

# Treasury Futures Fly High as Bond Market Fragments

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By Financial Times

## Sustaining the success of a new 'Ultra' Treasury future will depend on the buy in of asset managers

A new futures contract at CME Group that tracks the world's primary government bond benchmark has flourished since its launch in January as investors adjust to a world of low interest rates and heftier capital costs for holding bonds.

The new contract from the CME Group, the world's largest futures market, has "gone like a bat out of hell", according to a senior executive.

The "10-year Ultra Treasury note" contract tracks the US government security used as a benchmark all over the world, and has [traded](#) more than 1m contracts in the first seven weeks of life.

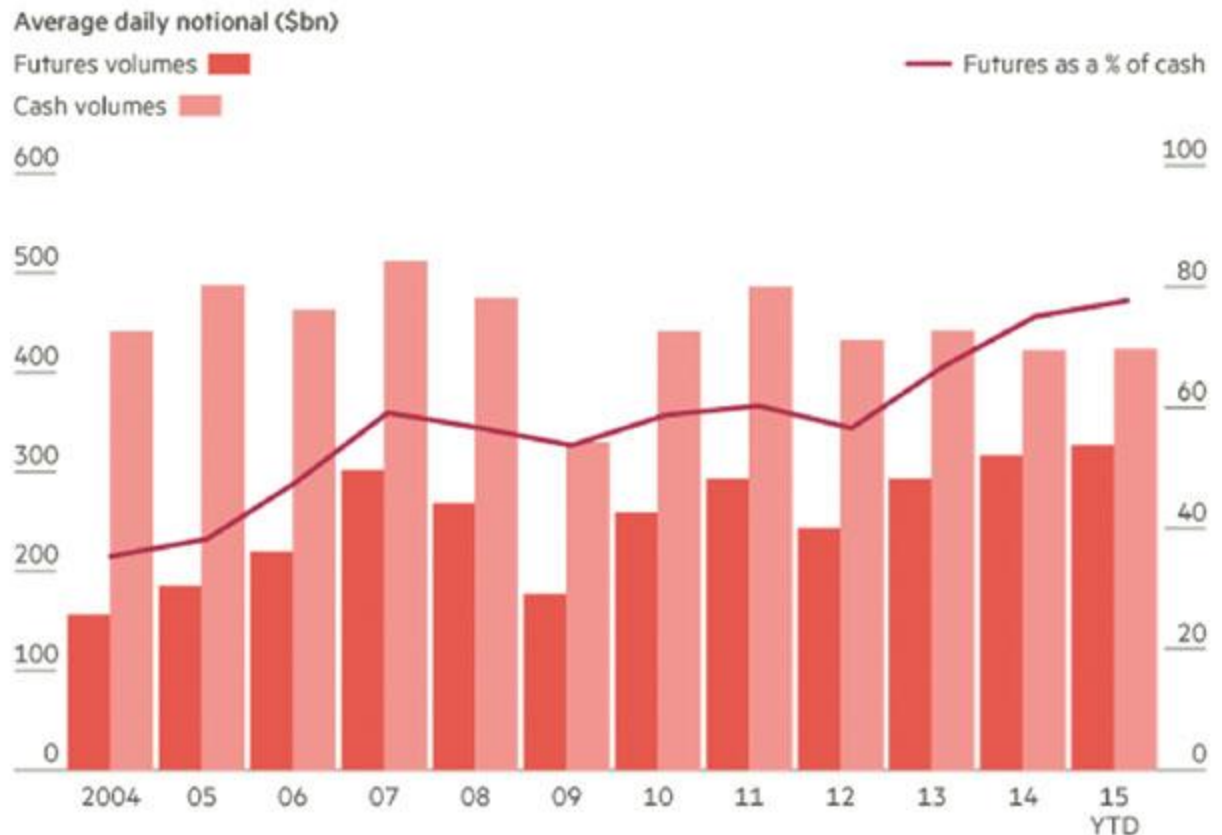
The success of the contract — already the fastest-growing product in the CME's 148-year history — reflects a growing shift in the structure of the US interest rate market, between cash and futures products, in the wake of post-financial crisis regulation. The long standing 10-year Treasury futures listed contract at the CME remains very popular, indicating that the market is not simply switching to the Ultra.

After a strong debut, the ultimate success of the contract will rest on broader market participation from asset managers, who tend to wait and see before committing to a new product.

"As liquidity grows there will be more pull to switch to the ultra 10-year," says James Ong, a derivatives strategist at Invesco Fixed Income. "We would like to see liquidity grow. As it does I think we will be using it more frequently."

The Ultra contract fills an important gap for investors and traders who transact in Treasury futures. Such derivative trades are often closed out near the expiry of the contract, by finding an old cash Treasury security and delivering that to the other party in the transaction. The Ultra contract provides greater flexibility in settling futures trades in the current climate of low interest rates.

