US Rates Strategy

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Range-bound basis

The Treasury cash futures basis trade has been range-bound since early 2025. We think lower intermediation costs from the expansion in sponsored repo has offset other influences to keep the basis narrow. But margin costs and uncertainty about potential changes in the size and composition of the Fed's balance could push the cash futures basis out of its current range.

- The cash futures basis is influenced by dealer intermediation costs and other factors such as interest rate shocks, Treasury issuance or the size of the Fed's balance sheet.

- **Two- and five-year bases have traded within a 1 tick range since early 2025 despite higher tariffs, war, and a sharp change in Fed rate expectations**. Expected widening has become the "dog that didn't bark".

- **Despite its thinness, hedge funds held about $830bn of cash futures basis trades in September 2025 – about a third of their Treasury long positions**. The basis is their largest position.

- We suspect that the narrowness of the basis is tied to an expansion in sponsored repo. **As cleared volumes have increased, dealers are able to provide their clients with more intermediation capacity at a lower cost**.

- We look for more margin cost pass-through to hedge funds. **But because these costs depend on the access model and other factors, we expect there will be a wider dispersion of intermediation costs in basis trades**.

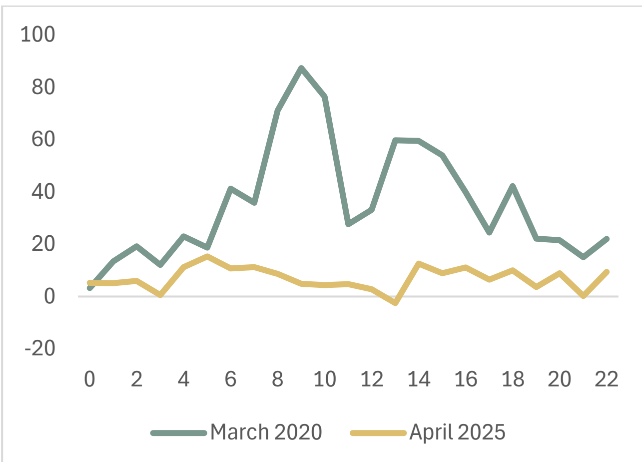
- **Non-intermediation factors which have helped to keep the basis narrow, could become more unpredictable in the next year**. The Fed's balance sheet task force will work through plans to shrink the balance sheet as well as to shift its maturity.

Trade structure

In a cash futures basis trade, the investor is long a Treasury security and simultaneously short a Treasury futures contract. Long basis trades are profitable when the cash inflows from the sale of the futures contract and its delivery option value exceeds the cost of the buying and financing the CTD (cheapest to deliver security). The delivery option value reflects the fact that the investor can choose which Treasury and when to deliver it into the futures contract.

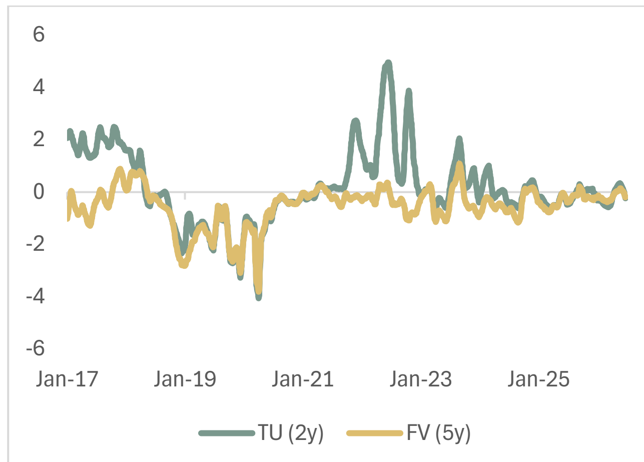
The trade's structure determines how it responds to changes in market conditions. For example, higher funding costs reduce the carry earned on the cash leg of the trade. Funding costs might increase because dealer balance sheets are congested and they have less room to finance their client's basis trades. Similarly, bank regulations that make it harder for dealers to intermediate in financing markets will affect the basis. **Ramaswamy et al argue intermediation capacity matters more than funding costs as investors typically hedge out their financing costs**.[1] Indeed, they estimate that term repo rates would need to increase 40-50bp to move the 5y net cash futures basis by 3bp.

