

Heard on the Street: Bonds to stay volatile... B11

Hedge Funds Are Wild Card In the Turbulent Bond Market

Pullback by pension funds creates void; New York Fed asks about potential risks

By Timothy W. Martin, Gregory Zuckerman and Jason Douglas

Anxiety about the Iran war, inflation and mushrooming public debt have driven the recent selloff in Treasury bonds. There is another factor that could add volatility into the mix: hedge funds, a growing force in this market. Note

For decades, governments could rely on predictable buy-and-hold investors to snap up their sovereign debt. Now, pension funds and other longrun investors are pulling back in search of higher returns elsewhere, leaving a void filled by hedge funds and other faster-twitch traders. Note

Hedge funds held about \$2 trillion of Treasuries at the start of this year, more than double their holdings five years earlier, according to the Treasury Department's Office of Financial Research, which said hedge funds controlled a record 7% of the market. Data released by the Federal Reserve on Friday suggest that funds' Treasury holdings remain elevated, said Molly Brooks, a research strategist at TD Securities. Note

At least some of those holdings are the result of funds pursuing the basis trade, in which they capitalize on small price gaps between Treasury bonds and futures, borrowing money to try to amplify their gains. This trade has plateaued in size over the past couple of quarters but remains sizable, Brooks said. Note

The metamorphosis has the Federal Reserve Bank of New York asking whether these shifts have introduced risks into the Treasury market, where \$1.2 trillion of securities change hands every day. Note

In recent weeks, staffers at

the New York Fed's markets group have been asking investors and others about the growing role of hedge funds in the government-bond market, with the goal of understanding how funds are affecting the market, according to people close to the matter.

There is little margin for error, given the structural forces already pressuring bonds. The yield on the benchmark 10-year Treasury note on Tuesday settled at just under 5%, a danger zone that risks hurting stocks and the wider economy. The yield on the 30-year bond closed at its highest yield since 2004.

Treasury Secretary Scott Bessent's bid to repurchase billions of dollars more of long-term debt has failed to calm the overall market. Higher yields pose a political challenge for the Trump administration, putting upward pressure on borrowing costs across the economy ahead of the midterm elections.

U.S. pension funds once held close to 40% of their assets in fixed income, though more recently that share has fallen to 10% to 15%, according to a recent report from the Centre for Economic Policy Research, a Paris-based group. Pensions in advanced European economies have seen their mix of bonds fall to about 20% from about 35% at the start of the century, the group said.

The driver: Bonds can't cover pension funds' obligations as in the past, pushing them into bigger allocations to private debt, real estate, infrastructure and other areas. This shift coincided with the era of low rates last decade that limited returns from bonds. Note

"The landscape has changed," said David Zee, a fixed-income specialist at Callan, which advises retirement systems. "That marginal dollar that would've gone to government debt may now be looking for other opportunities." He said pension clients are making one-tenth as many requests for active bond managers as they did two years ago.

Three decades ago, pension funds could generate 7.5% returns with a portfolio consisting of more than 80% of U.S. fixed income, according to Callan, which advises retirement systems. Now, to hit the same return, pension funds must accept more than twice as much risk.

"Bonds are no longer enough," said Jack Delany, a portfolio manager at Keyridge Asset Management's multiasset team. "We need to think about diversification more holistically now."

Over the past year, large pension funds in Denmark, the Netherlands and Australia have decreased their Treasury holdings. Earlier this month, Norway's more than \$2 trillion sovereign-wealth fund—the world's largest—proposed cutting its allocation to government bonds, including Treasuries, in favor of mortgage-backed securities and other riskier debt.

Hedge funds have been on the opposite path as pensions, increasing their Treasury bets. For policymakers, their growing role in the bond market is a wild card, especially given the heavy leverage funds often use to amplify bond bets.

The New York Fed staffers, which make regular calls to traders and others as they monitor financial markets, have been specifically asking about "relative value" bond strategies, according to those who have spoken with the Fed. These trades involve simultaneous bets on certain U.S. or other government-debt investments and shorts on others. Representatives of foreign central banks and the International Monetary Fund have been doing their own research on the growth of hedge funds in the Treasury market, the people said.

One area of interest for the New York Fed and others, according to these people: The growth of multimanager firms such as Millennium, Point72 and Citadel, which hire teams of traders to place bets on Treasury and other government bonds, using dollops of leverage to amplify these bets.

Some market participants say the rising role of hedge funds can benefit the government bond market. The funds add liquidity, or make it easier to buy and sell bonds.

Investors said if governments are worried about bond markets, then perhaps they should show more restraint in issuing debt. The U.S. federal budget deficit is projected to reach 6% of gross domestic product this fiscal year.

"The big question for markets is the fiscal stance—it's too loose," said Ranjiv Mann, lead portfolio manager for fixed income at Allianz Global Investors.

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