Stop hedge funds sparking a new global crash

US regulators are making moves to rein in the secretive, unsupervised hedge fund behaviour that is jeopardising US Treasury markets, but will their actions stabilise or shake global finance?

Propping up the existing financial architecture is a lose-lose equation, no matter which way you cut it. Plugging holes by propping up banks, making them too-big-to-fail, is risky all round, but the alternative—letting them collapse—is risky too. Easy monetary policy, money-pumping and interest rate cuts had long-term risks, as seen after the 2008 global financial crisis. But so does tightening the belt and raising rates, the brunt of which the world has been experiencing in the past few years, with average citizens paying the price for protecting “financial stability”.

The US Treasury (government bond) market has now fallen victim to this lose-lose formula. Rising rates have left banks with masses of devalued Treasuries on their books in a bind and made a game of “hot potato” over who will be left holding them.

There is no solution to this conundrum within the current framework. Our leaders have thus far failed to recognise the inherent corruption of the global financial system, which was entrenched after World War II to rig the game in favour of the City of London-Wall Street banking elite. Since the 1971 destruction of the last vestiges of the previous, Bretton-Woods monetary arrangement, which had ensured a connection between finance and the real economy, economies have suffered from a never-ending series of financial shocks. (See “Who ended the Bretton Woods system and opened an age of infinite speculation?”, available at citizensparty.org.au/australian-alert-service-feature-articles/economic)

The US Treasury market, where the US government issues debt securities to fund itself, is recognised as the premier bond market on the planet. It is the “bedrock” of global financial markets, due to the primacy of the US dollar system. It provides a benchmark for securities markets around the globe. But its reputation as the deepest and most liquid of all markets has been shattered, particularly since “repo” markets seized up in September 2019, and again in March 2020. The repo market is a facility where US Treasuries can be sold in return for cash and then “repurchased” on a shortterm basis (mostly overnight), so financial institutions can obtain liquidity, source treasury bonds required for collateral held against speculative trades, or to hedge against other risky positions. These trades also happen in the reverse (reverse repo).

The 20 December *Australian Financial Review* described the US Treasury market as “the cornerstone of global capital markets” and recounted, as this news service has done in recent years, how speculative hedge funds specialising in risky derivatives trading, have taken over the repo market. This occurred particularly as banks faced restrictions on more highly leveraged operations following the 2008 crisis. As a result, a handful of hedge funds now dominate operations of US Treasury markets, reports *AFR*, and like the banks they replaced, they have themselves become “too big to fail”. Efforts to save the existing system have created a whole new layer of vulnerability.

FINANCIAL REVIEW

The hedge fund traders dominating a huge bet on bonds

Three hedge fund traders are the driving force behind a gigantic wager on government debt that has regulators worried.

Nishant Kumar, Donal Griffin and William Shaw

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Jonathan Hoffman, John Bonello and Jonathan Tipermas share more than just similar first names. They're the driving force behind a gigantic wager on government debt that has been giving regulators sleepless nights.

The expanded participation of hedge funds in repo markets has fostered a massive growth of speculation in US Treasury bonds. Betting known as the “basis trade” has US regulators worried, reported *AFR* in its article, sourced from Bloomberg. This trade allows hedge funds to profit from the difference between Treasuries and futures contracts for Treasuries. While the miniscule difference does not readily make for large profits, it is done on such a large scale and with such highly leveraged debt, that it makes billions of dollars for its practitioners and has swamped the Treasury market. *AFR* points to the dominance of just three traders, ExodusPoint Capital Management, Millennium Management, and Citadel; fewer than eight traders are responsible for over half the basis trade bets on two-year Treasuries, according to Commodity Futures Trading Commission figures. Other indicators show the basis trade at the end of 2023 was surging.

Such highly-leveraged speculative trades can unwind rapidly and disrupt the entire Treasury market.

Hence, the regulator crackdown. On 13 December 2023 the Securities and Exchange Commission (SEC) voted 4-1 to introduce a new rule requiring some Treasury purchases and repo agreements to be centrally cleared—meaning that all trades will be conducted through a middleman which guarantees them in case either party defaults. This means hedge funds will have to post increased collateral to back their trades. The new rule, which will be phased in fully by June 2026, targets lightly regulated entities such as hedge funds and is designed to ensure liquidity and resolve volatility in Treasury markets.

AFR notes: “But regulators are in a bind. Crack down too hard and they could threaten the orderly

running of a US Treasuries market that has ballooned to US$26 trillion ($38.4 trillion) since the pandemic. Go too easy and there is the threat of too much financial leverage building up at these hedge funds. The size of the traders' positions means the Fed may have to intervene if they hit trouble again."

The man who is credited with inventing the basis trade, Suresh Sundaresan, a professor of finance and economics at Columbia University, who has consulted for leading investment banks and served on the Treasury Bond Markets Advisory Committee, is worried. He told Bloomberg that the industry has become "more levered than ever before with the possible exception" of just before the financial crisis. "Regulators' concerns are fully justified", he said. "My worry is that an exogenous shock may lead to margin calls, which may result in insolvencies or big losses for the hedge funds."

Piecemeal efforts to patch up the financial architecture, without a fundamental rethink and redesign will surely backfire. The win-win approach requires regulating the hedge funds out of existence. SEC chair Gary Gensler, the former Commodity Futures Trading Commission chair who blamed derivatives for the 2008 crash, has made a start, but *all* of the financial deregulation and neoliberal conditions which encourage these speculative agencies must be dismantled. Lawfully, those changes would also serve to encourage investment into productive enterprise and development, sparking real economic growth, the true panacea for all financial ills.

By Elisa Barwick, Australian Alert Service, 17 January 2024

For more articles on this subject, see our Reinventing Bailouts page.

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