Hedge funds shake up the euro zone's $10 trillion government bond market

reuters.com/markets/rates-bonds/hedge-funds-shake-up-euro-zones-10-trillion-government-bond-market-2024-03-19

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A view of the European Central Bank (ECB) headquarters in Frankfurt, Germany March 16, 2023. REUTERS/Heiko Becker/File Photo Purchase Licensing Rights , opens new tab

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- Hedge funds dominate eurozone government bond trading, data show
- Account for two thirds of trading in Italy's bonds - data
- Funds favour short-term strategies, debt auctions, sources say
- Hedge funds can pull out at any time posing a stability concern

LONDON, March 19 (Reuters) - Hedge funds are piling into the euro zone's $10 trillion government bond market, scenting opportunities as funding needs surge and the European Central Bank retreats.

The funds are buying a large share of government debt sales, providing a source of much-needed capital, traders and officials say. Yet the lightly-regulated investors often load their bets with bank debt, tying their fortunes to lenders, at a time when there is growing regulatory concern globally about their market impact.

Interviews with more than a dozen sources, including senior traders and treasury officials, as well as market data compiled exclusively for Reuters by electronic platform Tradeweb, show that hedge funds have become increasingly entrenched in the bloc's debt market.

Hedge funds accounted for a record 55% of European government bond trading volume on Tradeweb last year, up from 36% in 2020, displacing other financial firms to become the dominant players for the first time.

And their reach was largest in some of Europe's most indebted nations: hedge funds comprised two-thirds of trading volumes of Italian debt on Tradeweb, the data compiled for Reuters showed.

Tradeweb is one of the top three trading platforms for European government bonds, alongside Bloomberg and MTS, according to Coalition Greenwich, a financial services research company. The data includes euro zone countries and other European markets, including Britain.

Analysts at Barclays estimated in January the euro zone debt market needs to absorb a record 675 billion euros ($735 billion) of additional bonds this year as the ECB winds down its bond holdings. That comes as the pandemic and war in Ukraine have propelled government borrowing. Meanwhile, banks find their balance sheets constrained by rules introduced after the financial crisis of 2008.

Cue the hedge funds, lured by interest rates that have returned to positive territory after almost a decade.

Rapid growth in electronic trading in Europe, particularly since the pandemic broke out in 2020, has also lowered the costs of buying and selling securities, adding to the market's allure. Electronic trading in the region has lagged the United States.
"These markets are very exciting and constructive to trade in," Kenneth Tropin, founder of 30-year-old Graham Capital Management, which manages $18 billion in assets including government bonds, told Reuters. Graham is one of the longer-standing trend-following hedge funds.

Millennium and Citadel - two so-called multi-strategy funds that trade many different assets across a variety of strategies - and Haidar Capital together manage more than $120 billion and are among the most active hedge funds in the euro zone bond market, four of the traders and treasury officials said.

The three funds declined to comment for this story.

While hedge funds contribute to market liquidity, their increased presence strengthens the case for tightening their regulatory oversight, said Andreas Dombret, a former German central bank board member.

Banks typically have formal commitments as so-called 'primary dealers' to buy government bonds and to trade them actively in good times and bad, but hedge funds have no such obligations.

"They're the first to leave the party if things get rough," said Dombret, who now works as an adviser to banks including at consultancy Oliver Wyman.

Compared to the banking sector, the $3.5 trillion hedge fund industry is lightly regulated. It is comprised of private investment vehicles that do not report their profits publicly and do not disclose, sometimes even to their own investors, how they make money.

