

# iTraxx Series 9 vs. Series 19 Equity Tranches

## European Credit Derivatives – Trade Ideas

- **The rally in iTraxx Series 9 Jun-18 equity tranches has been considerable recently, driven by investors searching for yield** and favouring first loss synthetic tranches in portfolios with exposure to both high yield and periphery credits.
- **We believe the outperformance of Series 9 equity tranches is overdone, in particular when compared to performance vs. iTraxx Series 19 equity tranches** which offer less stretched valuations and a much cleaner portfolio – without the very wide names in Series 9 (e.g. Peugeot, Banca Monte Dei Paschi, Banco Espirito Santo and Portugal Telecom) and with a lower exposure to periphery credits.
- Back in April, we recommended investors to sell protection on Series 9 Jun-18 equity tranches (see “[Views and Trades on iTraxx Series 9 Tranches](#)”, 18-Apr); we think it is time to take profits on that recommendation and rotate long risk positions into Series 19 equity tranches.
- **Trade Idea: Buy protection on Series 9 equity tranches vs. sell protection in Series 19 equity tranches; both delta-hedged and with a Jun-18 maturity.** In our view, investors should position for Series 19 equity tranches to outperform Series 9 equity tranches.
- **The trade offers a short periphery vs. non-periphery underlying exposure.** After outperforming over most of the last 12 months, we believe that periphery credits offer a very asymmetric risk-return profile from here: low potential to continue outperforming if we tighten and high potential to underperform if we widen.

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Figure 1. Trade Details

Index	Tranche	Tenor	Maturity	Protection	Notional (€m)	Upfront	Delta	Index Ref (bp)
Series 9	0-3%	10y	20-Jun-18	Buy, delta-hedged	10	46.25%	5	132
Series 19	0-3%	5y	20-Jun-18	Sell, delta-hedged	10	31.75%	6.2	108

Source: Citi Research, indicative prices as of 5-Jun.

- Starting with this trade idea and going forward, we will keep track of the performance of our trade idea recommendations (see last section of this report).

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

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## The rally in S9 Jun-18 equity has been considerable ...

The iTraxx Series 9 Jun-18 equity tranche has enjoyed an extended rally over the last few months (Figure 2) on the back of three main factors:

- The general tightening in spreads across all market segments.
- **The outperformance of periphery credits vs. the general market since mid-2012.** As we review in a later section, iTraxx Series 9 has a large peripheral component, with 19 periphery credits. Many of these periphery credits are amongst the widest names in the index and, as a consequence, they have a large impact on the relative performance of the equity tranche. Figure 3 shows the spread ratio between the 19 periphery credits in iTraxx Series 9 and the index spread; the outperformance of periphery credits, especially in the second half of 2012 is very clear.
- **The search for yield trend we have experienced over the past 4 months.** Investors have lost no time when chasing high spread instruments this year on the back of Central Banks' commitments to continue supporting the economy and financial markets via liquidity injections and other related measures. Series 9 equity tranches have been a very popular trade among investors searching for yield, given their distressed valuations (running spreads above 20%) and levered exposure to a portfolio with a bucket of high yield and periphery credits – two asset classes which investors favored when reaching for yields throughout this year.<sup>1</sup>

**On the back of the aggressive demand for iTraxx Series 9 equity tranches, tranche correlations have recently increased to record high levels** (Figure 4). As investors piled into iTraxx Series 9 equity tranches, these tranches outperformed the index and the rest of the capital structure.

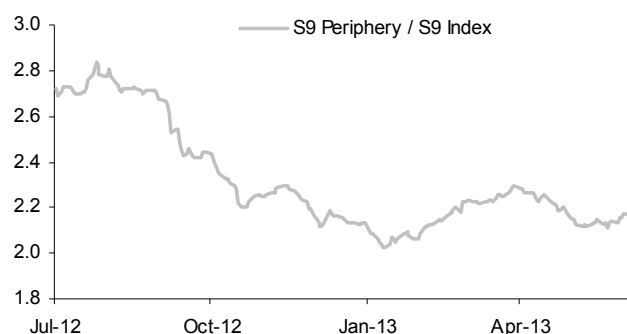
Figure 2. iTraxx S9 Jun-18 (10y) 0-3% Upfront



Source: Citi Research, Markit.

