

Long risk Senior Fins. vs. short risk Main

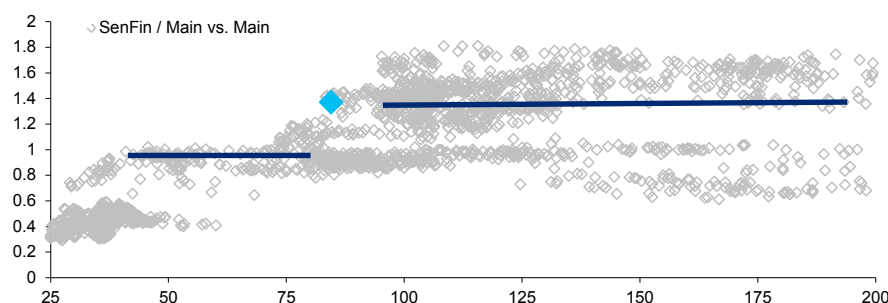
The spread ratio is lagging the recent market tightening

- **Fins to outperform corporates if we stabilize at current levels or tighten further** – Pricing-wise, as Figure 1 shows, the current spread ratio between Senior Financials and Main is still in-line with a world of wide spreads and is lagging the recent market tightening. As we stabilise at current levels or drift tighter, we believe financials will outperform corporates and the ratio of Senior Financials to Main will decrease.

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Figure 1. Current spread ratio: average for wider spreads, high for tighter spreads

Historical spread ratio between Senior Fins and Main (y-axis) vs. Main spreads (x-axis). 5y on-the-run spreads, in bp.



Source: Citi Research, Markit. Daily data since 2004.

- **Game changer** – Stabilising or even tightening from current levels represents a game changer to us, in terms of the investment dynamics which will drive markets going forward. At current, or tighter levels, we think the investment dynamics and relative value relationships will be much closer to the ones back in 2005-2008 than the ones over the past three years. There are three relative value trades which have upside in this new trading environment: long risk Senior Financials vs. Main, [long risk Main vs. Crossover](#) and [curve flatteners](#).
- **Too tempting** – In a tight-world, every basis point counts, and the basis between financial and corporate spreads is too tempting (5y spreads at 112 and 84bp for SenFin and Main respectively).
- **Trade: Position for the spread ratio** (currently at ~1.35) **to fall via a “neutral-carry” trade**. The ratio should be much closer to 1 in our view.

Figure 2. Trade details – long risk SenFin vs. Main; “zero-carry”.

Index	Protection	Spread (bp)	Notional (m)
Senior Fins. 5y S20	Sell	112.3	100
Main 5y S20	Buy	83.9	135

Source: Citi Research, Markit. Indicative spreads shown.

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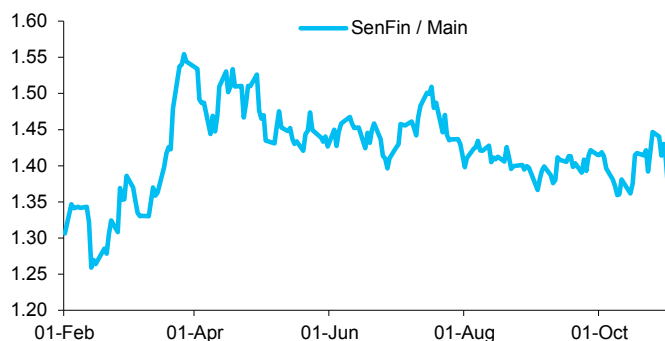
The upside is in Fins

We remain [constructive](#) view-wise, although realise that before we can tighten much further we will likely spend a few weeks in a relatively narrow and boring trading range. In our view, a period of very low realised volatility is very important for investors to feel confident enough to meaningfully add risk at the tightness of the year.

We are still in a world where central bank liquidity and support remains key to buy the necessary time for the economy to fully recover and drive markets. As we transition from a central bank-led to an economy-led market recovery, the financial sector needs to be anchored and regain investors' confidence; and we expect central banks to continue supporting it, more so than the corporate sector. Next year's AQR and stress tests can be seen as another tool that central banks and regulators plan to use to convince market participants that the financial system is regaining the stability needed to keep the economy moving forward.

