The rise of the hedge funds

By Elisa Barwick

Laughably, the US Federal Reserve claims all banks passed its latest stress tests with flying colours, with more than enough capital set aside to save themselves in a crunch. However, the Fed needs to scrutinise other financial entities with the capability of shaking the banking system to its inadequate foundations: hedge funds.

Last week we looked at the dangers of barely-regulated hedge funds speculating on the movements of cryptocurrency. ("Crypto blind spots could blow up financial system", *AAS*, 7 July.) Now we take up an even more dangerous development that threatens financial stability. Over recent years hedge funds, which speculate in risky financial derivatives on behalf of elite investors to make profits entirely unconnected to the real economy, have been granted an increasingly central role in provision of liquidity for the overall banking system.

This role is one of the reasons for the financial crunch of March 2020, which is now viewed by many experts (albeit quietly) as a real-life stress test of the banking system, which amounted to a gigantic failure. More importantly, even by official reports, the episode revealed that a gradual but dramatic shift in finance is under way.

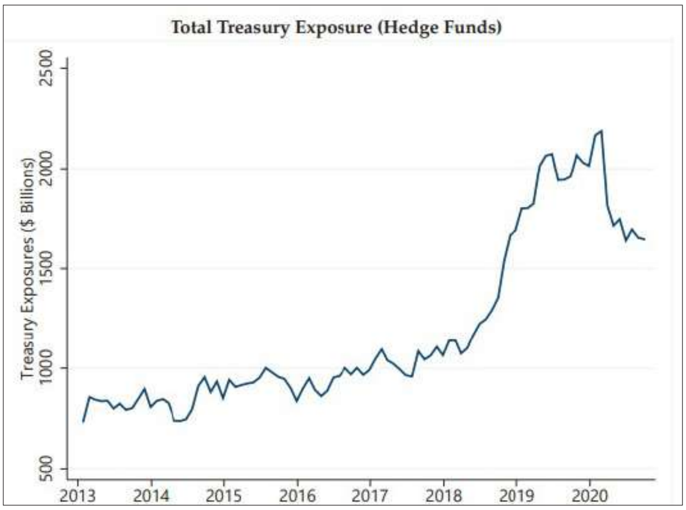
An April 2021 report by the US Fed Board, "Hedge Fund Treasury Trading and Funding Fragility: Evidence from the COVID-19 Crisis", makes this shift apparent. The stakes are clear at the outset: "Compared to previous crisis episodes, the March 2020 shock was unprecedented", stated the Board, "particularly in the speed and scale at which extreme moves occurred and in its impact on otherwise safe and liquid markets such as the UST [US Treasury bond] market."

This destabilisation was made possible due to regulatory changes allowing hedge funds greater and more direct participation in repurchase agreement ("repo") markets, the markets that supply overnight and short-term liquidity to the entire financial system, in which Treasuries are put up as collateral. This has fostered a major expansion of hedge fund speculation in US Treasury (government) bonds.

Unlike banks, which deal with deposits, retail investments and lending into the economy, hedge funds should theoretically have a more limited impact if they collapse. However, as they have become more intricately intertwined with everyday financial market functions and with the too-big-to-fail banks, their dangerous speculative activity threatens to explode the entire financial system—impacting government, banks, the economy and ordinary people.

Treasury turmoil

The Fed report examined the impact of Treasury market turmoil triggered by a sudden brake on economic activity combined with a foreign and domestic Treasury bond sell-off as COVID-19 reached the USA. As their bets on Treasuries went bad, hedge funds were desperate for cash and sold close to 20 per cent of their Treasury holdings, worsening the Treasury market dislocation. The impact flowed through other capitals markets, which seized up. The Fed had to intervene, purchasing billions of dollars of Treasury paper itself.



