ASX Interest Rate Futures Research

Spread trading opportunities between the Australian and US Treasury Bonds

The Aus US Bond Spread

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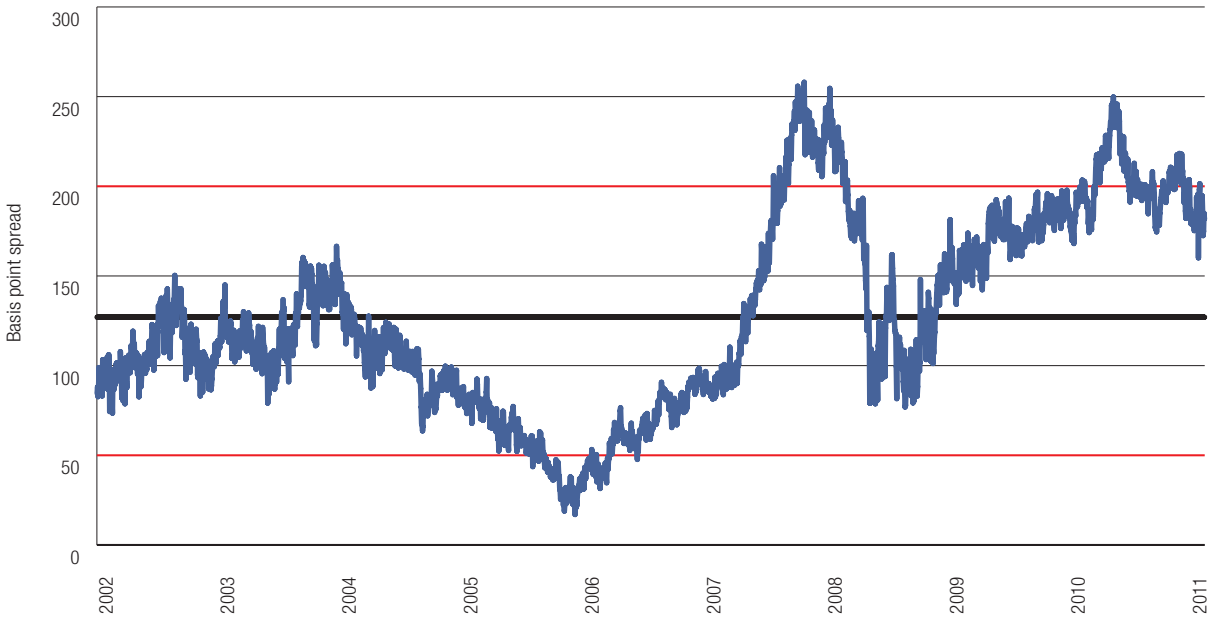
This trading strategy paper discusses opportunities in spread trading between Australian and US Treasury Bonds

Treasury Bond yields – a leading economic indicator

Treasury bond yields are the foundation of a currency's (and thus economy's) yield curve. The yield curve is the relation between the interest rate (or cost of borrowing) and the time to maturity of the debt for a given borrower in a given currency. The slope of the yield curve is one of the most powerful predictors of future economic growth, inflation, and recessions. An inverted yield curve is often a harbinger of recession. A positively sloped yield curve is often a harbinger of inflationary growth.

The connection between the bond yield and the economy derives from the way interest rates affect aggregate demand. Bond yields are thus an excellent leading economic indicator. Long dated Treasury bonds are an ideal instrument for bond traders who seek to profit from correctly forecasting changes to economic conditions. Differences in the economic conditions and cycles between the US and Australian economies mean that Australian and US Treasury yields do not always move consistently over time – although they do exhibit a strong tendency towards mean reversion. This can be seen in the graph below. Trading this spread therefore presents opportunities to profit from macro-economic differences between the two economies.

Australian US 10 Year Bond Futures Spread



Data source: Bloomberg

Benefits of trading Treasury bond futures

Constructing the spread trade using futures contracts provides a convenient and efficient method for taking advantage of any trading opportunity when yields are either very compressed or widely divergent. To construct this trade the ASX 10 Year Treasury Bond Futures (ASX XT) can be used in conjunction with the 10 Year US Treasury Note Futures (US TY), which is traded on a number of US futures exchanges, the most liquid being that listed on the Chicago Board of Trade (CME Group). Both futures contracts listed on ASX and CBOT exhibit strong market turnover and depth and are well suited for spread trading.

