Opportunity in crisis: sovereign debt futures for proprietary traders

The European debt crisis caused the buy side to seek more accurate hedging instruments as Euro-Bund Futures, traditionally used as a proxy for generic EU debt, diverged sharply from single country benchmarks. This real money demand prompted Eurex Exchange to list futures on Italian and French debt. Since their launch, the market has embraced the new contracts. Volume records are being set on a regular basis despite the decrease in volatility in light of the abatement in the EU crisis. The launch of the products has generated opportunities for proprietary traders to access new liquidity pools. Moreover, because the contracts are not yet universally traded, these new sovereign debt futures offer unique opportunities of the road less traveled.

The Chinese word for crisis, *wēijī* is made up on two characters which mean danger and opportunity; as such, it is an appropriate embodiment of the realities of the European sovereign debt crisis.

The European debt crisis that began in late 2009 has completely altered the landscape of the EU debt market. The splintering of sovereign yield and reduction in some ratings has created a new demand in the European fixed income market for products that investors can use to hedge lower-rated government debt.

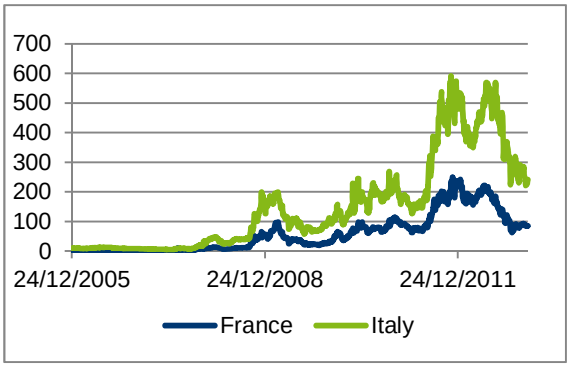
The new reality:
European credit ratings 1 August2013

	Moody's	S&P	Fitch
Germany	Aaa	AAA	AAA
France	Aaa	AA+	AA+
Italy	Baa2	BBB+	A-
Greece	C	CCC	CCC

To meet the needs of this new landscape Eurex Exchange launched a range of Italian and French fixed income futures, which include the two most actively traded contracts, ten-year Italian Euro-BTP Futures and ten-year French Euro-OAT Futures. In June 2013, the BTP futures contract exceeded 1 million contracts for the month. The OAT contract was introduced in April 2012and has become one of the fastest growing futures contracts with over 10.5 million contracts traded since inception. Year over year second quarter volume, the OAT future contract increased 257 %. This warm reception by the market has resulted in additional liquid futures contracts that can be accessed by the investment community. In fact, the strong market acceptance of the contract based on French bonds led Eurex Exchange to list options on the ten-year OAT future 10 September, 2013.

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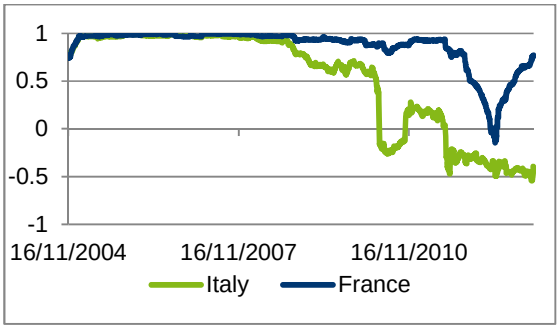
French and Italian CDS spreads as a representative illustration of the crisis timeline



The credit default market (CDS) spreads on France and Italy demonstrate the apex in late 2011 through early 2012. The crisis has subsided in part because of the bailout programs but the absolute levels remain historically high.

The graph depicting correlation between German debt, which has been long-considered the benchmark in the Eurozone, and French and Italian debt shows a major breakdown starting in 2009. The correlation has certainly rebounded but has not come close to approaching pre-crisis levels.

Correlation to German debt



These indicate that the market now recognizes intra-European divergences and that going forward will continue to value sovereign debt on a country by country basis instead of returning to a reliance on German debt as a proxy. The availability of Eurex Exchange sovereign debt futures makes their hedging process easier.

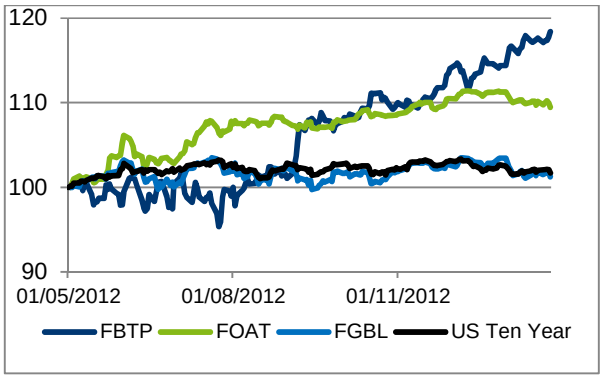
Express your view on single countries

The Italian and French futures contracts offer new ways for both buy and sell side market participants to express their viewpoints on key individual countries within the Eurozone as well as their relationships to other fixed income complexes within Europe and on a global basis. The volumes in the contracts are characterized by narrow spreads and good distribution throughout the trading day, making it possible for traders and investors to express their views on longer and intraday horizons.

Relevance for U.S .fixed income traders

The benefits of Eurex Exchange's Italian and French sovereign debt futures are certainly not limited to those traders that are already active in European fixed income markets. In today's interconnected world, European and U.S. markets exhibit significant correlations. As such, they can be interesting for traders of U.S. fixed income markets that are looking to expand their spreading opportunities.

