

The Credit Index Call

Technicals Remain Dominant



17 May 2011

Commentary and Trade Ideas on Index Options and Tranches

Credit and equity markets seem likely to remain locked in their current range as negative fundamentals in the form of concerns about growth and European sovereigns balance against positive technicals in the form of cheap money and credit fund inflows. The strength of these technicals was demonstrated by the way risky assets managed to ignore the volatility in commodities and short-end rates. A correction in commodities brings mixed messages for credit. On the one hand lower input costs, less inflationary pressure, but on the other it reflects concerns over the recovery. On balance, we are inclined to think that leaving policy rates on hold for longer will have the most influential effect on demand for credit. For option investors, the cancelling out of these influences means that the low vol and mean reverting environment is likely to persist through to the June expiry, in the absence of more definitive macroeconomic data.

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CREDIT

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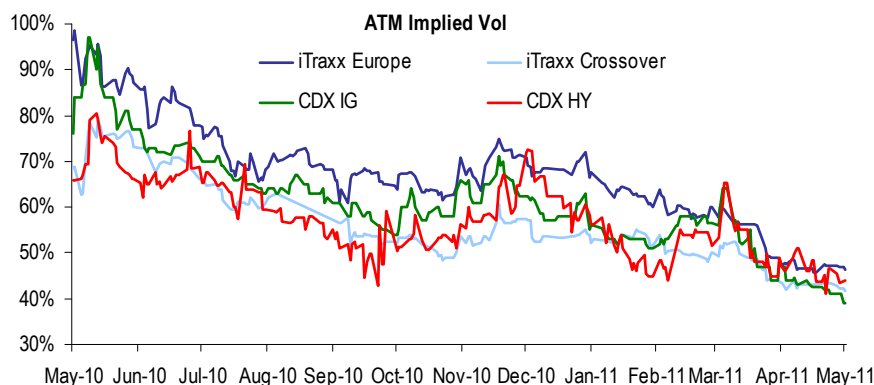
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Volatility is still at historical lows in both Europe and the US (Figure 1) and is still going lower as investors continue selling vol and US rate hikes look more distant. Specifically, we have seen appetite for selling strangles (Sell June receivers at 90 strike and payer at 120 strike) or even butterflies for those that don't want tail risk exposure.

Figure 1: iTraxx and CDX implied vol for IG and HY credit (%)



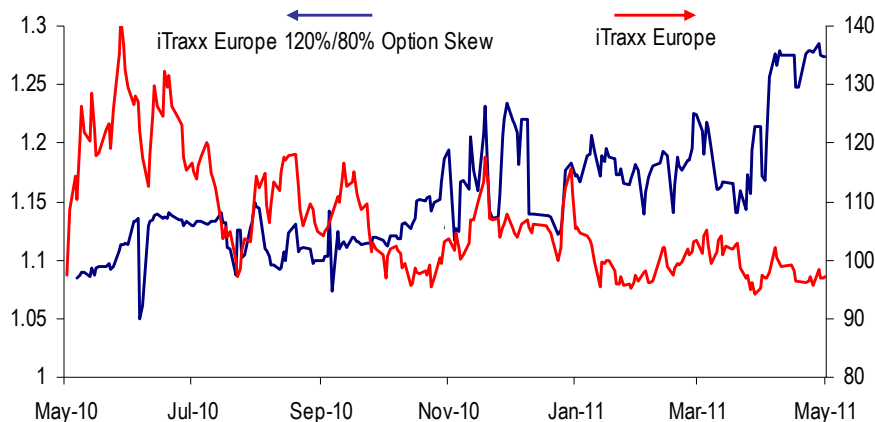
Source: CIRA

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Historically, credit vol and credit spreads are positively correlated; both are approaching new lows not seen since pre-crisis. Credit is at the very tight end of the range that it has been trading since last summer. Although iTraxx IG15 ATM vol is low the skew is very steep, which suggests that investors are nervous about the potential for downside, with payers much more expensive, in relative terms, than receivers. Figure 2 illustrates that the ratio between iTraxx IG15 OTM payers and OTM receivers is at historic extremes.