Figure 3. Ratio of spreads: periphery credits in S9 vs. S9 index

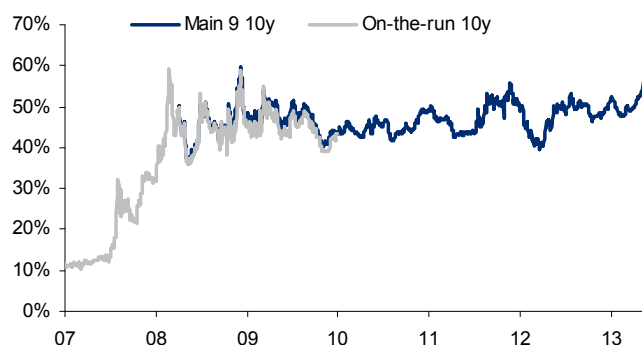
Ratio of 5y theoretical index spreads.



Source: Citi Research, Markit.

Figure 4. iTraxx Equity Tranche Correlation

In %.



Source: Citi Research, Markit.

<sup>1</sup> See "How to Earn 10%": [Part 1](#) and [Part 2](#), A. Basu and S Antczak.

## ... but is probably overdone

We believe there is very little upside left in iTraxx Series 9 equity tranches and we expect these tranches to underperform going forward as investors take a pause in their hunt for yield operations:

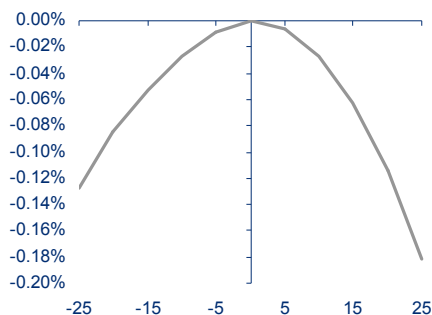
- If the market remains weak, we expect investors to lighten up on their high spread / high beta / periphery exposed instruments ... and Series 9 Jun-18 equity tranches tick all those boxes.
- If investors are reassured by Central Banks of their long term commitment to support the economy and the market via QE and other measures, we expect them to continue searching for yield, but in instruments which are less stretched, valuation-wise, than Series 9 equity tranches (e.g. Series 19 equity tranches as we argue below).

## Shorting equity tranches is an expensive and negatively convex trade

Shorting equity tranches, even if delta-hedged, is a very difficult trade to run given both their very negative time value and their negative spread convexity (see Figure 5, Figure 6 and Figure 7).

**Figure 5. Spread sensitivity – Delta-hedged**

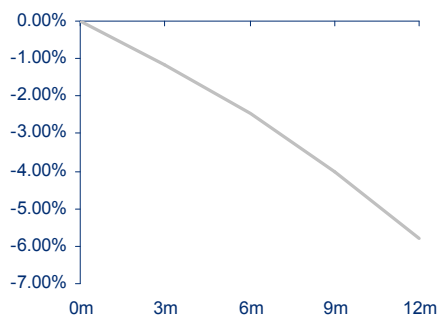
Y-axis: trade MtM as % of tranche notional. X-axis: spread shock, in bp, applied to all names in the index.



Source: Citi Research.

**Figure 6. Time value – Delta-hedged**

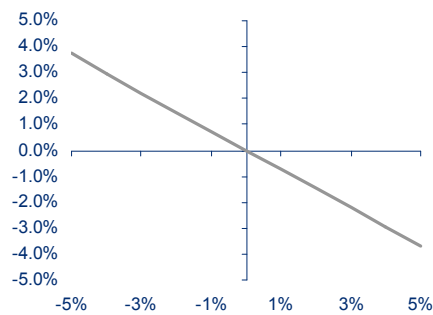
Y-axis: trade MtM as % of tranche notional. X-axis: months going by\*.



Source: Citi Research. \* Correlations do not change and single name spreads roll down their current curves.

**Figure 7. Correlation sensitivity – Delta-hedged**

Y-axis: trade MtM as % of tranche notional. X-axis: change in tranche implied correlation.



Source: Citi Research.

**We believe investors should pair a short in iTraxx Series 9 equity tranches with a long risk in another instrument which:**

- Has similar characteristics regarding high spreads and synthetic leverage, i.e. it can compete with Series 9 equity tranches if investors continue searching for yield.
- Mitigates the negative convexity and very negative time value of a Series 9 equity tranche short.
- Is not as stretched, valuation-wise.
- Has less exposure to periphery credits which, after outperforming over most of the last 12 months, offer a very asymmetric risk-return profile from here in our view (low potential to continue outperforming if we tighten and high potential to underperform if we widen).

