Sand Spring Advisors LLC

The CDS Market Explored & Recent Market Nastiness

by,

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We recently had the opportunity to listen to the head of a major investment bank's credit derivatives department deliver a luncheon speech at a major hedge fund event. This event was itself focused on introducing hedge fund managers playing some aspect of the relative credit game. To our ear, this speech was amazingly naïve and myopic, and thereby worrisome enough to also be worthy of mention here.

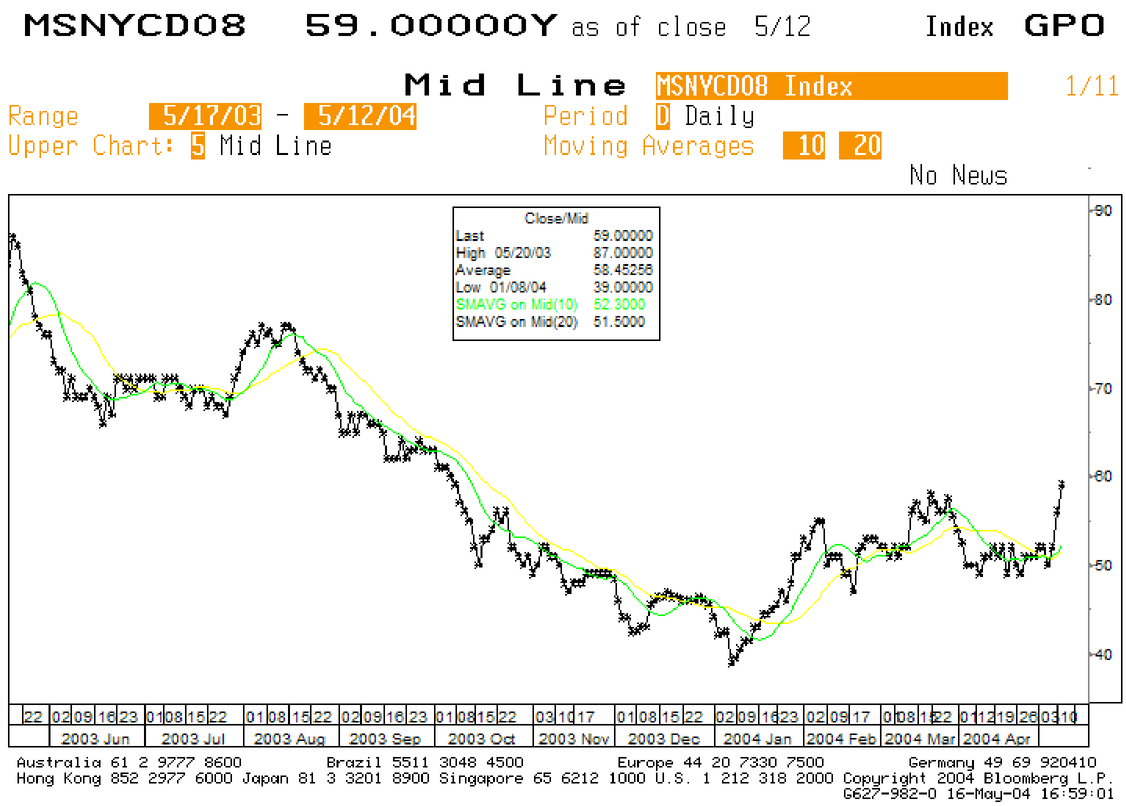
The basic gist of the speech went as follows: Come to our financial institution and you can buy any variety of individual single credit default products, or trade spreads between single credit default swaps, structure lower-cost baskets of "first-to-default" credit default swaps, or enter into tranches of pools of credit default swaps. In other words, a variety of different types of credit insurance (some structures with high deductibles and other structures with low deductibles) all exist for the asking, as do both spread bets and outright bets on the overall direction credit spreads on different debt pools.

The speaker proudly pointed out that this market had grown from slightly over $1 trillion in total notional size of outstandings in 2001 to approximately $5 trillion in 2004, with an expected growth trajectory toward $7.5 trillion by 2006.