Figure 1: Implied repo spread (bp)



Note: 5y basis. Spread between implied repo and actual term repo rates. X-axis is days after start of month. Source: Ramaswamy et al, SMBC Nikko

Figure 2: Net basis (1/32nd)



Source: Bloomberg, SMBC Nikko

They measure intermediation capacity as the implied repo rate on the trade; that is the cost of term funding adjusted for the embedded delivery option in the futures contract and any idiosyncratic difference between the price of the CTD and the futures contract. Implied repo rates on the FV contract spiked nearly 90bp during COVID as dealers' balance sheets became crowded with off-the-run Treasuries in the "dash for cash" (Figure 1). Despite the sharp sell-off following the April 2025 tariff announcement and over $400bn in off-the-run Treasuries sitting on dealer balance sheets at the time, implied repo rates were little changed. Two-year and 5y cash futures bases were also unchanged.

Too narrow?

In fact, the 2y and 5y basis has been range-bound within a 1-tick range since early 2025 (Figure 2). This has led some to describe the basis trade as the "dog that didn't bark" – that is, the market expected it would widen on several occasions in the past two years but it didn't. The thinness of the spread since early 2025 suggests that shifts in Fed expectations, changes in bank regulations and the shape of the yield curve have been overcome by some other, offsetting, force(s) that has disrupted any expected

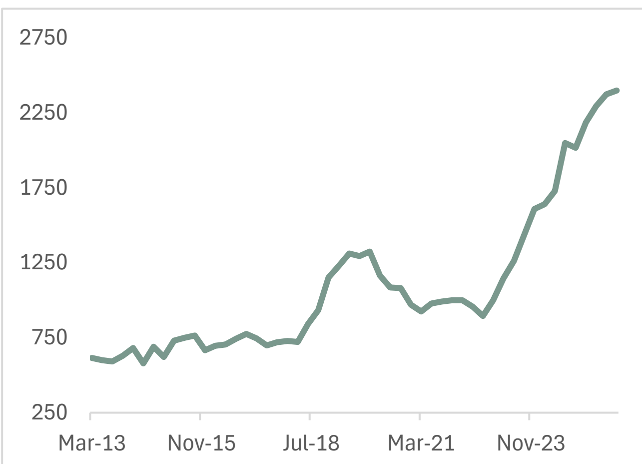
[1] See, "How Sensitive is the Treasury Cash-Futures Basis Trade to Funding Condition Shifts", S. Ramaswamy, H. De Vere, M. McCormick and S. Searls, Federal Reserve Bank of Dallas, July 15, 2025.

widening. This narrowness appears to have reduced the appeal of the trade for hedge funds.[2] Indeed, there may not be enough spread left in the trade to make it worthwhile.[3]

As funding markets shift to mandated central clearing, will an expansion in dealer intermediation capacity keep the basis permanently narrow?

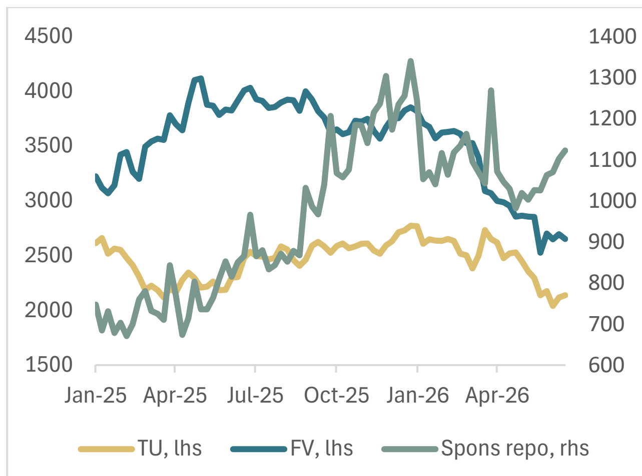
Although the cash futures basis has narrowed, hedge fund appetite is still strong. Using SEC regulatory filings, Monin, breaks out the composition of hedge fund Treasury longs by trading strategy.[4] Hedge fund long positions increased nearly 20% in the past year. Of the roughly $2.4trn in long Treasury exposures (Figure 3) last September, $830bn (35%) was invested in cash futures basis trades. **This was hedge funds' biggest Treasury strategy. It was more than two times larger than relative value trades like trading the spread between on- and off-the-runs or TIPs versus nominals**. Monin estimates that hedge fund demand for cash futures basis has increased four-fold since 2020 and is currently 3.5% of outstanding Treasury supply.

