Quarterly Interest Rate Review

A Global Trading Summary of Interest Rate Futures, Options and OTC Products

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As the world’s leading and most diverse derivatives marketplace, CME Group (cmegroup.com) is where the world comes to manage risk. CME Group exchanges offer the widest range of global benchmark products across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, agricultural commodities, metals, weather and real estate. CME Group brings buyers and sellers together through its CME Globex electronic trading platform and its trading facilities in New York and Chicago. CME Group also operates CME Clearing, one of the world’s leading central counterparty clearing providers, which offers clearing and settlement services across asset classes for exchange-traded contracts and over-the-counter derivatives transactions. These products and services ensure that businesses everywhere can substantially mitigate counterparty credit risk.
SECOND QUARTER HIGHLIGHTS

Interest Rate Complex Volume: +7% Jan-June 2014 vs. Same Time Period in 2013
- Seeing YTD growth vs. 2013, despite a low-volatility environment and strong volume in 2013.
- Averaged 6.7 million contracts per day complex-wide.
- Quarter-end Open Interest (O.I.) of 44.1 million contracts.
- All-time high of 73.4% penetration of U.S. Treasury cash market.

Interest Rate Options Growth: ADV +27% (1.38 million) vs. Q2 2013, 32% Electronic
- Eurodollar options (total): 779,185 contracts in ADV, +28% vs. Q2 2013.
- Weekly Treasury options: 58,139 contracts in ADV, +17% vs. Q2 2013.
- Weekly Eurodollar Mid-Curve options: 326,640 contracts traded from launch on November 18, 2013 through June 30, 2014.

Increasing Activity in 30-Day Fed Funds Futures and Options
- Averaged 22,539 contracts per day, +16% vs. Q2 2013, +16% from Q1 2014.
- Traded 103,000+ futures contracts on July 10, our highest volume day for 2014 for the product (the day following the release of the June FOMC meeting minutes).
- Options on 30-Day Fed Fund Futures are available for trading.

Deliverable Swap Futures (USD): Steadily Increasing Participation
- Q2 ADV was 6,415 contracts per day, +17% vs. Q2 2013.
- Open Interest briefly surpassed 131,000 contracts on June 16, 2014.

Cleared OTC IRS: Offering a Superior Solution to Meet Client’s Needs.
- June was a record month for IRS volume, which averaged $145.4 billion per day, +120% YoY and +10% from our previous record month in March.
- We continue to see strong momentum in our open interest growth, which is now over $16 trillion, averaging 51% market share in terms of open interest for Q2.
- With the broadest product scope in the market consisting of 18 currencies, clients are taking advantage of the most capital-efficient solution.
- 60 new clients are clearing with us in 2014, bringing total client universe to more than 460 clients who have cleared since launch.
- Eight Clearing Members are live with the portfolio margining solution.
  - Over 60 accounts benefiting from this solution
  - Portfolio margining total savings is $3.4 billion.

For the latest news and product information, visit cmegroup.com/interestrates
QUARTERLY OUTLOOK
Market Insights with CME Group Chief Economist Bluford Putnam

The flow of economic data in the U.S. suggests a rising probability for the scenario in which the Federal Reserve (Fed) raises its target federal funds rate and abandons its near-zero interest rate policy sooner rather than later in 2015. If and when the rate-rise decision is made, however, it is less clear how the long-term U.S. Treasury market will react. If the Fed rate-rise decision is driven primarily by an improved labor market with little sign of creeping inflation, then the yield curve may steepen as short-term rates rise more than bond yields. The contrasting scenario would involve both an improving labor market and incrementally creeping inflation. In this case, the Fed might be perceived as being behind the inflation curve, and the yield curve might shift upwards more or less in parallel.

By way of background, as we enter the second half of 2014, the U.S. economy appears healthy. Net new jobs are being added at a solid pace and the unemployment rate continues to fall. The exceptionally severe winter in the midwest and northeast disrupted real GDP data for Q1-2014, producing a sharply negative report. The labor markets, however, did not blink. Most businesses felt the disruptions were temporary. Indeed, when Q2-2014 real GDP data is released, the market consensus suggests that positive growth will have resumed. With healthy economic growth, our best-case scenario has a high probability for the unemployment rate to decline to 5.5% by early 2015.

