BNY
iFlow
SHORT THOUGHTS

**June 25, 2024**

# Treasury Basis Trade Endures

## Short Futures, Leverage, and Vulnerability

- Futures positioning data show basis trade still in vogue
- BNY iFlow and securities lending data confirm likewise
- Repo volumes fairly stable but the highly leveraged trade vulnerable to funding risks

The US Treasury basis trade remains in effect since we last wrote about it a few months ago (see here). Through this popular mechanism, leveraged players in the market short bonds in futures while maintaining a long position in cash bonds. Bond prices in futures markets are often higher than in corresponding cash markets, thanks to strong structural demand from long-term investors like pension funds, insurance companies, et al. Long-short players can exploit these pricing differentials – which are often minimal – when bond prices move around.

The top chart below shows this phenomenon via futures positions compiled and reported weekly by the Commodity Futures Trading Commission. The orange line shows CFTC combined futures positions by leveraged funds since 2017. The blue line shows the same data but for institutional asset managers. Note the almost mirror-like behavior of the two.

The bottom chart below further disaggregates leveraged funds' positions by maturities (2y, 5y, and 10y). The 2y and 5y shorts are significantly larger than the 10y shorts, which have been coming off. Inference suggests that the relatively lighter 10y positioning is due to low term premia in longer-date bond markets, making it less likely the 10y bond will rise significantly in price until the term premium (currently negative) rises.

