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Credit hedges for Brexit

CDS indices and CDS index options to the rescue

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The most simple protection for a credit portfolio against widening spreads is to reduce exposures, either by selling holdings or by hedging some credit risk via credit default swaps (CDS). Investors who may wish to retain a more asymmetric risk/reward profile by keeping the potential upside while protecting the downside, can employ CDS option instruments (swaptions). These can present attractive strategies that either reduce the cost of hedging or provide a proxy portfolio hedge at a macro level when other 'vanilla' hedges are unavailable.

For euro credit the derivatives market is relatively deep, meaning investors can find reasonable levels of liquidity in terms of significant transaction size, reasonably narrow bid-offer spread and limited execution delay. The instruments in question are single-name CDS, CDS indices or CDS index options (eg in iTraxx). Today, euro credit investors can hedge a credit portfolio of 5-year maturity by buying protection in the iTraxx Main 5y CDS index, at an annual cost of 85bps vs a portfolio spread annual income of 90bps. Following the event being hedged and the associated repricing in risk premia, investors could unwind the hedge at a wider spread than what they paid for protection, and crystalise the mark to market gains. This will offset some or all of the adverse valuation impact on their cash portfolio.

Euro investors could also explore the use of CDS swaptions to benefit from a potential spread widening in euro credit in a more cost efficient way. In their simplest form, swaption strategies may involve the purchase of outright payers (buying a put on a CDS index), which gain increasingly in mark to market terms above their strike price, once the option premium has been recouped. Investors who believe that spread widening will be capped (say due to the Corporate Sector Purchase Programme backstop) can reduce the cost of their hedge by selling a payer at a wider strike (selling a put further out of the money). In such a strategy, mark to market gains level out if spreads widen beyond the wider strike, as further gains on the long payer are offset by losses on the short payer. *Exhibit 1* shows indicative pricing information for some typical payer and payer spread strategies with July and September expiries.

Exhibit 1

Typical payer and payer spread hedging strategies in iTraxx Main

Option type	Strikes, bps	Expiry	Premium, Bid/Ask, bps
Payer	87.5	July 2016	45/47.5
Payer spread	87.5/107.5	July 2016	27/29
Payer spread	87.5/117.5	July 2016	33.5/35.5
Payer	87.5	September 2016	65/68
Payer spread	87.5/107.5	September 2016	29/31
Payer spread	87.5/117.5	September 2016	39/40

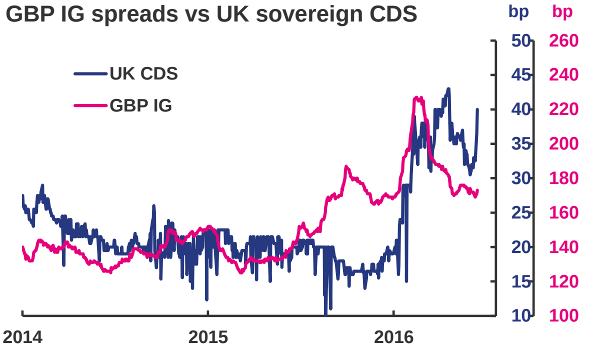
Source: Bloomberg, AXA IM – As of 14/06/16

For sterling credit investors matters are more complicated given the lack of a GBP CDS market, in either single-names or CDS indices. Some UK credit names do trade actively in EUR CDS and this could be used as a partial hedge, inasmuch as it may cover the credit risk but not the currency risk. One possibility is bespoke hedging solutions like trading a total return swap (TRS) on a cash GBP credit index (usually iBoxx), but higher costs, lower liquidity, possibly higher counterparty risk and the fact that gains may be harder to monetise (hence a much bigger market move may be required to make them worthwhile) can render them unattractive.

Investors could also resort to macro proxy hedges and the more simple choices are probably UK sovereign CDS (*Exhibit 2*) or Cable FX (*Exhibit 3*). UK CDS is probably a nearer proxy to sterling credit but, again, liquidity is a key consideration and investors may prefer the clearly superior liquidity of the FX market.

Exhibit 2

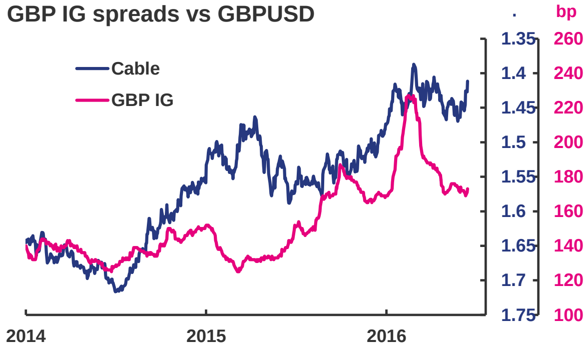
GBP IG spread tight vs UK CDS



Source: BofAML and AXA IM Research

Exhibit 3

GBP IG spread significantly tight vs Cable



Source: BofAML and AXA IM Research

Our Research is available on line: **http://www.axa-im.com/en/research**

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