

My Bazooka Is Bigger Than Yours!

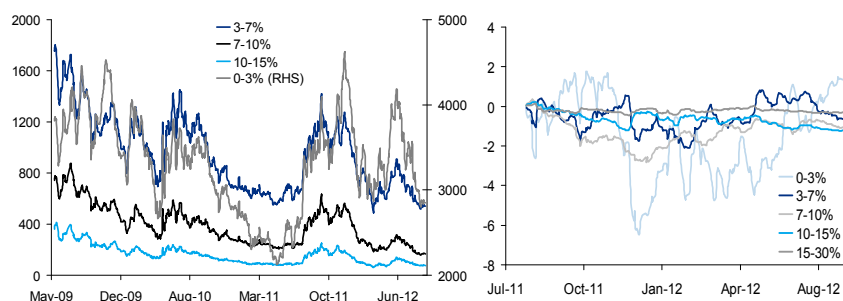
BUY DEC IG18 OTM RECEIVERS, SELL DEC MA17 OTM RECEIVERS

Market Outlook

Once again, thin volumes and investors staying on sidelines awaiting central bank policy action have characterized trading activity in the past few weeks. The first significant event during this time was Fed Chairman Bernanke's Jackson Hole speech on Aug 31st, which reconfirmed a more accommodative stance but stopped short of actually signaling QE3 in September. This was followed by the ECB meeting on September 6th, where the rates were left unchanged at 0.75%, but President Draghi elaborated on the ECB bond buying plans in the post meeting conference. Specifically, he indicated that the ECB would engage in full sterilized, unlimited bond buying in secondary markets in order to "address distortions" in bond markets. Further, the ECB, when purchasing bonds, would have no seniority over other creditors. For once, the ECB president did not disappoint and markets reacted by tightening sharply. Investors are now looking ahead to the German Constitutional Court ruling on ESM on September 12th, and the FOMC rate decision in the US on September 13th.

Over the last month, indices were mostly range bound since the initial tightening after President Draghi's press conference in August. During this period, credit indices generally drifted sideways on low volume (August traditionally being a holiday month) while investors were awaiting further details of Draghi's plan that were finally articulated on September 6th. In Europe, iTraxx Main traded within a range of 135bp to 152bp, while the range for iTraxx Xover was 550bp to 600bp. In the US, the CDX IG index traded within a much tighter range (98bp to 103bp) in the last few weeks. After the Draghi speech on September 6th, credit indices have once again gapped lower, with Main tighter by 15bp, Xover by 52bp, and CDX IG by 7bp in past two days.

Fig 2. IG9 7Y Tranche Spreads (left), bp, Delta Adjusted Moves (right), pts



Source: Markit, Citi Research

In the tranche space, the CDX IG9 equity tranches have rallied strongly over the

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Credit

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The Credit Index Call - Yes We Can (Kick the Can)!

The Credit Index Call - A Trade for All Seasons

The Credit Index Call - Crossover – Senior Financials Straddle

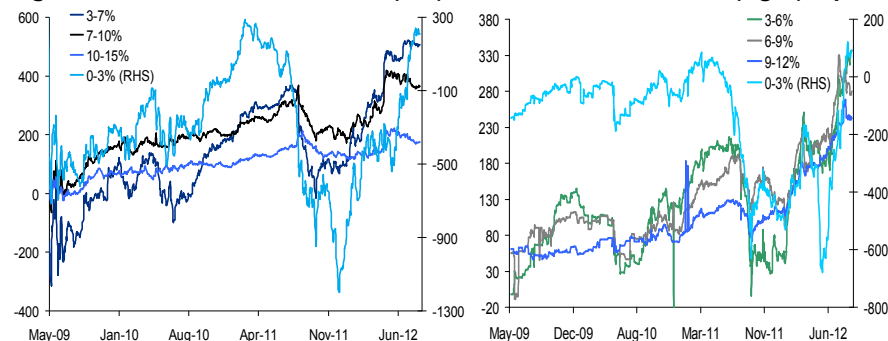
The Credit Index Call - Buy Volatility in Europe, Pay by Selling US Tail Risk

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

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past few weeks, outperforming the index on a delta adjusted basis (see Fig 2). Recent strong results from the Radian Group (RDN), which is one of the widest credits in CDX IG9, have also contributed to the performance of the equity tranche. The junior mezzanine and senior tranches have also tightened significantly, but have underperformed their deltas. The performance characteristics have been similar for both the 7Y and 10Y maturities.