Dow Jones -- that venerable entity that for so long refused to even allow a futures contract to be built around the Dow Jones Industrials Average for fear of having its corporate image somehow sullied -- has even lent its name to a new TRAC-X Dow Jones CDX Index. This index recently merged with another index group named iBoxx to together become the definitive provider of global Credit Default Swap indices. DJ Trac-X indices now exist around North American, European, and Asian debt markets -- including specific indices referencing both high grade corporate debt pools as well as more speculative corporate debt pools.

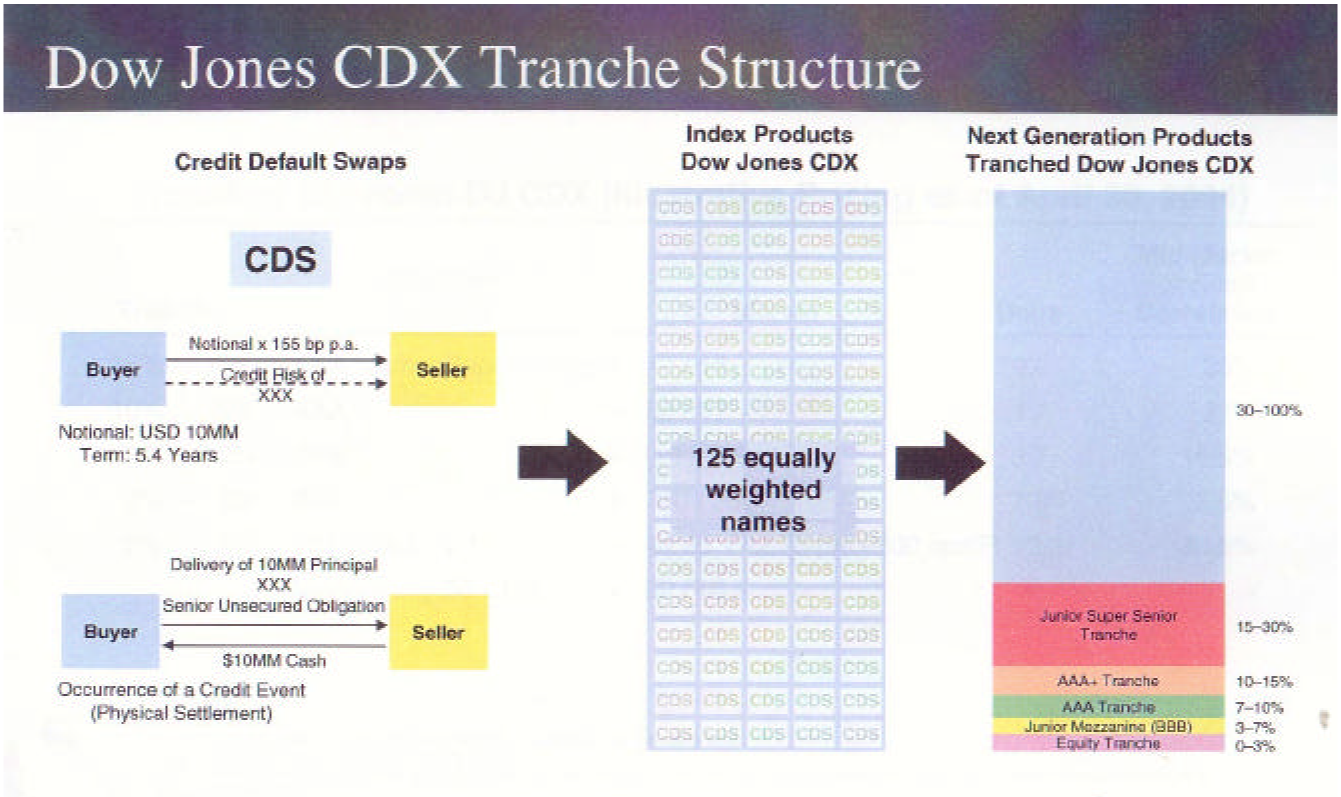
But what exactly is a tranche of a CDS pool? And what exactly is the Dow Jones TRAC-X CDX Index?

