

The Credit Index Call

Curve Flatteners in Mezzanine Tranches



LONG 10YR CDX IG9 7 -10% TRANCHE, SHORT 7YR CDX IG9 7-10% TRANCHE

14 June 2012

Market Outlook

Global markets over the past few days have been dominated by the news flow out of Spain. The Spanish government announced over the weekend that it would formally request aid from the Eurozone to recapitalize its ailing banking sector, to the tune of EUR 100B. Despite the size of the rescue being larger than expected, market reaction has largely been negative, given the lack of details about the rescue. In particular, investors continue to be concerned about the subordination of private bondholders to the new loans since it is unclear whether the money would come out of the new ESM funds (that require subordination of existing bondholders) or the existing EFSF (which treats existing bondholders as pari passu). The upcoming Greek elections over the coming weekend also continue to add to the uncertainty about the situation in Europe.

The major credit indices have reacted to these headlines by widening across the board, with the 5Y iTraxx Main wider by 7.5 bp and the 5Y CDX IG wider by 5 bp over the week. The market action in the index space has been reasonably orderly, once again a reflection of negative to neutral investor positioning. In general, the credit markets have seen sparse action, with investors mainly on the sidelines, waiting for events in Europe to play out. The market moves over the past few days have been very similar, with indices opening tighter in Europe (potentially due to a short squeeze) and then beginning to leak wider into the US open as the shorts get reset, ending up wider each day at the end. This obviously reflects lack of market conviction about the efficacy of the bank recapitalization plans. Overall, credit indices have significantly underperformed equity indices post the Spain bailout announcement.

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In credit options markets, expectations of future elevated volatility in light of upcoming events (in particular, the Greek elections) have led investors to bid up the tails to buy protection against outsized spread moves, especially to the downside. We show the volatility skews between the ATM payers and the 20% OTM payers for different expiries in Fig 1. The skews have been normalized over the period shown for ease of comparison. The steepening of the payer volatility skew is particularly pronounced for the 6M expiry, which indicates that market

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The Credit Index Call - Long Junior Risk Without The Widest Names

The Credit Index Call - Relative Value in Uncertain Times

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participants expect large down moves in the credit markets to materialize in that timeframe.

Fig 1. Normalized Volatility Skews

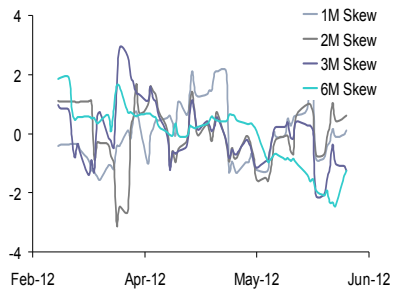
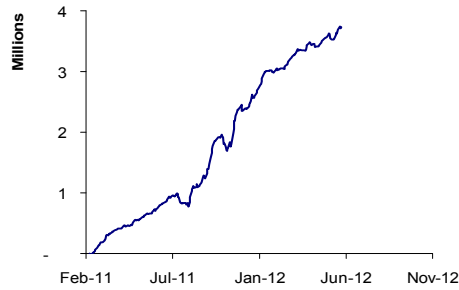


Fig 2. Pnl Selling ATM Volatility



Source: CIRA

Note: Past performance is no guarantee of future results.

Interestingly, there has been considerable selling of ATM volatility to take advantage of the significant difference between implied and realized volatility in the credit options markets. Credit option markets typically tend to overprice volatility given the discontinuous (gapping) nature of credit moves, and past history has shown that strategies that systematically sell ATM volatility have profited handsomely. For example, in Fig 2 we show the Pnl from selling front month ATM straddles and re-hedging daily till option expiry. We expect that this kind of arbitrage will disappear with time as more market participants engage in volatility selling strategies.

Fig 3. iTraxx Mezz 7s-10s Curves (3/20/2008 = 100)

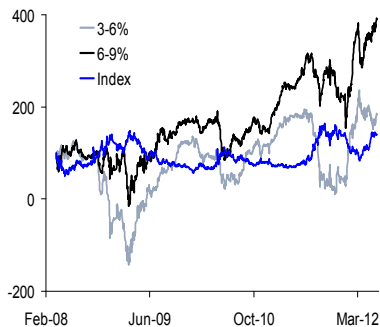
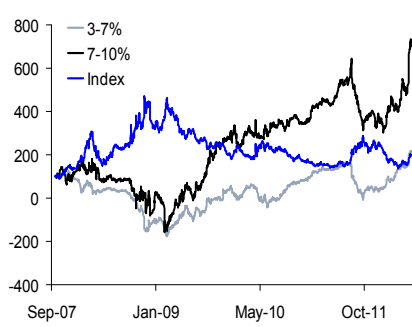


Fig 4. CDX IG9 Mezz 7s-10s Curves (9/20/2007 = 100)



Source: CIRA

The action in the tranche space has been mainly focused in Europe, given the nature of news flows. The current consensus is that the announcement of Spanish bank recapitalization has taken near term bank debt default risk off the table. This can be perceived as a positive for the equity tranches in the iTraxx9 index given the concentration of financial names in the index. Consequently, the protection buyers have moved out of the equity tranches into the mezzanine part of the capital structure. There has also been a steepening of the 7s-10s part of the tranche curves, especially in the mezzanine tranches. For example, the 10Y 3-6% tranche has widened significantly as investors have begun using it as a high beta market short, while the 7Y 3-6% tranche has remained comparatively tight.

