

The Credit Index Call

IG versus HY - Protecting the Downside



14 September 2011

Commentary and Trade Ideas on Index Options and Tranches

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CREDIT

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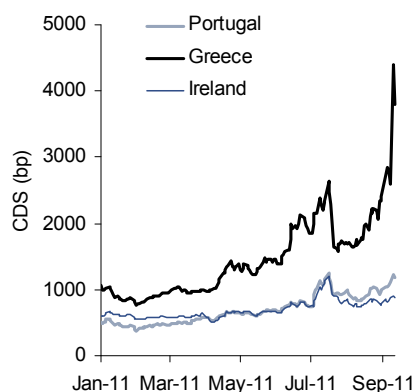
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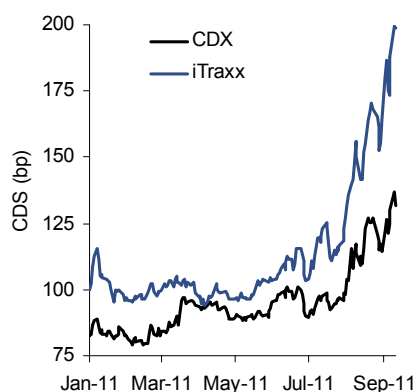
Market Outlook

Investors are getting back to their workplaces, but see little respite from the environment they left in August. The markets remain extremely volatile and daily triple-digit Dow swings are becoming the norm. The good news is that policymakers are getting more proactive. The Fed is widely expected to introduce new unorthodox measures in September, while the ECB should cut rates at its next meeting. Unfortunately, these measures are not going to be viewed as game-changing and even QE3 (if enacted) is not likely to have anything other than a short-lived effect. Meanwhile, lack of decisive actions from European policymakers has allowed for the crisis to spread. Concerns about credit quality of Greece and other periphery sovereigns continue to pressure credit spreads (see figures below). Thus far, we see little willingness by policymakers to finally resolve pending issues. As a result, we think that near term the market will remain volatile and, despite attractive valuations, investors should exercise caution when adding exposure.

Periphery CDS Spreads



CDX IG vs iTraxx



Source: MarkIt

Options and Tranche Commentary

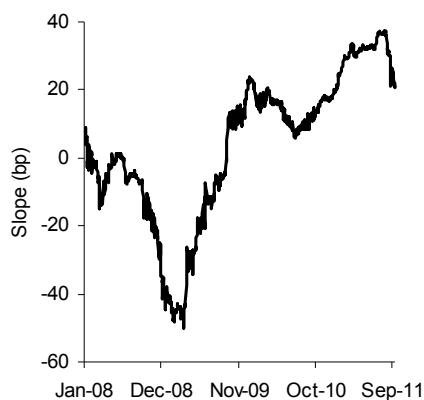
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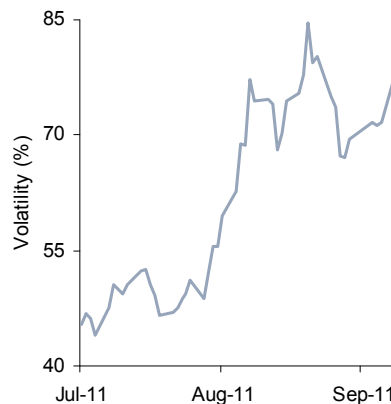
We had a volatile start to September, a month which is typically cruel to risky assets. CDX IG index has widened by 15bp, while the index curves have continued to flatten (see figure below). CDX junior tranches got under pressure, especially the mezz tranches, which were pressured by CDO unwinds. The short-dated HY equity tranches have been attracting a lot of attention from risk-takers. We continue to like HY11 10-15% 3yr (maturing in December) since we believe that the near-term risk of default remains low and its short duration mitigates price volatility. Meanwhile, CDX implied vols have been inching higher and IG options have been quite active. The 1-mo ATM vols increased by 6% last week, while 3-mo was higher by only 2%, capped by sellers of long-term vega (see figure below). Trading in HY options has been spotty, and the skew has flattened.

The IG roll should take place next week. AT&T Mobility, Progress Energy, R.R. Donnelley, The TJX and Toll will be replaced by Boston Scientific, Heinz, Macy's, Nabors and The Gap. We expect CDX IG17 to open 6-9bp wide to IG16, helping holders or long-dated IG16 receivers. The tranches should also roll this time around, but we think there will be little trading in the new series.

