

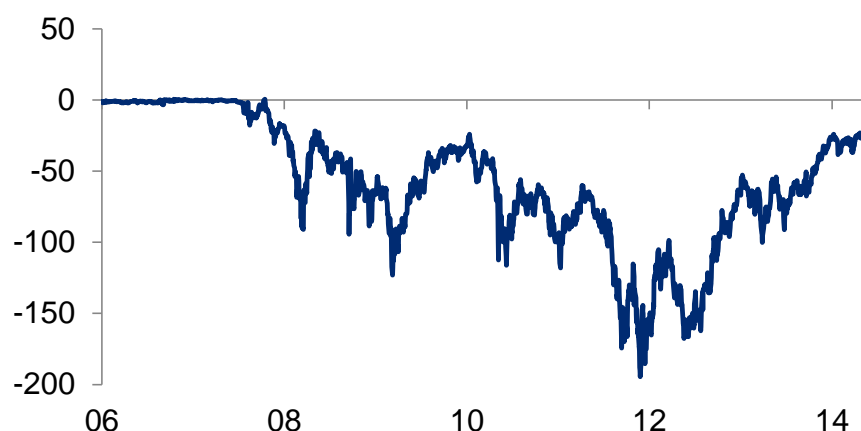
A time to be flat

5s10s Flatteners in Senior Fins

- **The rationale for iTraxx Senior Fins 5s10s flatteners is compelling** - duration-weighted flatteners are at their cheapest level post-crisis and the 5s10s curve near its steepest ever in ratio terms.
- **From 3s5s to 5s10s** - the 3s5s index flattener we advocated previously could not be applied to Senior Fins due to the lack of a 3yr index. We believe that the flattening in this part of the curve has largely run its course and we now [expect it to occur](#) in the 5s10s space.
- **iTraxx Senior Fins optimally positioned to benefit from flattening trend** - financials in particular look set to benefit both from a strong technical, with net issuance set to remain negative again this year. As short-end spreads near their post-crisis tight, investors are being pushed further out on the curve.
- **Not much further to go to offset negative carry** - even if the 5yr index fails to tighten from here, we'd need only another 2bp of flattening to offset any negative carry on a 12-month horizon.
- **Alternatives in single names** - although we prefer index flatteners we have identified several single-name CDS alternatives to avoid liquidity constraints: Generali, Intesa, Santander and BBVA.

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Figure 1. iTraxx Senior Fins, DV01-neutral flatteners, 3m carry & slide (€ 1000s)*



Source: Citi Research, Markit, *Assumes 10mn notional of the 5yr leg

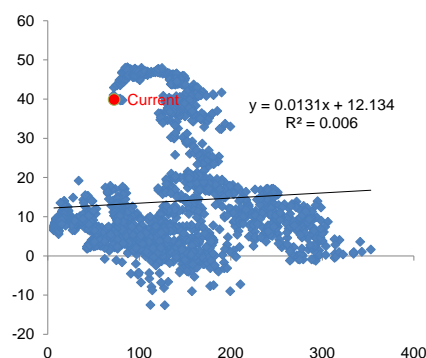
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The rationale for Senior Fins 5s10s flatteners in the current environment looks compelling - The 5s10s curve in the iTraxx Senior Fins, while now below the record heights of earlier this year, remains high relative to history in absolute terms (Figure 2). And the ratio of 10- to 5-year spreads is currently at 1.55 (Figure 3), just off its post-crisis highs.

With spreads in the 5yr index at their lows of the last four years, we expect investors to be pushed further out on the curve if the tightening continues, as we expect it to, with curve flattening as the likely result.

Figure 2. iTraxx Senior Fins 5s10s vs 5y Spread, bp Figure 3. Ratio of iTraxx Sen Fin 10yr to 5yr Spread, bp



Source: Citi Research



Source: Citi Research

History suggests that the risk of the 5s10s curve on senior Fins steepening significantly from current levels is small, even if spreads widen from here. This was seen during the widening between the 13th and 20th of May, when curves failed to steepen, despite the Fins 5yr index widening by 10bp.

Senior Fins 5s10s flatteners are cheap to implement relative to history – Carry and slide on DV01-weighted 5s10s flatteners is at its least negative since 2008 (Figure 4). With downside likely to be limited if spreads widen, we think now is the time to put flatteners on.

Figure 4. iTraxx Senior Fins S21 5s10s duration-weighted flattener Carry, slide and time value expressed in cents of the 10y notional traded

	Tenor	Maturity	Prot. Spread (bp)	Notional (€)	12m Slide (€)	12m Time (€)
Buy	5Y	20-Jun-19	73	-17,984	-97	-228
Sell	10Y	20-Jun-24	112	10,000	35	147
Total			39.9	-7,984	-63	-81

Source: Citi Research, Markit.

