

Everything You Wanted to Know About Credit Trading but Were Afraid to Ask

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Markets have become far less volatile than last year, but many investors remain focused on the credit markets for signs and cues regarding the next move. With so many people looking for moves in credit markets and trying to determine how successful auctions have been, I thought it would make sense to go through some examples of how credit trades. At one extreme you have a real market (like the E-mini S&P futures). That trades from Sunday at 6pm EST until Friday at 4:15 EST. It is virtually continuous and at any given time you can see the bids and offers for the entire market. Then you have credit trading, which has almost nothing in common with ES futures and their incredible liquidity and transparency.

I will look at some examples of a European CDX Index trade, a single name CDS trade, what an investment grade bond new issue looks like, and how a block trade in high yield bonds works. These examples aren't quite meant to be the norm, but in spite of being simplified with some slight embellishments, they are pretty typical.

This is a work of fiction and none of the banks or people mentioned represent real banks or individuals.

An hour in the life of the MAIN CDX Index in Europe.

Cast of Characters

- **MAIN CDX Index**
 - This is a CDS index with 125 reference entities. They are all European investment grade credits (a mix of corporates and financials).
- **Market Makers**
 - Big Axed Bank: This bank is a major dealer and for some reason (positioning or client flows) it is currently an "axed" buyer of MAIN.
 - Big Bank 2: A strong market maker and liquidity provider in MAIN but currently indifferent on the market.
 - Weak Bank: A marginal player in the market trying to retain a presence because they feel that they need to be in the business.
 - Interdealer Broker: Not really a market maker, but not really a client either. They only trade with market makers (market makers only trade with each other through an interdealer broker).
- **Clients**
 - Aggressive Hedge Fund: Looks for opportunities to push the market and profit from making the market "more efficient."
 - Fast Momo Fund: A fund that is very momentum driven and is fast to react to quick/small trades.
 - Slow Momo Fund: Looks for trends to develop a bit longer before making decisions, especially in credit where they have less experience.
 - Caught Short Fund: This fund is positioned to short the market with tight stops.
 - Bank Hedger: This is the desk responsible for hedging a bank's exposure to credit across all products.

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Initial Runs or Prices

Each dealer sends out runs via Bloomberg and updates their “screens” for clients.

Big Axed Bank goes out with 155.5/156.5 and updates their client screen with that price. They also put up 155/157 on the Interdealer Broker screen just to get something going “in the street”.

Big Bank 2 goes out with 155/156. They hear that it is better bid away, but with stocks stable (and if anything ticking up a bit in spite of mediocre data), they are more likely to be sellers than buyers. They decide to join the bid on the broker screen mostly because they are bored and doubt that they will get hit since they are second bid (but figure that it will mess up the better bid that is out there).

Weak Bank also goes out with 155/156. They checked with some of their “run monkeys” and get color on where everyone else is. With the stability in stocks, 155/156 is far safer than going out with 155.5/156.5, though they are a bit scared that if they get lifted, they can’t immediately cover in the street.

The First Trade

The aggressive hedge fund sees all three screens. He is curious why Big Axed Bank is so well bid. It seems a bit aggressive, especially with stocks ticking up in spite of weak data. He gets on the phone with his salesperson at Big Axed Bank:

Aggressive Hedge Fund (AHF): Hey, how’s it going? You guys seem axed to buy MAIN, anything going on?

Big Axed Bank Sales (BABS): Nah, I was already checked by someone else. Trader wants to clean up a small position. Thinks it might go tighter but just wants to book some profits.

AHF: How much is he looking for?

BABS: I can ask, how much are you looking to do?

AHF: I’m just checking some other positions, but probably not too much if I have anything to do.

BABS: Trader said that he was really looking for \$100 MM, but would take \$250 MM for you if he had to.

AHF: I’m not sure that I have \$250 MM to go, but what size would take him out? Last thing I want to do is hit him and have him leave it bid.

BABS: \$150 MM would take him out.

AHF: Done, I will sell you \$150 MM at 155.5.

BABS: Done, thanks for the trade.

