"Cheap Lottery Tickets": How To Make A 39x Return In Days As Debt Ceiling Crisis Looms

BY TYLER DURDEN

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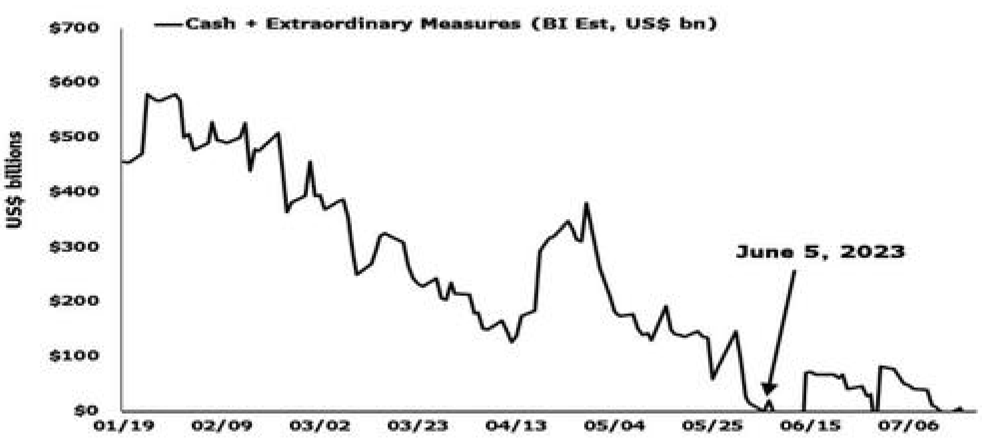
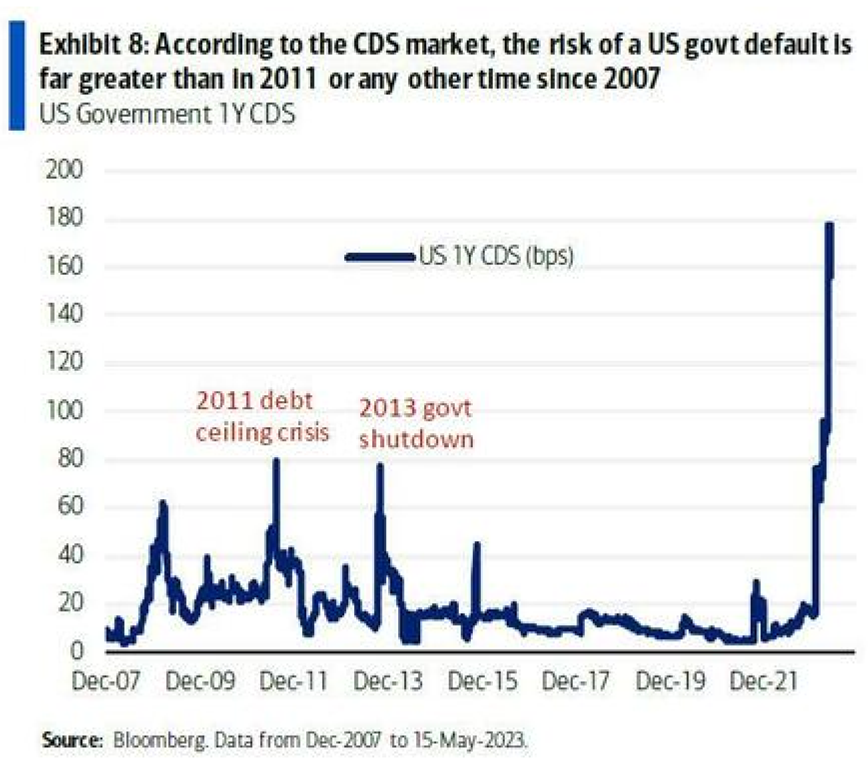
One week ago, we used a recent analysis by Bank of America's derivative strategists to lay out several cheap hedges for the coming debt ceiling crisis. But what if instead of merely hedging, one wishes to actually make a (sizable) profit from US profligacy and the coming technical default? Well, **BofA has a trade for that as well, one which has a payout ratio of up to 39x**... and best of all, the US doesn't even need to default: a mere repeat of the 2011 crisis will be sufficient.