Well, the Dow Jones CDX North America Index is specifically a pool of 125 equally-weighted Credit Default Swaps on different large U.S. corporate entities. The DJ Trac-X CDX North America Index is not yet listed on any exchange, but is actively traded over-the-counter between banks. This index moves up and down with the general level of credit spreads on the underlying reference bonds. The index reflects the average credit spread over Treasuries for the pool of bonds, thereby moving lower as credit spreads narrow and moving upwards when credit spreads widen. The chart below shows how the Track-X CDX NA Index has behaved over the past 18 months or so, declining over the benign 2003 environment, but most recently advancing a bit since January 2004. To sell this index outright at its current 59 basis point level, one would collect 59 bp per annum at the risk losing money in any given year if just one out of 125 underlying corporations happens to default (1/125 equaling an 80 basis point payout, while two corporate entities defaulting would equal a 160 basis point payout, etc.).



An over-the-counter market also exists whereby investment banks make markets in different tranches of this pool's default liability. If the pool results in a 0-3% annual loss, one tranche exists called the Equity Tranche that is the first to suffer losses should any of the 125 companies default. Another tranche called the Junior Mezzanine Tranche pays off all annual credit losses between 3-7% of the pool. 7-10% losses are borne by what is called the AAA Tranche; 10-15% losses are the responsibility of the AAA+ Tranche; and 15-30% losses become the responsibility of the "Junior Superior Tranche." A final 30-100% Tranche exists that nobody apparently ever trades since it is so hard for anyone to imagine 30-100% of large-cap corporate America actually defaulting at the same time.

Institutions now actively trade one tranche versus another, one popular trade being to sell the 3-7% tranche against buying the 7-10% tranche, thereby allowing one to generally pocket the premium difference between these tranches as an extra annual yield pick-up, with capped maximum risk that only kicks in after an initial default cushion region. It would take an extreme market where four or more of the pool constituents default in a given year for the seller of such insurance to start suffering.



It is a fact that the "new new thing" in the hedge fund world is the Credit Default Swap market, and hedge fund managers have already built entire multi-billion dollar hedge fund offerings around the trading of Credit Default Swaps. CDS structures are also actively used by other strategies such as convertible bond arbitrage and long-only investment managers and bankers who may want to hedge against a credit widening in a given debt issuer or the entire market. We do not want to imply that these are "evil" instruments. They are not – they have a clear hedging usefulness.

The problem though is that when a major investment bank holds a focused hedge fund conference where one can choose among 20+ credit derivatives managers, <u>this is likely the one exact strategy area that one should avoid like the plague</u>. Whatever is being handed out on a silver platter and so easily found is likely not a good investment. Strategies that are much harder to find – say good short-biased hedge fund managers, or natural resource-oriented hedge fund managers, or managers that might actually benefit from a credit spread widening – are instead areas where one should likely be focused. Only in few years time, when investment banks are holding their first-ever "Short-Biased Hedge Fund Manager" Conference, will it be appropriate to potentially change this thinking.

A second problem that people forget about is that credit defaults are built around whether certain ISDA default definitions are triggered or not, with a huge amount of money often hanging in the balance around mere legal verbiage. But unlike Smarty Jones' recent romp in the Preakness that was definitive and clear, credit default events can easily end up more muddied. Potential conflicts of interest abound. A bank can easily take what is in actuality a restructuring of a problem loan (a technical default), and call it instead a loan repayment and new debt issuance -- thereby avoiding a CDS trigger event. What would happen in such an instance if a bank were also found to be short CDS contracts on this issuer, thereby benefiting its own position? One can easily imagine lawsuits flying, with the general collection value of CDS contracts suddenly being discounted.

In other words, just as the U.S. government systematically underestimates inflation in its calculation of the CPI Index, thereby negatively impacting the yield payoff to TIPS holders, bank consortiums hold most of the cards in the workouts of problem corporate debts. If it behooves the lead bank of a credit workout to avoid a CDS trigger event, then that bank can likely structure the work-out verbiage on a given event such that someone economically impaired by a company's fall from grace may actually collect very little (if anything) from the supposed insurance. People only presume that the major banks will act with some honor in such situations and be self-policed by their peers. But when enough money is potentially hanging in the balance, will they?

A precedent already exists that suggests not. In the 1998 Russian ruble devaluation and debt default event, many banks such as SG and Credit Lyonnais failed to honor currency "non-deliverable forward" contracts because of small legal verbiage that said such contracts were not valid "if any bank branch anywhere in the world were impinged from sending rubles out of Russia." Lawsuits remain outstanding on these contracts today.