We would note that there is a lot of debate inside and outside the Fed about whether the headline jobs data and unemployment rate are providing the full picture. Pessimists point to relatively elevated part-time jobs, a low participation rate, and a high number of long-term unemployed, just to name a few of the other indicators being studied. In our research, (see http://www.cmegroup.com/education/featured-reports/the-yellen-fed-and-us-labour-market-dynamics.html for the full report issued in June 2014), we contrast a dynamic interpretation of a wide variety of labor market indicators with the more standard view. Our dynamic approach puts special emphasis on the long-term factors such as the declining growth rate of the labor force, the rising average age of the labor force, and how the shift towards e-commerce has impacted hiring practices. As well, we consider the critical, one-time, post-recession downward adjustment in state and local government jobs that was only completed by mid-2013, which cost the economy 850,000 jobs and overshadowed a much more robust private sector job growth. In every case, we argue that the labor markets are much healthier than the pessimists suggest, when all of these key dynamic factors are given proper weight in the analysis.

On the inflation front, there are some very modest signs of possible incremental rises coming in the price level during the second half of 2014. Some of the price pressure, though, is coming from the more volatile food and energy sectors, which the Fed leaves out in its focus on core inflation. Over the longer run, longer-term US Treasuries typically maintain a premium over the core inflation rate, so gauging the bond market reaction to any Fed rate-rise decision involves taking a view on inflation, where the evidence is much more ambiguous, at least in our view, than regards the labor market data.

In terms of the timing of a Fed rate-rise decision, QE needs to end first, and that should happen in the fourth quarter. Once past the QE-exit milestone, the rate-rise debate will take on new urgency, and we should note that it is often the debate and not the actual decision that moves markets. The strength of the U.S. economic expansion is likely to heat up this debate sooner rather than later.

For more of Blu’s views and commentary, visit cmegroup.com/putnam

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PRODUCT OVERVIEW

EURODOLLARS

Eurodollar O. I. Trends: Increase in Short Positions by Leveraged Money

- Short O.I. positions held by Leveraged Money have increased significantly since end of 2013 – surpassing 2 million positions (close to 8% of total O.I.)
- Leveraged investors have initiated a net short exposure for the first time since the financial crisis.
- Eurodollar futures offer a flexible and highly liquid means of managing short term interest rate exposures.

Source: CFTC Commitment of Traders Reports.

EURODOLLAR OPTIONS

Eurodollar Options: Renewed Interest in Front-End of Curve

- Before the financial crisis, 70% of Eurodollar options volume was in transactions in the quarterly expiry options structures.
- As a result of the Fed’s zero interest rate policy, activity in White and Red month quarterly options declined and shifted to Mid-curve structures.

As the market anticipates potential rate hikes, activity is shifting back to these White and Red quarterly options.
PRODUCT OVERVIEW

INTEREST RATE OPTIONS

Interest Rate Options Block Trades: Expanded Access to Liquidity

- Block-eligible interest rate options provide participants globally with added flexibility for accessing the liquidity of our markets during North American (RTH), European (ETH) and Asian (ATH) trading hours.

- Blocks make it easier for participants to capitalize on the benefits of our listed futures and options outside of regular trading hours.

- The last four quarters have seen a significant increase in total block option trade ADVs.

- Includes strong traction in Treasury options block ADVs during ETH hours.

Q2 ADV (RTH): 76,000
Q2 ADV (ETH): 3,000
Ex-pit ≈ 11% of volume

Q2 ADV (RTH): 12,000
Q2 ADV (ETH): 21,000
Ex-pit ≈ 4% of volume

TREASURIES

Record High Penetration of the U.S. Treasury Cash Market

- In June, our Treasury futures and options volumes reached an all-time high of 73.4% penetration of the underlying cash market.

- Represents substantial outperformance vs. other available alternatives.

- Points to the increasing use of listed futures and options contracts to manage Treasury exposure and to optimize balance exposure.
PRODUCT OVERVIEW

LARGE OPEN INTEREST HOLDERS

- Over 1,600 large open interest holders across interest rate futures and options – an all-time high.
- Data is consistent with participation trends shown by cash market penetration and trading activity despite a low volatility environment. These trends support the thesis that market participants continue to migrate to futures as an alternative to OTC products.