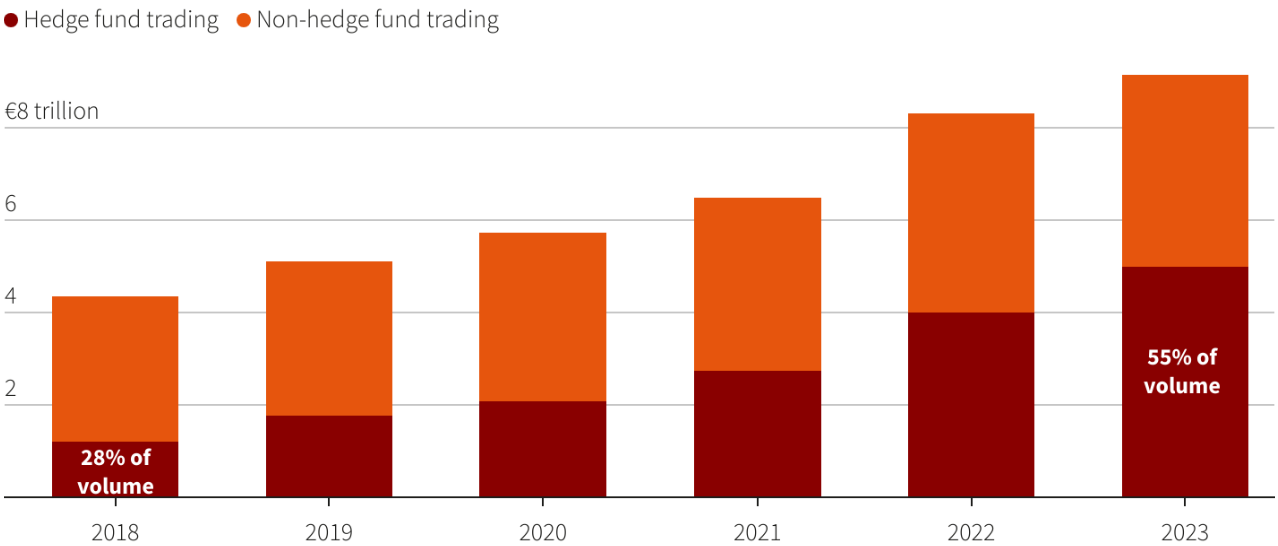
They speculate on asset prices rising as well as falling to make money for their clients, which include pension funds, sovereign wealth funds and rich individuals.

A spokesperson for ESMA, the European Union securities watchdog, declined to comment on growing hedge fund activity in the bloc. ESMA chair Verena Ross told Reuters on the sidelines of a conference that the regulator looks carefully at "particular funds" that build up leverage.

A spokesperson for the ECB told Reuters the central bank supports global efforts to boost regulations addressing investment funds and hedge funds.

Hedge funds a fast-growing force in European bond markets

Hedge funds’ share of electronic trading volumes has doubled in five years



Note: Chart shows notional volume of European government bond trading executed on Tradeweb. The data includes Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, Slovenia, Slovakia, Spain, the European Union, Britain, Denmark, Norway, Sweden, and Switzerland.
Source: Tradeweb | Reuters, March 19, 2024 | By Harry Robertson

Reuters Graphics

RISING VOLATILITY

Hedge funds' footprint is growing as price swings become the new norm, as their flexibility can permit them to take advantage of volatile markets.

Volatility in benchmark German bonds surged to a record in 2022, when the bloc's inflation peaked at over 10%, and remains higher than before the inflation surge. German yields rose 44 basis points in the third quarter of 2023, then fell 80 bps the next, in one of the two biggest quarterly moves since 2011.

The presence of hedge fund trading may also contribute to price swings, two of the traders said.

"On both sides, there were some extreme moves, and that can happen if everyone is trying to chase the same trade and positioned the same way, and therefore have to step out," said Zoeb Sachee, head of euro linear rates trading at Citi, a primary dealer for the bloc's governments.

At the height of the pandemic in March 2020, investors including hedge funds sold bonds while dealers took more on their books, according to research , opens new tab from the Financial Stability Board (FSB), which groups officials, regulators and central bankers from the G20 economies.

The scale of the selloff threatened economic and financial stability, prompting the ECB to stabilise markets with massive stimulus. Now the central bank is stepping back, removing the stabilisers that help limit financial stress.