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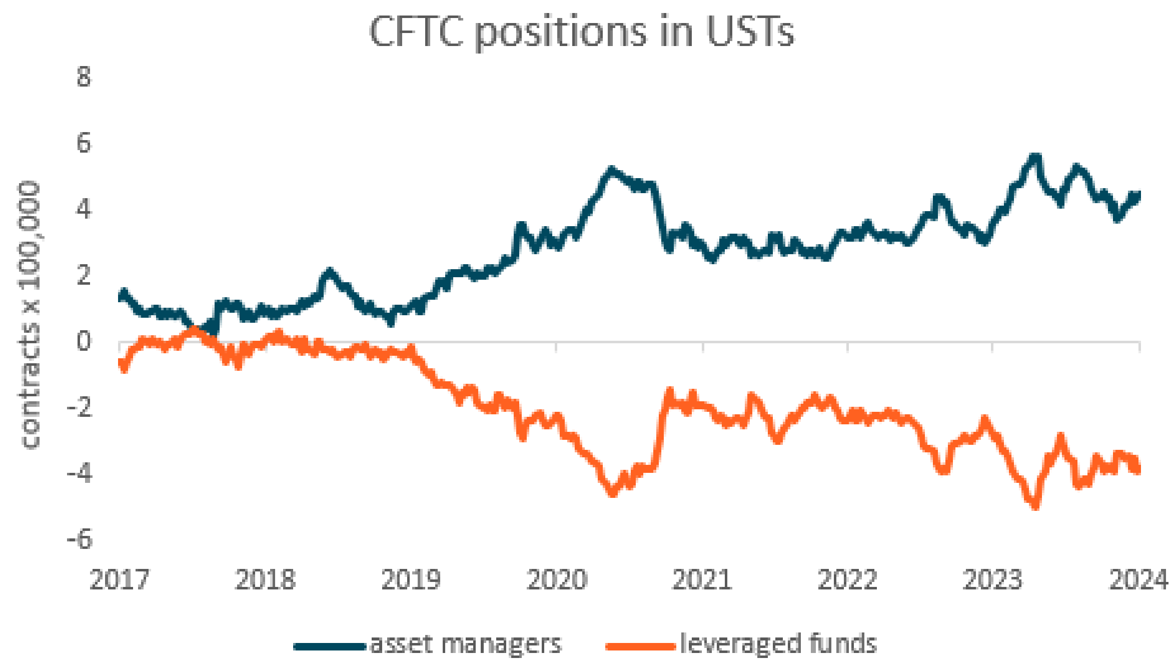
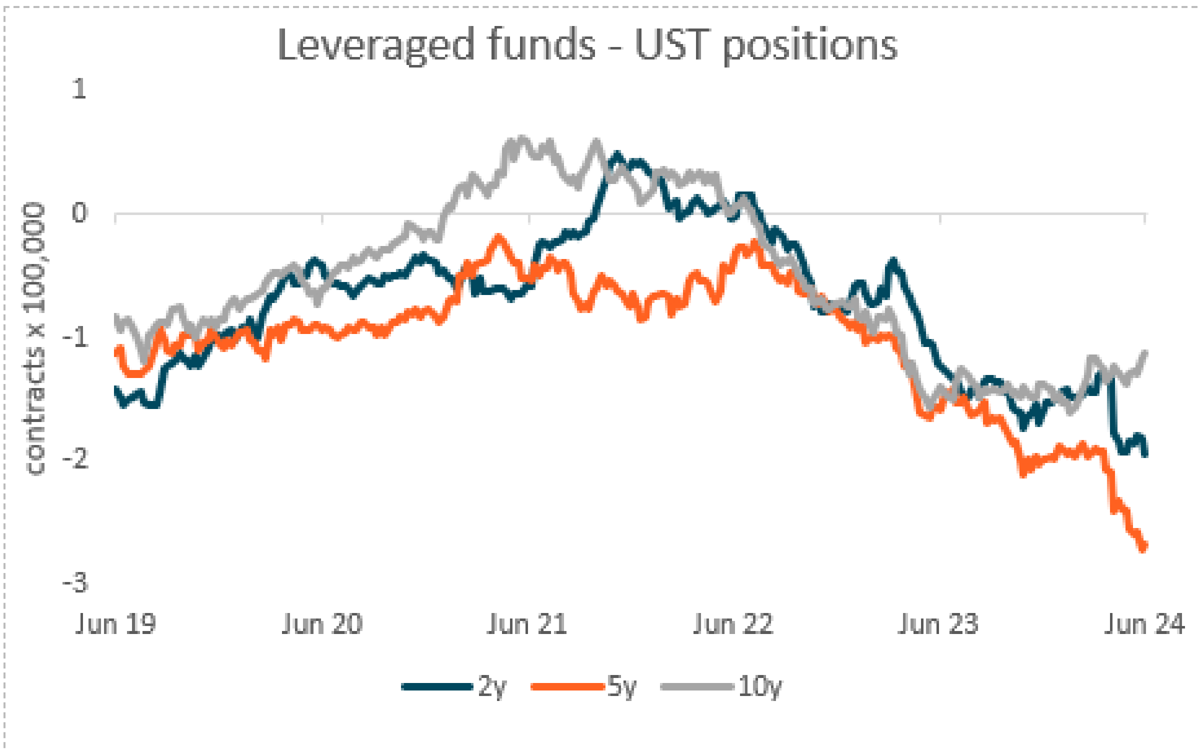
**The Long-Short Trade**




Source: BNY Markets, CFTC

**Belly Of Curve More Popular To Short Than Long End**




Source: BNY Markets, CFTC

Proprietary data from BNY reinforce this general inference. iFlow, our custody-based data on real money asset flows report – as we have documented frequently (see here, for example) –

relentless appetite for US Treasury securities. The top chart below confirms that since the middle of 2023, flows into the US sovereign bond market have been consistently positive, with only a handful of weeks exhibiting selling. Since the beginning of 2024, there have been only three weeks with negative flows. Real money is content to stay invested in the market.

For some insight into the other side, we can exploit BNY's securities lending program, which is the largest such operation in the world. The bottom chart below shows open interest in US Treasuries as a percent of total market cap. This indicates that nearly 0.8% of all US Treasuries outstanding are on loan, or in other words, are being shorted. Leveraged money is borrowing bonds to short at one of the fastest rates in the past decade. The two charts combined tell the story: asset managers are long, and hedge funds are short.