Figure 3: Hedge fund long Treasuries ($bn)



Source: SEC, SMBC Nikko

Figure 4: Hedge fund short futures and repo ($bn)



Source: Bloomberg, SMBC Nikko

That said, our sense is that hedge fund demand may have slackened since last September given the level of spreads and based on alternative data on hedge fund positions and repo funding. Without the Form PF trade level breakdowns used by Monin, we compare hedge funds' short futures positions against the volume of dealer sponsored repo. Hedge funds' futures positions include other activity unlinked to a cash position. As a result, they overstate basis activity. Last September, hedge fund shorts in the 2y and 5y futures exceeded 6m contracts but have since fallen below 5m (Figure 4).

Similarly, because dealers provide sponsored repo funding to other long investors in addition to hedge funds, these data also overstate the size of the basis trade. Sponsored repo volumes rise ahead of

[2] Our focus is on hedge fund interest in this piece. Changes in asset manager appetite for futures and cash Treasury holdings also influences the basis.
[3] See, "Treasury basis trade loses its allure as returns shrink", R. Baird-Remba, Risk.net, June 15, 2026.
[4] See, "Decomposing Hedge Funds' US Treasury Exposures", P. Monin, Federal Reserve Board, June 22, 2026.

reporting dates as dealers push more activity into clearing to net down their balance sheets. Moreover, as dealers gear up for the mandatory clearing mandate next year, we expect more financing trades – in both basis and non-basis transactions – will move into clearing. Last September, dealer provided sponsored repo was $1050bn. Given the imprecision of the futures and repo data we think they may only provide directional information about hedge fund basis trade appetites.

With these *caveats* in mind the decline in sponsored repo volumes and hedge funds short futures positions suggest the basis trade as shrunk since the start of the Iran conflict.

Lower intermediation costs

We think the growth in central clearing may have been a factor behind the narrowing of the cash futures basis since 2025. As sponsored repo has grown, it has become easier for dealers to net down their long and short financing positions. Growth in sponsored repo activity since 2020 has roughly matched the expansion in hedge funds' basis trading reported by Monin. Sponsored repo enables dealers to provide "remote" access to clearing for their clients. In doing so, the dealer can net both sides of a financing trade with different counterparties. As more clients sign up for sponsored access, it becomes easier for dealers to net down their balance sheets and they can provide more financing to hedge funds (and others) more flexibly at lower cost. In figure 5 we plot the implied repo on the 2 and 5y contracts. Excluding a brief bout of repo specialness in late May, implied funding rates have been steady relative to overnight repo since before the start of the Iran conflict.

Margin

But lower balance sheet costs from clearing are only *part* of the basis trade's intermediation cost. **Clearing expenses – particularly margin costs – are another part of the intermediation cost dealers pass along to their basis trading clients.** And these are likely to become more variable as they depend on the clearing access model, availability of cross-product margining, as well as how these expenses are passed along to clients.[5]

DTCC's margin costs are based on a VaR framework that is calibrated to include the severe GFC funding shock. The platform charges and collects margin twice a day, although in periods of financial stress the frequency can increase. VaR margining is sensitive to the maturity of the collateral pledged in repo – longer maturity securities have higher margins. Access to cross-product margining between CME and DTCC is limited to sponsored repo clients on a gross basis where margin is collected on a client-by-client basis without offsets across different clients. **Sponsored access costs tend to be higher than other access frameworks where activity is agented or trades are "done away"**. Separately, centrally clearing trades through a sponsored framework is easier for overnight maturities than term. Clearing term maturities to provide the financing necessary for cash futures basis trading may require more engineering.

Currently, most of the cost to clear is borne by the dealer. But as the clearing mandate deadline approaches, and the availability of non-centrally cleared bilateral repo declines, we expect more of the direct expenses from clearing will shift to basis traders. We expect this to push implied repo rates higher. However, as basis traders can work with dealers to minimize these costs, **we expect some dispersion in basis trade intermediation costs**.

