

Lazy longs for July

Limited downside on a near term market sell-off

- **World Cup, Wimbledon, holidays, nice weather¹ ... plus bullishness all around and no near-term visible catalysts.** There may be too many distractions to get extremely long here, even if the views justify it. At the same time, leaving the office flat or short is going to be too painful every time you check your Blackberry while on holiday (or watching your country make it to the final²) and see Main unchanged or grinding another 0.5bp tighter.
- **We recommend trades which generate the carry you need** – so you don't get distracted from your football/tennis watching when you see Main 0.5bp tighter – **but which have a limited and more palatable downside than pure longs if markets sell off** – so you can finish the match without having to run back to the office to close positions.
- **The trades**, all of which are among our top recent recommendations (i.e. we would recommend them even if you don't leave the office) **are**:
 - **Main 1x2s receiver options**
 - **5s10s equal notional flatteners**
 - **Long risk 1y equity tranches**

Read on for a review of these trades.

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¹ Only sporadically in the UK.

² Doesn't apply to Spanish (and English) people, sadly.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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More details in our recent publication:

[European Credit Weekly: Has the ECB triggered changes in our trades?](#)

Receiver 1x2s

- **We remain bullish but we reckon that the near term tightening potential in European synthetic indices is somewhat limited** after the strong outperformance of synthetics vs. cash on the back of the ECB announcements. Our base case is for synthetic spreads to remain very range-bound, realizing little vol, and cash spreads to slowly catch up.
- **At the same time, we sense that investors are under-hedged** (compared to anytime this year). This is very clear when looking at recent flows in options, a market which real money investors have used extensively to source hedges this year: since the ECB investors have been better sellers of payers and better buyers of receivers (i.e. the opposite of hedging!). Pricing-wise, this is reflected in the low receiver and payer skews which all indices currently exhibit – see Figure 4. If we were to widen (which is not our central scenario), we think it can be self-fulfilling as unhedged real money investors would likely chase spreads wider setting up hedges.
- **Thus, when going long risk we prefer to take downside exposure to a large gap tighter than to a gap wider. Receiver 1x2s is an attractive way to do that.** As the example in Figure 3 shows for a 55-60bp July Main Receiver 1x2, the downside of the trade on a widening is limited and the upside for a small tightening is paid for with downside to a large tightening (the breakeven of that trade is ~51bp at expiry – 16th July).

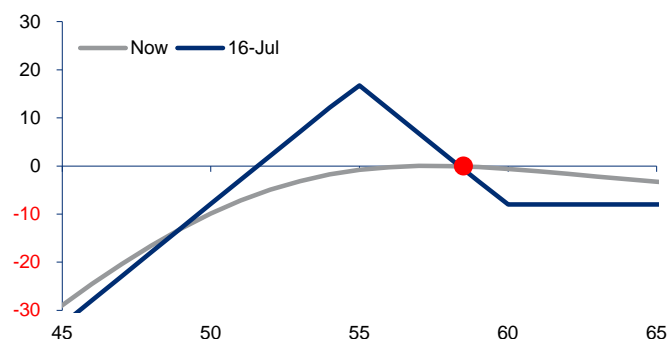
Figure 1. Main July 55-60bp Receiver 1x2 – [Link to the pricing tool](#)

Type	Strike	Expiry	Price	Position	Notional	Upfront	Delta	Gamma	Theta	Vega	Vol %
Receiver	60	16-Jul	16.0c	Buy	100,000,000	-160,000	-25,867	2,813	-1,834	2,833	46.8%
Receiver	55	16-Jul	4.0c	Sell	200,000,000	80,000	22,224	-4,980	3,703	-4,334	39.8%
Index	@ 58.5 bp			No position							
Total						-80,000	-3,643	-2,167	1,869	-1,501	

Source: Citi Research. Indicative prices shown.

Figure 2. Main July 55-60bp Receiver 1x2

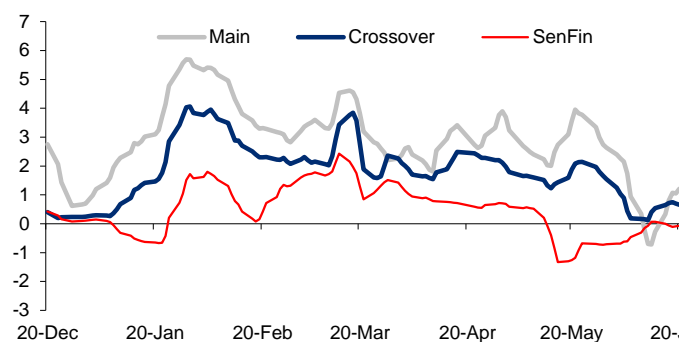
Y-axis: P&L in cents of the high strike receiver bought. X-axis: index spreads, bp.