The Next Trade

Big Axed Bank refreshes their screen at 155/156 and sends out a run posting the trade and refreshing the market via Bloomberg as well. While this is occurring, AHF is quickly hitting the 155 bid Weak Bank had up on their screens. The screen only worked for \$100 MM, but AHF sells \$100 MM at 155 electronically. This leads to a quick call from the Weak Bank salesperson to thank them for the trade and confirm that it is done. A junior trader at AHF asks the senior trader why he didn’t sell more at 155.5 to Big Axed Bank or why he didn’t hit Big Bank 2 at 155 since they do a lot more business with them than Weak Bank. The senior trader just rolls his eyes and explains that he knows Weak Bank has

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no tolerance for risk and would immediately offer it out in an attempt to make a quick profit. Although Big Axed Bank had told him that they were out of the axe, he didn't think selling them much more at 155.5 or even 155 would have scared them at all. Big Bank 2 also has enough strength that it might have taken a lot of size to move them off of their bid. Weak Bank is already scrambling to cover.

Sure enough, Weak Bank immediately refreshes their screens at 154.5/155.5 and updates their Bloomberg distribution with the post that it traded down. They also put in a 156.5 offer on the Broker screen. The Broker screen had been 155/157 with 2 guys on the bid. Weak Bank gives them the 156.5 offer (which is higher than where they are offering it to clients) in the hopes that one of the bids steps up to 155.5.

Now It Gets Interesting

Both Big Axed Bank and Big Bank 2 are immediately posted by friendly clients that it traded down at 155 away. Big Bank 2 immediately refreshes his price as 154.5/155.5 for clients and pulls his "street" bid on Broker Screen from 155 to 154 since he really doesn't want to get hit by another dealer.

The trader at Big Axed Bank puts all of his skills to work. While screaming at the salesperson who covers AHF and asking what is going on/if it's his client spraying the street, he is sending out a fresh price of 154.5/155.5 and yanks his bid from the broker screen in disgust. The salesperson who covers AHF comes over and quietly explains to the trader that there is no way AHF is spraying the street (that's not how that account behaves), and that even if they did, they would never do it to us since we are friends. We were out last week at that new restaurant, he loves us, and he was just trying to throw us some business. If anything, he was just helping out since you were axed, so relax. It definitely isn't our guy out there messing around, besides stocks are ticking up a bit so someone else probably decided to sell some here too.

Weak Bank is getting a bit nervous now. The "street picture" went from 155/157 with two guys on the bid, and now it's 154/156.5 (his offer and only one bid). He picks up the phone to talk to his broker at their Interdealer Broker.

Weak Bank Trader (WBT): What is going on, where did the bids go?

Broker 1: Hey mate, how are you? What are you thinking here?

WBT: What am I thinking? You had two bids that you lost. Why should I ever use you all if you can't keep your markets together?

Broker 1: C'mon mate, you know how hard it is with these screens, let me give them a ring and see if we can get them back, I'm sure we can.

WBT: Fine, just do it. (Hangs up the line).

Broker 1 (Turns to the other guys on the desk): C'mon, get those MAIN bids back. We haven't done a trade all day, and I can smell this one. I can tell the guy at WBT got hit and has to get out. His boss is already probably freaking out on him since he's had the position for 12 seconds (laughs and shakes head), so let's get those bids back and make some money.

The brokers call their traders at the two big banks seeing if they can get their bids back. The trader at Big Axed Bank is mad at himself for leaving money on table and just to share the misery decides to pull his bid completely and actually put up a 156 offer, undercutting the other offer for no reason other than that he is annoyed at himself for paying 155.5 when suddenly the market feels well offered. He

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leaves his price at 154.5/155.5 for retail.

Big Bank 2 sees the street suddenly go offered and decides to play it safe. He refreshes his price to retail as 154/155.

Another Player Gets Involved

Fast Momo Fund has seen stocks tick up and watched 155.5 and 155 get hit in MAIN. He watches stocks continue to tick up and is thinking that selling MAIN could be a good trade. Then his screen flashes as Big Bank 2 pulls back to 154/155. He reacts quickly and hits Big Axed Bank at 154.5 before that bid disappears. As he confirms with the salesperson that his trade is done, he smiles as he notices that Weak Bank had already refreshed as 154/155 (what a joke, he thinks to himself).

So now Big Axed Bank paid 155.5 for someone to cover an axe and is short at 154.5. Weak Bank is short at 155 and thinks that it may have traded tighter than that, and can't find a decent street bid to get out of his position. Aggressive Hedge Fund got a block off at 155.5 (and another piece at 155) and knows that it just went down at 154.5 so he is feeling good about his trades. Fast Momo Fund is long at 154.5.

