Markit Recap – 12/15/2014

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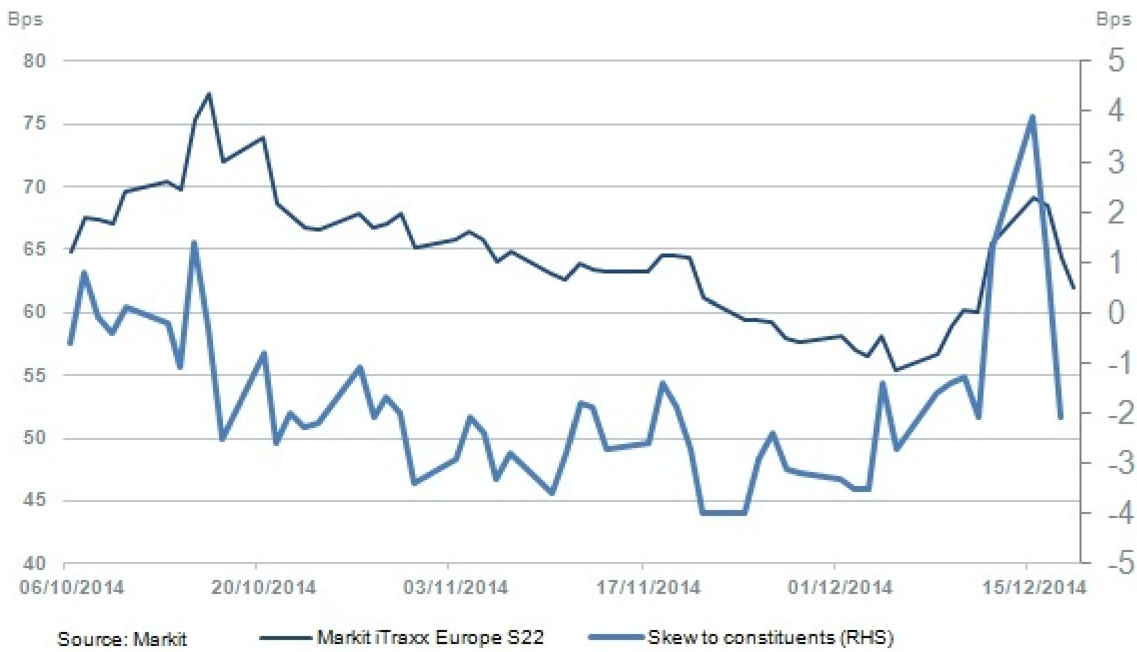
If one were to look at the week-on-week change of the main credit indices, it would be perfectly understandable to assume that it was another uneventful few days in the markets. The Markit iTraxx Europe was trading at 61.5bps on December 18, just 1.5bps wider than the previous week. The Markit CDX.NA.IG was 3bps tighter at 66bps over the same period.



But an assumption of docility would be mistaken. Volatility has returned and the indices have seen large swings, particularly in high yield. The Markit iTraxx Crossover was trading at 336bps on December 11, widened beyond 400bps on December 16 and then two days later it was back at 336bps. Even though it is investment grade, the Markit iTraxx Europe is traditionally the most volatile index due to its status as the instrument of choice for directional macro trades. The VolX Europe, which tracks investment grade realised volatility, moved above 50% after falling to 28% earlier this month.

The unpredictable trading climate has produced some unusual phenomena beyond the headline figures. The skew to the underlying constituents for the Markit iTraxx Europe has been negative since the roll in October, ie the theoretical level of the index was wider than the traded level. Volatility observed this week caused that relationship to change, albeit briefly. The skew became positive, and on December 15 it was as high as 4bps. Positive skew was also seen during the volatility spike in October, though it wasn't as large. This indicates that risk aversion triggers flows into the most liquid products – the indices – and pricing dislocations often occur as a consequence. If volatility subsides going into year-end, we can expect the normal relationship to resume.

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