BNY MELLON
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SHORT THOUGHTS

April 23, 2024

Leverage In UST Basis Trade & Private Credit

- IMF and Fed publish separate financial stability reports
- Hedge funds in the basis trade using increasing amounts of repo financing
- Private credit main leverage risk in the firms that borrow from its providers

The Basis Trade

Earlier this month, the International Monetary Fund published its semi-annual Global Financial Stability Report, and last week the Federal Reserve released its own Financial Stability Report. Both editions look at various risks to the financial system. The IMF argues that although its base case for 2024 is a soft landing globally, non-baseline risks are important to understand. The Fed looks at leverage in the financial sector and points out that while the US banking sector “remained sound and resilient overall”, pockets of leverage exist, especially for hedge funds. Overall hedge fund leverage is greater than at any time in recent history, and the basis trade continues to use leverage via repo financing. In this piece, we examine leverage across the basis trade, as well as leverage and risks in private credit.

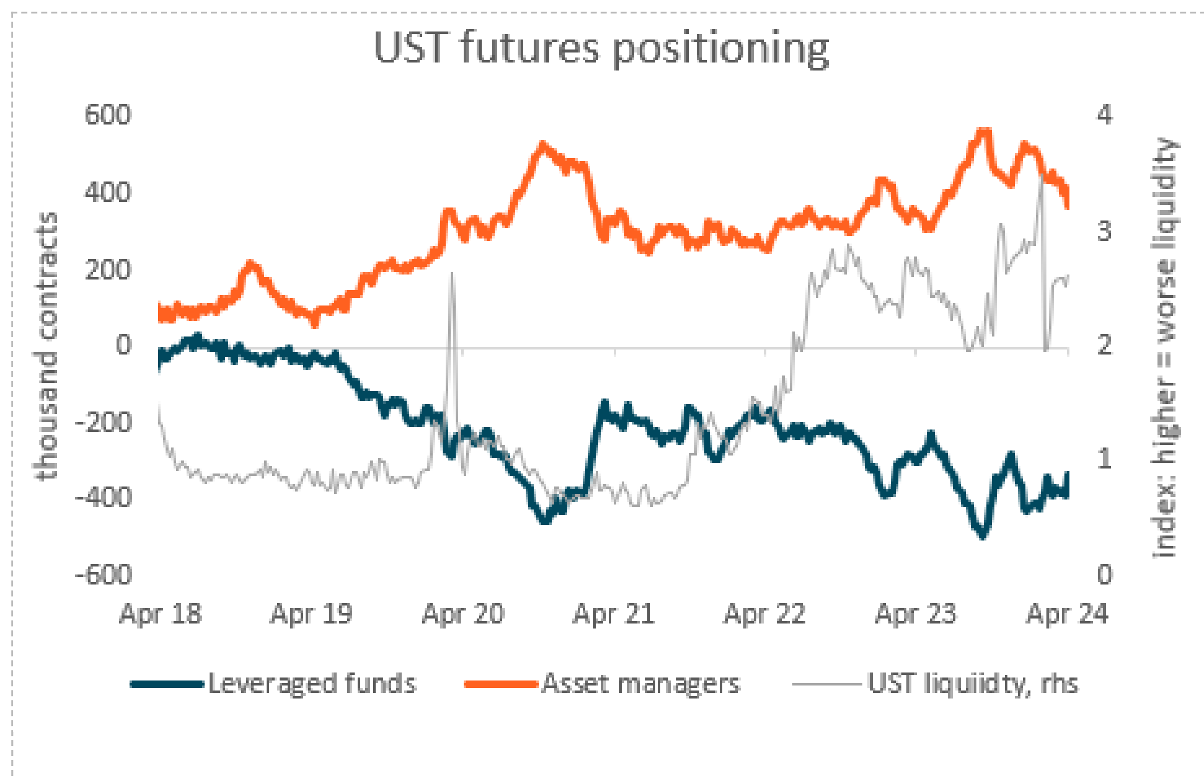
Broadly speaking, the Fed’s report indicates that “measures of leverage averaged across all hedge funds increased further in the third quarter of 2023, reaching the highest level observed since the beginning of data availability (2013).” Combining repo and margin loans, and derivatives exposure, average gross leverage for hedge funds is nearly 9 to 1. Furthermore, much of this leverage is concentrated in the 15 largest funds.

The basis trade – hedge funds short US Treasury futures/go long cash Treasuries to profit from small price deviations between the two – is funded by leverage financed by repo market borrowing. We have written about this in the past (see here). We show in the first chart below the evolution of UST futures positions for both leveraged funds and long-only asset managers, along with Bloomberg’s popular government bond liquidity measure.