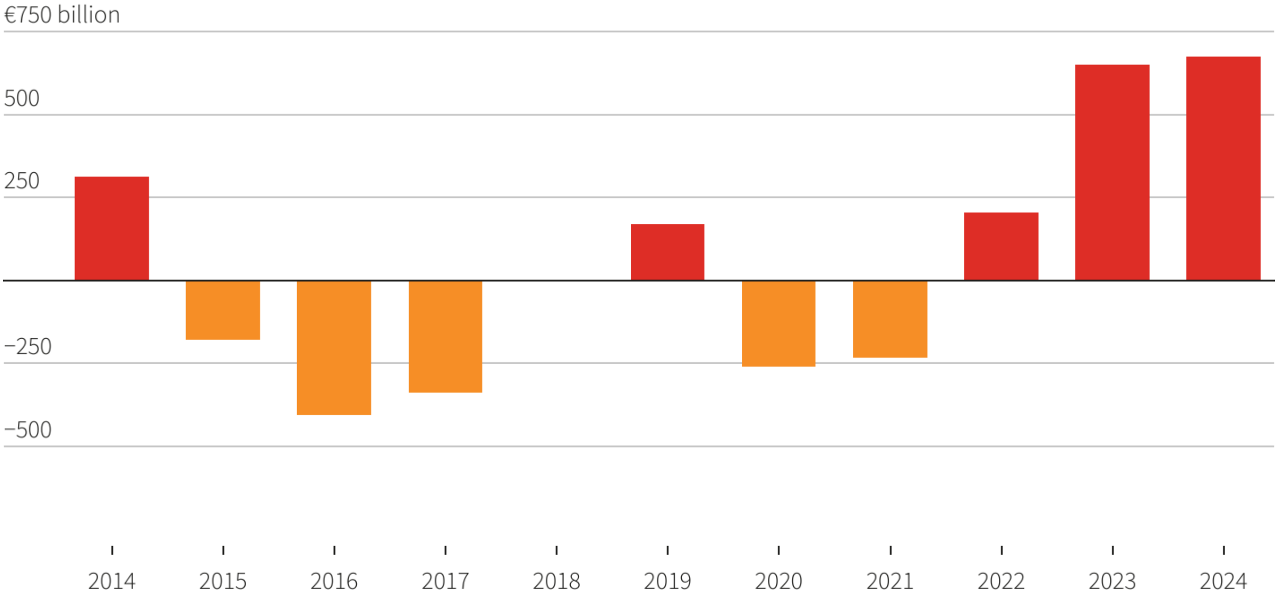
Francesco Papadia, who led market operations at the ECB during the euro zone debt crisis of the early 2010s, said hedge funds are currently playing a constructive role given benign markets but this shouldn't be taken for granted.

"Should prospects worsen, hedge funds could lead the move towards more difficult conditions for both issuers and investors," said Papadia, a senior fellow at Brussels-based think tank Bruegel, adding hedge funds could emerge as 'bond vigilantes'.

That's a term attributed to investors who penalize governments they perceive as fiscally reckless, demanding higher returns for lending.

Markets must absorb record amount of euro zone debt in 2024

High government funding needs and ECB shrinking bond holdings keeps bond supply high



Note: Chart shows gross issuance net of redemptions and central bank bond buying or selling
Source: Barclays | Reuters Breakingviews, Jan. 3, 2024 | By Francesco Guerrera

Reuters Graphics

FILLING A VOID

Bond issuance is the main way governments finance themselves on financial markets. That happens mostly at auctions, where the banks designated as primary dealers buy the bonds, then sell them to other investors.

Maric Post, Belgium's debt management chief, acknowledges the risk of higher volatility if hedge funds unwind big trades or step away from the market.

But for now, he says, he's not worried, adding that hedge fund demand for Belgian bonds has worked "quite well" to smoothen out debt sales, he told Reuters in an interview this month.

Three traders estimated that hedge funds have been buying between 20% to more than 50% of auctions in some instances. Another trader, who requested anonymity, said hedge funds buy around 35% at auctions on average, up from roughly 20% five years ago.

How much hedge funds buy also depends on how much the primary dealer wants to pass onto them. The post-2008 regulations have constrained primary dealers' balance sheets, so they can no longer hold onto large amounts of bonds for long periods of time - for example, weeks after an auction.

Bruno Benchimol, head of euro zone government bond trading at Credit Agricole, said hedge funds' involvement smoothens debt sales by extending the time horizon in which the new bonds must be bought by longer-term investors like pension funds and insurers.

One common strategy used by funds playing price swings tries to take advantage of a regular pattern where bond prices tend to fall ahead of auctions as markets prepare to digest the supply, then typically recover once the sale is complete.

Hedge funds playing that strategy tend to offload the government's bonds before the auction, betting on prices falling, including by going short, three of the traders said.

Once the bonds cheapen, hedge funds buy the new debt at auction, then sell it on over the next few days or weeks, locking in profits.

Hedge funds also set up relative value trades capturing how outstanding bonds - from different maturities or issuers - move against each other around debt sales, or use the auctions to buy bonds for broader relative value or macro strategies, traders said.