Source: Citi Research, Markit.

Figure 3. 1m receiver skews across indices

Implied vol difference between 50% and 25% delta receivers, in %.



Source: Citi Research. 5 days moving average.

More details in our recent publications:

[Time to move on? ... From 3s5s to 5s10s](#)

[A time to be flat: 5s10s flatteners in Senior Fins](#)

Equal notional 5s10s flatteners

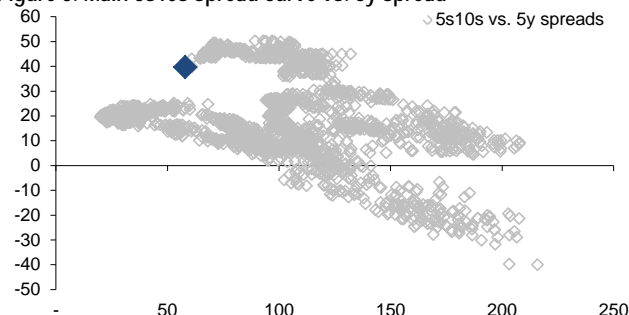
- **Although the main reason why we like 5s10s flatteners is their upside if we tighten** (where we'd expect a substantial bull flattening as investors extend maturities), **investors looking for lazy longs should like them because of the limited downside they have historically exhibited in widening episodes.** As Figure 6 shows, the 5s10s curve (currently at ~40bp) has never steepened above 50bp on a widening ... and it did invert substantially in the 2009 sell-off.
- **Equal notional flatteners are a good way to go long risk with a tail-hedge, in our view.** As we showed in a [piece](#) last year, moving from an outright long to an equal notional flattener, keeping the net spread duration constant, essentially involves something very similar to adding a bearish risk reversal to the original long risk position.
- **The very steep curve compared to the current absolute spread levels makes the forward spread very attractive** as Figure 7 shows.

Figure 4. Main 5s10s equal notional flattener

Tenor	Maturity	Spread (bp)	Notional (€)	12m Carry (€)	12m Slide (€)	12m Time (€)
5y	20-Jun-19	58	-100,000,000	-578,967	-375,134	-954,102
10y	20-Jun-24	97	100,000,000	974,919	353,997	1,328,916
20-Jun-14		40	0	395,952	-21,137	374,815

Source: Citi Research. Indicative prices shown.

Figure 5. Main 5s10s spread curve vs. 5y spread



Source: Citi Research, Markit. Daily data since 2005.

Figure 6. 5s10s forward spread – outright and ratio to 10y spreads



Source: Citi Research. 5 days moving average.

More details in our recent publications:

[Last squeeze to Jun-15 Series 9 Main equity](#)

Figure 7. Sell S9 Jun-15 Protection
(No delta)

Index	ITXEUR S9
Tranche	0-3%
Maturity	Jun-15
Protection	Sell
Upfront	-1.75%
Coupon	500 bp
Spread	325 bp
Delta	23.3
MtM*	
Spreads** +10bp	-2.46%
Correl +5%	0.19%
Jump-to-def.**	-16.6%
3m time value	1.35%

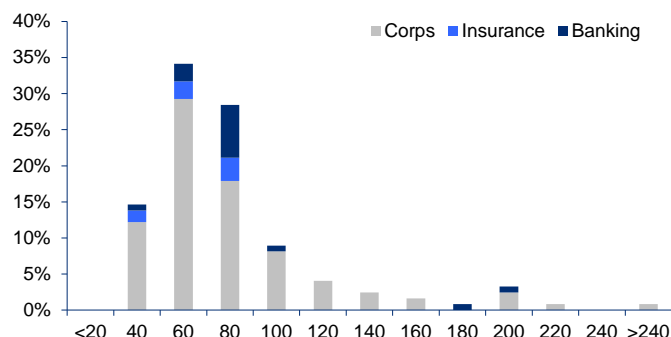
Source: Citi Research, Markit. * MtM as % of tranche notional. ** Single name spreads. *** Instantaneous default (Peugeot).