Price Action and Weak Hands

Each dealer is now out 154/155 to their clients. Big Axed Bank had started the day well, is annoyed for leaving money on the table, but isn't particularly worried about having been hit at 154.5. Big Bank 2 hasn't done a trade and is kind of happy, and still doesn't really have a strong view, but his thinking is that he will be a buyer soon. The Weak Bank trader is freaking out a bit. His best case now is breaking even if he can get lifted at 155. Interdealer Broker is having a rough day. Somehow it went from two bids (and a chance of a trade) to nothing. They now have 2 guys sitting on 156 offers without a bid, and they know that Weak Bank would improve their offer if they could get a good bid.

Slow Momo Fund can't help but notice the price action. They call each of the 3 market makers and see if anyone will step up and pay them 154.5 for MAIN. All of the dealers just repeat their 154 bid and ask for orders. He doesn't feel like leaving an order on the table (since if it starts going wider, his whole momentum trade is pointless). He is thinking about holding off for now, but then sees S&P futures tick up 1 point and decides that he better smack a bid in case the U.S. comes in and takes everything higher and tighter. Since he had been on the phone, he calls back Weak Bank and tries to sell them 154s on MAIN. They flake, the salesperson claims that they are 153.5 bid best now, and the trader at Slow Momo Fund winces as he sees the Weak Bank Screen refresh as 153.5/155. He quickly hits the 154 screen bid at Big Bank 2 and wonders why he ever tried to deal with that flake at Weak Bank.

Weak Bank is in panic mode. They are calling all potential buyers of MAIN to see if they can get out of this trade. They are willing to sell at 154.5, thinking that is an extremely good offer and losing a ½ bp isn't the worst thing in the world especially as they are getting some good flows and inquiry.

The Caught Short Fund is getting a bit nervous. They had it marked at 155.5 and now it just went down at 154. Worse than that, it seems like suddenly everyone is a seller. Maybe they should cut their losses and reload later? They are going to hold off for a bit, but are seriously considering cutting.

The trader at the bank hedging desk gets the call from Weak Bank. She is thinking that 154.5 sounds like a decent offer and that she might even be able to get the offer down a bit with the market feeling so strong. They are a bit underhedged, so this seems like a good opportunity to take off some risk. Just as she is considering the trade, her boss calls and explains that the market feels good, and he is worried about losses on the hedges. Exasperated, she tries to point out that if anything they are underhedged,

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so this move tighter is a good opportunity for them, and that so far the move seems isolated to the indices as neither the single name CDS nor the cash markets seem particularly strong. The all-knowing manager sitting in the corner office insists that the market is turning and that soon there will be some great bids for their precious bond and loan inventory and that he wants her to take some hedges off in advance of that. She is embarrassed and out of courtesy she calls Weak Bank back and explains that not only is she not a buyer of MAIN right now, but she would also be looking to sell some, and asks Weak Bank if they want some at 154.

Not only does Weak Bank not want any at 154, but they are also starting to panic. That small 155 trade from the morning is starting to look a bit ugly. They can't afford to let Bank Hedger trade away though (it would completely mess up their position), so they basically beg her to leave an order with them. They point out that they are a seller themselves and if they get lifted, they will sell some for her. She doesn't have a good feel about this but decides to leave Weak Bank with an order at 154.25.

The Capitulation

Big Axed Bank and Big Bank 2 are both 153.5/154.5 now. The Broker is now 155 offered (Big Axed Bank cut his own offer in further frustration at his dumb first trade at 155.5). The brokers are "discussing" how to get a decent bid back ("discussing" involves sitting around and calling each other a bunch of names and saying that the market (and the job) is ridiculous while lamenting that all the market makers are ungrateful).

Weak Bank sends out a Bloomberg message stating that they are an axed seller and have a block to go at 154.25. They figure that is the best offer by a $\frac{1}{4}$ bp and if they get lifted, they can probably convince Bank Hedger to trade at 154. They would lose $\frac{3}{4}$ of a bp on their original trade, but make back a $\frac{1}{4}$ bp on the order. Not good but not horrible.

The Caught Short Fund sees the axed seller message from Weak Bank. He knows how "weak" the Weak Bank is and has this gut feeling that they are going to have to get out of a position soon. He knows that if he calls either of the Big Banks, they are likely to flake, so he hits Big Axed Bank on the screens at 153.5. He's not happy, but thinks that it's the prudent thing to do (the market feels strong) and that he will be able to reload later.