**We believe that the most attractive way to fund an iTraxx Series 9 equity short is to sell protection in an iTraxx Series 19 equity tranche.** In particular, we would use the Jun-18 maturity which both Series share: 10y Series 9 and 5y Series 19.

## Short risk S9 vs. Long risk S19 equity; Jun-18; delta-hedged

### Trade rationale

Series 9 and Series 19 equity tranches offer a similar exposure in the following dimensions:

- Both are candidates for investors searching for yield.
- Both have comparable convexity and time value exposures, which make the exposure of a delta-hedged trade to large spread movements limited and it also keeps the time value exposure under control.

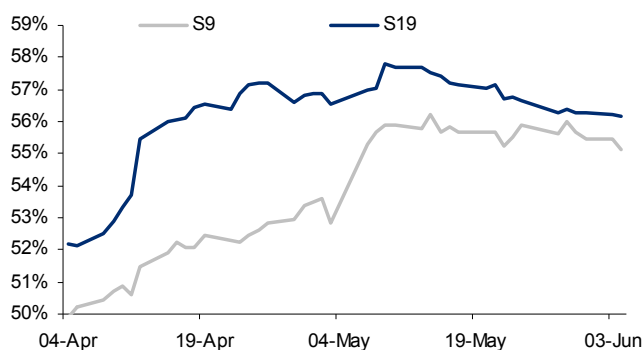
However, they have two key differences in our view:

- **Series 9 equities look way too tight, whereas Series 19 equity tranches do not. This is the main rationale of the trade, in our view.**

The best way to show this is to compare the way correlations have behaved in both tranches since Series 19 started trading in early April (see Figure 8 and Figure 9). As we review later, compared to Series 9, Series 19 offers a much cleaner portfolio with less periphery exposure. As a consequence, most investors expected Series 19 tranches to trade with a much higher correlation than Series 9 tranches, both from a “theoretical” point of view (the room for negative surprises in Series 19 is lower) but also from a “technical” point of view: there isn’t a natural protection buyer of Series 19 equity tranches in the sense that the default or idiosyncratic risk on Series 19 is limited (vs. Series 9, with many names that have been trading at very distressed levels not that long ago and with a much higher exposure to any negative “surprises” in periphery credits).

**Figure 8. Equity tranche correlations – Series 9 vs. Series 19**

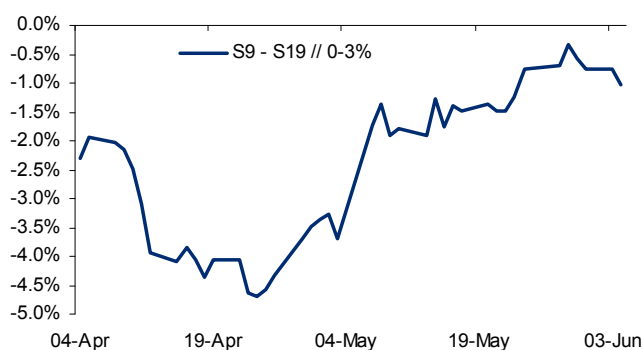
In %.



Source: Citi Research, Markit.

**Figure 9. Equity correlation difference – Series 9 minus Series 19**

In %.



Source: Citi Research, Markit.

When Series 19 tranches started trading with correlations only 2.5% above the correlations in Series 9, the initial flow was one way only, with investors selling Series 19 equity tranche protection and buying Series 9 equity tranche protection.

This caused Series 19 tranche correlations to increase relative to Series 9 correlations, with the difference reaching 5% (see Figure 8 and Figure 9).

At that point, the search for yield in equity tranches intensified and the flows concentrated in Series 9 equity tranches, where the liquidity is higher and where high yield and distressed investors felt more comfortable taking risk given their knowledge of all the high yield names in Series 9.

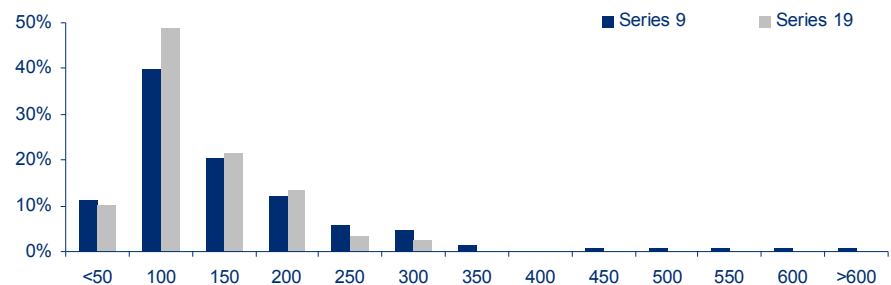
Since late April, the outperformance of Series 9 equity tranches has been substantial, causing Series 9 correlations to increase to almost the levels of Series 19 correlations. We do not think this is justified and believe the outperformance of Series 9 vs. Series 19 equity tranches is overdone.

