Twitter Thread by Tar ■

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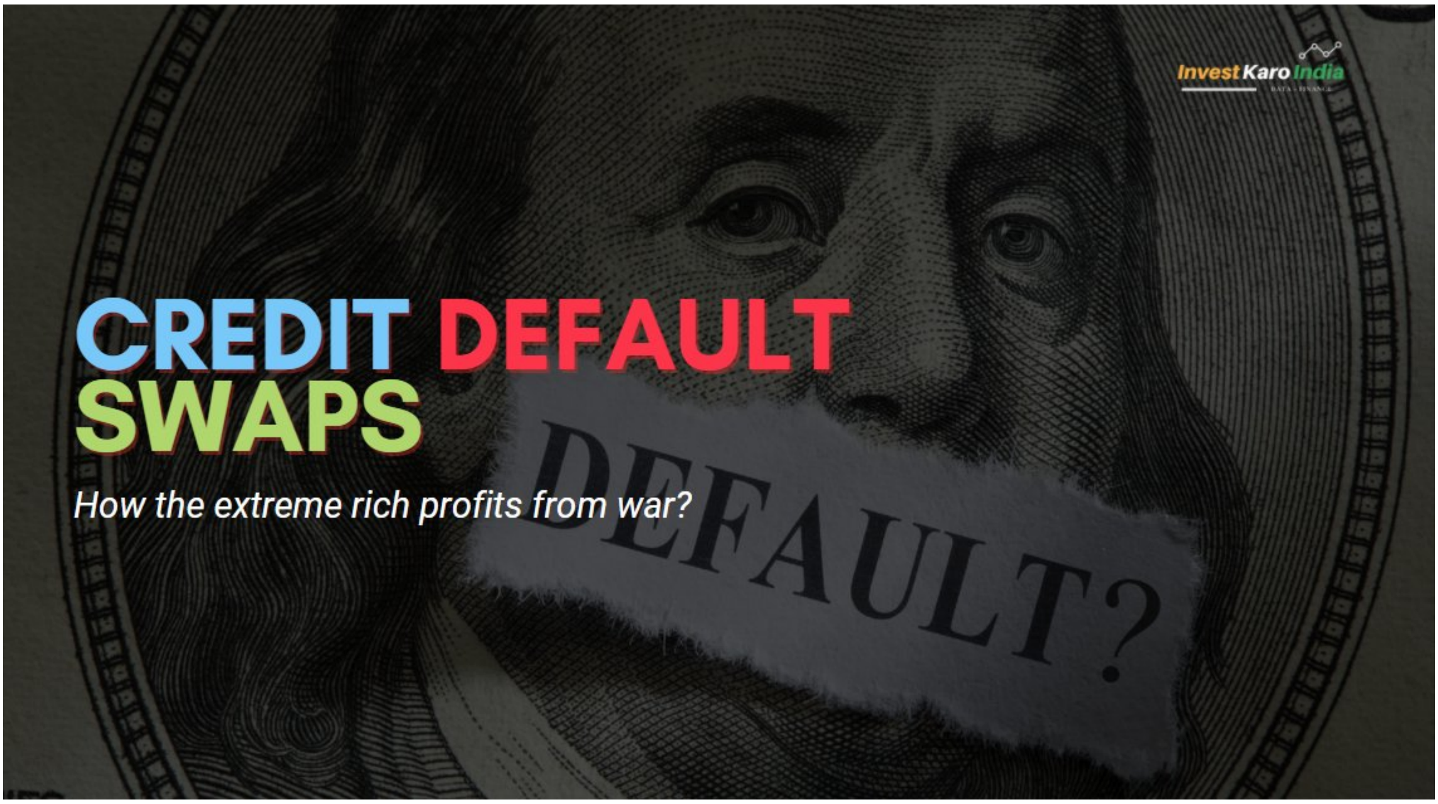
Amid the ongoing war, you would have heard Nickel rising by over 200%, Wheat by 80% and Oil by 50%