Bank Hedger sees the 153.5 trade print and gives Weak Bank a fill or kill on her order. They can't fill her and worse than that, they won't even provide her with a bid! And sure enough the boss is calling, no doubt to see if she had sold any MAIN. Both of the Big Banks have refreshed their screens as 153/154, but she knows that Big Bank 2 hasn't been hit, so she calls them to see if they will match the trade away and take some at 153.5. The Big Bank 2s trader thinks about it and decides that the move is a bit overdone, so doesn't mind buying some MAIN here and Bank Hedger is a good and fair client so he will pay 153.5. Bank Hedger is happy (though happy isn't exactly the right word). She thinks that her boss is clueless, and they should have been adding to their hedge on this move rather than selling into it, but c'est la vie.

Big Bank 2 is feeling good about his trades. He owns MAIN down at 153.75 on average and doesn't see anything in the cash markets to justify such a big move. He is getting color that Weak Bank needs to get out of a position so he decides to mess around with him, plus he is annoyed with his Interdealer Broker constantly bugging him for a bid. He decides to "fix" that problem and gives the Broker 151/154. The broker kindly thanks him for the two sided market, knowing that the bid is not great and the rest of the desk is going to be angry about the improved offer.

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Weak Bank sees the street go 151/154. They hear it is 153/154 away at both Big Banks, but can't get that bid. They know that Bank Hedger sold some away (they don't know what level), but figure that someone has an axe. They wish that they had just bought more from her (this is really messing up their picture).

Aggressive Hedge Fund has seen almost no follow through in stocks, bonds, or single name CDS. The market is okay, but nothing special. He can see that Big Banks are both 153/154 and that Weak Bank is 152.5/154 right now. He saw their plea to find a buyer at 154.25 and decides that the time is right and calls Weak Bank's salesperson.

AHF: Hey, what do you think of the market here?

Weak Banks Sales (WBS): Feels strong, looks like lots of sellers of MAIN (then in a whisper) I don't think that our trader is happy about that trade earlier because we can't find any buyers.

AHF: Tell you what, since we did that trade, I shifted some other positions around (total lie) and could actually buy back the MAIN I sold earlier.

WBS: Really?

AHF: Yeah, where do you think that you could get it done?

WBS: I checked, the trader would sell them at 154, and I might be able to get him down to 153.75.

AHF: Might? What do you mean might? That is a bad offer. The guy who got hit at 153.5 is desperate to get out of them (total lie) and I'm hearing that it was a big seller who may have a lot more to do (total lie).

WBS: Let me see what I can do. What's your best?

AHF: I will pay 153.25. I'm pretty sure that I can get that done away in a heartbeat if you don't care, though I might hold off because it seems like this thing could run a lot tighter.

WBS: Fine, my trader can sell you at 153.25, but you have to keep us in the flows. This trade hurt, but I told him how important it was to see your flows and that you would work hard to make it up to us.

AHF: Sure, tell you what, I can source more of the bonds that I'm buying away (total lie), and could upsize the trade at 153.25. I have another block to buy, you want to sell those and increase the size of the trade?

WBS: Sure, let me check, yes, that's done. Thanks for the trades. We will do an unwind on our trade from this morning, and is that a new trade on the other piece?

AHF: I think that it might be an assignment. I have sold old hedges around, so let me figure it out and give you a name that you will face on that second piece.

WBS: Cool, thanks a lot, appreciate the trade and keep us updated. Glad we are getting business going.

As soon as he hangs up, he strolls over to the trader to explain how wrong the trader was about the client and how well this relationship is working. The trader can't understand why the salesperson doesn't think that the 1 ¾ bp loss isn't a big deal and so far, he hasn't made money on the short that he just put on at 153.25.

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The Reversal

Weak Bank puts in a call to Bank Hedger letting them know that they can pay 153 now. Bank Hedger is starting to get a little annoyed with Weak Bank and “congratulates” the salesperson for informing her that Weak Bank now has a generic bid. Just to make her day extra special, she gets a call from her boss. Not only doesn’t it look like they are going to be able to sell any of their cash inventory, but they are being asked to participate in a new loan, so they need to put that hedge back on. Then (a little sheepishly) he explains that management wants to run a completely hedged book, so he wants them to take advantage of the strength in the market to put on some additional hedges. Typical, she thinks, and then decides what to do. If Weak Bank is now a buyer, she knows that they won’t make a good offer since they don’t have the ability to take on much risk, let alone print her on a double trade. She calls Big Bank 2 and tells them that her boss changed his mind, and she wants to buy back the MAIN that she sold earlier and actually wants to buy an additional block. The salesperson is hoping that the trader will do it all at 153.5 so that his client doesn’t lose money on the first trade. The trader laughs and explains that the market is doing nothing, and if anything, it feels like buyers of MAIN are creeping out of the woodwork and he is considering moving the market back to 153.5/154.5, but he would sell the entire piece at 154. Bank Hedger decides that is fair and is almost happy to lose a ½ bp on the boss’s dumb trade idea just so he will keep his nose out of the day-to-day trading which he seems so clueless on.

