iTraxx Tranches Views & Trades

European Credit Derivatives

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- **Equity tranches on fire**. There is only one thing investors seem to have any remaining conviction on: absence of defaults. In a world with plenty of volatility but no defaults, investors are reaching the conclusion that the best course of action is to make the most of "roll down" or "pull to par": "If I cannot make any money timing the market or playing relative value, I'm just going to sit on whatever gives me the most roll down and time value"…and that is what short dated, in particular distressed, credit provides – junior tranches have been one of the clearest beneficiaries of this trend.

- **What else is going on in tranches?** (i) **No signs of sellers of senior protection … yet**. (ii) **Series 19 tranches continue gaining liquidity**. (iii) **Activity in the bespoke market is picking up**.

- **How would we position?** The main reasons which have pushed investors to chase short dated junior tranches are unlikely to go away. However, there are two issues which worry us: The first is how stretched valuations currently are in the tranche market, with record high correlations, and the second is periphery risk. As a consequence we believe investors should start adding longs in senior tranches (Jun-18 Series 9) and we would favour equity tranche longs in Series 19 (vs. Series 9).

  – **Where would we go long?**

    - Jun-15 3-6% Series 9 tranches.
    - Jun-16 equity and 3-6% Series 19 tranches.
    - Jun-18 9-12/12-22/22-100% Series 9 tranches.

  – **Relative value trades:**

    - Sell Series 19 equity protection vs. Series 9 equity protection; Jun-18, both delta hedged. Published on 5 June.
    - Sell Jun-16 3-6% Series 19 protection vs. Buy Jun-18 Series 9 index protection. New relative value trade.

  – **Where would we go short?** On an outright basis, senior tranches look way too wide to go short, and junior tranches are very painful to sustain as a short given their very negative time value and convexity. Like many investors, we think the tranche market is the place to set your medium term longs, and the index and option markets are better places to enter shorts. On a delta-hedged basis, we would turn to short dated senior tranches to add shorts.

Equity tranches on fire

Pull to par is the final word – it seems – in a world with plenty of volatility but with no defaults.

As a consequence, short dated "distressed" instruments have been very sought after.

Equity tranches have, and still are, well positioned to profit from this trend.

Although spreads have remained relatively range-bound over the past six months, volatility (within those ranges) has been very elevated. Every time we have approached the wide end of the range, central banks came to the rescue; and every time we approached the tight end of the range market participants got too worried about withdrawal of central bank support. Investors have painfully realised that trying to time the market – either when going long or when hedging – is extremely difficult in this environment.

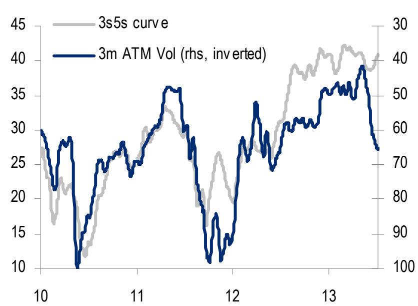
Relative value trades have also been hard to find and exploit – either when trading relative value between sectors, indices or tenors (i.e. curves), investors have again realised that, although many relative value metrics do look very dislocated, they have failed to move at all. As we have argued before,[1] the liquidity introduced by central banks is distorting the way financial markets react to economic and other developments.

If there is something investors had (and still have) high conviction on and which has played out as everyone expected was … absence of defaults. Default rates, both expected and realised, have remained subdued across Europe and the US – a combination of loose monetary policies around the world and an economic backdrop which, although poor, has managed not to fall apart have contributed to the low default rates we have recently experienced.

Given (i) how difficult is to beat any benchmark or make any "alpha" in an environment where spreads are very volatile within a range and where relative value metrics hardly move, and (ii) that the conditions which have kept default rates very low look set to continue, investors have slowly come to the conclusion that the best course of action is to exploit the very large "pull to par" or "roll down" associated with short dated distressed credit instruments. Even if there is plenty of vol, as long as there are no defaults, the "pull to par" will eventually play out – that's how the argument goes.

