



Financial markets seem to be taking a breather and digesting the recent avalanche of developments. This has served to produce a period of consolidation and reduced volatility. That in part is what makes the piece below seem so timely. - *Andres Drobny*

QE2, Volatility and CDS

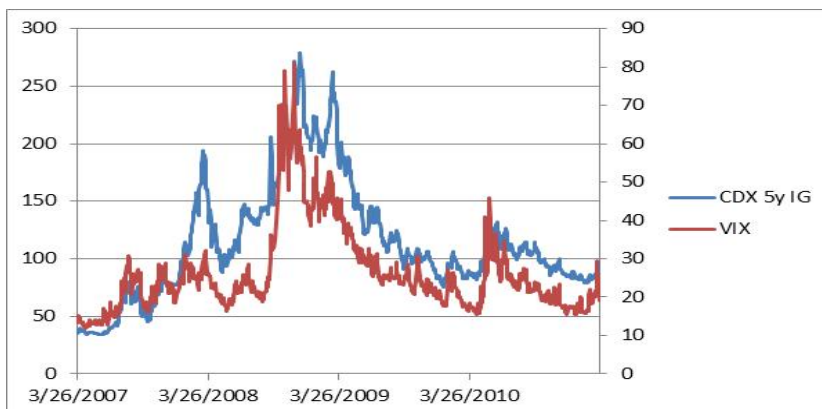
Adam Fisher

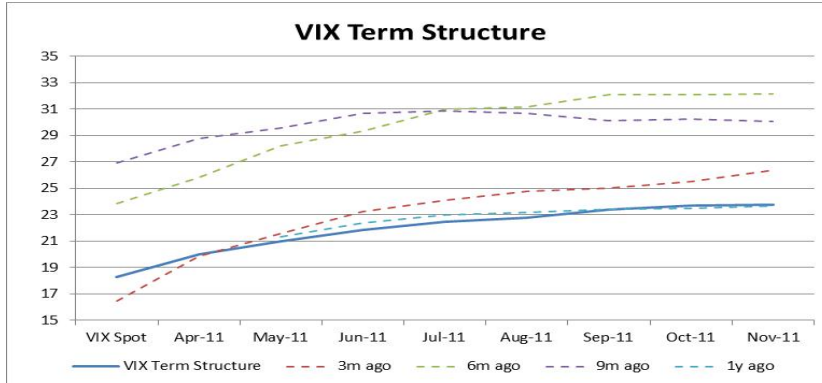
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What happens when QE2 ends? Is it going to be like the end of QE1, when risk assets fell sharply? The powerful turn in the stock market, credit spreads and commodities last August in anticipation of QE2 and after implementation adds to a sense that the imminent end of the policy may have the opposite effect. Further, the recent underperformance of EM vs DM equities lends credence that QE2 in the US has been a driver of equity and credit performance.

Yet, the analogy to QE1 may be faulty. At that time the European Debt crisis was only starting to be understood and factored in. And, the US economy looked in worse shape at the end of QE1 and last August. This time we have fiscal stimulus in the US, especially in the form of the 100% depreciation allowance for all CAPEX this year which can continue to drive risk assets.

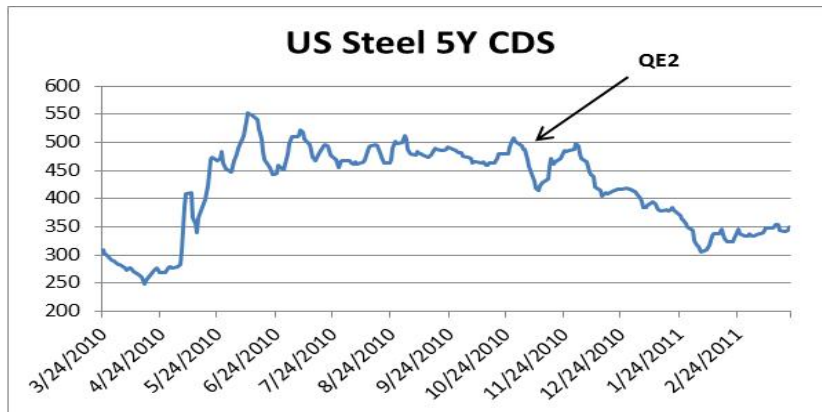
Whether the end of QE2 produces another turn in risk assets or not, it does seem likely to produce a rise in generic volatility. Vol was pulled down by QE2, and is now mispriced as we head towards the end of the program. QE2 helped reduce credit spreads and establish and sustain the trend decline in the VIX and CDX (below).





It also seems to have had a big impact on the term structure of the VIX (above).

Risk assets benefitted from much lower volatility. The FED's activities in CMBS, RMBS, UTSs, mark to market accounting for financial institutions, etc, helped ensure that liquidity remains ample for borrowers. This allowed even the weakest borrowers to in many cases refinance their operations at generationally low levels (picture of US steel 5yr CDS below).



A reversal of any or all of these trends due to the ending of QE2 should at a minimum impact these markets adversely. That takes us to the CDS market. It is increasingly recognized that credit is less expensive than equities at the moment.

CDS is basically an option in credit; it reflects credit spreads but also embeds a variance swap curve (options on fixed income). It is thus a put option on sold volatility which means it itself is very volatile when volatility increases generically. The combination of



tight credit spreads and the upcoming end of vol smoothing by the FED suggests that most CDS are underpriced now and should be bought going into Q2.

A big question is which CDS to buy. CDS indices are probably poor for this. Our approach is instead to look for reasonably liquid single names that correlate to the VIX as well as have high financial leverage. The likely targets are banks, real estate companies (REITs), and high beta commodity companies like USX, etc. Given their constant need for credit (buyers of their paper are always in the market hedging with CDS adding liquidity to the market), they will likely provide the best opportunities to exploit a likely increase in generic volatility that should come from the ending of QE2.

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