## Client trading of Treasury futures compared with cash



Source: CME Group

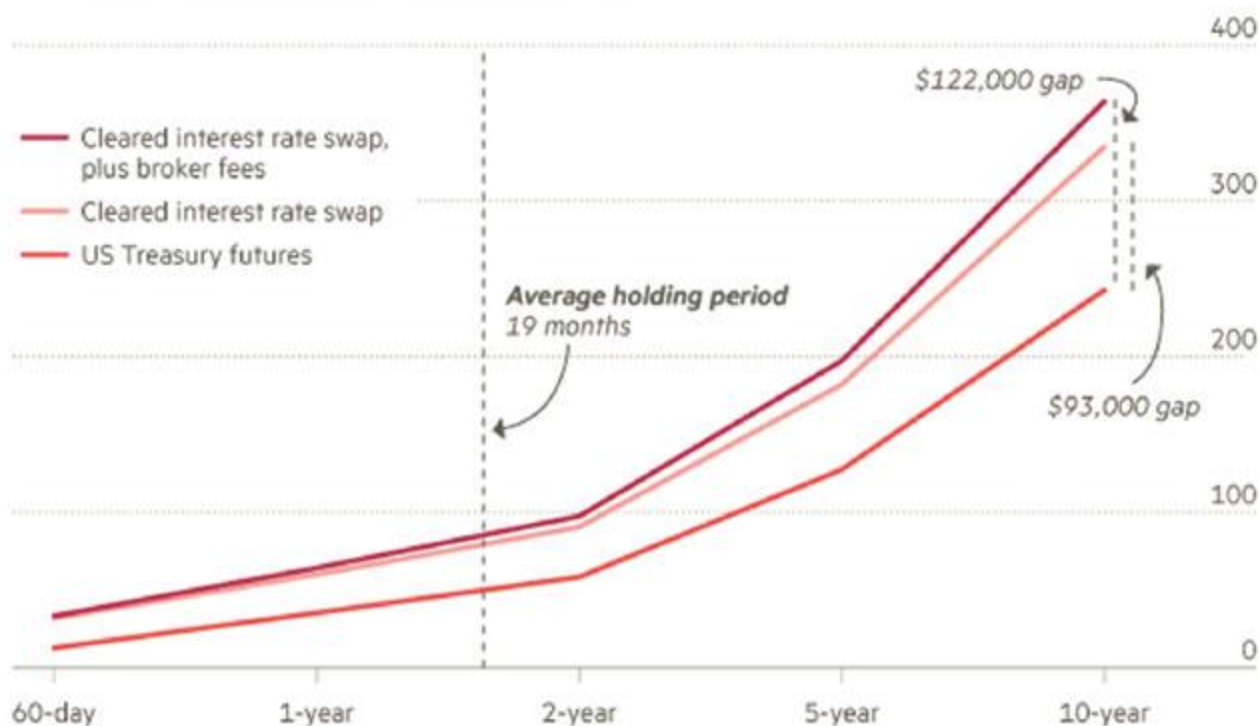
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The crucial element of trading, however is cost, particularly in the wake of post-financial regulation as the effects of banking and markets reforms resonate for investors.

As banks face higher capital charges for trading over-the-counter derivatives, the use of futures offers a cheaper alternative, according to a recent report by Greenwich Associates, a capital markets consultancy. Using futures also appeals greatly to high-frequency traders, who have become bigger players in the US bond market in recent years.

## Estimated total cost of trading

Trade size of \$100m, 30% of margin financed (\$ '000)



Source: Greenwich Associates

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“Financing is a really, really important part of the ecosystem that has been a little bit overlooked and that is where we will almost certainly see innovation. It’s where many investors are substantially more focused,” says Paul Hamill, global head of fixed income, currencies and commodities at Citadel Securities.

That concern is being exacerbated by [a breakdown](#) in the fundamental industry tool: market activity that links Treasury bonds and OTC derivatives, notably interest rate swaps.

The vast US fixed income market has long supported a variety of ways for buying and selling interest rate exposure, via OTC and listed derivatives and cash Treasuries. A crucial area of trading and one that is often overlooked, is how positions have long been funded via the repurchase or repo market. New rules on capital ratios make it more expensive for banks to undertake such activity. The US repo market is 40 per cent smaller than it was at the height of the financial crisis.

That has triggered a dislocation between government bonds and swaps, with Treasury yields being quoted above swap rates, a [negative relationship](#) that upends financial theory. Under normal market conditions this would be swiftly reversed but it has been entrenched for nearly six months, indicating how higher capital costs are reinforcing dislocations.

“Total cost analysis is going to become very, very complex. The question of how they’re best going to use their margin will determine which trade they do. The tail may start to wag the dog, so to speak,” says Mike du Plessis, global head of execution services at UBS.

Some people envisage a shift away from using swaps for hedging in certain circumstances, or a move to using futures like the CME Ultra, rather than just cash Treasuries.

RJ O'Brien argues that this situation may continue for several years. The futures broker believes the answer lies in using futures like the Ultra, which can be cleared at the CME and offset against other Treasury futures.

Others, however highlight how swaps can be customised for specific rate exposure, whereas futures are a blunter tool.

David Clark, chairman of the Wholesale Markets' Brokers Association, a trade body, says the repo market problem is too short-term focused to affect swaps trading. "But it's much more important down the curve. Increasing capital costs aren't going to get magicked away."

ClarusFT, an OTC swaps data provider, says the acceptance of the Ultra contract has coincided with an increase in swaps trading.

"You'll have futures and OTC markets working symbiotically, as they always were," says Mr Clark.

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