Figure 1. 3s5s vs. implied vol

LHS: On-the-run Main 3s5s bp curve. RHS: 3m ATM implied, %, inverted.



Source: Citi Research, Markit.

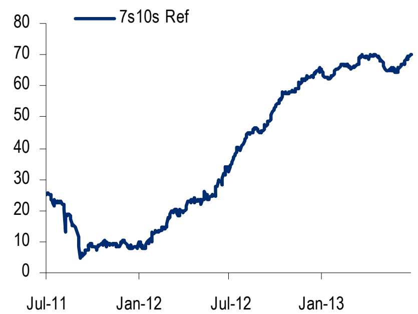
As a consequence, investors have favoured short dated high spread instruments like high yield bonds, bank subordinated debt … and junior tranches. In the tranche market, the demand for short dated equity (and junior mezz) tranches investors have shown over the past few months has been unparalleled, driving valuations to stretched levels. This is also the dynamic which, in our view, explains why credit curves keep steepening on an environment of very high volatility (see Figure 1 and Figure 2) – if there is anything investors are confident about, that is the absence of defaults and, as a consequence, short dated tenors remain very well supported.

As investors piled into short dated equity and junior mezz tranches, implied correlations increased to record levels, as Figure 3 shows. Over the past 4 months, while the Jun-15 Series 9 index has returned just 0.4%, the Jun-15 equity has returned 10.7% on an outright basis and 6.3% on a delta-hedged basis (Figure 4). Paying for time value by taking exposure to defaults, which is what equity tranches provide, has really paid off. Long risk junior tranches also offer a long convexity position, which works perfectly in an environment of high spread volatility – what else can we ask for?

[1] "Too much money, not enough assets to buy", H. Lorenzen, 25 April

Figure 2. S9 – Index spread curve

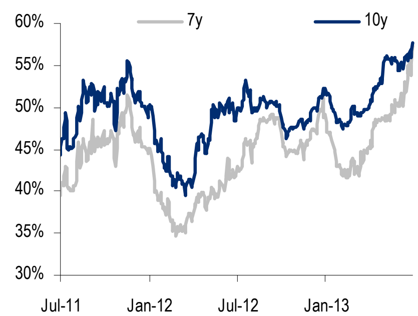
In bp, 7s10s curve (i.e. Jun-15/18).



Source: Citi Research, Markit.

Figure 3. S9 – Correlations

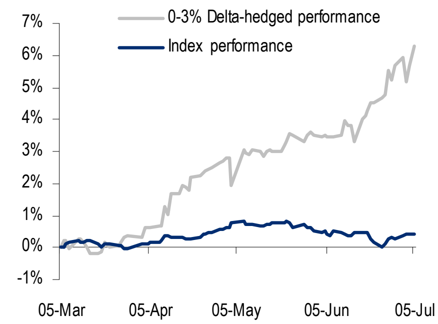
Equity tranche implied correlations.



Source: Citi Research, Markit.

Figure 4. 0-3% delta-hedged vs. index returns

Series 9 Jun-15. From a protection seller's point of view.



Source: Citi Research, Markit. As % of notional. Outright performance for the index. Assuming daily delta rebalancing for the tranche.

We do not think any of the reasons which have caused investors to favour equity tranches is going to go away any time soon. However, valuations are very stretched and, as a consequence, we would be selective when choosing short dated junior longs. As we argue next, we favour short dated equity and 3-6% tranches in Series 19 (Jun-16) as well as short dated 3-6% tranches in Series 9 (Jun-15); periphery concerns make us reluctant to have a high conviction in Series 9 equity tranches. But more on this later …

What else is going on in tranches?

- **No signs of sellers of senior protection … yet**. The outperformance of junior tranches is taking correlations to record high levels and pushing risk up the capital structure, causing senior tranches to trade at very attractive (wide) levels. However, the demand for senior tranches is still not there – investors prefer to continue selling junior protection.

