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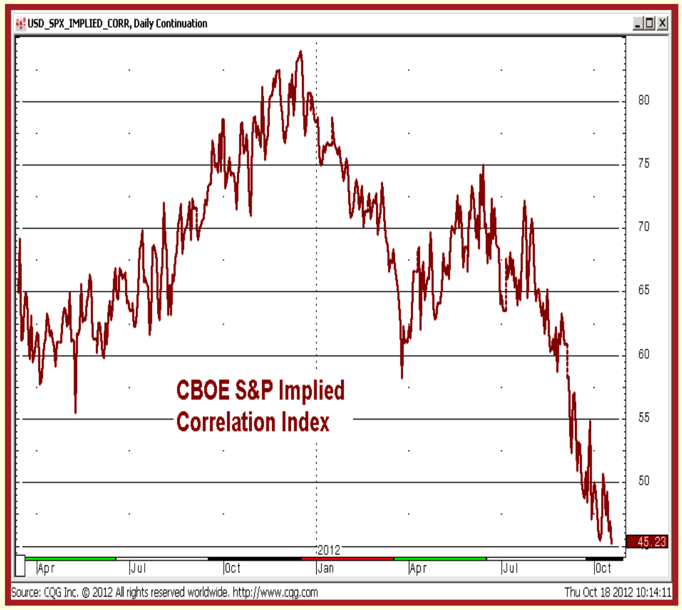
EQUITIES – Options Long-Term View

Implied Correlation

By Joseph Palmisano

The CBOE S&P 500 Implied Correlation Index is pushing to lows not seen since just before the implosion of Lehman Brothers in September of 2008. The Implied Correlation Index tells us what the options markets are implying will be the degree to which stocks (in this case, the 50 largest S&P 500 components) move together as one. Just as implied volatility is an estimate of what future volatility will be, so implied correlation is a prediction about likely future movements of stocks together. The lower the Index trades the more individual stocks and market sectors begin to move independently again. This would indicate investors are becoming more optimistic about the future of the economy. **The fact the Index is drifting toward the 40 area provides further evidence that investors are focusing more on individual companies and less on index-level risk scenarios.**



The biggest risk scenarios that have worried investors over the past several years have begun to fade: the European Central Bank's announcement late last month that it will purchase the sovereign debt of beleaguered peripheral nations, upon their request, through its Outright Monetary Transaction (OMT) program, and the fading prospects for a severe recession in the US along with additional non-standard monetary easing measures are at least seen as a stop-gap and have removed a great deal of tail risk in the markets.

This decline in the Index is important because high implied correlation was one of the lingering effects of the financial crisis. Elevated implied correlation among stocks had persisted well after other measures of economic and financial health, like credit conditions (TED spread) and equity implied volatility (CBOE Volatility Index (VIX)) had returned to pre-crisis levels. If QE3 is able to put a floor under the economy, we can expect equity implied correlation to decline further, which, on balance, is a good thing for investors. Our cycles call for equities and risk assets in general to head higher for several more months and we recommend the following options strategy to take advantage of the rally.

Buy 3-month 105% call on SPZ2, 0.75% with a strike at 1531. Spot ref: 1457