

The Credit Index Call

What's On Your Calendar?

BUY IG18 ATM SEP-DEC CALENDAR SPREADS

Market Outlook

The long-awaited Greek elections turned out to be a non-event, as the market quickly jumped to the next topic. Given that the coalition government has been created, the Troika might end up showing some leeway in terms of implementation of austerity measures, which reduces the probability of near-term headline risk coming from this part of the world. Investors also stoically responded to the continued concerns surrounding Spanish banks as well as the selloff in Spanish sovereign bonds, breaching the psychologically important 7% level (Figure 1).

On the positive side, as expected, the Fed extended Operation Twist until the end of the year, and left room for additional accommodation down the line. The G20 meeting underscored the importance of continued accommodation for Europe – hence we are likely to see more proactive actions coming from the ECB and the BOE.

Responding to continued accommodative policies, both iTraxx and CDX have tightened by 12bp in June, while MCDX has done even better, rallying by 30bp. Given that the market is focusing on the influx of liquidity rather than on the negative news, in our view, the path of least resistance for credit spreads is still tighter near-term. The next pressure point is likely come from Moody's downgrade of the US banks, expected any day now, according to press reports.

Fig 1. Spanish 10yr Yields

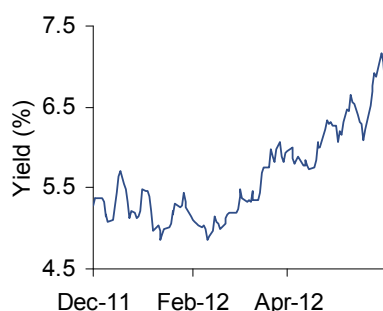
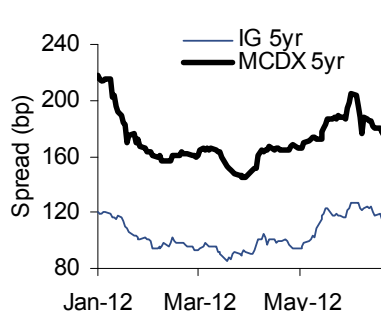


Fig 2. CDX IG 5yr; MCDX 5yr



Source: Bloomberg, CIRA

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CREDIT

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Since early June, option volatility has been for sale in both equity and credit markets. By comparison, credit volatility did not decline as much as equity – VIX dropped from a high reading of 26.5% to just under 18%, staying below the psychologically important 20% level for several days. Over the same time frame, CDX IG 1M ATM volatility dropped from 62% to 52%, while a more appropriate level should have been in the mid-40s, comparable to levels observed in the early May (Figure 3). Hence, we expect credit vol to decline even more and prefer selling short-dated butterflies.

In tranches, the CDX IG9 7y-10y curve has reached its steepest ever point this week (44bp), driven by unwinds and profit-taking (Figure 4); we feel that investors should consider index and possibly senior tranche flatteners. Meanwhile, the rally in credit spreads gave boost to the equity tranches. CDX IG9 0-3% premiums dropped by 2.5-3.5pts (depending on tenor) this month, while HY10-15% also rallied by several points. If the rally continues, there is probably more room for junior tranches to outperform, though over the last several days we have seen some profit-taking.

Fig 3. VIX vs. CDX IG 1M ATM Vols

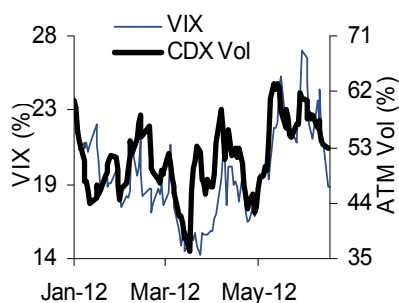
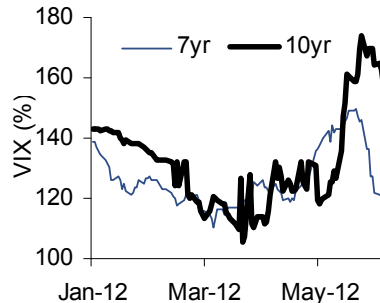


Fig 4. CDX IG9 7s10 Index Curve



Source: Bloomberg, CIRA

Trade Idea: Carry Neutral 3M-6M IG18 ATM Calendar Spreads

As discussed above, near-term we are likely to see a shallow and probably short-lived rally. It feels like the market was able to digest a good deal of bad news without trouble; policymakers on both sides of the Atlantic continue to provide stimulus to the market, and investors are positioned defensively. However, medium-term, we are likely to see a resurgence of volatility as fundamental issues in Europe are yet to be adequately addressed, and moving into the second half of the year, US investors will likely be a lot more focused on the debt ceiling and the fiscal cliff. We believe that this view is best expressed using calendar spreads.

