

# Another warning on US Treasury market instability

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The Bank for International Settlements has warned that the \$22 trillion US Treasury market could be headed for another episode of major turbulence because of highly leveraged hedge fund bets.

“Speculative positions by leveraged investors are back,” it said. Bets by hedge funds were creating conditions similar to those which led to turbulence in September 2019 and a major crisis in March 2020.

The warning, set out in the BIS quarterly review issued on Tuesday, is the third to come from a major regulatory body in the past weeks.

In a report last month, the US Federal Reserve said there had been a build-up in the so-called “basis trade” which seeks to exploit the very small differences between the price of Treasury bonds and their price in futures markets.

The Financial Stability Board, a global watchdog consisting of the world’s major finance ministers and central bankers, issued a report to the recent G20 meeting. It warned that hedge funds with large levels of debt created using derivatives had the potential to create market instability.

Adding its voice to these warnings, the BIS said: “The current build-up of leveraged short positions in US Treasury is a financial vulnerability worth monitoring because of the margin spirals it could potentially trigger.”

This refers to a situation in which lenders call for an increase in cash from the hedge funds to which they have lent money—a margin call—because the value of the underlying asset on which the loan is based has fallen. This can trigger a sell-off of assets to meet the call, and a downward spiral, as borrowers seek to meet the demand for additional cash.

“Margin deleveraging, if disorderly, has the potential to dislocate core fixed income markets,” it said.

The source of the potential turbulence lies not in the periphery but at the very centre of the global financial system. The US Treasury market forms the foundation of the global financial system.

In September 2019 there was major turbulence in the repurchase or repo market in which traders receive money, sometimes merely overnight, on the basis of bonds which they agree to repurchase. Repo interest rates underwent wild swings, sometimes reaching record highs, forcing to the Federal Reserve to intervene to restore stability.

This was the prelude to a much bigger crisis in March 2020, at the start of the pandemic. The Treasury market froze. For several days no buyers could be found for US government debt, supposedly the safest financial asset in the world. As a result, the Fed had to intervene to the tune of trillions of dollars.

The potential for extreme market volatility lies in the nature of the trades being carried out. The difference in the price of Treasury bonds and their price in futures markets is miniscule and so large amounts of money must be outlaid to make a profit.

The hedge funds do not spend their own money but borrow heavily in order to leverage their profits.

However, if market conditions turn in an unanticipated way, then highly leveraged funds can be forced to liquidate their positions and trigger a broad market sell-off.

Adding to the potential market instability is uncertainty over the direction of the Fed’s interest rate policy. After hiking interest rates by 5.25 percentage points over the past year and a half, the question is whether it will continue to increase or announce a pause, possibly at the meeting scheduled today.

So far this year investors have put \$1 trillion into short-term money market funds, where they receive a

return of around 5 percent because they are unsure of where the Fed is heading.

According to analysts at the Bank of America, the flood of cash into lower-risk market funds is an expression of “one trillion dollars of doubt.”

“The inflows to cash reflect a tremendous amount of doubt as to whether it’s a soft or hard landing, whether the Fed’s done or not done, whether it’s a bull market or still a bear market,” Michael Hartnett, a BofA investment strategist wrote.

The uncertainty means that even more attention than usual will be paid to the Fed’s summary projections of its members—the so-called dot plot—that will be released when it announces its interest rate decision today.

Apart from the immediate market movements, there are deeper processes at work.

Writing in the *Financial Times* earlier this month, Vinod Thomas, a former vice-president at the World Bank, likened the global financial system to the Titanic, which was assumed to be unsinkable.

“A similar assumption underpins today’s international financial architecture in the face of a polycrisis: runaway climate change, financial faultlines, the health pandemic, geopolitical dangers, the next generation of artificial intelligence and global water and food shortages.”

He warned that the interplay of the climate crisis with financial fragility alone threatened “potentially insurmountable dangers unless immediate action is taken.” As a result of the effects of climate change, “insurance companies would face unprecedented claims and a decimated investment portfolio, wiping out their capital bases.”

Banks would then be “knocking on central bank doors to fend off the impact of insurance company defaults.”

Thomas noted that global debt had reached “unprecedented levels” under conditions where, following the global financial crisis of 2008, a shadow banking system of non-bank financial intermediaries (NBFIs) dominates about half of global financing. The amount of unregulated financing attributable to NBFIs is about \$240 trillion.

Moreover, financial authorities, as has been made clear in numerous reports, including from the International Monetary Fund, have little or no idea about the connections of much of the NBFI operations

with the broader banking system.

Highlighting the mounting debt crisis of the global capitalist system, was the announcement on Tuesday that US national debt had gone over \$33 trillion. A little more than a year and a half ago when it passed \$30 trillion the *New York Times* characterised it as an “ominous fiscal milestone” that underscored the fragility of the long-term health of the US economy.

Now it has zoomed past that milestone and is set to go further, above all because of increased military spending.



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