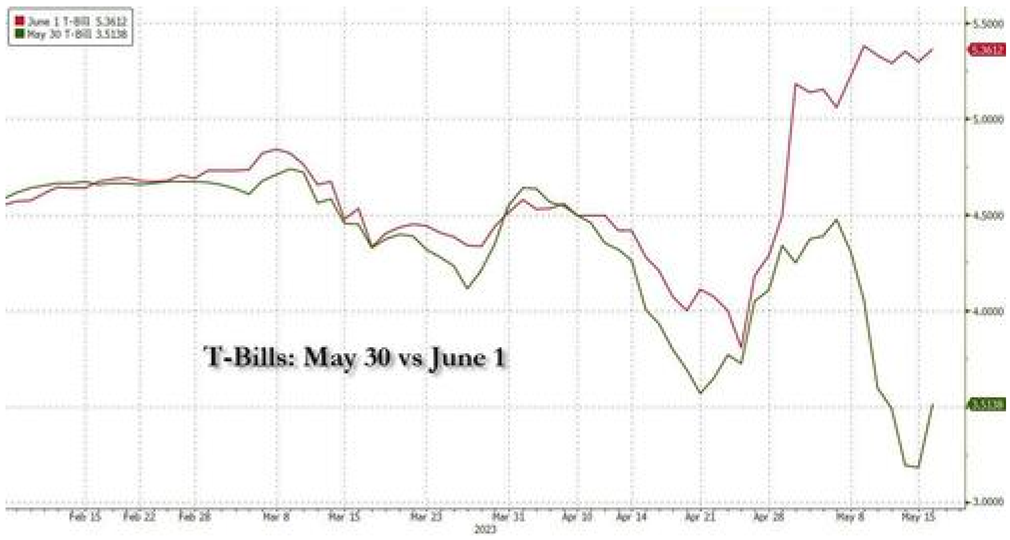
First some background: as BofA derivatives trader Gonzalo Azis lays out the situation, Janet Yellen's debt ceiling X-date of June 1st is fast approaching - as a reminder, Yellen may be off by a few days, but an early June X-date is virtually certain now...



.... yet many markets are still turning a blind eye... but not all: the markets most directly exposed to the source of risk, like the T-Bill and sovereign CDS markets, are showing clear signs of stress. In fact, the US govt CDS implies a much higher chance of default than it has since data starts in 2007...

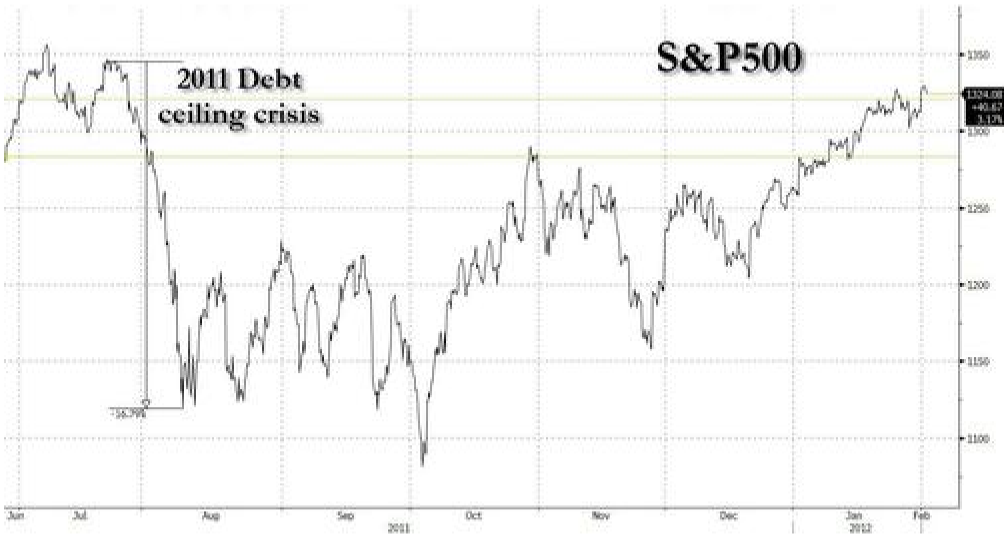


... while the T-Bill market shows a stunning break between paper maturing on May 30 and June 1, as bond traders freak out about risk of getting repaid next month.