The basis trade continues apace. The divergence of asset managers' positions (extended longs – orange line) and those of hedge funds (blue line) is clear. At the same time, bond market liquidity has been challenged since April 2022 – roughly coinciding with increasing basis trade positioning. In the second chart below, we plot weekly General Collateral repo volumes against the increasing short positions accumulated by leveraged money and see a clear connection. The IMF warns that basis trades are heavily exposed to repo market leverage and, should money markets endure a spike in repo rates, this "can render the trade unprofitable and could trigger the forced selling of Treasury securities and a brisk unwinding of futures positions as funds seek to quickly delever."

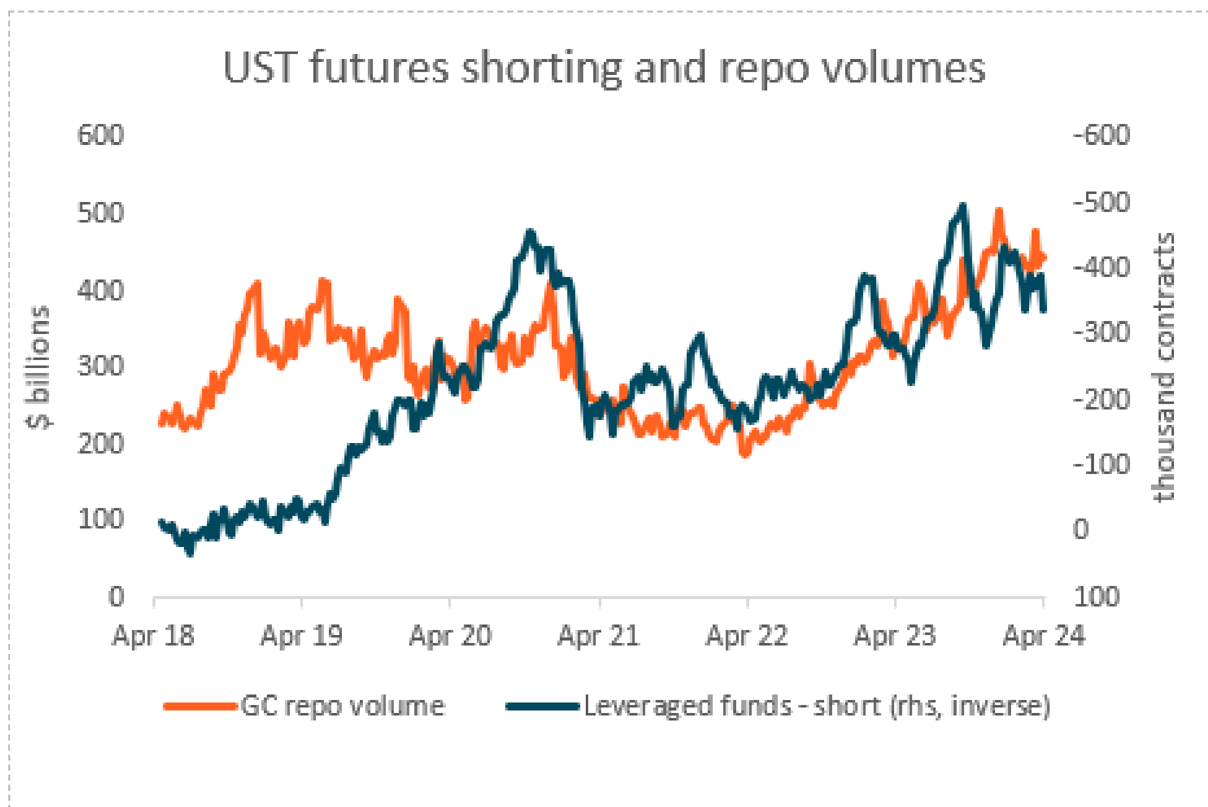
We have warned of potential shocks to funding markets, most likely coming from reserve scarcity. While not a problem at present, we continue to watch for declining reserves and the impact on funding markets, noting that the Fed – in our view – is poised to slow the pace of quantitative tightening in coming months.

The Basis Trade & Treasury Market Liquidity



Source: BNY Mellon Markets, Bloomberg

The Basis Trade & Repo Volumes



Source: BNY Mellon Markets, Bloomberg

Private Credit

Private credit is another area of the market that's gotten much attention for potential risks. The IMF's report devotes an entire chapter of its 124-page, three-chapter report to the topic. Rather than summarize the entire 24-page, 14-diagram section, we'll cut to the chase with this: in general, the IMF's view of private credit is surprisingly relaxed given the concern that has been generated by this growing – and largely opaque – asset class.

Some basics. In the US, private credit has grown in asset size from next to nothing at the beginning of the 21st century to nearly $2trn in 2023 – nearly as large as the entire high-yield and leveraged loan markets. The average firm size of a private credit borrower is just around $500mn in total assets, much smaller than the two aforementioned asset classes, but with higher debt-to-EBITDA ratios (earnings before interest, taxes, depreciation and amortization). Due to longer lock-up periods, lower liquidity and less transparency, among other features, the median yield on private credit loans is around 12%, compared to 10% for leveraged loans, 8% for HY and around 5% for IG corporates.