Total Treasury bond holdings of hedge funds. Source: OFR report, "Hedge Funds and the Treasury Cash-Futures Disconnect"

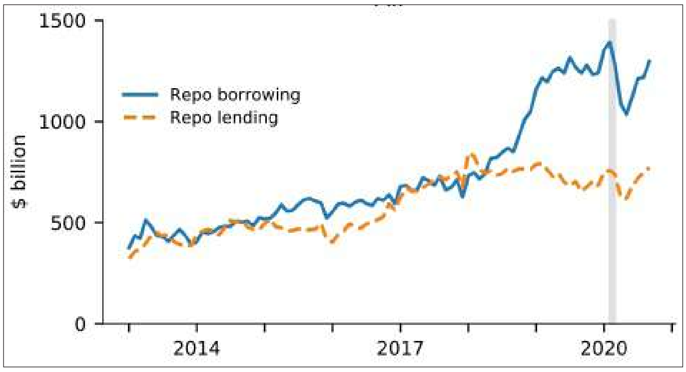
The average hedge fund with Treasury exposure recorded a monthly return of negative 7 per cent. The funds were primarily engaged in betting on the difference between the current Treasury bond price and "futures contracts" (the price for future delivery) on the same instruments. In this trade, known as the Treasury cash-futures basis, hedge funds are big users of overnight repo market borrowing.

The Fed reported that the actions of hedge funds in March 2020 were "consistent with a flight to cash and precautionary hoarding of liquidity and significant losses, increased uncertainty, and anticipated redemptions", adding that "little is known about the liquidity management behaviour of the hedge fund sector in stressed conditions". It was its quick intervention to stabilise Treasury markets, the Fed noted, that "likely prevented a deleveraging spiral in which hedge funds would have further sold off positions in a declining market, realising more losses and further depleting their equity." Such a meltdown would have detonated the ready-to-burst global financial bubble.

Post-2008: the shift begins

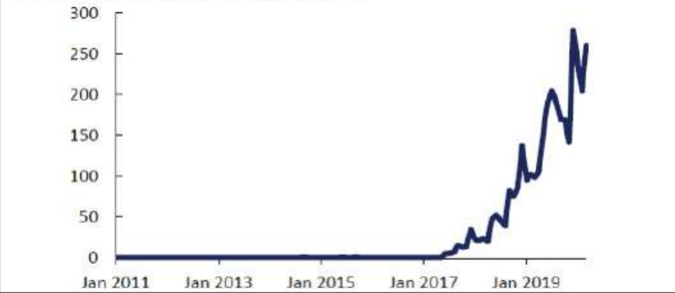
It is important to remember that the US Treasury market is not just a sideshow where investors can make a quick buck. It is the debt market that funds the US government. The US Treasury issues bonds and they are purchased with cash. If this market seizes up, as in March 2020, it has critical implications. As Fed Chairman Jerome Powell made clear in a 28 April 2021 press conference, "the US Treasury market is probably the single most important market in the economy and the world. It needs to be liquid." He explained, however, that primary dealers (the banks that manage Treasury and repo markets with the Fed) are "committing less capital" to Treasuries than 10 or 15 years ago, while more capital than ever is needed, given there is "so much more supply of Treasuries".

In its report, the Fed stated that the role of hedge funds in US Treasury markets has increased since the 2008 financial crisis "as bank-affiliated broker-dealers ceded some of their traditional activities in UST market arbitrage and liquidity provision to nonbank financial institutions". US Treasuries have a "vital role in the global financial system", the



Increase in hedge fund repo borrowing and lending (reverse repo). Source: US Fed report, "Hedge Fund Treasury Trading and Funding Fragility"

Figure 20: **Money market fund repo with FICC ($ billions).** Aggregate repo volume outstanding. FICC stands for Fixed Income Clearing Corporation.



The increase in repo volume by money market funds. According to the OFR, "cash provided by money market funds is mostly passed on to hedge funds". Source: OFR report

report states, yet the "hedge funds' impact on UST market functioning is not well understood because they are less regulated than traditional broker-dealers and provide few disclosures". Furthermore, the report adds, "hedge funds employ substantial leverage coupled with investment strategies that are less liquid". The report is billed as a preliminary effort to provide "a granular view of how hedge funds face a systematic crisis in terms of their liquidity and leverage management". Yet, these entities have not been separated from the nation's critical financial machinery!

Already by mid-2019 hedge funds held almost US$1.4 trillion in US Treasuries, with banks holding only US$524 billion. The gross exposure of hedge funds to Treasuries doubled from 2018 to 2020, reaching US$2.4 trillion.