- The second difference between Series 9 and Series 19 tranches comes from the higher exposure of Series 9 equity tranches to periphery risk, given that (i) there are many more periphery names in Series 9 and (ii) they are among the widest names. Thus, **a short risk Series 9 vs. Series 19 equity tranche trade offers a short periphery vs. non-periphery underlying exposure.**

Figure 10 shows the spread distribution among the underlying credits in both indices, and Figure 11 shows the widest credits in both portfolios.

**Figure 10. Spread Distribution in Series 9 & Series 19 iTraxx Main**

Jun-18 spreads, in bp.



Source: Citi Research, Markit. Spreads as of COB 4-Jun.

There are 18 periphery credits in Series 9 (3 Portuguese, 1 Greek, 7 Spanish - one with double weight - and 7 Italian) and 10 periphery credits in Series 19 (4 Spanish and 6 Italian). The periphery credits in Series 9 which are not part of Series 19 are: 3 Portuguese (EDP, Banco Espirito Santo, Portugal Telecom), 1 Greek, 4 Spanish (BBVA, Endesa, Repsol, Gas Natural<sup>2</sup>), 3 Italian (Finmeccanica, Monte Dei Paschi, Telecom Italia).

<sup>2</sup> Gas Natural is included in both Series 9 and Series 19 – however, it has a double weight in Series 9 due to the succession event between Gas Natural and Union Fenosa.

**Figure 11. Widest credits in Series 9 & Series 19**

Spread in bp.

	Credit	Spread	Series 9	Series 19
1	Peugeot Sa	637	x	
2	Banca Monte Dei Pasc	600	x	
3		519	x	
4	Banco Espirito Santo	460	x	
5	Portugal Telecom Int	410	x	
6	Finmeccanica S.P.A.	323	x	
7	Edp - Energias De Po	313	x	
8	Unicredit, Societa P	296	x	x
9	Dixons Retail Plc	293	x	
10	Telecom Italia Spa	292	x	
11	Intesa Sanpaolo Spa	282	x	x
12	Thyssenkrupp Ag	257	x	
13	Postnl N.V.	255	x	x
14	Banco Bilbao Vizcaya	248	x	
15	Renault	243	x	
16	Banco Santander, S.A	240	x	x
17	Assicurazioni Genera	234	x	x
18	Lafarge	227	x	
19	Glencore Internation	220	x	x
20	Telefonica, S.A.	204	x	x

Source: Citi Research, Markit. Spreads as of COB 4-Jun.

## Trade Details

We recommend investors buy Series 9 equity tranche protection and sell Series 19 equity tranche protection, both with Jun-18 expiry and delta-hedged (Figure 12). We trade the same notional on each equity tranche.

**Figure 12. Trade details**

Index	Tranche	Tenor	Maturity	Protection	Notional (€m)	Upfront	Delta	Index Ref (bp)
Series 9	0-3%	10y	20-Jun-18	Buy, delta-hedged	10	46.25%	5	132
Series 19	0-3%	5y	20-Jun-18	Sell, delta-hedged	10	31.75%	6.2	108

Source: Citi Research, indicative prices as of open 5-Jun.

We expect the biggest driver of this trade to be the relative movements in implied correlations in both tranches, i.e. the supply/demand dynamics for each particular tranche (isolating movements in the underlying indices).

As we showed above (see Figure 8 and Figure 9), although Series 19 correlation is still above Series 9 correlation (the difference is ~1%) we believe it should increase to, at least, the levels we saw back at the end of April (~5%). Figure 13 shows the trade MtM as correlations in both tranches move.

In general, for each 1% that Series 19 correlation differential increases relative to Series 9 correlation, the trade gains around 0.75% (and vice versa). Thus, other things equal, **if the correlation differential moves to our 5% target, we should expect a P&L close to 4%.**

**Figure 13. Correlation exposure. Long risk Series 19 equity vs. short risk Series 9 equity; Jun-18. Equal notional.**  
Trade MtM if equity tranche correlations change.

