

Growing vulnerabilities in US Treasury market

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In March 2020, at the start of the pandemic, the \$22 trillion US Treasury market, where US government debt is bought and sold, froze. It threatened to set off a global crisis potentially worse than the financial market meltdown of 2008.

Stability was only restored to the world's most important financial market through a massive intervention by the US Federal Reserve which pumped in around \$4 trillion, essentially becoming the backstop for the entire financial system.

In the period since then, despite various reports and investigations, none of the problems that set off the crisis has been resolved and there are warnings the conditions that produced it are building up again.

Writing in the *Financial Times* last week, columnist Gillian Tett pointed to a report by the US Federal Reserve which indicated that conditions in the Treasury market were beginning to resemble those that preceded and helped spark the March 2020 crisis.

The immediate cause of that crisis was the movement of interest rates in such a way that hedge funds were forced to exit the highly leveraged bets they had made based on US Treasuries. The sell-off set in motion a stampede for the exits, such that at one point there were no buyers for US government debt, supposedly the safest financial asset in the world.

The hedge funds relied heavily in their operations on repurchase agreements (repos) in which bonds are exchanged for cash which is then used to finance further bets. Now those conditions are returning.

According to the Fed report, economists had noted that “hedge fund repo borrowing rose by \$120 billion between October 4, 2022, and May 9 2023, and was higher as of May 9 2023 than it was at its previous peak in 2019.”

Tett continued: “Yes, you read right: positioning is

apparently more extreme today than before the pandemic debacle. And this, they note, ‘presents a financial stability vulnerability because the trade is highly leveraged [dependent on borrowed funds] and is exposed to both changes in futures and changes in repo spreads.’”

That is, as Tett noted, the market is highly vulnerable to sharp shifts in interest rates.

A report by the Financial Stability Board, a global watchdog comprised of top finance ministers and regulators, prepared for the G20 Summit last weekend, also points to sources of instability.

A letter sent to the Summit by FSB chairman Klaas Knot, president of the Dutch central bank, offered reassurances that mechanisms put in place by the G20 after 2008 had largely held up.

The report itself, however, indicated a number of sources of instability, particularly the use of “synthetic leverage” where debt arrangements are based not on an actual asset but on a derivative, the value of which depends on an underlying asset.

It also indicated, as have many other reports, that there are large areas of the financial system, mostly those involving non-banking financial intermediaries (NBFIs) such as hedge funds, of which regulators and financial authorities have little or no knowledge.

The FSB report noted that some hedge funds had “very high levels of synthetic leverage” using complex financial instruments to create debt which frequently does not show up on balance sheets.

“Several recent market events,” the report said, “such as the March 2020 turmoil as well as the failure of Archegos Capital Management and strains in commodities and bond markets, underscore the need to strengthen the resilience of non-bank financial intermediation.”

However, to strengthen the resilience of the system it is necessary to know what is going on. And here there are major problems, which the report revealed.

It identified “a number of data gaps which have made it difficult to fully assess the vulnerabilities associated with NBFIs leverage. Family offices [Archegos Capital was one such], for example, may be taking on leverage, but little public and regulatory data are available to measure the nature, the size and concentration of those positions.”

“Similarly,” the report continued, “pension funds’ leverage is difficult to assess without more information on their investments.”

Pension funds, which might have once been viewed as conservative institutions far removed from the kind of speculative activities associated with hedge funds, came sharply into view in Britain a year ago.

Financial investments they had made were hit by a rapid rise in interest rates. A major crisis was only averted through the intervention of the Bank of England into the bond market.

In her comment on Treasury market vulnerabilities, Tett noted one of the reasons why the FSB was sounding the alarm: “2020 demonstrated how shockwaves from NBFIs trades could spread. And what is particularly unnerving right now is that the structural vulnerabilities in the Treasuries market that exacerbated the Treasuries basis shock not only remain in place—they could actually be getting worse.”

This only raises the question of why the US Treasury market, supposedly the most liquid and safe in the world and one of the central foundations of the global financial system, has increasingly come to resemble a giant gambling casino in which major losses can be incurred.

One of the reasons is the trillions of dollars pumped into the system by the Fed and other central banks have gone, under the quantitative easing program, into financial markets that have financed speculation.

Another factor is the regulatory changes introduced after the crisis of 2008 aimed to increase the stability of banks, especially those deemed “too big to fail.”

As often happens when a reform is introduced to try and maintain a rotting system, it creates problems elsewhere. In this case, in order to comply with the new requirements, the banks stepped back from the Treasury market where their role as primary dealers had a

stabilising effect.

This has meant that hedge funds, often engaged in speculative ventures funded with borrowed money, have come to play a more significant role.

According to a paper by Darell Duffie, a Stanford professor, one measure of the decline in traditional sources is that “since 2007, the total size of primary dealer balance sheets per dollar of Treasuries outstanding has shrunk by a factor of nearly four and could go even lower.”

Tett described it as “one of the most startling statistics I have recently seen.”

And for good reason. Together with other data and the open admission by authorities that they have no real knowledge of the system over which they are supposed to preside leads to an obvious conclusion. Despite public assurances that the financial system is “sound and resilient,” it is on the road to another crisis.



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