

Sell Crossover Receivers

Add a bit of extra carry at the expense of portfolio upside if we gap tighter

- **Turning more cautious ... but not bearish.** Our conviction in the tactically bullish view we've held almost all year is weakening, and we've been exploring ways to reduce risk without losing too much carry. Selling receivers is one of them.
- **Selling receivers fits our current views well.** It adds carry to a long risk portfolio if spreads remain unchanged or widen at expiry, at the expense of giving up part of the portfolio upside if we tighten substantially.
- **Crossover is our preferred index to sell receivers:** Fundamentally and technically we believe it is the index with least room to tighten in the medium term.
- **Trade: Sell no-delta Crossover 250bp August receiver options @ 14c** (indicative). It generates a breakeven at expiry of around 247bp.

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Turning more cautious ... but not bearish

Our conviction in the tactically bullish view we've held for a while is weakening, as we have highlighted in our recent [European Credit Weeklies](#). Our mantra for 2014 has been to trade against the US labour market data. So we argued a few weeks ago that for the first time in a long while we'd be sellers on rallies rather buyers on dips. In our latest weekly we suggested that one way of reducing risk without losing too much carry would be to lighten up on exposures with high volatility per unit of spread risk.

Continue to look for ways to reduce risk without losing carry

The strong US GDP number this week was a reminder that the US recovery seems on an increasingly upward path. Thus, following our own mantra, we continue to look for ways to reduce risk without losing carry. We believe that selling slightly OTM receivers is a good way of doing that, especially for long risk investors: i.e. selling covered receivers. Selling receivers adds carry to a long risk portfolio if spreads remain unchanged or widen at expiry, at the expense of giving up part of the portfolio upside if we tighten substantially.

Selling receivers fits our current views well

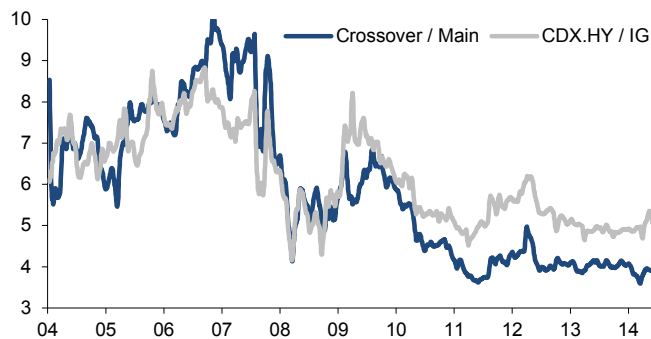
Selling receivers fits our current views well: our bullish conviction is weakening but we are not ready to add costly shorts. Our medium-term view is still on the constructive side, with the path of monetary policy in Europe still in expansionary mode. Moreover, the positioning picture which our [latest credit survey](#) reveals is a little less stretched, with the aggregate long in credit declining slightly. The most encouraging message from our survey was the fact that it was the highest beta sectors where the cutting (of long risk positions) was most evident: the long in HY declined to its lowest level in over a year, and positions in bank sub debt were substantially reduced. While the aggregate long is still extended, the resilient inflows and high beta cutting leave the technical looking less vulnerable than it did a few weeks ago.

Crossover is our preferred index to sell receivers

Fundamentally and technically we believe iTraxx Crossover is the index with the least room to tighten in the medium term. We have argued for a while that CDS investors will likely be more comfortable in a further tightening adding levered synthetic longs in investment grade rather than continue adding unlevered high yield beta; i.e. we think Main offers higher upside in a bullish scenario. Moreover, from a pricing point of view, Crossover is trading tight to both iTraxx Main (see the spread ratio in Figure 1) and to CDX HY (see their recent spread history in Figure 2).

Figure 1. Ratio of HY to IG synthetic index spreads: iTraxx & CDX

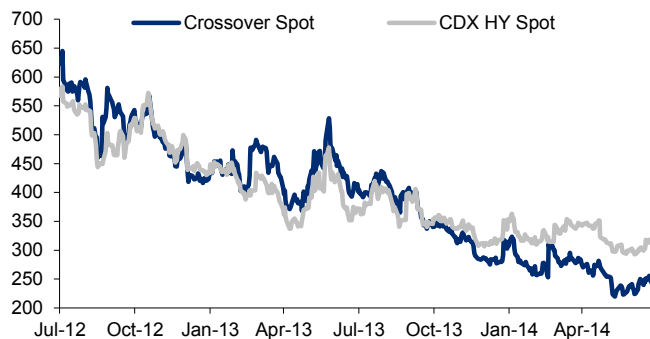
On-the-run 5y indices. 10d moving average.



