

Interest Rate Products

Intercommodity Treasury Spreads: Take a Closer Look

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Trading the Treasury yield curve with U.S. Treasury futures Intercommodity Spreads (ICS) has never been more popular, due in part to CME supported implied functionality. In order to offer the smallest possible clip size and provide the ability to assign individual leg prices of spreads at eligible price increments (e.g. .25/32nds or .50/32nds), spread prices are disseminated and orders are entered at the “standard” .25/32nd and .50/32nd tick increments.

Did you know? Implied Treasury ICS curve trades may often match at prices narrower than the standard .25/32nd or .5/32nd. Yet, many participants continue to “leg” these trades—accepting execution risk in exchange for the opportunity to execute the spread at the narrowest possible bid/ask spread. While the exchange-supported implied versions of the NOB, BOB, FYT, etc., are typically listed with bid/ask spreads that match the tick size of the spread leg that has the narrowest increment, many participants are not aware that implied ICS orders are frequently matched at bid/ask spreads narrower than the “standard” tick.

How is this possible? On CME Globex, incoming ICS orders match first with resting ICS orders—if there is a resting order that matches (or is better than) the price of the incoming order. If there is no resting order at the designated price, Globex will then look to the constituent leg prices to see if there is a potential match. In these cases where Globex “legs” the trade, that spread will trade at the most advantageous differential possible. Often this “legged” price may be better than the price on the incoming order.

How about an example? Here’s one:

- The September FYT is currently listed at a 3:2 quantity ratio (and a corresponding 1.5001 price ratio). Execution of one spread order creates a position of three 5- Year T-Note futures and two 10- Year T-Note futures. Prices are expressed in terms of each leg’s net change from the previous day’s settlement price.
- September 2010 5-Year T-Notes have a bid-ask spread of +1.25B/+1.5A
- September 2010 10-Year T-Notes have a bid-ask spread of +5.0B/+5.5A
- Based on these leg prices, the September FYT market would be:
 - **Bid price:** $(+1.25) - (+5.5/1.5001) = -2.4164B$
Disseminated as -2.50 (-2.416 rounded down to the nearest .25/32nd increment)
 - **Ask price:** $(+1.50) - (+5.0/1.5001) = -1.8331A$
Disseminated as -1.75 (-1.8331 rounded up to the nearest .25/32nd increment)
- Absent resting spread bids at -2.5 or offers at -1.75, in this scenario an aggressor entering an order to sell the spread at -2.5 would actually be filled at -2.4164, while a buyer would pay -1.8331.

Where is there “edge”? Traders with resting spread orders in the book will match with incoming orders at the designated price at the “on tick” price. As the previous example demonstrates, this “on tick” price may differ from the price implied by individual legs by the rounding difference.

IMPLIED TREASURY SPREADS--BASED ON SEPTEMBER 2010 FUTURES CONTRACTS				
Spread Name	Futures Contract Legs	Price Ratio*	Leg Quantity Ratio*	External Name*
TYT	2-Year T- Note vs. 3-Year T-Note	1.5001	3:2	TYT 03-02 U0
TUF	2-Year T- Note vs. 5-Year T-Note	2.0001**	1:1	TUF 01-01 U0**
TUT	2-Year T-Note vs. 10-Year T-Note	3.3332**	5:3	TUT 05-03 U0**
TUB	2-Year T-Note vs. T-Bond	6.0001**	3:1	TUB 03-01 U0**
TUL	2-Year T-Note vs. Ultra T-Bond	8.0001**	4:1	TUL 04-01 U0**
TOF	3-Year T- Note vs. 5-Year T-Note	1.5001**	3:4	TOF 03-04 U0**
TUN	3-Year T-Note vs. 10-Year T-Note	2.0001**	1:1	TUN 01-01 U0**
TOB	3-Year T-Note vs. T-Bond	4.0001**	2:1	TOB 02-01 U0**
TOU	3-Year T-Note vs. Ultra T-Bond	6.0001**	3:1	TOU 03-01 U0**
FYT	5-Year T-Note vs. 10-Year T-Note	1.5001	3:2	FYT 03-02 U0
FOB	5-Year T-Note vs. T-Bond	2.5001	5:2	FOB 05-02 U0
FOL	5-Year T-Note vs. Ultra T-Bond	4.0001	4:1	FOL 04-01 U0
NOB	10-Year T-Note vs. T-Bond	1.6668	5:3	NOB 05-03 U0
NOL	10-Year T-Note vs. Ultra T-Bond	3.0001	3:1	NOL 03-01 U0
BOB	T-Bond vs. Ultra T-Bond	1.5001	3:2	BOB 03-02 U0
*Leg quantity and price ratios are subject to change				
**Price ratios of spreads involving 2-Year and 3-Year T-Notes are doubled to account for larger notional size (\$200K) in the price changes of the spreads. However, the ratio of the TYT is not doubled because the contracts have the same notional size.				

To

more about Intercommodity Treasury and Swap Spreads, visit www.cmegroup.com/ics.

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