

More mezz, less seniors

iTraxx Tranches Trade Idea – 3-6% vs. super senior

- **Losing faith in the seniors – Short them.** The underperformance of senior, especially super senior, tranches continues, and what looked like a promising long a few months ago continues disappointing with no investor base in sight. True, correlation remains high, but it's been high for a very long time and we don't think it will fall aggressively.

- Why have we changed our views on seniors? Because the investor base selling equity protection keeps doing so, a new investor base selling mezz protection is emerging, and we see no material signs of the long-awaited seller of senior protection. Our expectation last year was to see demand for senior risk, and we are not seeing it; it is the demand for mezz risk that is coming strongly. Since we do not see this changing, we are expecting mezz to outperform and equity not to underperform, leaving the seniors taking all the risk which goes out of more junior tranches.

- We would use super seniors as shorts in relative value trades.

- **The “mezz story” is playing out nicely – Continue adding risk.** We see plenty of upside for mezzanine tranches this year. In our view, real money investors should realize synthetic leverage without direct first loss exposure (i.e. mezzanine tranches) is one of the best ways to add longs. Moreover, we expect fast money investors also to go long risk mezz after the large outperformance of equity last year.

- We like mezzanine tranches as outright longs and would also pair them with shorts like Crossover or super senior tranches.

- The entry point for 3-6% longs looks attractive here. We have already recommended longs in 6-9%.

- **Pair them: Long risk 3-6% vs. short risk 22-100%; Jun-18 Series 9.** The trade is neutral to parallel spread movements, positive time value, long correlation and negative jump-to-default.

Figure 1. Trade details – No delta.

Tranche	Maturity	Upfront	Coupon (bp)	Par spread (bp)	Protection	Notional (€m)
3-6%	Jun-18	-5.5%	500	366	Sell	50
22-100%	Jun-18	0.027%	25	25.625	Buy	451

Source: Citi Research, Markit. Indicative prices.

- **iTraxx Tranche Daily Analytics at Citi Velocity:** [Series 9](#) and [Series 19](#).

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

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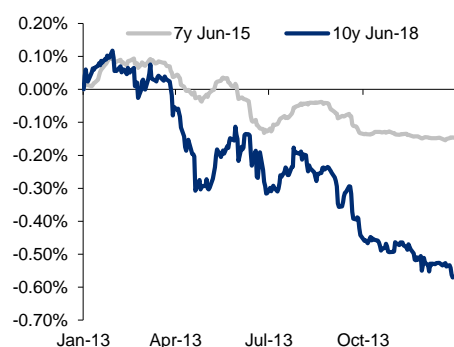
Losing faith in the seniors – Short them

Senior underperformance continues – see Figure 2. We've been waiting for senior tranches to outperform for months. In our [last tranche piece](#) back in November we wrote: "Seniors – Very promising pricing-wise, but completely forgotten by the market. Good for long term carry trades, but don't expect a quick performance."

We do not currently see, and cannot figure out, who can step in to take senior risk, in size; we do not find any obvious candidate, whereas we easily find them for equity – hedge funds – and mezzanine tranches – "sophisticated" real money. Dealers have been marketing leveraged super senior trades for months, without much success as far as we are aware.

Figure 2. 22-100% delta-hedged performance

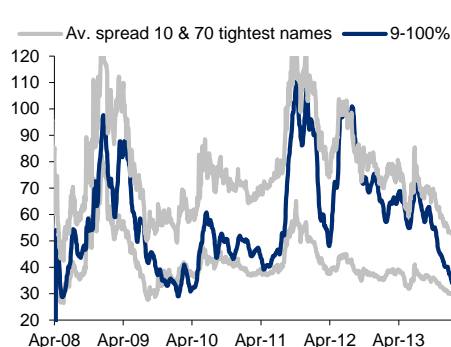
% of tranche notional.



Source: Citi Research, Markit.

Figure 3. 9-100% vs. tight names

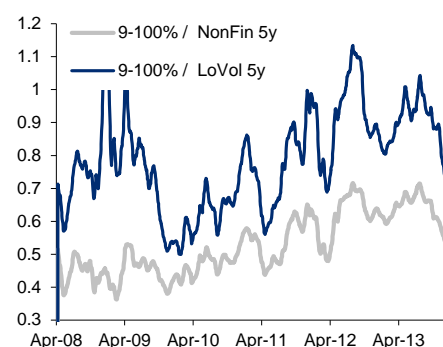
Spreads, in bp. 5y interpolated maturity.



Source: Citi Research, Markit. 10d moving average.

Figure 4. 9-100% vs. indices

5y spread ratio. 5y interpolated maturity.