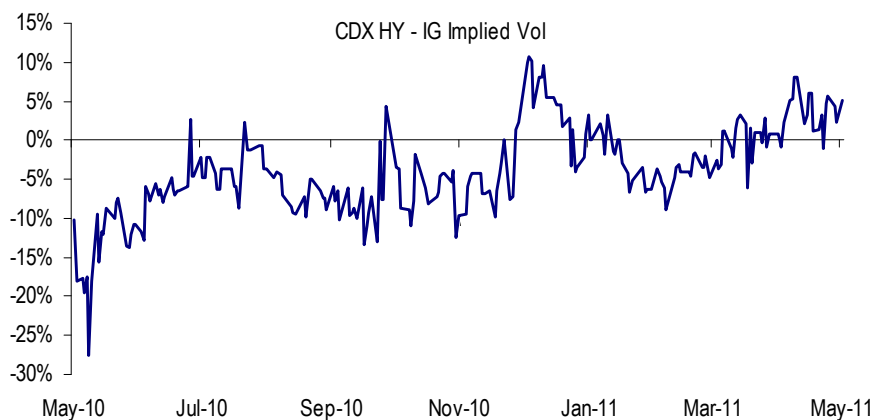
Figure 2: iTraxx Europe 120% / 80% strike option skew vs iTraxx Europe (% ,bp)



Source: CIRA

CDXIG16 vol is low relative to HY vol which is at odds with the significant rally we've seen in high yield. This probably reflects investor nervousness at the extent of the rally and some heightened expectation of downside.

Figure 3: CDX HY – IG implied Volatility (%)

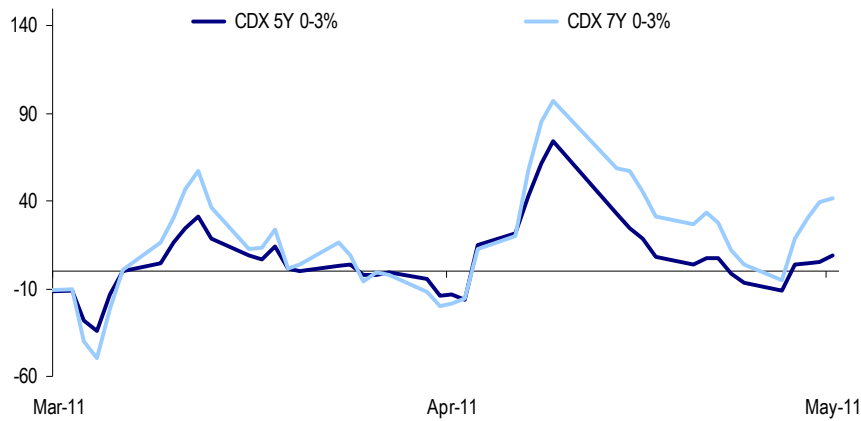


Source: CIRA

In tranche space, activity has been muted but the majority of investors have been interested in leveraged trades. This has seen most activity in equity tranches with investors looking to maximise returns. The assumption being that current spreads overstate the short-dated risk, especially if idiosyncratic risks are hedged out as we suggested in our previous edition of *The Credit Index Call*.

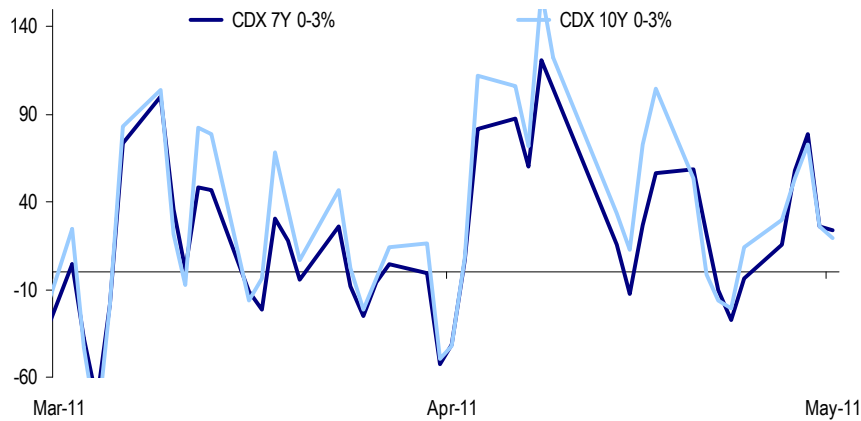
In delta-adjusted terms, the long end of the CDX curve has outperformed as the curve steepened (Figure 4). 10Y CDX9 0-3% has outperformed the 7Y for quite a while, but it looks like 7Y has started to outperform for the past week as the curve steepens (Figure 5)