- **Series 19 tranches continue gaining liquidity**. Although investors who believe periphery risks will remain subdued are still happy to take risk in Series 9, a growing number of investors are happy to give up some spread for the piece of mind which the "clean" Series 19 portfolio provides. As a consequence, liquidity continues increasing in Series 19 tranches. As we have published recently and argue later, relative value opportunities between Series 9 and 19 tranches are starting to appear.[2]

- **Activity in the bespoke market is picking up**. Investors looking at short dated junior tranches are actively considering and trading not only standard but also bespoke tranches in order to tailor the risk profile of the trades to their risk and spread targets – both in terms of portfolio composition as well as attachment/detachment points.

[2] "iTraxx Series 9 vs. Series 19 Equity Tranches", A. Elizalde, 5 Jun.

Tranche performance review

Recent tranche performance and investor activity

Junior tranches continue outperforming, especially short dated ones as the 1m delta-hedged performance tables below show (see Figure 6 and Figure 9 for Series 9 and 19 respectively). Both in Series 9 and 19, short dated equity and 3-6% have outperformed the most – long dated junior tranches have also outperformed the index, but to a lower extent. **The stellar performer over the past month has been the Series 19 Jun-16 equity tranche, with a 3% delta-hedged return over the month** – this can also be seen in the jump that 3y Series 19 equity correlations have experienced recently (see Figure 10). This shows that the demand for junior tranches remains strong, with investors now favouring short dated tranches and, in particular, short dated equity tranches in Series 19.

A growing number of investors are turning to the tranche market for medium term (6-12m) long risk trades, trying to profit from the pull to par in short dated equity and junior mezzanine tranches as we explained above. Although most of these investors enter these trades without delta, they tend to actively hedge them (via indices or options) in order to remove their MtM volatility and take a cleaner exposure to trade-off between "roll down" and default they provide. This trading strategy has been very successful so far.

Figure 5. S9 – Tranche levels

Upfront for 0-3%, flat spreads for the rest (bp).

Series 9	Jun-15	Jun-18
0-3%	15%	45%
3-6%	329	795
6-9%	155	507
9-12%	81	319
12-22%	43	150
22-100%	13	49
Ref	67	138

Source: Citi Research, Markit. COB 8 July.

Figure 6. S9 – 1m performance delta-hedged *

From a protection seller's point of view.

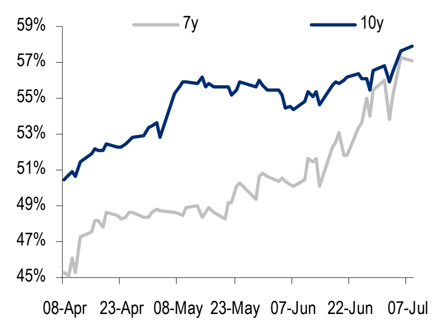
Series 9	Jun-15	Jun-18
0-3%	2.83%	2.18%
3-6%	0.87%	0.71%
6-9%	0.65%	0.36%
9-12%	0.03%	-0.06%
12-22%	-0.16%	-0.28%
22-100%	-0.139%	-0.033%
Ref **	-0.016%	-0.335%

* As % of notional. ** Outright performance for the index. Assuming daily delta rebalancing for the tranches.

Source: Citi Research, Markit.

Figure 7. S9 – Correlations

Equity tranche implied correlations.



Source: Citi Research, Markit.

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Figure 8. S19 – Tranche levels

Upfront for 0-3%, flat spreads for the rest (bp).

Series 19	Jun-16	Jun-18
0-3%	14%	33%
3-6%	372	553
6-9%	196	369
9-12%	116	240
12-22%	63	123
22-100%	20	40
Ref	69	110

Source: Citi Research, Markit. COB 8 July.

Figure 9. S19 – 1m performance delta-hedged *

From a protection seller's point of view.

