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Europe

Views & Trades on iTraxx Series 9 Tranches

European Credit Derivatives – Trade Ideas

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- **Most attractive longs: iTraxx Series 9 Jun-15 3-6% and Jun-18 0-3%**. As investors struggle to pick up yield, in Europe we think buying tranches is preferable to moving down in quality, and is much better than buying peripherals. A pick-up in enquiries over recent weeks suggest that a growing number of real money and hedge fund investors are coming to the same conclusion. Our two favourite longs are Jun-15 3-6% and Jun-18 0-3%: yields on the latter are fully 20%.

- **Barbells: In Jun-18 iTraxx tranches we favour a barbell strategy, with longs in equity tranches and in very senior tranches (12-22%)**. However, we realise that, although the spreads that long-dated senior tranches pay are very attractive, very few investors will be keen on taking tail risk exposure right now.

- **Long risk Jun18 0-3% vs. short risk 3-6%** – **On the relative value front**, we include a new recommendation which should appeal to investors who want to gain "convexity" to the developments in the economic and political situation in Europe. Long risk Jun18 0-3% vs. short risk 3-6% has positive time value and convexity, and provides a "make-up or break-up" exposure to the European political situation.

- **On the short risk side** – Overall, we favour the tranche market for long risk positions. For shorts, we recommend "moderate" hedges via options and "tail" hedges via index flatteners and positive basis trades (long risk CDS vs. short risk cash). Only when **hedging idiosyncratic single name stories**, with a few companies widening to distressed levels and flattening aggressively, would we look at tranche trades: in particular **equity tranche flatteners and shorts in Jun-15 equity** (hedged with a more senior tranche or with a large delta to reduce the negative time value). In both cases, we recommend the Jun-15 equity tranche as a core short risk position, funded by either the Jun-18 equity tranche, the Jun-15 3-6% or the index.

A growing number of investors seem to be turning to tranches, mostly in their struggle to find yield in this environment. Frankly we think the tailored risk profile they offer is greatly preferable to some of the alternatives, like moving into peripherals. This short publication outlines some of our favourite ideas in Europe – from a long, a short and from a relative value perspective. Our overall favourite for real money is **short-dated, high-spread longs in mezzanine tranches**; our favourite for HY/distressed funds is the **distressed-type returns in equity tranches**.

Long risk trades:
Jun15 3-6%; Jun18 0-3% & Jun18 12-22%

Although we think there is value in long-dated senior tranches given how high correlations remain, we get much more push-back when we recommend longs in Jun-18 12-22% than when we recommend either Jun-15 3-6% or Jun-18 equity longs. We next review all of these tranches and argue that they represent attractive long (risk) positions; each one with clearly different characteristics.

Overall, except in short-dated maturities (Jun-15), we prefer to follow the **barbell theme** we have referred to elsewhere, recommending long risk positions in both equity and very senior tranches, and shorts in mezzanine tranches.

Relative value:
Long risk Jun18 0-3% vs. short risk 3-6%

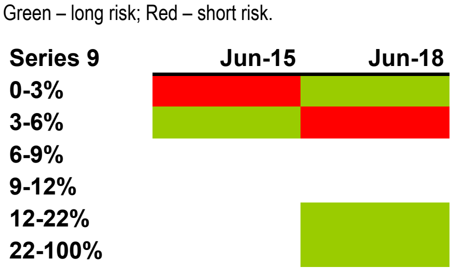
On the relative value front, we include a new recommendation which should appeal to investors who want to gain "**convexity**" to the developments in the economic and political situation in Europe: long risk Jun18 0-3% vs. short risk 3-6% This trade has always been popular given its positive time value and convexity, and was also fashionable last year on the back of renewed euro break-up fears.

Hedging idiosyncratic events:
Jun15/18 equity tranche flatteners & short risk Jun-15 equity

On the short risk side, and as we argued in a recent piece about hedges[1], we prefer options and curves as a vehicle for shorts. Only when **hedging idiosyncratic single name stories**, with a few companies widening to distressed levels and flattening aggressively, would we look at tranche trades, in particular equity tranche flatteners and shorts in Jun-15 equity (hedged with a more senior tranche or with a large delta to reduce the negative time value). We recommended both trades recently (Link to publication and Link to publication).

Figure 1 provides a summary of our views across the Series 9 capital structure and Figure 2 shows the current tranche levels. Finally, Figure 3 shows the 7 widest names in the Series 9 index, a portfolio with 18 periphery credits – 7 Italian, 7 Spanish (one with double weight), 3 Portuguese and 1 Greek.

