ICE FUTURES EUROPE

INTEREST RATE DERIVATIVES

TRADING BASIS BETWEEN EURO SOVEREIGN AND EURO INTERBANK YIELDS

Fast Facts

What is it?
Euro Swapnote® is an on-exchange futures contract referenced to the European interbank curve.

Who is it for?
Euro Swapnote® futures are for anyone who wishes to gain or hedge exposure to the European interest rate swaps curve via a centrally cleared contract.

What does it provide?
Euro Swapnote® provides an open and efficient means of gaining euro swap market exposure in a contract that already meets new regulatory requirements.

Swapnote® futures are designed to reflect the interbank swap curve, and can be traded against German Government Bond futures to gain exposure to changing market views on the relative credit pricing in the interbank and sovereign debt markets. For a given maturity date this relative credit pricing will be expressed in the yield spread between the interbank and sovereign curves.

For example, the yield spread is 0.6524%. An investor believes that this yield spread will narrow as interbank credit improves relative to German Sovereign credit. By entering into a position which profits from a rise in the lower (German Sovereign) yields and / or a fall in the higher (interbank) yields, the investor is able to express his view on relative credit pricing. This can be achieved through selling Euro Bund futures whilst simultaneously buying 10 Year € Swapnote® futures, with the proportional number of futures traded determined by their relative basis point values.

When the investor enters the trade, market values are as follows:

- 10 Year € Swapnote® price: 136.48
- 10 Year € Swapnote® bond equivalent YTM: 1.950%
- 10 Year € Swapnote® BPV: €109.17 per lot

- Bund future price: 141.83
- Bund future implied YTM: 1.307%
- Bund future BPV: €113.50 per lot

The Bund futures yield to maturity (YTM) and basis point value are derived using the cheapest to deliver (CTD) bond. In an upward sloping yield curve environment, the CTD bond typically has a shorter maturity; in the case of Bund futures shorter than ten years from the delivery date, therefore there is also an element of curve trading in this example strategy.

Here, the yield spread is is 1.950% - 1.307% = 0.643%

The proportional number of futures to trade is 109.17 : 113.50 = 0.96185

Therefore for each 100 contracts of 10 Year € Swapnote® purchased, 96 Bund futures should be sold. In practice, given the closeness of the basis point values, these trades are often transacted on a 1 for 1 basis for simplicity.

A week later, market values are as follows:

• 10 Year € Swapnote® price:	137.07
• 10 Year € Swapnote® bond equivalent YTM:	1.895%
• Bund future price:	141.52
• Bund future implied YTM:	1.354%

Here, the yield spread is 1.895% - 1.354% = 0.541%, narrowing as predicted, as interbank yields have fallen whilst sovereign yields increased.

The return on this trade is:

- Return = Swapnote® return – Bund return
- Return = (100 x (137.07 – 136.48) x €10 / 0.01) – (96 x (141.52 – 141.83) x €10 / 0.01)
- Return = **€88,760**

Further Information

Interest Rate Derivatives

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