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CME offers basis traders a leg up

New Treasury Link service 'levels playing field' in strategy dominated by high-speed players. By *Rebecca Baird-Remba*

For fixed income relative-value traders, 'legging risk' has long been seen as the enemy of good execution. Because each leg of, say, a US Treasury versus futures basis trade is processed with a slight delay, there's a chance they get executed at a level different than what was expected.

Eliminating this risk for banks and asset managers is a key goal for CME's new Treasury Link service, which will allow traders to simultaneously execute cash Treasuries on BrokerTec and futures on the Chicago Board of Trade with a single order submission. It's expected to debut in the fourth quarter, pending regulatory approval.

CME is billing Treasury Link as the first out-of-the-box solution for executing both legs of the basis trade simultaneously. This is done by matching the trade with existing buy and sell orders based on the price differential when it was submitted, rather than necessarily the best price.

"[Treasury Link is] a spread functionality that allows participants to trade the difference between futures and cash as a single execution and a single order," says Matt Gierke, CME's global head of BrokerTec, "meaning that the typical slippage risk or legging risk that traders might have to deal with when trading independently through two separate liquidity pools goes away".

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> Jamie Mortimore, Citi

That could help banks and asset managers compete on a more level footing with principal trading firms (PTFs) and hedge funds, which dominate the basis trade and have engineered ways to shrink the delay in executing multi-leg transactions down to tenths of a second – including by connecting directly to CME's data centres for cash and futures trading in New Jersey and Chicago.

"Treasury Link takes out some of the latency between Chicago and New York, which makes execution more efficient for everyone," says Jamie Mortimore, global head of electronic rates trading at Citi. "That's good for the dealer community."

There may be other benefits, too. Bank market-making desks often outsource their basis trade orders to brokers, largely to avoid the headache of staging and managing multiple legs.

Reed Staub, North America head of futures execution at Morgan Stanley, expects Treasury Link to "draw strong demand" from bank dealer desks "who will no longer be deterred by order staging and appreciate the efficiency and benefits of self-trading".

Still, some have mixed feelings about the service, with one rates trader describing as "a little bit of a curse and a blessing". Treasury Link could "greatly simplify [dealers'] ability to manage their own hedging and lower some of their own fees", the trader says. But it also brings "more efficiency to an already efficient market" and further compresses already thin margins.

Treasury Link will cover all seven on-the-run benchmark Treasury denominations on BrokerTec, along with CME's six main Treasury futures contracts. Off-the-run transactions are excluded. Spread trades can be executed on a one-to-one ratio or weighted to DV01, the sensitivity of bond prices to one basis point move in underlying yields.

The launch of Treasury Link coincides with a marked increase in basis exposures among banks. Reforms to the US supplementary leverage ratio, finalised last November, have allowed banks to finance and warehouse more Treasuries that they hedge with short futures – effectively recreating the basis trade on their books.

Data from the US Commodity Futures Trading Commission shows dealer net short positions in five-year Treasury futures has increased by 12% since January, while repo-style exposures jumped 11.6% in the first quarter.

CME's FX Link, which allows users to execute a simultaneous spot and futures transaction via single order, has seen significant uptake from dealers since launching in 2018.

Chicago calling

CME also hopes Treasury Link will incentivise more banks to connect to BrokerTec Chicago, a relatively new central limit order book (Clob) for cash Treasuries aimed at relative value traders. The exchange says it has onboarded 35 clients to date, though adoption among large US banks so far has been uneven.

CME's Gierke expects Treasury Link to "accelerate" the growth of BrokerTec Chicago and bring more participants and liquidity to the new venue.

Citi's Mortimore agrees CME's Chicago Clob could get a boost from Treasury Link.

"The more volume that goes over Treasury Link, the more volume the Chicago Clob gets, and the more interesting it becomes as a place to trade," says Mortimore.

One question is whether Treasury Link will find an audience beyond bank trading desks. Agha Mirza, CME's global head of rates and over-the-counter products, says asset managers and hedge funds that use futures to manage their duration exposure from bonds have also shown interest. These firms currently have "to use auto spreaders or legging strategies to unwind" their cash-futures spread positions, he says, "and with this offering they can unwind with no legging risk".

Citi's Mortimore thinks brokers will also find the service appealing. "The brokers that execute these trades on behalf of clients, I would expect them to start using this more," he says. "That's a very competitive space, and any edge that firms can get there, they're definitely going to try and make the most use of it to provide the best prices to their clients."

A source at one PTF also welcomes Treasury Link, noting that it is an easier way to flatten basis risks passively that get built up through market-making, and allows them to earn the bid-offer spread on both legs instead of paying it to avoid legging risk.

The rates trader, though, doesn't expect hedge funds to be big users of Treasury Link. Hedge funds generally "don't like the simplified constraints of a listed spread because they have different ratios they want to use, or because they've got more that they want to build into the custom basket that they're trading, so maybe they're not the big user of this", this person says.

But that is not necessarily a problem for CME, the trader adds. "Not everyone's going to adopt [Treasury Link], but I think a lot of the market-makers and bank dealers alone can trade this and make it a successful and viable means of trading basis risk." ■

Editing by Kris Devasabai and Lukas Becker