Figure 1. Where to buy/sell protection
Green – long risk; Red – short risk.



Source: Citi Research.

Figure 2. Tranche levels
Upfront for 0-3%, par spreads for the rest (bp).

Series 9	Jun-15	Jun-18
0-3%	20%	51%
3-6%	377	818
6-9%	176	496
9-12%	79	321
12-22%	38	157
22-100%	9	47
Index	70	139

Source: Citi Research, Markit. Mids as of EOD 17 April.

Figure 3. Widest credits in the S9 portfolio
5y spread (Jun-18) in bp.

Ticker	5y spread
OTE	722
PEUGOT	706
MONTE	691
BESPL	533
PORTEL	431
DSGILN	414
FNCIM	390

Source: Citi Research, Markit. Mids as of EOD 17 April.

[1] "*A hedge for all seasons*", 28 Mar.

Long risk trades

Our preferred long – Jun-15 3-6 %

Trade level:
-2.625% upfront + 5% coupon
375bp flat spread
(as of 17-Apr-13)

The iTraxx Series 9 Jun-15 3-6% tranche is starting to attract plenty of attention from real money investors looking to add high spread instruments to their (currently) defensive portfolios. We expect this to continue going forward.

Our conversations with European investors suggest that, after spending most of the last 9 months unwinding a substantial fraction of their exposure to periphery and financial credits, their portfolios are now on the defensive side (overweight core corporates, underweight periphery etc). We view this as one of the main reasons why investors didn't feel the need to unwind cash bonds when index spreads widened substantially on the back of political/banking catalysts such as the Italian elections and the Cypriot bail-out.

At the same time, investors are also feeling the pressure to add new longs in order to push up the low spread their portfolios are currently generating. Although many remain fundamentally bearish, the value of the "central bank put" doesn't seem to decrease and investors are now probably spending more time evaluating the alternatives to add spread to their portfolios than identifying the parts of their portfolio that they are not comfortable with. However, many are currently very reluctant to look at periphery or financial credits for the "missing" spread in their portfolios. They are cognizant (i) that periphery and financial credit will likely underperform in any new "European" event and (ii) of how long it can take to lighten up on those types of risks if need be (given that they went through that exercise last year).

As a consequence, both real money and macro investors are increasingly turning to the derivatives space to look for the spread their portfolios lack and that they do not want to extract from periphery or financial credits. In particular, investors are becoming more active in the options market (e.g. selling receivers outright and receiver 1x2s) and on the tranche market. Specifically in tranches, the Jun-15 3-6% is the natural spot for these investors to add long risk positions, and we believe the early trend of investors adding longs in this tranche will continue and cause the tranche to outperform both the index as well as other high spread instruments (e.g. Crossover, periphery and financials).

The Jun-15 3-6% is attracting (and should continue to attract) investors looking for high spread instruments for the following reasons:

- **High spread (above 350bp) and short dated maturity (2y)**. Within the constituents of the Series 9 index, only Monte dei Paschi, OTE, Banco Espirito Santo and Peugeot offer a higher spread in the 2y tenor (Figure 4). The tranche spread is also above the spread for the S19 3y (Jun-16) Crossover index (Figure 5).

- **If kept until maturity, the tranche can withstand 6 defaults with an average 40% recovery before suffering a notional impairment** (see Figure 6). Considering the bucket of high spread periphery names in the portfolio, the 3% subordination provides a reasonable cushion against potential default losses. The 3% subordination and 2y maturity substantially reduce the concerns that investors have around the impact of the potentially poor economic performance on periphery countries, and even of a medium to long term euro break-up scenario.

- **Ability to trade larger sizes than in the cash or single name CDS market**. The typical size on Jun-15 3-6% is around €10-20m, with an average bid-ask upfront below 0.5% (around 7bp on a running basis).

Figure 4. 2y spreads for widest credits in S9

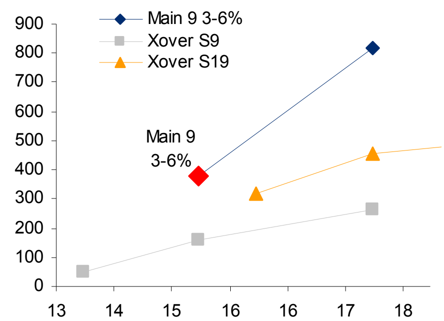
2y spread (Jun-15) in bp.