Figure 3. Spread ratio: past 9m

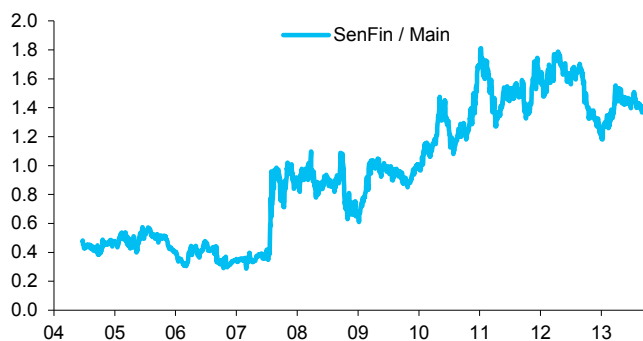
Historical spread ratio between Senior Fins and Main. 5y on-the-run spreads, in bp.



Source: Citi Research, Markit.

Figure 4. Spread ratio: since 2004

Historical spread ratio between Senior Fins and Main. 5y on-the-run spreads, in bp.



Source: Citi Research, Markit.

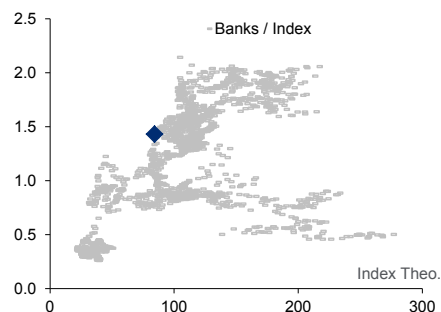
Figure 3 and Figure 4 show the historical spread ratio between Senior Financials and Main for the past 9m and since 2004 respectively. Since April this year the ratio has progressively fallen, although in a fairly volatile fashion. We expect the recent outperformance of Senior Financials vs. Main to continue going forward.

When looking at the banks and insurance companies within the Senior Financials index, Figure 5 and Figure 6 show that, in both cases, the ratio of spreads to Main is very high if we were to stay at current levels or tighten further.

Figure 5. Spread ratio: banks vs. Main

Historical spread ratio between banks and Main (y-axis) vs.

Main spreads (x-axis, in bp).

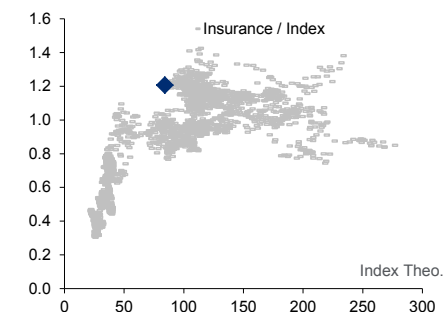


Source: Citi Research, Markit. 5y theoretical on-the-run spreads, in bp. Daily data since 2004.

Figure 6. Spread ratio: insurers vs. Main

Historical spread ratio between insurance companies and Main

(y-axis) vs. Main spreads (x-axis, in bp).



Source: Citi Research, Markit. 5y theoretical on-the-run spreads, in bp. Daily data since 2004.

Trade Recommendations Summary

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

We are opening the trade recommended in this report and taking profits in two of our three tranche trades (S19 3-6% vs. S20 Crossover and iTraxx vs. CDX IG super senior).