But did you know there is another asset class that rose by over 2000% since Dec

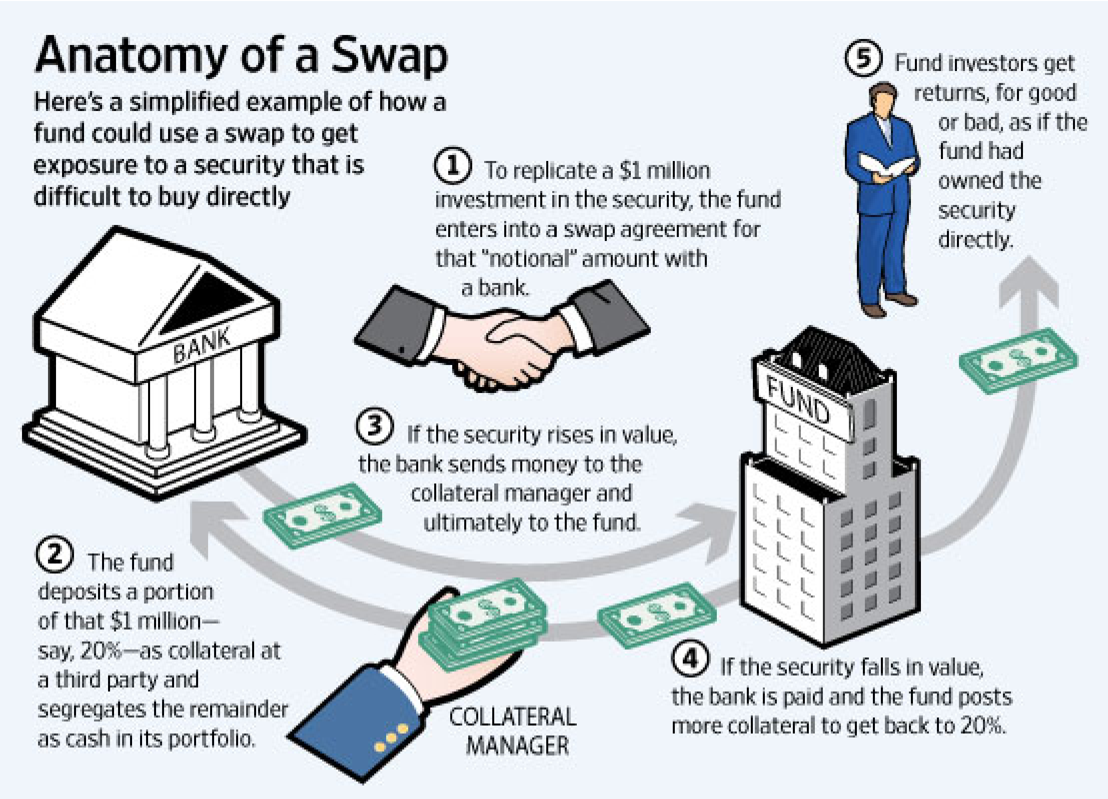
Todays thread is about Credit Default Swaps, an asset class only accessible to the ultra rich ■■



This thread is divided into the following parts

1. Basics & History of Credit Default Swaps
2. How Russian CDS rose over 2000%?
3. Why these instruments are limited to the ultra wealthy?
4. Can you profit indirectly from CDS?

Credit Default Swaps belong to a category of derivative products called Swaps.



Derivative products are usually of two kinds

1. Standardized Derivative Products like Futures and Option Contracts that are traded over the exchange

2. Non Standardized Over the Counter Products like Forwards and Swaps

Swap at its simplest is an agreement between two parties to exchange a series of cash flows for a set period of time

Swaps were basically invented to help large banks and companies manage their interest rate and currency exposures

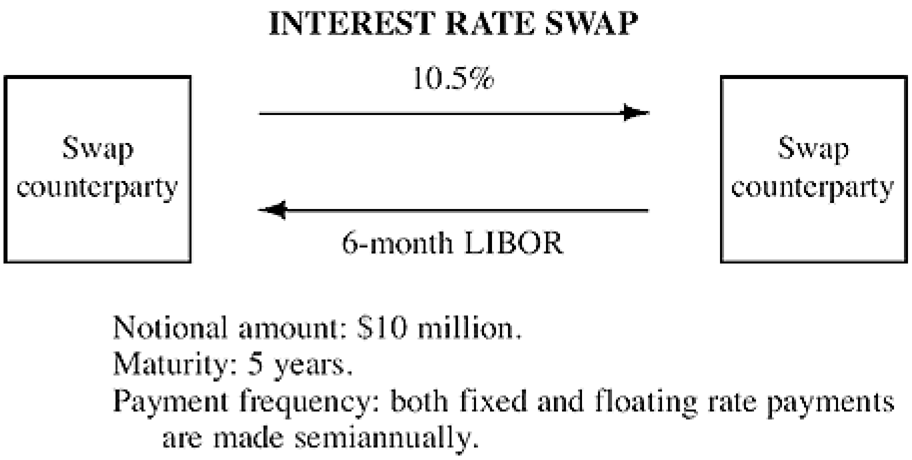
Take for example a bank that receives fixed rate interest on a bond