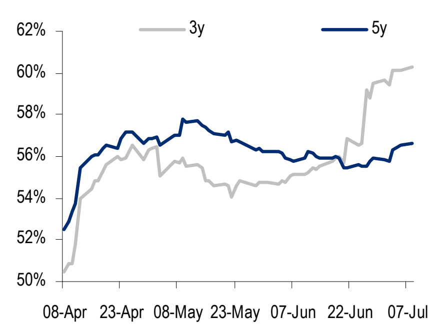
Series 19	Jun-16	Jun-18
0-3%	3.12%	0.81%
3-6%	0.64%	1.12%
6-9%	0.48%	0.66%
9-12%	-0.06%	0.11%
12-22%	-0.04%	-0.08%
22-100%	-0.142%	-0.071%
Ref **	-0.026%	-0.177%

* As % of notional. ** Outright performance for the index. Assuming daily delta rebalancing for the tranches.

Source: Citi Research, Markit.

Figure 10. S19 – Correlations

Equity tranche implied correlations.



Source: Citi Research, Markit.

How would we position?

As we argued above, the main reasons which have pushed investors to chase short dated equity tranches are unlikely to go away, namely: (i) absence of defaults / negative idiosyncratic surprises and (ii) "within the range volatility" in credit markets. As a consequence, **we still believe the flows in the tranche market will continue to be dominated by investors positioning in high spread short dated tranches to profit from their roll down**. However, there are two issues which worry us:

- The first is how **stretched valuations** currently are in the tranche market, with record high correlations (see Figure 3).

  What does this mean? Although we acknowledge that, in a one way market, like the tranche market seems to be at the moment, valuations can get plenty more stretched than they currently are, we believe **investors should start adding longs in senior tranches**.

- The second is **periphery risk**. If there is one risk which we believe many investors seem to have, to a large extent, written down is the possibility of another round of periphery-led concerns disrupting financial markets. As we clearly saw recently in Portugal, political tensions on the back of "austerity fatigue" can resurface at any time and, at some point, this may be accompanied by either a serious problem in the banking system or by public protest.

  What does this mean? We would **favour equity tranche longs in Series 19** vs. Series 9. We acknowledge the fact that all the periphery exposure in Series 9 makes junior tranches more appealing, but we think that (i) spreads in Series 19 are wide enough (e.g. Jun-16 0-3% and 3-6% paying equivalent spreads of 10% and 3.7% respectively) and (ii) it is worth giving up some carry for the piece of mind we gain by the limited periphery exposure in Series 19.[3]

Figure 11, Figure 12 and Figure 13 show our preferred longs, shorts and relative value trades.

Figure 11. S9 – Views

Green – long risk; Red – short risk.

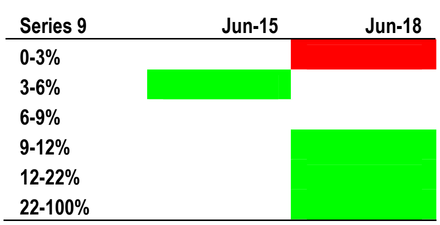
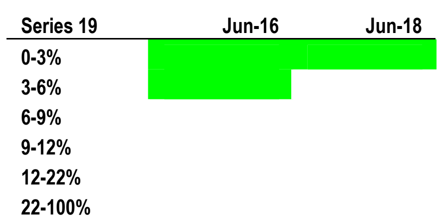


Figure 12. S19 – Views

Green – long risk; Red – short risk.



Source: Citi Research.

Figure 13. Relative value views

Equity tranche implied correlations.

Jun-18 0-3%: long S19 vs. S9.

Long S19 Jun-16 3-6% vs. S9 Jun-18 index.

Source: Citi Research, Markit.

[3] There are 18 periphery credits in Series 9 (3 Portuguese, 1 Greek, 7 Spanish – one with double weight - and 7 Italian) and 10 periphery credits in Series 19 (4 Spanish and 6 Italian). The periphery credits in Series 9 which are not part of Series 19 are: 3 Portuguese (EDP, Banco Espirito Santo, Portugal Telecom), 1 Greek, 4 Spanish (BBVA, Endesa, Repsol, Gas Natural*), 3 Italian (Finmeccanica, Monte Dei Paschi, Telecom Italia). * Gas Natural is included in both Series 9 and Series 19 – however, it has a double weight in Series 9 due to the succession event between Gas Natural and Union Fenosa.