Source: CFTC Commitment of Traders Reports.

DELIVERABLE SWAP FUTURES

- Record open interest of 131,404 contracts ($13.1 billion notional) on June 16, 2014.
- Record monthly ADV of 12,179 contracts in June 2014.
- More than 2.2 million contracts have traded since the December 2012 launch.
PRODUCT OVERVIEW

CLEARED OTC IRS

- Open interest continues to trend upward, increasing to over $16 trillion by mid-July from $12.5 trillion in March.
- 60 new clients are clearing with us in 2014.
- More than 460 global market participants have cleared at CME since launch, taking advantage of the most capital-efficient solution.

PRODUCT SCOPE

Learn more at cmegroup.com/otc
VALUE-ADDED TOOLS

Fed Watch Tool | cmegroup.com/fedwatch

- Fed Funds futures and options represent a highly effective means of hedging or speculating potential Federal Reserve overnight interest rate changes.
- CME Group FedWatch tool allows market participants to assess probabilities of Fed monetary policy changes.
- The tool monitors current probability but also tracks previous day probability and previous month probability.
- Prior to the financial crisis, CME Fed Fund futures and options averaged 120,000+ contracts per day.
- Given an expected tightening by Fed over the next 12 months, activity in these contracts is already starting to pick up.
- Fed Fund futures averaged nearly 58,500 contracts per day for the week ended July 11, 2014.
- On July 10, Fed Funds futures traded 103,751 contracts. In 2014, Fed Funds ADVs are up 21%, averaging 22,629 contracts daily.
- The Fed Fund Rate (FFR) implied by a rule-based approach is on the rise. The chart at left shows one such approach of how the Fed should balance dual mandates of full employment and price stability to set the target FFR.
- A simple regression analysis based on the Jan 1997-Dec 2007 time period -- with current 6.1% unemployment and 1.48% PCE -- implies a FFR of 77 bps.
- Slightly changing these inputs to 5.5% unemployment and 1.8% PCE (reasonably attainable numbers within a few months) implies a FFR of 2.4%.
VALUE-ADDED TOOLS

Daily Treasury and Eurodollar Market Updates

- Get daily market reports for our Treasury and Eurodollar products automatically delivered to your inbox.
  
  These emails provide timely information on options activity and the distribution of puts and calls.

- To subscribe, email david.reif@cmegroup.com

Euro DSF Analytics Page | cmegroup.com/dsfanalytics

- Quickly view the prices, rates and risk of USD and Euro DSF contracts.
- Easily perform comparisons with USD/EUR DSFs and corresponding OTC spot and forward swaps.
- Provides an excellent approximation of the implied rate.
NOW AVAILABLE

COMPRESSION VIA COUPON BLENDING

Compression via Coupon Blending is a new and innovative solution to actively reduce IRS notional amounts and line items.

To date, this solution has provided **average gross notional and line item reductions of 18% and 33%, respectively**, from 32 portfolios across house and customer accounts.

This patent-pending innovation provides clients with:

- The first automated and scalable compression solution available to all market participants with cleared IRS trades
- The ability to net pay-fixed and receive-fixed swaps with the same attributed but different fixed rates and notional amounts
- Flexibility to utilize daily on an automated basis as part of the existing EOD workflows, or selectively as an ad-hoc process
- Additional cost efficiencies with fewer transaction ticket charges when terminating or rolling outstanding residual positions, and lower third party costs for portfolio maintenance items

Learn How You Can Benefit from the Liquidity and Efficiencies of Our Interest Rate Solutions.

Contact Us Today at interestrates@cmegroup.com.
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Swaps trading is not suitable for all investors, involves the risk of loss and should only be undertaken by investors who are eligible contract participants (ECPs) within the meaning of section 1(a)18 of the Commodity Exchange Act. Swaps are a leveraged investment, and because only a percentage of a contract’s value is required to trade, it is possible to lose more than the amount of money deposited for a swaps position. Therefore, traders should only use funds that they can afford to lose without affecting their lifestyles. And only a portion of those funds should be devoted to any one trade because they cannot expect to profit on every trade.

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