The bank expects the interest rates to go up and as such wants to participate in the upside by exchanging payments from the fixed rate bonds in its portfolio for payments from floating rate bonds

On the other side you have a risk averse bank that wants a fixed cash flow and doesn't want the volatility associated with a floating rate bonds

Two parties can get into a swap agreement, where Bank A will exchange cash flows from a fixed rate bond in exchange for the cash flows of a floating rate bond from Bank B

This agreement is know as a Swap and big financial institutions like GS, JPM etc. act as Swap Dealers.



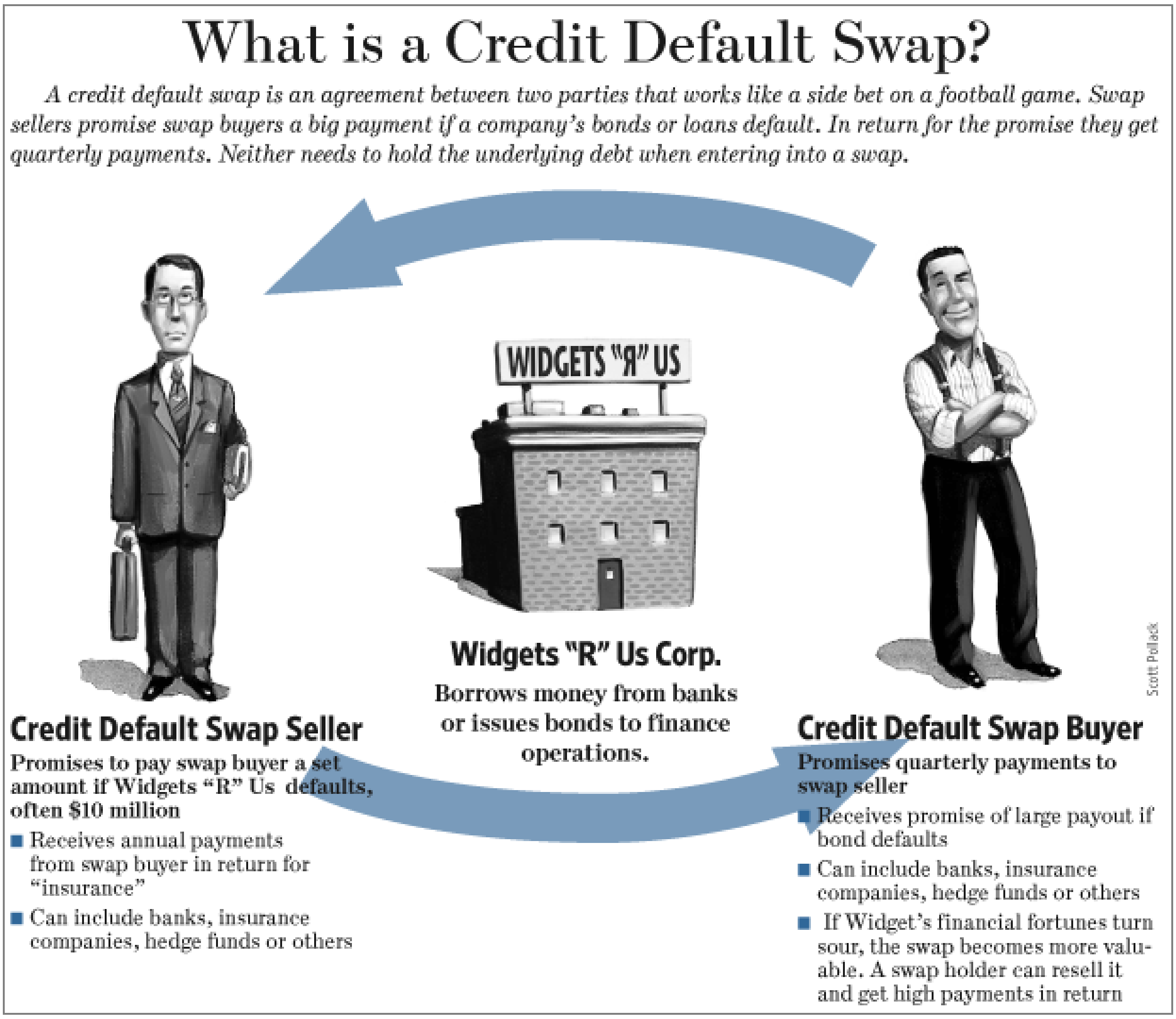
Here is the kicker, in real life, both the banks don't even need to hold these bonds and can just enter into agreements without ever buying the underlying financial instrument