CDX IG 5s10s Slope



CDX IG 3-MO ATM Vol



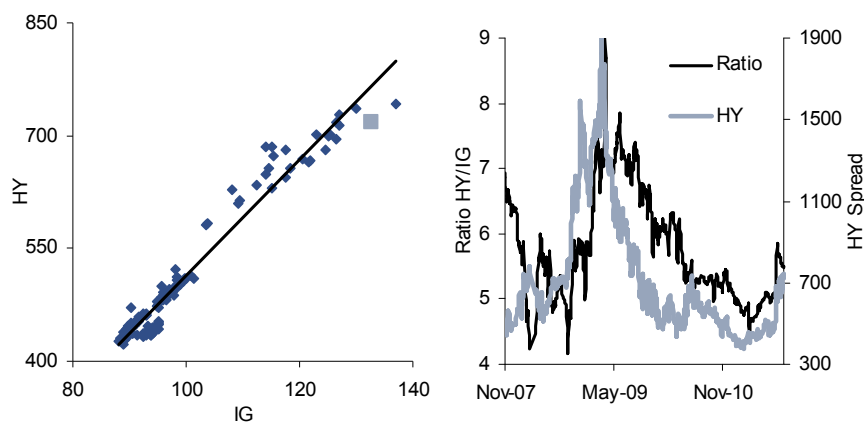
Source: Bloomberg, CIRA

IG versus HY: Indexes, Options and Tranches

One would have expected to see spread decompression in the aftermath of the recent market selloff. However, given the systemic nature of the crisis and a much better liquidity of CDX IG, compared to other indexes (making IG the most popular hedging vehicle), CDX HY has outperformed CDX IG adjusted for beta (see figure below). We feel that this outperformance is temporary. If the credit market falls out of bed (as a result of either deteriorating economy in the US or a sovereign credit event in Europe), CDX HY has a lot more downside than CDX IG. Meanwhile, in the short covering rally CDX IG should regain the ground it lost.

More specifically, the spread ratio of CDX HY to CDX IG (which is frequently used as a measure of the relative richness / cheapness) increased from 5.0 earlier this summer to 5.4. At times of stress (2008-09) this ratio was as high as 8.0-9.0 (see figure below). Hence, we think that going long CDX IG versus CDX HY (via the 5 to 1 ratio) could make money in both the bullish and the bearish scenarios.

IG16 vs. HY16 (Apr. 2011–Sep. 2011) HY Spread vs. HY / IG Ratio

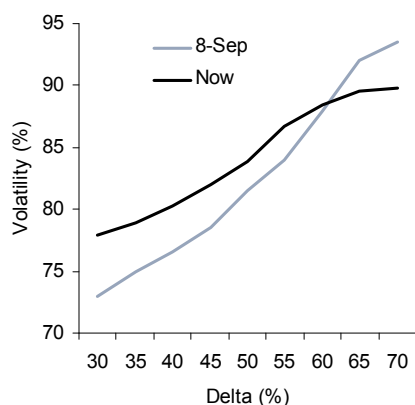


Source: MarkIt

One can execute the IG-HY idea via CDS indexes, but we also like implementing the trade via either CDX options or tranches. Firstly, we recommend buying Out of the Money HY CDX payer options, against selling CDX IG Out of the Money payers. The IG vol skew remains rather steep, while the HY skew flattened dramatically last week (see figure below). Hence, one would be selling “expensive” IG Out of the Money options, against buying “cheap” HY Out of the Money vol. One could sell \$50mln CDX IG16 October 2011 payers struck at 150bp versus buying \$10mln CDX HY16 October 2011 payers struck at \$89. This trade is effectively costless.

Secondly, in the tranche space we recommend going long CDX IG9 7yr 3-7%, which has been underperforming the other IG9 mezz tranches against HY15 3yr 15-25%. CDX IG9 7yr mezz has underperformed its delta by 2.1pts since August 1 and by 4.0 points year to date. CDX HY15 did much better, underperforming its delta by only 0.75pts since August. Sell protection on \$10mln CDX IG9 7yr 3-7% versus buying CDS on \$20mln CDX HY15 3yr 15-25%.

HY 1-Mo Option Skew



IG9 3-7% 7yr vs. HY15 15-25% 3yr

Tranche	1-Aug Sprd. (pts)	Now Sprd. (pts)	Chng. Sprd. (pts)
IG9 7yr			
Index	94	149	55
0-3%	47.3	58.3	11
3-7%	4.8	18.3	13.5
7-10%	-8.8	-0.5	8.3
HY15 3yr			
Index	104.8	99	-5.8
0-15%	74.5	57	-17.5
15-25%	105	93.9	-11.1
25-35%	109.4	103.9	-5.5

Source: CIRA

Risks

When buying calls and puts the maximum loss is the premium paid. When selling calls, the maximum potential loss is unlimited as the shares rise to infinity. For puts, the maximum potential loss (amount below the strike) would eventuate should the shares fall to zero. Sector index options are cash settled. The above calculations do not include any additional fees or transaction costs.

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Appendix A-1

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