Admittedly, in the current environment, we suspect that most investors will be reluctant to engage in a negative-carry trade. But we would note that the degree of flattening required to make this trade carry positive is fairly minimal. Assuming the iTraxx Senior Fins 5yr were to remain where it is now, the 5s10s curve would need to be only ~2bp for the trade to become carry neutral on a 12-month horizon. And even if the 5yr level widens out to 100bp, the curve would only need to be ~5bp flatter to eliminate the negative carry. Given the 8bp flattening in the curve year-to-date, further flattening seems eminently plausible.

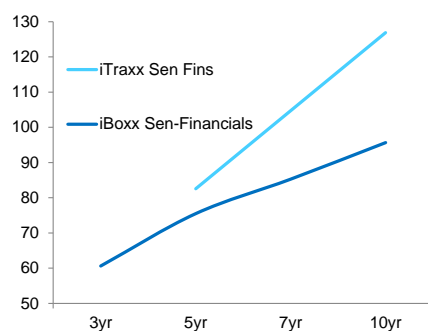
For those investors who want to avoid negative carry, we'd suggest "funding" the flattener, which of necessity requires going long risk. Our favourite way to do this is by reducing the amount of short leg (5yr) risk. As Figure 3 illustrates, a duration-weighted flattener involves buying 1.8x 5yr protection for every 1x 10y protection sold. In order to turn the 5s10s flattener into a time value (carry + slide) neutral trade, this ratio would change to 1.16x.

Senior Financials flatteners have fundamentals in their favour – The technical backdrop for financials is looking stronger than it has done in a while and this is likely to induce investors to add longer-dated risk in the sector as the year progresses. Net supply from financials in € looks set to remain in negative territory for the fifth year running. The announcement of [remarkably lenient "stressed" scenarios](#) for the ECB AQR has curtailed worries that banks will be exposed to significant risk of bail-in this year.

Together with rising deposits and ongoing bank deleveraging, there's every reason to expect the tightening we've seen in senior financial spreads year-to-date to continue over the coming months. And with spreads in the 5yr Index only 10bp away from their post crisis tight, investors have an increased incentive to take risk in the 10yr index, which is still 32bp away from the level it reached in early 2010.

We'd advocate setting index flatteners, but liquidity constraints may make these difficult to execute - We tend to prefer taking duration in CDS rather than bonds anyway, due to the relative steepness of curves in synthetics versus their flatter cash counterparts. This is certainly the case for senior bank debt, as Chart (Figure 5) illustrates.

Figure 5. Estimated € iBoxx Senior-Fin cash curves vs iTraxx Senior Fins, bp



Source: Citi Research, Markit

We'd prefer to express our view through flatteners on the 5- and 10-year iTraxx Senior Fins indices, to dilute exposure to idiosyncratic risk. However, due to the fact that the iTraxx Senior Fins 10yr index is not traded particularly actively, this trade may come up against liquidity constraints.

So we've identified substitutes in both the single name CDS and Senior cash space - We've examined the constituents of the Senior Fins index to see which single name CDS are the most plausible candidates for the flattener trade.

We ranked the iTraxx Senior Financials index constituents in order of curve steepness (measured as a ratio of 10yr/5yr CDS), and scored their curves' current levels relative to their own histories since 2010. Many of the steepest curves are (a) steep relative to their own history and (b) beginning to flatten.

The steepest names on the list in ratio terms (Figure 6) are high-quality insurers, whose 5yr CDS have rallied quite considerably over the past year. While we believe the sector is fundamentally sound, we've reduced our overweight on it due to the diminished potential for further tightening, in part due to rising regulatory risks.

Figure 6. iTraxx Senior Fins constituents ranked by curve steepness to each other

Rank	iTraxx Senior Fins	5s10s	Ratio
1	Munich Re	35.8	1.8
2	Allianz	33.7	1.8
3	HSBC	34.2	1.7
4	UBS	34.8	1.7
5	Zurich	39.0	1.6
6	Swiss Re	37.1	1.6
7	Credit Suisse	35.6	1.6
8	Credit Agricole	41.0	1.6
9	Deutsche Bank	38.0	1.6
10	AXA	40.6	1.6
11	Barclays	37.0	1.6
12	Lloyds	35.9	1.6
13	Aviva	41.7	1.6
14	BNP Paribas	36.7	1.6
15	Aegon	44.1	1.5
16	Societe Generale	41.2	1.5
17	Commerzbank	43.5	1.5
18	Generali	43.4	1.5
19	Santander	44.0	1.5
20	BBVA	45.0	1.5
21	Standard Chartered	37.7	1.5
22	RBS	37.6	1.5
23	Intesa	42.9	1.4
24	Unicredit	44.1	1.4

