

Crossover – Senior Financials Straddle

25 July 2012

Credit markets have been stuck in a range-bound holding pattern all summer with Crossover between 630-750bp and Main in a 155-185bp range. With politicians on holiday and the Olympics starting markets are increasingly lacking any form of conviction and watching the headlines.

Therefore, it is not so surprising that in this sort of environment investors not wanting to lose time value have been selling volatility. However, hot weather and sporting events don't guarantee stability, last year the Crossover index moved from 400 to over 800 between July and September.

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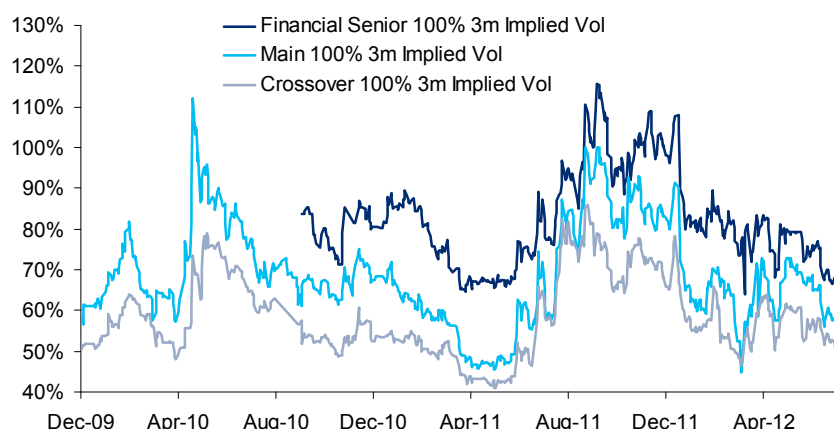
Credit

Investment Overview

Global

Corp. High Grade

Figure 1. Implied vol in iTraxx Main, Crossover and Senior Financials, %



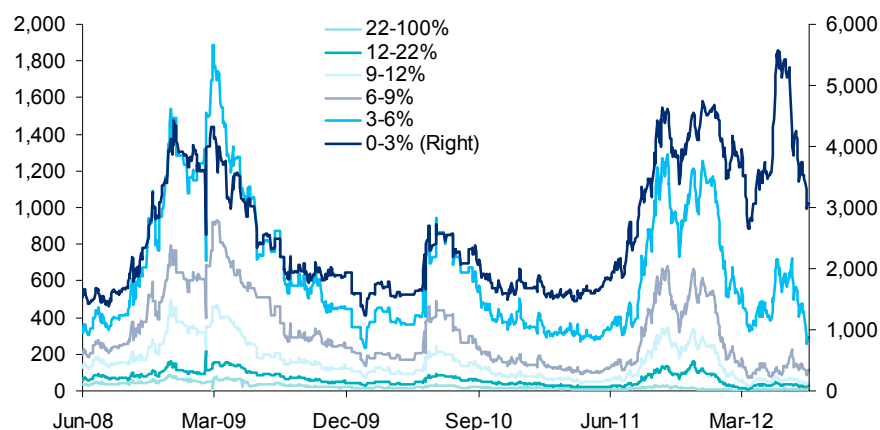
Source: Citi Research

Volatility is near historic lows. The Vix, as a bellwether, is at 18% and has only rarely gone below 15% in the last five years. For iTraxx Financials current implied volatility is close to the lowest it has been for a couple of years as we can see in Figure 1. Equally, Crossover volatility was last this low a year ago. We'd argue that circumstances are much less stable now than then; even if at current spread levels much more bad news is already priced in.

Figure 2. 5Y iTraxx S9 (1Y remaining) All-Running Spreads, (bp, bp)

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Source: Citi Research

Tranche markets, by contrast, have had quite separate dynamics. Junior 5y iTraxx IG9 tranches have been particularly active. From thinking that a Greek Euro exit might be imminent, and hence an OTE default, investors are now more convinced that OTE will survive until past the maturity date of 20 June 2013. The relationship between OTE and the equity tranche can be quite clearly seen in Figure 3. Equally, there are a large number of periphery financials and corporates that, via a similar logic, seem safer now than they did making a greater portion of the junior capital structure more attractive. Equity, 3-6% and 6-9% have almost halved in spread level recently as can be seen in Figure 2.

