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Testing for Statistical Arbitrage in Credit Derivatives Markets

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Abstract

This paper studies statistical arbitrage opportunities in credit derivatives markets using strategies combining Credit Default Swaps (CDS) and Asset Swap Packages (ASP) by means of an improved statistical arbitrage test. Using four different databases (GFI, Reuters, CMA, and JP Morgan) from 2005 to 2009, we find persistent mispricings between the CDS and ASP spreads of individual firms, which should be priced similarly, before and during the 2007-2009 financial crisis. These mispricings are more frequent in low credit quality bonds and appear to offer arbitrage opportunities. We also aggregate the firms' CDS and ASP in a portfolio and still find persistent deviations, mainly in the lower rated bonds. In aggregate terms the deviations from the parity relation can be explained from systematic factors such as financing costs, counterparty risk, and global risk. However, after considering realistic estimations of funding and trading costs, all these mispricings are unlikely to provide profitable arbitrage opportunities.

Keywords: Credit Derivatives, Credit Spreads, Persistent Mispricings, Subsampling.

JEL classification codes: C12, G12, G14.

1 Introduction

In this paper we analyze statistical arbitrage opportunities from a strategy involving two credit derivatives contracts: Credit Default Swaps (CDS) and Asset Swap Packages (ASP). A CDS is a credit derivative designed to transfer the credit exposure of fixed income products between two parties. The purchaser of the CDS makes periodic payments (CDS premium or spread) to the seller until the maturity date of the contract or until a credit event materializes. In the latter case

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