[5] See, "Treasury Market Practices Group Releases Best Practice Recommendations for US Treasury Repo Risk Management", Federal Reserve Bank of New York, May 22, 2025

Spread widening?

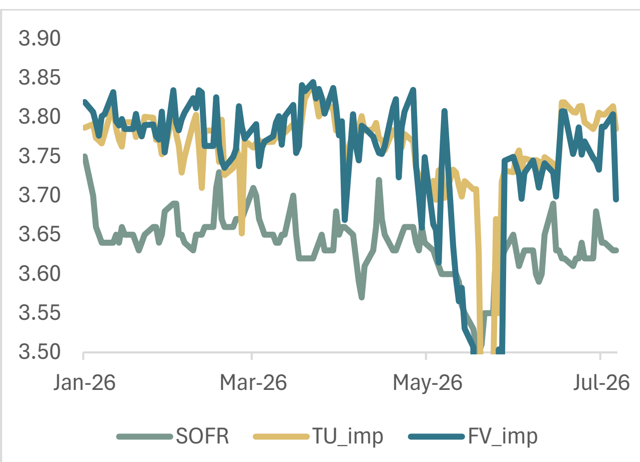
Finally, some of the recent stability in the basis may reflect factors outside intermediation costs such as changes in Treasury supply, the Fed's balance sheet or a tightening in bank regulations. **These non-intermediation factors have been stable or at least predictable since January 2025**. Our sense is that they will remain so through year-end, with cash futures basis remaining tight.

The Treasury has shifted issuance into bills instead of coupons (Figure 6). As the bill/debt ratio increases, however, the Treasury will need to increase coupon auction sizes. But their recent refunding announcements have suggested that the Treasury is still several quarters away from increasing coupon sizes. Given the administration's sensitivity to higher term rates, we expect future increases in coupon auction sizes will be concentrated in the 2-5y sector. But any changes in coupon issuance are unlikely before February 2027.

We think the Fed's balance sheet policy may become less stable and predictable. However, we are unlikely to learn much about its future path until the newly convened task force finishes up its work at year-end. Shrinking the balance sheet may require changing bank liquidity requirements as well as reducing banks' appetite for reserves. The Fed also needs to encourage banks to tap central bank liquidity programs like the discount window and the SRF regularly.

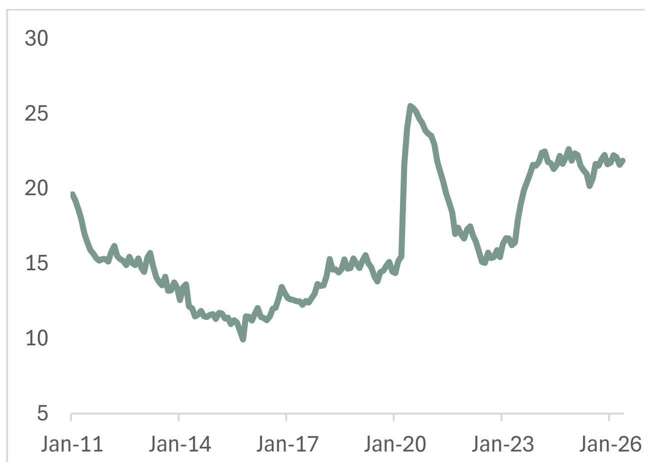
Our general sense is that the Fed may not be able to shrink its $6.8trn balance sheet enough to affect the basis near-term. Pushing the level of reserves below $2.9trn increases funding market pressure and makes the Fed nervous about secondary market liquidity in the Treasury market.

Figure 5: Implied repo TU and FV (%)



Source: Bloomberg, SMBC Nikko

Figure 6: Bill share (% debt outstanding)



Source: US Treasury, SMBC Nikko

That said, other changes in Fed balance sheet policy might influence the basis. The WAM of the Fed's portfolio is about 3y longer than the overall Treasury market. The Fed intends to bring its WAM toward the Treasury level by increasing its bill holdings gradually. It is accomplishing this by reinvesting its maturing MBS into bills. But it could decide to accelerate the process, say, by selling MBS, or by diverting some of its maturing Treasury coupons into bills. We expect the long run composition (and how quickly to get there) will be one of the balance sheet taskforce's assignments. And these decisions could alter the basis after a long period of little volatility.

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