Source: Citi Research, Markit. 10d moving average.

Correlation remains high, but super senior tranches do not look cheap any more vs. their closest competitors: "tight" names (Figure 3) and "tight" indices (Figure 4). The investor base who could consider senior tranche longs will, in our view, compare their attractiveness on a spread level vs. competitors, not on a correlation basis. Besides, we don't expect correlation to aggressively fall anytime soon – the wide names in the index have progressively tightened and we are not expecting any single name surprises in the near term (Monte is probably the name with the highest uncertainty – although we believe it is more of an equity than a debt story).

Finally, although we don't believe MAV unwind technicals¹ will play a major role for senior tranches, they certainly won't help.

Thus, we've lost faith in seniors. In fact we believe they have become attractive shorts. We prefer to short the most senior tranche (22-100%) simply because it's the tighter and we expect any potential investor thinking about going long risk to look at the absolute level of spreads, rather than at correlation relative value metrics, when deciding which tranches to go long.

¹ See [Global Structured Credit Outlook: A Rockier Ride](#), R Roy, A Basu, K Malhotra, R Brauchler, 20-Dec, p. 16/17.

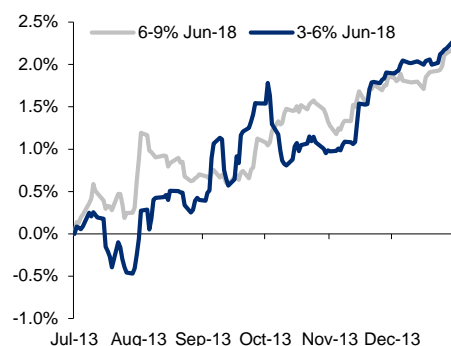
The “mezz story” is playing out nicely – Continue adding

Mezzanine tranches are one of our highest conviction longs for 2014 – as we expect them to be the part of the capital structure which attracts most of the marginal new investors in tranches.² They have already been performing strongly for the past few months – see Figure 5.

Unlike for senior tranches, we do not have any trouble figuring out who can sell mezz protection going forward – the ones who are doing it right now and many more investors struggling to find high spread longs going forward. As we argued in our recent [outlook](#), the tranche market over the past 4 years was for specialists – investors happy to sell equity tranche protection and manage the default risk. In a low-default environment, they've enjoyed the very high roll-down on equity tranches. However, many of the potential entrants to the tranche market will probably not want to take default risk, in our view, and will more likely look at mezzanine tranches. They still pay a multiple of the underlying index.

Figure 5. Mezz delta-hedged performance

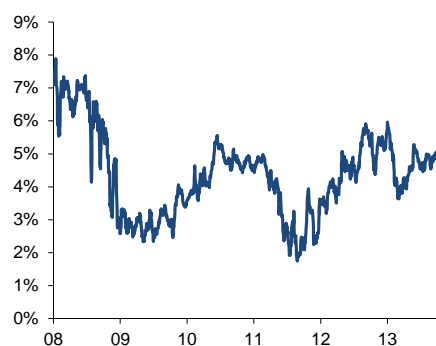
% of tranche notional.



Source: Citi Research, Markit.

Figure 6. 9% minus 6% base correlation

In %. Jun-18 maturity.



Source: Citi Research, Markit.

Figure 7. Ratio of tranche expected losses

Jun-18 maturity.



Source: Citi Research, Markit.

Jun-18 3-6% and 6-9% are our preferred tranches. Investors have so far favoured 6-9% tranches, trading above 200bp, but we expect the 3-6% to also attract flows, especially if we continue tightening and the 6-9% starts looking optically less attractive (i.e. tighter in absolute levels).

We recommended a [long risk 6-9% vs. Crossover](#) trade in our last tranche report. We continue believing in the “mezz story” and, in this report, we diversify our exposure by adding longs in 3-6%. As Figure 6 and Figure 7 show, the outperformance of the 6-9% (vs. the 3-6%) has been quite pronounced recently.

² See [Mezz may be back next year ... though nowhere near 2004-7](#), 15 Nov..

Trade: Long risk 3-6% vs. short risk 22-100% – Jun-18 S9

Pairing a 3-6% long (risk) with a super senior short provides a good way to position for the views we outlined before. We size the trade to be initially delta-neutral – see Figure 8.

Figure 8. Trade details

Index	Tranche	Maturity	Upfront	Coupon (bp)	Spread (bp)	Protection	Notional (€m)	Upfront (€m)	Coupon (€m)	12 m time value (€m)
ITXEUR S9	3-6%	Jun-18	-5.500%	500	366	Sell	50	-2.75	2.50	3.93
ITXEUR S9	22-100%	Jun-18	0.027%	25	25.625	Buy	451	-0.12	-1.13	-2.37
Total								-2.87	1.37	1.56

Source: Citi Research, Markit. Indicative prices shown.