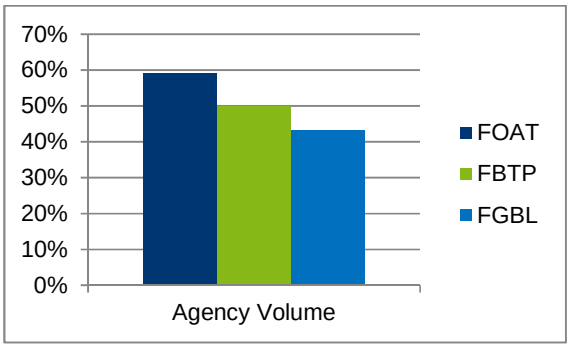
Normalized graph of fixed income futures



Open interest in both the OAT and BTP future is not merely remaining constant during rolls. It is increasing, which is a widely accepted signal that the contract is quickly gaining acceptance as a stable benchmark to non- AAA rated debt within the EU.

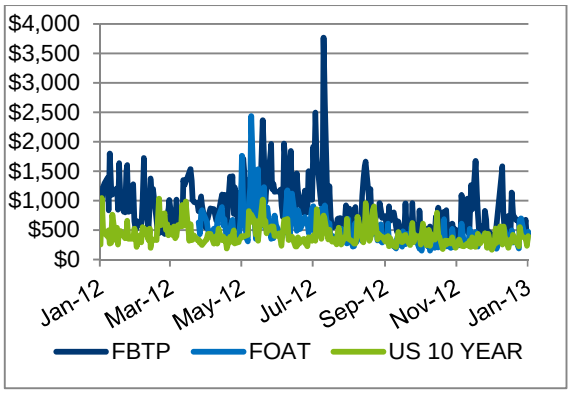
With a high percentage of agency business in the Euro-OAT and Euro-BTP Futures, participants are willing to cross the bid/ask spreads. The fact that more volume is agency leads to a healthy and dynamic ecosystem for liquidity providers. Any developed market needs participants with different trading motives. Agency business provides different perspectives for the proprietary community to facilitate liquidity. Also, with different maturities in the French and Italian contracts available, yield curve trades are possible.

Agency percentage per product



Interestingly, the increase in volume and open interest is occurring despite decreasing volatility and increased certainty within the EU. In the OAT contract, realized volatility decreased from 10 percent to a low of 2.62 percent after EU stability mechanisms were implemented.

Daily tick range in USD

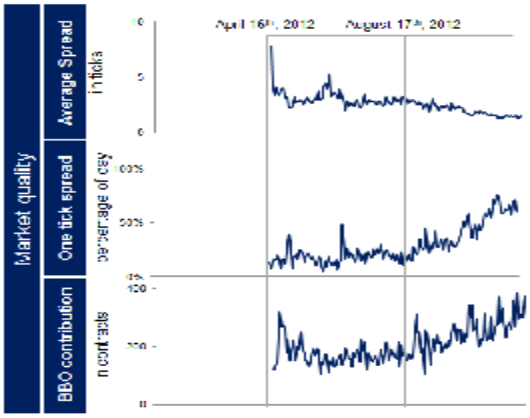


The BTP contract has been more volatile throughout the crisis and is still trading at elevated levels when compared to U.S. Treasury futures. This is depicted in the chart above, which shows average daily tick ranges in U.S. dollars.

Increasing market participation

The number of unique market participants in the OAT contract has grown quickly from 50 to over 180 and has been accompanied by a dramatic decrease in the bid/ask spread.

Throughout the year, the spread has narrowed substantially. The increase in market quality is most noticeable when looking at the amount of time a one tick spread is present throughout the trading day.



Interestingly, the size available at the improved spread has increased to approximately 50 contracts. The fact that the bid/ask spread decreased and quantity increased is very encouraging for trading participants to effectively enter and exit the market.

The crisis going forward

The European debt crisis may continue for some time into the future. Given this backdrop, the fixed income complex at Eurex Exchange is a good fit for market participants looking to efficiently hedge and mitigate risk from countries with different levels of credit worthiness. European Union actions and austerity measures have calmed the market regarding a Eurozone country defaulting. However, the decrease in the crisis has not slowed the appetite for specific EU fixed income futures, demonstrated by the increasing open interest and volume numbers in Eurex Exchange's French and Italian complex.

Single country debt will remain a focus

According to the IMF Working Paper, "Government Debt Issuance in the Euro Area" the global crisis has had a major impact on government debt issuance practices. Due to increased need for sovereign funding, countries ramped up government auctions. A large increase was observed in France in particular. Italy, before the crisis issued a lot of debt, and gross issuance further rose during the crisis. Along with an increase in auctions, risk was shifted to the sovereign countries through increased yields.

Italy has the second highest debt ratio at 120 percent with France not to far behind according to Eurostat.

While the critical phase of the recent Eurozone crisis appears to have subsided, greater political and fiscal integration of the European Union is yet to be achieved. This process is bound to be characterized by advances and setbacks. Greater integration will likely take a lengthy time to occur, meaning that single country sovereign debt risk will remain an important factor going forward. France and Italy are global players and have different debt risk, which market participants have a keen interest in appropriately hedging. The OAT and BTP complex provide financial instruments with new liquidity and new opportunities for proprietary traders to extend strategies and discover new trading patterns. This will be extended even further with the introduction of OAT options.

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