Relative Value of Credit Default Swaps

We analyze the relative value of credit default swaps with the I2 incomplete information credit model developed in Giesecke and Goldberg (2004). Carry neutral portfolios constructed using a “rich-cheap” analysis based on I2 relative value forecasts generate significant positive returns. Further, the analysis identifies outliers that may be elements of a capital structure arbitrage strategy.

Our forecasts rely on the cross-market calibration capabilities of I2, which is a first passage structural model driven by two risk factors: firm value and firm leverage. As we show empirically, the default swap market spreads incorporate these risks differentially over time, by industry and by coarse quality. The I2 model parameters exhibit a strong temporal dependence that mirrors the market.

The material presented in this talk was developed in collaboration with Rajnish Kamat and Vijay Poduri.