Ticker	2y spread
MONTE	704
OTE	497
BESPL	453
PEUGOT	413
UCGIM	253
ISPIM	237
PORTEL	209

Source: Citi Research, Markit. Mids as of EOD 17 April.

Figure 5. Spreads: S9 3-6% vs. Crossover

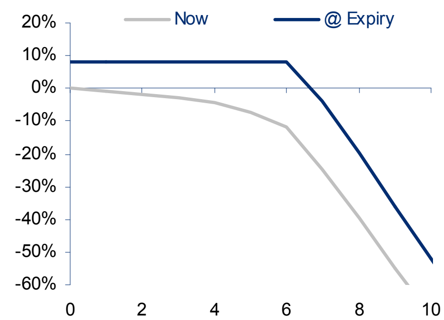
Current spreads in bp. Y-axis: maturity (year).



Source: Citi Research, Markit

Figure 6. Tranche default exposure

Y-axis: tranche MtM. X-axis: number of defaults.

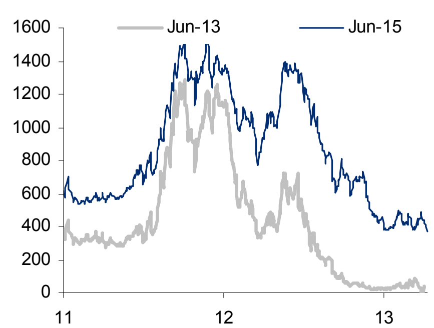


Source: Citi Research, Markit. MtM as % of notional. Assuming a 40% recovery rates and that the widest credits default first.

- **In the absence of defaults, the tranche "delevers" as time goes by**. The tranche subordination means that, as time goes by, its delta (i.e. exposure to general market movements) goes down substantially. Figure 7 and Figure 8 show the historical spreads and deltas of the Jun-13 and Jun-15 3-6% tranches. It is clear when looking at the history for the old Jun-13 3-6% tranche that its spread and delta fell aggressively – and didn't subsequently increase – when its maturity went below 1-1.25y (i.e. around Mar-Jun last year). Figure 9 shows the delta of both tranches as a function of their time to maturity. We expect the same dynamics to drive the 3-6% spread and delta much lower when the tranche approaches 1.25y of remaining maturity, i.e. in Q1 next year.

Figure 7. Historical 3-6% spreads

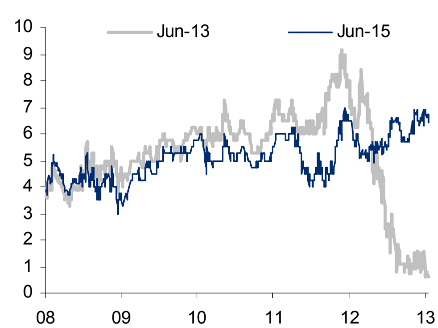
In bp.



Source: Citi Research, Markit.

Figure 8. Historical 3-6% deltas

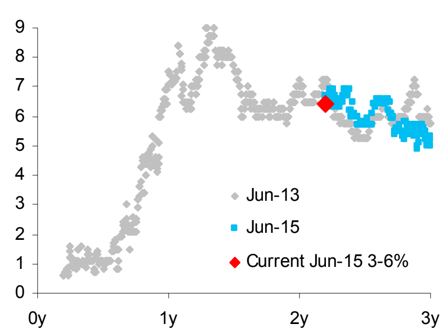
Versus the respective indices.



Source: Citi Research, Markit.

Figure 9. 3-6% delta vs. time to maturity

Historical data; time to maturity in years.



Source: Citi Research, Markit.

Looking for distressed returns? Long risk Jun-18 0-3%

Trade level:
50.75% upfront + 5% coupon
(as of 17-Apr-13)

On the back of the strong rally in distressed assets in the second half of last year, high yield and distressed investors are not having an easy time this year finding distressed opportunities. After dipping their toes in the standard synthetic market last year (via long risk positions in iTraxx Series 9 Jun-13 tranches when they were trading at 40% upfront), high yield investors are turning their attention to longer dated synthetic equity tranches where they can obtain distressed-type returns in portfolios with a bucket of high yield credits (e.g. OTE, Peugeot, Portel …in Series 9), which allows them to leverage their credit skills.