Figure 4: 5y CDX9 and 7y CDX9 0-3% delta adjusted performance (5 day average return, bp)



Source: Markit

Figure 5: CDX 7Y and 10Y 0-3% delta adjusted performance (2 day average return, bp)



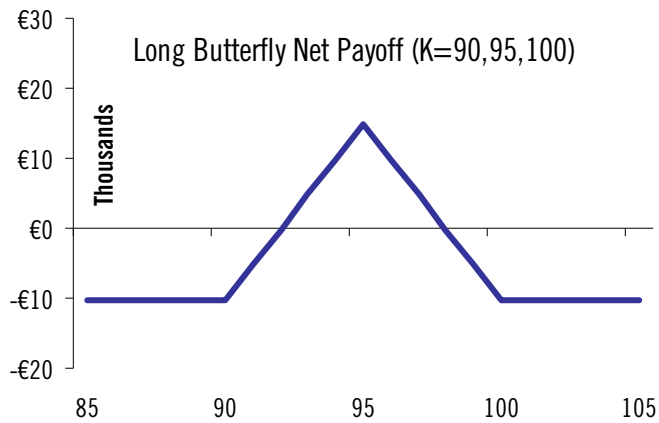
Source: Markit

Buying a June Butterfly

Given that we expect credit and equity to remain range-bound and we fail to see any short-term trigger to disrupt the balance between technicals and fundamentals, we continue to suggest selling vol. Previous pieces have suggested selling a variety of different structures but this week we suggest buying and holding a June butterfly to maturity. If the iTraxx Europe remains unchanged by June at 96, this trade realises €14,750 on a notional of €10M, and if things go wrong the downside is limited at €10,250.

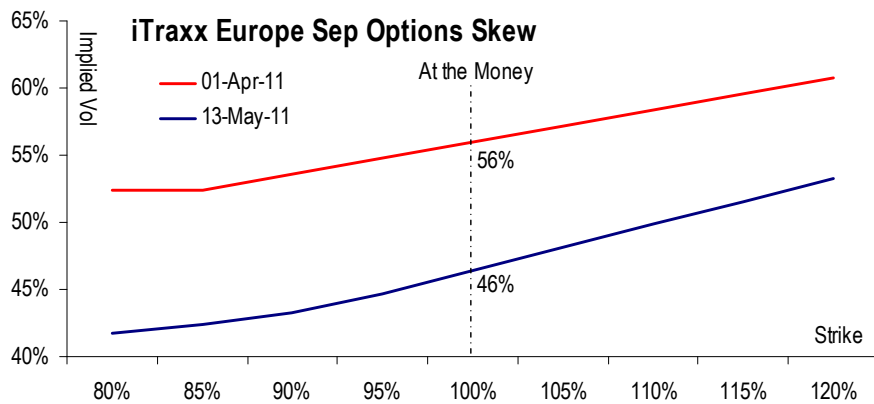
		Type	Maturity	Strike	Premium
Buy	10m	Payer	June 15	90	€48,500
Sell	20m	Payer	June 15	95	€61,000
Buy	10m	Payer	June 15	100	€22,750

Figure 6: Pay-off profile of a June 1x2 'costless' receiver spreads

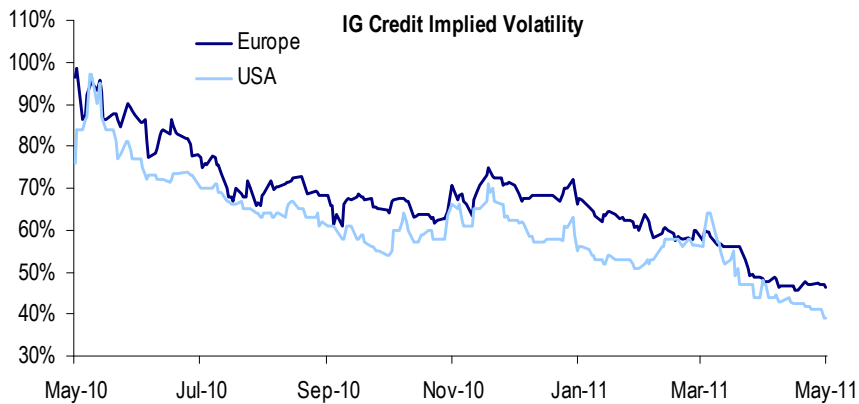


Source: CIRA

Chart Appendix



Source: CIRA



Source: CIRA

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