The ASX XT provides:

- Strong price transparency and liquidity, which reduces trading costs;
- Immediate execution and confirmation on ASX 24;
- Reduction of counterparty risk – Trades on ASX 24 are supported by a clearing guarantee. The ASX Group also maintains a conservative capital structure and some of the most sophisticated client margining regimes available, allowing investors to trade with confidence;
- 24 hour trading which provides investors with maximum flexibility and minimum risk in placing a trade in two different time zones.

Trading considerations

When creating an Australian / US 10 Year Treasury spread trade, there are a number of factors that should be considered, namely, the foreign exchange exposure, impact of the cheapest to deliver (CTD) bond and margin requirements.

Traders can elect to maintain the spread trade without an FX hedge however the longer the spread trade is held the greater the currency risk and potential to erode the profit resulting from the trade.

Another important factor to consider when undertaking this type of spread trade, relates to the design features of the contracts that make up the spread. The US TY is a cheapest to deliver contract with the potential for the CTD Treasury to change whilst the spread position is open. This may affect the profitability of the spread trade.

Unlike the US TN, the ASX XT is based on a basket of bonds with an approximate average maturity of 10 years. Holding the spread trade over an expiry means either or both of the futures positions need to be rolled into the next expiry month, with potential for changes in either the CTD or bond basket, with the commensurate impact on the value of the spread.

Traders also need to consider initial and variation margin requirements, which have implications for both liquidity and the time value of money. Initial and variation margins are payable for positions held on both exchanges. Information on current margin requirements for the ASX XT is available from the ASX website www.asx.com.au

Trading Strategies

1. Trading for the spread to widen

The graph on the previous page illustrates the performance over time of the spread between the ASX XT and US TY. In early 2006, this spread narrowed to only 19 basis points, with the ASX XT trading at 5.18% and US TY trading at 4.99%.

With the spread at an historical low, a trader that sold the ASX XT and bought the US TY was expecting a widening or reversion of the spread to more normal levels. Throughout the remainder of 2006, this spread did in fact widen as the Reserve Bank of Australia (RBA) implemented a series of official cash rate increases. By the end of 2006, the spread differential had widened to 80 basis points with the ASX XT trading at 5.65% and US TY trading at 4.85%. The spread trade generated a 61 basis points profit.

2. Trading for the spread to narrow

Traders can also profit when the Australian / US Treasury spread is markedly wider than historical norms in the expectation of the spread reverting back to the average. For example, in November 2010, the ASX XT was trading at 5.37% and the US TY was trading at 2.88%, giving a spread of 249 basis points – some 125 basis points wider than the historical norm.

At the time, the long term prospects for the US and Australian economies both improved from November 2010 to March 2011. Although the US Federal Reserve funds rate remained at 0.25% over this period, markets had increasingly formed the view that the US would not face any medium term threat from deflation and by the end of this period markets could see an end to the US Federal Reserve's program of quantitative easing. Economic growth prospects were also buoyed by record low interest rates and a weak US dollar which had helped improve the US trade balance.

By contrast, although the Australian economy was continuing to grow thanks to a mining and investment boom, there were significant factors such as a high Australian dollar and subdued retail spending affecting the overall economic outlook. Over this period the RBA cash rate remained steady at 4.75%.

By the start of 2011 with the global recovery beginning to take shape, the spread between the ASX XT and US TY narrowed markedly. By the end of March 2011, the ASX XT was trading at 5.45%, whilst the US TY was trading at a yield of 3.68%, resulting in a spread of 177 basis points. The spread trade in this example yielded a profit of 72 basis points.

For more information and research on ASX interest rate products, visit **www.asx.com.au/interestrates**

To read more about ASX 10 Year Treasury Bond Futures please refer to the product factsheets.

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www.asx.com.au For these contracts the market is operated by Australian Securities Exchange Limited ABN 83 000 943 377