Where would we go long?

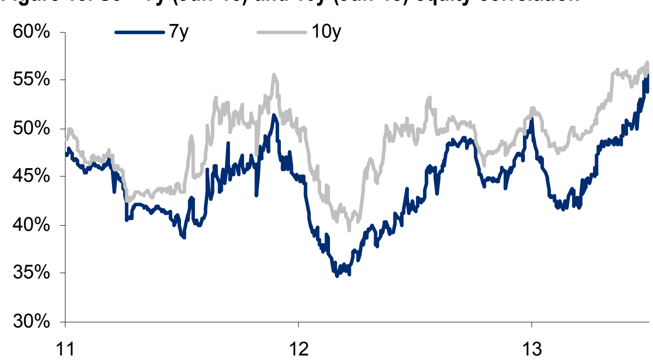
Figure 14. S9 – Ratio of 7y (Jun-15) 0-3% and 3-6% expected losses

Source: Citi Research, Markit.

- **Jun-15 3-6% Series 9 tranches**. The rationale for being long risk short dated junior tranches is still a good one, in our view, but our "periphery" concerns and how tight the Jun-15 equity tranche already is, make us prefer the 3-6% as a high spread short dated long. Figure 15 shows not only how high equity correlations are in general, but also how high short dated equity correlations are compared to long dated equity correlations. Moreover, Figure 14 shows that the expected loss ratio between the 0-3% and the 3-6% tranche in Series 9 has fallen considerably over the past few months (i.e. the equity tranche has outperformed the 3-6% tranche on an "outright" basis). With less than two years to maturity and an equivalent spread of around 330bp we believe the 3-6% tranche is a better way to position in the periphery-heavy Series 9 index.

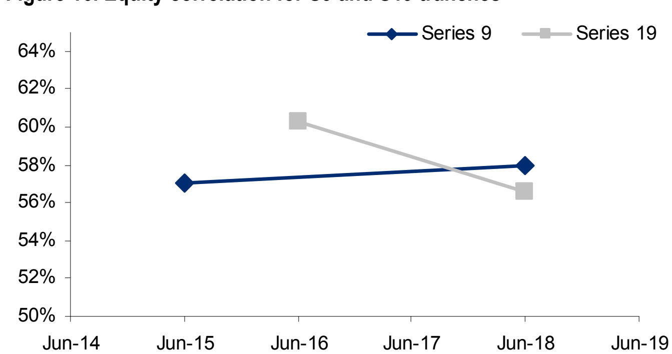
- **Jun-16 equity and 3-6% Series 19 tranches**. We still are very positive in Series 19 short dated junior tranches and believe they will continue outperforming the Series 19 index and other tranches as well as Series 9 tranches. As we argued above, what has made junior tranches perform and attract investor's attention is their "roll down" or "pull to par" and in an environment of high volatility, one needs to be willing to hold to these tranches for at least 6-9 months. Considering the medium term horizon of these trades, we prefer an index like Series 19 to take levered exposure to the first loss of a "clean" and mostly non-periphery portfolio. The Jun-16 equity tranche in Series 19 trades at an equivalent spread of around 10% per year; below the 14% at which the Jun-15 Series 9 equity tranche trades, but still wide enough. We also like the Jun-16 Series 19 3-6% tranche, trading at 370bp, given that we expect it to profit from investors' search for high spread short dated instruments.

Figure 15. S9 – 7y (Jun-15) and 10y (Jun-18) equity correlation



Source: Citi Research, Markit.