	Series 9										
	-5%	-4%	-3%	-2%	-1%	0%	+1%	+2%	+3%	+4%	+5%
Series 19	-5%	-0.1%	-0.9%	-1.6%	-2.4%	-3.1%	-3.9%	-4.6%	-5.3%	-6.1%	-6.8%
	-4%	0.6%	-0.1%	-0.9%	-1.6%	-2.4%	-3.1%	-3.8%	-4.6%	-5.3%	-6.0%
	-3%	1.4%	0.7%	-0.1%	-0.8%	-1.6%	-2.3%	-3.1%	-3.8%	-4.5%	-5.3%
	-2%	2.2%	1.4%	0.7%	-0.1%	-0.8%	-1.5%	-2.3%	-3.0%	-3.7%	-4.5%
	-1%	3.0%	2.2%	1.5%	0.7%	0.0%	-0.8%	-1.5%	-2.2%	-3.0%	-3.7%
	0%	3.7%	3.0%	2.2%	1.5%	0.7%	0.0%	-0.7%	-1.5%	-2.2%	-2.9%
	+1%	4.5%	3.7%	3.0%	2.2%	1.5%	0.8%	0.0%	-0.7%	-1.4%	-2.2%
	+2%	5.3%	4.5%	3.8%	3.0%	2.3%	1.5%	0.8%	0.1%	-0.7%	-1.4%
	+3%	6.0%	5.3%	4.5%	3.8%	3.0%	2.3%	1.6%	0.8%	0.1%	-0.6%
	+4%	6.8%	6.0%	5.3%	4.5%	3.8%	3.0%	2.3%	1.6%	0.8%	0.1%
	+5%	7.5%	6.8%	6.0%	5.3%	4.5%	3.8%	3.1%	2.3%	1.6%	0.9%

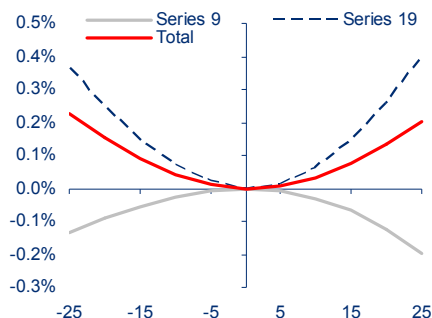
Source: Citi Research.

Figure 14 and Figure 15 show the trade spread sensitivity (slightly positively convex) and its time value (around -1% for a 6m horizon; including carry and slide).

Finally, Figure 16 shows the trade exposure to spread movements in periphery credits only: the trade has a bearish exposure to periphery credits if they move by similar % amounts. However, we expect the impact of periphery credits to be not via their spread movements but mainly via the fact that the lower concentration of periphery credits in Series 19 should make investors prefer Series 19 equity tranches (vs. Series 9 tranches).

**Figure 14. Spread sensitivity – Delta-hedged**

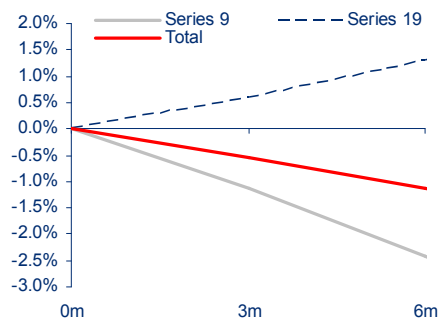
Y-axis: trade MtM as % of tranche notional. X-axis: spread shock, in bp, applied to all names in the index.



Source: Citi Research.

**Figure 15. Time value – Delta-hedged**

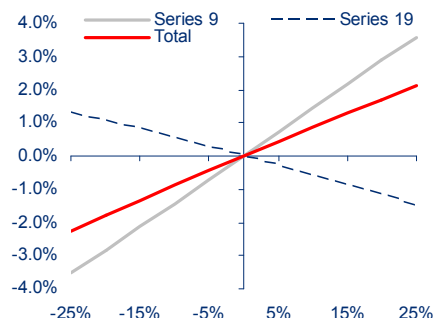
Y-axis: trade MtM as % of tranche notional. X-axis: months going by\*.



Source: Citi Research. \* Correlations do not change and single name spreads roll down their current curves.

**Figure 16. Periphery Spread sensitivity**

Y-axis: trade MtM as % of tranche notional. X-axis: spread shock, in %, applied to periphery names.



Source: Citi Research.