Source: Citi Research, Markit

Figure 7. iTraxx Senior Fins constituents ranked by curve steepness to history

Rank	iTraxx Senior Fins	5s10s	Zscore to 2010
1	Generali	43.4	3.3
2	Unicredit	44.1	3.0
3	BBVA	45.0	2.9
4	Santander	44.0	2.9
5	Intesa	42.9	2.8
6	Aegon	44.1	2.8
7	Aviva	41.7	2.8
8	Commerzbank	43.5	2.6
9	AXA	40.6	2.5
10	Credit Agricole	41.0	2.5
11	Barclays	37.0	2.5
12	HSBC	34.2	2.4
13	RBS	37.6	2.4
14	Zurich	39.0	2.3
15	UBS	34.8	2.3
16	Munich Re	35.8	2.2
17	Societe Generale	41.2	2.2
18	Lloyds	35.9	2.2
19	Allianz	33.7	2.0
20	BNP Paribas	36.7	2.0
21	Credit Suisse	35.6	2.0
22	Deutsche Bank	38.0	2.0
23	Swiss Re	37.1	2.0
24	Standard Chartered	37.7	1.8

Source: Citi Research, Markit

We like peripheral names in CDS – We favour Italian and Spanish financials in outright terms due to their potential for continued outperformance. And though they are mostly clustered towards the bottom of the list in terms of 5s10s ratios, when we score the ratios for each name relative to their own history (Figure 7), the picture looks very different. Each of the five peripheral names in the iTraxx Senior Fins is currently more than 2.85 standard deviations steeper than its historical mean, while none of the other names in the index are.

Given both the improving fundamentals in the periphery together with the aggressive balance sheet repair that peripheral banks are undergoing, we think 5s10s flatteners on periphery names look particularly attractive at these levels.

In Figure 8 we show the carry and roll-down for our favoured single names. We've limited the selection to peripherals with no more than 120 cents of negative carry on a 12 month basis of the 10yr notional traded.

Figure 8. Senior Fins CDS flattening candidates

	Notional (€)	12m Carry (€)	12m Slide (€)	12m Time (€)	Current 5s10s (bp)	Flattening for Carry Neutral (bp)*
Generali	-7863	-22	-81	-103	43	3
Intesa	-7770	-33	-78	-111	43	4
BBVA	-7741	-31	-90	-121	45	4
Santander	-7772	-30	-99	-129	44	4

Source: Citi Research, * Breakeven: how much the curve needs to flatten on a 12m horizon, assuming spreads in 5yr leg remain at current levels.

And a few bonds with a not-too-positive basis - Should investors struggle to find liquidity in the long-dated leg of this trade, we'd suggest using bonds as a potential alternative. We've listed the bonds that we deem to be the most plausible candidates for this trade in Figure 9.

This shows all the bonds in the € iBoxx Senior Financials index that (a) are issued by European issuers, and therefore more likely to benefit from a potential ECB asset purchase programme, (b) have a residual maturity of more than 5 years and (c) trade with either a negative basis or a positive basis of not more than 15bp. The latter criterion enables taking greater advantage of a reversal in cash underperformance versus CDS as the flattening gets under way.

Figure 9. Flattener Candidates in € iBoxx Senior Fins

ISIN	Company	Coupon	MatureDate	Spread	Basis
XS0452314536	Assicurazioni Generali	5.125	16/09/2024	155.6	-15.6
DE000A1AKHB8	Allianz Finance II	4.75	22/07/2019	48.6	-0.9
XS1014759648	Assicurazioni Generali	2.875	14/01/2020	111.6	-11.1
XS0819738492	BNP Paribas	2.5	23/08/2019	68.0	3.2
XS0906403059	Banque Federative du Credit Mutuel	2	19/09/2019	69.8	0.5
XS0526612188	Banque Federative du Credit Mutuel	4.125	20/07/2020	77.2	0.8
DE000A1G0RU9	Allianz Finance II	3.5	14/02/2022	66.6	4.5
XS1045553812	Banque Federative du Credit Mutuel	2.625	18/03/2024	98.4	-7.9
XS0997775837	Banque Federative du Credit Mutuel	3	28/11/2023	91.6	-1.1
XS0954928783	Banque Federative du Credit Mutuel	2.625	24/02/2021	79.5	1.0
FR0011321405	Klepierre	2.75	17/09/2019	75.5	6.2
XS0478074924	Coooperatieve Centrale Raiffeisen	4.125	14/01/2020	51.7	11.6
XS0256967869	Coooperatieve Centrale Raiffeisen	4.375	07/06/2021	63.9	13.6
XS1014704586	BNP Paribas	2.25	13/01/2021	75.1	12.8

Source: Citi Research, Markit

Appendix A-1

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