

The Credit Index Call

Relative Value in Uncertain Times



SHORT 5Y HY11 25-35% TRANCHE, LONG 5Y HY10 25-35% TRANCHE (NO DELTA)

22 May 2012

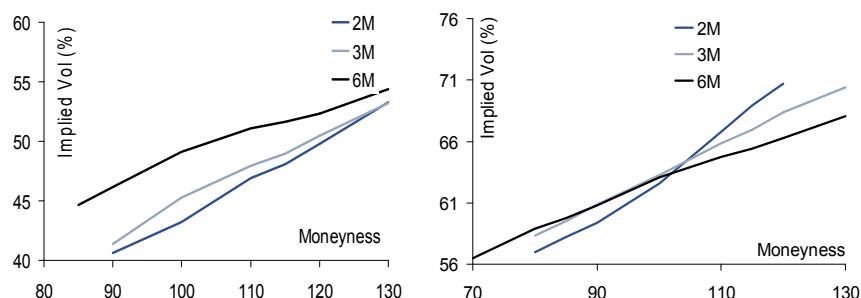
Market Outlook

Over the last week, there has been a definite risk-off move with credit indices in Europe and the US gapping wider. Foremost among investor worries were the increased probability of a Greek exit from the Eurozone and accelerated deposit flight from the banks in peripheral Eurozone countries. As of the beginning of the current week, markets have taken some solace from the G8 summit over the weekend where leaders have, in principle, agreed that Greece should remain in the Eurozone and are beginning to switch focus from austerity to growth measures to resolve the crisis. However, disagreements still remain over the specifics of a growth strategy, adding to uncertainty in the short to medium term.

In the tranche markets, the CDX IG9 index widened by 15–20 bp in the 5Y-10Y tenors over the week, most likely as a fallout of the continuing unwinding of the JPM trades. As in the past few weeks, investors continue to bid up protection in the senior tranches given the high cost of buying protection on the juniors, as well as rising systemic risk globally. At the other end of the spectrum, the longer dated CDX IG9 0%–3% tranches have remained well offered in the face of shorts being unwound ahead of expected future volatility.

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Fig 1. Volatility skews (left: as of 3/16/2012, right: as of 5/18/2012)



Source: CIRA

Credit volatility continues to pick up after reaching multi-month lows earlier in

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CREDIT

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May. Over the past week, we have seen the option implied volatility for 3M ATM CDX IG go from 54% to 65%. In Euro land, the option implied volatility for 3M ATM iTraxx Main ended the week at 73%, up from 67%. However, it continues to remain stubbornly below the highs of mid-80's reached at the beginning of this year, despite the index itself hitting multi-month wides at 182 bps.

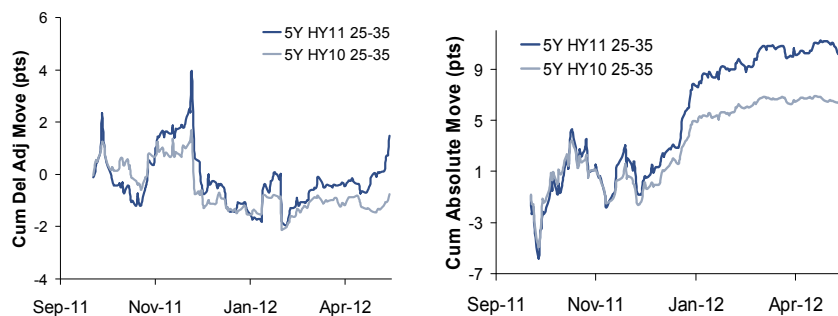
Looking at the term structure of volatility (see Figure 1), it can be seen that over the last two months, implied volatility for shorter tenors (e.g., 2M) has overtaken implied volatility for longer tenors (e.g., 6M), especially for OTM payers. This can typically be associated with signs of distress in the market. In other words, investors are expecting higher volatility (particularly to the downside) in the shorter 2M–3M term compared to a longer 6M time frame.

Going forward, we expect volatility to be elevated in the options space, with investors going long gamma to prepare for large moves in the credit markets, mostly with a bias towards the widening side. Tranche markets should reflect this as well, with investors going long risk on equity tranches and short risk on seniors, to benefit from the positive convexity (on a delta adjusted basis) in an index widening scenario.

Trade Idea: Short 5Y HY11 25%–35% tranche risk against Long 5Y HY10 25%–35% tranche risk

In uncertain markets such as today, with increasing likelihood of large moves driven by headlines, it is difficult to commit to directional trades. The two obvious possibilities under such circumstances are going long volatility or market neutral relative value trades. Given that implied volatility remains elevated in options markets, we focus on a relative value trade idea involving HY tranches.

