ...). Technically, the very flat/inverted vol skews provide a very attractive entry point to this trade.

<sup>1</sup> We are adding this trade to our credit derivatives model portfolio.

## The week ahead (Joseph Faith)

Although there will only be a couple of top tier data releases in Europe, next week looks set to be fairly busy in other respects, particularly given the recent escalations of tensions in Iraq. Besides the FOMC rate decision on Thursday, several data releases should give us an insight into the state of the US recovery.

The final reading of Eurozone CPI for May, out on Monday, is expected to be unchanged from the preliminary reading at -0.1% MoM and +0.5% YoY.

Despite this week's disappointing US retail sales number, our US economists believe that the prospects for a Q2 rebound in activity are undiminished. Consensus expects US Industrial Production, out on Monday, to increase for the first time in four months, by 0.5% MoM. On the other hand, the Empire Manufacturing survey, out on the same day, is expected to decline to 15, following last month's spike higher to 19. May's figure for US housing starts is out on Tuesday. Consensus expects growth, at 1033k, to have slowed from its five month high in April, led by a decline in starts on multifamily dwellings.

The FOMC decision will take place on Wednesday. We believe the Fed will stick to its previous course of cutting asset purchases by \$10 billion. So we're more interested in the FOMC members' forecasts for the benchmark rate and in any changes to their economic projections. That said, our US rates strategists don't expect significant changes in rate guidance at this meeting, with any notable shifts likely to be met with a "material" market reaction.

Also on Thursday, Eurozone finance ministers will meet in Luxembourg in their capacity as governors of the ESM. Direct bank recapitalisations will be at the top of the agenda, following this week's agreement by Eurozone member states that the ESM will be able to recapitalise failing banks that have written off 8% of their liabilities should they fail to "attract sufficient capital from private sources" or from the "ESM member concerned". EU finance ministers will discuss the draft 2015 EU budget at the Eurogroup on the following day.

The advance reading for Eurozone Consumer Confidence in June is also out on Friday. Consensus expects this to continue on its improving trend, with the indicator moving up to -6.8, from -7.1 last month.

### Key Economic Indicators (16 June – 20 June 2014)

Monday 16 June	Consensus Forecast	Last
Eurozone CPI MoM	-0.1%	0.2%
Empire Manufacturing	15.00	19.01
US Industrial Production	0.5%	-0.6%
Tuesday 17 June	Consensus Forecast	Last
ZEW Survey Current Situation	62.1	62.1
ZEW Survey Expectations	35.0	33.1
US Housing Starts	1033k	1072k
Thursday 19 June	Consensus Forecast	Last
FOMC Rate Decision	0.25%	0.25%
Fed QE3 Pace	\$35bn	\$45bn
Friday 20 June	Consensus Forecast	Last
Eurozone Consumer Confidence	-6.8	-7.1
US Leading Indicators	0.6%	0.4%
Source: Bloomberg		

## Earnings Releases (16 June – 20 June 2014)

### Tuesday 17 June

Adobe

### Wednesday 18 June

FedEx, Hennes & Mauritz

### Thursday 19 June

Oracle, Kroger, BlackBerry

Source: Bloomberg

Recent Research Publications	Author	Date
<b>European Credit Research</b>		
<a href="#">Long IG vs. short HY in European synthetics: Playing it with 3-6% and Crossover</a>	Abel Elizalde	June 12, 2014
<a href="#">Small is beautiful – but also rather risky: impediments to European securitization</a>	Matt King	June 5, 2014
<a href="#">CreditBrief: a wobble withstood</a>	Joseph Faith	June 3, 2014
<a href="#">Global Credit Survey: technically unchallenged</a>	Joseph Faith	June 2, 2014
<a href="#">A time to be flat: 5s10s flattens in Senior Fins</a>	Joseph Faith	May 30, 2014
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<a href="#">European Credit Derivatives – Views and Trades: Slow grind tighter from here – what are the best carry trades?</a>	Abel Elizalde	February 27, 2014
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<a href="#">Corporate Leverage: Should you be worried?</a>	Hans Lorenzen	February 24, 2014
<a href="#">iTraxx Tranches Views &amp; Trades: Sell equity protection and sell straddles</a>	Abel Elizalde	February 20, 2014
<a href="#">European Credit Outlook 2014: (Positioning &amp; Trades)</a>	Hans Lorenzen	January 17, 2014
<a href="#">European Credit Outlook 2014: The Year of the Greater Fool's Game? (Strategy)</a>	Hans Lorenzen	January 17, 2014
<b>US Credit Research</b>		
<a href="#">US Credit Derivatives View: What to do now?</a>	Anindya Basu	April 15, 2014
<a href="#">How To Find Value In Credit Options? Relative value across strikes and maturities</a>	Anindya Basu	April 11, 2014

Source: Citi Research

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