A Quick Recap of What has Gone on so Far

Aggressive Hedge Fund sold MAIN at 155.5 and 155 and covered the entire piece at 153.25 for an average profit of 2 bps on two pieces.

Fast Momo Fund is long at 154.5.

Slow Momo Fund is still long at 154.

Caught Short Fund closed the short at 153.5, but is getting a bit nervous that he covered too early especially since he HATES the market!!

Weak Bank bought 155 and covered it at 153.25 for a loss of 1 ¾ bps and is now long at 153.25.

Bank Hedger lost a ½ bp on one block but now has added to the short on the day and is exactly where they would like to be from a risk standpoint.

Big Bank 2 bought a piece at 154 and 153.5 and sold it all back at 154, so it made a ¼ bp on average and is back to flat.

Interdealer Broker hasn’t done a trade and Big Bank 2 just pulled the 151/154 market and said that they were going to lunch.

Big Axed Bank covered their axe at 155.5 (a trade in which the trader is kicking himself). He is short at 154.5 and got shorter at 153.5, which is annoying, but not a particularly big concern yet since they did have buyers the previous day giving him the axe, but he definitely wants to sell some MAIN here rather than buying more.

Back to Unchanged

Big Bank 2 goes out 153.75/154.75 fresh. Still no strong view, and made a bit of money, but would prefer to buy some more MAIN rather than selling any here.

Big Axed Bank hears about the market away and guesses that someone just lifted 154, so goes out

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153.5/154.5 fresh as they are now getting too short and wants to make an offer.

Weak Bank can't believe that they sold at 153.25 and now seem to be getting topped and turned. They call their Interdealer Broker and beg them to get the 154 offer back. This time one of the brokers manages to convince Big Axed Bank to flash a 154.25 offer on the screen. Weak Bank lifts the 154.25. The broker pounds his chest and calls the rest of the desk a bunch of losers, and has the guts to ask each of the banks if they want to leave something on the follow. All he gets from Weak Bank is a click as the trader closes the line to think about what a miserable day it's been.

While joking around with the broker, Fast Momo lifts his 154.5 offer on the screen, taking him out of another block.

I hate these screens (he mumbles to himself) as he goes out 154/155 fresh. Big Bank 2 comes back from lunch and makes them 154/155 as well. Weak Bank goes out 153.75/155.25 and has no desire to sit there any longer. Caught Short regrets covering since he hates the market so much and comes back to lift 155 from Big Axed Bank. Slow Momo is annoyed, but decides to hold on for now. However, the market is back to 154.5/155.5 after starting the day at 155/156 (with a high print of 155.5 and a low print of 153.25).

What Can We Learn From this Series of Trades?

MAIN moved over 2 bps and not one single trade had anything to do with "valuation" or "fundamentals". Thinking that all moves reflect a change in fundamentals or a large scale change in risk positioning is just wrong in a market that is as illiquid as this (and MAIN is about as liquid as it gets in the credit markets).

Some clients are just as happy to keep CDS Indices off of exchanges as the dealers are.

The salesperson at Weak Bank will be annoyed that the trader is losing money and dropping his clients because of how will he get paid on the sales credits and keep his great relationships intact when the trader is so bad.

All market makers will go home cursing the screens and wondering why salespeople get anything when their clients just click on a screen.

The broker who got the trade done will go home thinking that it's better than the alternative ways of making a living and wondering if he should take the trader out to a match next week.

Aggressive Hedge Fund will go home and wonder when the Weak Banks will give up and why other funds spend so much money on research when it is all so easy. Caught Short will go home promising not to second guess himself so quickly. Fast Momo fund will go home breaking even, somehow feeling that they could have done a bit better, but not too upset since it was all just a guess and it hadn't worked out that badly. Slow Momo just wishes that this market would go back to trend following and has decided that the trade is actually not so much a momentum trade, but a view that the market seemed strong and fundamentals are better. He will keep the trade on since it should work out well over the next day or two.

Bank Hedger checks out the bank share price before heading home and can only think that the bank would be in a lot better shape if they didn't leave the idiots in charge.

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