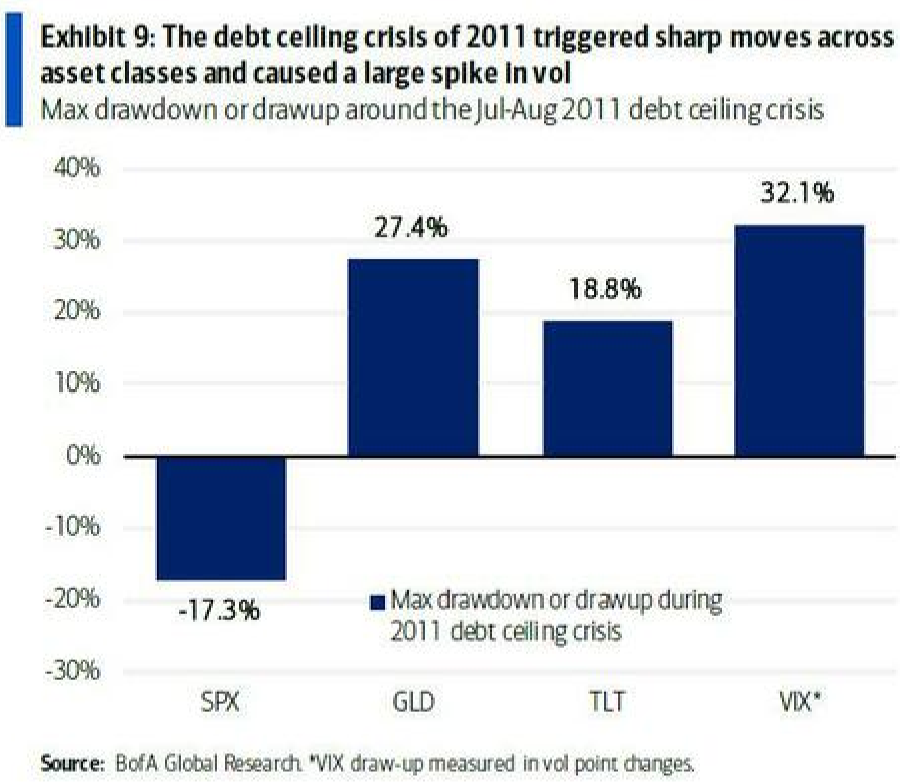


Remarkably, not even in the summer of 2011, when the US government barely avoided default and lost its AAA credit rating, did CDS contracts price close to as much risk as they are pricing today.

Similar to today, it took the stock market until the very last minute to finally freak out, but once it started all bets were off, with stocks eventually tumbling over 17% before taking months - to recover.

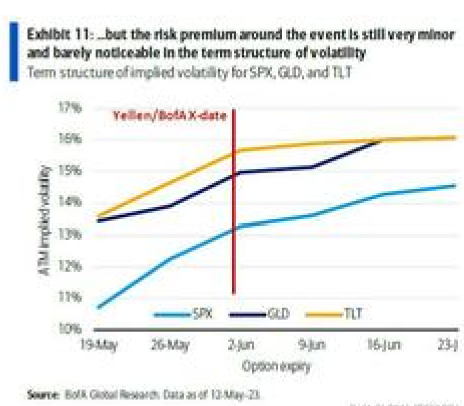


Indeed, the 2011 debt ceiling crisis triggered sharp moves across asset classes and caused a large, **belated** spike in vol.

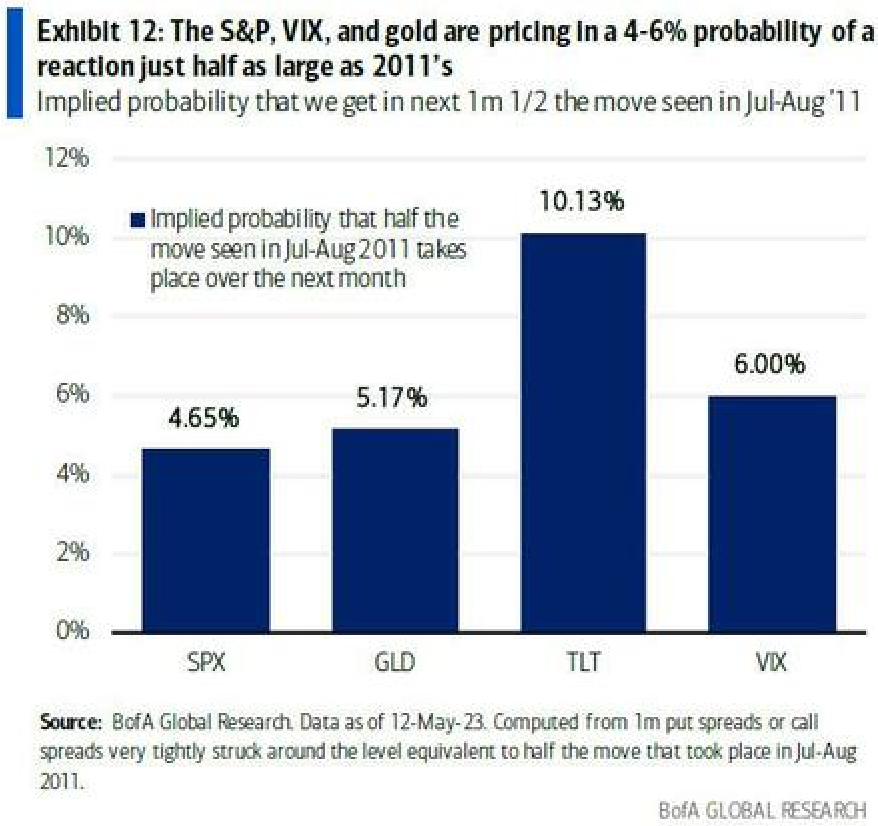


It is these same asset classes which remain shockingly unafraid about the current (arguably riskier) situation, which will most likely come down to the wire again.