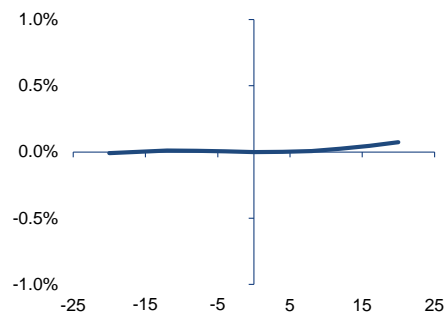
The trade is **neutral to spreads for parallel additive movements** – i.e. all credits move by the same bp amount, see Figure 9 – and has a **long risk exposure for multiplicative % shocks** – i.e. all credits move by the same %, see Figure 10. In other words, **the trade benefits from spread compression in the index**.

The trade offers a **positive time value** (including carry and roll down) of around 3.1% per year (as % of the 3-6% tranche notional) and has a **negative jump-to-default** of around 1.3/1.9% (depending on the name defaulting).

Finally, the super senior short makes the trade **long correlation** – see Figure 11.

Figure 9. Spread exposure – bp shocks

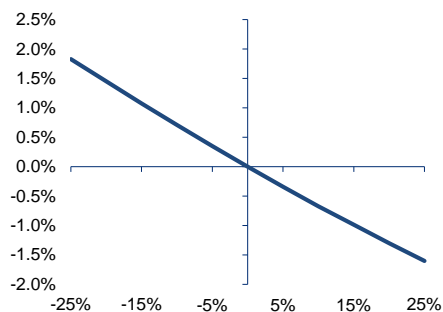
X-axis: additive spread shock, in bp, to all the maturities of all the credits in the index. Y-axis: trade MtM as % of 3-6% tranche notional.



Source: Citi Research.

Figure 10. Spread exposure – % shocks

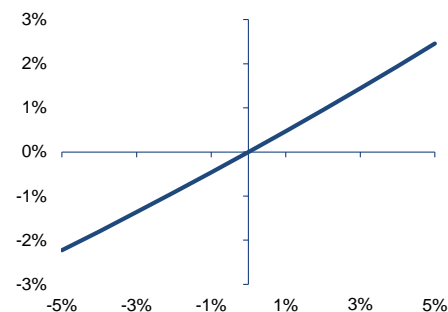
X-axis: proportional spread shock, in %, to all the maturities of all the credits in the index. Y-axis: trade MtM as % of 3-6% tranche notional.



Source: Citi Research.

Figure 11. Correlation exposure - % shocks

X-axis: correlation shock, % additive. Y-axis: trade MtM as % of 3-6% tranche notional.



Source: Citi Research.

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 closing the Main 75-85 strangle (expiring today) and the long risk super senior vs. light delta (S9 Jun-18).

Figure 12. Open trades – Summary and P&L

Trade Description	Leg	Format	Direct.	Notnl.	Entry Upfront	Entry Spread	Coupon	Current Upf.	Current Spread	P&L* Total	P&L* Month**
iTraxx Main Eq. Notional Flattener 05-Sep-13	Main S19 3y	Prot.	Buy	1.00	-0.97%	65	100	-1.66%	33	-1.05%	-0.35%
	Main S19 5y	Prot.	Sell	1.00	0.24%	105	100	-1.59%	64	2.19%	0.55%
									Total	1.14%	0.21%
S9 6-9% vs. S20 Crossover 15-Nov-13	Main S9 6-9% Jun-18	Prot.	Sell	1.17	-0.25%	294	300	-3.41%	219	4.28%	2.31%
	Crossover S20 Dec-18	Prot.	Buy	1.00	-7.07%	344	500	-9.47%	287	-3.23%	-1.86%
									Total	1.05%	0.46%
Sell Crossover Receiver 09-Jan-14	275bp Feb. Receiver	Price	Sell	1.00	0.32%			0.25%		0.07%	
									Total	0.07%	
Sell 1m Main straddles *** 09-Jan-14	Sell 1m Main straddles	Price	Buy	1.00	0.00%			0.05%			
									Total	0.05%	
Payer spread vs. index long *** 09-Jan-14	Buy 3m 25-60% pay spread	Price	Buy	1.00	0.00%			0.00%			
	Buy index prot.	Price	Sell	1.00	0.00%			0.01%			
									Total	-0.01%	
SenFin vs. Xover Recs *** 09-Jan-14	3m SenFin Recs	Price	Buy	3.40	0.00%			-0.04%		-0.14%	
	3m Xover Recs	Price	Sell	1.00	0.00%			0.02%		-0.02%	
									Total	-0.16%	
3-6% vs. super senior 14-Jan-14	Main S9 3-6% Jun-18	Prot.	Sell	1.00	-5.50%	366	500				
	Main S9 22-100% Jun-18	Prot.	Buy	9.00	0.03%	26.625	25				
									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. *** We track the trade P&L by using an initial 0% upfront and a current upfront equal to the trade P&L in %.

