



## MEMORANDUM

**TO:** Federal Financial Analytics Clients  
**FROM:** Karen Petrou  
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In a speech last week, Secretary Bessent described Treasury obligations as “not only the bedrock of the global financial system, but also the American dream.” So they are, but they are also a huge source of profit to basis-trading hedge funds happily evading U.S. taxes in the Cayman Islands. Should the Fed grow its already-gargantuan portfolio at still more taxpayer risk and expense just to keep the good times rolling? Are there no better ways to ensure Treasury-market stability without a Fed portfolio so large that, as Secretary Bessent has also [said](#), it makes America ever less equal? There are indeed better ways and the Fed should deploy them, not just comfort the morally hazardous with still another backstop.

An October Federal Reserve [study](#) finds that a longstanding source of FRB systemic-risk worries —basis trading hedge funds — is dramatically under-counted in conventional Treasury-market data sources. Cayman Island-domiciled hedge funds are now, the Fed data show, the largest foreign holders of Treasuries with \$1.85 trillion as of the end of 2024 – a trillion-dollar run-up in just two years. Their holdings now eclipse those of each of China, Japan, and the U.K. who are otherwise the largest foreign holders. Only the Federal Reserve holds more Treasury obligations than all these hedge funds in the tax-free sun.

At the same time, short-term rates continue to show significant signs of stress surely worsened by the fact that leveraged basis-traders borrow repos without posting lending to net out most of the risk. FRB officials at last week’s Treasury-market conference were thus at pains to say not only that the central bank will resume buying Treasuries as the FOMC [promised](#), but do what it takes to ensure that the Fed’s portfolio is funded by bank reserves that are at least “ample,” if not also “abundant.”

Although once upon a time QE was meant to transmit monetary [policy](#), it is now clearly a giant backstop for the Treasury market. But, is the real risk to this vital arena illiquidity at banks that can be reduced by still more trillions in reserves comprised of bank funds taken away from fueling economic growth? Data strongly suggest that basis-trading hedge funds are in fact the root of this evil, posing not only a systemic threat, but also the urgent question of which parts of the global financial system should be bailed out by U.S. taxpayers.

Cayman-domiciled leveraged hedge funds do not exactly rise to the top of this list in terms of the public good. The Fed’s determination to do what it takes to stabilize Treasuries makes highly-leveraged hedge funds a classic case of privatized profits thanks to socialized losses. Is there no way to ensure higher margins at foreign-domiciled hedge funds trading the enormously systemic repo market? This has been discussed since 2008, but never meaningfully attempted. The Fed’s recent hypothetical stress [test](#) showed umbilical cords between banks and these funds – can these be broken or, at the least, priced for risk without resort to safety nets? There are surely better ideas

than these, but they need to be released, revised, and implemented before the Fed throws still more trillions into the pockets of financial rascallions.

Why is the Fed so willing to put taxpayers at risk to support financial profiteers? In the direst of circumstances, it must do so because financial crises have many, many innocent casualties. But, trillions of taxpayer dollars should be a last resort, not the very first the Fed deploys because coming up with anything else takes more work.