CHART OF THE WEEK

13 December 2023

UNITED STATES: RISING INTEREST RATES FUEL HEDGE FUND ARBITRAGE

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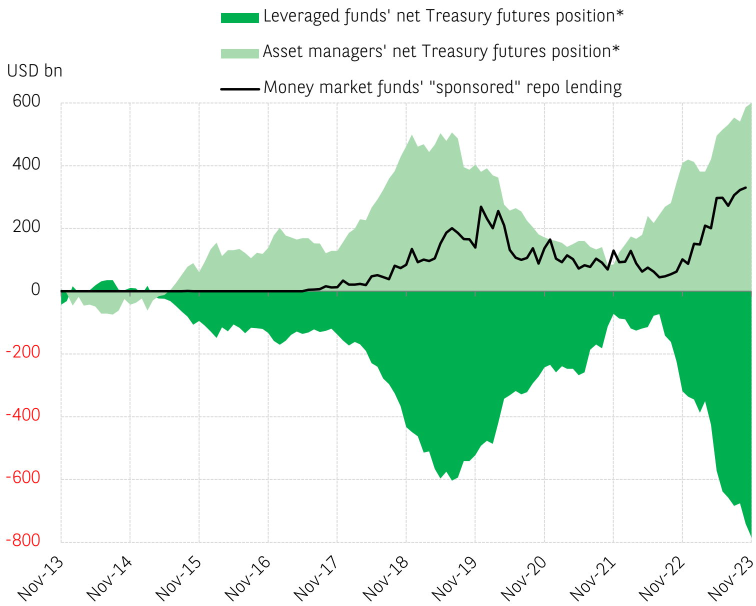
Hedge funds' net short position at an all-time high



* Sum of net futures positions in 2-, 5- and 10-year contracts

Source: CFTC, OFR, BNP Paribas

The net short position of hedge funds in the US Treasury futures market has expanded considerably over the course of the year. At the end of November, it stood at an unprecedented level of almost USD 800 billion. Asset managers, eager to hedge against interest-rate risk, increased their net long positions.

Among hedge funds, some are betting that Treasuries yields will continue to rise (and thus anticipate a decline in the future value of the securities), while others are exploiting the price difference between the cash and futures markets («cash-futures basis trade»). This second strategy involves buying securities on the cash market, financing the purchase on the repo market, taking a short position on the futures market, and finally delivering the securities when the futures contract expires. To maximize their gains, hedge funds use leverage by piling up positions. However, in the event of a spike in volatility on one of the market segments, as was the case in March 2020, the simultaneous unwinding of positions can spread stress and disrupt all the markets on which Treasuries are traded.

The re-emergence of this strategy is confirmed by the increase in repo borrowing by hedge funds[1], in particular from money market funds via the «Sponsored service» of the Fixed Income Clearing Corporation (FICC)[2]. This service enables dealers to sponsor the «indirect» membership of some of their counterparties (money market funds and hedge funds) in the FICC, rather than acting as intermediaries in the non-centrally cleared (tri-party and bilateral) markets. This enables them to lighten their balance sheets and save capital. The reallocation of money market fund assets[3], triggered by the rise in market rates, thus seems to have contributed to recent hedge fund arbitrage and preserved the balance sheet capacity of primary dealers.

1 The first strategy (taking positions on the futures market only) does not require prior financing (except to meet margin calls).
2 The FICC authorizes multilateral centralized clearing of positions between clearing members and between «sponsored» members, see United States: Will the Fed's QT2 balance sheet reduction programme last the course?
3 See United States: The centrally cleared repo segment expands and United States: Money market funds reallocate their assets outside the ON RRP facility

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