## Trade Recommendations Summary

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

Starting with the trade idea in this report, we will be tracking the performance of our recommended trade ideas. We will open each trade idea at the time of its publication, and we also inform investors when we close them in later publications. Going forward, we will include this section in our Trade Idea publications, where investors will find a summary of the performance of our recommended trade ideas and where we will make explicit when we close any trade idea.

Figure 17. Open trades – Summary and P&L

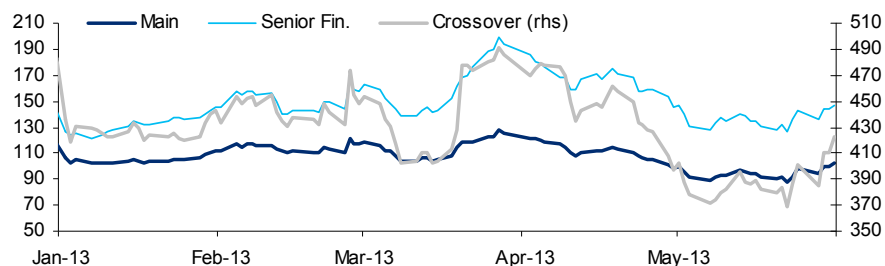
Trade Description	Leg	Format	Direct.	Notnl.	Entry Upfront	Entry Spread	Entry Coupon	Current Upfront	Current Spread	P&L* Total	P&L* Month**
Series 9 vs. Series 19 equity	iTraxx Main S9 0-3% Jun-18 (10y)	Prot.	Buy	1	46.25%	1,720	500				
4-Jun-13	iTraxx Main S9 Index Jun-18 (10y)	Prot.	Sell	5	-2.1%	132	175				
	iTraxx Main S19 0-3% Jun-18 (5y)	Prot.	Sell	1	31.75%	1,227	500				
	iTraxx Main S19 Index Jun-18 (5y)	Prot.	Buy	6.2	0.4%	108	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 5-Jun.

### Representative Market Conditions

Figure 18. Historical spreads – iTraxx 5y on-the-run indices

Period: 1-Jan-13 – Now



Source: Citi Research, Markit. In bp.

#### 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.



Investing in options is not suitable for all investors. Please see the disclosures concerning the risks of investing in options below and discuss whether this particular options strategy is suitable for you with your Financial Advisor.

## Recent Trade Ideas

Figure 19. Published Trade Ideas – reverse chronological order.

Trade Ideas	Date
<a href="#">Hedging via Crossover Bearish Ladders</a>	16 May 2013
<a href="#">Buy Main straddles; sell CDX IG straddles</a>	1 May 2013
<a href="#">Views &amp; Trades on iTraxx Series 9 Tranches</a>	18 April 2013
<a href="#">Beware of retail and food releveraging – short risk retailers &amp; food vs. Main Non-Financials</a>	18 April 2013
<a href="#">Receiver 1x2s – Mind the tail if going long</a>	2 Apr 2013
<a href="#">Hedging menu: payer spreads, 3s5s flatteners and Jun 15/18 equity tranche flatteners</a>	28 Mar 2013
<a href="#">Long insurers vs. short premium autos</a>	19 Mar 2013
<a href="#">Flatteners in iTraxx Equity Tranches</a>	6 Mar 2013
<a href="#">Long risk 3-6% vs. short risk 0-3% - Jun-15 iTraxx Series 9 tranches</a>	12 Feb 2013
<a href="#">Long risk Main vs. Crossover via indices and receiver options</a>	12 Feb 2013
<a href="#">iTraxx Main payer ladders</a>	3 Jan 2013
<a href="#">iTraxx Main 3s5s duration weighted flatteners</a>	3 Jan 2013
<a href="#">Long risk iTraxx Main vs. short risk iTraxx Crossover</a>	3 Jan 2013
<a href="#">Long risk CDX IG vs. short risk iTraxx Main</a>	3 Jan 2013

Source: Citi Research.

### 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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#### Citi Research Equity Ratings Distribution

<b>Data current as of 31 Mar 2013</b>	<b>12 Month Rating</b>			<b>Relative Rating</b>		
	<b>Buy</b>	<b>Hold</b>	<b>Sell</b>	<b>Buy</b>	<b>Hold</b>	<b>Sell</b>
Citi Research Global Fundamental Coverage	48%	39%	12%	7%	87%	7%
% of companies in each rating category that are investment banking clients	53%	49%	43%	65%	49%	51%

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