Growing concerns over US Treasury market speculation

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The $25 trillion US Treasury market, the basis of the global financial system, where US government debt is bought and sold, is increasingly coming to resemble a giant gambling casino.

Traditional mechanisms, generally models of financial conservatism, through which the market has functioned for decades, are being dispensed with. It is becoming more and more dominated by hedge funds and their highly speculative and risky operations.

Sound common sense would suggest that regulatory authorities should take action to control and limit the role of the hedge funds. Already their activities have led to major turbulence, in September 2019 in the repo or repurchase market, where Treasury bonds are traded for cash on a short-term basis, and in March 2020 when the Treasury markets froze for a number of days.

But seeming rationality does not get a look-in because hedge fund activity, based on highly leveraged bets, is essential for the functioning of the market itself. The issue has sparked concern among regulatory authorities but no remedies to what are perceived as dangers have been advanced. This is not least because, lacking necessary data, the authorities themselves have no clear idea what is going on.

In recent weeks the issue has been the subject of reports by the US Federal Reserve, the Financial Stability Board and the Bank for International Settlements.

These have focused on the so-called basis trade which involves the making of profit from the very small difference between the price of bonds and their price in futures markets. Hedge funds have been shorting Treasury futures, that is selling what they do not have, and buying bonds in the market when the futures contract becomes due.

If the bond is priced higher in the futures market, then a profit is made. But the difference is miniscule, often just a few thousands of a percentage point, so a vast amount of money must be laid out. The hedge funds spend little of their own capital but leverage the deal by using borrowed money.

Because they are dealing in US Treasury bonds, regarded as the safest financial asset in the world, hedge funds are only required to put up a small amount of cash with their lenders. Sometimes they can lever up by more than 100 times. The *Financial Times* reported a case where leverage was 500 times.

Vast profits can be made in this way, seemingly out of thin air. But under conditions of market disturbance, things can quickly unravel in a number of ways. Lenders may demand increased collateral where risk is seen to have increased or the clearing houses, which run futures trading, may do the same.

This can lead to a situation where to meet cash demands traders must sell assets. In a recent article on the basis trade, the *Financial Times* (FT) noted: “Regulators say all this adds up to a situation where just a few large firms getting out of their bets could potentially encourage or force others to do the same, quickly leading to a doom loop of distressed selling in the world’s most important asset market.”

The article cited Matthew Scott, head of rates trading at AllianceBernstein, who said: “My biggest concern is that if we get a big unwind in this leveraged trade, it could really cause liquidity to dry up in the Treasury market.”

This is what happened in March 2020 when investors all headed for the exits and there were no buyers for US debt.

But the risky trades continue, not least because the speculators are counting on the Fed to intervene in the market to carry out a rescue operation to bail them out

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as it has in the past. That is, they operate on the basis that, in the final analysis, they have the backing of the financial arm of the state—a situation of so-called moral hazard.

In the words of one unnamed executive at a US bank cited by the FT: “The assumption is that the Fed will step in to save the repo market, which they have in the past, so my view is they will step in again if anything happens.”

The hedge funds maintain that, while their operations are certainly not risk free, they perform an essential role without which the market could not function. And it is a measure of the inherent instability of the entire global financial system, which has only deepened since the crisis of 2008, that there is more than a grain of truth in their assertions.

Two of the most significant phenomena of the past 15 years have been the expansion of US public debt and the size of the Treasury market.

In 2007, on the eve of the financial crisis, debt was around 35 percent of GDP. Today it is touching 100 percent and is expected to rapidly go beyond that mark. Twenty years ago, national debt was around $6.5 trillion. It has now just passed $33 trillion—a five-fold increase.

There has been a corresponding growth in the US Treasury market. It has expanded from around $5 trillion at the start of 2008 to $25 trillion today. This has been coupled with a transformation in the way it has functioned.

Previously, market stability was provided by the so-called primary dealers, the 24 banks which deal directly with the Treasury department. They continue to play an important role. But as a result of regulations introduced in the wake of 2008, aimed at trying to increase their capital base, these banks have pulled back from Treasury market operations and hedge funds have assumed an ever-greater role.

As one senior executive at a major global hedge fund told the FT: “If hedge funds stopped buying Treasuries, I don’t know who would buy them.”

Another, Don Wilson, chief executive of DRW, a major global trading firm, made a more threatening comment.

Noting that the amount of US Treasury debt was growing, and deficits were here to stay, he said: “The need for leveraged market participants to facilitate cash-to-derivative transformation will keep growing and discouraging it will bring significant adverse consequences.”

In other words, having promoted the growth of the hedge fund speculators through the continual pumping of money into the financial system by the Fed and more than a decade of virtually zero interest rates, the supposed regulators and guardians of the stability of the most important financial market in the world, are now completely beholden to them.

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