Sell Jun-14 S9 equity protection

- **ECB non-standard monetary measures?** They may not have a long term impact on the economy, but keeping the high levels of liquidity in the market should prevent near term defaults. There's enough money to be borrowed if need be – making it hard to see who might default over the summer.
- **We think selling short dated equity protection is a comfortable strategy in an environment** – at least in Europe – where excess liquidity is not going to disappear – keeping investment grade default risk at the top of our preferred risks to take.
- True that implied correlations are high and equity is tight, but with one year to go, the S9 Jun-14 equity tranche has very little exposure to either correlation or general market spreads. We believe that any event impacting the market which does not materially impact the risk of short term defaults will have a very small impact in short dated equity tranches, even if it causes 5y spreads to sell-off.
- **The tranche spread is around 325bp and the 3m time value of the trade is above 1.3%. One default with 40% recovery would trigger a 16% default loss.** The upside/downside analysis doesn't look great if one doesn't consider the probability of a default in an IG portfolio. The Main S9 portfolio is heavy in periphery credits but doesn't have any credit trading above 250bp in the 5y tenor. The 8 widest credits are: Peugeot, Portel, OTE, BES, Thyssen, Finmeccanica, Monte dei Paschi and Telecom Italia.

Figure 8. iTraxx Main S9 5y spread distribution

Y-axis: % credits. X-axis: 5y spread bucket, in bp.



Source: Citi Research, Markit.

Figure 9. iTraxx Main S9 5y country distribution

Country	# Credits	Country	# Credits
Portugal	3	Germany	24
Greece	1	Austria	1
Spain	7	Finland	1
Italy	7	Norway	1
France	26	Sweden	5
Belgium	0	Switzerland	8
Luxembourg	1	United Kingdom	29
Netherlands	9		

Source: Citi Research.

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

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
Tranches -	Long risk iTraxx S9 Jun-18 (10y) super senior vs. short risk CDX IG S9 Dec-17 (10y) super senior	26 Sep 2013

Latest [“European Credit Derivatives Views & Trades”](#) Investor Presentation

Other publications

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
Hedging menu: payer spreads, 3s5s flatteners and Jun 15/18 equity tranche flatteners	28 Mar 2013
What bail-in means for CDS	11 Feb 2013

Source: Citi Research.

Trade Recommendations Summary

We are not opening or closing any trades (the three trades recommended in this report are already in our model portfolio).

Figure 10. Open trades – Summary and P&L

Trade Description	Leg	Format	Direct.	Notnl.	Entry Upfront	Entry Spread	Coupon	Current Upf.	Current Spread	P&L* Total
Sell 1m Main straddles *** 09-Jan-14	Sell 1m Main straddles	Price	Buy	1.00	0.00%			0.54%		0.54%
									Total	0.54%
Payer spread vs. index long *** 09-Jan-14	Buy 3m 25-60% pay spread Sell index prot.	Price Price	Buy Buy	1.00 1.00	0.00% 0.00%			-0.61% 1.50%		-0.61% 1.50%
									Total	0.90%
SenFin vs. Xover Recs *** 09-Jan-14	Buy 3m SenFin Recs Sell 3m Xover Recs	Price Price	Buy Buy	1.00 0.29	0.00% 0.00%			0.96% -3.12%		0.96% -0.92%
									Total	0.04%
Equity tranche vs. straddle *** 20-Feb-14	Sell Jun-18 S9 equity prot., DH Sell 1m Main straddles, DH	Price Price	Buy Buy	1.00 0.50	0.00% 0.00%			-0.28% 0.23%		-0.28% 0.11%
									Total	-0.17%
Releveraging trade 24-Feb-14	Basket of low spread/leverage CDS Main NonFins	Prot. Prot.	Buy Sell	1.00 0.50	-3.14% -1.54%	35 67	100 100	-3.33% -2.08%	31 58	-0.48% 0.42%
									Total	-0.06%
iTraxx Main 5s10s flattener 25-Apr-14	Main S21 5y Main S21 10y	Prot. Prot.	Buy Sell	1.36 1.00	-1.42% 1.48%	71 117	100 100	-2.06% -0.22%	58 97	-1.09% 1.86%
									Total	0.77%
Series 9 Jun-15 0-3% 21-May-14	Series 9 Jun-15 0-3%	Prot.	Sell	1.00	-0.75%	430	500	-1.40%	359	1.07%
									Total	1.07%
Main vs. CDX IG *** 28-May-14	Sell 3m Main DH straddles Buy 3m CDX IG DH straddles	Price Price	Buy Sell	1.00 1.00	0.00% 0.00%			-0.02% -0.03%		-0.02% 0.03%
									Total	0.02%
3-6% vs. Crossover 12-Jun-14	Sell 3-6% S21 Main prot. Buy S21 Xover prot.	Prot. Prot.	Sell Buy	1.00 1.00				6.98% -12.66%	248 224	-0.46% -0.64%
									Total	-1.09%
Main July Rec 1x2s 13-Jun-14	Main July 60bp Rec Main July 55bp Rec	Price Price	Buy Sell	1.00 2.00	0.13% 0.04%			0.17% 0.05%		0.04% -0.01%
									Total	0.03%