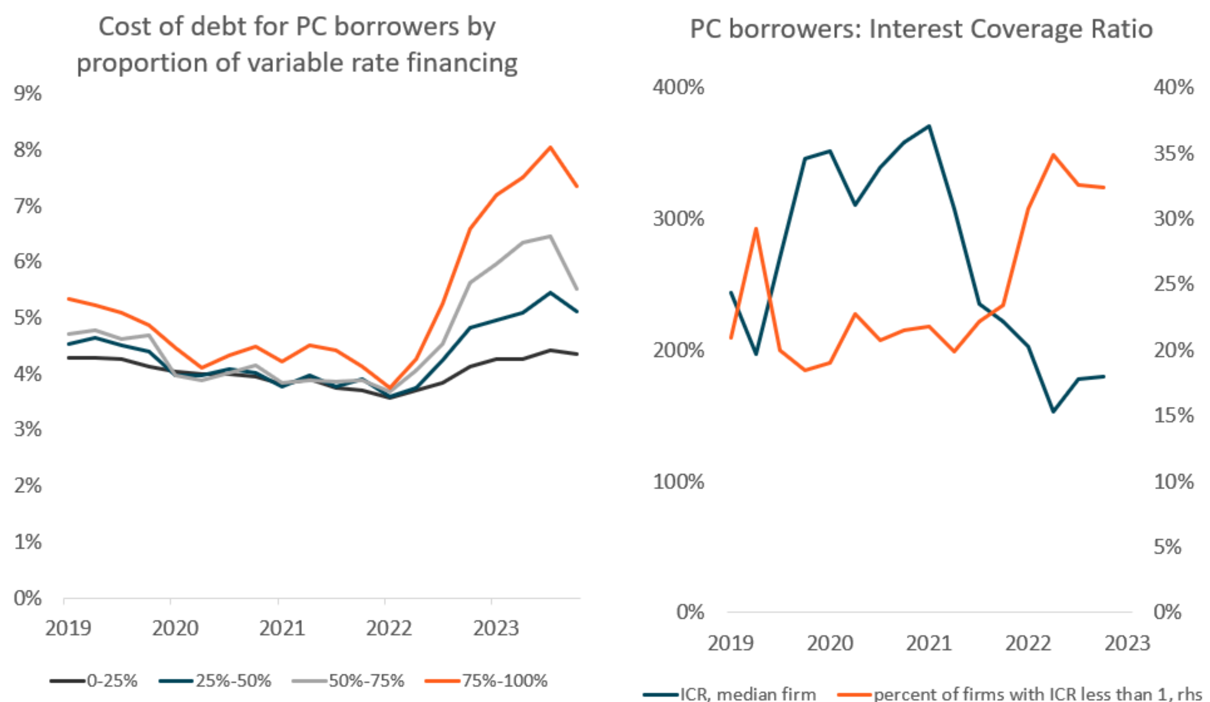
One of the biggest risks facing private credit in the medium term (i.e., throughout the course of the current economic cycle) is potential deterioration in borrower credit quality should business conditions for those firms deteriorate if and when the economy sours. The IMF goes on to say, "such an adverse scenario could see a delayed realization of losses followed by a spike in defaults and large valuation markdowns."

Private credit usually comprises variable-rate financing. As interest rates rise and expectations of Fed rate cuts continue to get pushed back, the underlying assets in private credit funds could come under significant financing stress, especially considering these borrowers' underlying leverage. Consider the charts below. In the left-hand panel, we show the evolution of the cost of debt of borrowers related to the proportion of variable-rate financing these firms have taken on. Since rates began to rise in mid-2022, those firms with the largest proportion of variable-rate financing have seen nearly a doubling in the cost of debt. Even those with lower proportions have seen debt costs rise significantly.

When combined with borrowers' coverage ratio metrics (right-hand panel), the seeds of potential risk become clear. The median firm which borrows from private credit has seen its interest rate coverage ratio (ICR) halve since the pandemic, down from nearly 4 times in 2020-2021 to just under 2 times, while the number of firms with an ICR under 100% has risen from 20% of all private credit borrowers to nearly 35%.

As always, the quality of an investment's underlying assets is the ultimate source of risk to the creditor. So, we think the credit quality of underlying firms is a key risk to private credit. Private credit's growth, both in size as well as numbers and types of investors that hold private credit, could represent a potential problem. On the other hand, the IMF: "Private credit loans are funded largely with long-term capital, mitigating maturity transformation risks. The use of leverage appears modest, as do liquidity and interconnectedness risks."

Private Credit Leverage: Borrowers' Credit Quality Declines



Source: BNY Mellon Markets, International Monetary Fund

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