A 25 May *Barron's* article by Alexandra Scaggs cites a number of sources indicating the Fed has knowingly allowed hedge funds to take up the slack left by banks in the Treasury market, opening it up to extreme vulnerability. Scaggs calls this a "tectonic shift" that began quietly after the 2008 crisis, with banks retreating from supplying liquidity as their capital requirements were raised, engaging instead in more high-risk trading for greater profit. As they withdrew, "Hedge funds and other trading firms have moved in to replace them", wrote Scaggs.

Barron's reported: Fed economist and US President Joe Biden's pick for Under Secretary for Domestic Finance, Nellie Liang, warned of changes in the market and "shifts in market participants' behaviour" in her confirmation testimony to the US Senate; the Treasury Borrowing Advisory Committee, which advises the Treasury on debt management, suggested that "market structure" has contributed to recent volatility; a 1 April 2021 report by independent Treasury bureau the Office of Financial Research (OFR), "Hedge funds and the Treasury cash-futures disconnect", pointed to the risks created by "non-bank actors in the current structure of the Treasury market"; JPMorgan Chase interest rate strategist Joshua Younger observed that "Treasury inventory management is being outsourced to the hedge-fund industry"; and Treasury Secretary and former Fed Chair Janet Yellen told a March 2021 meeting of the Financial Stability Oversight Council that "The pandemic showed that leverage of some hedge funds can amplify stresses too".

Hedge fund takeover

The April OFR paper discussed "the rise of hedge funds as participants in both repo and Treasury markets", examining details of the "changing nature of the Treasury market, particularly the increased importance of non-bank actors and repo markets in Treasury market functioning".

In 2017, clearing and settlement facility, the Depository Trust and Clearing Corporation, allowed hedge funds to participate in repo operations for the first time, under the sponsorship of official dealers. This increased dramatically in April 2019 when sponsorship was expanded to a broader range of parties, opening the floodgates to expanded repo borrowing and untrammelled Treasury speculation by hedge funds.

A number of changes, including increased Treasury bond issuance, the saturation of the balance sheets of primary dealers with Treasuries, and restrictions on bank leverage ratios, saw an explosion of hedge fund participation in Treasury trading in early 2018 and, according to OFR, this created a significant vulnerability by late 2019. Repo borrowing by hedge funds grew with the increase in their heavily-leveraged Treasury gambling. In September 2019, the first shock to repo markets occurred, which the Bank for International Settlements obscurely connected three months later to hedge fund activity.

In September 2019 primary dealers flush with liquidity had stopped lending via repo markets to hedge funds, which were haemorrhaging cash. The Fed had to step in with unprecedented regular injections of daily cash, later to be dwarfed by its March 2020 intervention ("March meltdown dwarfed September precursor!", *AAS*, 21 Oct. 2020). JPMorgan demanded banks shouldn't have to lend their reserves out overnight at all—which pool forms the base of repo lending—and that the Fed initiate a "standing repurchase-agreement facility" as a source of short-term lending that didn't involve the dealers, leaving them free to invest in higher risk (and profit) ventures. The Fed began to take steps in this direction, proposing to lend directly to hedge funds rather than via middlemen in the repo structure, something the 14 January 2020 *Wall Street Journal* said would amount to "backstopping their bets".

This picture must be viewed in the context of the "regime change in monetary policy" proposed by the world's largest asset management fund BlackRock to central bankers gathered at the August 2019 Jackson Hole summit, suggesting the Fed take over government fiscal functions and pump money directly into the economy to revive it. ("BlackRock's monetary 'regime change' is fascism", *AAS*, 28 Aug. 2019) The repo crisis which brought this proposal, and more, to prominence followed less than a month later. It cannot be allowed to stand as a pretext to usher in a transfer of the power of elected governments to private parties. Instead, speculation must be excised from the banking system with a revival of the 1933 Glass-Steagall bank separation law that put the post-1929 crisis ridden US banking sector back on track. Treasuries should be used as collateral in a national bank to bankroll economic reconstruction and development, as intended by first US Treasury Secretary Alexander Hamilton, a plan already tabled in the US Congress in the form of the National Infrastructure Bank bill (p. 12).