Figure 16. Equity correlation for S9 and S19 tranches

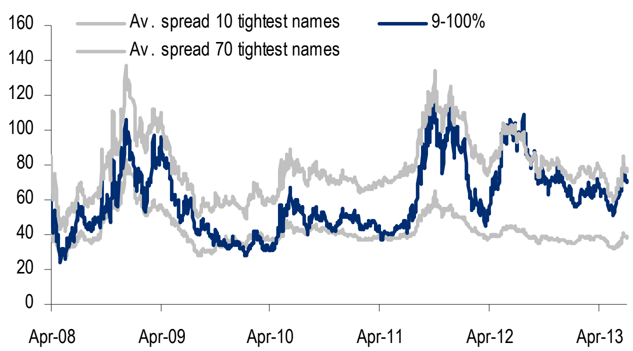


Source: Citi Research, Markit.

- **Jun-18 9-12/12-22/22-100% Series 9 tranches**. Although the seller of senior tranche protection is yet to be found, senior spreads are getting more attractive as a consequence of all the protection investors have sold in equity tranches. Probably not a trade to enter immediately in full size, because the near term dynamics will likely see junior tranches outperforming, but we argue it does make sense to progressively build a position in Series 9 senior tranches. As Figure 17 and Figure 18 show, the 9-100% spread is now very wide when compared both to the tightest names in the index as well as with either the on-the-run Main or Senior Financials indices.

Figure 17. S9 – 9-100% vs. tightest names

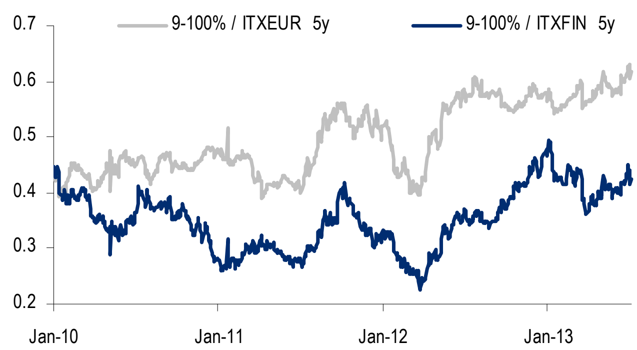
In bp, 5y calendar spreads.



Source: Citi Research, Markit.

Figure 18. S9 9-100% vs. on the run indices

Ratio of 5y spreads.



Source: Citi Research, Markit.

Relative value trades

- **Sell Series 19 equity protection vs. buy Series 9 equity protection; Jun-18, both delta hedged**. Both in Series 9 and Series 19 short dated correlations have increased substantially vs. longer dated correlations, as Figure 15 and Figure 16 show. We expect the difference between short and long dated correlations to stay low as investors continue favouring short dated equity tranches. In Series 19 in particular, Jun-16 correlations are above Jun-18 equity correlations. In our view, the most attractive relative value trade considering the current correlation term structure in both indices is to sell Series 19 Jun-18 equity protection and buy Series 9 Jun-18 equity protection, as we recommended last month.[4] Again, this is predicated on our conservative stance towards taking first loss risk in a portfolio heavy on periphery risk like Series 9.

- **Sell Jun-16 3-6% Series 19 protection vs. Buy Jun-18 Series 9 index protection**. See next section for more details.

Where would we go short?

- On an outright basis, senior tranches look way too wide to go short, and junior tranches are very painful to sustain as a short given their very negative time value and convexity. Like many investors, we think the tranche market is the place to set your medium term longs, and the index and option markets are better places to enter shorts.

- On a delta-hedged basis, we would turn to short dated senior tranches to add shorts.

[4] "iTraxx Series 9 vs. Series 19 Equity Tranches", A. Elizalde, 5 Jun.

Trade Idea

Sell Jun-16 3-6% Series 19 protection vs. Buy Jun-18 Series 9 index protection

- **Position for investors to continue selling short dated junior protection** by selling Jun-16 Series 19 3-6% protection and hedge the MtM risk by buying Series 9 Jun-18 equity protection.
- We source the “time value” in 3-6% tranches, given how tight equity tranches are in correlation terms, and pair a long risk position in Series 19 vs. a short risk position in Series 9, providing the trade with a **short risk periphery vs. non-periphery exposure**.