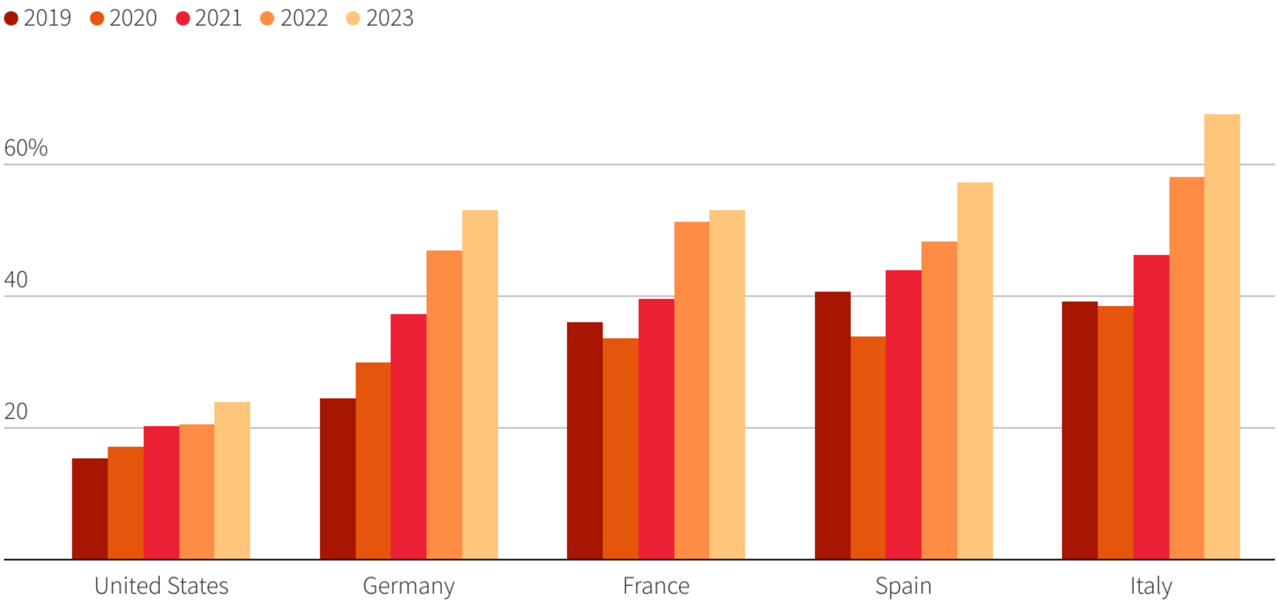
The International Capital Markets Association (ICMA), an industry body representing financial firms, flagged relative value strategies as a significant source of trading , opens new tab in a report this month. The study also warns about the potential risks when hedge funds suddenly pull out of markets.
"There isn't a one or two type strategy that's repeated over and over. There's a large, diverse set of activities that are being deployed," said Kal El-Wahab, head of EMEA linear rates trading at BofA, whose clients include hedge funds.

The variety of their strategies makes hedge funds' impact on bond market pricing harder to assess, especially at a time when demand for the asset class is broadly strong.

The closely-watched risk premium Italy typically pays over Germany , a bellwether of market stress, just hit its lowest in over two years.

Italian bonds are hedge funds' top pick in euro zone

Two thirds of Italian bond trading on Tradeweb comes from hedge funds, interest up sharply across bloc



Notes: Chart shows hedge funds' percentage of total accepted sovereign bond trading volumes on Tradeweb
Source: Tradeweb | Reuters, March 19, 2024 | By Harry Robertson

Reuters Graphics

RECORD TRADING VOLUMES

Helped by hedge fund interest, trading volumes in European government bonds have surged to a record, which is good news for investment banks making money from the boom.

It also helps ease pressure from costly primary dealerships that have become less profitable over the years due to tighter regulations on banks' use of capital.

Banks have been dropping out of dealerships. European governments now have 17 dealers working for them on average, down from 20 in 2015, trade body AFME said. But the expansion of hedge funds has also brought challenges.

Since 2021, hedge funds have poached about one third of banks' euro rates traders, according to two recruiters, who asked not to be identified. Hedge funds are subject to fewer rules, including on compensation.

What's more, hedge funds mostly borrow from Wall Street firms to fund their bets, meaning those banks' exposure is a potential financial stability risk, the Bank of International Settlements (BIS) warned earlier this month in a report , opens new tab. Goldman Sachs, Morgan Stanley, JPMorgan, UBS, Barclays and BNP Paribas are the biggest, according to the BIS.

Ultimately, record bond sales mean governments have few alternatives. Longer-term investors like pension funds would demand higher returns to show up at regular auctions, a trader and a treasury official said, which would push borrowing costs higher.

Those investors "tend to participate more when they have tangible needs at that particular point in time, whereas hedge funds will participate to the extent there's an opportunity," JPMorgan's co-head of euro linear rates trading Julian Baker said.

Reporting by Yoruk Bahceli, Nell Mackenzie, Harry Robertson and Dhara Ranasinghe, additional reporting by Anton Bridge in Tokyo; editing by Elisa Martinuzzi and Daniel Flynn