Figure 3. 5Y iTraxx IG9 0-3% vs 5Y OTE CDS spread

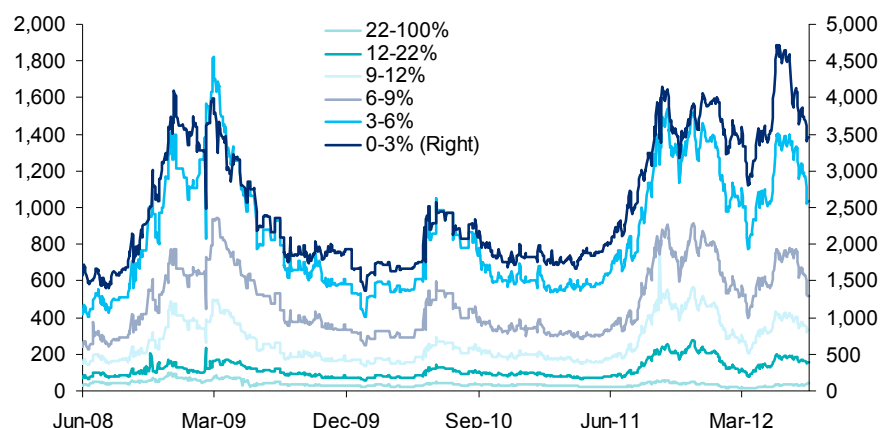


Source: Markit, Citi Research

There has been continued investor interest in taking 7y iTraxx mezzanine risk. Investors are looking to benefit from the steep roll-down as the life of the tranche drops from three years down to two years. Spreads on junior tranches have compressed as can be seen in Figure 4.

A few investors have been looking to buy senior and super senior protection as a systemic risk hedge.

Figure 4. 7Y iTraxx S9 (3Y remaining) All-Running Spreads, (bp, bp)



Source: Citi Research

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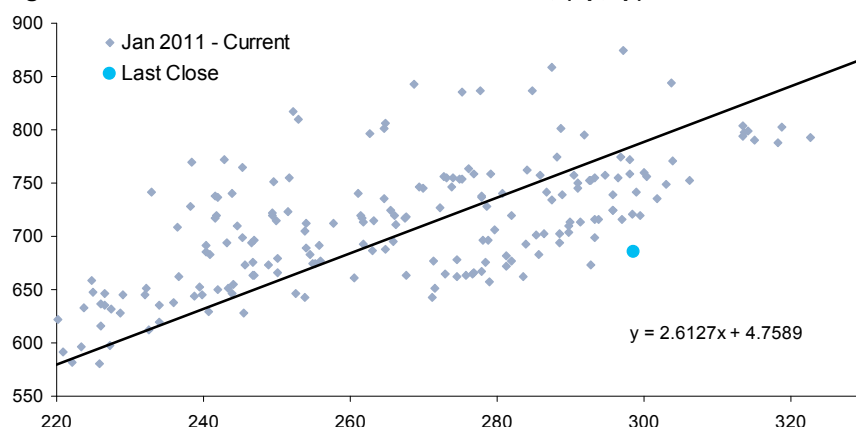
Trade Idea: Buy Crossover-Financials Straddle

Last week we suggested selling 5y CDX IG straddles to fund 5y iTraxx IG straddles. This week we suggest something similar with a twist, buying a straddle on iTraxx where one leg is on the iTraxx Crossover and the other is on the Senior Financials. Thus our trade combines a view on low implied volatility and the tightness of the Crossover index relative to Senior Fins and Main.

Crossover versus Main (and Senior Fins) index trade has been popular with many investors. However putting this view on indices has resulted in a lot of investors getting stopped out as Crossover outperformance has been persistent. A similar view expressed using swaptions helps to reduce this risk by limiting downside potential but still providing full exposure to this market dislocation.

How dislocated is Crossover relative to Senior Financials? The chart below, showing market closes of these indices since January 2011, illustrates Crossover is trading at its tight relative to Senior Financials.

Figure 5. 5Y iTraxx Crossover vs Sen Financials, (bp,bp)

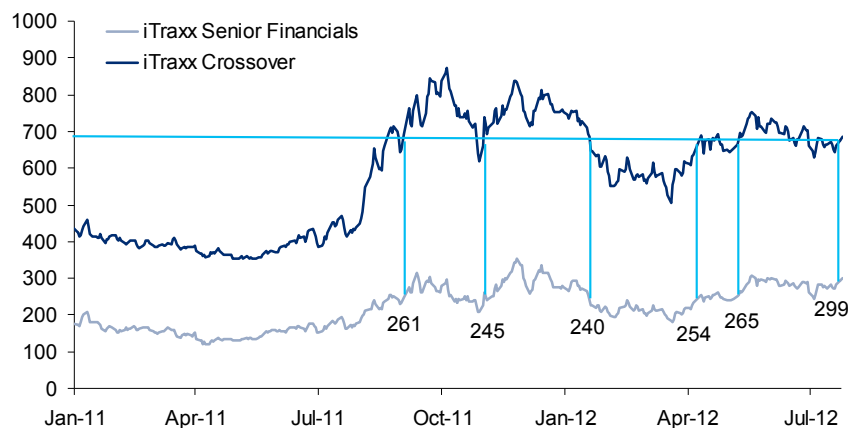


Source: Citi Research

Every time during the recent crisis, and also the 2008/2009 period, when the

Crossover was trading at current levels of 685, the iTraxx Financials was tighter (Figure 6).