Source: Citi Research, Markit.

Figure 2. iTraxx Xover vs. CDX HY spreads

On-the-run 5y indices, bp.



Source: Citi Research, Markit.

The technical backdrop in US high yield is currently very weak after heavy recent outflows from both mutual funds and ETFs – see Figure 3 and our [US high yield strategists' recent weekly](#). Although the technical picture in European high yield still feels robust, we fear the market may be underestimating the spillover risk from US

Figure 3. US High Yield weekly fund flows, \$bn



Source: Citi Research, Lipper, Bloomberg. Includes high yield funds and ETFs.

outflows to Europe. The recently heavy new issue calendar has prevented many deals from performing well, which might cause high yield spreads to trade on the weak side for a bit.

There are two **pushbacks** against our recommended trade, one technical and another fundamental. First, the skew ("basis-to-theoretical") in Crossover is currently on the wide side at >10bp (i.e. index wider than single names). We have very little to argue against this: we wish we could do this trade with a very negative skew; however, we feel the Crossover skew may remain on the positive side for a while. Second, ECB monetary policy has gained momentum recently after the negative deposit rate and the TLTRO, and it can be followed by some form of QE. We would argue this should be factored in to a large extent already, and that any potential QE would benefit high yield credit the least.

Trade: Sell no-delta Crossover 250bp August receiver options

The details of this trade are included in Figure 4. The investor receives around 14c upfront (indicative), which generate a breakeven at expiry of around 247bp. Figure 5 and Figure 6 show the trade P&L vs. index spread movements as well as the trade breakeven vs. the recent history of Crossover spreads.

The uptick in recent implied volatility – see our [vol analytics report](#) – should provide an attractive entry point; however the short dated nature of the option means its Vega is small (~1c). As a consequence, we don't expect the P&L of this trade to be driven by movements in implied vol.

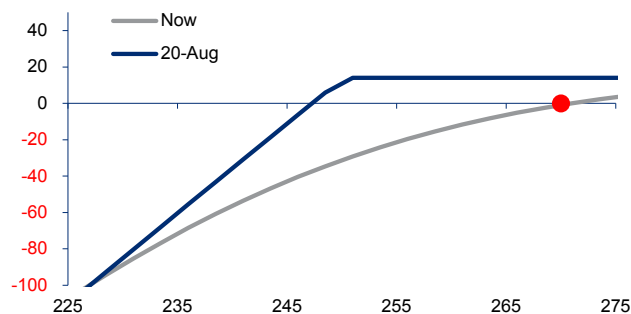
Figure 4. Xover 250bp August Receiver Sold – Trade details

Type	Strike	Expiry	Price	Position	Notional	Upfront	Delta	Gamma	Theta	Vega	Vol %	Delta	Gamma	Theta	Vega
Receiver	250	20-Aug	14.0c	Sell	100,000,000	140,000	9,014	-484	9,412	-8,098	43.0%	18.4%	-1.0%	0.9c	-0.8c
Index		@ 270 bp		No position											
Total						140,000	9,014	-484	9,412	-8,098					

Source: Citi Research

Figure 5. Xover 250bp August Receiver Sold – P&L

X-axis: index spreads in bp. Y-axis: Trade P&L in cents of the option notional.



Source: Citi Research, Markit.

Figure 6. Trade breakeven at expiry (247bp) vs. Historical index spread

On-the-run 5y indices, in bp.



Source: Citi Research, Markit.