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. *** We track the trade P&L by using an initial 0% upfront and a current upfront equal to the trade P&L in %. DH = delta hedged.

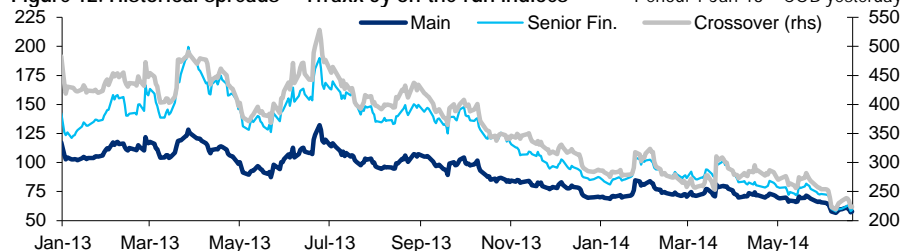
Figure 11. Open and closed trades summary statistics

Number	Open	Closed*	Percentage	Open	Closed*
In profit	7	19	In profit	79%	73%
In loss	3	7	In loss	21%	27%
	10	26			

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

Representative Market Conditions

Figure 12. Historical spreads – iTraxx 5y on-the-run indices



Source: Citi Research, Markit. In bp.

Figure 13. Closed trades since Oct-13 – Summary and P&L

Trade Description	Leg	Format	Direct.	Notnl.	Entry Upfront	Entry Spread	Coupon	Final Upfront	Final Spread	P&L* Total
Senior Fin vs. Xover straddle	Xover Dec-13 400bp straddle	Price	Sell	1.00	2.64%			2.63%		0.00%
Opened: 9-Oct-13	SenFin Dec-13 140bp straddle	Price	Buy	2.05	1.29%			1.48%		0.40%
Closed: 15-Nov-13									Total	0.40%
325-350-375 Nov. Crossover Receiver Ladder	325 Xover Nov Rec	Price	Sell	2.00	0.18%			0.02%		0.32%
Opened: 23-Oct-13	350 Xover Nov Rec	Price	Sell	1.00	0.61%			0.47%		0.14%
Closed: 15-Nov-13	375 Xover Nov Rec	Price	Buy	1.00	1.45%			1.46%		0.01%
									Total	0.47%
CDX IG vs. Main Receivers	CDX IG S21 Nov 85 Receiver	Price	Buy	1.00	0.47%			0.62%		0.15%
Opened: 15-Oct-13	Main S20 Nov 100 Receiver	Price	Sell	1.00	0.52%			0.91%		-0.39%
Closed: Expired 20-Nov-13									Total	-0.24%
S19 Jun-16 0-3% vs. 3-6%	Main S19 0-3% Jun-16	Prot.	Sell	1.00	8.00%	839	500	3.88%	725	5.11%
Open: 26-Sep-13	Main S19 3-6% Jun-16	Prot.	Buy	2.00	-7.00%	234	500	-9.75%	132	-7.47%
Closed: 9-Dec-13									Total	-2.36%
SenFin vs. Main	Senior Fin. 5y S20	Prot.	Sell	1.00	0.60%	112	100	0.07%	102	0.61%
Open: 26-Sep-13	Main 5y S20	Prot.	Buy	1.35	-0.79%	84	100	-0.94%	81	-0.32%
Closed: 9-Dec-13									Total	0.29%
S9 super senior vs. light delta	Main S9 22-100% Jun-18	Prot.	Sell	1.00	0.18%	30	25	0.03%	26	0.19%
Open: 15-Nov-13	Main S9 index Jun-18	Prot.	Buy	0.33	-3.65%	93	175	-4.24%	77	-0.29%
Close: 14-Jan-14									Total	-0.10%
75-85 Main January strangle	75bp Jan Main receiver	Price	Sell	1.00	0.08%			0.19%		-0.11%
Open: 9-Dec-13	85bp Jan Main Payer	Price	Sell	1.00	0.13%			0.00%		0.13%
Close: 14-Jan-14									Total	0.02%
Sell Crossover Receiver	275bp Feb. Receiver	Price	Sell	1.00	0.32%			0.17%		0.15%
Open: 9-Jan-14										
Close: 13-Feb-14									Total	0.15%