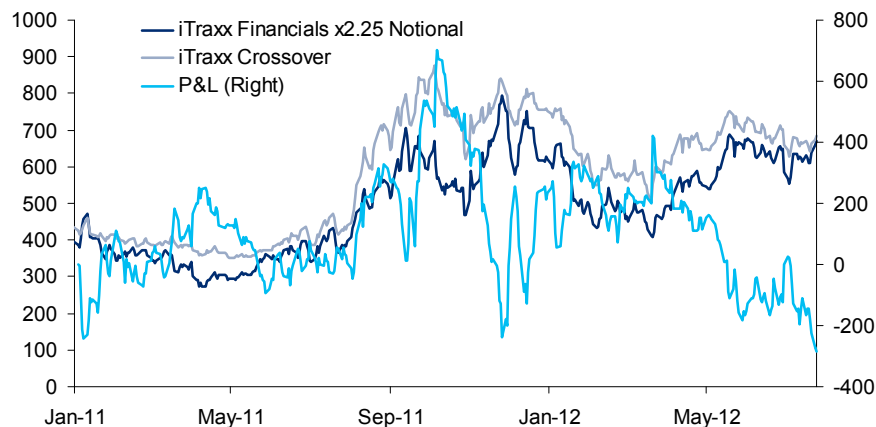
Figure 6. 5Y iTraxx Crossover vs Sen Financials, (bp,bp)



Source: Citi Research

Putting this trade on in indices with a DV01-adjusted beta of 2.25 would result in a quite volatile P&L, especially at times of Sen Fin underperformance as illustrated in Figure 7. Had this trade been put on in March it would have lost 600bp of notional. Relative spreads are showing an increasingly extreme market dislocation and high market volatility; making this a difficult trade to put on.

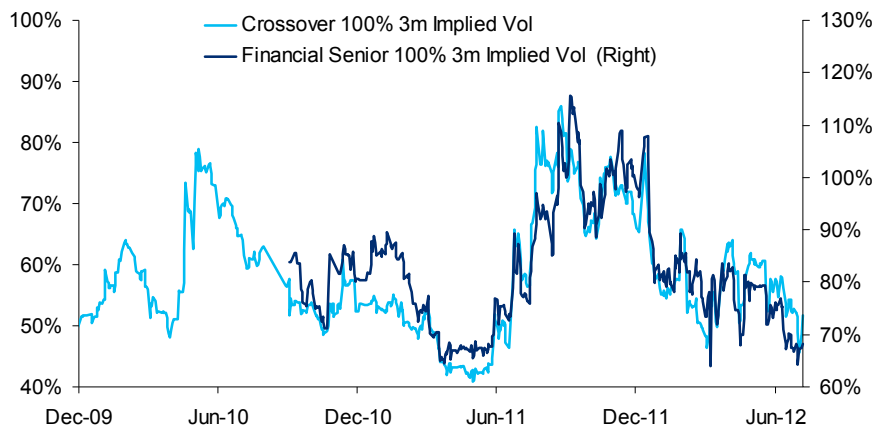
Figure 7. 5Y iTraxx Crossover vs Sen Financials x2.25 Notional, (bp,bp)



Source: Citi Research

However, putting this trade on options, as discussed above, can limit the maximum downside while at the same time putting on the view of Crossover underperforming the Sen Financials. Implied volatility for both indices is trading close to multi-year lows making this trade even more attractive.

Figure 8. iTraxx Crossover vs Sen Financial Implied Vol, (%,%)



Source: Citi Research

We think there is more room for the Crossover to widen in the case of a sell-off and for the Sen Financials to tighten in case of a rally. Therefore, we suggest buying €45m notional of September Crossover payers on the Crossover struck at 700bp and €100m notional of September Sen Fin receivers struck at 270bp.

