YieldCurve.com

The Futures Bond Basis: government bond futures and basis trading
A serialisation in three parts

ABSTRACT

Government bond futures contracts, traded on an exchange and representing a very liquid product, are a key component of the global bond markets. The nominal value of bonds represented by daily trading in the futures markets far exceeds the actual nominal value of the cash bond market itself. The difference between the price of a cash bond and its implied price as given by a futures contract, is the *basis*. The basis has a significant impact on the use of bond futures for both hedging and speculative purposes. Given its importance, it is vital that market participants have a clear understanding both of the basis itself as well as its dynamics.

The objective of this serialisation, in three chapters, is to describe and explain the basis in non-technical terms. We do this by taking examples from the United Kingdom gilt market, although the basic principles will be applicable in any bond futures market. As such, we consider:

- the futures contracts themselves, including contract specifications and the concept of the cheapest-to-deliver;
- price and delivery data for a sample of gilt contracts;
- the drivers of the basis and its dynamics;
- the mechanics of basis trading;
- a detailed explanation of gross and net basis, and the implied repo rate.

We wish to provide an introductory description and analysis of the futures bond basis; readers who wish to investigate the markets in greater depth may wish to consult Moorad Choudhry's book *The Bond and Money Markets: Strategy, Trading, Analysis*, published by Butterworth Heinemann.