Analytics, Past Trade Ideas & Publications

Analytics – Available at Citi Velocity

Options	iTraxx Volatility Report CDX Volatility Report European Cross-Asset Volatility Report Volatility P&L Report – Credit Indices	Tranches	iTraxx Series 9 Tranche Report iTraxx Series 19 Tranche Report iTraxx Series 21 Tranche Report
Curves	iTraxx Curve P&L Report	Indices	Main Report Crossover Report CDS Indices Positioning Report CDS Indices Trading Volumes Report
Returns	European Credit Derivatives Returns		

Recent Trade Ideas

Tranches -	Long risk super senior tranches	21-Jul-14
Options -	Main receiver 1x2s	13-Jun-14
Options -	Main bearish risk reversal	13-Jun-14
Curves -	5s10s Senior Fin flattener (J. Faith)	30-May-14
Options -	European vs. US credit vol	28-May-14
Tranches -	Sell 0-3% Jun-15 S9 protection: outright, vs. CDX IG 5y or vs. SX5E	21-May-15
Indices -	Sub/Senior Financials compression (J. Faith)	20-May-15
Curves -	5s10s Main Flatteners	25-Apr-14
Options -	Main 70-75 May Receiver 1x2	2 Apr 2014
Options -	Buy SenFin vs. Sell CDX IG straddles	18 Mar 2014
Single names vs. Index	Releveraging Trade (H. Lorenzen)	24 Feb 2014
Tranches vs. Options -	Sell protection and monetize the positive convexity by selling straddles	20 Feb 2014
Tranches -	Buy 9-100% S9 Jun-18 protection, delta-hedged	20 Feb 2014
Tranches -	Sell 3-6% S9 Jun-18 protection, delta-hedged	20 Feb 2014
Options vs. Curves -	Flatteners vs. OTM payers	13 Feb 2014
Options -	Sell Main vol, buy SenFin vol	21 Jan 2014
Tranches -	More mezz, less seniors - 3-6% vs. super senior	15 Jan 2014
Options -	SenFin vs. Xover Recs	9 Jan 2014
Options -	Payer spread vs. index long	9 Jan 2014
Options -	Sell 1m Main straddles	9 Jan 2014
Options -	Sell Crossover Receiver	9 Jan 2014
Options -	Sell strangles and go on holidays: Position for spreads to stay in the recent range in mid-January	9 Dec 2013
Tranches -	Sell S9 Jun-18 6-9% protection vs. Xover 5y S20	15 Nov 2013
Tranches -	Sell S9 Jun-18 22-100% protection vs. light delta	15 Nov 2013
Indices -	Long risk Senior Fins. vs. short risk Main	5 Nov 2013
Options -	Crossover receiver ladders	23 Oct 2013
Options -	Long risk CDX IG vs. Main via Receivers	15 Oct 2013
Options -	Buy Senior Financials straddles vs. sell Crossover straddles	9 Oct 2013
Tranches -	Long risk equity vs. short risk 3-6% in S19 Jun-16 (3y)	26 Sep 2013
Tranches -	Long risk S19 Jun-18 (5y) 3-6% vs. 5y S20 Crossover	26 Sep 2013

“European Credit Derivatives Views & Trades” Investor Presentation

Teach-in presentations: [Options](#) / [Tranches](#)

Other publications

Smart Ways to Sell Credit Volatility (A. Basu)	24 Jul 2014
2014 CDS Definitions getting closer II: Update on protocol and CoCo supplement	11-Jul-14
Hedging the tail – Why real money should consider all options (with H. Lorenzen)	1 Jul 2014
Lazy longs for July	23 Jun 2014
Where do we expect iTraxx rolls to trade?	19 Mar 2014
Our preferred carry trades in indices, options and tranches	11 Mar 2014
New 2014 CDS Definitions - What's new? What's changing? Why? When? How?	26 Feb 2014
iTraxx Roll - Potential Changes: Crossover number of constituents will increase to 60 names	10 Feb 2014
2014 European Credit Outlook: Strategy // Positioning and Trades	13 Jan 2014
Global Structured Credit Outlook: A Rockier Ride (R Roy, A Basu, K Malhotra, R Brauchler)	20 Dec 2013
2013 Trading Volumes in European Credit: CDS Indices, Single Name CDS and IG Bonds	5 Dec 2013
Credit Options - What did investors do in 2013? What will they do in 2014? (2013 European Credit Conference Presentation)	4 Dec 2013
Credit Index Options 1-0-1: Launching our option pricing tool @ CitiVelocity (2013 European Credit Conference Presentation)	2 Dec 2013
Europe Returns: Assessing value across flow and structured credit assets	22 Nov 2013
iTraxx Tranches Views & Trades: Mezz may be back next year	15 Nov 2013
Financial CDS to get a re-vamp	7 Aug 2013

Source: Citi Research.

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Appendix A-1

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