Figure 9. Trade levels for Long Straddle

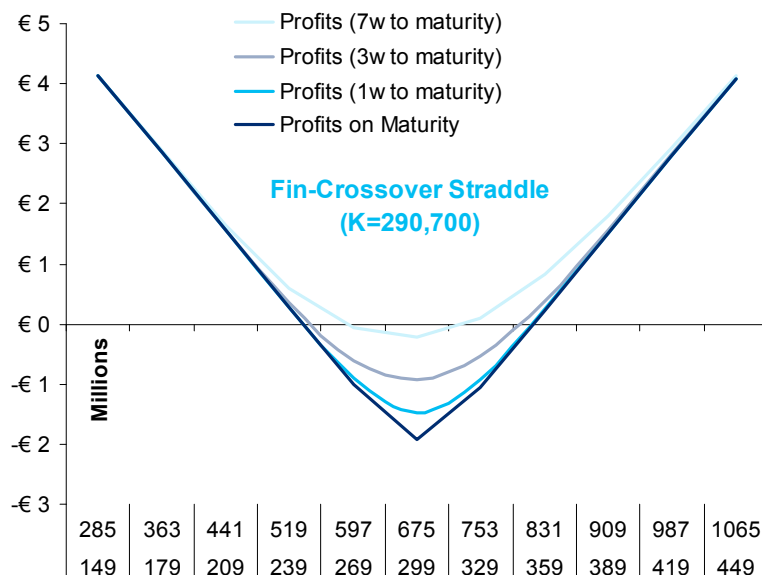
		Strike	Maturity	Notional	Cost
Buy Payer	5Y iTraxx Crossover	700bp	19-Sept-12	€45m	- €970,000
Buy Receiver	5Y iTraxx Sen Fin	290bp	19-Sept-12	€100m	- €950,000

Total **-€1,920,000**

Source: Citi Research

Total cost of trade is €1,920,000 on notionals of €45m and €100m respectively. The breakevens at maturity are Crossover above 820bp level or the Sen Financials to drop below 243bp (Figure 10). Losses would occur between those two points.

Figure 10. Profits assuming a spread beta of 2.61, € millions



Source: Citi Research

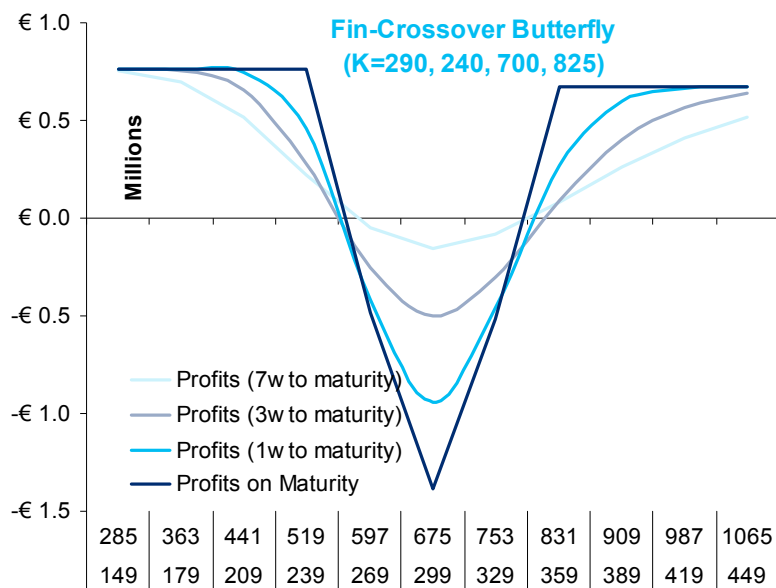
Similarly, this trade can be done as a butterfly by selling OTM payers and receivers and thus reducing the cost of the trade and bringing the breakevens closer. Specifically, the cost is reduced to €1,389,000 for the suggested notionals and the breakevens are Crossover above 785bp level or the Sen Financials to drop below 255bp (Figure 12). Losses would occur between those two points.

Figure 11. Trade levels for Short Butterfly

		Strike	Maturity	Notional	Cost
Buy Payer	5Y iTraxx Crossover	700bp	19-Sept-12	€45m	- €970,000
Buy Receiver	5Y iTraxx Sen Fin	290bp	19-Sept-12	€100m	- €950,000
Sell Payer	5Y iTraxx Crossover	825bp	19-Sept-12	€45m	€341,000
Sell Receiver	5Y iTraxx Sen Fin	240bp	19-Sept-12	€100m	€190,000
Total					-€1,389,000

Source: Citi Research

Figure 12. Profits assuming a spread beta of 2.61, € millions



Source: Citi Research

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When buying calls and puts (or receivers and payers) the maximum loss is the premium paid. When selling calls (or receivers), the maximum potential loss would occur as the index spread decreases but is limited by the index spread being floored at zero. For puts (or payers), the maximum potential loss (amount below the strike) would eventuate should the index price fall to zero. Sector index options are cash settled. The above calculations do not include any additional fees or transaction costs.

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