Figure 13. Open and closed trades summary statistics

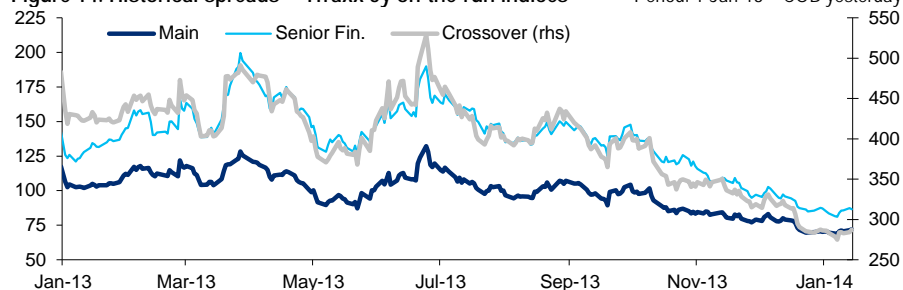
Number	Open	Closed*	Percentage	Open	Closed*
In profit	4	12		67%	75%
In loss	2	4		33%	25%
	6	16			

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

Representative Market Conditions

Figure 14. Historical spreads – iTraxx 5y on-the-run indices

Period: 1-Jan-13 – COB yesterday



Source: Citi Research, Markit. In bp.

Figure 15. Closed trades since Jun-13 – Summary and P&L

Trade Description	Leg	Format	Direct.	Notnl.	Entry Upfront	Entry Spread	Coupon	Final Upfront	Final Spread	P&L* Total
Main July Receiver Fly	105bp Receiver	Price	Buy	1.00	0.25%			0.23%		-0.01%
Opened: 18-Jun-13	90bp Receiver	Price	Sell	2.00	0.04%			0.00%		0.07%
Closed: Expiry	75bp Receiver	Price	Buy	1.00	0.00%			0.00%		0.00%
									Total	0.06%
Senior Fin vs. CDX IG Receivers	SenFin October 140bp receiver	Price	Buy	1.00	0.53%			0.69%		0.17%
Opened: 26-Jul-13	CDX IG October 75bp receiver	Price	Sell	2.00	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	1.00	46.25%	1,720	500	39.82%	1,703	-7.98%
Opened: 5-Jun-13	iTraxx Main S9 Index Jun-18 (10y)	Prot.	Sell	5.00	-2.05%	132	175	-2.73%	114	6.12%
Closed: 25-Sep-13	iTraxx Main S19 0-3% Jun-18 (5y)	Prot.	Sell	1.00	31.75%	1,227	500	25.15%	1,188	8.15%
	iTraxx Main S19 Index Jun-18 (5y)	Prot.	Buy	6.20	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	1.00	-3.59%	375	500	-7.23%	229	4.72%
Opened: 9-Jul-13	iTraxx Main S9 Index Jun-18 (10y)	Prot.	Buy	2.50	-1.58%	138	175	-2.73%	114	-3.83%
Closed: 25-Sep-13									Total	0.89%
Commerzbank sub/senior compr.	Sub CDS	Prot.	Sell	1.00	-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	1.00	-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	1.00	-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	1.00	-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	1.00	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%
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%

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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Analytics, Past Trade Ideas & Publications

Figure 16. 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
Curves	iTraxx Curve P&L Report	Indices	CDS Indices Positioning Report CDS Indices Trading Volumes Report

Source: Citi Research.

Figure 17. Past Trade Ideas

SenFin vs. Xover Recs	9 Jan 2014
Payer spread vs. index long	9 Jan 2014
Sell 1m Main straddles	9 Jan 2014
Sell Crossover Receiver	9 Jan 2014
Sell strangles and go on holidays: Position for spreads to stay in the recent range in mid-January	9 Dec 2013
Sell S9 Jun-18 6-9% protection vs. Xover 5y S20	15 Nov 2013
Sell S9 Jun-18 22-100% protection vs. light delta	15 Nov 2013
Long risk Senior Fins. vs. short risk Main	5 Nov 2013
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 18. Other publications

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
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Source: Citi Research.

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