The most natural way of doing the trade is via selling the front-month contract (1M options), since it is likely to outperform in a rally, versus buying longer-dated options. However, as we see in Figure 5 and regressions on Figure 6 and Figure 7, one-month volatilities have been already dropping much faster, compared to long-dated vols. The 1M-3M and 1M-6M term structures have steepened already and, in our view, there is limited room for further steepening if spreads continue to rally and volatilities continue to drop. Meanwhile, it appears the 3M-6M term structure is still close to its fair value (Figure 8). Even if the 3M volatilities are not going to react as much as 1M volatilities, we still prefer executing the 3M-6M calendar spreads using payer options.

Fig 5. IG ATM Option Term Structure Fig 6. 1M-3M (Jun 11-Jun 12)

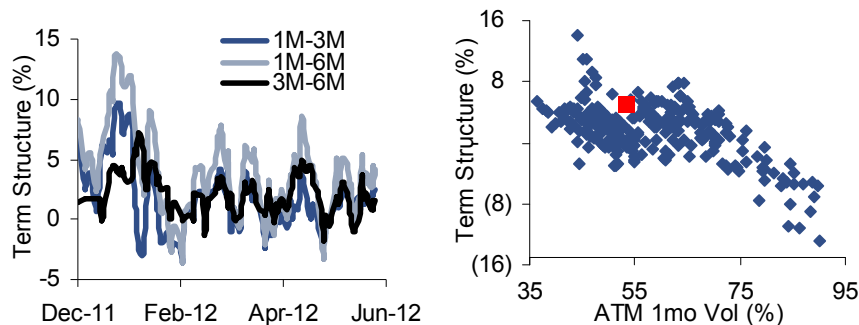


Fig 7. 1M-6M (Jun 11-Jun 12)

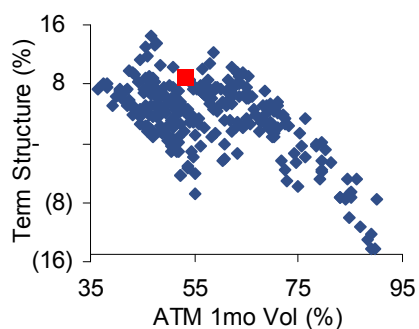
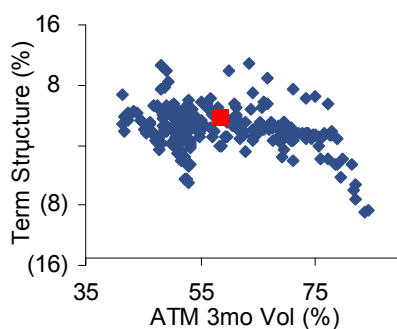


Fig 8. 3M-6M (Jun 11-Jun 12)



Source: CIRA

One way of doing the trade is notional-neutral. In this case, the cost is about 28bp and investors are slightly short credit risk (CR01). To neutralize these negative effects, we recommend either doing the trade delta-neutral (1.05 by 1.00) or cash-neutral (1.6 by 1.0) (Figure 9). Given our relatively bullish near-term outlook, we prefer the latter (this is a CR01 positive trade). While investors are exposed to spread widening in this case, increase in volatility and flattening of the volatility term structure should partially mitigate negative P&L effects.

Fig 9. Trade Details as of 6/20/2012

Product	Action	Nominal	Strike	Prem.(Mid)	Total Premium	Delta	Vol
IG18 Payer Sep.	Sell	\$16mln	130	46.5	74.4	45%	57.4%
IG18 Payer Dec.	Buy	\$10mln	140	74.8	74.8	49%	61.5%

Source: CIRA

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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.

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