Fig 3. 7s-10s IG9 tranche curves (left), iTraxx9 tranche curves (right), bp

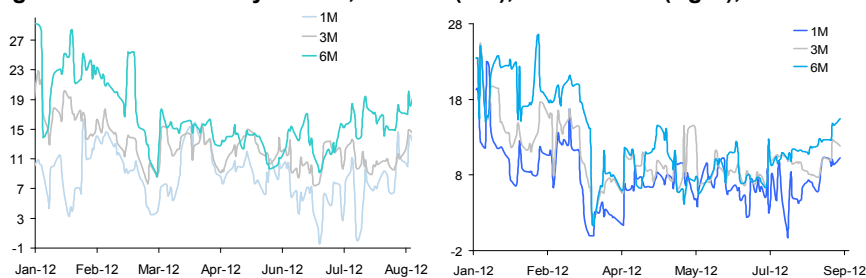


Source: Markit, Citi Research

The 7s-10s curves for both IG9 and iTraxx9 equity tranches have steepened significantly (see Fig 3), as investors have grown more bullish about idiosyncratic defaults in the short term, and have thus pushed down the shorter end of the curve. As default expectations have become more back ended due to the bullish outlook, risk has flowed back into the 10Y equity tranches, pushing the mezzanine and senior tranches tighter, causing a flattening of the 7s-10s curve for those tranches (see Fig 3). Going forward, given the commitment by the ECB to provide a credible backstop to the European bond markets, we expect the bullish technicals to continue. In particular, we expect the equity tranche curves to steepen further as more investors continue to roll their 5Y equity longs into the 7Y equity tranches. Further, given the recent tightening in the senior part of the capital structure, it may also make sense for investors interested in cheap shorts to consider short positions in the senior tranches, particularly in the 10-15% tranches for IG9 and the 9-12% tranches for iTraxx9.

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Fig 4. 25 Delta Volatility Skews, CDX IG (left), iTraxx Main (right), %

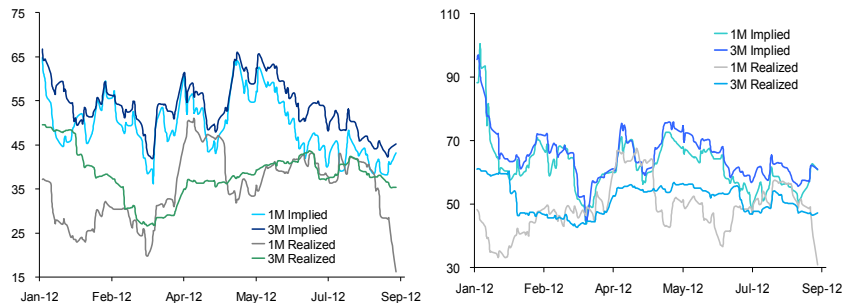


Source: Citi Research

Over the past few weeks, there has been increasing activity in hedging tail risk using credit options, both in the US and in Europe. This was mainly event driven

– in particular, investors have been concerned about the market response to European (ECB meetings, German Constitutional Court ruling on ESM) and US (November elections) headlines over the next 2-3 months. This has caused the volatility skews to steepen (see Fig 4) for CDX IG and iTraxx Main. Implied volatility for ATM options for both CDX IG and iTraxx Main has also been on the rise since the 3rd week of August while realized volatility has dropped, especially for the 1 month tenor (see Fig 5).

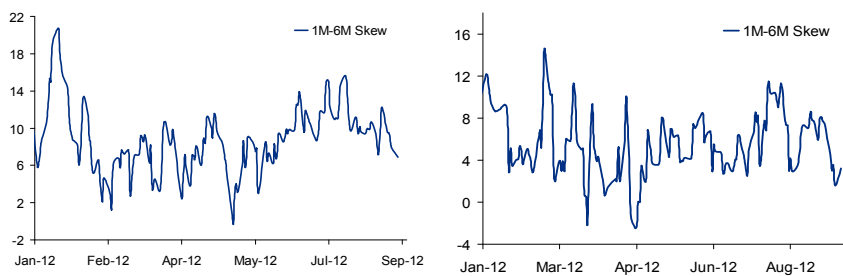
Fig 5. Realized and ATM Implied Vols, CDX IG (left), iTraxx Main (right), %



Source: Citi Research

As 1M realized volatility has dropped, investors that were short front month volatility have looked to lock in profits by buying back 1M volatility. This has flattened the volatility term structure (see Fig 6). As events unfold over the next few months and investors digest the impact of the ECB's bond purchase plans, we expect the volatility skew to steepen, especially when we consider the uncertainties related to the US elections/fiscal cliff as well as the poor prognosis for the Euro zone particularly in light of the recently lowered GDP forecasts from the ECB.