Figure 7. Open trades – Summary and P&L

Trade Description	Leg	Format	Direct.	Notnl.	Entry Upfront	Entry Spread	Entry Coupon	Current Upf.	Current Spread	P&L* Total	P&L* Month**
iTraxx Main Eq. Notional Flatteners 05-Sep-13	Main S19 3y	Prot.	Buy	1	-0.97%	65	100	-1.58%	40	-0.77%	-0.25%
	Main S19 5y	Prot.	Sell	1	0.24%	105	100	-1.13%	75	1.53%	0.65%
									Total	0.75%	0.41%
S19 Jun-16 0-3% vs. 3-6% 26-Sep-13	Main S19 0-3% Jun-16	Prot.	Sell	1	8.00%	839	500	6.23%	760	2.31%	2.57%
	Main S19 3-6% Jun-16	Prot.	Buy	2	-7.00%	234	500	-8.38%	176	-3.84%	-2.41%
									Total	-1.52%	0.15%
Senior Fin vs. Xover straddle 09-Oct-13	Xover Dec-13 140bp straddle	Price	Sell	1	2.64%			2.64%		-0.01%	
	SenFin Dec-13 140bp straddle	Price	Buy	2.05	1.29%			1.35%		0.13%	
									Total	0.13%	
CDX IG vs. Main Receivers 15-Oct-13	CDX IG S21 Nov 85 Receiver	Price	Buy	1	0.47%			0.57%		0.10%	
	Main S20 Nov 100 Receiver	Price	Sell	1	0.52%			0.78%		-0.26%	
									Total	-0.17%	
325-350-375 Nov. Crossover Receiver Ladder 23-Oct-13	325 Xover Nov Rec	Price	Sell	2	0.18%			0.10%		0.15%	
	350 Xover Nov Rec	Price	Sell	1	0.61%			0.58%		0.03%	
	375 Xover Nov Rec	Price	Buy	1	1.45%			1.42%		-0.03%	
									Total	0.15%	
SenFin vs. Main 05-Nov-13	Senior Fin. 5y S20	Prot.	Sell	1	0.60%	112.3	100				
	Main 5y S20	Prot.	Buy	1	-0.79%	83.9	100				
									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.

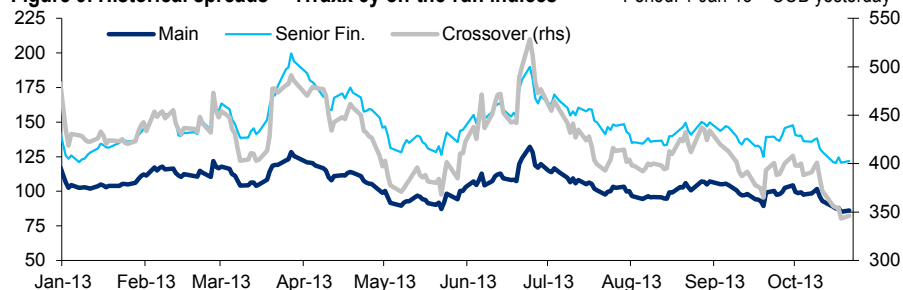
Figure 8. Open and closed trades summary statistics

Number	Open	Closed*	Percentage	Open	Closed*
In profit	3	8		60%	89%
In loss	2	1		40%	11%
	5	9			

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

Representative Market Conditions

Figure 9. Historical spreads – iTraxx 5y on-the-run indices



Source: Citi Research, Markit. In bp.