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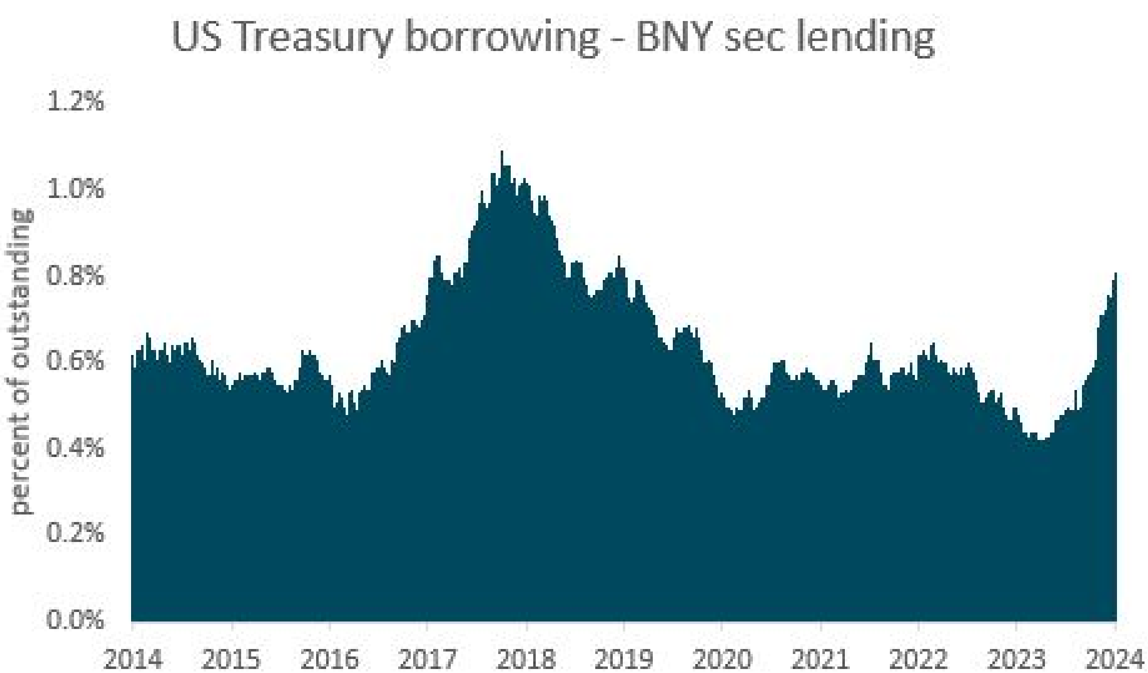
**Bond Borrowing Rises**