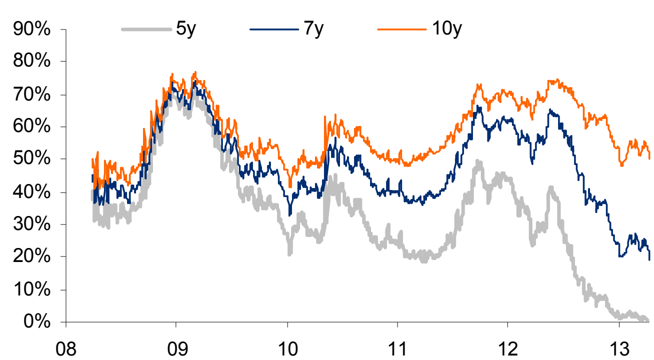
High yield investors have a competitive advantage, given their credit analysis skills, when taking exposure to the first lost piece of portfolios with high yield credits (like iTraxx Series 9, CDX HY and off-the-run series in CDX IG). Moreover, as we have recently shown in a two part publication on "How to earn 10%"[2], synthetic equity tranches offer very competitive IRRs vs. alternative ways of sourcing distressed opportunities.

Figure 10 shows the historical upfront levels of iTraxx Series 9 equity tranches. The Jun-18 tranche currently trades above 50% upfront and a 5% running coupon. With the expected loss on the index close to 7%, this tranche is currently very "saturated" with losses (i.e. the expected losses priced in the underlying index are well above the tranche detachment point). The tranche has never traded above 75%, which suggests a good risk-return trade-off for investors willing to take the default risk in the Series 9 portfolio.

In the absence of defaults before expiry, IRRs reach the 25% level. Figure 11 shows the IRRs of a long risk position on this tranche as a function of the number of defaults and the timing of these defaults.

Figure 10. iTraxx Series 9 Equity Upfront

In %. Equity tranches trade with a 500bp running coupon.



Source: Citi Research, Markit.

Figure 11. IRRs – Selling Jun-18 0-3% Protection in "Bond" format

Assuming a €100 notional, €49 price* and 6% annual coupon**.

# Defaults @ Jun-13	IRR	Total CFs (Sum)
0	25%	82 €
1	16%	45 €
2	4%	8 €
3	-22%	-28 €
4	-37%	-37 €
5	-46%	-42 €
6	-63%	-47 €
7	-100%	-48 €

# Defaults @ Jun-18	IRR	Total CFs (Sum)
0	25%	82 €
1	22%	66 €
2	18%	50 €
3	14%	34 €
4	8%	18 €
5	1%	2 €
6	-10%	-14 €
7	-15%	-18 €

Source: Citi Research. * €100 notional times (1 – 51% equity upfront). ** 5% equity tranche coupon plus 1% retribution on the collateral.

Although we realise that taking first loss default exposure in a portfolio like iTraxx Series 9, with a bucket of high yield periphery credits, is not for the faint of heart, we expect this tranche to attract investor interest going forward given (i) the competitive returns it offers, (ii) the scarcity of distressed valuations elsewhere as well as (iii) its high liquidity and low bid-offer spreads (compared to high yield cash bonds).

[2] See "*How to Earn 10%*" Part 1 and Part 2, A Basu, S Antczak, J Lee and R Roy.

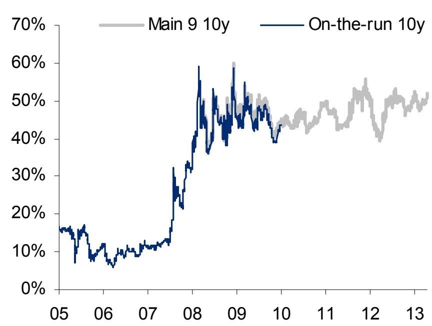
Not afraid of the tail? Long risk Jun-18 12-22%

Trade level:
156bp flat spread
(as of 17-Apr-13)

As we have highlighted in the past,[3] tranche correlations are close to all-time highs (Figure 12), indicating that investors are still willing to pay aggressively for tail-hedges via shorts in senior tranches.

Investors who believe Europe will not experience a tail event which threatens to default a large fraction of the Series 9 portfolio should, in our view, sell Jun18 12-22% protection. The tranche is currently trading wider than both the S9 and S19 iTraxx indices, and not much tighter than the S19 Senior Financial index (Figure 13). For reference purposes, CDX IG Series 9 Dec-17 15-30% tranche is trading at 49bp.

Figure 12. iTraxx S9 implied correlation
Equity correlation in %.



