

STRATEGIC INSIGHTS

An Institutional Perspective

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The Basis Trade

The U.S. Treasury (UST) cash futures basis trade is a type of arbitrage that seeks to take advantage of small differences (aka the basis) between the futures and spot price of UST securities. To make serious money from the trade, you need leverage, lots of leverage, and there's the rub. A rapid unwinding of the trade can disrupt markets, including the UST market, the deepest and most liquid in the world. This happened in March 2020, necessitating Fed intervention to restore order to the market. The size of the basis trade has increased rapidly and is now nearly double the level reached prior to the March 2020 dislocation. This edition of our Strategic Insights series analyzes the workings of the Treasury cash-futures basis trade and why it matters.

Basis Trade – Who, What, Why, and How

The profitability of the basis trade derives from the preference of asset managers to establish long UST positions through futures contracts rather than in the spot market. Managers of bond funds use long futures as a cost-effective way to calibrate their duration exposure, especially when they take off-benchmark credit positions with relatively short durations. The long futures bias of asset managers creates a premium on UST futures that asset managers willingly pay to invest in higher yielding securities.

Exhibit 1

Hedge Funds' Shorts Mirror Asset Managers' Longs

Source: CFTC. Net UST futures positions of hedge funds, asset managers, and dealers. Data as of January 13, 2026.



Hedge funds pursuing relative value strategies engage in basis trades to capture the premium created by the long futures bias of asset managers. The cash futures basis trade is a convergence trade that consists of a short UST futures position, a long position in the underlying UST security, and

repo financing for leverage. If the basis is greater than the cost of repo financing, the trade is profitable. There is thus a symbiotic relationship between asset managers and hedge funds. Hedge funds take the opposite side of the asset managers' trade such that hedge fund short positions are a mirror image of asset manager longs (Exhibit 1.) In this way, hedge funds have become an important source of liquidity to the UST market.

Given the small size of the premium that hedge funds seek to capture, they employ leverage of 20-30 times financed through the repo market. The net repo borrowing of hedge funds is a mirror image of their net short UST futures position (Exhibit 2). In this way, the basis trade links three critical financial markets – the cash market for USTs, the futures market for USTs, and the repo market.

Exhibit 2

Repo Borrowing Finances Hedge Fund Basis Trade

Sources: CFTC and Office of Financial Research. Net UST futures position and net repo borrowing of hedge funds. Data as of Q3 2025.



What Could Go Wrong?

Basis trades are premised on the belief that the relationship between two securities that are near substitutes will remain predictable. They are, however, vulnerable to sharp changes in spreads, margin requirements, market volatility, and liquidity. The unraveling of basis trades is typically precipitated by an exogenous shock, that disrupts the stable relationships basis trades are premised on. The Russian debt default and LTCM collapse in 1998 and the March 2020 dysfunction in the UST market are notable examples of market turmoil that were amplified by the unraveling of highly levered basis trades.

The current market environment of rapidly growing fiscal debt and deficits, concerns over the erosion of Fed independence, and high levels of economic policy uncertainty increases the risk of an exogenous shock that could disrupt the premise of stable market relationships at the foundation of basis trades. The potential for broader market disruption from an unraveling of the basis trade is significant given the partial reliance of the UST market on the highly leveraged basis trades of hedge funds as a source of market liquidity. The rapid growth of basis trades since the March 2020 market dislocation thus poses a source of potential market vulnerability. As was the case in March 2020, an unraveling of the basis trade has the potential to trigger a spike in market volatility and in UST yields and require massive Fed intervention to restore calm.

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