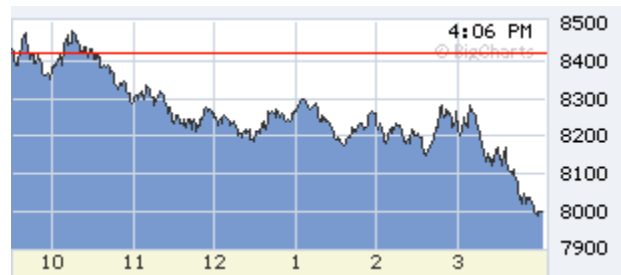


Four at Four: Don't Be A Hero

November 19, 2008, 5:00 pm

Posted by David Gaffen

The news of the day was hardly positive, what with poor housing figures, more worries about the automakers, and concern in credit markets, but the late-day implosion probably sparked more than a few corner-office types storming onto the trading floor and shouting to nobody in particular, "What the hell just happened?"



The collapse of major financial stocks —

Citigroup finished down 23.4% — served as one catalyst, along with massive widening in credit-default-swap spreads, an indication that the credit markets have bugged out again. The Federal Reserve's [minutes](#), released at 2 p.m. ET, added to the tumult, as the committee said it lowered its projections for economic growth for 2009, saying "the staff expected that real GDP would continue to contract somewhat in the first half of 2009 and then rise in the second half, with the result that real GDP would be about unchanged for the year." That's a nice way of saying the economy is in a recession and will be for the first half of the year — and truth be told, there's no visibility yet on the second half of the year. Meanwhile, all the "successful tests" of the various bottoms that the market had hit in the last month-plus went out the window, as the [S&P slumped](#), falling to 806.58, just off the day's lows and establishing a new five-year closing low. Thursday, stocks could gain 8% or something, but the pessimism won't be washed away. Investors are left waiting for the economic turnaround that appears remote. **"You need a lot of things and right now, you don't have it, so why stand in front of it? Why be a hero? That's what most people are feeling right now,"** says **Joseph Saluzzi**, co-head of equity trading at **Themis Trading**.

The market rout was concentrated in the financial names. The Financial Select Sector SPDR fund, which tracks the S&P's financial stocks, lost 11.15% on the day, led by heavy declines in [Citigroup](#), [Goldman Sachs](#) (down 11%), and [Morgan Stanley](#) (down 14.8%), and so go the financials, so goes the rest of the market, said Stephen Sachs, director of trading at Rydex Funds. "We're all comfortable with the government backing of Citigroup, but that's not going to keep people from continuing to punish the stock," Mr. Sachs says. Just 13 months ago (which feels like three lifetimes), financials accounted for more than 20% of the Standard & Poor's 500-stock index's market capitalization, the most of the 10 S&P industries. Now, it ranks fifth, having fallen to about 12% of the market cap, behind, in order, information technology, health care, energy and consumer staples. Traders said much chatter surrounded short-term debt owed

by Citigroup, which is, of course, usually not an issue, but in today's market, becomes something to worry about. The company's credit-default swaps, a measure of insurance cost against default, **rose to a cost of \$360,000 to protect \$10 million in bonds against default, compared with \$240,000 on Tuesday.** Citigroup's stock closed at \$6.40, lowest close since May 2, 1995, and it has given up 78% in this year alone. "It's yet another day where the world is ending," Mr. Sachs says.

Volatility, of course, is off the charts. **The Chicago Board Options Exchange volatility index, or the VIX,** closed at a ridiculous 74.26 Wednesday, and the result has been the



proliferation of two kinds of trades: very safe ones, or crazy bets that don't quite seem so ridiculous at this moment. Chris Jacobsen, chief options strategist with Susquehanna Financial Group, says people are using a lot of "vertical spread strategies," which involves buying and selling call and put options with the same expiration at different strike prices. "It mitigates the cash outlay, and allows for the lessening of costs," he says. On the other hand, more outlandish trades are finding their way into the market as well. Since it costs so much to buy calls or puts on S&P options, even those just barely out of the money, some people have been taking positions in the likes of put options on the S&P at 750. These are expiring at the end of the week and they're trading at about \$3, says William Lefkowitz, chief options strategist at vFinance Investments. A goofy bet like this would normally cost the buyer a nickel, because it's so preposterous. Not anymore. And there's more than token interest in deep out-of-the-money calls and puts on liquid, volatile names like [Apple](#), even with expiry on Friday. **"I used to be the big seller of these puts but I'm afraid to now,"** Mr. Lefkowitz says. "I generally like the guy who wants to bet on the one-day disaster problem, but I'm afraid now to write these way-of-the-money options on either side because of the volatility."



Meanwhile, there's apparently nothing to see here, according to Neel Kashkari, interim assistant secretary for financial stability at Treasury, who said today that "the combined actions of Treasury, the Federal Reserve, and FDIC have stabilized the financial system and prevented a financial collapse." Don't be so proud of this technological terror you've constructed, Mr. Kashkari. The key index of credit-default swaps that looks at investment-grade bonds **widened out to a cost of \$247,000 to protect \$10 million in bonds** for five years, according to Phoenix Partners Group, which marks an all-time high for that index. The commercial-mortgage markets are going nuts, and most other major credit markets are trading thinly. Investors trampled over one another to get a piece of the Treasury market, which is becoming increasingly difficult as time goes on. The 10-year Treasury rose 1-10/32 to yield 3.37% and the desire for the safest investment around is causing turmoil in the repurchasing market, where dealers borrow Treasuries from one another to cover positions. Normally, when a dealer borrows Treasuries from another, they lend cash in return, which is usually paid with an interest rate at around the federal-funds rate. Because the demand for Treasuries is so tight, the

borrower of cash is paying hardly any interest at all. “Everybody seems to be trying to get out of all the spread product they’ve been in for the last 10 to 15 years and get into something they know is going to be there,” says Thomas di Galoma, head of U.S. treasury trading. **“Even with the deficit growing and the bailout package as big as it is, there still doesn’t seem to be enough Treasurys to support all the demand.”**