Fig 6. Volatility Term Structure, CDX IG (left), iTraxx Main (right), %



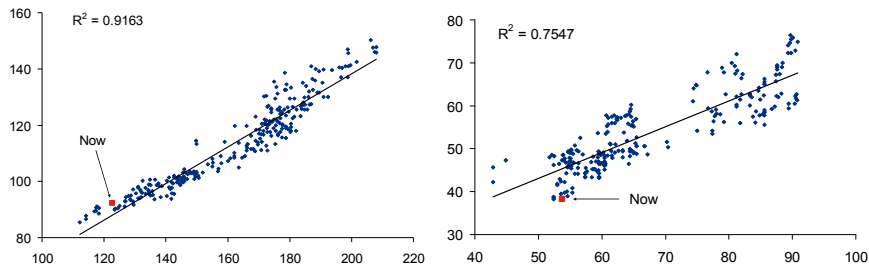
Source: Citi Research

Trade Idea: Buy Dec IG18 85 Strike Receivers, Sell Dec MA17 110 Strike Receivers

Our proposed trade this week is to do a relative value US versus European credit trade in the options space. We propose buying 85 strike Dec IG18 receivers and fund that by selling 110 strike Dec MA17 receivers. We believe that this is a compelling trade for multiple reasons. First, while the proposed ECB bond buying program has produced a strong risk-on move in the European credit markets, fundamentals in Europe continue to be weak as reflected by the ECB's own lowered forecasts of Euro area GDP. In contrast, the US fundamentals are at best mixed, with the housing markets showing strong signs of improvement and employment numbers that are slowly improving at worst. Further, the ECB has already articulated its plans to support the European markets ("shot its big bazooka") while in the US, the Fed has yet to announce its form of the big bazooka, i.e. QE3. We believe that the somewhat soft employment numbers and

the impending elections make it highly likely that this will be announced in the next few months. Thus, while the current spread tightening in the US credit markets has been comparatively muted in relation to Europe, we think that there is more scope for tightening in the US going forward.

Fig 7. IG(Y) vs Main (X): Spreads (left), bp, 20-Del 3M Implied Vol (right), %



Source: Citi Research

The current technicals also appear to favor the trade as well. If we look at the relative levels of CDX IG versus iTraxx Main, we find that CDX IG spreads are significantly wider on a relative basis compared to iTraxx Main (see Fig 7). Moreover, if we look at implied volatility levels for 3 month 20 delta receivers for CDX IG versus iTraxx Main over the past year, we find that CDX IG implied volatility is significantly cheaper relative to iTraxx Main volatility (see Fig 7). The trade has a net positive upfront payment (see Fig 8), which ensures a profit if the options end up being unexercised (due to spread widening or not enough tightening). Thus, from both technical and fundamental perspectives, we believe that the proposed trade makes sense. The details of the trade are shown in Fig 8.

Fig 8. Trade Details (as of 9/7/2012)

							USD
Trade	Index	Spot	Strike	Expiry	Price	Delta	Cost
Long OTM Recv	IG 18	93.125	85	12/19/12	11.8	21%	118,000
Short OTM Recv	MA 17	125.750	110	12/19/12	25.05	23%	320,615
Net							202,615

All prices/levels are mids, EURUSD = 1.2799, cost shown for 100MM notional.

The above calculations do not include any additional fees or transaction costs.

Source: Citi Research

The main risk to this trade is the possibility that Main tightens significantly more than IG over the next 3 months. However, we have argued earlier as to why we think this is unlikely, given the timing of the central bank actions. Moreover, if we look the distribution of 3 month spread moves for each of these indices over the past 2 years, we see that the probability of IG tightening by more than 8bp (to be in the money) would be roughly 36% whereas the probability of Main tightening by more than 15bp (to be in the money, and therefore loss making) would be roughly 20%. Further, based on the relative moves of the two indices over the past year, we find that Main has a beta of 1.3 to IG. Thus, if Main tightens by more than 15bp (in order for the short option position to be loss making), IG should tighten by at least 11.5bp, putting it at least 3.5bp in the money, which should mitigate the loss to a large degree.

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Appendix A-1

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