iTraxx Main Eq. Notional Flatteners	Main S19 3y	Prot.	Buy	1.00	-0.97%	65	100	-1.57%	33	-1.04%
Open: 5-Sep-13	Main S19 5y	Prot.	Sell	1.00	0.24%	105	100	-1.47%	65	2.15%
Close: 13-Feb-14									Total	1.11%
S9 6-9% vs. S20 Crossover	Main S9 6-9% Jun-18	Prot.	Sell	1.17	-0.25%	294	300	-3.19%	223	4.37%
Open: 15-Nov-13	Crossover S20 Dec-18	Prot.	Buy	1.00	-7.07%	344	500	-9.80%	274	-4.06%
Close: 19-Feb-14									Total	0.31%
3-6% vs. super senior	Main S9 3-6% Jun-18	Prot.	Sell	1.00	-5.50%	366	500	-5.34%	367	0.34%
Open: 14-Jan-14	Main S9 22-100% Jun-18	Prot.	Buy	9.00	0.03%	26.625	25	0.12%	28	0.60%
Close: 19-Feb-14									Total	0.94%
Main vs. SenFin vol ***	Sell Feb 70 Main straddles, DH	Price	Buy	1.00	0.00%			-0.02%		-0.02%
Open: 21-Jan-14	Buy Feb 80 SenFin straddles, DH	Price	Buy	0.50	0.00%			0.02%		0.01%
Close: Expired									Total	-0.01%
Senior tranche short ***	Buy Jun-18 S9 9-12% prot., DH	Price	Buy	0.03	0.00%			0.26%		0.01%
Open: 20-Feb-14	Buy Jun-18 S9 12-22% prot., DH	Price	Buy	0.10	0.00%			0.24%		0.02%
Close: 20-May-14	Buy Jun-18 S9 22-100% prot., DH	Price	Buy	0.78	0.00%			-0.05%		-0.04%
									Total	-0.01%
Mezz tranche long ***	Sell Jun-18 S9 3-6% prot., DH	Price	Buy	1.00	0.00%			-0.55%		-0.55%
Open: 20-Feb-14										
Close: 20-May-14									Total	-0.55%
Main May Rec 1x2s	Main May 75bp Rec	Price	Buy	1.00	0.24%			0.16%		-0.08%
Open: 2-Apr-14	Main May 70bp Rec	Price	Sell	2.00	0.10%			0.02%		0.16%
Close: 20-May-14									Total	0.09%
Flattener vs. OTM payer ***	3s5s flattener Main	Price	Buy	1.00	0.00%			0.36%		0.36%
Open: 13-Feb-14	Sell 3m 120bp Main payer	Price	Buy	0.75	0.00%			0.12%		0.09%
Close: 27-May-14									Total	0.44%
Senior Fin vs. CDX IG straddle	SenFin Jun-14 90bp straddle	Price	Buy	1.00	0.97%			0.79%		-0.18%
Open: 18-Mar-14	CDX IG Jun-14 65bp straddle	Price	Sell	1.90	0.51%			0.19%		0.61%
Close: 27-May-14									Total	0.43%

Source: Citi Research. Spreads and coupons in bp. * P&L expressed as % of the leg with notional equal to 1. *** We track the trade P&L by using an initial 0% upfront and a final upfront equal to the trade P&L in %.

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.

Risks: 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. Note that ratio writing would leave the writer uncovered in one leg of the trade.

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Appendix A-1

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