Figure 19. Sell Jun-16 3-6% Series 19 protection vs. Buy Jun-18 Series 9 index protection

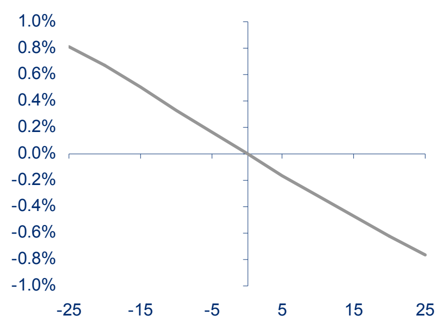
Index	Tranche	Maturity	Upfront	Coupon (bp)	Par spread (bp)	Protection	Notional (€m)	Upfront (€m)	Coupon (€m)	m time value (€m)
ITXEUR S19	3-6%	Jun-16	-3.59%	500	375	Sell	20	-0.72	1.00	0.70
ITXEUR S9	Index	Jun-18	-1.58%	175	138	Buy	50	0.79	-0.88	-0.60
							Total	0.07	0.13	0.10

Source: Citi Research, Markit. Indicative spreads as of COB 8 July.

We’ve sized the trade such that it has a long risk exposure if spreads in both indices move in parallel, as Figure 20 shows, and that its time value is slightly positive (see Figure 23). The trade has an underlying spread curve exposure, benefiting from curve steepening (and, as a consequence, from percentage spread changes as Figure 22 shows).

Figure 20. Spread exposure – parallel shocks

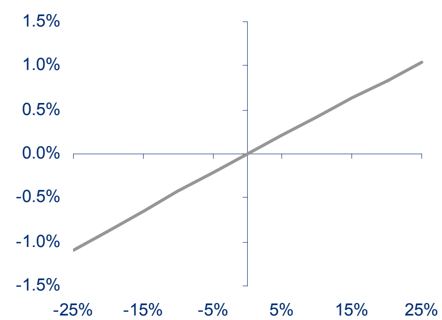
X-axis: spread shock, in bp, to all the maturities of all the credits in both indices. Y-axis: trade MtM as % of tranche notional.



Source: Citi Research, Markit.

Figure 21. Spread exposure – % shocks

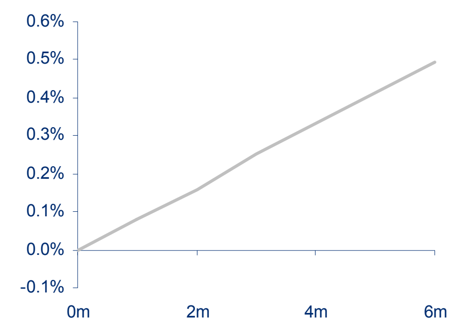
X-axis: spread shock, in %, to all the maturities of all the credits in both indices. Y-axis: trade MtM as % of tranche notional.



Source: Citi Research, Markit.

Figure 22. Trade “time value”

Including roll-down and carry, in % of tranche notional.



Source: Citi Research, Markit.

Trade Recommendations Summary

This section provides details of the trade ideas recommended in our published research.

We are adding the S19 Jun-16 3-6% vs. S9 Jun-18 index trade to our model portfolio.

Figure 23. Open trades – Summary and P&L

Trade Description	Leg	Format	Direct.	Notnl.	Entry Upfront	Entry Spread	Entry Coupon	Current Upfront	Current Spread	P&L* Total	P&L* Month**
Series 9 vs. Series 19 equity	iTraxx Main S9 0-3% Jun-18 (10y)	Prot.	Buy	1	47.75%	1,720	500	45.11%	1,911	-1.60%	-1.11%
04-Jun-13	iTraxx Main S9 Index Jun-18 (10y)	Prot.	Sell	5	-2.1%	132	175	-1.6%	138	-1.57%	0.87%
	iTraxx Main S19 0-3% Jun-18 (5y)	Prot.	Sell	1	31.75%	1,227	500	32.6%	1,446	-0.42%	-0.01%
	iTraxx Main S19 Index Jun-18 (5y)	Prot.	Buy	6.2	0.4%	108	100	0.6%	110	1.01%	-1.15%
									Total	**-2.58%**	**-1.40%**
Main July Receiver Fly	105bp Receiver	Price	Buy	1	0.2450%			0.0089%		-0.16%	
18-Jun-13	90bp Receiver	Price	Sell	2	0.0350%			0.002%		0.07%	
	75bp Receiver	Price	Buy	1	0.0024%			0.000%		0.00%	
									Total	**-0.09%**	
S19 Jun-16 3-6% vs. S9 Jun-18 Index	iTraxx Main S19 3-6% Jun-16 (13y)	Prot.	Buy	1	-3.59%	375	500				
09-Jul-13	iTraxx Main S9 Index Jun-18 (10y)	Prot.	Sell	2.5	-1.58%	138	175				
									Total		

