Hedge fund surge in momentum EGB trading stirs unease

Dealers voice concerns that crowded positions could lead to liquidity squeezes following mass unwinds

By Rebekah Tunstead

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The sharp rise of momentum-based trading in European government bonds (EGBs) by hedge funds is raising fears that a sudden unwind could lead to a liquidity squeeze and heighten market volatility, dealers say.

Hedge fund activity in electronic EGB trading has risen to 56% of volumes in 2023, up from 26% in 2018, according to data from Tradeweb. Changes in interest rates over the past two years, as well as the European Central Bank reducing its stock of bonds as part of its quantitative tightening policy, have opened bond trading opportunities for hedge funds.

But the concentration of investor activity in momentum strategies has drawn concern among dealers who fear hedge funds may rush to unwind their positions in the event of a disruption to the prevailing trend.

"We sit around all day worrying that people will run for the emergency exit at the same time," says a head of hedge fund sales at a large bank.

"So far, we haven't seen it, and so far, if you trade for that dynamic to happen at any given moment, more months than not, you haven't done well because it costs money to go the other way," the head adds.

Members of a bond industry forum convened by the European Central Bank first expressed concerns in June about the move by funds from macro to directional momentum-based strategies. The group warned this could bring about crowded positioning, which if unwound, could amplify market moves and increase volatility.

> **56%**
> **Hedge fund share of electronic EGB trading volumes in 2023**

Charles-Henri Baubigeat, head of European government bonds trading at Natixis Corporate & Investment Banking, says capturing short-term market momentum depends on "building the right tool and getting good access to liquidity", whereas macro trading requires hedge fund portfolio managers to correctly anticipate moves in financial assets. As a result, momentum strategies are "more attractive in the current environment", he adds.

Others suggest the shift in trading strategy may be a consequence of the rise in multi-strategy funds.

"With how many of these multi-strategy hedge funds have spawned, it becomes self-fulfilling, because if you're looking at the same model, then that momentum indicator just becomes stronger as more people join the trade," says a rates trading head at the large bank.

Already, the evolution of hedge funds from macro to momentum-based strategies over the past two years has had a visible impact for dealers.

With hedge funds tuning into the same momentum signals at the same time, market-makers are facing similar requests, in similar duration. "This makes risk recycling harder, and matching different clients on opposing interests has become a rare occurrence," says Baubigeat.

This effect, combined with the shorter holding periods of momentum strategy trades compared to macro trades, could quickly amplify market volatility in the case of a mass exit, particularly in cases where bank balance sheets are constrained. But market pricing doesn't always take these risks into account, dealers say.

"In periods where several hedge funds are trying to get into the same trade and liquidity starts to thin, dealers still try to maintain a level of liquidity that isn't reflective of the state of the market," says Baubigeat.

The increase in hedge fund activity in EGBs is not restricted to momentum-based strategies.

Natixis reports an increase in relative value strategies by hedge funds in the past six months.

The European Central Bank in May noted a rise in hedge funds putting on short basis trades, where users put on long futures positions while borrowing the underlying bonds in the repo market and short-selling them.

The announcement of a snap election in France in June by president Emmanuel Macron prompted a flurry of EGB basis trading, which had a knock-on effect on the US Treasury basis trade "due to the fact that there were resources being reallocated given the volatility pick-up in Europe," says the rates trading head.

However, market participants point to limitations on European basis trading. In the US, the basis trade requires large sizes and leverage to generate profit, whereas in Europe hedge funds are less leveraged and "there is less reward for basis trades", says Baubigeat.

For now, hedge funds have generally supported market liquidity by absorbing the net supply of EGBs – particularly since the European Central Bank launched its quantitative tightening programme in March last year.

But that support is not guaranteed as, unlike primary dealers, hedge funds are not bound by commitments to provide liquidity even during stressed periods.

Editing by Alex Krohn