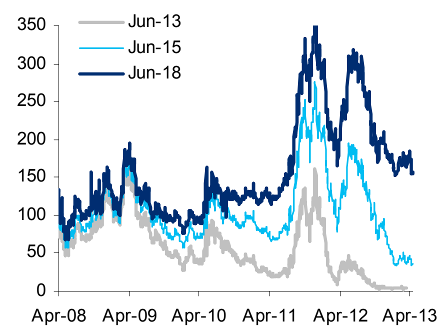
Source: Citi Research, Markit.

Figure 13. Spreads for Jun-18 instruments
In bp.

	Jun-18 spread
SenFin S19	171
S9 12-22%	**157**
Main S9	139
Main S19	113
CDX IG S20	84

Source: Citi Research, Markit.

Figure 14. S9 12-22% historical spreads
In bp.



Source: Citi Research, Markit.

We realise that selling protection on a long-dated senior tranche is going to be a tough pitch. In the current market environment, very few investors will be happy to take the tail exposure these senior tranches generate – the costs of this strategy (not only in terms of portfolio MtM but mainly in terms of the likelihood of losing your job) if a tail-event materialises are substantial. For this very same reason, these tranches are trading as wide as they currently are (Figure 14).

With an average 40% recovery, it would take around 25 defaults for the index losses to erode the 12% tranche subordination. Considering that there are 18 periphery credits in Series 9, receiving above 150bp for selling protection in this tranche when the index spread is below 140bp looks an attractive proposition for investors who do not believe in a euro break-up scenario before Jun-18.

As we argued above, we do not expect investors to rush into this tranche for the time being. But we also believe it offers very competitive spreads for investors who are not worried about euro break-up risks and want to take advantage of the 12% subordination the tranche offers. The performance of this tranche in the short term will likely be driven by whether investors who still have tail risk shorts via X-100% tranches unwind their positions. We have recently seen this tranche outperforming the index and other senior tranches, and we expect this to continue.

[3] "*A hedge for all seasons*", 28 Mar.

Relative value trades

In relative value space, we highlight a new relative value trade recommendation which should appeal to investors who want to gain "convexity" to the developments in the economic and political situation in Europe. The trade offers positive "time value" and attractive payoffs both if nothing happens or if euro break-up fears resurface and/or materialise.

Make-up or break-up: Long risk Jun-18 0-3% vs. 3-6%

The view that spreads will remain range bound going forward is gaining momentum among credit market participants. The fundamentals and the structural challenges in the European banking and political fronts should prevent any large tightening, and the central bank put should avoid a large widening – that is how the argument goes. As a consequence, investors are increasingly willing to position for a range-bound environment, paying for it via exposure to large spread movements (either tighter, wider or both) – this is particularly evident in the options market, where implied volatility remains low and where the demand for trades that profit from spreads not leaving their recent ranges has increased substantially.

We are sympathetic to that view, but believe that investors should add trades which provide optionality for spreads moving either much tighter or wider. On one hand, the low liquidity that credit markets have exhibited post the Italian- and Cyprus-led widenings exacerbates the probability of a "moderate" widening becoming a large one if real money investors decide to start unwinding positions, even in small amounts; and we believe we'll have plenty of scope for moderate widenings going forward (if only one of them can actually get started). On the other hand, the early signs of investors reaching for yield as they grow confident that central banks will continue injecting liquidity and providing a backstop whenever a widening catalyst appears should not be underestimated; it can take very little time and very few positive economic data points to make investors rush for yield and move spreads substantially tighter.

Thus, we are happy trading the range, but we would add trades which provide convexity on large spread movements. We have argued elsewhere that flatteners are a good way to position for large spread widenings. In our view, a long risk Jun-18 0-3% vs. 3-6% trade (equal notionals) is another attractive way to position for that.

Figure 15. Tranche trade details

Tranche	**Index**	**Upfront**	**Coupon** (bp)	**Flat spread** (bp)	**Protection**	**Notional** (€m)	**Upfront** (€m)	**Coupon** (€m)	**12 m time value** (€m)
Jun-18 0-3%	ITXEUR S9	50.75%	500	2,169	Sell	5	2.54	0.25	0.71
Jun-18 3-6%	ITXEUR S9	14.25%	500	849	Buy	5	-0.71	-0.25	-0.61
						Total	**1.83**	**0.00**	**0.095**

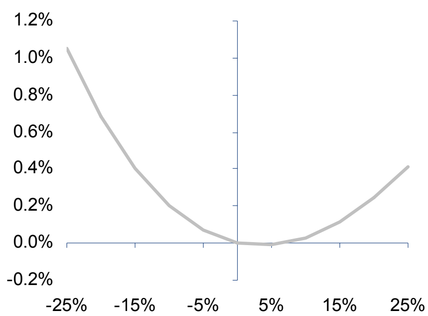
Source: Citi Research, Markit. Indicative prices as of 17 April.