Source: BNY Markets

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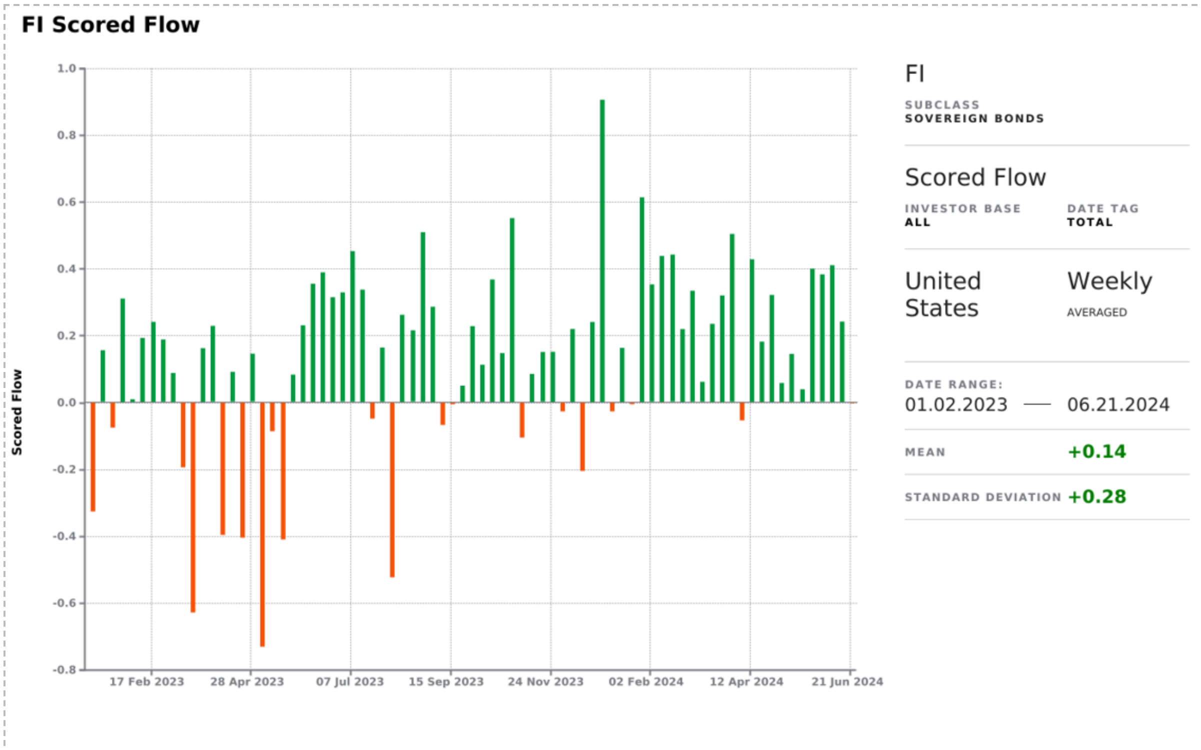
**Asset Managers Stay Long Treasuries**




Source: BNY Mellon Markets, iFlow

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Given the nearly trivial (yet still positive) profits that can be made from exploiting the Treasury basis trade, especially when taking into account borrowing costs, hedge funds employ significant leverage, funding positions via repo. This makes the basis trade especially vulnerable to potential ructions in the repo market. We are relatively sanguine that funding markets can remain relatively stress-free – through the end of the year at least. We think this should enable the basis trade to endure over that time horizon.

According to the US Treasury's Office of Financial Research, tri-party repo volumes have stabilized after a period elevated levels, while general collateral borrowing in repo has nearly tripled in volume since late 2022. Still, the latter is dwarfed by the former, and it's hard to untangle funding sources for basis trade leverage. Nevertheless, current volumes in both markets suggest no undue concern, and repo borrowing rates should stay well behaved.

The basis trade is an important feature of US Treasury markets and should continue to be in vogue. However, should repo markets begin to get stressed, an ugly unwind and hasty and significant short covering could pose a vulnerability for the bond market.

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**Repo Volumes Well Behaved**


Source: BNY Mellon, Office of Financial Research

## Disclaimer & Disclosures

**Please direct questions or comments to:** iFlow@BNYMellon.com

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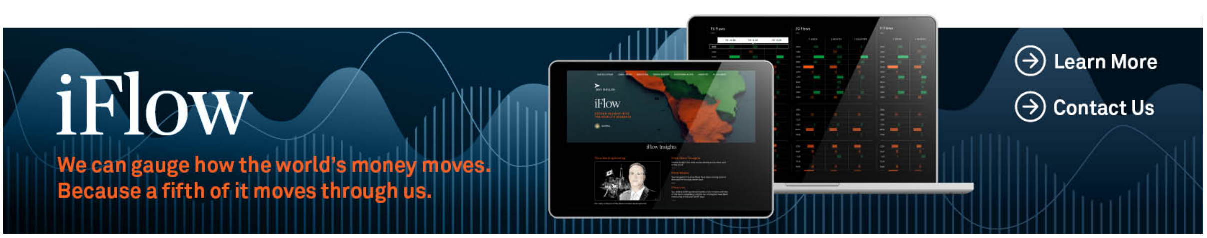


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