Similar movements have also occurred in the CDX IG9 tranches, with buyers of risk protection continuing to move out of the expensive equity tranches and into the mezzanine tranches. The 7s-10s mezzanine tranche curves are also exhibiting a high degree of steepness, especially for the 3-7% and 7-10% tranches. This can be clearly seen in Figs 3 and 4 where we show sample

iTraxx9 and IG9 mezzanine tranche curves, with the historical start date normalized to 100 for easy comparison. Clearly, these curves are exhibiting steepness levels never seen before.

Trade Idea: IG9 7s-10s Curve Flatteners Using the 7-10% Tranche

As markets continued to get whipsawed by headlines, we once again revert to recommending relative value trading ideas (see [The Credit Index Call - Relative Value in Uncertain Times](#)) as opposed to taking a directional view. In particular, given the recent steepening of the mezzanine 7s-10s curve for both iTraxx9 and IG9 indices, we analyzed the some of these tranche curves to find the most optimal flattener trade.

Fig 5. iTraxx9 6-9% Tranche vs Index

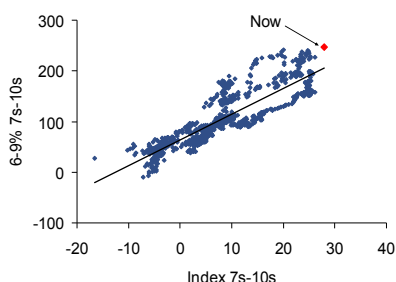
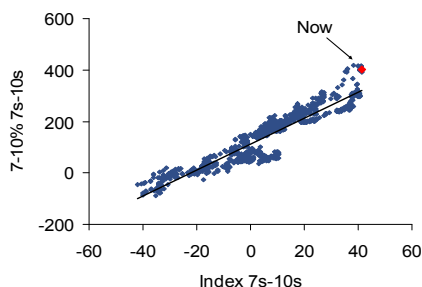


Fig 6. IG9 7-10% Tranche vs Index



Source: CIRA

While part of this extreme tranche curve steepening can be attributed to the steepening of the index curve itself, we investigated whether that is sufficient to explain the steepness of the tranche curves. The regression graphs in Figs 5 and 6 illustrate this issue more clearly. In particular, we see that the current iTraxx9 6-9% tranche curve and the IG9 7-10% tranche curve are both significantly steeper (red markers in the graphs) than the fair values imputed from the regressions. In this particular case, we recommend the curve flattener trade using the IG9 7-10% tranches since it has better roll down characteristics. In particular, the (above par) short 7Y position benefits from a stronger pull to par, being closer to maturity compared to the corresponding short 7Y position in the iTraxx trade. The trade details are shown in Fig 7 below.

Fig 7. Trade Details as of 6/12/2012

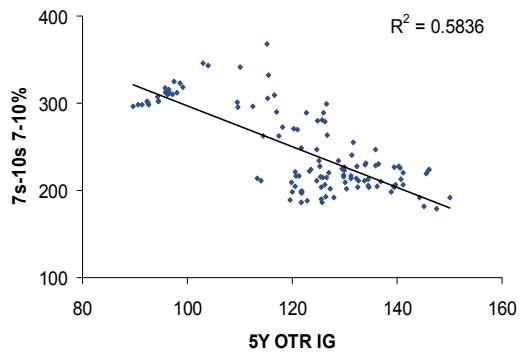
Trade	Notional	Duration	SNAC	Upfront	Annual	
					Carry	Roll
Long 10Y 7-10%	10MM	4.81	707bp	9.25pts	500bp	472bp
Short 7Y 7-10%	-10MM	2.48	299bp	4.90pts	-500bp	220bp
Net				14.15pts	0bp	692bp

Note: 7Y has a negative upfront and roll down, so shown as positive for a short position.

Source: CIRA

We do the trade on a no-delta, notional neutral basis, which gives as a positive upfront of 14.15 pts, flat carry and a positive roll down of approximately 692bp per year based on the current tranche curve, which makes the economics of the trade very attractive.

Fig 8. Curve Slope in Stressed Markets (July 2011 – Dec 2011)



Source: CIRA, Markit

The circumstances under which the trade may suffer will be a further curve steepening which we deem unlikely given that the curve steepness is close to its historic highs. Further, since the trade has a net positive duration, a general widening of spreads without any change in the curve shape can hurt the trade. We deem this to be less likely as well since a general spread widening is related to an increase in market stress and usually causes the term structure of credit curves to flatten because of an increase in near term risk. This can be seen (Fig 8) from the behavior of the 7s-10s curve for the IG9 7-10% tranche versus the on-the-run (OTR) 5Y CDX IG spreads (used as a proxy for the market) during the period of market stress beginning last summer. The graph clearly indicates the positive correlation between general spread widening and tranche curve flattening.

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