Since 2000, ISDA has worked diligently to tighten CDS contract language after certain events surrounding Conseco's default proved past credit default definitions to be more "gray" than "precise." Notwithstanding, the entire payoff of CDS contracts remains based upon whether a binary credit event takes place or not. Unfortunately the world remains a non-binary one, and any time that the transfer of a large amount of money hinges around a single legal document and a single event, it is our experience that litigation risk in collecting on that legal contract is usually underestimated.

Other litigious events may hold an example. Was the 9-11 attack one event or two? No one ever worried about such a question before the WTC attack occurred. Elsewhere, if it could be shown that banks acted in bad faith when initially issuing Enron debt securities, was the AAA insurance wrapper offered by companies like AIG around these securities valid or not? Few of course worried about such a question when buying these securities – after all, these bonds were simply sold as AAA-guaranteed.

Some small legal nuances like these – nuances mostly ignored or unknown today -- undoubtedly still linger under CDS contracts. We will thus not be surprised to see a massive legal food fight on CDS contracts somewhere down the road.

A final problem was also blithely ignored by the speaker at this recent conference – a problem that revolves around the fact that banks now hold 60% of total credit outstanding in some form of mortgage-related debt. Given this fact, if either of two large specific credits --- namely, Fannie Mae and Freddie Mac – ever were to get into substantive financial difficulty, a variety of financial institutions could find themselves in deep financial trouble. Thus the question may be asked: What is really the value of buying credit protection from an investment bank on the debt of some other entity if the investment bank itself could become credit impinged? Even if one took the added precaution of buying CDS protection on the investment bank itself, the question would still remain: From whom could such protection be bought today that would still honor it if Fannie or Freddie were to fall from grace? During a Fannie or Freddie-related credit default accident, all banking institutions would likely find themselves severely impaired and cry Force Majeure.

We do not want to sound like a "doom and gloom" banking-crisis pundit, but we honestly believe such "Iceberg Risk" is consistently underestimated.

And yet there are still other examples of what can go wrong in the mortgage market that few think about. Here's one: Homeowners in California generally cannot buy earthquake insurance, and yet Fannie Mae still underwrites the mortgages of these homes. One major earthquake, and puff—Fannie could become the largest U.S. landowner as keys are handed in on homes that no longer exist. At an 80-1 asset to equity ratio, Fannie would also undoubtedly become liquidity impaired. Even if Freddie Mac and Fannie Mae were eventually to be bailed out by the U.S. Government during such a period of financial stress, the path getting to that point might first bury many other financial institutions.

With the above discussion as a backdrop, we show an updated chart of Fannie Mae below. It continues to hang precariously on the edge of a 10-year uptrend line. If this chart were to suddenly break this uptrend line, a swift move toward a 38.25 target would be in the cards. In general, if there is any single trendline break that could precipitate an overall equity crash environment, the chart below is it.

Meanwhile other financial companies such as levered Bermuda-based re-insurer XL Capital also appear dangerously near the edge of a trendline break.

Another company, Ambac -- which as its core business provides financial guarantees to municipalities, school districts, hospitals, health care organizations and asset-backed issuers -- also looks to have left horrific oscillator divergence on its last thrust higher. Could there already be some sort of financial accident looming behind the scenes for some of Ambac's customers courtesy of the recent bond market plunge?

Meanwhile, our previous bearishness on Citigroup has also recently been rewarded. Based on the hourly chart of Citi shown below, a price toward 40 should soon be seen before any substantive relief bounce.

Given such chart patterns within the financial sector, we do not see the small rally in the broader equity market indices that transpired Wednesday through Friday of this past week to likely represent any sort of significant equity market low. While we do believe that the bond market decline is currently petering out, the equity market decline may still have a significant leg down to go.

Among the major indices, the Dow Jones Transports (see next page) looks particularly poised to us for a downside plunge. The DJTA pattern specifically resembles that of the 1929 and 1987 crash charts, even if the DJTA has already passed beyond the 34-day count at which time these other charts accelerated lower.