These are called synthetic derivatives and its a multi billion dollar yearly market.

Its like gambling, only on a larger, legal and more sophisticated level.

I wont get into the technicalities of synthetic derivatives as it will get very complicated, but do Google them if you are interested.

Credit Default Swaps are a type of swap derivative instruments that let two parties bet on the credit rating and standing of a company or a country

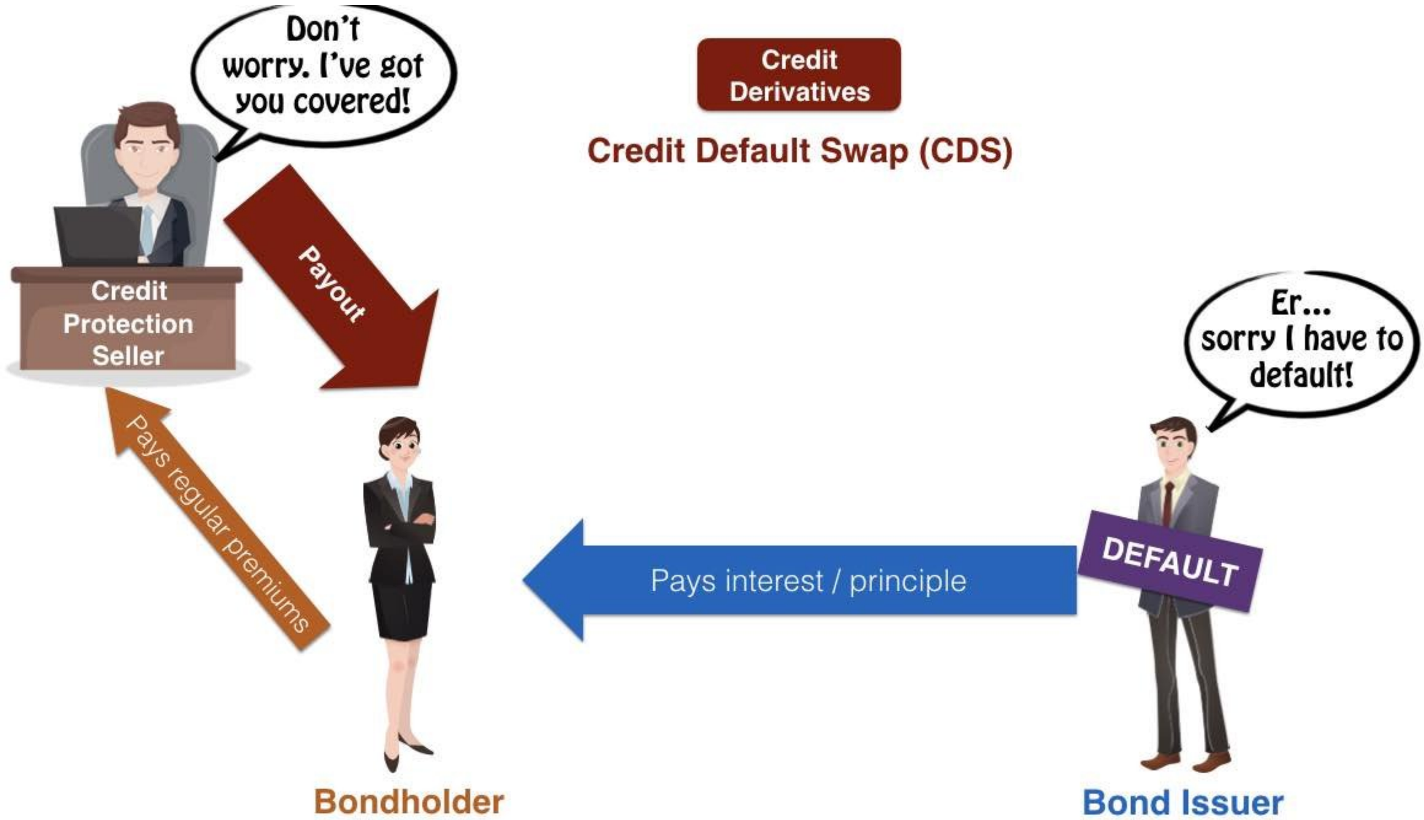


If you're rich enough and have one of the large investment banks as your broker, you can buy CDS on anything in the world as long as it has a credit history.