Fig 2. Relative outperformance of 5Y HY11 25-35% tranche



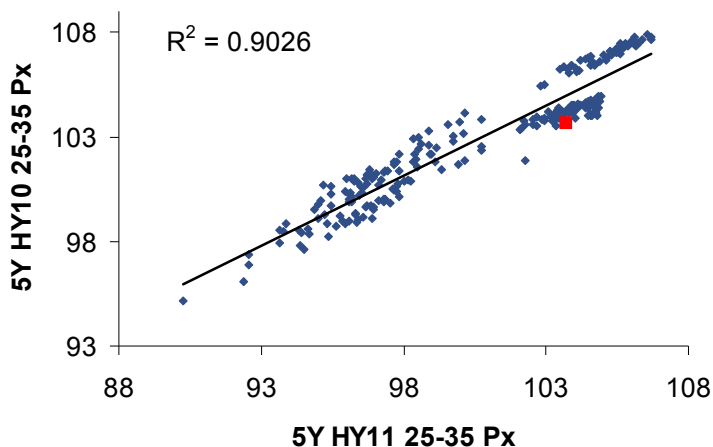
Source: CIRA

A relative value trade on a reasonably senior tranche is preferable in order to avoid the risks arising from idiosyncratic factors related to individual credits in the HY portfolios. This makes the 15%–25% and 25%–35% tranches more appropriate for such a trade. In particular, the 5Y HY11 25%–35% tranche has significantly outperformed the corresponding HY10 tranche both on an absolute and a delta adjusted basis, especially since the end of February (see Fig 2). A similar trend can also be observed for the 15%–25% tranche, but the higher upfront cost of doing the trade using 15%–25% tranches makes the 25%–35% tranches more attractive.

Further, based on price (or upfront) levels, the 5Y HY10 25%–35% tranche appears to be considerably cheap compared to the 5Y HY11 25%–35% tranche (see Fig 3). The red marker represents the current price levels, which indicates that the current HY10 tranche price lies significantly below the trend line computed by the linear regression (with an R^2 of 90%). The deviation of the current HY10 tranche price from the fair value of the regression line is in the 4th

percentile of the deviation distribution, which implies a high probability of reverting to the fair value — in this case, upwards relative to the 5Y HY11 tranche price.

Fig 3. Rich / Cheap analysis of HY10 vs HY 11 senior tranches



Source: CIRA

Finally, after eliminating the common and defaulted names in the two portfolios, the average credit spread in HY10 is significantly tighter than that in HY11 (see Table 1). Consequently, chances of actual default losses are much higher in the HY11 portfolio, leading to a loss of subordination below the 25%–35% tranche.

Table 1. Comparison of HY10 and HY11 portfolios (as of 5/21/2012)

Only in HY10	5Y CDS	Only in HY11	5Y CDS
Allegheny Energy Supply	260	Boyd Gaming	985
Alltel	19	Louisiana-Pacific	318
Freeport-McMoran Copper & Gold	199	Radian Group	2572
Ikon Office Solutions	65	Sprint Nextel	909
The Mosaic Co	77	Tyson Foods	160

Source: Markit

The overall trade details are shown below. The trade is done on a no-delta basis, adjusting the notionals for the delta to the respective indices and accounting for the beta (1.4) of the HY11 index with respect to the HY10 index on a price basis. This gives a notional ratio of roughly 1:1 and the net upfront cost of the trade is slightly negative. However, the trade benefits from the better roll down characteristics of the long HY10 leg (shorter maturity) and is carry neutral. The time horizon of the trade is about 3–4 months.

Trade as of May 21, 2012: Short HY11 tranche, Long HY10 tranche

Tranche	Risk Notional	Delta	Upfront (pt)	Annual Carry (bp)
5Y HY10 25-35	10MM	1.2	-4.125	500
			(\$-412,500)	(\$500,000)
5Y HY11 25-35	-10MM	1.6	-3.00	500
			(\$-300,000)	(\$-500,000)
Net			(\$-112,500)	\$0

The main risk of this trade would be a sudden widening in HY10 due to heightened idiosyncratic risk in the names not common to the HY11 portfolio. However, based on our analysis, we view that chance as remote. Other risk factors include continued out-performance of the HY11 tranche driven by technicals due to investor positioning.

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Appendix A-1

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