Figure 10. Closed trades since Jun-13 – Summary and P&L

Trade Description	Leg	Format	Direct.	Notnl.	Entry Upfront	Entry Spread	Entry Coupon	Current Upfront	Current Spread	P&L* Total
Main July Receiver Fly	105bp Receiver	Price	Buy	1	0.25%			0.23%		-0.01%
Opened: 18-Jun-13	90bp Receiver	Price	Sell	2	0.04%			0.00%		0.07%
Closed: Expiry	75bp Receiver	Price	Buy	1	0.00%			0.00%		0.00%
									Total	0.06%
Senior Fin vs. CDX IG Receivers	SenFin October 140bp receiver	Price	Buy	1	0.53%			0.69%		0.17%
Opened: 26-Jul-13	CDX IG October 75bp receiver	Price	Sell	2	0.19%			0.18%		0.02%
Closed: 13-Aug-13									Total	0.19%
Series 9 vs. Series 19 equity	iTraxx Main S9 0-3% Jun-18 (10y)	Prot.	Buy	1	46.25%	1,720	500	39.82%	1,703	-7.98%
Opened: 5-Jun-13	iTraxx Main S9 Index Jun-18 (10y)	Prot.	Sell	5	-2.05%	132	175	-2.73%	114	6.12%
Closed: 25-Sep-13	iTraxx Main S19 0-3% Jun-18 (5y)	Prot.	Sell	1	31.75%	1,227	500	25.15%	1,188	8.15%
	iTraxx Main S19 Index Jun-18 (5y)	Prot.	Buy	6.2	0.39%	108	100	-0.53%	88	-7.63%
									Total	-1.34%
S19 Jun-16 3-6% vs. S9 Jun-18 Index	iTraxx Main S19 3-6% Jun-16 (3y)	Prot.	Sell	1	-3.59%	375	500	-7.23%	229	4.72%
Opened: 9-Jul-13	iTraxx Main S9 Index Jun-18 (10y)	Prot.	Buy	2.5	-1.58%	138	175	-2.73%	114	-3.83%
Closed: 25-Sep-13									Total	0.89%
Commerzbank sub/senior compr.	Sub CDS	Prot.	Sell	1	-5.65%	375	500	-8.03%	327	3.24%
Opened: 13-Aug-13	Senior CDS	Prot.	Buy	2.51	2.37%	150	100	1.95%	140	-1.49%
Closed: 14-Sep-13									Total	1.75%
RBS sub/senior compr.	Sub CDS	Prot.	Sell	1	-7.71%	339	500	-11.10%	254	4.25%
Opened: 13-Aug-13	Senior CDS	Prot.	Buy	2.02	2.80%	168	100	1.77%	139	-2.43%
Closed: 14-Sep-13									Total	1.82%
BNP sub/senior compr.	Sub CDS	Prot.	Sell	1	-14.42%	198	500	-16.21%	168	2.65%
Opened: 13-Aug-13	Senior CDS	Prot.	Buy	1.68	0.86%	118	100	0.26%	105	-1.30%
Closed: 14-Sep-13									Total	1.36%
S19 3-6% vs. S20 Crossover	Main S19 3-6% Jun-18	Prot.	Sell	1	-3.25%	422	500	-5.70%	366	2.99%
Opened: 26-Sep-13	Crossover S20 Dec-18	Prot.	Buy	1.00	-5.18%	386	500	-6.96%	343	-2.32%
Closed: 4-Nov-13									Total	0.67%
iTraxx vs. CDX IG super senior	Main S9 22-100% Jun-18	Prot.	Sell	1	0.60%	37	25	0.34%	32	0.29%
Opened: 26-Sep-13	CDX IG S9 30-100% Dec-17	Prot.	Buy	1.00	-3.54%	13	100	-3.43%	16	0.00%
Closed: 4-Nov-13									Total	0.29%

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

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.

Analytics, Recent Trade Ideas & Publications

Figure 11. Analytics – Available at Citi Velocity

Options	iTraxx Volatility Report CDX Volatility Report	Tranches	iTraxx Series 9 Tranche Report iTraxx Series 19 Tranche Report
Indices	CDS Indices Positioning Report CDS Indices Trading Volumes Report	Curves	iTraxx Curve P&L Report

Source: Citi Research.

Figure 12. Recent Trade Ideas

Crossover receiver ladders	23 Oct 2013
Long risk CDX IG vs. Main via Receivers	15 Oct 2013
Buy Senior Financials straddles vs. sell Crossover straddles	9 Oct 2013
Long risk equity vs. short risk 3-6% in S19 Jun-16 (3y)	26 Sep 2013
Long risk S19 Jun-18 (5y) 3-6% vs. 5y S20 Crossover	26 Sep 2013
Long risk iTraxx S9 Jun-18 (10y) super senior vs. short risk CDX IG S9 Dec-17 (10y) super senior	26 Sep 2013
Equal Notional 3s5s Flatteners: Adding cautious longs by selling forward protection	5 Sep 2013
Sub/Senior compression trades in European banks	13 Aug 2013
iTraxx Senior Financials vs. CDX IG via Receivers	7 Aug 2013
Sell Jun-16 3-6% Series 19 protection vs. Buy Jun-18 Series 9 index protection	9 Jul 2013
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

Source: Citi Research.

Figure 13. Other publications

Financial CDS to get a re-vamp	7 Aug 2013
What bail-in means for CDS	11 Feb 2013

Source: Citi Research.

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http://www.theocc.com/components/docs/March_2011_ODD_Definitive_Supplement.pdf, and

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Appendix A-1

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