Think India's credit rating with fall? You have a CDS for that.
Think China's real estate market will collapse? You have CDS products for that as well.

Anything that has a credit rating in the world, has an equivalent CDS product for it as well.

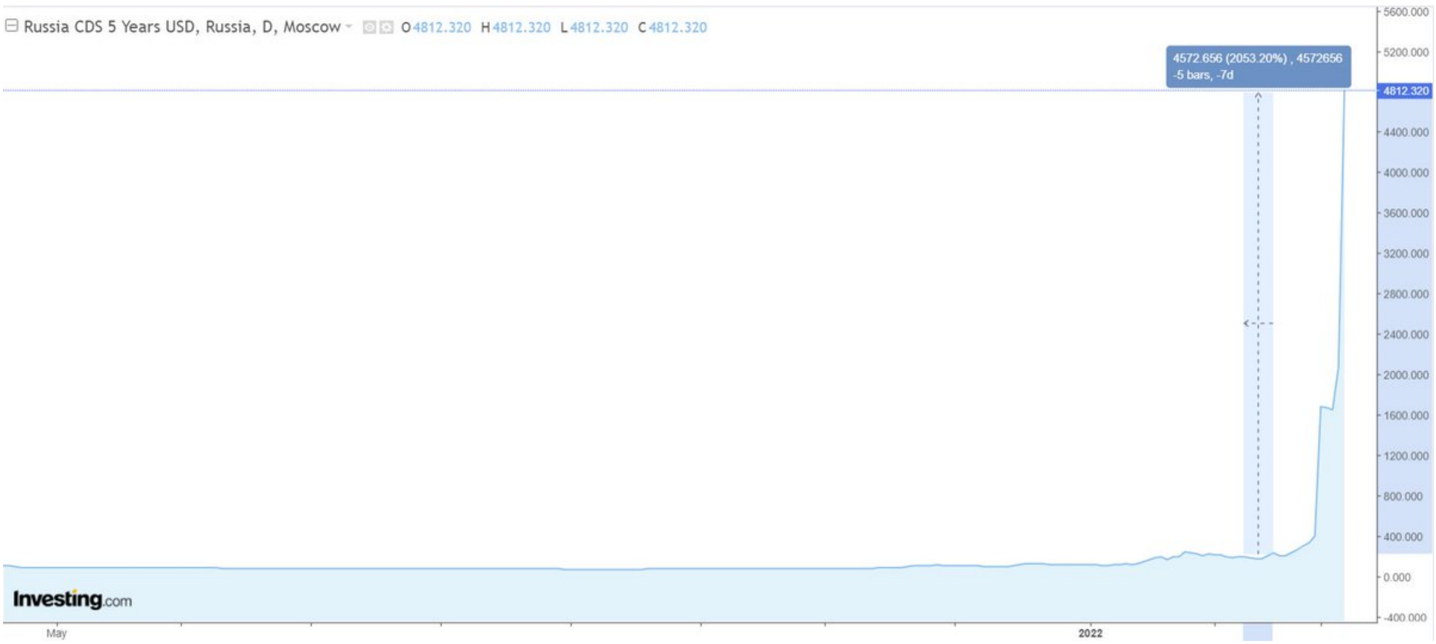
In a CDS agreement, the buyer pays a regular premium in exchange for a lumpsum payment should in case the underlying event occurs.



In our case, the ultra rich and giant banks of the world could buy a CDS on Russian Sovereign Debt which required them to pay a regular premium in exchange for a hefty payout if and when Russia's credit rating diminishes.

And that's exactly what happened.

When Russia attacked Ukraine in late Feb and the West started sanctioning Russia, the value of these CDS products sky rocketed, rising by over 2000% (20x) since their value in Dec.



So why are these products limited to only ultra rich, you ask?