The trade has positive time value (Figure 15) and provides convexity with respect to instantaneous spread movements (Figure 16) as well as default scenarios (Figure 17).

The largest risk of the trade – which is the way the positive convexity is paid for – derives from its negative exposure to idiosyncratic defaults or single name distressed stories. Also, as time goes by, the delta on the equity tranche will increase vs. the delta on the 3-6% tranche (currently they are very similar) and the trade, if not re-hedged, will become longer (risk).

Figure 16. Spread sensitivity

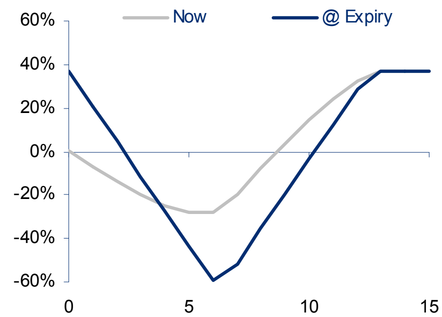
Y-axis: Trade MtM (as % of equity tranche notional). X-axis: proportional change in all single name spreads.



Source: Citi Research.

Figure 17. Default sensitivity

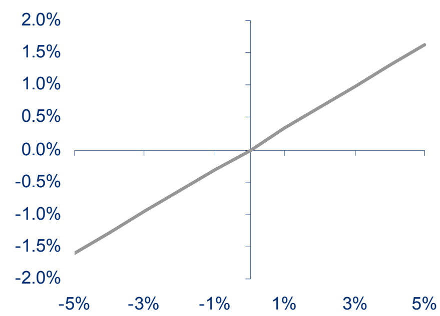
Y-axis: Trade MtM (as % of equity tranche notional). X-axis: number of defaults.



Source: Citi Research. Assuming a 40% recovery rates and that the widest credits default first.

Figure 18. Correlation exposure

Y-axis: Trade MtM (as % of equity tranche notional). X-axis: additive change in 3% and 6% base correlations.

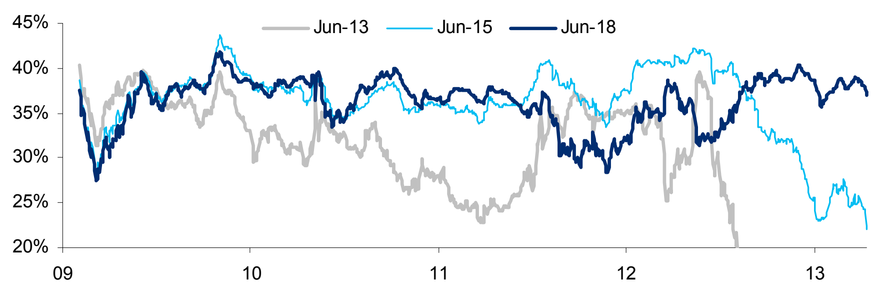


Source: Citi Research.

From an entry level point of view, as Figure 19 shows, the upfront difference between the two tranches, currently around 37%, is in the top half of the range where it has traded for the past few years.

Figure 19. Historical upfront difference between 0-3% and 3-6% tranches

In %, both tranches trade with a 5% coupon.



Source: Citi Research, Markit.

We recently recommended the opposite trade in the Jun-15 maturity, which we still believe represents an attractive way to position for an absence of systemic tail-events in an environment where idiosyncratic single name stories start becoming more frequent. In our view, investors should position for convexity on Jun-18 equity and for idiosyncratic events on Jun-13 equity. Essentially, both trades together can be seen as an equity tranche flattener (which we have also recommended recently) plus a 3-6% steepener (which fits with our view that Jun-15 3-6% will likely be the instrument of choice for investors searching for yields).

Recent Trade Ideas

Figure 20. Published Trade Ideas – reverse chronological order.

Trade Ideas	Date
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.

Analytics @ CitiVELOCITY

Figure 21. Analytics – Available at CitiVELOCITY

EUR Corporate Basis Report
GBP Corporate Basis Report
World of Intrinsics
iTraxx & CDX Curve Monitor
Cross-Market Report (Long-Term)
Cross-Market Report
EUR iBoxx Corporate Indices
Sovereign Credit Report
Corporate-Sovereign Correlation Report
CDX Corporate Indices Daily Review

Source: Citi Research.

Appendix A-1

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The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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