$TRAN - Dow Jones Transportation, Daily
05/14/04
O: 2859.2200 H: 2868.1500 L: 2828.0500 C: 2848.8899
-10.9101
1.000 (3090.1000)
0.910 (3027.5158)
0.764 (2926.2848)
0.618 (2825.0538)
0.500 (2743.1809)
0.382 (2661.3080)
0.236 (2560.0770)
0.090 (2458.8460)
0.000 (2396.2618)
3100.0000
3007.6644
2900.0000
2800.0000
2700.0000
2600.0000
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Jul Aug Sep Oct Nov Dec 2004 Feb Mar Apr May
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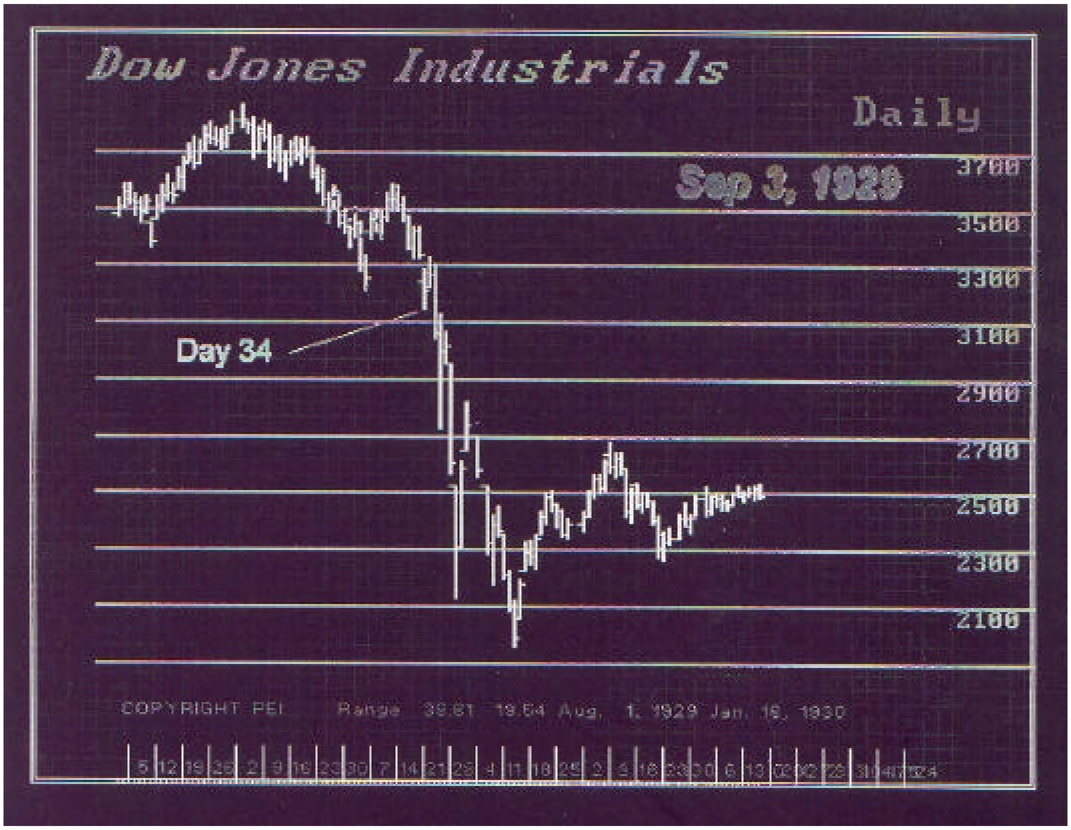
Day 34
The 1987 Crash
Dow Jones Industrials
2,800
2,600
2,400
2,200
2,000
1,800
1,600
150
100
50
0
Millions
Jun Jul Aug Sep Oct Nov Dec



Of course, other indices such as the Russell 2000 and Value Line Index have only just begun declines as of an April 5th high. The 34-day count to potential acceleration for these markets still potentially lies in the future. As this paper is written, 28 trading days have specifically transpired since the all-time high in the Value Line and Russell 2000 indices. 34 trading days will only come as of May 24th.

In all probability, the current equity market decline will simply continue a slow sloppy decline into our expected August 2004 low.

But could the market suddenly accelerate lower into a mini-crash? You bet it could, and we do not want to bet against this path in any manner. Subscribers should not try to pick bottoms on the equity market for now. Even previously espoused support at 1065 could give way in a flash, and prices on the S&P nearer 1010 or even the mid-990's quite quickly seen.

Send us your comments at information@Sandspring.com.

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