Well, cause the governments around the world wants to 'protect' small investor interests and only allow smart rich accredited investors to invest in such complicated financial products.

These arent meant for dumb retail investors like you and me.

The world of finance is a walled off place that is meant to feel complicated so that insiders keep making more money and common crowd stays away.

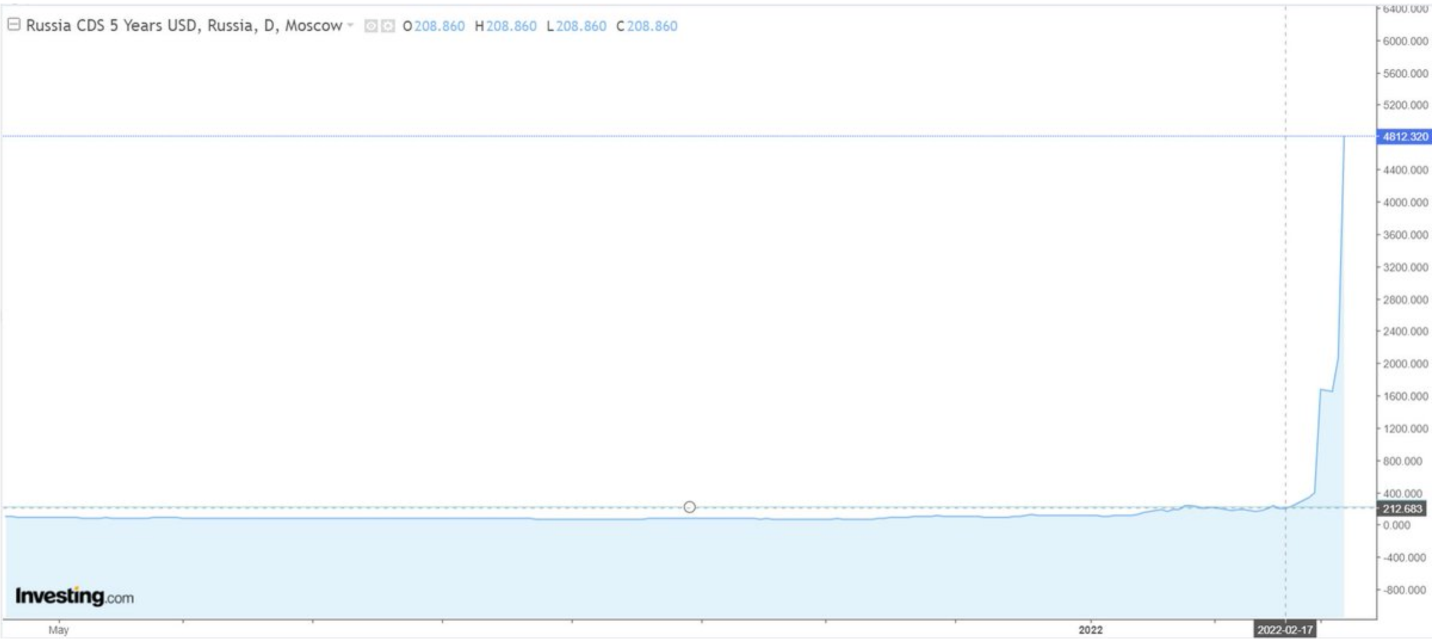
Its the same reason why there are so many jargons in this profession.

Okay, if we 'dumb retail investors' cannot participate in these CDS directly, can we indirectly benefit from it?

The answer is yes!

You see, Russia invaded Ukraine on 24th Feb 2022, but the prices of Russian CDS started moving up from 17th Feb itself.

The prices of these CDS rarely move up and to those who knew about it, this was a signal that an invasion of Ukraine by Russia was around the corner.



There are always signals in the market, someone somewhere always knows something relevant.

We just need to know where to look.

So that was a short thread on how CDS works and how maybe in the next macro event, you can leverage the CDS price data to identify the signal from the noise.

I do encourage you to learn more about CDS, the synthetic derivative market is a fascinating world.

If you find this thread useful then follow me @itsTarH

I write a new thread every weekend simplifying investing concepts.

All my previous work, can be found here.
https://t.co/sMnxlGcQ99

> All my Threads so far \U0001f9f5 \U0001f447\U0001f3fc
>
> — Tar \u26a1 (@itsTarH) June 5, 2021

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Here is my latest article on Delhivery ■

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