Source: Citi Research. Spreads and coupons in bp. * P&L expressed as % of the leg with notional equal to 1. ** Over the last month. Prices as of COB yesterday.

Figure 24. Open and closed trades summary statistics

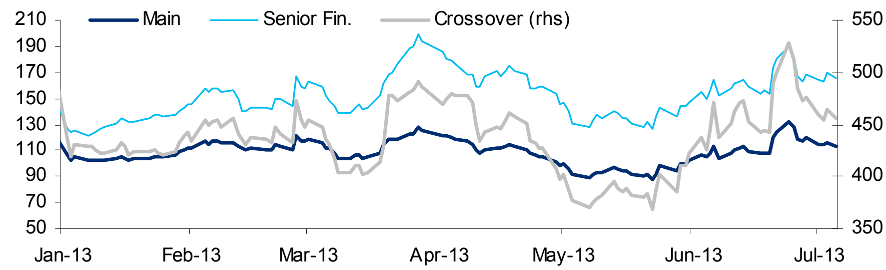
Number	Open	Closed*
In profit	0	0
In loss	2	0
	2	0

Percentage	Open	Closed*
In profit	0%	NA
In loss	100%	NA

Source: Citi Research. * Since 1-Jun-13. Excluding the trade ideas opened in the current publication.

Representative Market Conditions

Figure 25. Historical spreads – iTraxx 5y on-the-run indices Period: 1-Jan-13 – COB yesterday



Source: Citi Research, Markit. In bp.

Notes:

- The list of open trades reflects our current views; we have no plans to provide regular coverage or updates to these trades.
- P&L on trade ideas includes carry and roll costs but not trading commissions/costs.
- Results should not, and cannot, be viewed as an indicator of future performance.

Recent Trade Ideas

Figure 26. Published Trade Ideas – reverse chronological order.

Trade Ideas	Date
Option trades ahead of the FOMC	18 Jun 2013
iTraxx Series 9 vs. Series 19 Jun-18 equity tranches	5 Jun 2013
Hedging via Crossover Bearish Ladders	16 May 2013
Buy Main straddles; sell CDX IG straddles	1 May 2013
Views & Trades on iTraxx Series 9 Tranches	18 April 2013
Beware of retail and food releveraging – short risk retailers & food vs. Main Non-Financials	18 April 2013
Receiver 1x2s – Mind the tail if going long	2 Apr 2013
Hedging menu: payer spreads, 3s5s flatteners and Jun 15/18 equity tranche flatteners	28 Mar 2013
Long insurers vs. short premium autos	19 Mar 2013
Flatteners in iTraxx Equity Tranches	6 Mar 2013
Long risk 3-6% vs. short risk 0-3% - Jun-15 iTraxx Series 9 tranches	12 Feb 2013
Long risk Main vs. Crossover via indices and receiver options	12 Feb 2013
iTraxx Main payer ladders	3 Jan 2013
iTraxx Main 3s5s duration weighted flatteners	3 Jan 2013
Long risk iTraxx Main vs. short risk iTraxx Crossover	3 Jan 2013
Long risk CDX IG vs. short risk iTraxx Main	3 Jan 2013

Source: Citi Research.

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Appendix A-1

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