The next two charts show that, while the focus on the debt ceiling X-date has risen over the last month, **risk premium in equities, gold, and Treasuries around the event remains almost negligible.**

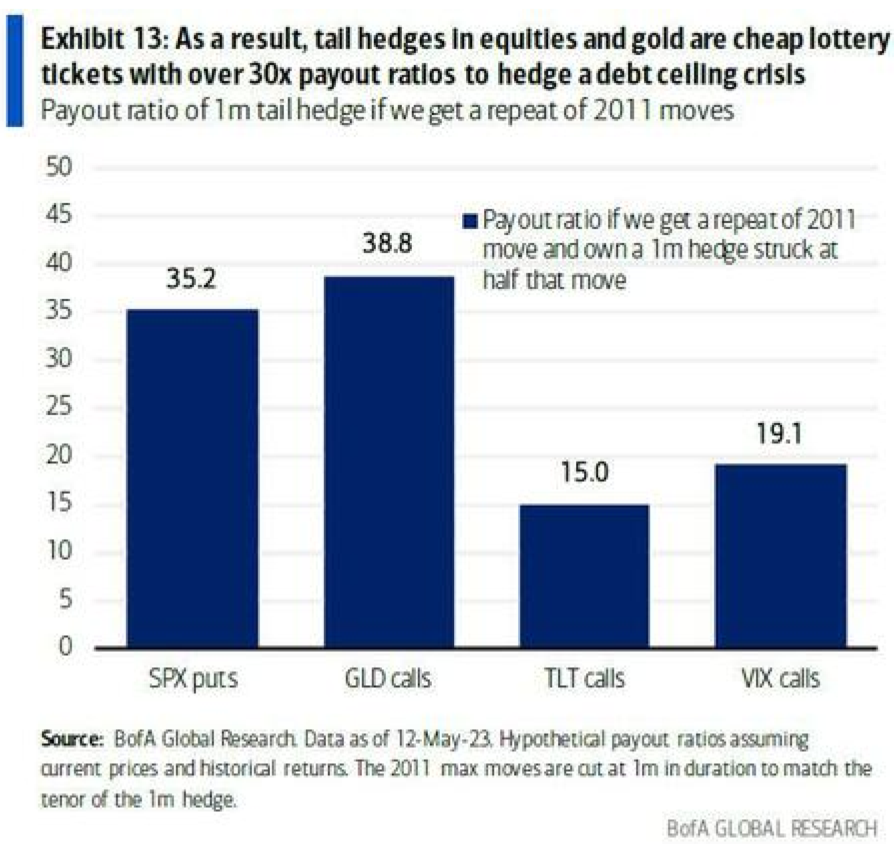


In fact, using option prices, BofA's strategists estimate the probability that various assets are implying for a 2011-style crisis: they find that **the S&P, the VIX, and gold are all implying a 4-6% probability of a crisis just half as large as what we saw in 2011...**



... while long-dated Treasuries imply such a shock is twice as likely (~10% odds).

More importantly, we can also gauge how various hedges would perform in a repeat of the 2011 shock. Which brings us to the punchline: the next chart shows **the hypothetical payout ratios in a 2011-style shock of 1m hedges bought at current prices and struck at half the 2011 move** (e.g., if the S&P fell 17% over the next month as it did in Jul-Aug 2011, it shows the payout ratio of an S&P 1m put struck 8.5% out of the money).



The results would be 35x, 39x, and 19x payout ratios for SPX puts, GLD calls, and VIX calls, respectively. Meanwhile calls on TLT would offer 15x payout ratios – still impressive, and also consistent with this year's theme of rates pricing significantly higher risks than equities.

So here are the recommended trades:

- **Trade #1:** Buy SPX Jun 3800 puts for $13 (ref. 4136.28)
- **Trade #2:** Buy GLD Jun 200 calls for $0.75 (ref. 187.21)

Or, as BofA puts it, *"tail hedges in equities and gold are cheap lottery tickets with over 30x payout ratios to hedge a debt ceiling crisis."*

More in the full BofA note available to pro subs in the usual place.